Macro Insights Weekly

Pitfalls of an everything rally

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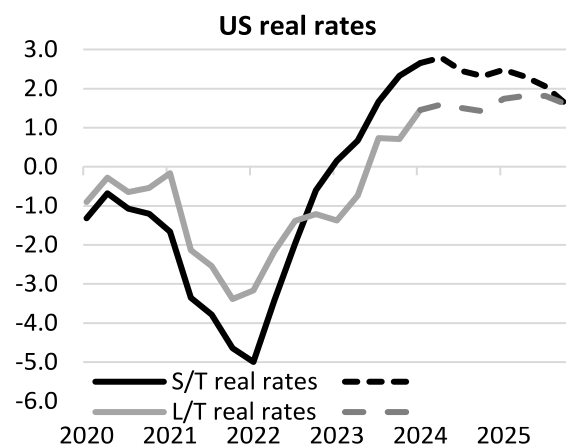
- *With 10%+ year-to-date gains across a wide range of asset classes, 2024 has turned out to be much better-than-expected for investors. What are the drivers and how sustainable is this?*
- *Rally in precious metals show heightened geopolitical concerns.*
- *Industrial metals rally reflects green energy infrastructure buildup.*
- *Stocks are underpinned by strong earnings expectations and AI exuberance.*
- *Credit spread compressions are driven by attractive absolute yields and soft-landing bets.*
- *But dizzying valuations have pitfalls. The higher they go, the harder they may fall.*

Chart of the Week: Peak in US real rates?

Even with the higher-for-longer narrative setting in, US rates appear to have peaked. Dataflow has softened; with 2Q GDP Nowcast easing to below 2% and core PCE below 3%, the 10-yr bond yield has rallied by 25bps over the past month. We think the path ahead for nominal and real rates may not be smooth given the mixed nature of the dataflow, especially with regards to jobs, but the overall direction of rates is either sideways or lower. Not much juice left in the inflation trade, in our view.



Source: CEIC, DBS. Short-term real rates calculated by taking the difference between end-quarter Fed funds rate and the average core PCE inflation for that quarter. L/T uses end-Q 10-yr bond yield.

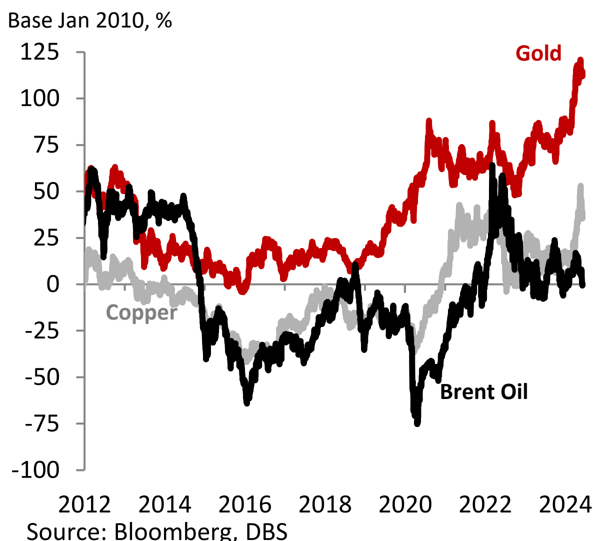
Refer to important disclosures at the end of this report.

Commentary: Pitfalls of an everything rally

With 10%+ year-to-date gains across a wide range of asset classes, 2024 has turned out to be much better-than-expected for investors. Despite the burden of high interest rates, simmering geopolitical risks, and record high valuation, volatility has come down and the breadth of the rally has widened. What are the drivers and how sustainable is this?

