

# INFLATION: STAYING DOWN OR RISING BACK UP?

Any movie watcher will know that well-trodden scene in which the hero puts the villain to the sword, turns around triumphantly only to see the same villain rising ominously behind them ready for action.

When it comes to inflation, we are at a point in which central bankers have effectively said inflation is now coming under control and thus we look forward confidently to lowering interest rates. In our movie analogy it's that exact part where the hero thinks they have slain the monster and confidently turns around for a victory lap. What the market is waiting for is to see if that monster (inflation) stays on the ground or not.

Many in the market are turning for their own victory lap, confident that inflation has been beaten and thus, happier, lower inflation times can be looked forward to, without a recession. The equity market is rallying strongly off this assumption with its strength broadening out into stocks which are not linked to AI and/or mega-cap tech which was what 2023 was all about. You can see European stocks doing well, as well as value stocks and small cap stocks. All of which indicate investors looking away from just tech

stocks for their outperformance. TAM is no different here, we have some great investments in Europe, value stocks, US (non-tech) and small cap which have all done well this year.

Some of the tailwinds driving stock (and corporate bond) performance center around the avoidance of a recession, with company earnings looking better (cause for celebration) and central banks telling markets they are going to be cutting rates this year despite inflation not being below 2% (another cause for celebration). Both good reasons to keep buying, which are being funded by good savings levels and a willingness to invest spare cash into the market, which last year was parked in money market funds. Think of money market funds as a huge cash stockpile, which investors are drawing down on to invest back into the market because of the first two points. With interest rate cuts making money market funds less attractive amid a roaring stock market, it makes sense that investors are rotating away from cash funds on FOMO (fear of missing out).

**Things are going well, markets are up and word on the street is rate cuts are coming, but does the monster now get back on its feet?**

One of, if not the largest risk to the bull market ending is the prospect of inflation starting to head back up, or at least not coming back down anymore for a long time. A large part of the positivity is underpinned by the anticipation that rates are going to be cut. The biggest challenge to this narrative sticking is inflation moving higher, to the extent that markets realise it would be lunacy to cut interest rates, an inflationary act. The even more drastic scenario would be central banks issuing interest rate cuts, spurring a surge in inflation which has to be cut in half with more rate hikes. Not a good look for any central bank.

**Are these scenarios likely?**

In December, the US was expected to grow by 1.4% in 2024 with 2.4% rise in PCE (personal consumption expenditure). Last week that same projection was increased to 2.1% growth in 2024 with a 2.6% rise in PCE, which is an increase not a decrease! That's a large growth uplift with inflation also set to rise. That's probably the part in the movie where we see the monster's finger start to twitch.

The obvious juxtaposition here is central banks verbally committing to ease financial conditions by cutting rates in 2024 when the economy is accelerating, and inflation is arguably rising not falling. That's a little like pouring petrol on a fire. We all know how that ends.

The market is currently taking this news well because it wants central banks to cut rates. This would mean easier financial conditions that are more conducive to long-term corporate growth which then gets reflected in share prices.

The downside here is investors are potentially ignoring the rising inflation dynamic because it challenges the bullish mood markets are in right now. This could set up a showdown later in the year if inflation starts rising, not falling, and central banks drop their commitment to lowering rates, which would be a volatile situation for stocks. This would constitute that part of the movie where the monster slowly rises off the floor for another fight, with moviegoers shouting, "it's behind you!".

**What are we doing about it?**

TAM remains invested into what is doing well from this "rate cuts are coming" narrative because it's dragging the market higher and we want to go with it.

That's in the form of high-quality corporate bonds over government ones, high-quality small cap stocks, global value stocks, UK stocks and some precious metal bullion, and stocks which are showing up as some very attractive investments at the moment.

There will come a point later in the year when we need to redress the portfolios' exposure to these factors and re-engage with funds which thrive in volatile conditions via investing into defensive "risk-off" asset classes.

Market insight written by James Penny, Chief Investment Officer at our investment management partner TAM Asset Management.

If you would like to speak with us about anything in this note, or to discuss our discretionary investment management services in general, please get in touch with our Head of Investment Phillip Hadley.

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