Economic & Market Update

February 2024 Outlook

Global Economy

- The surprising resilience of the U.S. economy in the face of tighter monetary policy was manifested in fourth quarter gross domestic product (GDP) growth of 3.3%. Continued job and wage growth are driving consumer spending, but both are beginning to slow entering 2024. It appears that a boost in workplace productivity in addition to stronger-than-anticipated spending by the recently retired baby-boom generation will likely sustain consumer spending in the first half of the year. Businesses have been more reticent about their capital spending budgets, but owners and operators generally understand the need to invest in productivity-enhancing technology to both satisfy current demand and to compete in an environment of relatively scarce labor. Government fiscal spending may be deemed excessive to economists but will likely be additive to GDP for most of the 2024 election year. Overall growth should slow this year from the rapid rate of the second half of 2023, although there should be continued economic expansion at a rate only slightly below the longer-term trend of this mature economy.
- With goods price inflation having been largely eradicated in the U.S. economy, services inflation needs to show steady progress toward Federal Reserve (Fed) targets. Shelter inflation appears to be poised to decline over the coming months, which leaves wage inflation as the biggest source of inflationary pressure. We expect further improvements in worker productivity, as businesses better embrace technology to bring down unit labor costs over the coming quarters.
- Europe has been able to barely stay out of recession despite the contraction in Germany and stagnation in France, the two largest economies on the continent. Strength in the services sector of the European economy has helped drive growth in Spain and Italy. Given the relatively weak population demographics, it is imperative that government officials aggressively attempt to resolve the low workforce productivity by encouraging greater investment in innovative technologies.
- The Japanese fiscal and monetary authorities are supplying enough support to their domestic economy, while exports to the United States and Asian neighbors have helped the external economy. Recent Japanese yen strength may be somewhat of a challenge to trade growth and cause the overall economy to slow in 2024.
- In addition to the well-known secular headwinds around a declining population and continued trade wars with the United States and its allies, the Chinese economy is in the midst of a real estate crisis that has the potential to devolve into a larger debt crisis. Investors are looking to the government to provide adequate support to avoid any further capital flight.

Monetary Policy

- Investors are eagerly anticipating more concrete signs of when the Fed will begin to ease monetary policy. While the real federal funds rate has continued to rise as inflation has trended lower, the two consecutive strong quarterly GDP prints will likely keep the Fed on hold until the second quarter. There also will likely be some adjustment to the magnitude of balance sheet reduction, as the Fed becomes more concerned about overall market liquidity.
- Weak growth in the eurozone should place more near-term pressure on the European Central Bank to begin easing interest rates as early as the end of this quarter. Continued progress on bringing inflation down to target levels will provide adequate rationale for lower rates although recent wage settlements with unions could stall the progress in services inflation.
- Despite the aggressive tightening policies implemented over the last two years by most global central banks, the Bank of Japan (BOJ) has remained stubbornly easy in keeping its short-term benchmark rate in negative territory and targeting a 0% interest rate for its 10-year government bond. Look for the BOJ to gradually move away from such aggressive monetary ease as inflation becomes more entrenched in the Japanese economy.
- The People's Bank of China has begun to ease slightly through unorthodox means, such as a decline in the required reserve ratio among banks. Given the current weakness in the economy, declines in the key benchmark rates should occur over the next few months.

Bond Markets

- The decline in the rate of inflation and the anticipation of Fed easing have combined to stoke demand in the Treasury and investment-grade corporate debt market. The supply overhang due to the unusual case of growing fiscal deficits in a strong growth environment may be a cause for concern and keep intermediate-term rates higher than economic fundamentals indicate.
- The Treasury yield curve should continue its gradual move back to the more traditional upward slope, although the surprisingly strong economy may further delay the process as the Fed pushes out its first rate decline by a couple of months.
- While it is admittedly a rather perfect environment for high-yield debt, worries persist that the necessary spreads to investment-grade securities are not attractive enough, particularly with the pressure of debt maturities on the horizon that will need to be refinanced at much higher rates.

Equity Markets

- Global equity markets have gotten off to a rather good start in 2024, mainly on anticipation of lower inflation eventually leading to lower benchmark rates set by global central banks. With valuations already quite high in the U.S. markets, investors are looking for earnings growth to be the catalyst for continued advances. A better indicator of a truly healthy market would be a notable increase in the breadth of participation in this bull market. With the average stock much cheaper than the overall market, there could also be some multiple expansion in addition to an earnings recovery driving prices higher.
- European equities are much cheaper on average than those in the United States, but that is likely warranted by slower earnings growth and the paucity of industry-dominant growers when comparing markets. Given current low valuation levels, any signs of central bank ease should lead to multiple expansion, although earnings growth will continue to be challenged.
- A weaker Japanese yen in a continued extremely easy monetary policy regime should help drive the prices of the large Japanese exporters higher, although the domestic companies in this market may struggle to produce enough earnings growth to warrant similar advances.

» Below-trend economic and earnings growth combined with government policies that have not been attractive to foreign investors have taken a toll on Chinese equities over the last few years. It would be appropriate to remain underweight emerging market equities until policymakers become more palpably supportive of the economy and welcoming to international investors.

Commodities and Currencies

» The volatile geopolitical environment and some colder-than-expected weather around the world drove oil prices higher in January, but the supply-demand fundamentals do not appear strong enough to maintain higher prices, as weaker Chinese growth and greater-than-expected production in both OPEC and non-OPEC nations should continue to serve as price caps. Difficult-to-predict developments in the Middle East and Russia and Ukraine could upset this prediction of rather stable prices.

» With no artificial supply constraints that exist in the energy space, the industrial metals complex is more reliant on global economic growth to drive prices higher. Below-trend Chinese growth may prove to be too strong of a headwind and is likely to lead to price declines for certain commodities.

» Since its sharp rise in the fall of last year, gold prices have traded in a rather narrow trading range over the last few months. With the current level of short-term yields and a more benign inflationary environment, the primary catalyst for appreciation would be greater signs of near-term central bank easing initiatives.

» Calls for some U.S. dollar depreciation in 2024 may make some sense from a mean reversion and wishful thinking perspective, but it is difficult to identify the currencies with strong-enough fundamentals to overtake the dollar given the strength of the U.S. economy and the current level of interest rates.

What This Means For Investors

» The current U.S. economic environment of strong, above-trend growth with declining inflation is admittedly unusual, but it is very favorable to both bond and stock markets. With the full effect of monetary tightening still not having been felt and the Fed probably a little further out on the calendar for its first rate cut than investors currently expect, markets may be prone to heightened volatility and a slight pullback from current levels. Greater confirmation of sustained earnings growth and inflation moving closer to the Fed's target should lead to a resumption in the bull market for equities and a stabilization in intermediate-term bond yields.

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