What We Are Watching in 2024

GLOBAL MACROECONOMIC RESEARCH SERIES
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Key takeaways

- → Central banks may soon start to cut interest rates, but the timing, pace and amplitude of cuts will be a major determinant of asset prices in 2024. The gap between the Fed's outlook for interest rates and that of the markets has recently narrowed but questions remain about the timing and pace of cuts.

- → The US labor market will be a key factor in the Fed's decision-making process. The labor market has stayed strong, despite high interest rates and inflationary pressures. Low unemployment bodes well for earnings growth but could also keep inflation elevated.

- → Inflation remains above the Fed's target, and the path of inflation in the months ahead will likely be the largest determinant of the course the Fed pursues. The resiliency of the US consumer in the face of higher prices for goods, services, and credit will also play no small part.

- → Regional conflicts in the Ukraine and Middle East pose threats to global stability and supply chains. China's domestic woes, combined with growing tensions with the US, could likewise disrupt the economic tailwinds of falling inflation and policy rates in 2024.

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Overview

At the beginning of each year, we collect our thoughts at Meketa on what we think may shape the markets' performance as the year progresses. For 2024, we selected four themes that we believe may have the greatest impact on performance. Many of our themes are interconnected, as that is the nature of economics and financial markets.

First, we explore whether the bad news that markets feared in 2023 – recessions, layoffs, and deteriorating corporate earnings – will arrive in 2024. Second, we discuss the balancing act that the US is facing on multiple fronts, including the labor market, consumer behavior, and inflation. Third, we discuss the recent changes in market expectations for the path of policy interest rates and the questions that remain about the timing and pace of cuts. Fourth, we wrap up on a political note, focusing on the geopolitical risks we believe have the highest likelihood and/or most potential to impact investors.

To help us know where we are going, it helps to know where we have been. Hence, we set the stage by briefly reviewing 2023.

2023: Testing conventional thinking

Last year proved to be a humbling year for almost anyone charged with making economic projections.[1] Markets have anticipated an economic recession in the US since inflation proved to be more persistent than initially expected and it became clear the Federal Reserve was going to take aggressive actions to bring it back down.[2] In 2022 and 2023, the Fed implemented its most aggressive rate hiking cycle since the Volker period in the early 1980s. In the past, the Fed's rate hikes have often been followed by a pull-back in economic activity as the elevated cost of credit cooled business investment and bank lending.

Yet, even as rates rose from 0.25% to 5.5%, the US economy proved remarkably resilient. Real economic growth accelerated in 2023 (see Figure 1) and US unemployment remained low. The US economy grew above potential at an annualized rate of 3.3%,[3] primarily due to a strong labor market, fiscal spending, and leftover savings from pandemic-related stimulus. Indeed, many projections that were based on traditional business cycle analysis were found lacking between 2021 and 2023. For example, inflation did not decline as quickly as expected, demand for housing only increased, job openings have been much higher than the available number of workers, and economic growth and investment have surprised to the upside.

[1] Including ourselves and many professional economists. Source: New York Times, J. Smialek, "New Normal or No Normal: How Economists Got it Wront for three years, " October 13, 2023.

[2] Source: Bloomberg, R. Miller, "Fed Ditches 'Transitory' Tag, Paves Way for Rate Hike," November 21, 2021.

[3] Source: Bureau of Economic Analysis January 24, 2024.

