TierOne

World Economic and Market Outlook

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Summary

It is impossible to be definitive about how the economic cycle will play out. Conventional economic models have not been able to predict the continued strength in economic activity, especially in the States during 2023. A slowdown in the US economy in Q4 would now be the market surprise when a year ago this was the consensus view.

Although sentiment towards China remains very negative, the authorities still have plenty of levers to pull to ensure the economy does not collapse and China remains a very entrepreneurial society. It is worth remembering that a year ago there were two big consensus calls: the first was for a recession in the States and the second was forecasting a strong reopening economic boom in China. China remains a world leader in many technologically driven industries, especially electric vehicles and it remains well placed in fields ranging from AI to robotics. China has now surpassed Japan as the world's leading exporter of EVs. With anti-China sentiment so high any small mood change could see the market rally. The elephant in the room remains the property market which may well unravel further with land and home prices contracting at an annual rate of around 5%. There is some early evidence emerging from satellite observations of higher activity in September such as mall footfall.

There are both cyclical and structural elements to the current economic cycle. If it is "end cycle" then this is often a time when it is harder to implement correct policies with a risk of over tightening or easing too soon. This time around there are of course novel features from both the pandemic and Ukraine war and much heightened geo-political tensions resulting in de-globalisation. The Fed seem to expect the US to slow as the impact of pandemic handouts fades although capex from onshoring will continue to prolong the cycle. On balance it seems likely most central banks will err on the side of caution before changing stance. Structural elements have both inflationary effects: de-globalisation, defence, and demographics and deflationary ones: debt levels and digitisation.

In the short-term markets will be focused on the outlook for interest rates and the realisation that rates will remain high by post GFC standards for a long period of time. The oil price remains a threat to economic growth and falls in future levels of inflation in the developed world, and some emerging market economies such as India have always been vulnerable to oil price shocks. An upward move of over 30% since June in WTI and Brent crude is not something to be ignored and would favour US economic growth over that of Europe. Europe faces a double whammy of a weak currency versus the US$ in which

oil is priced and currency weakness, if it occurred, would put further pressure on the ECB on the interest rate front. At present the most recent language of President Lagarde is that rates, whilst not having to rise further, will be held until there is definitive evidence inflation is on its way back to the 2% target rate. Unlike the Fed, the ECB does not have a dual mandate and so is not focused on preserving full employment if inflation remains above mandated levels.

The Bank of Japan surprised the market in the past week by increasing rates, but it may be the end of the year before there is enough data to allow investors to have more certainty on whether the end of the negative rate regime is in sight.

There has been a fundamental shift away from ultra-low inflation world but the extent of regime change is still not certain. In the 70's and 80's, inflationary forces dominated markets but the 90s and 2000's saw disinflation boosting equity market valuations. Even today there are both disinflationary and inflationary forces at work over the longer-term, so it would be dangerous to be categoric about how inflation will evolve over the next decade. Markets have sold off in Q3. This is not due to significant declines in earnings estimates, but more due to pressure on valuation levels as real yields in particular in the States have risen over the quarter. The US, in particular, using conventional measures such as equity yields vs bond yields or the market PE vs real interest rates of over 2% looks expensive. But of course it has done so for a while.

We remain in an environment where investors need to proceed with a certain level of caution. Evidence emerging of a slowdown of sufficient magnitude that the Fed would change its stance would see a rally in both bonds and equities. The caveat on this would be if economic activity nosedived and it became apparent the Fed was not going to respond with market friendly measures. The 'goldilocks' type scenario would see lower bond yields and oil price, a retreat in the US$ and a corresponding rally in equities. For a definite move into a new bull market phase there needs to be clearer evidence that interest rates globally have peaked, and inflationary pressures will continue to ease, allowing scope for rate cuts of a meaningful nature especially if economic activity weakens, even if these do not start to occur until the back end of 2024 or 2025. Shorter term technical indicators have shown the US market at over sold levels with the RSI down at 30 (normal range 30-70).