First, some stocktaking, starting with commodities. Gold and copper, bellwether for precious and industrial metals, respectively, have soared this year, while energy markets have been subdued. For gold, the high yield on US treasuries is typically a bearish signal, but heightened geopolitical uncertainty, especially the weaponization of the greenback by the US authorities in recent years, has kept gold and silver investors interested. Agriculture prices have rallied here and there, including of cocoa, coffee, and rubber, but key food prices like rice, corn, wheat, and soybean have been well behaved. Copper's rally is a bit puzzling, given high inventory and subdued demand, but it is likely reflecting expectations of a sizeable global rollout of green energy infrastructure.

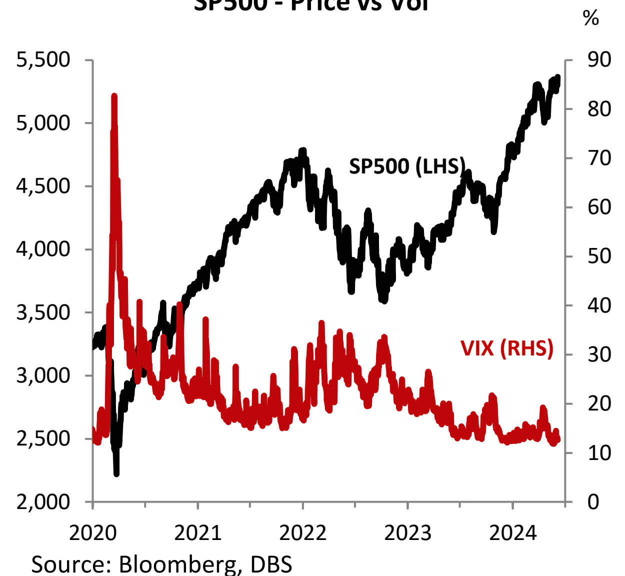
Brent Oil vs Copper vs Gold



Source: Bloomberg, DBS

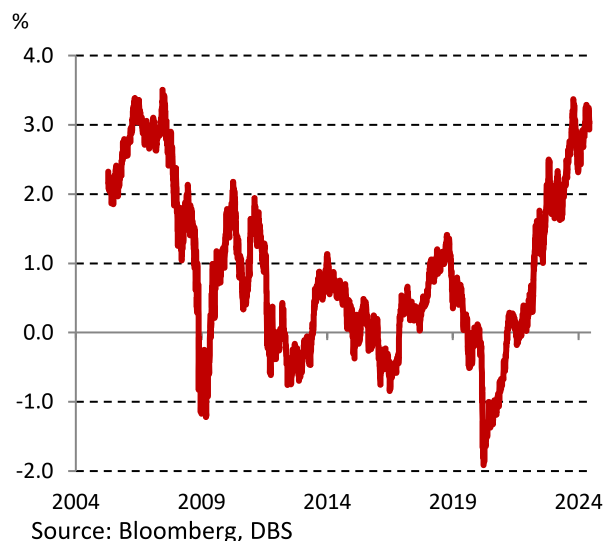
Some commodity prices may have rallied in a puzzling manner, but that phenomenon is nothing compared to the utter comfort with the bullish dynamic in equity markets. US stock markets are at an all-time high, while VIX volatility is at its lowest in the cycle. Some of the exuberance is clearly in the tech sector, related to AI, but there has also been substantial run-ups in a wider array of sectors, including pharmaceuticals, financials, consumer durables, and communications. This rally is particularly notable given the historically high yield-gap between AAA debt and equities.