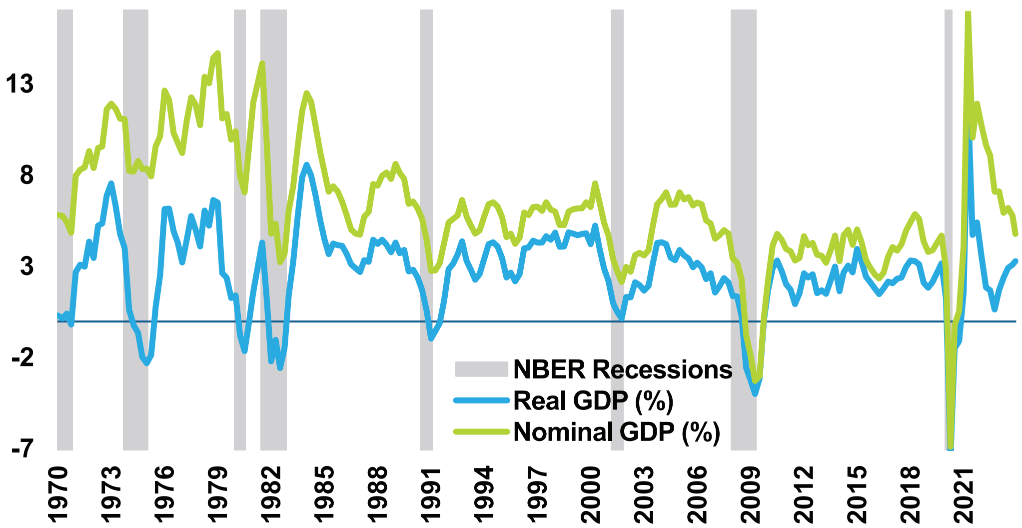

FIGURE 1
US Nominal & Real GDP 1973 to 2023 (% YoY)

Source: FRED as of October 2023. Bureau of Economic Analysis preliminary data for December 2023.

Given the fallibility of conventional wisdom over the past few years, we acknowledge that we are amid powerful crosscurrents in 2024. On the one hand, we see evidence in the US and beyond that inflationary pressures are weakening.[4] On the other, tight labor markets, the proliferation of regional conflicts, and US-China tensions could re-ignite inflationary pressures. Likewise global growth has been slowing, particularly in China. Despite this decline in growth, there are some bright spots with Mexico, India, and Japan emerging as new growth leaders.

1. Can the good news on growth, employment, and earnings continue?

In 2024 we will be watching if the Federal Reserve can manage a "soft landing" of the US economy.[5] A soft landing is when the Fed is able to sufficiently reduce inflation without increasing unemployment and turning growth negative.[6] The Fed is forecasting that the US will grow 1.4% in 2024.[7] That being said, some recession models still have the chance of a US recession at those of a coin flip.[8]

Often, as policy rates peak, inflation starts to fall due to the impact of the rate increases flowing through the economy and slowing demand. However, in this most recent cycle, the supply-side shocks of the pandemic that disrupted the supply of food, fuel, goods, and services were a large part of the spike in inflation. As these supply-chain bottlenecks eased, inflationary pressures also diminished.[9] Throughout this inflationary period, markets' long-run inflation expectations remained close to the Fed's inflation target of 2%. This expectation helped place an implicit cap on longer-term interest rates and bond yields. The inversion of the yield curve, where short-term interest rates are higher than long-term interest rates, persisted through 2023 and into 2024.

This inverted yield curve allowed governments and companies to issue longer-dated debt (or refinance existing debt) at lower rates than if they were issuing

4 Source: IMF, "World Economic Outlook," January 2024 and Federal Reserve, "Summary of Economic Projections," December 2023.

5 Source: Federal Reserve of St. Louis, " K. Engermann, ""A Soft Landing for the Economy : What it Means and What Data to Look at," October 11, 2023. The Fed was not able to tame inflation in the late 1970s and early 1980s without triggering economic recessions and raising unemployment.

6 Source: Federal Reserve of St. Louis, " K. Engermann, ""A Soft Landing for the Economy : What it Means and What Data to Look at," October 11, 2023.

7 Source: IMF, "World Economic Outlook," January 2024 has forecast US growth to be 1.5% in 2024. See also Federal Reserve, "Summary of Economic Projections," December 2023. Real GDP for US in 2024 range from 0.8% to 2.5%.

8 Source: Wall Street Journal, H. Troy et al., "A Recession is No Longer the Consensus," October 15, 2023. Wall Street Journal survey of economists estimate probability of recession below fifty percent. There are economists who have included a 'no landing' outcome where growth remains strong and labor markets are tight with falling inflation.