Investors are still faced with an unusually wide scenario of potential end outcomes and for those looking to try and exploit short term volatility, buying the dips and selling the rips, watching a variety of sentiment indicators, is perhaps the way forward. This remains an environment where going all in on any one style or market carries high

levels of risk as market sentiment can change quicker than most investors can reposition a portfolio.

Introduction

Markets have had a more challenging third quarter as investors realise the strength of the US economy and a so called "soft landing" would not lead to a rapid reversal in US Federal Reserve policy, meaning rates would stay elevated for a longer period of time than markets expected. Bond markets in particular re-priced at the longer end of the curve, as market participants realised that even when the Fed stopped raising rates cuts were not likely to follow quickly. For a good bit of the quarter, equity markets ignored the valuation impact of rising nominal and inflation linked (real) yields, but during the second part of the quarter came under pressure as bond yields rose close to the 4.5% level in 10 year debt in the States.

The US economy has remained robust with unemployment numbers still hovering around the 3.5% level despite interest rates being raised by 525bp since the Fed embarked on its monetary tightening. With inflation in the States falling (the recent rise in energy costs has yet to hit) the consumer has remained in fine fettle and service sector spending remains strong. Earlier perceptions that the US would be the first central bank to cut rates have evaporated this quarter and with the UK and European economies showing more signs of economic slowdown than the States, the US currency has seen strong gains during the third quarter. This has also provided challenges to the emerging market universe, although other fundamentals within the developing world by and large remain positive. China is a separate story and will be discussed later.

Within the Eurozone, a majority of businesses have reported falls in activity over the last couple of months including a decline in new orders, with the latest Purchasing Managers Index hovering around 47%, well below the key 50 mark which differentiates between growth and contraction. There have now been four successive monthly decreases in new orders with manufacturing demand continuing to fall and now signs of softness in the service sector in many countries. A more difficult economic outlook in Europe has resulted in the Euro falling versus the Dollar and whilst lower levels of economic activity should be a positive for inflation, currency weakness, especially at a time of oil price strength (with that commodity priced in US$) there

remains a risk of inflation remaining stubbornly strong despite economic growth forecasts likely to be downgraded. The ECB have indicated that the current 4% interest rate may not need to be raised further but is likely to be held at this level until there are clear signs inflation is falling back to the 2% level. Germany has suffered from the overall weakness in global manufacturing activity and seems especially impacted by the slowdown in China. The UK economy has shown an even sharper drop in activity, with the latest PMI number expected to decline to below the 47 level. Some companies are now facing a margin squeeze as wages and fuel costs rise, but it has become more difficult to raise output prices.

US Federal Reserve

The third week of September saw the latest US central bank meeting and the Federal Reserve commentary and changes to the SEP (Summary of Economic Projections) showed the Fed remained absolutely committed to returning inflation to the 2% level. The Fed announced policy rates were being left unchanged at this meeting, but a majority of participants are forecasting an additional increase in rates before the year end. For the past 18 months Fed Chair Jay Powell has been unrelenting in explaining that the Fed believe a 2% inflation rate is a level compatible with maximising employment and growth over a full economic cycle and that reducing inflation from current levels is likely to require a period of below trend growth and some softening of labour market conditions.

Powell emphasised during the press conference that the SEP was not a plan by voting members, but an accumulation of individual forecasts from 19 people on a particular day. Economic activity in the labour market has remained stronger than the US central bank had expected and as a result growth forecasts were revised up and the Fed do not see a return to the 2% inflation target until around 2026. As usual Chair Powell was very frank during media questions, but the Fed could not definitively say what the neutral rate of interest was in the post Covid/Ukraine world, but it was possible it was now higher than before. The Federal Reserve continue to believe that a soft landing is possible but recognise this is not easy to deliver. To date the economy has seen some level of slowdown without a negative impact on levels of employment. The Fed clearly want time to assess further economic data and there are also a number of short-term issues which could affect US economic growth including the car worker strike, a potential government shut down, the resumption of student loan payments, higher long-term interest rates and the recent rise in the oil price. Powell was very up front about the difficulties of forecasting in an

economic environment which has not been seen for many years where there has been supply side shocks cause by Covid and Ukraine.