SP500 - Price vs Vol



Source: Bloomberg, DBS

10Y UST yield - SP500 Dividend yield

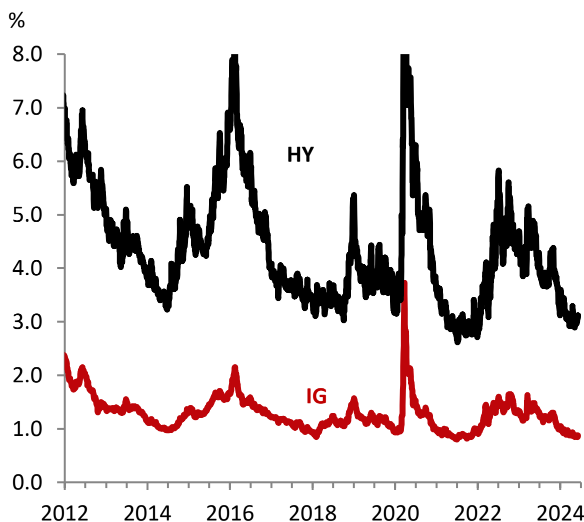


Source: Bloomberg, DBS

The equity rally has not just been US-centric. Several Asian stock markets have returned handsomely in USD terms so far this year, including Malaysia, Hong Kong, India, Japan, and Vietnam. Pressure from USD rates or USD itself have not held back these markets.

Credit has shown strength, as US credit spreads, both high yield and investment grade, have narrowed to historic lows despite sustained monetary easing. Just like the stock market, credit has rallied beyond the US market as well. A key reason for strong credit performance has been the fact that despite narrow spreads, corporate debt is yielding high in absolute terms. Additionally, market liquidity is ample, assuaging investor concerns about a liquidity squeeze. It is worthwhile to note that despite two years of quantitative tightening, G4 central bank balance sheet size, as a share of GDP, is still higher than the pre-pandemic level.

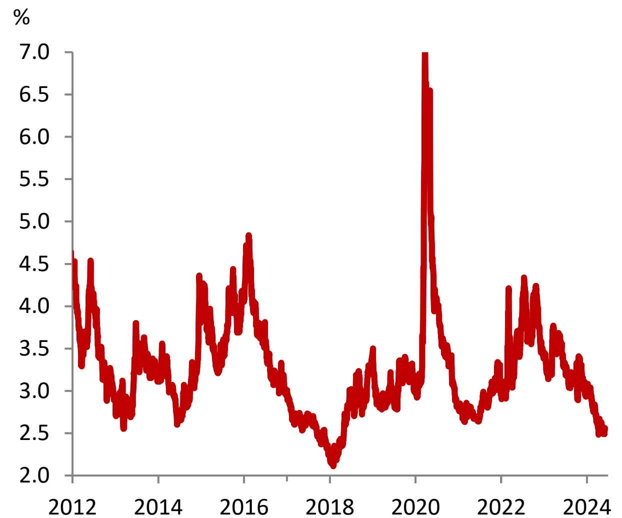
Credit Spreads - US Corporate



Source: Bloomberg, DBS

Credit is not uniformly strong. US commercial real estate market, and Hong Kong and South Korea's property sectors remain vulnerable to high rates. China's property markets have sizeable stress as well, but they are receiving steady support from PBOC's policy easing.

