Outlook 2024

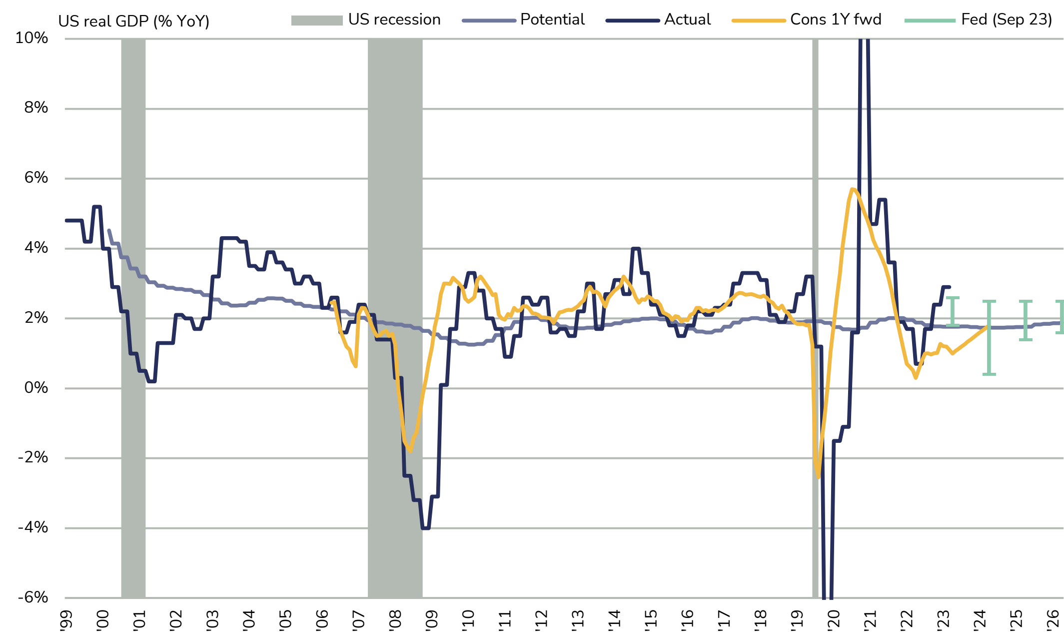
Macro

11 December 2023

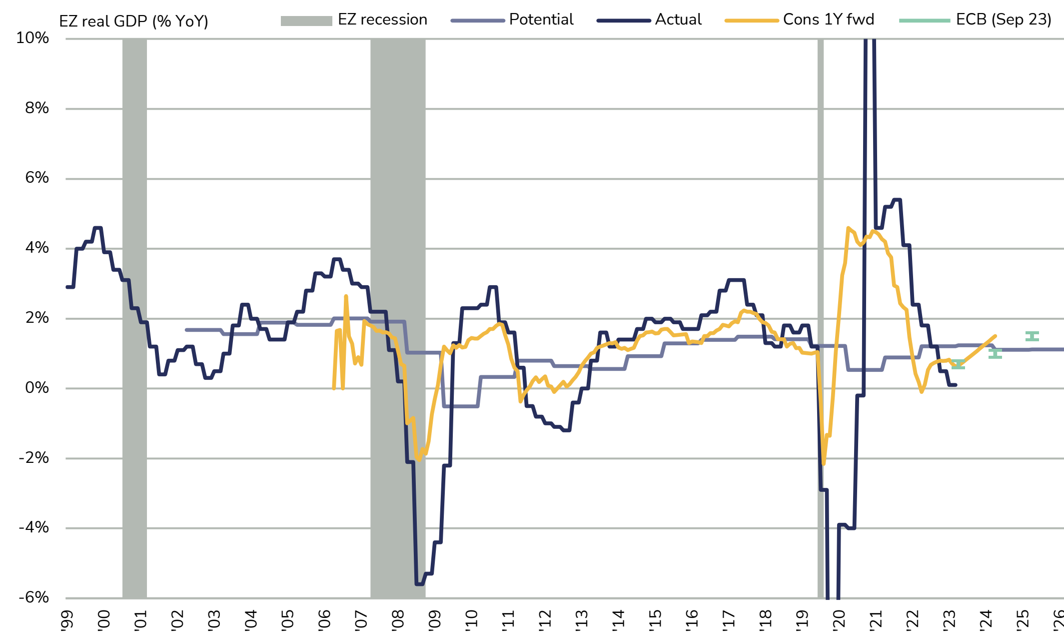
SIGNET

Economic growth in the US and the Eurozone
Ocean between us

1. Surprisingly strong US GDP growth may normalize in '24.



2. Eurozone economic growth may stay below potential levels in '24 and '25.



US economy

Positive real GDP growth close to long-term potential level.

- The US economy has proved its status as a global economic growth locomotive once again. After a single digit COVID drawdown in 2Q20 (-7.5% YoY, here and after — real GDP), US GDP crossed its high watermark by 3Q21 and has since expanded another 7.2%.
- In 2Q23, the US economy has likely seen its local trough. We can see acceleration of major economic indicators — led by business activity and orders — since then. And the aggregate real GDP numbers have positively surprised investors in 2Q23 and 3Q23.
- The Bloomberg consensus forecast for real US GDP growth in 2024 is 1.2%. The Fed's range is 0.4—2.5% (**fig. 1**). We believe that it is more likely that the US economy will surprise on the upside, especially due to potentially higher consumer consumption and elevated business activity in the high-tech space. Our base case scenario is real GDP growth in the range of 1.5—2.5% (4Q23 YoY).

Eurozone economy

Sluggish, but positive real GDP growth below long-term potential level.