9 Source: Federal Reserve of Cleveland, M. Gordon, "Impacts of Supply Chain Disruption on Inflation," May 2023. European Central Bank, S. Tenreyo, "Monetary Policy in the Face of Supply Shocks: The Role of Inflation Expectations," June 26-28, 2023.

short-term debt. In addition, credit spreads tightened in 2023, thus lowering borrowing costs for some corporate issuers. At the start of 2024, US corporations issued a record amount of debt at an average yield of 5.44% for ten-year corporate bonds.[10] For now, credit markets have low levels of distress and narrow spreads.[11] The net result is that, rather than facing elevated borrowing costs in 2024, many companies may be able to issue longer-dated debt at attractive rates.

Like the resilient credit markets, the US labor market remains healthy, with forecasts for only slight increases in unemployment for 2024 and 2025 (e.g., the Fed is forecasting an unemployment rate of 4.1% for both years).[12] In 2022, the Fed forecasted that unemployment would rise in 2023 to 4.4%. Instead at year-end 2023 the unemployment rate was just 3.7%.[13] While the pace of job creation in the US slowed in 2023, the US economy still added a healthy 2.7 million jobs last year.[14] The current number of job openings (9.0 million) still exceeds the number of available workers (6.1 million).[15] Wage increases year-over-year have slowed from their peak of around 6% to 4.2%, but they are now positive in real terms.[16]

[10] Source: Bloomberg, C. Mutua, "US Corporate Bonds Sales Hit $188 Billion in January," January 29, 2024.

[11] Source: Federal Reserve of New York, "Corporate Bond Market Distress Index", January 31, 2024.

[12] Source: Federal Reserve, "Summary of Economic Projections," December 2023. Unemployment forecast 4.1% for 2024. In September 2022, the FOMC forecast unemployment to rise to 4.4% in 2023.

[13] Source: BLS as of January 2024. FOMC, "Summary of Economic Projections," September 2022.

[14] Source: Bureau of Labor Statistics, January 2024.

[15] Source: BLS, February 2024. In 2022 the US economy added 4.8 million jobs at an average monthly pace of 399,000.

[16] Source: Employment Cost Index, December 31, 2023.

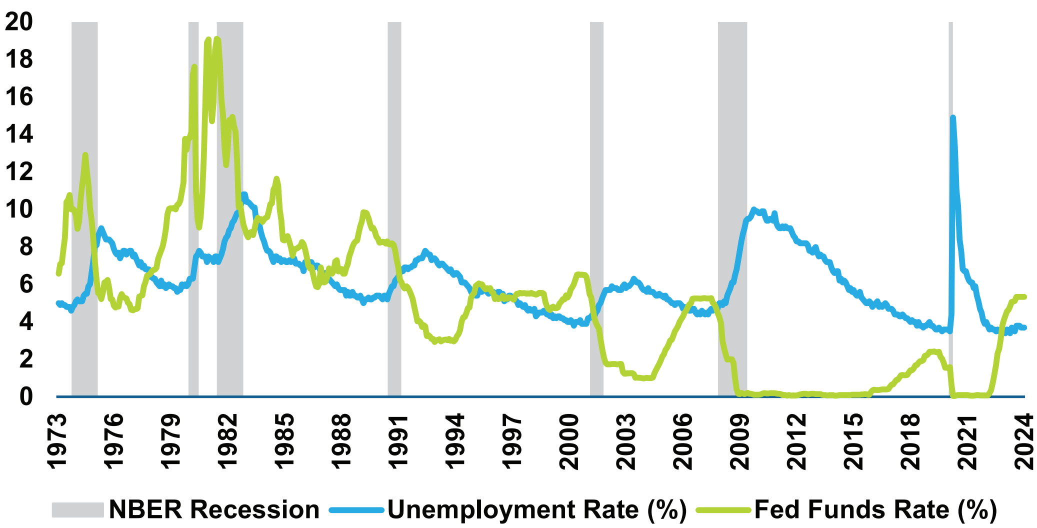

FIGURE 2

US Unemployment Rate & Fed Funds Rate 1973 - 2023 (%)

Source: FRED as of January 2024.

The prospects for corporate earnings are linked to all these factors. Higher borrowing costs cut into earnings, so lower rates would ease that burden. If economic growth continues to be better than expected, it will bode well for earnings growth. Finally, rising wages can cut both ways. Higher labor costs may dampen earnings, but full employment implies that the broad population will be in a better position to fuel growth.

