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Speaker: Two Barclay's analysts, one hot topic, all sides explored. This is The Flip Side. The Flip Side is a podcast series featuring lively debate between two Barclay's research analysts taking opposing viewpoints on timely topics of importance to economies and businesses around the globe.

Jeff Meli: Welcome to The Flip Side. I'm Jeff Meli, the Head of research at Barclays. I'm joined today by Ajay Rajadhyaksha, our Chairman of Global Macro Research. Thanks for joining me, Ajay.

Ajay Rajadhyaksha: Thank you for having me, Jeff.

Jeff Meli: Today we're going to discuss what's driving equity markets. Now, stock prices across the developed world are generally higher this year after having a pretty rough year in 2022, but the past few months have been extremely volatile. We've had days with very big positive swings and other days with very big negative swings, and sometimes it's been hard to square the economic news with the market reaction. Generally speaking, we think that good news about the economy is good news for stock prices, but this maximum, so to speak, seems to have been upended lately.

Ajay Rajadhyaksha: It has, Jeff, and for good reason. Good economic news today translates directly into higher interest rates, given the ongoing fight against inflation. And higher interest rates do mean lower equity prices. So what seems like a contradiction at first glance actually makes a lot of sense to me.

Jeff Meli: Well, I disagree, Ajay, I think the market has it backwards. I think the implication of higher rates is being overstated. I'm expecting a return to normalcy, so to speak, where the market reaction lines up more with the momentum we're seeing in the economy.

Ajay Rajadhyaksha: All right, take a step back, Jeff. In 2022, the Federal Reserve and other central banks started raising interest rates to try to tame inflation. And you will admit, that has proven harder than expected. The rate hikes have been fast and furious; over 5% in the US or 4% in Europe. And no surprise equity markets fell. For example, the S&P 500 was down over 20% last year.

Jeff Meli: Now, that move in equity prices was basically driven by the belief that such a rapid increase in interest rates would lead to a slowdown in the economy. Obviously, a slowdown in the economy is bad for corporate earnings and that ends up being bad for the stock market. Now, at the same time, some common recession indicators were flashing red. Now, for example, the yield curve was inverted. That means that bonds with longer maturities actually had lower yields than bonds with shorter maturities. Usually it's the opposite. When this inversion happens, it's usually a sign that investors are expecting a major economic slowdown.

Ajay Rajadhyaksha: That is true, and it is also true that it didn't happen, at least not yet. The economy in the US has proven very resilient and it shows no signs of slowing down.

Jeff Meli: No signs of slowing down? Ajay, I think the economy is actually accelerating. I mean, let's be clear, most economists expected a recession a year ago, and yet, in the last nine months, the US economy has been growing at about 3%.

Ajay Rajadhyaksha: Yeah, some recent data points do suggest that it is accelerating. For example, September payrolls showed that the labor market remains extremely strong. We had upward revisions to prior months. Consumer spending is also very healthy.

Jeff Meli: And big picture, the equity market is up this year, over 10% in most developed markets. For example, the S&P 500 is up about 14%. But a few months ago I noticed a change. First of all, the market is off the highs and second, it seems to be reacting differently to economic news.

Ajay Rajadhyaksha: That is true. The major stock markets fell 8 to 10% in August and September, and yet the data was really strong. We are growing at almost 5% in Q3.

Jeff Meli: Yeah, that's my point exactly. Now, the reason why stocks fell was because bond yields have risen sharply since early August. The bond yields are reacting to all that good economic news that you talked about, and that translates into higher yields and that has been translating into lower stock prices. So we have this weird paradigm where good economic news has been bad for equity prices, and I just don't buy that.

Ajay Rajadhyaksha: Look, you keep saying equity indices, but I have to point out that although the overall market is [inaudible] this year, many stocks are actually flat to down. The index performance is being driven by a remarkably small number of mega cap stocks that are up over 50% for the year.

Jeff Meli: Yeah, those are the so-called Magnificent Seven, which are the companies that are most heavily linked to the revolution in AI. But Ajay, I would point out that a small group of companies is typically responsible for most of the moves in the stock market. It's just that exactly which companies are moving is what changes over time.

Ajay Rajadhyaksha: Yes, but this time the concentration is so narrow, the breadth of the equity rally is so shallow that I think it makes stocks more vulnerable. Honestly, if just one of these firms stumbles, Jeff, so will the entire market. And sure, the hype around AI may prove true, but the stat I gave highlights just how hard it is for equities overall to perform well in a rising rate environment. Away from transformative technology, stocks struggle and the reason in part is just mechanical. When interest rates rise, the value of future cash flows falls and so do equity prices.

Jeff Meli: Well, we have definitely seen that in the bond market. You know who has not enjoyed this good economic news? It's bond investors. Bonds have now lost more value than stocks did during the global financial crisis. We reached a multi-decade high in both mortgage rates and 30-year treasury yields. Now, the Financial Times just calculated that investors lost more money investing in the Austrian AA-rated 100-year bond issued in 2017 than they did investing in the Argentinian 100-year bond, which then defaulted three years later.