- The Eurozone economy recovered broadly in line with the global economy in 2021—2022 (+9.5% vs +10%). However, 2023 was a very challenging year: anemic growth of around 0.5% is the most probable outcome (latest reading of 3Q23 is 0.1% YoY, **fig. 2**).
- The main reasons for such underperformance were a substantial rise in interest rates (ECB key rate 4.5% vs 2.5% in 4Q23 and '22), which dampened consumer spending and investments, and lower export potential with stronger EURUSD (+2.7% year average YoY) and muted China activity.
- We think that normalization of inflation may allow the ECB to change its hawkish stance in 2024, thus providing some relief to the economy. European heavy industries (e.g. chemicals and utilities) seem to have found a trough in mid-2023 and may surprise on the upside. Nevertheless, European exposure to high-tech industries, a major driver of modern growth, remains low compared to the US. Our base case scenario is real GDP growth in the range of 0.0—1.0% (4Q23 YoY).

Charts source. (1) Bloomberg, Federal Reserve, US Bureau of Economic Analysis. (2) Bloomberg, ECB, Eurostat.

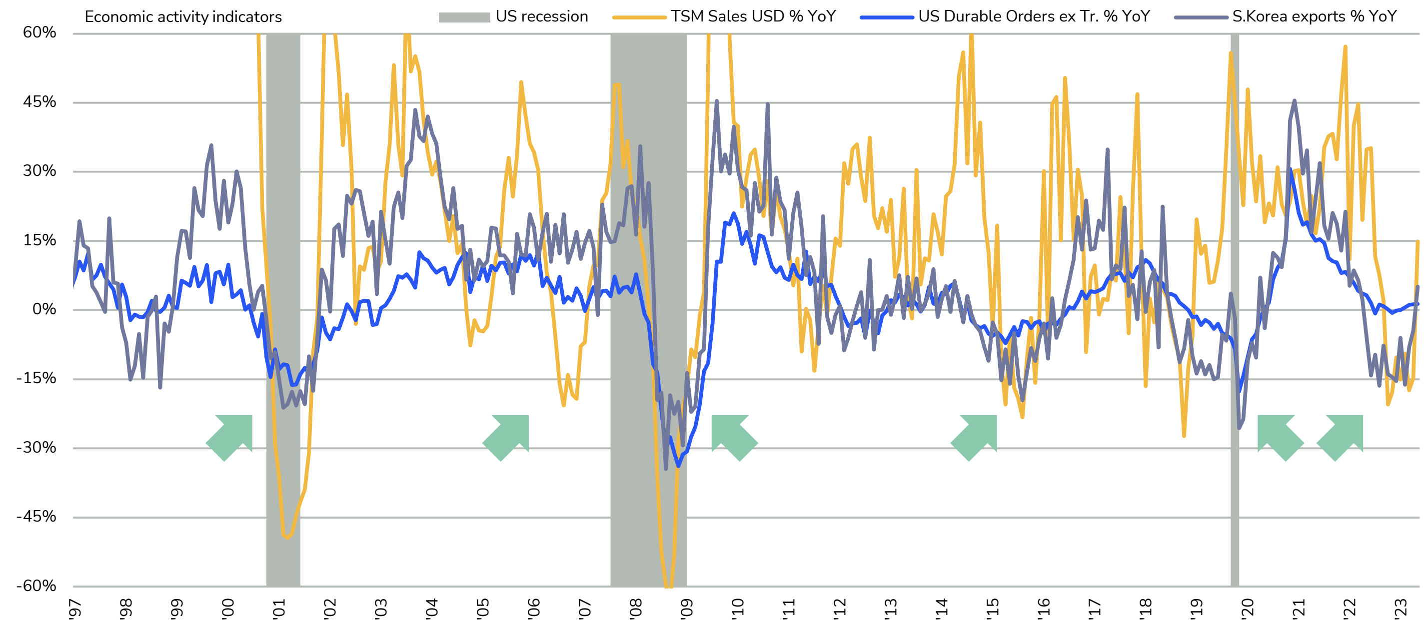
Global, US and Eurozone economic activity
Faster now

Global economic activity may accelerate in 2024

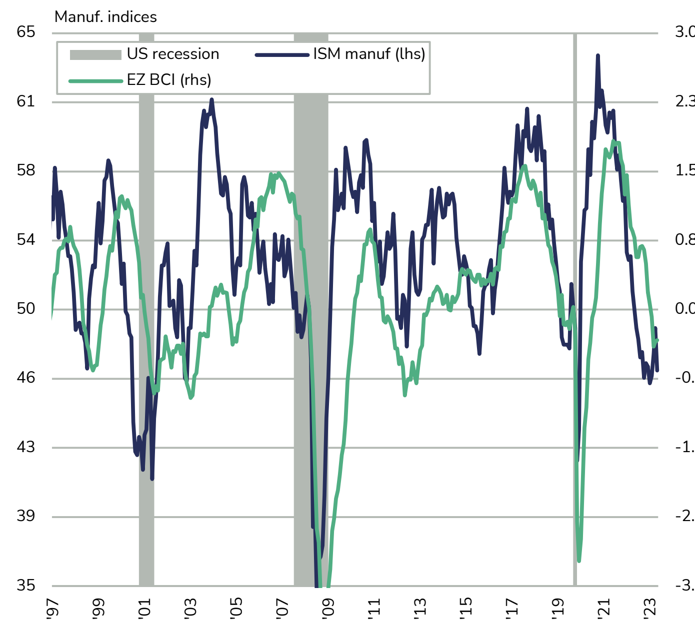
- The year of 2023 started with investors' concerns of about potential recession due to monetary tightening that started in 2H23. However, none of these risks have materialized.
- The global economy has digested high interest rates. None of the major economic powerhouses experienced problems with growth (except for Japan, which is in a league of its own), and we may have seen a local troughs for major economic indicators in mid-2023 and even some acceleration afterwards.
- Companies and countries heavily involved in semiconductor production posted inspiring results in 3Q23. Likewise, US durable goods orders may follow in early 2024 (**fig. 1**).
- The US business activity is usually ahead of the European by 1—2 quarters, both in pickup and slowdown (**fig. 2**). Manufacturing activity in the US has high chances to switch from recovery to expansion mode in 1H24.
- High share of high-tech industries in the US economy is probably the single most important reason for outperformance of the US equity market compared to the European. On the both sides of the Atlantic, high-tech industries have materially outperformed non-tech in terms of production over the last 30 years (**fig. 3**). While the relative tech outperformance in the EZ was 4.5% p.a. (Jan'91—Oct'23), the US posted a staggering 16% p.a. AI-related production and services will most likely give a boost to the global economy, and the US is much better prepared for that.