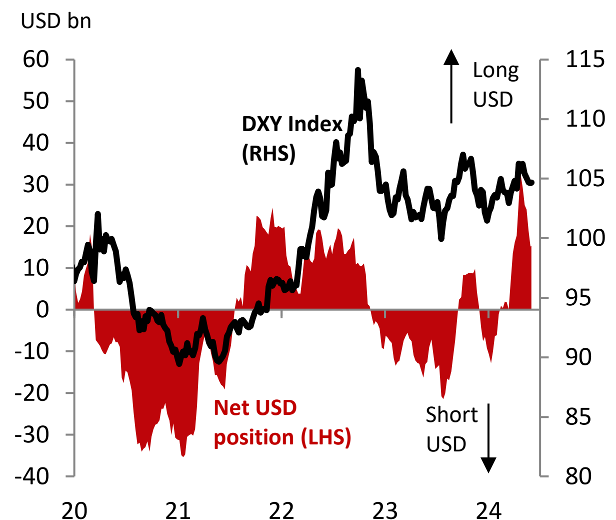
Credit Spreads - Emerging Markets USD



Source: Bloomberg, DBS

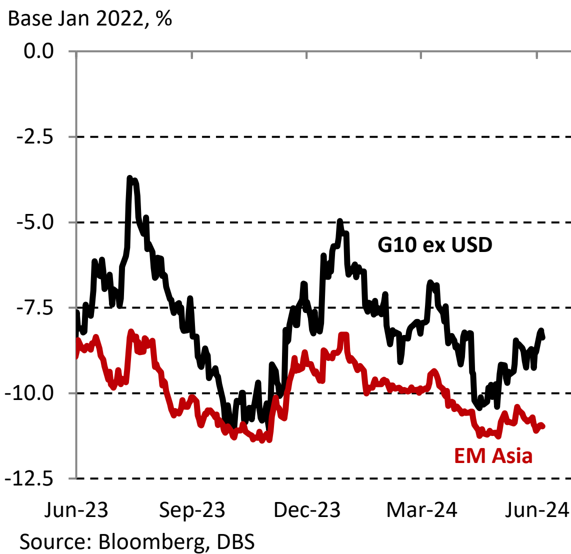
The higher-for-longer narrative has manifested in a strong USD this year, forcing investors to reverse their positioning, as they had come into 2024 largely short the greenback. All major currencies have lost their value against the USD, with the Japanese yen the most extreme, down by 10%+ ytd, building on another double digit decline the previous year. What we find remarkable is that the strong USD, coupled with high US interest rates, have not caused any financial stability issues worldwide.

Speculative positioning on USD



Source: Bloomberg, DBS

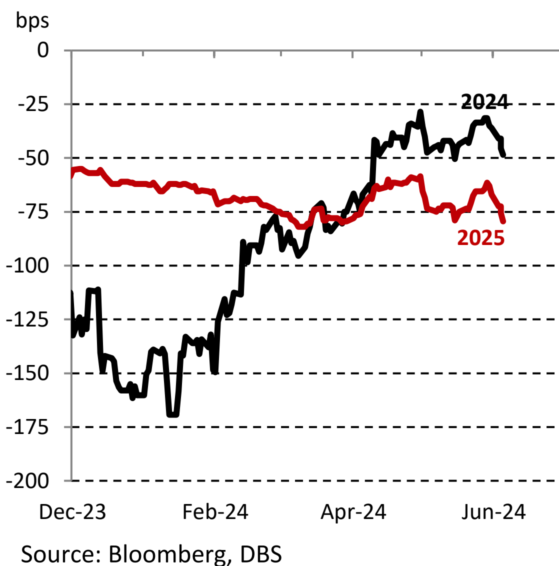
Currency Returns - EM Asia vs DM



Source: Bloomberg, DBS

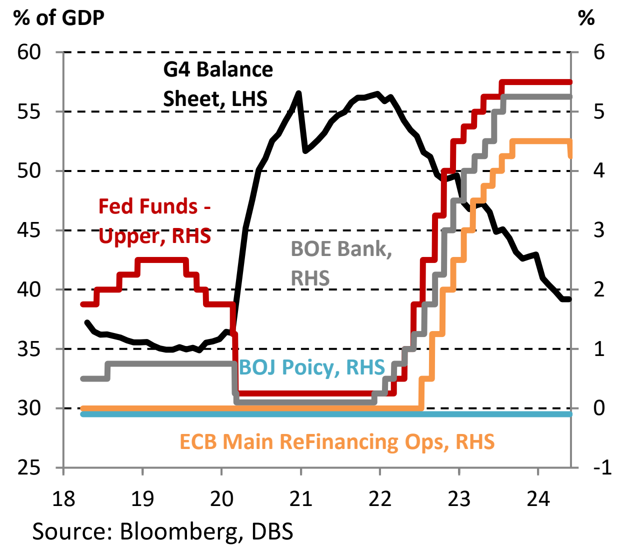
All this boils down to Fed pricing. The markets may have been wrong on the Fed cutting rates expeditiously this year, but the thought process behind the Fed narrative has evolved. We came into 2024 expecting economic slowdown and resultant softening of price pressures. Inflation has proved to be stickier than expected, but not in an alarming manner. Meanwhile, the growth dynamic has been largely constructive. Expectations around earnings and wages have therefore remained sound, underpinning the everything rally, in our view.