2. Consumers versus inflation

Inflation, after surging during and after the global pandemic, has significantly declined from its peak in the US and other advanced economies. Inflation remains above the Fed's target though, largely driven by the "stickier"[17] services sectors. In January 2024, CPI was at 3.1%, well below its peak of 9.1% in June of

[17] Source: Federal Reserve Bank of Cleveland, M. Bryan, "Are Some Prices More Forward Looking than Others? We Think So"", May 19, 2010. Sticky prices are the prices for goods and services that do not respond quickly to aggregate demand. Medical care, personal services, insurance, and education are some examples of sticky-price services and goods. About 70% of headline CPI includes goods and services with another 30% of the index reflecting goods and services that change prices more quickly in response to consumer demand.

2022.[18] Core CPI, which strips out the volatile food and fuel components, finished the year at 3.9% and remains at that level at the start of this year but is down from a 6.6% peak.[19] Core inflation is higher than headline inflation, as price increases for parts of the services sector, particularly shelter, medical care, and auto insurance, remain elevated. In contrast, food prices were up just 2.6% and energy fell 4.6% for the same period. We will be watching the path of inflation closely on this (hopefully) final leg toward the Fed's target. We will pay particularly close attention to the stickier parts of the CPI basket.

[18] Source: Bureau of Labor Statistics as of February 13, 2024.

[19] Source: Bureau of Labor Statistics as of February 13, 2024. In January 2024, shelter costs accounted for two-thirds of inflation.

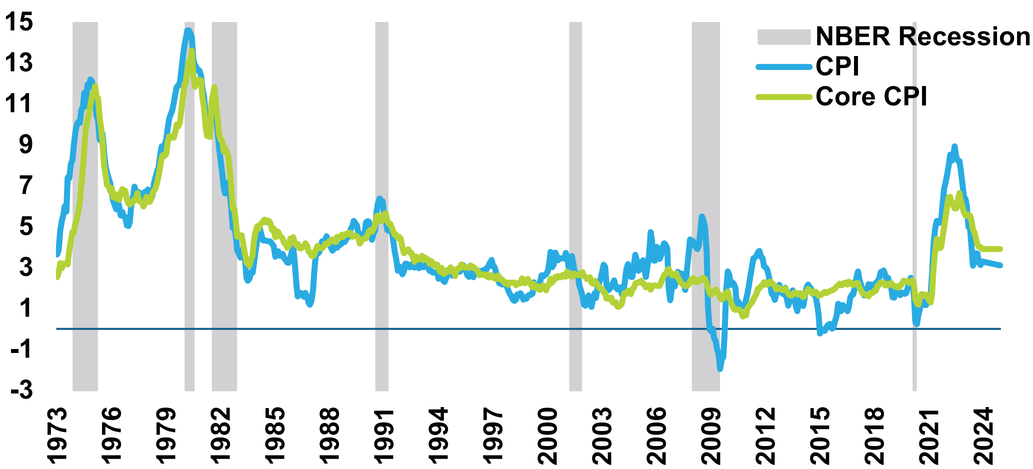

FIGURE 3
Headline & Core Inflation 1973-2023 (%)

Source: FRED as of February 13, 2024.

So far, the US consumer has weathered higher prices, increased borrowing costs, and fears of a potential recession. However, some pressures are building under the surface for the US consumer related to debt. Much of the savings that was accumulated during the pandemic has now been spent, and despite wage increases recently becoming positive in real terms, overall wage gains have not kept pace with inflation.[20] This has led to consumers turning to borrowing at a time of rapidly rising interest rates. Recently, total US consumer credit soared to over one trillion dollars, a record high, while the average interest rate on this debt also reached a record of over 20%.[21] This has not created a major strain on the consumer yet,[22] but that could rapidly change if economic growth slows, and the labor market weakens.

[20] Source: BLS, January 2024.

[21] Source: FRED, data.as of September 2023. Student loans reached $1.7 T dollars. Revolving consumer credit for all commercial banks was $1.0 T as of January 2024The Commercial Bank Interest Rate of Credit Card Plans reached 21.5% as of November 2023.