While the comments of the Fed Chair were consistent with their belief that a 2% inflation target will be achieved, markets had hoped for signs that there would be rapid relief from high borrowing costs when inflation started to pull back. Whilst Chair Powell did not rule out rate cuts if inflation was on a clear downward tack, in other words ensuring real rates did not increase further, the dot plot of individual interest rate estimates released in the SEP showed officials now see a slower path of rate cuts in 2024 and 2025 and if the US economy remains strong, interest rate cuts could be a number of years away. Market participants now believe by 2026 the Fed Fund's rate will still be 3% which is above previous estimates of the neutral US rate of interest. As long as growth remains robust there remains a risk that inflation does not make a rapid return to the 2% level, with the targeted level not be achieved for a number of years. The latest core Personal Consumption Expenditure price index stands around 4.2% at the core level.

US Economy Defies Expectations

The US economy is now estimated to have grown by around 3% in the third quarter despite significantly higher interest rates. Tighter monetary policy has been offset by big spending ($8tn) by the Biden administration, a buoyant consumer who has seen strong wage growth and until August falling fuel prices at the pump ($5.5 to under $4), together with the AI investment boom. American consumers since the 2008 downturn have both reduced debt and locked in low rates on mortgages. The average mortgage holder is still paying only 3.6%! Many consumers were still flush with stimulus cash at the start of 2023. The suspension of the student loan payments put around $8bn in the pockets of the young and this program only ends shortly. Relief cheques had helped the consumer build up savings. The level of excess savings had been estimated at $2.1tn at the end of 2020 and whilst this has been run down to around one third of this level helps explain why the US economy has continued to outstrip its peers. Biden's new industrial policy subsidising US companies to compete with China has resulted in increased levels of corporate capex and since late 2022 when Chat GPT was launched the tech sector has rallied by close to 40% making shareholders feel wealthier. As these effects wear off the economy will face stronger headwinds and the huge amount of monetary tightening may have a greater impact, but the dynamism of US corporates has confounded the doomsters for many years.

Economic Modelling

Economic models have struggled to forecast reliably in the post Covid/Ukraine war environment and the views of investment banks are even hugely split as to where the States is in the economic cycle. For example, Bank of America believe that this is the early stage of an economic upswing, whilst Morgan Stanley believe that the US is a late cycle economy. Powell himself stated that it was unprecedented that the labour market could remain resilient after 525bp of interest rate increases, so clearly conventional economic models are struggling to understand what is happening in the real world. It does seem certain that the economy is now in a new regime of higher rates, and this is impacting on equity market valuations globally. While economic activity is weakening in the Eurozone and the UK, central banks there may be precluded from cutting rates for fear of further currency weakness which would keep inflation above target rates. Europe and the UK remain more vulnerable than the States to the impact of higher energy costs with the oil price now having risen 30% plus from its June lows. The global environment remains one where supply side shocks are causing difficulties and it is much harder for central banks to formulate policies to combat this effectively. For much of the past 25 years, bonds and equities have been negatively correlated which has made achieving portfolio diversification relatively straightforward, but as we have seen during 2022 and once again over this quarter in periods of rising inflation concerns, bonds and equities become positively correlated, making portfolio construction challenging.

Japan

In the third week of September the Bank of Japan Governor Ueda once again surprised the markets by stating he had “yet to foresee” inflation settling at the target level of 2%, which once again meant market expectations that the central bank was close to ending its ultra loose monetary policy stance were confounded which sent the Yen tumbling. Japan continues to have the world’s only negative interest rates and the comments on inflation surprised the market as consumer price growth has now exceeded the 2% target for 17 straight months with core inflation around 4.3% in August. A huge interest rate differential between the States and Japan has naturally weighed on the exchange rate with the Yen declining significantly over the past 24 months. Japan has also not made any adjustments to its yield curve control

policy (YCC) in 2023. Persistent currency weakness has had a significant effect on stock and sector performance in Japan with

domestic businesses previously viewed as high quality, often having some input costs in overseas currencies and do not benefit from a weakening currency either through exports or currency translation from overseas subsidiaries. Many of the stocks heavily exposed to movements in the Yen Dollar rate are cyclicals and as a result value stocks have continued to outperform this year in Japan.

