Parmenion
Investment Management

Macro Outlook

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Summary

Positive forecasts

Global growth slowed, but with inflation continuing to moderate, forecasts remain positive.

Gradual monetary policy easing

Central banks look likely to cut interest rates gradually, supporting both defensive and growth assets.

Politics take centre stage

Across the globe politics takes centre stage, but history shows it's economic growth, interest rates and earnings that drive investment returns.

US labour market cools

A cooling US labour market and rising delinquencies in credit cards and auto loans raise doubts about consumer resilience, despite rising property prices, equities and real incomes

Markets tolerating US deficit

US budget deficit looks unsustainable over the long term, but markets appear tolerant for now.

UK growth surprises

Upside surprise to growth and earnings in the UK could drive the market higher.

Diversification opportunities

Greater diversification opportunities thanks to better-than-expected macroeconomic data as growth recovers in EU, Japan, UK and emerging markets.

For financial professionals only

What's the outlook?

Expectations matter

Consensus expectations of a 'soft landing' in the US helped to maintain investor risk appetite through the second quarter, despite disappointing macroeconomic data.

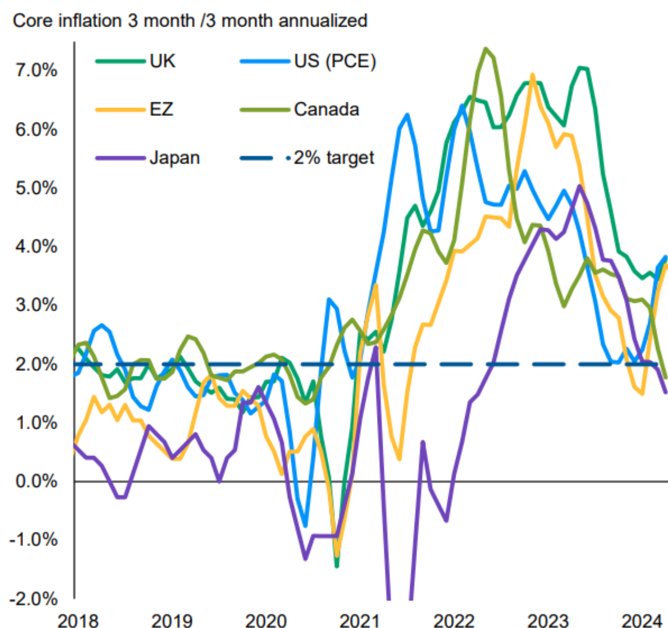
The prospect of interest rate cuts also helped, with the ECB, Swiss National Bank, Swedish Riksbank and Bank of Canada all cutting rates for the first time since the peak in this cycle. Combined with early signs of recovery in the EU and UK, this led to positive returns for most equity asset classes. Asia Pacific ex Japan, Emerging Markets and UK Equity Income led the field with returns of over 5%.

2024's political calendar kicked into action in the second quarter with unexpected results in India and South Africa, an earlier than expected election in the UK, and a surprise French parliamentary election. Elections may bring excitable newspaper headlines but the impact on long term growth and corporate earnings is less clear. We're looking beyond the noise and focussing on structural and cyclical trends to identify relative investment opportunities. Looking forward to 2025, we see several compelling and attractively valued long term possibilities on the horizon.

Focus shifts from inflation to growth

Since late 2021 the market has focussed on inflation. The post-Covid spike proved more persistent and problematic than central banks expected, so interest rates have stayed higher for longer. With rates now comfortably higher than inflation, restrictive monetary policy is having the intended slowing effect on economic growth. Headline and core inflation is coming down slowly, and leading indicators point to this trend continuing. We expect central banks to shift their focus towards growth to minimise the risk of overtightening, increasing unemployment and threat of recession.

Core inflation is yet to fall to target, but it's on its way



Source: J.P. Morgan Asset Management 2024

We expect interest rate cuts going into 2025, though it's difficult to predict their speed and scale. The extraordinary fiscal and monetary policies adopted through the pandemic, as well as the delayed impact of higher interest rates on corporates and households as low-cost fixed term debt rolls onto new, more expensive terms, will take time to play out.

