CULROSS GLOBAL

Macro Outlook Summary

April 2024

In April markets have yet again been wrestling with the outlook for inflation, growth and rates. US growth and the strong employment market has continued to surprise everyone. This underpinning by the US consumer has kept pressure on inflation especially in the services sector. As a consequence, the much-anticipated return of inflation to target had just not happened in the timescale previously expected. Central banker optimism about rate cuts in June is drying up and government bond investors have now shifted to a new and decidedly pessimistic consensus that rates will likely stay higher for far longer while the 'soft landing' narrative had been replaced by 'no landing at all'.

In April, 10Yr government bond yields have pushed meaningfully higher with the US 10Yr rising from 4.2% to 4.6%, Germany from 2.3% to 2.5% and the UK from 4% to 4.3%. These yields are about 20bps short of levels reached in October last year which were 'peak' yields, so one could say the bond bull market of the last two months of 2023 has been nearly fully reversed and is set to play out a second time, at some point.

Two growing divergences have emerged. The first is that at this rate the US will be forced to hold rates higher for much longer than Europe. An EU rate cut on 1st June remains likely in our view, but diminishingly likely for the US. We think the UK should hold off cutting in June because of ongoing service sector inflation which has not shown any weakness, but the BoE may choose otherwise. The real point however is that after one or two 25bps cuts from G3 central banks it is very hard to see justification for anything further unless growth and particularly inflation data trends change meaningfully.

This leaves equities looking increasingly out of touch with reality, especially in the US where government bond yields have reversed back to Oct'23 highs. Meaningful central bank rate cut expectations have completely faded yet equities remain 16%+ higher. If US equity markets decide to correct, they will bring the rest of the world down with them, excepting China which seems resolutely to dance to its own tune.

Government bonds on the other hand look like a great place to be. Not just for a trade but to buy and hold, locking in rates that appeal to investors weary of zero returns and equity market volatility. The yields on offer should generate attractive income for many years to come. Corporate credit markets pay more than government bonds but better still, if the agenda is buy and hold, then opportunities in private credit where double digit returns can be accessed for reasonable credit risk look best.

Offerings in private credit lending to highly creditworthy businesses, often family owned, via senior secured instruments have multiplied over the past ten years. The catalyst for change has been the reduced capacity amongst large commercial banks to lend generally and specifically to medium and small sized corporates due to post GFC balance sheet restrictions.

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Their balance sheets have not been allowed to grow and the risk weighting applied by regulations is high. As a result, independent teams have been assembled in all corners of the world to step in where banks once used to play but with better technology, better lender screening, scoring and smarter covenant terms. We believe this is a secular change in the structure of credit markets taking these segments away from being part of the private domain of banks and giving access to investors where previously there was none. We would not be surprised if 2024 goes down in history as a great year for bond and credit investors.

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