[22] Source: FRED, data as of September 2023. Household Debt Service Payments as a Percent of Disposable Personal Income is at pre-pandemic levels at 9.8%.

3. Uncertainty remains on the path of interest rates

The median of the Fed's dot plot forecasts a Fed Funds Rate of 4.6% by the end of 2024, while futures markets expect a similar rate of 4.5% by the end of the year (see Figure 4).[23] This is a recent change as previously there was a wide gap between the Fed's interest rate outlook and that of the market. Although both are now forecasting similar declines in interest rates this year, questions remain on the timing of rate of cuts. Market expectations are pricing the probability of an interest rate cut at just 50%-60% for many of the upcoming meetings. The timing of cuts and their magnitude could prove to be a key driver of results this year.

[23] Source: Federal Reserve, "Summary of Economic Projections," December 2023. The Fed dot plot shows the range of policy rate forecasts of each of the FOMC members where the mid-point is established. Observers can see the range for each forecast in a dot-plot layout where each dot is a voting member's forecast.

Market participants increased their bets late last year and into early this year on how many times the Fed would lower rates in 2024 from two all the way to seven. At peak rate-cutting enthusiasm, the timing of the first rate hike was expected to take place in March. Given strong economic data and recent Fed guidance, the number of cuts anticipated by the markets for 2024 has since been reduced to three or four, with the first cut now expected in the second half of 2024.[24]

[24] Source: Chicago Mercantile Exchange, February 27, 2024.

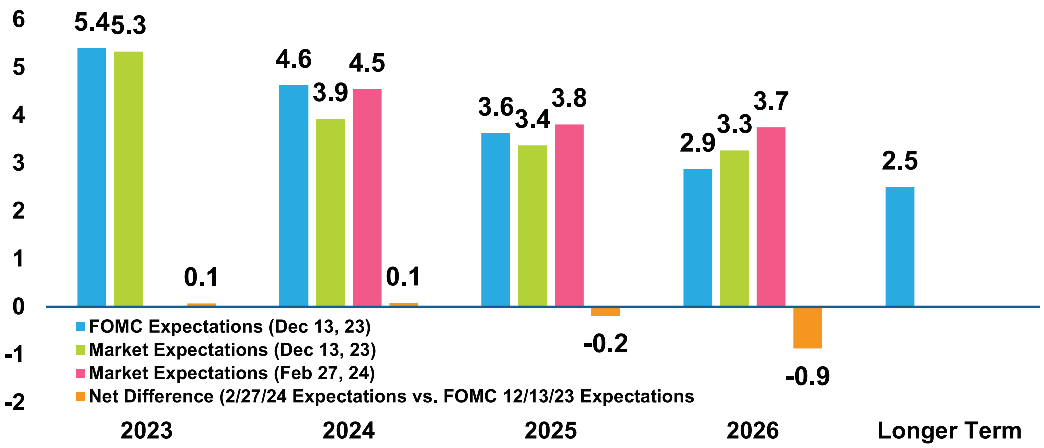

FIGURE 4
Market and FOMC Rate Projections

Source: Bloomberg as of February 27, 2024.

This year we will be closely watching key economic data releases for any clues to the path of Fed policy. If the Fed cuts interest rates at a faster pace than is currently expected, we could see further gains in risk assets. However, if the timing of cuts are further delayed or the magnitude of cuts is lower than expected, we see an asymmetric risk to the downside for risk assets, as this adjustment would likely be driven by continued strength in the labor market and inflation remaining elevated.

4. Geopolitical risks

China is one of the first countries we inspect on the world stage, given its economic and political heft, not to mention its rivalry with the US. China's geopolitical ambitions continue to worry its neighbors and the US. Tensions may escalate for any number of reasons, such as the US signaling support for the winning pro-independence party in Taiwan's recent election. While the re-election of Taiwan's ruling DPP party was expected, US-China strains have not subsided despite President Xi's visit to the US last summer.[25]

[25] Source: Center for Strategic and International Studies, B. Hart et al., "Taiwan's 2024 Elections: Results, and Implications," January 19, 2024. China has issued diplomatic communications to the US, Japan and the EU for sending delegations to Taiwan.