Charts source. (1) US Census Bureau, Ministry of Trade, Industry and Energy of South Korea, TSMC.(2) ISM, European Commission. (3) Federal Reserve, Eurostat.

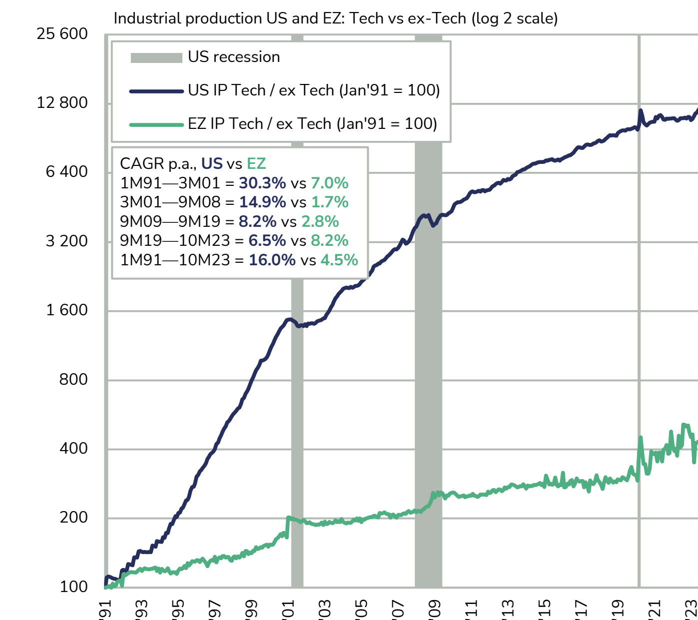
1. Multiple signs of acceleration of global economic activity.



2. US rebounds first, EZ likely to follow.



3. Big tech is eating non-tech.



Prices in the US and the Eurozone
The party is over

US economy

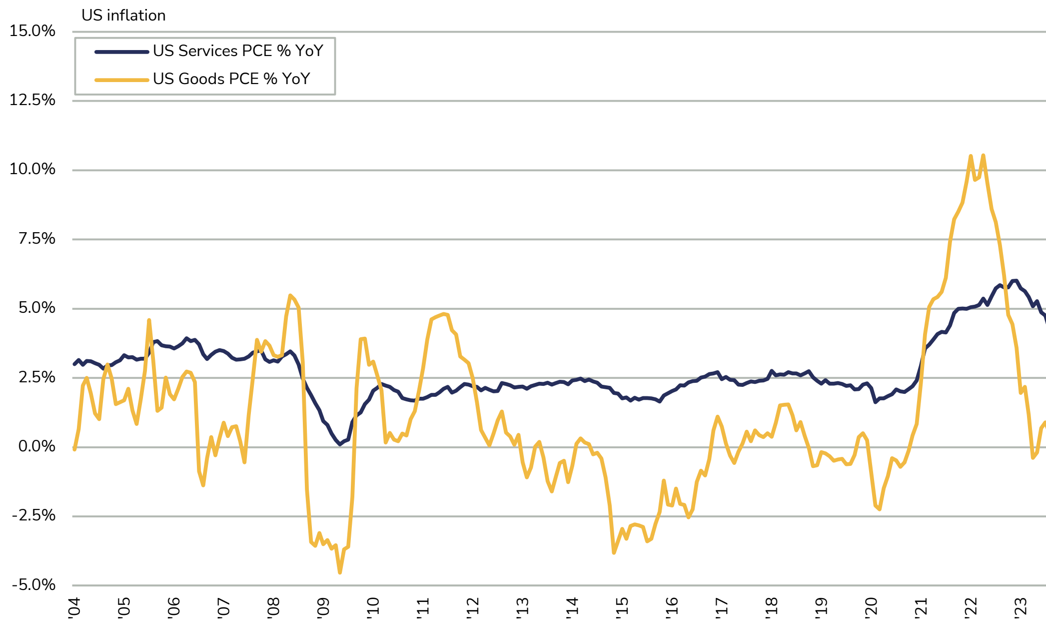
- Anti-COVID measures will be long remembered by investors. Unprecedented expansion of monetary and fiscal stimuli by major governments of the world aligned with economic shutdowns created a debacle in supply chains and triggered double-digit inflation.
- The open and flexible US economy has largely dodged this bullet. By the end of 1Q23 goods inflation was back to pre-COVID levels of c. 2% and by the end of 2023 it was flirting with the zero level (**fig. 1**). The more sticky services inflation touched local highs 8 months after the peak in the goods PCE YoY growth (Feb'23 vs Jun'22). We assume that US services inflation will fall from its current rate of 3.8% and reach normal levels of 2.5% by the 2Q23.
- Overall our view is that USD-based and global inflation should not be a major problem in 2024, of course, *ceteris paribus*.

