Macro Outlook Summary

March 2024

Dispersion in the SPX remains high as the Magnificent Seven dominate and drive the index higher. The SPX index in January gained +1.7% yet the SPX equally weighted index lost -0.8%. Bond and credit markets have also delivered some unusual results this year. Government bonds have undertaken a severe re-think about the scale and timing of central bank rate cuts in the US and Europe. As a result, 10Yr yields in the US have backed up from 3.9% to 4.3% YTD and German yields similarly rose from 2.0% to 2.5%.

In any sort of 'bear market' for government bonds, credit spreads widen, maybe only by a small amount but sometimes a lot. Not so this year when they have stayed almost locked to their end-Dec tightest spreads. In January the CDX IG, CDX HY and iTraxx spreads were all unchanged on the month and only the iTraxx Crossover backed out by 18bps. Delving into this number the three worst performing reference names: Atos, Intrum and Ardagh together caused a 48bps widening of the index while the other 70+ names tightened by a collective 30bps resulting in the 18bps widening of the index. So, in an almost mirror opposite of the SPX where seven dominated the SPX, in credit the three worst names dominated the iTraxx Crossover credit index.

In Asia, dancing to a different tune, there are tentative signs that the bear market in China may be drawing to a close. GDP came in at +5.2% for the year, prices are slowing with deflation visible, interest rates are high and the stress in real estate valuations is well out in the open. The China A50 bounced in late February as did the Shenzhen Composite and Hang Seng all recovering most if not all of their significant January losses.

One of our Asian macro managers who has built a particularly good track record judging the China economy and markets refined their view through last year to reach an outlook that is significantly differentiated from consensus. The popular view is that central bank policy is on the brink of delivering significant rate cuts and intervention stimulus to support the stock market, prop up the indebted consumer and rekindle demand.

Our manager's take is different and revolves around how they believe the authorities intend fundamentally to address rather than bail out the consumer debt burden issue and the consequent bank/SOE stress from NPLs. President Xi's anti-property speculation stance has been clear for over a year and cooling policies have worked. Now the weakness in the housing market and the financial pressure arising from recent policy measures being applied to property owners is equally clear. Sentiment towards property is bad, has spilled over into the stock market and youth unemployment is rising. So, they believe that phase of the enforced adjustment is complete and the administration now wants to begin easing pressure but only slightly.

Home purchase restrictions have been relaxed and there is widespread talk of the government stepping in to take over distressed developments and repurpose them into low-cost housing. But the key point to understand they believe is that this does not mark the beginning of another upcycle in real estate prices and speculation. The government expects those at the extreme to suffer stress and seems intent on following that through.

So, the next key point is to realise that the government is fully focused on controlling the financial risks in the banking system as the economy rebalances through household and corporate deleveraging. This implies pursuing measures which sustain or promote bank profitability therefore protecting bank net interest margins (NIM) and so enabling banks to absorb stressed loan write downs through their income statements. This seems like a logical resolution to the property speculation saga and importantly one which doesn't let the 'bad guys' off the hook so the message transmits loud and clear.

Moving on from real estate the second policy agenda is to promote investment away from the property sector and towards high-end manufacturing. As this story slowly unfolds the challenge to Germany and Japan becomes clear.

They do not therefore see extensive rate cuts as an integral part of the government's plan but do see intent to stabilise the stock market by directing cash from SOEs into the market and broadening the clampdown on market speculation/high frequency trading/short selling. Echoing what has been going on in Japan over the past year the government also appears to be increasingly messaging to SOE bosses that shareholder returns are now a highly important metric of their performance evaluation going forward.

The China CSI300 big cap index is trading near its 5-yr low so the obvious question is whether it has much further to fall or can it find a floor from which to recover. If these policies succeed then the banking sector will not melt down as many have been expecting and solid foundations for the next wave of long-term growth may be set. What is clear is that this next wave of growth will not be centred on real estate and consumer leverage and will therefore in all likelihood be slower to unfold.

As we discussed last month the paths of the Fed and ECB are visibly diverging. Recent payroll data from the US has been stronger than economists expected and the overall strength of the economy has defied the majority of commentators. The strength is real but we subscribe to the idea that recent payroll strength is unlikely to continue in the months and quarters to come and more importantly that while employment may remain high, wage growth has begun to slow which is the key point of focus for the Fed.

For 2023 total worker compensation rose 4.2% against the long-term range of 1.7-3%. In the private sector this rate peaked at 5.5% in Jun'22 and for the government sector at 4.9% one year later. Both the core PCE deflator and ECI are coming back into sync with each other having been distorted during the Covid era and are now heading down below 3%. The ECI wages and salaries data is published quarterly with the 1Q24 release on 30th April. This will be closely studied by the FOMC members on the first day of their meeting. If it confirms an ongoing decline in wage rates then the following day is the first chance of a Fed rate cut by 25bps, but this is far from certain.

What will be weighing on the minds of the Fed is how long this higher interest rate environment has existed and how far it has fed through into the real economy. The general rule of thumb is that hikes take 4-6 quarters to reach the consumer and hiking first started Apr'22. The first few increases were simply picking up the slack in rates but by 3Q22 rates were 2.5-3.0% and starting to bite. We are now 5Q on from then, so the moment of impact is very much now. We continue to attach a very high probability to the resulting soft landing outcome with 150bps of cuts in the second half of this year to take the edge off the Funds rate. Anything more will surely require evidence of economic weakness or widespread stress which is far from where things stand today but perhaps in the 2H things look different and weaker.

The US Equity market remains in buoyant mood despite the delay in rate cuts. Like the bond market they are confident the day will come and that it is most likely going to be early summer. Interestingly the SPX rally since 30Oct23 has made new highs but with sequentially declining RSI on each new peak meaning momentum in the up move is fading. In the short term this is usually a good indicator that if the support line is broken there will be a good correction.

In Europe concerns remain centred on Germany where their manufacturing engine is stalling, real estate values continue to decline and bank balance sheets are consequently under scrutiny for signs of stress, yet again. Like the US, the ECB focus is on wage growth and evidence of weakening in wage settlements will only be visible in June when 1Q24 data is released. Rate cuts before then seem deeply unlikely notwithstanding growing unrest in Germany. But when the ECB feel able to move it seems likely they will be inclined to cut further than the US in order to assist the German economy and provide general stimulus to the Eurozone. This means the interest rate differential is likely to widen in the 2H of this year which may underpin the USD to remain strong against European currencies.