Ten Second Into The Future 2024

Inflation has dominated investors’ attention since 2021. In 2023, core inflation cooled from 6.6% to 4.0%, a significant move yet well above the 2.0% target of the Federal Reserve. Meanwhile, the Fed raised rates 4 times from 4.50% to 5.50% and while it signaled that market expectations for rate cuts in 2024 might be premature, investors had begun to place bets on such rate cuts and bought up equities. Equities (MSCI World) are up almost 18% while bonds (Global Aggregate) are up almost 2% with a month to go to the year end.

At the end of 2022, we made some predictions as to what the economy would look like not just in 2023 but into the future. In summary, they were:

- Inflation would be structurally higher.
- Economic growth would be structurally higher.
- Such economic growth would be more inclusive and of higher quality.

See: Ten Seconds Into The Future 2023 Outlook for details.

We still hold these views. Let’s reiterate the reasons why.

- Inflation will be structurally higher:
  - China demographic dividend fading.
  - Near-shoring is less efficient than specialisation and trade.
  - Climate crisis mitigation and adaptation investment.

- Economic growth will be structurally higher and more inclusive.
    - Constrained monetary policy and increasing expansionary fiscal policy.
    - Net transfers from rich to poor, from capital to labour, from corporates to households.
    - Less inequality leads to lower savings rates and more consumption.

These are long term dynamics. In the shorter term the picture is complicated.

Recession

In 2023/2024, we may already be experiencing recession. However, as investment in near-shoring and climate crisis mitigation accelerates, national income accounts are flattered even as some segments, such as manufacturing, fall into recession. Europe is most vulnerable to tight monetary policy and is already in recession. The US is also in a manufacturing recession with non-manufacturing just hanging on to expansion. China’s economy is suffering from a property bust which threatens financial contagion and has already substantially dampened consumer and business sentiment. India is a bright spot among the larger economies and continues to show expansion in services and manufacturing.

Interest Rates

Going purely on the economics, we expect interest rates to rise.

- Inflation to settle at a higher equilibrium level.
- Fiscal policy to remain expansionary.
- Increased demand for capital from investment from supply chain near-shoring and climate crisis mitigation.

However, one has to consider the consequences of simply holding rates where they are.

- Recession already underway.
- Cost of debt has yet to increase as corporates have termed out liabilities.

Regionally.

- Europe. The ECB is likely to have to begin cutting rates sooner than the US Federal Reserve. Financial conditions are already tight, inflation is falling due to recession and the economy is less robust and able to withstand higher debt costs.
- The US economy is more robust against higher debt costs with less reliance on bank funding.

Bottom Line.

There are a couple of moving parts to this, inflation and the term premium. Currently, yield curves are still inverted albeit less than they were a year ago. 2 year UST rates are 4.60% with CPI at 3.20% for a real rate of 1.40%. Assuming inflation is sticky at 3.20% and a reasonable real 2Y UST rate of 1.00%, this suggests the nominal 2Y could trade to 4.20%.

If the 10 year UST trades 0.50% higher than the 2 year, that implies a nominal 10 year rate of 4.70%. (It trades at 4.25% today).

2 year bund rates are 2.70% with Euro CPI at 2.90% for a real rate of -0.20%. The market has surely moved ahead of the ECB and brought real rates back into negative territory. This could stay the hand of the ECB from any rate cut expectations in 2024. Assuming inflation settles into the 2.20% range (job done for the ECB), and a reasonable real 2Y bund rate of -0.60%, this suggests the nominal 2Y bund could trade at

1.60%. Assuming a 2-10 spread of 0.25% puts the 10 year bund at 1.85%. (It trades at 2.36% today).

Equities

The S&P500 has returned 10.8% per annum since 1970, 11.6% since 1980, 10.2% since 1990, 7.1% since 2000, 13.2% since 2010. US equity valuations are high relative to history. It is reasonable to expect that returns will be lower from here on for the next 10 years; we expect 5%-7% is a reasonable range, all things being equal. Much depends on the path of interest rates discussed above. If rates play out as above, equity returns while modest can be sustained. If rates rise beyond the above then expect equity returns to be lower and more volatile. If, however, rates moderate further, then equity returns could be higher.

Credit

Credit spreads are thin and do not appear to be pricing economic fundamentals. This can change quickly as markets tend to overreact to noise as much as signal. There is a persistent complexity premium to be earned in markets like structured credit and securitisation, and strategies like solution capital and distress. It’s also an interesting landscape for investors who can trade the evolution of relative value between credit sub-markets. The long only buy and hold, or more accurately buy and hope strategy is going to be fraught.

Duration is another area of macro risk exposure that is sometimes ignored as investors hug benchmarks for comfort. Duration will be a tricky bet this year for a number of reasons. One, while inflation may be receding, central banks are unsure if this is durable or transitory. The focus on duration in the last two years have led markets to second guess central banks leading to overreactions to central bank signals. Central banks are increasingly high frequency data dependent which in turn leads to confusing signalling to the market. And finally, the complexity of the economy and financial plumbing make modelling and policy highly uncertain.