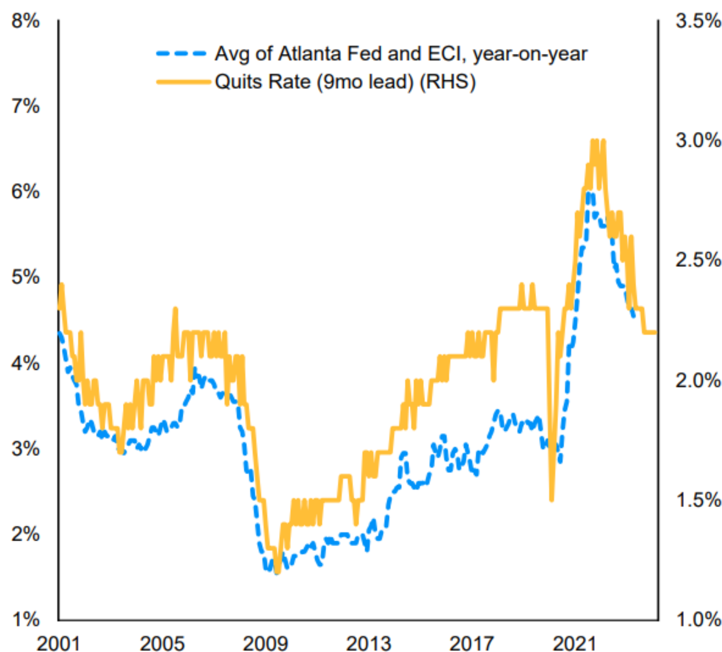
Central banks are expected to move cautiously to avoid the risk of loosening too soon and seeing inflation return. While they attempt to re-establish their inflation fighting credibility, rates are likely to stay 'higher for longer'. This means investors in government bonds can pick up a dependable income with the upside of capital appreciation when rates start to come down.

Softening labour markets

The Fed has a dual mandate: maximum employment and stable prices. With inflation better controlled, the spotlight is shifting to employment where leading labour market indicators are showing signs of weakening.

Job openings are falling, temporary employment is declining, and the quits rate (resignations) is now below pre-Covid levels. Hiring plans are fading, especially among small businesses, which make up almost 50% of private sector employment. As a result, wage growth is easing, which is helping to ease pressure on sticky service sector inflation. However, this raises the risk of increased unemployment. In an election year, pressure from politicians on the Fed to lower rates will probably grow to lessen the risk of rising unemployment.

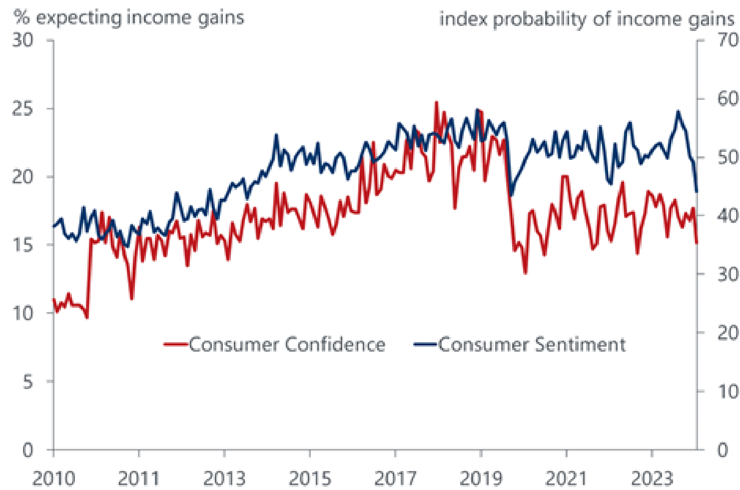
Falling quits rate points to falling wage growth



Source: Bureau of Labour Statistics, Atlanta Fed and J.P Morgan Asset Management

The US consumer makes up over 67% of US GDP, and it looks like confidence is starting to fall as jobs become less secure, wage growth is moderating, and the savings rate is lower than average.