Eurozone economy

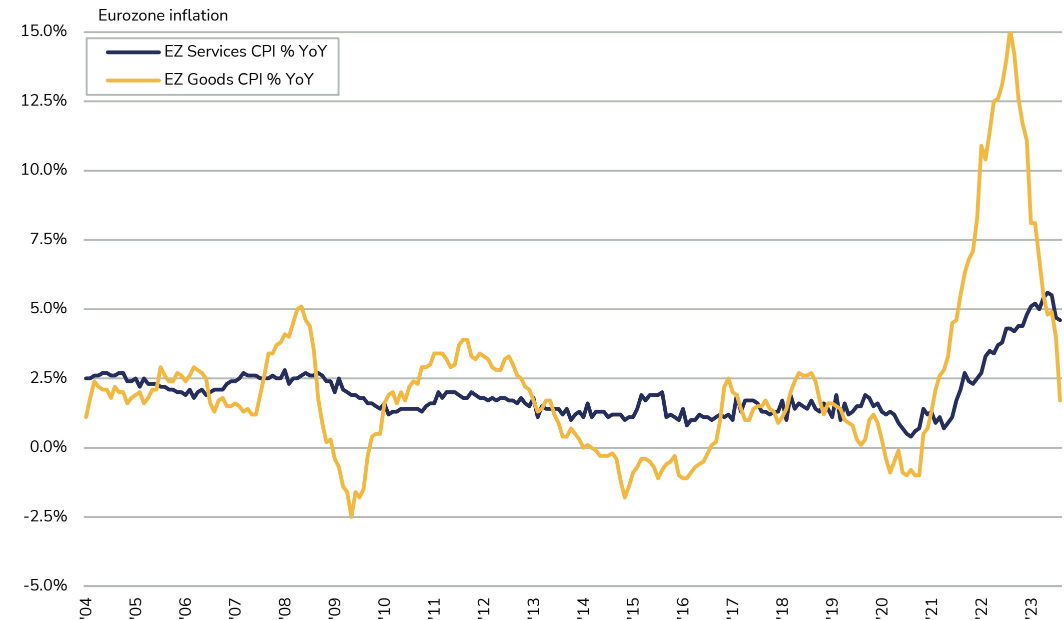
- We find that the ECB is currently is a lose-lose situation. Inflation is not yet back to normal levels (Oct'23 reading of 2.9% vs below 2% target), but the economy is on the brink of recession. Keeping high rates may deliver another blow to the economy, but lowering rates could trigger another round of price hikes.
- Though the Oct'23 reading of goods inflation (1.7%) is close to the long-term average of 1.5% (Mar'04—Dec'19), services inflation remains stubbornly high compared to pre-2020 levels (4.6% vs 1.8% respectively, **fig. 2**).
- We believe that it will take another full year for the EZ services prices to normalize. And this will most likely postpone early cutting of key rates by the ECB.

Charts source. (1) Bloomberg, Federal Reserve, US Bureau of Economic Analysis. (2) Bloomberg, ECB, Eurostat.