Portfolio Challenges

August/September proved a challenging month for many multi asset portfolios due to the positive correlation between bonds and equities in a rising rate environment where concerns over inflation have driven market moves. The May through July period saw equities rally despite bond yields edging up as optimism mounted over the ability of the US Federal Reserve to engineer a soft landing. In other words economic growth expectations improved despite rising rates.

Since August bond markets have continued to remain under pressure but the last four weeks have seen equities also pull back as higher levels of both nominal and real bond yields weighed on equity market valuations. To date, the pull back in equities has not been, in the main, driven by concerns over economic growth or falling profitability, although higher rates have led to some investors worrying that this year’s recession is merely postponed until 2024.

At the start of 2023, Investors expected equity markets to suffer from the consensus view of an impending recession, despite the fact that in the States economists have not forecast a single US recession since records began in 1970. At the back end of 2022 economic forecasters, as a group, gave a probability of a recession in the States at 60% but as John Maynard Keynes once warned, “The inevitable never happens. It is the unexpected always”. As a result, investor positioning in equities at the start of 2023 was relatively cautious and as economic growth and therefore corporate profitability held u, conditions were favourable for a rally in equity markets in the first half.

Since early to mid-August, asset markets across the world have been impacted by the rise in real bond yields in the States and higher nominal yields, together with some level of yield curve dis-inversion or

moderate bear steepening, as investors realised that the term premium on longer dated bonds (which was negative at the time versus cash rates) was dependent on early rate cuts which no longer looked likely to occur. The US currency has benefited from the relative resilience of US economic activity, together with a rise in oil prices, with the US the only major western economy in a position of an energy surplus.

Potential Outcomes

There remain three potential outcomes for both the US economy in particular and the world in general.

The most positive outcome would be the so-called soft landing, although markets began to realise in August that even this had some level of downside as with employment remaining strong there was no pressure on the US Federal Reserve to rapidly reverse course and cut interest rates-certainly not while inflation at the core level remains persistently and significantly above its 2% target rate.

For the moment the US still seems to be in a low no landing regime, or in other words a 'growthflation' environment with, in particular, non-housing service sector inflation not pulling back significantly. Wage rises are not compatible with a 2% inflation target if persisting at current levels.

The third outcome a significant economic slowdown/recession would not be positive for equities but would favour government bonds initially. The medium-term response from equity markets would depend on how rapidly the Fed cut rates in a slowdown with inflation for now above target. Markets have concerns that while the US is currently seeing 'no landing' the cumulative effects of monetary tightening will kick in all at once in 2024 and explains the underperformance of broader US equity indices vs the tech mega caps in recent weeks.

The impact of the US election with the leading Republican candidate facing the threat of jail makes forecasting market implications even more difficult than usual.

The rise in the oil price from its June levels of over 30% does present challenges to the global economy and will clearly benefit some countries at the expense of others. In the emerging world the Middle Eastern stock markets are likely to be beneficiaries of the higher price of oil, whilst the US remains well positioned compared to the UK and Europe. Within Asia, India has at times shown vulnerability to oil price

moves, especially if it exerts pressure on either the current account or fiscal deficit.

The third quarter has seen US equities perform well in a relative sense and overseas investors have benefitted from the stronger currency. The US has continued to see improvements in its supply side as the economy has learned to live with the post Covid/Ukraine war shocks. Most commodity prices fell during the first six months of the year and in the third quarter it has been oil that has rallied the most. The US has seen rising labour force participation and Fed Chair Powell commented that the mismatch between unemployed workers and unfilled vacancies had improved. He also commented on the repair to the global supply chain which was helping push down certain elements of inflation. Overall, economic activity has held up in the States while China, the EU and UK have seen disappointing data indicating economic slowdown. The Atlanta Fed GDP Now projection (the equivalent of a Nowcast forecast) for the quarter remains in excess of 5% and the Atlanta Fed wage trackers continues to show increases in compensation coming in around the 5% level.

Oil-How High?

