Allianz Global Investors

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Capital Markets Monthly

Descending from the rate peak

Let us briefly cast our minds back to 2022, a year that closed out with losses across practically all asset classes. The backstory to this started with a reversal in monetary policy spearheaded by the US central bank, the Federal Reserve (Fed). The subsequent interest rate hiking cycle, emulated by central banks the world over, was virtually unprecedented in terms of its pace and magnitude. Thankfully, even the darkest clouds have a silver lining and it simultaneously brought an end to the phase of extremely low and, in many segments of the market, even negative bond yields. Capital markets more or less returned to a state of normality. Gone were the days of deflation worries, of the pandemic and even of the fallout from the housing market crisis in the US and the eurozone sovereign debt crisis. While the Fed had previously made some attempts to extricate itself from this scenario, COVID thwarted its plans. Ultimately, though, nominal bond and money market yields moved back into positive territory.

Meanwhile, investors need to be on their guard as central banks have already commenced their descent from the rate peak. The next meeting of the **Fed Open Market Committee** right at the start of November should serve as another reminder of this cutting cycle, which is likely to continue well into 2025.

While this is good news for the economy, it poses a challenge for investments as it is becoming increasingly apparent that high nominal yields, especially for short and medium-term durations, cannot be guaranteed.

The descent from the **rate peak** also means that investors seeking higher returns must consider where to find them. In this respect, lessons learnt from leaving rate peaks in the past may provide us with some guidance. Since 1981, the Fed has launched nine distinct rate-cutting cycles, with today's being the tenth. By examining the timeframe from the first to the last interest rate cut and comparing the returns on various asset classes with an alternative investment on the money market (which was driven down), this purely historical analysis shows that, on the whole, bonds performed well across the board and achieved higher returns than a money market investment. Things get a little tricky for equities, which fared more badly overall than the money market.

Dr Hans-Jörg Naumer
Director
Global Capital Markets & Thematic Research

Publications

→ Bond market view: smooth landing in sight?
The US Federal Reserve's policy pivot has ushered in a new investment regime that should help cushion the slowdown in the US economy and provide a near-term floor for risk sentiment.

→ Rewiring technology for sustainable growth
The rate, scale and breadth of technological advancement is the most extensive it has ever been.

→ EMD Monthly Market Musings
Emerging markets' (EM) fixed income performance has proven resilient this year through geopolitical risk, market volatility, elections and changes in the US Federal Reserve's (Fed) narrative.

It is important to bear in mind, though, that not all rate-cutting cycles are the same. While some ended in recession, almost half succeeded in preventing one. If we focus on this type of “recession-averting cycle” in which the primary motivation for monetary policymakers in reducing interest rates was to avoid an economic downturn, a different picture emerges. In this case, bonds performed better than the money market as well – but so did equities. Granted, “past performance is not indicative of future performance” – a consistently right and valid maxim that should be included in every investor document. Even if you should not be guided by the rear-view mirror in managing your investments, the results are not without a certain degree of logic. Should central banks succeed in combatting inflation – which is precisely what current trends appear to show – this would be favourable for bonds. If they can then successfully avert a recession – that is to say, if the economy makes a ‘soft landing’ – this would also create a positive environment for businesses by enabling them to reduce overutilized capacity and invest in expanding their operations, in turn kickstarting the economy.

Stimulating economic growth remains a top priority because the past teaches us that a “crash landing”, in other words a recession, can never be ruled out, even if it an unlikely outcome from today’s perspective.

Stay active when descending from the rate peak,

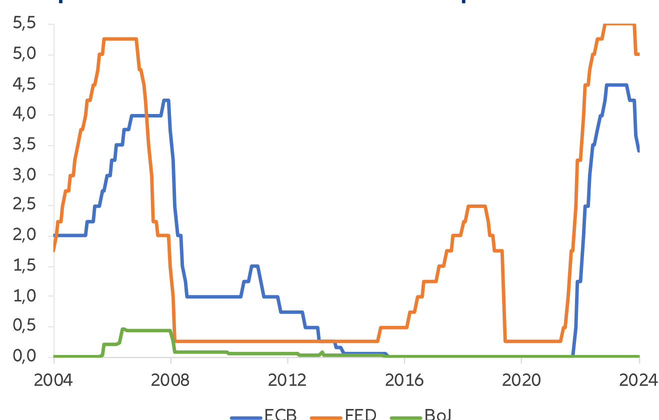
Dr Hans-Jörg Naumer

UPCOMING POLITICAL EVENTS 2024

5 Nov	US	Presidential elections
6–7 Nov	US	Meeting of the US Federal Open Market Committee (FOMC)
7 Nov	GB	BoE announcement and minutes
11–22 Nov		COP29 in Azerbaijan

→ **Overview political events 2024 (click here)**

Key interest rates of the Federal Reserve Bank, European Central Bank and Bank of Japan



Source: LSEG Datastream, AllianzGI Global Capital Markets & Thematic Research, 28.10.2024

Past performance, or any prediction, projection or forecast, is not indicative of future performance.