1. Goods inflation in US is back to normal, services will follow in 2024.



2. It may take another full year for EZ services inflation to normalize.

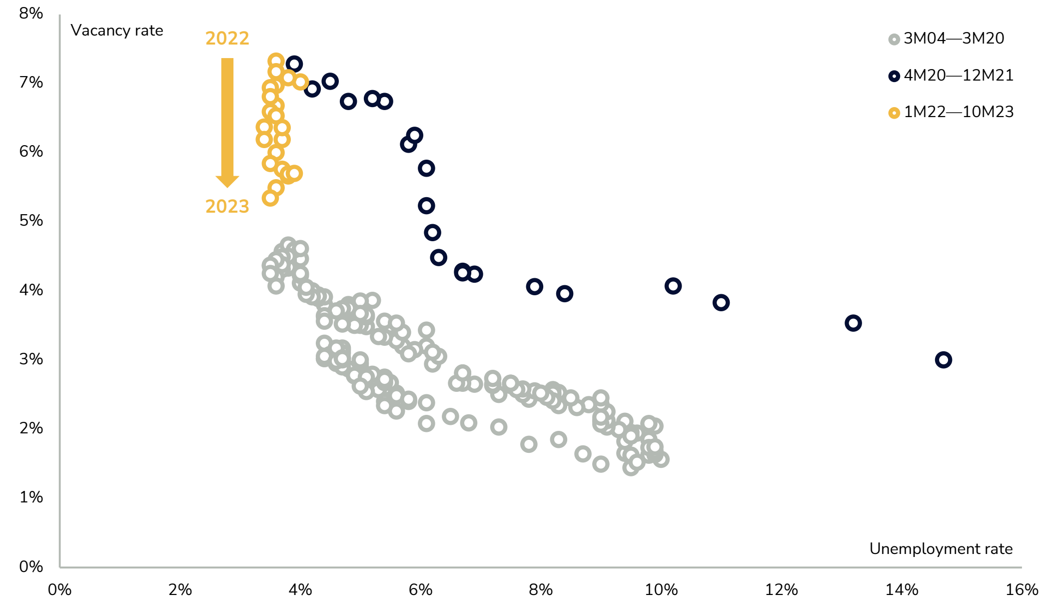


Employment in the US and the Eurozone
Back to the future work

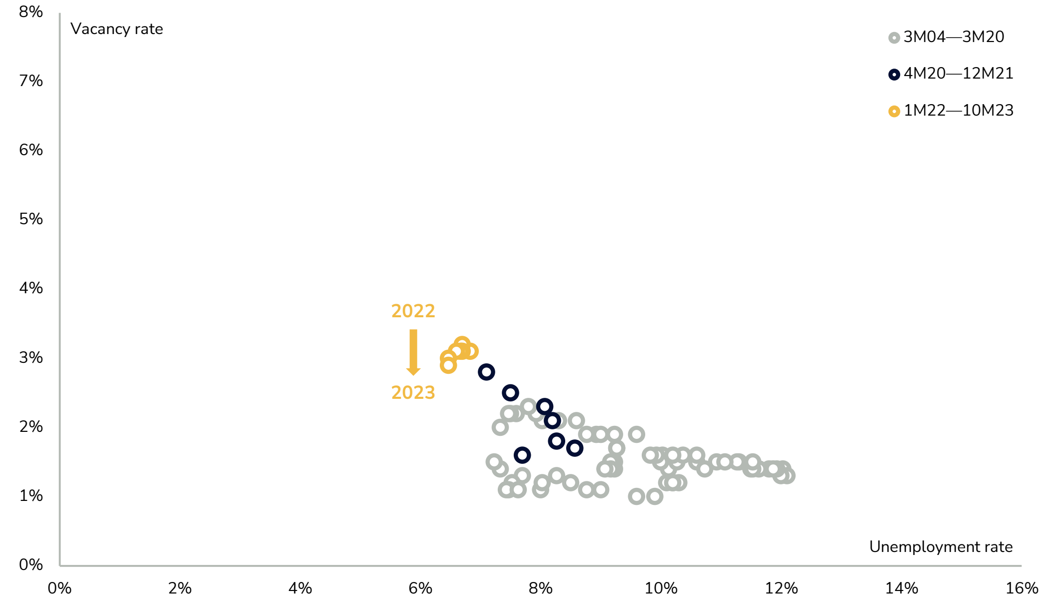
Labor market is cooling down

- Structural changes in the labor market are another consequence of the COVID outbreak in 2020. Firstly, quite a lot of workers quit the labor force (5% of labor force as of Mar'20), e.g. due to early retirement, in 2020—2021. Secondly, there is substantially more demand for employees in healthcare: out of all sectors healthcare (coupled here with education) vacancies grew by 691 000, the most in absolute terms (US, Bureau of Labor Statistics, Dec'19—Nov'23).
- Now when the savings rate is back to normal levels (3.8% of disposable income vs average 13% in 2020—2021), early retirees are returning to the labor market in search of employment. The labor participation rate is now 62.7% (Oct'23) compared to local lows of 60.1% (Apr'20) and Dec'19 level of 63.3%. This rise in the supply of labor has cooled wage growth — 2Q23 level is 5.2% YoY vs 6.7% year ago.
- Both the US and the EZ economies are running close to full capacity in terms of employment of the labor force. The US unemployment rate is just 3.9% (Oct'23) compared to a multi-decade average of 5.8% (Jan'90—Oct'23), while in the Eurozone respective values are 6.5% and 9.2% (Apr'98—Oct'23).
- A lot of companies — first of all in healthcare and IT — had to adapt to rising demand for their services in 2Q20—1H22 and started hiring spree by opening an excessive number of vacancies (**fig. 1 and 2**), which caused substantial wage growth amid tight and falling labor supply.
- Overall deceleration of the global economy and the return of formerly employed people into the job market rebalance labor market on both sides of the Atlantic. We believe that unemployment rates will likely to stay at low levels in 2024 both in the US and the EZ.

1. US companies opened too many vacancies in 2021. Hiring spree is ending.



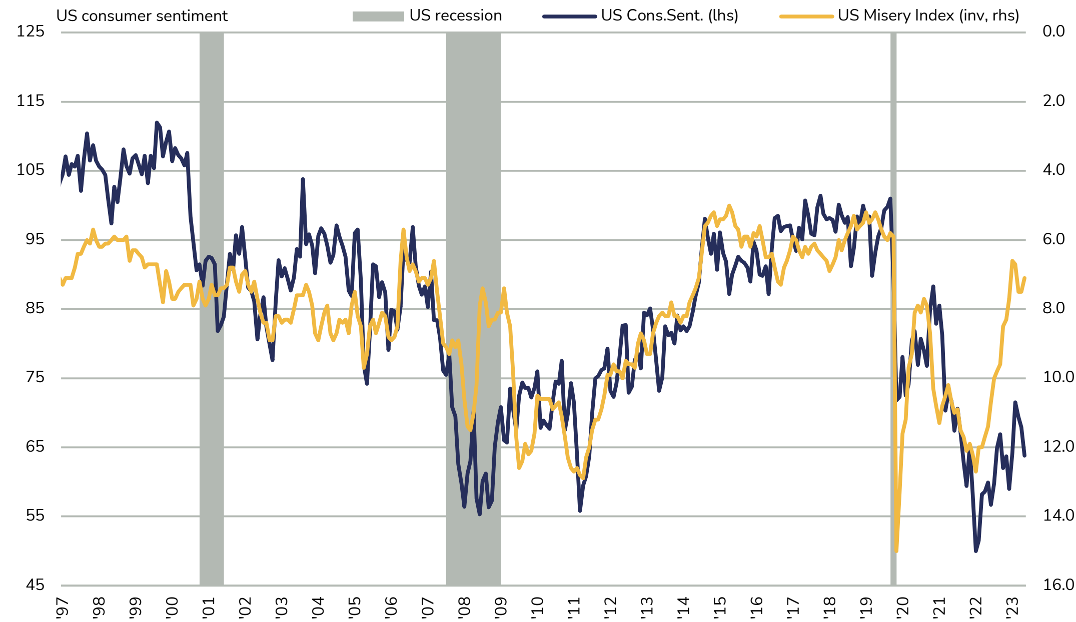
2. Eurozone is also running at high, but decreasing vacancy growth rate.