Shrinking US consumer confidence and income expectations



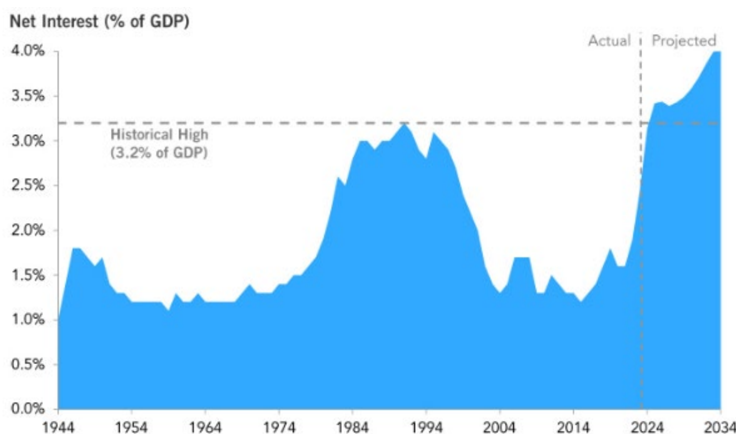
Source: Oxford Economics/Haver Analytics

Importantly, US household balance sheets seem resilient, with positive wealth effects from appreciating house prices and equity market. This is expected to underpin consumer spending, just at a slower pace.

US debt keeps climbing

One of the more extraordinary features of the post-pandemic US growth story has been the continued expansion in government debt and fiscal deficits. Typically, above trend growth leads to a reduction in debt as a percentage of GDP and a narrowing budget deficit as unemployment and welfare payments decline. That hasn't been the case this cycle. Expansionary fiscal policy combined with a higher cost of debt has led to an escalating budget deficit - and rising concerns about the sustainability of servicing this debt.

US net interest costs forecast to reach new highs



Source: Peter G. Peterson Foundation and Congressional Budget Office

So far, the market has tolerated this ill-discipline, but the Congressional Budget Office (CBO) recently increased its federal government budget deficit forecast to almost $2 trillion for 2024. That's up $400bn from February, and they expect this to grow to $2.8 trillion by 2034.

With total debt already close to 100% of GDP and forecast to reach 122% by 2034, an unexpected slowdown would make the CBO's projections conservative. This raises the risk of upset for fixed income investors, potentially leading to higher yields.

For now, US exceptionalism plus the dollar's status as the world's reserve currency gives it a privilege no other nation enjoys, and it's hard to see it being de-throned. As always, it is prudent for investors to stay vigilant - this 'exorbitant privilege' may run out of road at some point.

UK economic activity positively surprising

The financial press would have us believe the UK is a 'basket case', but the reality is rather different. Since the technical recession in Q4 2023 the composite PMI has been growing, with readings above 50. Services PMI has led the way, supported by improvements in the manufacturing and construction PMI. This breadth of recovery is feeding into a revival in consumer confidence.

GfK UK consumer confidence

Source: Oxford Risk/ Haver Analytics

With real incomes turning positive, interest rates set to come down, property prices anticipated to sequentially improve and savings rates near recent historical highs (excluding Covid), the UK consumer appears well placed to positively surprise. This should support growth and help underpin stability in the labour market.

Political change and moving on from the chaos of recent years is welcome, as is Labour's commitment to accelerating and supporting growth via a fully costed and funded investment roadmap. Clearly the details matter, but early indications are encouraging, and at a time of significant political upheaval elsewhere, the UK is standing out as a source of stability. It's a long time since we've been able to say that!

Crucially, UK plc is also doing reasonably well as we emerge from the challenges of elevated inflation pressurising margins through high input costs. Consensus forecasts of low double digit earnings growth into 2025 look not only achievable but likely to surprise on the upside.

This reaffirms the compelling value available in UK equities, drawing increased M&A activity, private equity investment and share buybacks as corporate managements vote with their feet, believing their share prices are too low versus the company's intrinsic value.