Market overview as of 25.10.2024

Equity Indices		
DAX		19,464
Euro Stoxx 50		4,971
S&P 500		5,808
Nasdaq		18,519
Nikkei 225		38,606
Interest Rates %		
USA	3 Months	4.85
	2 Years	4.10
	10 Years	4.20
Euroland	3 Months	3.07
	2 Years	2.10
	10 Years	2.26
Japan	3 Months	0.45
	2 Years	0.42
	10 Years	0.92
FX		
USD/EUR		1.083
Raw Materials		
Oil (Brent, USD/Barrel)		75.9

Tactical allocation for equities and bonds:

- While a 'soft landing' is on final approach and a spattering of economic data recently indicated that we can expect a bumpy touchdown, growth and monetary policy remain on the agenda.
- Beyond the United States, investors are presented with quite difference economic backdrops. Downside risks predominate in the **euro area**, whereas hopes are pinned on better prospects ahead in **China**. In **Japan**, the economy would seem to be sufficiently resilient, with the yen's performance currently driving market activity.
- The **Fed**, with its policy of following the data, is probing its way back into the cycle and has its work cut out accordingly. The latest labour market, inflation and macroeconomic data do not necessarily suggest a rate cut is warranted at its next meeting at the beginning of November. Judging by statements made by Fed officials, though, this would appear likely. The situation should be more complicated in December, as money markets are pricing in a low probability for a rate cut in the final month of the year.
- Just as the month gets underway, markets will also have to contend with **elections in the United States**. At the time of writing, the latest opinion polls suggest it is unclear who has the best chance of winning the highest office in the land and the same goes for which parties are likely to obtain majorities in both houses of Congress.
- In addition, there is no excluding the possibility that the ballot counting process will drag on, i.e. that the result of the election will remain uncertain for an extended period after polls close.
- The outcome of the election is not without significance, particularly from an economic policy standpoint. Trade (tariffs), foreign policy, regulation and climate policy are among the key areas in which the president has the power to effect change without any major congressional action. Congress has control over the federal budget, meaning that a president must have majorities in both the House of Representatives and the Senate for most policies that impact federal taxes and spending. In this respect, both candidates appear to have an appetite for expansionary fiscal policies, which should have a stimulating effect on the economy, at least in the short term. That said, Kamala Harris leans more towards higher taxes to finance additional spending than her rival Donald Trump.
- On balance, conditions for both bonds and equities are likely to remain favourable, with expectations suggesting a focus on equities in advanced economies, investment grade corporate bonds and sovereign bonds in particular.
- Investors can expect an increasingly volatile combination of economic indicators/"final approach", elections in the United States and geopolitics. Among the latter factors to be considered are developments in the Middle East and Ukraine that may lead to a further rise in energy prices.
- **Bond markets** are pricing in a "soft landing" scenario. Consequently, a steepening of the entire yield curve is to be expected that will largely be determined by the monetary policies of the leading central banks.
- Risk premiums for credit defaults on corporate bonds are very low. This segment of the market is indicative of an optimistic economic scenario that leaves little room for negative surprises. With this in mind, investors would be wise to focus on bonds with higher credit ratings.

Investment theme:
Take the plunge or wait and see?