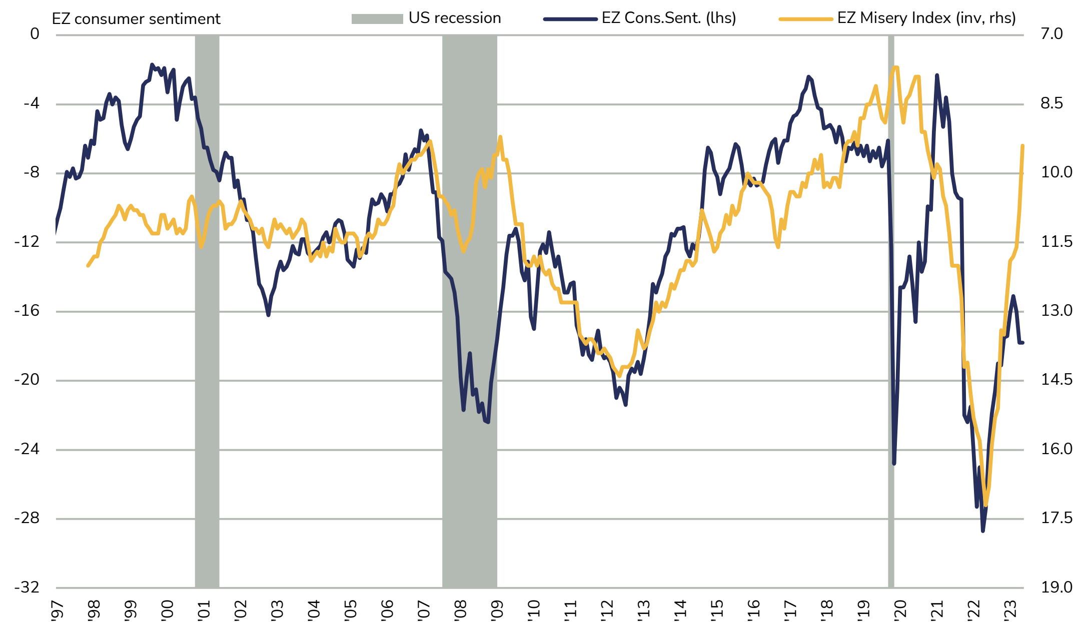
Charts source. (1) Bloomberg, Federal Reserve,, US Bureau of Economic Analysis. (2) Bloomberg, ECB, Eurostat.

Consumer confidence in the US and the Eurozone
Why worry?

1. US consumer confidence is likely to catch up once prices stabilize…



2. …And EZ consumers hopefully will become less distracted as well.



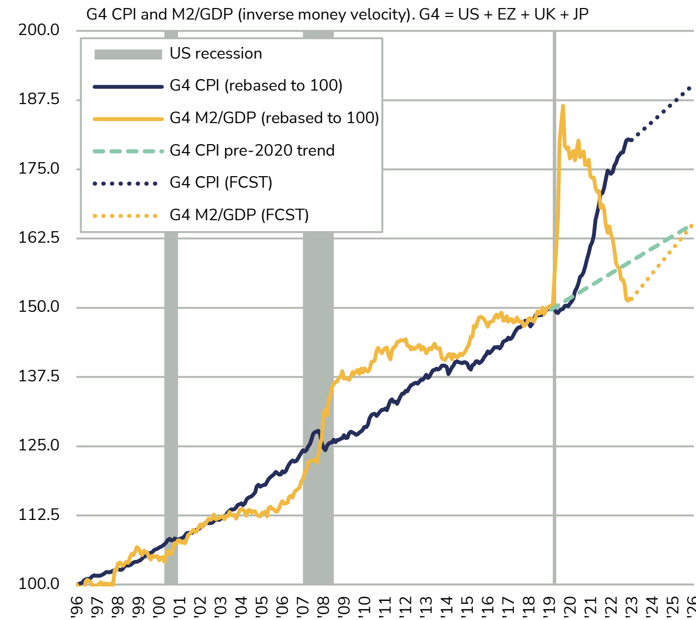
Consumers' perceptions are grimmer than the reality

- The last three years hit consumers quite hard. COVID, lockdowns and unemployment in 2020 morphed into rising inflation in 2021, political tensions and conflicts and another round of inflation in 2022. The year of 2023 was relatively uneventful by recent standards. However, consumer confidence is still subdued.
- Inflation has gone down significantly over the last 12—18 months. Headline US inflation was 3.2% YoY in Oct'23, way below the Jun'22 reading of 9.1%, albeit still marginally higher than the multi-year average of 2.7% (Jan'90—Oct'23). The EZ numbers are 2.9% (Oct'23), 10.6% (Oct'22, local peak) and 2% (Jan'97—Oct'23) respectively.
- Both economies currently run almost at multi-decade low unemployment rates — 3.9% and 6.5% for the US and the EZ respectively (Oct'23).
- On top of that employees' average wages increased in real terms, on the back of a tight labor market and despite elevated (by historical standards) inflation. Wages in the US grew at 5.2% (3Q23) in nominal terms, the respective figure for the EZ was 4.6% (2Q23).
- The misery index represents a rule of thumb methodology for calculating what people are mostly scared about economically speaking: inflation + unemployment. These indices are back to levels seen in 2014—2019 (**fig. 1 and 2**), when there were a relatively low number of global problems.
- However, despite falling inflation, low unemployment and higher salaries in real terms, consumers may feel that it may be too early to see the end of the tunnel.
- We believe that once prices finally stabilize and there are another couple of quarters without global issues, this may materially increase consumer confidence and provide another boost to the world economy.