Ajay Rajadhyaksha: And equities have some similarities to long-dated bonds. To your point, equities are dependent on future cash flows. As an equity holder, you own all the future earnings of a company and as rates rise, the value of those future earnings declines. There is an inverse relationship between equity prices and yields.

Jeff Meli: Right. First of all, Ajay, only a fixed income person would say that equities are like long-dated bonds. I'm pretty sure you just lost every equity investor out there listening to this.

Ajay Rajadhyaksha: Well, I'm only talking about the sensitivity to rates, Jeff.

Jeff Meli: Yeah, but more seriously here, the Federal Reserve, the ECB, all these other central banks, they've done the bulk of their hiking already. Yeah, sure, the economic news has been good. Rates are already high though. This mechanical relationship that you're talking about, it might explain the selloff that happened last year, but at this point, it just seems less relevant. I mean, we're not going to have another 500 basis points of interest rate hikes, are we?

Ajay Rajadhyaksha: We are not, but I think you're still missing something interesting that has happened lately. And that is that the strength of the economy has led investors to rethink how long the Fed and other central banks will have to keep rates high.

Jeff Meli: Yeah, indeed. Higher for longer – that's the current mantra. Basically, the rate hikes have not immediately translated into lower inflation. I mean, US core PCE inflation, which is, sort of, the favored measure of the Federal Reserve, it's off the highs, which were close to 10%, sure, but it's still near 4% – nowhere close to the 2% target. And really the easy part of the inflation battle is done. So now the expectation is that interest rates are going to stay at these levels for the foreseeable future.

Ajay Rajadhyaksha: And yes, and that has led to the long end of the rates curve, like 30-year treasuries, to experience the largest increase in yields. Now, this matters a lot for equities, way more than the short end, like the Fed funds rate rises. The discount rate used to price equity earnings far in the future is based on long-end treasuries, not the front end. So when those yields rise, it translates immediately into lower stock prices, which is what has happened recently. So I go back to this, what you're taking as good news for the economy is in fact bad for stocks.

Jeff Meli: Back-of-the-envelope math here, Ajay, just looking at this rise in interest rates, you've had 30-year yields up about 60 basis points from the lows. That's worth about nine points in price terms for the 30-year treasury, based on duration. Now, the S&P 500, as you said, is down about 10% from the highs, but the duration of stocks must be lower than that of bonds. That means that they must be less sensitive to interest rates than bonds are, because stocks are riskier. So just looking at that rate move isn't sufficient to talk about what's happening in equities right now.

Ajay Rajadhyaksha: All right, so I have two pushbacks here. First, the starting point matters. From peak to trough, you're right but I think the likely path of rates is finally settling in, in the equity market's mind. So some of this is just catch-up from what should have happened earlier. And second, I think earnings pressure is going to be another factor weighing on stocks.

Jeff Meli: Yeah, I'm not really sure I'm following here, Ajay. The economy is accelerating. We just talked about that. Why is that bad for earnings? I mean, based on current analyst forecasts, investors are expecting the S&P 500 earnings to grow at like 13 or 15% for each of the next two years.

Ajay Rajadhyaksha: Yeah, color me skeptical. Earnings are not inflation adjusted, which means earnings growth is easier when inflation is high. Last year, Jeff, the economy grew 10% in nominal terms, but inflation is so much lower now that we are likely to – more likely to grow 4 to 5% nominally over the next few years. And that's assuming we avoid a recession. I just don't know how company earnings are going to grow at 15% straight for two years.

Jeff Meli: Well, don't forget Ajay, that if all that hype around AI is justified, double-digit earnings growth might even be an underestimation.

Ajay Rajadhyaksha: It's a big if, Jeff, and I would say it is more than reflected in the valuations of those stocks. Remember, it takes decades for even game-changing technologies to go mainstream. As a simple example, it took the United States 50 years to fully electrify, even though electricity was a clear blessing from day one.

Jeff Meli: Ajay, that's an example from over a century ago. It took us 20 to 25 years for the personal computer to go mainstream, 10 to 15 years for the internet to go mainstream. The pace of which these changes and technologies are embedded into our economy is speeding up. I think AI is going to be the fastest one yet.

Ajay Rajadhyaksha: Look, we'll see. But meanwhile, I think the risks of a recession in the near term are real and rising. The labor market in particular, I worry is going to force the Fed to over-hike. We will see them continue to raise rates.

Jeff Meli: Now Ajay, this is the reasoning that I really object to. The economy has proven resilient to over 500 basis points of rate hikes, right?

Ajay Rajadhyaksha: Yes, it has.