- Despite prevailing negative real returns, the iron rule holds true: if you are seeking higher returns, you must be prepared to accept a greater level of risk in the shape of more price volatility. That places the spotlight on equity markets.
- Past experience shows that this strategy has paid off throughout all peaks and troughs. But there have also been some rather unpleasant phases in between.
- This begs the question: should I take the plunge into the stock market or rather wait and see what happens? Currently, there is an elevated level of uncertainty with the invasion of Ukraine, in particular, leading to a host of unpredictable factors. Further, we should also not lose sight of the prospect of rising inflation and of central banks that, in the big picture, may once again tighten monetary policy.
- So, the question remains: Take the plunge or wait and see? A difficult decision to make from the perspective of behavioural finance, as investors' typical aversion to risk may mean they wait too long. In other words, their fear of loss is simply too great and may also result in missing out on returns.
- A historical analysis underlines this phenomenon: If an investor had, for example, invested in the global equity market over the previous 25 years, represented in this case by MSCI World, but had missed the best 20 days on the stock market, they would have achieved an average annual return of 2.7%. If they had even missed the best 40 days, they would have suffered a loss of 0.6% per year. However, if they had remained invested the entire time, they would have enjoyed a return of just under 8% per annum.
- It goes without saying that this is purely based on past performance, which is very unlikely to be replicated one for one. However, it is helpful to look back at history as it illustrates the cost of a "wait-and-see" approach.
- One advisable tactic is to invest gradually in the market. You determine how much you want to invest, but instead of investing it all at once, you divide it up into equal amounts and invest it over a specific period of time, for instance over half a year.
- From a behavioural psychology perspective, an investor's commitment to a strategy is linked to the euro cost averaging effect that is a characteristic of savings plans.

Calendar Week 45

Monday			Consensus	Previous
GE	HCOB Mfg PMI	Oct	--	42.6
EC	HCOB Mfg Final PMI	Oct	--	45.9
EC	Sentix Index	Nov	--	-13.8
Tuesday				
JN	Monetary Base YY	Oct	--	0.10%
CN	Caixin Services PMI	Oct	--	50.3
GE	HCOB Services PMI	Oct	--	51.4
GE	HCOB Composite Final PMI	Oct	--	48.4
UK	S&P GLOBAL SERVICE PMI	Oct	--	51.8
UK	S&P GLOBAL PMI: COMPOSITE - OUTPUT	Oct	--	51.7
UK	Reserve Assets Total	Oct	--	194,097.58M
US	International Trade $	Sep	-71.8B	-70.4B
US	ISM N-Mfg PMI	Oct	--	54.9
Wednesday				
JN	Reuters Tankan N-Man Idx	Nov	--	20
JN	JibunBK Comp Op Final SA	Oct	--	49.4
JN	JibunBK SVC PMI Final SA	Oct	--	49.3
GE	Manufacturing O/P Cur Price SA	Sep	--	-2.9%
GE	Consumer Goods SA	Sep	--	98.1
EC	HCOB Services Final PMI	Oct	--	51.2
EC	HCOB - Composite Final PMI	Oct	--	49.7
UK	S&P GLOBAL PMI: MSC COMPOSITE - OUTPUT	Oct	--	53.0
UK	S&P Global CONSTRUCTON PMI	Oct	--	57.2
EC	Producer Prices YY	Sep	--	-2.3%
US	S&P Global Comp Final PMI	Oct	--	54.3
US	S&P Global Svcs PMI Final	Oct	--	55.3
Thursday				
CN	Exports YY	Oct	--	2.4%
CN	Imports YY	Oct	--	0.3%
CN	Trade Balance USD	Oct	--	81.71B
GE	Industrial Production YY SA	Sep	--	-2.51%
GE	Trade Balance, EUR, SA	Sep	--	22.5B
UK	Halifax House Prices YY	Oct	--	4.70%
EC	HCOB Construction PMI	Oct	--	42.1
GE	HCOB Construction PMI	Oct	--	41.7
EC	Retail Sales YY	Sep	--	0.8%
UK	BOE Bank Rate	Nov	--	5.00%
US	Unit Labor Costs Prelim	Q3	--	0.4%
US	Productivity Prelim	Q3	--	2.5%
US	Fed Funds Tgt Rate	7 Nov	--	4.75-5
US	Fed Int On Excess Reserves	7 Nov	--	4.90%
US	Consumer Credit	Sep	--	8.93B
US	Initial Jobless Clm	28 Oct, w/e	--	--
US	Cont Jobless Clm	21 Oct, w/e	--	--
Friday				
JN	All Household Spending YY	Sep	--	-1.9%
US	U Mich Sentiment Prelim	Nov	--	70.5
CN	M2 Money Supply YY	Oct	--	6.8%

The calendar data for the current week comes directly from Bloomberg. They are published in the week in which “The Week Ahead” appears. These are economic data that come from official sources. Where available, the previous figure is collected together with the consensus estimate. The consensus estimate is collected by Bloomberg through a survey of analysts and economists. It is the average of all estimates submitted.

If not mentioned otherwise data and information sources are from LSEG Datastream.

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