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Nathan Hughes: Rate-cut bets may be wide of the mark

By Perpetual Asset Management

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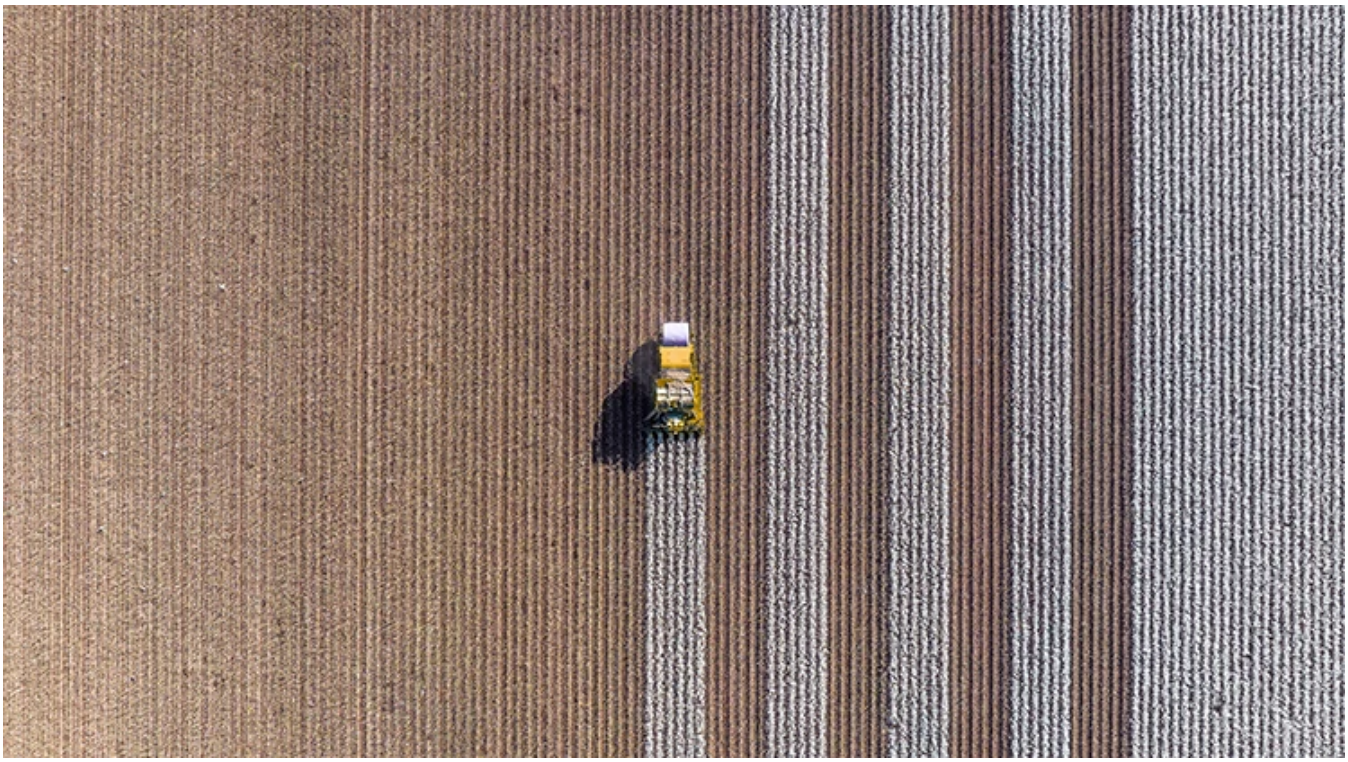

A swift shift in market expectations toward rate cuts has underpinned equities recently. But inflation pressure persists, and market optimism may be getting ahead of itself, argues

Perpetual's Nathan Hughes.

- Markets expect aggressive rate cuts
- But upwards risks to inflation persist
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Markets may be getting overly enthusiastic about the potential for interest rate cuts in 2024 – and a cautious approach to investing over the next few months would be prudent, says Perpetual's Nathan Hughes.