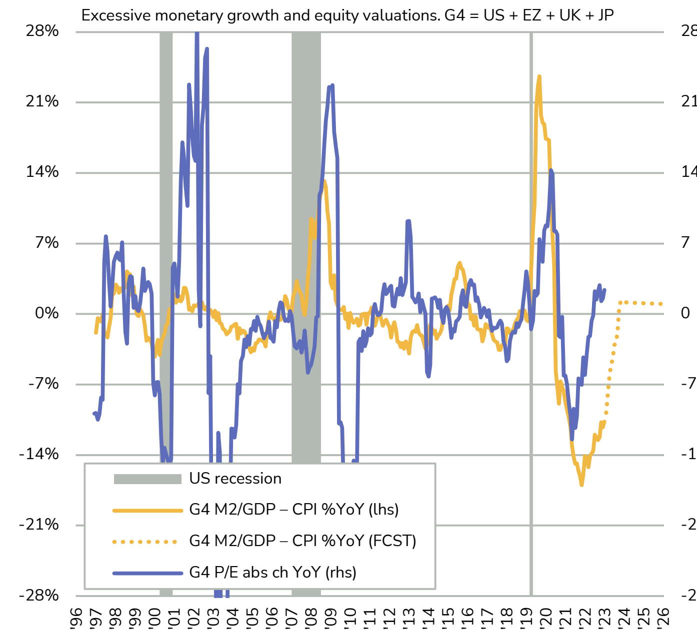
Charts source. (1) Bloomberg, Federal Reserve, US Bureau of Economic Analysis. (2) Bloomberg, ECB, Eurostat.

Central banks
Back on the highway

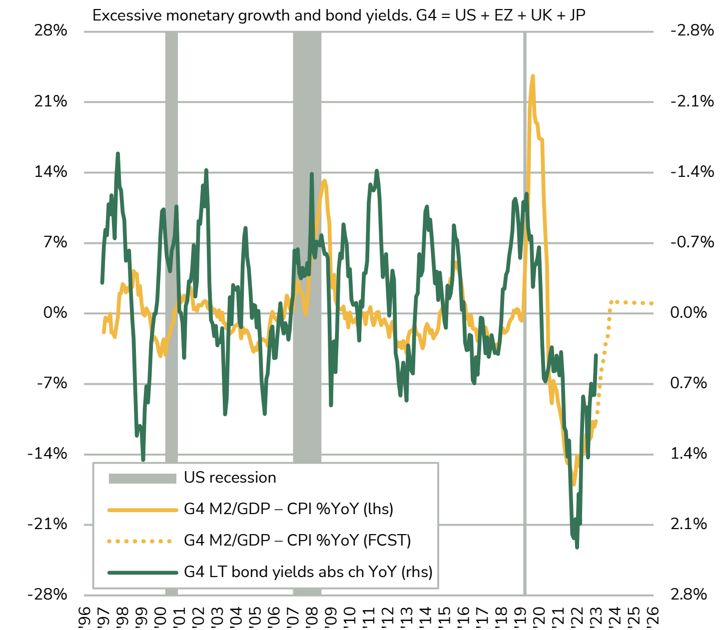
1. Money supply normalized. Back to trend?



2. …If so — this supports equity valuations…



3. …And decreases bond yields.



Monetary tightening is likely to be over

- It took half a year to inflate a monetary bubble in fighting COVID (M2 aggregate compared to GDP in G4 = US + Eurozone + UK + Japan), but another 3 ½ years to deflate it back (**fig. 1**).
- Now, when monetary supply is broadly in line with historical ratios to GDP in G4, it would be quite hard, in our view, to stay on the side of further monetary tightening.
- We believe that monetary policy will become less hawkish in general, and money supply growth may follow inflation levels that are on track towards normal levels of c. 2% p.a.
- This is definitely a multi-year rather than a multi-quarter process. However, we expect this trend to continue and accelerate in 2024.

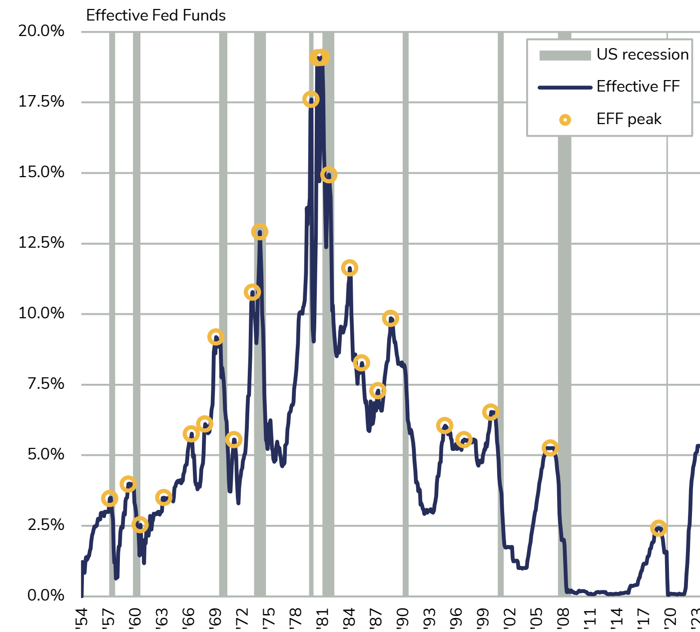
- What does this all mean for the equity and fixed income markets?
- Equity valuations usually rise in periods of monetary expansion (**fig. 2**). But not necessarily equity indices, because of falling earnings. And since 2008, when a monetary bazooka was pulled out for the first time with serious intentions, this relationship is getting tighter.
- P/E ratios in 2023 fully reversed the collapse of the previous year and even got a small up-lift (Nov'23 +1.5x YoY across G4), probably in anticipation of softer monetary conditions.

- Likewise, accommodative monetary policy is positive for bondholders. Yields on government bonds usually decrease during expansions in monetary supply (**fig. 3**). Corporate bond yields are highly likely to follow. Abundant cash needs to be invested, and government bonds can be considered the first suspect from a risk/reward perspective.

Charts source. (1) Proprietary calculations based on data from Federal Reserve, US Bureau of Labor Statistics, US Bureau of Economic Analysis, ECB, Eurostat, Bank of England, UK Office for National Statistics, Bank of Japan, Economic and Social Research Institute of Japan. (2) Same as in previous point and MSCI. (3) Same as in point 1 and Bloomberg.