Pricing for Fed Hikes(+)/Cuts(-)



Source: Bloomberg, DBS

G4 Balance Sheet vs Policy Rates



Source: Bloomberg, DBS

But so much strength in the financial markets, such lack of volatility, and such little stress, so far, from high rates make us a tad anxious. How much longer before profit taking makes sense; at what point does quantitative tightening becomes material; and when does the financial system step into a landmine of leverage larking beneath the surface? We worry about the collateral damage from a sizeable market correction, especially as higher the market climbs, the bigger the eventual adjustment becomes. While recognising the global economy's pleasantly stronger-than-expected shock absorption capacity and genuine underpinning for the markets from the new tech wave, we will keep our fingers crossed for a soft landing ahead. Markets reaching dizzying heights at this point in the cycle have typically been a harbinger for corrections ahead.

Taimur Baig

FX: FOMC and BOJ meet this week

Last Friday's 0.8% rebound in the DXY Index to 104.89 from the higher-than-expected US nonfarm payrolls **may be unsustainable**. The **US Federal Reserve will likely be more concerned about the US unemployment rate rising to 4%** in May, which was the highest since January 2022 and at the level it projected for 4Q24. Additionally, the Fed will be less confident about the US economy achieving 2.1% growth in 4Q24. Real GDP growth slowed significantly to an annualized 1.3% QoQ in 1Q24 after cooling to 3.4% in 4Q23 from 4.9% in 3Q23.

Despite the sticky US inflation this year, the US central bank will keep the Fed Funds Rate unchanged at 5.25-5.50% for the seventh FOMC meeting on June 11-12. The **Fed will likely reduce the three interest rate cuts projected for this year**, but Fed Chair Jerome **Powell will set a high hurdle for a hike**.

Powell will likely consider monetary policy sufficiently restrictive to lower inflation in 2H24, especially in month-on-month terms. Hence, the US **CPI data on June 12 will be important**. We see headline inflation slowing a second month to 0.1% MoM in May from 0.3% in April. Although the Fed's favourite gauge, the core PCE inflation, held around 2.8% YoY in February-April, it did not deviate far from its 2.6% projection for 4Q24.

Powell will likely warn that the US federal debt was on an unsustainable path. Over the weekend, the International Monetary Fund (IMF) urged the US to start consolidating its fiscal position. In March, the US Congressional Budget Office (CBO) warned that the federal debt held by the public would keep increasing to 116% of GDP in 2034 after rising to 99% of GDP in 2024 from 97% in 2023. America's fiscal finances have potential to become an issue at the US Presidential election less than five months away, one that could revive talks of de-dollarisation. Hence, pay attention to the discussion between New Fed President John Williams and Treasury Secretary Janet Yellen at the Plaza Hotel on June 13.

The Bank of Japan meeting will discuss scaling back its JGB purchases at its June 14 meeting. Despite easing by 9.4 bps to 0.976%, the 10Y JGB yield remained well above the 0.61% level at the end of 2023. The BOJ will likely **warn about a second rate hike this year due to persistent JPY weakness**, which is raising import costs and inflation expectations amid sustained wage gains. The OIS market reckoned that the BOJ could lift rates in July or October. Assuming no hawkish surprises at the FOMC meeting, **USD/JPY's rebound from the 154.50** low on June 4 **could stall at the 157.70** high seen on May 29.

USD/CHF should resume its decline if the Fed does not sound hawkish at its FOMC meeting. We do not see the Swiss National Bank delivering a back-to-back rate cut at its meeting on June 20. SNB President Thomas Jordan attributed the recent rebound in inflation to the CHF's weakness. He also noted that R star had probably increased from the estimated 0%. Switzerland's harmonized CPI inflation rose a second month from 1.4% YoY in April to 1.5% in May, the same level as the policy rate.

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