Economic & Market Update

May 2024 Outlook

Global Economy

- The U.S. economy is slowing from the rapid growth rate achieved at the end of last year. The advance estimate of first quarter gross domestic product (GDP) came in at 1.6%, weaker than both the consensus estimates and the long-term trend of roughly 2.0%. However, a worsening trade deficit and lower inventory investment, both of which are indicative of still-strong consumer demand, drove the shortfall. Jobs and incomes should grow comfortably in the second quarter, which will be supportive of spending. Businesses are growing more cautious but should continue to invest in productivity-enhancing technology. Housing investment should also be supportive of growth as builders meet the secular demand from first-time home buyers. The economy should be able to maintain GDP growth at a 1.5%–2.0% rate over the next two quarters.
- The slowdown in economic growth combined with the recent stalled progress in lowering the inflation rate to targeted levels are conjuring images of a "stagflationary" economic landscape last seen in the late 1970s. As that was a much different inflationary and monetary policy environment from which today's policymakers use as a frame of reference, the central bank rate increases implemented over the past two years should ultimately bring inflation closer to target. There is likely a greater risk these policies could worsen the economic growth outlook than stoke additional bouts of higher inflation, as goods prices have already generally stopped rising.
- First quarter GDP reports indicate that European economies appear to be turning a corner after an extended period of economic stagnation and are now showing surprising strength. The German and French economies are seeing greater export growth and some resurgence in domestic demand. This stronger growth is occurring as inflation is moving down closer to targeted levels, perhaps providing some room for policy stimulus.
- The Japanese yen's weakness had a positive impact on the export markets and drove much of the Japanese economy. Domestic demand remains rather anemic, although the recent wage negotiations should push consumer spending higher and allow the economy to climb out of recession.
- China will most likely fall short of its government-sponsored 5% growth target, as domestic demand remains muted due to the country's property crisis and slower jobs growth in the export sectors. Government stimulus initiatives are focusing on production-driven industries, which will likely produce excess capacity in the future but may have a near-term positive impact on domestic demand.

Monetary Policy

- Stubbornly high services and wage inflation is likely to cause the Fed to hold off on cutting the federal funds rate during its June meeting, with September now the more likely time when rates will be decreased by 25 basis points. The Fed should soon announce an adjustment to its balance sheet reduction program, which slows the rate of runoff of Treasurys and mortgage-backed securities. While this adjustment could be viewed as a form of monetary ease, it is primarily meant to assure the provision of broader liquidity to the economy and markets.
- Central banks in Europe appear to be better positioned to provide more immediate policy support through rate cuts, as inflation is generally falling faster. The Swiss National Bank has already reduced its benchmark rate, and the European Central Bank should begin to lower rates at its June meeting. They will likely exercise caution about moving too far ahead of the Fed, as it would provoke unintended currency weakness that could lead to a revival of inflationary concerns.
- The Bank of Japan (BOJ) has finally exited negative interest rates but remains incredibly accommodative compared to any other developed market central bank. The Japanese government is growing more uncomfortable with the resulting magnitude of Japanese yen depreciation and has discussed intervening in the currency markets. With the economy expected to be rather stagnant over the coming quarters, the BOJ will likely not tighten again until the end of the year.
- The People's Bank of China is balancing the need to stimulate a faltering economy with the desire to avoid a notable currency decline that could induce capital flight. It is likely to decrease rates only gradually over the coming months and may opt to use more targeted tools directed toward certain industries, such as housing.

Bond Markets

- Higher-than-expected inflation prints and weaker-than-anticipated demand in a few recent Treasury auctions has caused a shift up in the yield curve in a still-expansionary economic environment. Slower economic growth should prevent much further intermediate-term rate increases. However, the expected delay in Fed easing will put a floor on rates, so we would expect a rather tight trading range on the 10-year U.S. Treasury over the coming months.
- The Treasury yield curve may remain inverted for a while longer until the Fed is able to provide more clarity on when it will be able to decrease rates. The nearly two-year period of inversion has so far not led to the feared recession, but excessive Fed tightening into an already slowing economy is a growing risk to markets.
- The historically low level of interest rate spreads in the high-yield market is indicative of low default risk in a still-growing economy. Concerns around upcoming debt refinancings in a higher interest rate environment suggest caution in approaching this higher-risk fixed-income asset class.

Equity Markets

- Given the surprisingly strong first quarter performance of U.S. equities, investors expected a certain amount of consolidation. The recent decline in prices should prove temporary, as the rather strong first quarter earnings season should lead to even better year-over-year earnings growth comparisons for the three remaining quarters of 2024. Earnings growth will need to be the driver of any further equity advances, as valuations will be somewhat constrained in this elevated interest rate environment. Better earnings expectations should also lead to greater breadth of participation in this bull market, extending to the less expensive small- and mid-cap asset classes.

- The prospect of lower central bank policy rates and a pickup in economic growth can help drive multiple increases in the undervalued European equity markets. As these markets tend have more exposure to cyclical businesses than those in the United States, greater earnings momentum will be necessary to sustain any advance.
- The Japanese market has been one of the stronger developed markets year to date in local currency terms. As the stock price advance has been largely driven by the corporate beneficiaries of currency weakness, investors will be looking for proof these gains can be sustained and perhaps broadened in a more stable currency environment.
- Greater policy support and some surprising strength in export markets is attracting interest in the very cheap Chinese equity market. Even more aggressive monetary and fiscal policy initiatives are likely needed to extend any advance, as investors remain wary of the government's move away from free market principles.

Commodities and Currencies

- Despite heightened geopolitical risk in Eastern Europe and the Middle East, which has led to greater volatility, oil prices have not been able to sustain the upward momentum with which they began the year. Steady supply out of both the United States and OPEC and the lack of a notable spike in Chinese demand should keep prices contained barring any exogenous supply shock.
- The current level of global economic growth and the targeted stimulus policies of the Chinese government have led to a speculative spike in most of the industrial metals complex. It is difficult to foresee a continuation of this advance given the expectation of slower demand growth and anticipated greater supply of these price-sensitive commodities.
- Expectations that the Fed may keep rates at current levels for longer than initially anticipated should put a cap on gold prices, as attractive inflation-adjusted interest rates provide rather formidable competition to this nonyielding asset.
- Further delays in Fed easing should continue to be bullish for the U.S. dollar, as other global central banks appear much closer in moving to easier rate policies.

What This Means for Investors

- Investors expected a degree of consolidation of the strong equity market gains seen in the first quarter, and recent price action appears to be nothing more than a classic pullback/correction that occurs in bull markets. With economic growth slowing, but still positive, the disinflation trend should resume and allow the Fed to begin to ease policy in the fall. Bond yields are attractive at current levels, so extending the duration of fixed-income portfolios slightly should improve overall long-term portfolio returns.

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