February 7, 2023

Running Hot

- **Last week's US economic data was much stronger than expected**
- **Bond market will likely worry that the labour market is very tight**
- **US unemployment rate the lowest since 1969**
- **Fed will not be deflected from raising rates**
- **We expect further profit taking in bond and equity markets**
- **Adani a good business with the wrong share price**

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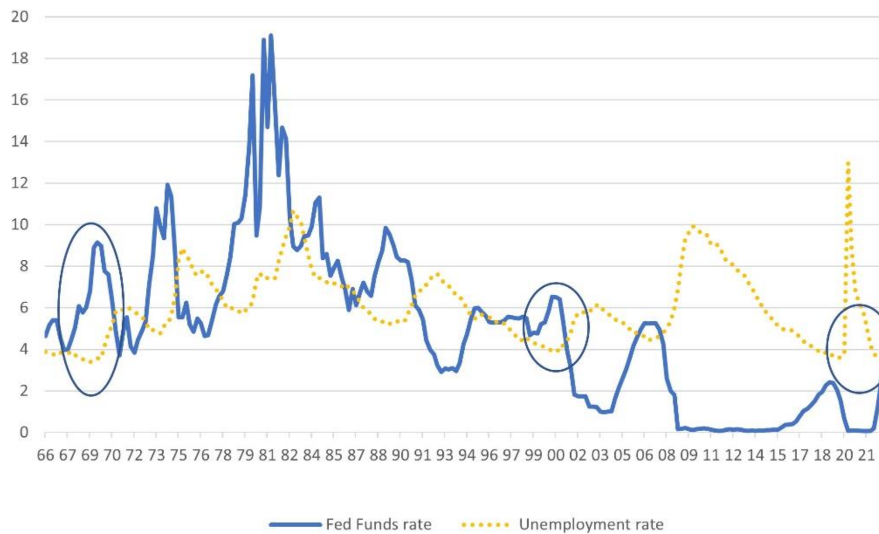
There are signs that the US economy is running hot – at least that's what the labour market appears to indicate. Last week's robust job numbers in the US will likely only strengthen the Fed's resolve that US interest rates will have to rise further and stay elevated for a prolonged period of time. We see some broad profit-taking in the bond and equity markets in the coming days.

The financial markets were so far staunchly in disagreement with the Fed's view of where interest rates should be in the future and had priced the rates to peak by the middle of this year and then gradually fall through the second-half. However, last week's much stronger-than-expected employment numbers were surprising, and could force the markets to reconsider their view.

The US labour market report was sharply ahead of market expectations. The US Department of Labor announced a net addition of 517,000 new fully employed workers in January, compared with market expectations of just 188,000. The official unemployment rate fell to 3.4%, a five-decade low. It is also worth noting here that the previous month's number was revised upwards to 260,000 from 223,000. In fact, in a further indication that the economy was on a strong footing, the ISM service sector survey showed a sharp turnaround in new orders (60.4 in January versus 45.2 in December). Of late, several indicators of economic growth have completely reversed their fourth-quarter pause. US auto sales are running at +18% year-on-year.

The labour market report has clearly altered the narrative – from whether or not consumer price inflation has peaked and how far it will fall, to one that focuses on the structural risks of inflation remaining higher for longer. In normal circumstances, an unemployment rate of just 3.4% would have the Fed increasing interest rates. On every earlier occasion that unemployment fell to these levels (it is at its lowest level since 1969) rates moved higher and not lower. The unemployment rate has been rarely as low as it is today in the United States. On each such occasion, the Fed funds rate went above 5%. In 1969, the Fed funds rate peaked out at around 10%!

Chart 1: Such low levels of US unemployment indicate higher short-term rates judging by history



Source: Bloomberg

The robustness of growth in the US is complemented at the global level by signs of a sharp improvement in economic activity in China. Consensus GDP forecasts for 2023 that were running at around 5.5%, are now being pushed upwards to close to 7%. JP Morgan estimates that global growth in the first quarter is running at an annualised pace of 2.4% – there're little signs of a global recession here. However, such robust growth may cause global inflation to retreat more slowly than anticipated, thus forcing central banks to tighten further and not resort to policy pivot/reversal that the bond market might have been hoping for.

The markets will have to start taking more seriously the central banks' determination to bring growth and inflation under control. The Fed, ECB, and the Bank of England were emphatic last week in indicating further monetary tightening ahead. Fed Chairman Jerome Powell's comment of "ongoing increases" may not be popular, but it's probably true. The ECB increased interest rates by 50bps and indicated that an increase of a similar magnitude was very likely at its next meeting in March.

Bond markets are likely to be under pressure. However, we would characterise the current conditions as duration challenging but credit neutral/positive. Hence, higher yielding assets such as high yields and preferreds should be better placed than government bonds to weather a sell-off, in our view.

Equities have rallied hard on hopes that the goldilocks scenario of good growth and accommodating central bank policy will ultimately unfold. The growth is still there but this time central bankers will not be of help. Stronger-than-expected growth helps to mitigate some of the near-term risks of a sharp setback in corporate profit forecasts. However, higher central bank policy rates and likely long-term interest rates will take their toll and push down P/E multiples of growth stocks in particular.

And then there's Adani

This week brought little respite for Adani Enterprises, which was somewhat surprisingly forced to pull its follow-on equity issue and its bond issue now looks in trouble as well. Shares in Adani Enterprises tanked a further 50%, retreating to where they were about 15 months ago. As one might expect, the fiasco has become a political hot potato in India with passionate exchanges between the government and opposition benches in the upper (Rajya Sabha) and lower (Lok Sabha) houses of parliament. The Adani fiasco has several pesky dimensions but there is one particular area of contention that we want to highlights – the issues plaguing the Adani Group (post the publication of the Hindenburg report) are about capital markets and not necessarily about Adani's capabilities and their role in the Indian economy in building out crucial infrastructure. The problems are in the main related to inflated valuations and a company that borders the public domain but exhibits the classic traits of a private company. The problem is about how inflated the valuations of Adani Enterprises and its group companies are, not the quality of the underlying businesses.

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