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Economic & Market Update

JUNE 2023 OUTLOOK

The global economy continues to show signs of strength amidst uncertainties, with the U.S. witnessing strong job and wage growth, despite concerns of short-term rates and banking turmoil. The GDP growth is projected to be around 1%-2% for the second quarter. There are rising concerns around inflation and the tightening of monetary policies, both in the U.S. and Europe. The Chinese economy's recovery is reportedly slower than anticipated, leading to expectations of further support from the People's Bank of China.

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GLOBAL ECONOMY

- Calls for an impending U.S. recession are being stifled by continued strong jobs and wage growth and the willingness of consumers to draw down on savings to fuel consumption. Businesses are becoming more hesitant to produce considering the dramatic increase in short-term rates over the last year and worries that the recent banking turmoil may restrict the availability of credit. However, there are few signs of excess inventory accumulation in the broader economy and banks continue to extend credit to those willing and able to borrow. Second quarter gross domestic product (GDP) should grow at a 1%–2% rate, which is admittedly below potential, but not recessionary. The second half of 2023 should produce similar economic growth.
- One of the effects of this slow-growth-but-no-recession environment is some stalling in the progress of fighting inflation. While most goods prices are rising at a slower rate and some are in outright decline as supply has inevitably caught up to demand, prices in the services and shelter sectors of the economy continue to rise to levels troubling to monetary policymakers. The biggest risk to the economy at this stage is monetary policy growing even tighter as the economy slows and prices naturally recede.
- European economies have been supported by a surprising decline in energy prices so far this year and a monetary policy that has generally not been as tight as that seen in the United States. But inflation appears to be more stubborn in many of these economies so the tightening cycle may be extended, and the risk of recession appears more imminent as Germany, the largest economy in the region, has already seen two consecutive quarters of GDP declines.
- The anticipated sharp rebound in the Chinese economy after the removal of stringent mobility restrictions has been somewhat disappointing as the country has experienced some COVID-19 outbreaks but has also been reminded of the effects of the trade war with the United States on its important export industries. Demographic challenges will also have a longer-term impact on Chinese economic growth.

MONETARY POLICY

- Federal Reserve (Fed) members appear to be rather evenly split about whether to pause or increase the federal funds rate another 25 basis points at the June Federal Open Market Committee meeting. Given the forecast for continued economic growth through year-end and the slow expected progress in bringing inflation back down to the 2% target, there should be no reduction in the federal funds rate this year.
- Central banks in Europe are fighting a seemingly more entrenched inflation problem and should theoretically grow and remain tighter than the Fed through the remainder of the year. A constraining factor to that approach would be a deteriorating economic situation led by the northern tier economies more heavily reliant on exports to China and higher energy prices.
- The Bank of Japan will likely leave its policy interest rate and rate of growth in its balance sheet at current levels until it is collectively convinced that the economy-wide inflation rate it has been trying for years to achieve has been more permanently entrenched.
- As the Chinese growth recovery has been somewhat disappointing, the People's Bank of China is expected to provide more monetary policy support. This will not necessarily come in the form of policy rate decreases, as it will carefully consider the currency impact of such moves, but in the continued use of more unorthodox techniques such as a decline in the reserve requirement ratio in the banking industry.

BOND MARKETS

- Continued economic growth with no recession is putting upward pressure on rates not only on the short end but across the yield curve. Expect upward pressure on the intermediate-maturity yields to continue as rates normalize to a more typical environment in which the Fed is not participating as aggressively in this part of the market.
- Resolution of the inverted yield curve should be achieved through a combination of rising intermediate rates in a continued economic growth environment with a slowly declining inflation rate as supply generally catches up to demand. The Fed can then bring short rates down to more reasonable levels to match this lower rate of inflation.
- Interest rate spreads have remained rather stable in the high-yield-debt space as there have been few signs of an impending increase in default rates despite the turmoil in the banking industry and growing concerns about the ability to refinance maturing debt. Rising interest rates have pressured bond prices in the asset class in the same manner as they have in the investment-grade space. Caution is advised in approaching high-yield debt as there is less of a balance sheet cushion should revenues falter in a slower growth environment.

EQUITY MARKETS

- As economic growth and corporate profits have been better than initial forecasts entering 2023, analysts have been slowly revising higher earnings estimates for the remainder of the year. Valuations in the U.S. equity markets appear fair to slightly undervalued except perhaps for the roughly 10 mega-cap stocks that have carried the market year to date. In a continued economic growth environment with some reduced input cost pressures due to lower producer price inflation, margins should improve slightly, allowing the rest of the market to catch up a bit with the stronger performers.
- European equity markets have given up most of their outperformance against U.S. markets over the past month as inflation rates trend higher and central banks are presenting greater risk. However, Japan has quietly taken on the mantle of the best performing developed international equity market in 2023, as monetary policy there has maintained a steady course with no tightening.
- The disappointing growth recovery in China has recently pressured Chinese and other Asian emerging equity markets. As Chinese growth stabilizes around current levels, equity markets in the Asian region should be poised to advance. Latin American markets will continue to be driven by events in the commodities markets, particularly oil.

COMMODITIES & CURRENCIES

- Crude oil prices have broken through the bottom of their trading range as slower-than-expected growth in China has reduced demand while supply has not been as constrained as anticipated given announced cuts in the OPEC+ cartel. While relaxed oil prices are beneficial to the overall global economy, continued growth in the major energy consumption countries in Asia and North America should exert some upward pressure on prices in coming months.
- Less turmoil in the banking system and a level of economic growth that may keep the Fed and other central banks in tightening mode should lead to upside resistance and possibly further downward pressure on the gold price for the next few months.
- Better relative economic growth, higher relative interest rates and a Fed that may not be as done with rate increases as many market participants thought only a month ago have led to a surprising advance in the U.S. dollar against most global currencies. Given the belief the Fed will be finished tightening before most of the other central banks, the U.S. dollar should settle at slightly lower levels, although it is difficult to predict which currency is truly ready to assume the leadership position.

WHAT THIS MEANS FOR INVESTORS

» The slow-growth-no-recession economic environment into which we appear to have settled can be confusing to investors. The equity markets seem to favor the implications although the lack of broad participation in the advance is troubling. The bond market is worried about stubborn inflation and subsequently higher rates. Tangible advances in fighting inflation and ultimately bringing it down to target levels will remove the Fed and other central banks as market impediments. The normalization of rates after over a decade of financial repression is likely a positive for market participants who can now concentrate on economic and market fundamentals in assessing investment opportunities.

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