Economic & Market Update

December 2023 Outlook

Global Economy

- The U.S. economy will inevitably slow from the rapid rate of growth in the third quarter to settle back to the 2% growth level in the fourth quarter that prevailed for the first half of the year. The consumer will slow, as the high savings rates accumulated from COVID-19 pandemic relief and remote working arrangements have largely been worked down. Continued job and wage growth into year-end will be the primary drivers of spending growth. Businesses will be more cautious in a slowing economy, although capital spending should continue to grow to meet current demand and to produce productivity enhancements to offset the rising cost of labor and lack of labor supply in some sectors. Despite being pressured by rising deficits, government spending may surprise by remaining positive as already passed fiscal initiatives are funded and state governments remain rather flush.
- After some stalling in the disinflationary progress over the summer, lower energy prices, some cooling in the labor market, and a slowing in rental price increases should allow both the headline and core inflation rates to continue to move lower and closer to the 2% target established by the Federal Reserve (Fed). As goods price inflation has already fallen below that target level, a decline in wage inflation will be needed to bring down the inflation rate in the services economy. Improvements seen year to date in workplace productivity will help control the rate of growth in unit labor costs in both the manufacturing and services sectors.
- The European economy is likely to register negative gross domestic product (GDP) growth in the fourth quarter, as Germany, the largest economy on the continent, has fallen into recession. High energy prices and weaker-than-anticipated demand from China and other trading partners have put pressure on Germany's key manufacturing sector. Continued growth in the United States, the continent's most important trading partner, and resiliency in the services sector should keep any European recession relatively short and shallow.
- With the yen beginning to strengthen, Japanese economic growth should cool moving into 2024 as the domestic economy remains muted. Favorable fiscal and monetary policies should help prevent any downturn in the economy, as exports continue to benefit from the economic strength of key trading partners and the year-to-date sharp decline in the currency.
- Weakness in the property market is leading to concerns around the Chinese banking system, which may cause slower credit growth throughout the economy. Investors will be looking to the Chinese government to provide relatively unfettered fiscal and monetary support to prevent any sharp deviation from the 5% target GDP growth rate in 2024.

Monetary Policy

- Now that the Fed is likely finished with federal funds rate increases, markets will be anticipating when the first rate cut will occur. Given the forecast of slow, but still positive (+1.5%) U.S. GDP growth in 2024, the Fed will likely wait until the second quarter to gather further confirmation of improving inflation rates. With the real federal funds rate now at historically restrictive levels and a continued steady reduction in the balance sheet, there is a growing risk the Fed may be tightening too aggressively and may have to be quicker to ease should the economy slow more than expected.
- A positive byproduct of the stagnant eurozone economy is a relatively faster decline in inflation rates, with headline inflation now much closer to the European Central Bank's 2% target. This should allow the central bank to begin lowering rates a little earlier than the Fed, perhaps as soon as the first quarter of next year.
- The strengthening Japanese yen may remove some near-term pressure on the Bank of Japan (BOJ) to finally join the rest of the global central banking community in raising rates. As inflation becomes more firmly entrenched in the Japanese economy, the BOJ should at least be able to begin the process of moving away from negative policy rates in the first half of 2024.
- The People's Bank of China will be expected by the government to support any signs of flagging in the Chinese economy, and the recent strength of the Chinese renminbi will help provide some cover for anticipated rate declines over the coming months.

Bond Markets

- The resumption of meaningful progress in the battle against inflation and the attractiveness of much higher yields stoked significant interest in the fixed-income markets in November, with the 10-year U.S. Treasury Note yield declining over 50 basis points. Continued economic growth with no recession expected over the short term should exert some upward pressure on yields into year-end.
- While the yield curve has been inverted for over a year, this abnormal situation should be resolved in 2024 through a combination of Fed ease reducing yields on the short end of the curve and intermediate yields rising slightly in a slower, but still positive U.S. economic growth environment.
- With no recession on the near-term horizon, high-yield bond spreads to Treasurys remain very narrow, with no significant rise in default rates expected by market participants. The concern around this asset class is more a function of refinancing risk in this higher interest rate environment.

Equity Markets

- With third quarter earnings having comfortably exceeded expectations and the reduction to estimates for the fourth quarter and 2024 still rather mild, equities seized on the lower intermediate yields to again challenge the summer highs. Further appreciation from these levels will be more reliant on expected earnings growth as opposed to valuation expansion, although a clearer signal of future Fed ease is a potential catalyst in 2024.
- European equities joined the global equity rebound in November, but not at the same magnitude, as no other country has the same exposure to the globally dominant growth companies housed in the United States. Equities are much cheaper in Europe from a valuation perspective, but that is likely warranted by lower expected earnings growth rates. A more important catalyst for future appreciation would be a clear sign of near-term central bank rate cuts.
- The apparent end of rapid Japanese yen depreciation against the U.S. dollar in an environment where monetary policy remains extremely loose can continue to drive Japanese equities where the market is dominated by the global exporters who should

benefit from still-ample global growth over the coming quarters.

- Very low valuations and some developing currency strength can be a good launching point for Chinese equities moving into next year. The government must make tangible moves to encourage foreign investors to come back into a market where capital can be in a better position both politically and economically to maximize revenues and profits.

Commodities and Currencies

- Oil prices have broken through the downside of the previously established trading range as U.S. production has notably increased at a time when the OPEC+ cartel has lost some of its production discipline. On the demand side, Chinese consumption has been somewhat muted due to the slower economic growth profile. OPEC has agreed to further production cuts, which should provide somewhat of a floor, but scant details have emerged as to who will bear the biggest brunt of the production cuts.
- Industrial metals prices are also rather reliant on incremental Chinese demand, although continued U.S. growth in both the overall economy and the capital spending sector should be helpful in allowing prices of metals like copper and zinc to edge higher.
- The anticipated acceleration of monetary ease worldwide as global inflation dissipates has been beneficial to gold prices, as has the tangible increase in geopolitical risk. With cash and bond yields still very competitive against zero-yielding precious metals, further appreciation of gold will be contingent on the speed and magnitude of future central bank easing initiatives.
- After appreciating sharply against most other currencies through most of 2023, the U.S. dollar has corrected somewhat over the last month. With most other central banks closer to either maintaining or implementing easier monetary policies than the United States, it remains difficult to identify the currencies that can meaningfully appreciate against the U.S. dollar.

What This Means For Investors

- Fixed-income securities are now competitive with stocks in balanced portfolios, so equities need to show meaningful earnings growth to finally recover to their previous highs. Continued progress on bringing inflation back to target levels should remove monetary policy as an economic and market impediment. This should allow greater participation in a further equity advance beyond the few growth stocks that have dominated market returns.

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