Investors are pricing rate cuts of more than 150 basis points in the US over 2024 – a shift that has underpinned much of the equity market's rally over recent months.

But despite optimism that inflation is in the past, there are risks ahead including strong jobs numbers, continued economic growth, robust corporate earnings and signs of an end to the inventory destocking cycle that has driven commodity prices lower.

"The expectations for rate cuts are remarkable," says Hughes, who manages Perpetual's ESG Australian Share Fund [GIVE:ASX].

"I'm asking the question: has the market got ahead of itself?

"There is evidence that inflation may be stickier and macro-economic data is holding up well. So why would you need to cut rates 150 points?"

The federal government's changes to the long-planned stage 3 tax cuts – which redistribute tax cuts away from high income earners towards low-income earners – could also pose a risk to inflation, says Hughes.

"The tax cuts may not be directly inflationary – but they certainly won't be deflationary given the higher propensity to spend amongst the beneficiaries of the policy shift."

Inventory poses inflation risk

The key upside risk for inflation is the end of an inventory destocking cycle that began post COVID, argues Hughes.

During the pandemic, as demand spiked due to stimulus and lockdowns, many companies stocked up on inventory, moving from the typical 'just-in-time' production model to an overstocked 'just in case' approach.

As demand normalised companies began aggressively destocking this excess inventory, contributing to falling commodity and input prices as supply outstripped demand.

“In our conversations with companies there are indications that the destocking cycle is coming to a close,” Hughes says.

“That could have an impact on goods inflation as commodity prices – especially some of the metals – may find a bottom.

“Destocking cycles typically only run for a certain period – usually not beyond 12to 18 months – because inventory finds a level.

“We’re talking to a raft of different companies in the industrials space and we’re seeing evidence of the cycle ending across a range of different industries, including spirits manufacturers, FMCG customers and packaging supplies.”

The end of destocking could put a floor under commodity prices, removing some of the downwards pressure on inflation, Hughes says.

“Metals prices – with the notable exception of iron ore – have been weak and the oil price has fallen over the last six months. The disinflation we’re seeing is underpinned by lower commodity prices.”

A note of caution

As a result, Hughes suggests investors take a cautious approach over the next few months.

“Be wary of chasing some of the rate-sensitive sectors – certain real-estate trusts, infrastructure, the higher-growth names that have longer duration and benefit from lower rates.

“Without wanting to sound overly bearish – because that’s not how I am – be a little bit cautious around market sentiment.

“We have had a big move off the lows and some of the riskier names probably benefited disproportionately.

“The message is cool your jets a little. Be selective, focus on company-specific issues, don’t forget about balance sheet strength, don’t get suckered into things where valuations are prohibitive.”

Domestically, Hughes says ASX industrial valuations are at the high end of their 20-30-year range, providing little valuation support for investors.

Long bond yields, a key input to valuations, have risen from December’s lows, making certain stocks less attractive to investors, he says.

The performance of local markets in coming months may pivot on the interest rate decisions of the Reserve Bank in February and March, he says.

“There is an open question as to whether the RBA lifts rates one more time in the next couple of months,” says Hughes.

ASX impact

A policy divergence between an RBA that is still tightening and a Fed that is cutting has a raft of implications for investors, says Hughes.

“There are a lot of big offshore earners in our market, particularly in healthcare, which could face a headwind from a rising Aussie dollar, while typically small caps do pretty well when the Aussie is rising.”

February’s ASX reporting season will provide investors with some important clues to how businesses and consumers are coping with higher rates, says Hughes.

“Some of the interesting questions we’re seeking answers to are whether people still have a propensity to continue traveling in a tougher macro environment. There was a bit of revenge spend after COVID – is that done?

“The supermarket results will be interesting too – especially the government risk.

“Bank earnings will also be topical. I think the bad debt cycle for banks is still far away but I think income growth is going to be a challenge given slowing loan growth, and higher expenses.”

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