Soft Landing?: **Investors have enjoyed a strong bounce off of Junes lows. Strategist Peter Lucas considers the prospect of a soft landing and where markets may go from here.**

My last article (*The Fed Pivot*, June 2022) said that the equity recovery had further to run in the short-term but would soon peter out in the expectation that that the Fed would keep tightening until there were more tangible signs that the war on inflation was being won. Oil would need to be at least down in the $80-90 range before interest rates could plateau, let alone fall. And the longer that the Fed stayed the course, the higher the risk of recession. In other words, equities were anticipating an imminent top in inflation, short-lived or otherwise, but had yet to price in the risk of lower corporate earnings. Eventually, rising unemployment would cause the Fed to pivot from fighting inflation to protecting jobs, but until we got there, bonds would be the safer of the two main asset classes.

In the weeks that have followed, both bonds and equities have performed well, with both comforted by signs of easing inflationary pressures. For instance, the oil price has fallen to the top end of my target range and the US ISM manufacturing prices paid survey has just experienced its fourth biggest monthly drop since the 1970s. However, these encouraging signs have been accompanied by some worrying growth indicators: the US economy has posted its second quarter of negative real growth, the University of Michigan Consumer Sentiment Index remains close to a record low and the ISM new orders-to-inventories ratio has dropped to a level that has historically been associated with recessions. And to cap it all, the US yield curve is now pretty much fully inverted beyond 1-year.

The recent rise in stock markets suggests that investors are betting on a soft landing – whereby inflation is tamed without the economy being pushed into recession – but the stubbornly high inflation rate and wilting economic indicators suggest that is a tough ask, particularly given that Fed officials are going out of their way to tell us that several more rate hikes are needed to get the job done. With all this going on, equity markets have more downside than upside at present.

If the US economy does slip into recession, then US Treasuries would be one of the main beneficiaries but ironically, bonds have lagged equities in the most recent phase in which Fed officials have been downplaying market expectations of a peak in interest rates. Sure, rising interest rates have a direct impact on bond yields, particularly at the short end of the curve, but by all rights the Fed's determination to stay the course should have unnerved the equity market more than bonds.

An inverted yield curve has been a reliable predictor of recessions with a lead time of around 12-18 months. However, the stock market also moves ahead of the real economy and hence the lead time between inversions and equity tops is that much shorter. Indeed, the last time that the yield curve (2/10s) was this inverted, the peak in equities followed within a week or two (March 2000).

In summary, equity have experienced a short-term, growth-led recovery, as predicted in earlier articles, but it is now time to batten down the hatches once more. My bet is that the Fed will pivot towards easing monetary policy in the months ahead. Furthermore, they will do so before the inflation dragon has been slain, resulting in (a) a dramatic reversal in the equity and commodity markets (particularly the latter) and (b) later down the track, a resumption of the longer-term bond bear market. But it is still too soon to be positioning for that. And as for Europe, all I will say is that the situation there makes America look like a bed of roses.

Peter Lucas

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