Jeff Meli: That includes in some very rate sensitive areas like housing, which we discussed in the last episode of The Flip Side. Why would the next couple of hikes have such an outsized effect when the first 500 basis points of rate increases did basically nothing?

Ajay Rajadhyaksha: Well, the effect of the initial hikes I think may only be lagged, not missing. And then when future hikes happen, which I believe will be the case, that'll just pile on.

Jeff Meli: You see, I just don't think the economy is that sensitive to interest rates at this point. I mean, take households. Sure, they borrow when they buy a house and mortgage rates are really high. But other forms of borrowing, like credit cards, are still relatively low. Households still have lots of excess savings. Actually, our economics team recently updated their forecasts and they looked again more closely at how much excess savings households have and redid their calculations. And we think US households still have excess savings close to $2 trillion. Households are in great shape and by the way, wages are rising. The rate story to me is just a sideshow. It has, at most, a second order effect, even on areas like housing, which should be the most sensitive. And I think all these structural issues about the return from COVID and how the economy is recovering, are just swamping what's happening with central banks.

Ajay Rajadhyaksha: I don't know. I think rates affect lots of parts of the economy, not just mortgages. Take corporates for example, their rates are going up too and that will eventually affect their investment, their hiring, all sorts of things.

Jeff Meli: Well, [inaudible] households though, corporates have been borrowing for years at very low rates. So the average coupon on the investment grade corporate bond index is actually under 4%. That's extremely low by historical standards and way lower than the interest rates that they would issue at today. So their actual interest costs are actually very contained. Just like is the case for households who took out a lot of mortgages during the COVID period when interest rates were extremely low. Look, I think you're trying to have your cake and eat it too. Either the issue is an elevated discount rate because the long end is really rising and that's going to affect the value of future cash flows or, it's the risk of a recession. But it can't be both, because the recession happens, long-dated interest rates aren't going to stay high. I would just point out that the market signals actually have started to reverse course on this recession probability.

Ajay Rajadhyaksha: You are right there. The yield curve is less inverted over the last few months and I think it is responding to the strength of recent data. And yes, that does suggest that recession is less likely. Now, of course, it's not a great signal because an inverted yield curve didn't lead to a recession of – six months ago. So it is still possible, I think, to have both higher discount rates and a chance of a recession. Now, mind you, there are lots of other factors that could also cause a recession: the slowdown in China, a possible recession in Europe, new and continuing conflicts in important regions. Even if the Fed has less control, I still think there are lots of sources of recession risk.

Jeff Meli: All right, I'll grant you that there are lots of things that could go wrong in the global economy.

Ajay Rajadhyaksha: All right, that's progress, Jeff.

Jeff Meli: Yeah, not so fast, not so fast. None of that explains why good news about the economy is currently bad for the market. Now those risks that you talked about are real, they're real risks, but they would be bad for both the economy and the market. And actually I think the recent market reaction to the payroll report is instructive. So as you mentioned, we’ve got a very, very strong jobs report in the United States for September. And yes, yields rose, they rose in response to that because the momentum in the economy is very strong. And yes, they rose more in the long end because the curve became less inverted.

Now initially, equity futures markets indicated that the stock market would fall in response to that, reiterating this sort of mantra[?] that we've been in, where good news is really bad for the market. But something strange happened when the market actually opened – stocks rose a lot, almost a full percentage point that day.

Ajay Rajadhyaksha: You're right about those facts. I just think you might be reading a bit too much into the price action from just one day.

Jeff Meli: Well, maybe, maybe. But I think that day represented a turning point. I think investors were much more concerned about the risk of a recession than they were about the potential effects of higher discount rates. And at some point, the momentum in the economy puts to bed the risk that the Fed is going to crash the economy. They might hike a few more times, but the momentum in the US is just too strong and that recession risk is really fading. Once we come to terms with that, then I think good news is a lot easier to interpret.

Ajay Rajadhyaksha: Maybe I'm just a worrywart, Jeff.

Jeff Meli: Yeah, well, you said it. One last point Ajay. For years, equity bears kept saying that stocks were high because the Fed was pumping in so much liquidity into the system. Almost like as the Fed bought all these bonds through their quantitative easing program, investors had no place else to put their money, so they were, like, begrudgingly forced to buy stocks, which forced their prices up. But guess what? That's clearly not been true in the last 18 months. The bond bubble has burst. Interest rates are way higher, the Fed's not buying anymore. And yet here we are, stocks healthily higher for the year.

Ajay Rajadhyaksha: I can't push back on the facts here again, but I would simply argue that not all markets price perfectly all the time and I still think equities have a fair bit of repricing, lower[?], to do. But in any case, I certainly hope you are right and I'm wrong, Jeff.

Jeff Meli: All right, thanks for joining me, Ajay. Clients at Barclays can read our latest take on markets in Global Macro Thoughts; Data, Not Geopolitics, available on Barclays Live.

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