Elevated US expectations set a high bar

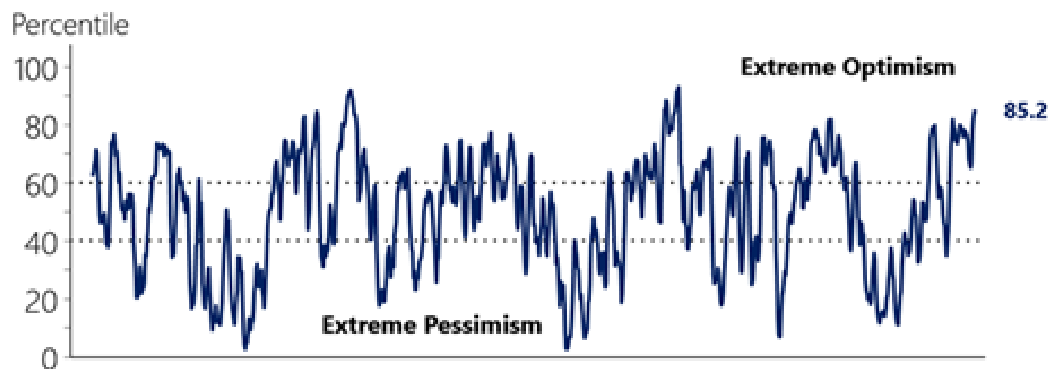
Large cap US technology, driven by excitement around AI, has delivered phenomenal earnings growth and share price appreciation for investors, especially Nvidia.

However, competitors like AMD and Intel are rapidly closing the gap in terms of chip functionality, speed and capacity, so there's a growing risk that this momentum will be hard to maintain.

For example, AMD has recently released a GPU chip which is faster, more efficient and priced at more than 50% less than Nvidia's equivalent. Yes, there are programming barriers to entry and it's hard to switch between chip manufacturers, but for customers starting out in AI capital expenditure, this price differential is hard to ignore. It also means they're not dependent on the same technology - Nvidia - as their competitors.

Discipline, care and caution are essential after such a strong run, especially when sentiment and investor expectations appear as extended as they are.

US investor risk sentiment index is near multiyear highs

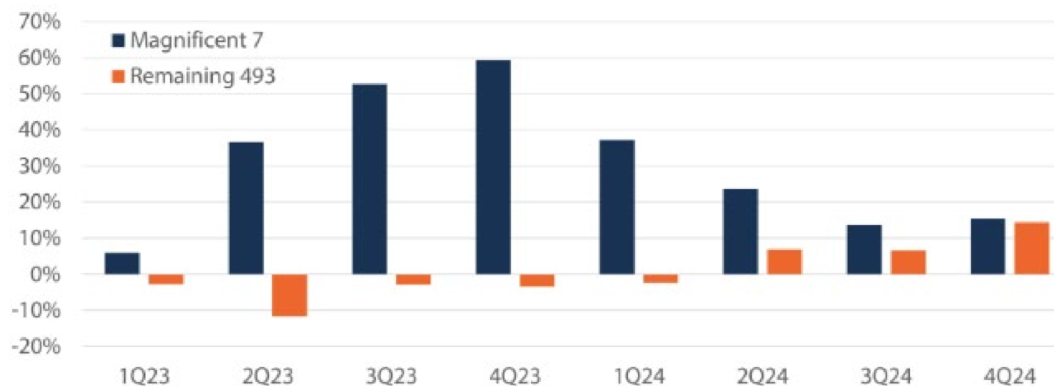


Source: Oxford Economics

After 15 years of US stock market appreciation, investor exposure and positioning are, in the words of one commentator, 'fully loaded'. Sailing against this, when projected GDP growth and earnings look OK, is hard and not something we champion at this stage.

Instead, we aim to identify attractively valued long term investment opportunities, such as those within US mid and small caps. These sub-asset classes have struggled over the past few years, but the prospect of easier monetary policy and lower input costs could see their earnings improve. This could narrow the gap with large caps and help close the valuation difference.

Quarterly EPS growth year-over-year – Magnificent 7 vs remaining S&P 493



Where are the opportunities for investors?