US Fed Funds peak
Heads or tails, bonds win

1. Peak in the Fed Funds does not imply recession.



- Now after that the inflation peak is more than a year behind us and the Fed rate (here — effective Fed Funds) reached a plateau, we present scenarios for asset performance after the local peak dates (**fig. 1** and **2**).
- The US economy has an almost equal chance to fall into a recession in one year from an effective Fed Funds rate peak (**fig. 3**), with a slight skew to the no recession scenario.
- In a recession, US equities heavily underperform bonds on average (-10.6% vs 9.3%, **fig. 2**). And outperform otherwise (21.8% vs 8.7%). Bonds, short-term and long-term, do pretty well in both scenarios (up 6.5—9.3% in all the cases).

2. S&P 500, short term, long term Treasuries performance after 1Y from eff. Fed Funds local peak date.

EFF peak date	EFF peak date + 1Y	EFF at peak	EFF at peak +1Y	Abs ch	Recess. at start	Recess. at end	S&P 500	LT UST	ST UST	S&P 500 vs LT UST	S&P 500 vs ST UST
Sep'57	Sep'58	3.5%	1.8%	-1.7%	1	0	22.7%	2.6%	2.2%	20.1%	20.5%
Oct'59	Oct'60	4.0%	2.5%	-1.5%	0	1	-3.9%	9.5%	3.6%	-13.4%	-7.6%
Feb'61	Feb'62	2.5%	2.4%	-0.2%	1	0	13.6%	1.8%	2.4%	11.9%	11.3%
Oct'63	Oct'64	3.5%	3.4%	-0.1%	0	0	18.2%	4.2%	3.6%	14.0%	14.7%
Nov'66	Nov'67	5.8%	4.1%	-1.6%	0	0	20.7%	0.1%	4.6%	20.6%	16.2%
May'68	May'69	6.1%	8.7%	2.6%	0	0	8.1%	0.6%	5.8%	7.5%	2.3%
Aug'69	Aug'70	9.2%	6.6%	-2.6%	0	1	-10.9%	2.5%	7.4%	-13.4%	-18.3%
Aug'71	Aug'72	5.6%	4.8%	-0.8%	0	0	15.5%	5.1%	4.3%	10.4%	11.3%
Sep'73	Sep'74	10.8%	11.3%	0.6%	0	1	-38.9%	3.8%	8.2%	-42.7%	-47.1%
Jul'74	Jul'75	12.9%	6.1%	-6.8%	1	0	17.3%	10.1%	7.2%	7.3%	10.1%
Apr'80	Apr'81	17.6%	15.7%	-1.9%	1	0	31.3%	0.9%	12.3%	30.4%	19.0%
Jan'81	Jan'82	19.1%	13.2%	-5.9%	0	1	-2.1%	9.9%	16.0%	-11.9%	-18.0%
Jun'81	Jun'82	19.1%	14.1%	-4.9%	0	1	-11.5%	13.6%	15.3%	-25.1%	-26.8%
Apr'82	Apr'83	14.9%	8.8%	-6.1%	1	0	48.9%	26.1%	11.3%	22.8%	37.6%
Aug'84	Aug'85	11.6%	7.9%	-3.7%	0	0	18.2%	22.1%	9.9%	-3.9%	8.3%
Dec'85	Dec'86	8.3%	6.9%	-1.4%	0	0	18.7%	15.6%	6.7%	3.1%	11.9%
Oct'87	Oct'88	7.3%	8.3%	1.0%	0	0	14.8%	9.7%	6.8%	5.1%	8.0%
Mar'89	Mar'90	9.8%	8.3%	-1.6%	0	0	19.3%	11.6%	8.8%	7.6%	10.5%
Apr'95	Apr'96	6.0%	5.2%	-0.8%	0	0	30.2%	8.4%	5.7%	21.8%	24.5%
Jun'97	Jun'98	5.6%	5.6%	0.0%	0	0	30.1%	11.3%	5.3%	18.8%	24.9%
Jun'00	Jun'01	6.5%	4.0%	-2.6%	0	1	-14.8%	9.8%	5.9%	-24.7%	-20.7%
Feb'07	Feb'08	5.3%	3.0%	-2.3%	0	1	-3.5%	11.4%	4.9%	-14.9%	-8.4%
Apr'19	Apr'20	2.4%	0.0%	-2.4%	0	1	0.8%	14.3%	2.1%	-13.4%	-1.2%
After EFF peak	Hit ratio						69.6%	100.0%	100.0%	60.9%	65.2%
	Average	8.1%	1.7%	-6.4pp			10.6%	8.9%	7.0%	1.7%	3.6%
EFF peak + recess. 1Y	Hit ratio						12.5%	100.0%	100.0%	0.0%	0.0%
	Average	7.7%	-4.3%	-12.0pp			-10.6%	9.3%	7.9%	-20.0%	-18.5%
EFF peak + **NO** recess. 1Y	Hit ratio						100.0%	100.0%	100.0%	93.3%	100.0%
	Average	8.3%	4.0%	-4.3pp			21.8%	8.7%	6.5%	13.2%	15.4%
Unconditional (1Y rolling)	Hit ratio						77.8%	82.4%	100.0%	69.0%	70.7%
	Average						11.8%	5.6%	4.5%	6.1%	7.2%

3. Recession probability in 1Y from effective Fed Funds rate peak.

			To EFF peak date + 1Y	
			Recession	No Recession
			35%	65%
From EFF peak date	Recession	22%	0%	100%
	No Recession	78%	44%	56%

The odds are slightly in the investors' favor that there will be no recession by mid-2024.

Charts source. (1) Federal Reserve. Proprietary calculations. (2) Federal Reserve, Bloomberg, proprietary calculations. EFF — effective Fed Funds rate. S&P 500, LT UST and ST UST — all total return. (3) Proprietary calculations based on Federal Reserve data.

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