A proliferation of ongoing and latent regional conflicts has the potential to destabilize markets. The war in Ukraine continues to demand more military and financial support.[26] Hamas' attack on Israel and the response of the Israeli Defense Force in Gaza has placed Israel's allies in a difficult position. While Iran has denied involvement in the attack, the long-association between Iran and Hamas has prompted concerns regarding a resurgence of proxy wars. The pressure on global supply chains has risen considerably as Houthi rebels (another group considered to be a proxy force for Iran) attack NATO/Israeli allied ships in the Red Sea.[28] So far, the attacks have provoked the re-routing of at least $200 billion in cargo, adding over 10 days and 3,000 miles to the transport route.[27]

[26] Source: Financial Times, C. Miller, "Active Defence [sic]: How Ukraine Plans to Survive in 2024," January 18, 2024.

[27] Source: Council on Foreign Relations, N. Berman, "How Houthi Attack in the Red Sea Threaten Global Shipping, January 12, 2024.

China, with its own troubled domestic economy and real estate crisis, could continue to favor pro-nationalist policies over economic growth. Politically, China might try to thwart US multilateral efforts to restore peace in the Middle East and contain President Putin.[28] Foreign investors are pulling a record amount of capital out of China, making China's economic woes worse (see Figure 5).[29] Despite Chinese policy makers scrambling to restore investor confidence and battle deflation, public markets in China continue to decline.

[28] Source: Brookings, P. Kim, "The US-China Relationship is Stabilized but Precarious," January 12, 2024.

[29] Source: Peterson Institute for International Economics (PIIE), N. Lardy, "Foreign Direct Investment is Exiting China, New Data Show," November 17, 2023.

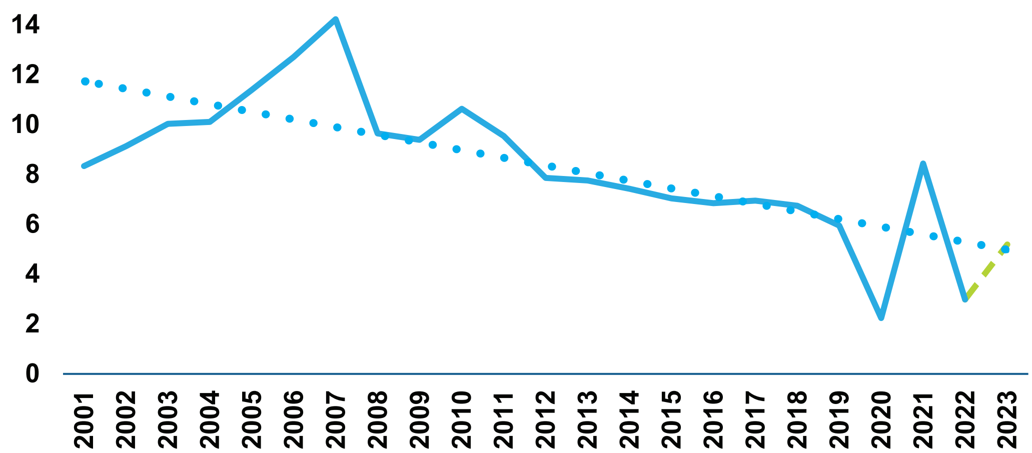

FIGURE 5
China Annual GDP (%)

Source: World Bank Data, January 2024. 2023 data from Premier Li's speech at Davos January 2024.

We will continue to evaluate these geopolitical concerns, with an eye toward their impact on inflation and growth. Increases in geopolitical conflicts could hamper supply chains and once again drive-up inflation. As the world's second largest economy, the health of the Chinese economy is important to many corporations and investors.

Summary

Falling inflation and policy rates could be a positive tailwind for asset prices in 2024, but the path forward is far from certain. Downside risks of recession, rising unemployment, and the downgrading of corporate earnings could emerge as headwinds for investors. Pockets of unexpected strength and resiliency could keep inflationary pressures elevated where strong labor markets and undaunted consumers keep upward pressure on wages and demand. Better than expected economic performance may keep central banks on pause as they consider rate cuts. Unpredictable geopolitical risks could, once again, disrupt supply chains and inflationary dynamics.

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