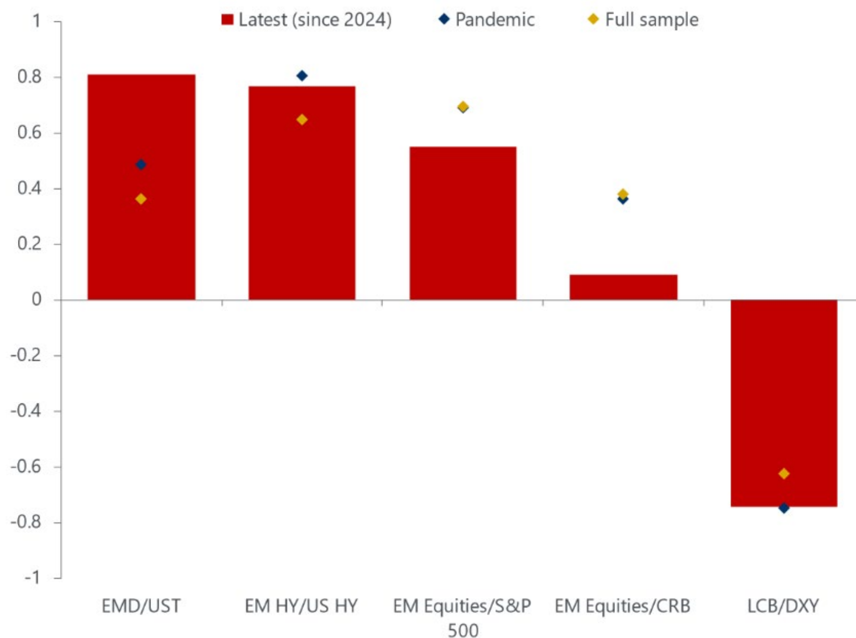
Diversification opportunities in Japan and Emerging Markets

Our strategic asset allocation framework shows that statistically, Japan and Emerging Markets provide differentiated risk adjusted returns. This is invaluable when building a diversified portfolio designed to deliver greater consistency of returns over time.

China (often seen as closely tied to global growth) is counter cyclical. As global growth slows, China becomes more attractive to investors. Despite its challenges - ageing demographics, excess property supply and geopolitical risks - China's policy stimulus is being rolled out. This indicates the intention to address these issues, and we believe long term investors should take note.

The diversification benefits from Emerging Markets compared to the S&P 500 have improved year-to-date, with correlations falling from 0.7 to just over 0.5. Dynamics like this are important considerations in building our diversified portfolios.

Correlations between asset classes



Source: Oxford Economics & Bloomberg

Japan is on a different path. Interest rates are expected to rise as inflation resurfaces and wage growth feeds into consumer activity. The surge of tourists attracted by the cheap Yen is boosting demand in the service sector. Along with the structural changes in corporate governance and a focus on shareholder value, Japan offers investors exposure to differentiated and attractive earnings growth at a good price.

Reinvestment risk on the rise

With central banks moving towards cutting interest rates, investors in money market funds or fixed term bank deposits risk getting lower yields as their products mature. This reinvestment risk doesn't usually trigger investors to change their behaviour until the second or third cut, by which stage the boat has likely already sailed. With over $9 trillion invested in global money market funds, it's expected that any movement will spark demand for both defensive and growth assets.

Diversification, diversification, diversification

Market leadership appears to be changing. Asset classes that lagged through 2023 have begun to recover, while the exceptional returns of some of the Magnificent 7 have started to falter.

Softening growth with stubborn inflation poses a dilemma for central banks, especially the Fed. As the labour market cools, there's a growing risk that the Fed is falling behind the curve, ultimately leading to faster and more aggressive interest rate cuts. We're not there yet, but we believe it's prudent to protect your portfolio via duration in case of a negative growth surprise.

There's also a risk of inflation spikes, owing to deglobalisation (I prefer re-globalisation but that's for another time), decarbonisation and geopolitical risks. To mitigate these risks, we believe our Diversified Alternatives asset class offers the real returns and inflation protection that's core to achieving the diversification we aim for. This suggests valuations are likely to be a more prominent driver of returns going forward. And as interest rates ease, the attraction of dividends and stable fixed interest yields are expected to become more popular.

Our recommendation is to stay disciplined and diversified to achieve attractive and consistent risk adjusted returns. We continue to lean into those opportunities where the risk/reward is in our favour, keeping in mind that returns tend to be greatest when capital is scarce, and nobody wants to own it.

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