The oil price has rallied significantly and was further boosted when the Saudis indicated they had no intentions of ending their temporary production cuts, all the time egged on by Russia. These two leading producers may well have targeted a $100 oil price. If oil reached this level, it would represent a significant supply side deterioration to the global economy and would weigh on risk assets as fears of 2024 slowdown increased.

China

China continues to see pressure on its growth rate with the real estate sector clearly seeing some levels of stress. More policy support from the government over time is likely, although the authorities in China will be unwilling to go down the route of using excessive leverage to boost economic growth. The leadership under Xi may well believe that it is better for the country to see some level of hardship now than continue relying on fiscal stimulus to deliver economic support if it is wasteful over the longer term. Xi seems focused on building up industries which are of strategic importance to China.

Eurozone

The EU has continued to see a further deterioration in economic activity and Germany as a manufacturing powerhouse has been hit by the move in global consumer spending towards services, together with the slowdown in the Chinese economy. Some European countries are now seeing more evidence of a slowdown in the service sector too, although of the major economies in the Eurozone Germany is the only one likely to fall into recession in 2023. Europe also of course benefitted from a relatively mild winter and there is no guarantee that this will be repeated.

Market Implications

The main positive for markets in the first part of the third quarter was the continued decline in reported inflation numbers. Optimists would argue the US will continue to see supply side improvements, including potential in higher levels of productivity and further increases in the labour force participation rate to maintain downward pressure on inflation which would allow the Fed to ease policy to a limited degree if only to maintain the current level of real interest rates.

How stock markets progress over the next 12 months will depend on how markets perceive firstly the possibilities and then the eventual economic outcome delivered. In the early part of the rate tightening cycle, markets were focused and split between the possibilities of a soft or hard landing, although today a third scenario has evolved which can be described as no landing or ‘growthflation’. This is particularly applicable to the United States today. Over the last quarter it has become apparent that different regions of the world may well behave in a very different manner with growth in the States proving far more resilient than is the case in Europe or the UK, while China has seen its economy deliver a very tepid post Covid recovery due to weakness in the property market, high levels of youth unemployment and a significant slowdown in manufacturing activity as consumer demand has shifted away from goods to services. These potential outcomes have not only reflected themselves in stock market movements, but also, or perhaps especially, in the currency markets. A year ago, most commentators expected a peak Dollar environment to soon emerge, but the relative strength of the US consumer has resulted in shifts in interest rate expectations favouring the US currency.

Markets today focus on short term news and often extrapolate this forward, so the eventual outcome of this economic cycle may be different from what the market expects in three months' time. During the early summer months, the market seemed to be pricing in a soft landing. Most investors definition of a soft landing is one where the labour market softens but without significantly increasing the unemployment rate, but as workers and job vacancies come into balance wage growth pressures moderate and inflation heads back towards the Fed's 2% target. As inflation declined the Fed would be able to reduce nominal interest rates to maintain the same level of real rates. Without stress in the labour market the US Fed would likely not be pressured to cut interest rates, so term premiums on longer dated bonds would increase. Without corporate profitability coming under serious stress the main constraints on upward progress in the markets would be the relative valuation of equities versus government debt.

Investors' fears of a hard landing, certainly in 2023 have disappeared, although some still feel the level of interest rate rises will have a sudden and sharp effect on US economic activity at some stage. If corporates felt a recession was looming, the decline in business confidence would result in reductions to the cost base and a knock on impact on consumer confidence which rising levels of unemployment would accentuate. Unemployment, still hovering close to the 3.5% level, if increasing sharply to 5.5% or 6%, would likely see abrupt change in US monetary policy while equities would see a sharp retreat.

The third possibility is one which most commentators did not acknowledge as a potential outcome a year ago which is one where growth and inflation stay above historic levels and has been variously described as no landing or 'growthflation'. This would see GDP growth continuing to run above trend and inflation remaining well above the 2% level, in part driven by strong wage inflation due to continued strength in the labour market. In this scenario, core inflation would stay stubbornly above the 3% level, well ahead of the Fed's target and would see further increases in the Fed fund's rate, which would impact negatively on longer dated government bond yields.

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