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Glide paths: the dance of growth and inflation

While the recent cut by the Federal Reserve was expected by markets, it was the choice in the size of the reduction – 0.5 percentage points – that surprised some. Yet, despite this, the market reaction was relatively muted with US equities ending the day largely unchanged. Of course, while rate cuts are, ceteris paribus, a positive for equities – reducing corporate borrowing costs, and making equities relatively more attractive – there is much else going on the global economy. Indeed, despite the Fed now signaling that the worst is over in terms of the battle against rising prices, there is still a great deal of uncertainty regarding the potential glide paths that growth and inflation will take in the coming months.

Potential headwinds – whither inflation?

So while the rate cut was certainly welcomed, other factors are still weighing heavy on investors and market participants. Of course, events such as rate cuts do not happen in isolation, and markets reactions will depend on a range of factors; yet the perennial investor concern – that cheap money signals central bankers' fears of economic weakness – seems unfounded in this case. While the US economy is certainly slowing, it does not seem to be entering recession and company earnings should fair better than in previous rate cutting cycles.

Other factors are also holding equity markets back in the wake of the recent rate cut. Chief among these is political uncertainty, both at the domestic and international levels. Domestically, the US is now late in its election cycle, with the outcomes of the Presidential and Congressional votes still completely uncertain, just weeks before polling day. And while we do not expect a momentous impact on markets, either way, a red or blue sweep of Congress and the White House – unlikely as it may be – would certainly lead to some significant changes in policy. Indeed,

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while a Harris win would provide a path of continuity, a big Republican victory in would probably have the greatest impact on markets, with the break from the previous administration that this would represent.

Uncertainty regarding domestic political outcomes is also spilling over into the geopolitical scene. While the US is unlikely to violently change course on the international scene, a Trump victory will almost certainly impact trade relations between the US and others, China especially. Indeed, while both candidates will certainly adopt an "anti-China" stance, the different will be in matters of degree and styles, with a second Trump administration likely to have the biggest impact on trade between the two economic powerhouses.

The danger underlying these political uncertainties is that an inflationary environment returns to some degree, especially if Trump were to apply wide ranging new tariffs. Growth is likely to remain muted for some time, and there is a risk that inflation does not follow a similar glide path. And glide path divergence between regions could also have currently unanticipated impacts on currencies. The worst outcome would be a stagflationary scenario with growth unable to keep up with rising prices.

A likely soft landing

However, at present, most indicators point to a more sanguine outlook, with a soft landing the likely outcome. And, despite the market's lukewarm reaction, the Fed's recent decision is nevertheless an unqualified good for equity markets.

Both US and European economies are showing resilience, while employment has also been solid on both sides of the Atlantic – despite the mild panic we saw over the summer at some unexpectedly soft figures. Despite some stickiness – particularly in the eurozone, driven in part by higher services inflation – forecasted inflation glidepaths are positive and the outlook for growth is improving. Indeed, some more rate sensitive economies may see a sharper rebound from recent central bank decisions. While Chinese economic growth has shown some softness recently, the government's resolve to provide support while maintaining a focus on innovation and long-term structural adjustment is important to monitor, given the size of the economy and its potential impact on many other markets.

Looking globally, a softer dollar will help emerging markets, while oil prices seem to be weathering growing conflict in the Middle East without any significant gains. Furthermore, the megatrends driving capex and efficiency gains across a broad range of sectors – most notably, artificial intelligence and the energy transition – remain intact and continue to present opportunities for investors.

THE OUTLOOK FOR INVESTORS

While we believe the outlook is positive, the next few months will be crucial in determining in determining whether the spectre of returning inflation has been a successfully managed and a constructive glidepath achieved. And, of course, much will depend on the outcome of November's elections in the US – while, regardless of who wins the Presidency, the most likely outcome is a divided government and thus a degree of policy continuity, the possibility of a red or blue sweep of Congress and the White House cannot be disregarded.

For investors, trade tensions between the world's two largest economies – amid China's emergence as an innovator and leader in a number of tech fields – underscores how the landscape is set to change over the coming years. We are likely to see a bifurcation of consumer behaviour around the world, with those in some markets leaning to predominantly Chinese suppliers while others take the US route. The impact of the emergence of rival "tech hemispheres" on equity markets is yet to play out, but investors should certainly be aware that this is the trajectory likely to be taken by the global tech scene – a trajectory that will also be shaped by the resolution of political and economic uncertainties in the coming months.

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