Insight INVESTMENT

GLOBAL MACRO RESEARCH
THE PIVOT FROM INFLATION TO GROWTH

NOVEMBER 2024

BNY | INVESTMENTS

EXECUTIVE SUMMARY

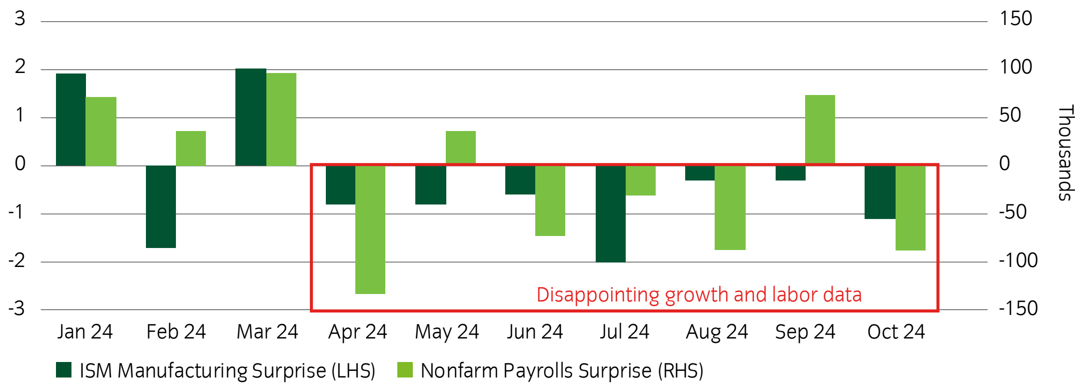
- With inflation moving back towards central bank targets, policy-makers in the US have shifted their focus to weakening labour markets and the easing cycle has begun.
- Across the world, central banks find themselves faced with differing economic realities and are adjusting policy accordingly. At the extremes, the People’s Bank of China is in full stimulus mode, while the Bank of Japan is the odd one out, edging rates higher from very low levels.
- Central bank easing and improving economic activity have shifted our macro regime framework to a regime that has historically been more positive for risk assets.
- One problem is that US equity valuations appear high relative to history. But when we analyse historical easing cycles, strong returns prior to an easing cycle have not been a harbinger of underperformance once the easing cycle begins. But the dominance of a small subset of stocks has characterised recent returns, and a broadening of earnings growth is likely necessary for healthy future gains.
- The US election result brings risks to the outlook given the size of the expected fiscal expansion and potential for tariffs to stoke inflation. Markets are likely able to withstand higher real rates, but the rate of change is critical, and more extreme moves could be of greater concern.
- In aggregate, this leaves us more constructive going into the end of the year, with favourable seasonality an additional tailwind.
- We believe that one way to diversify risk against the potential for a simultaneous decline in equities and bonds is via the US dollar – our favoured defensive strategy in the current environment.

SOFTER US DATA CAUSED A A POLICY PIVOT

LABOUR MARKET WEAKNESS BECAME THE FOCUS IN THE SUMMER

Barring the upward surprise to September's payroll data, US economic data released over the summer suggested the growth outlook had softened somewhat (see Figure 1). Consistent with our understanding of how growth dynamics filter through to asset classes, bonds benefited, while stock markets became choppier.

Figure 1: US labour market and manufacturing have generally disappointed over the past six months[1]



Although growth has slowed, we do not expect a recession. Growth is moderating, but from a healthy pace. Moreover, the cooling in the labour market appears to be driven more by an increase in supply (i.e., immigration) rather than a contraction in demand.

Critically, however, inflation has moderated to the point that central banks feel able to respond with looser policy. The Fed chair has made it clear that any further deterioration in the unemployment rate would be unwelcome, indicating a pivot in policy thinking, with the labour market becoming the primary concern.

Elsewhere, central banks are faced with differing economic realities and are adjusting policy accordingly.

ASSESSING THE GLOBAL EASING CYCLE

The Federal Reserve: scope to cut but the economy suggests little urgency

Recent trends in manufacturing remain a concern and with the Institute of Supply Management (ISM) Manufacturing Index declining to 46.5 in October, and readings for employment and new orders soft, there are clear points of worry. With the core personal consumption expenditures (PCE) price index, the Fed's favourite measure of inflation, moderating to a 2.1% year-on-year rate in October, moving into line with the Fed's 2% inflation target, the Fed has ample scope to ease policy from current levels.

The challenge is that with indicators such as the Atlanta Fed's 'nowcast' indicator signalling GDP growth above 2.5%, and activity in the service sector improving sharply (see Figure 2), there seems limited urgency to do so. Overall, it seems likely that the Fed will be able to engineer a softish landing or what may, in time, be described as a mid-cycle slowdown. Certainly, relative to many other areas, the US resilience story remains intact.

[1] Source: Insight and Bloomberg as at 7 October 2024.

Figure 2: Manufacturing and services activity are diverging in the US[2]

The European Central Bank: the core of Europe continues to struggle

The eurozone is in a slightly different position, as although the 0.4% rise in Q3 2024 euro-area GDP surpassed estimates, the outlook remains far from rosy and the German central bank's forecasts point to ongoing stagnation. Germany's leading economics research institute forecasts that GDP in the eurozone's largest economy will contract by 0.1% in 2024 and, while growth is projected to pick up next year, the institute says growth will not return to pre-pandemic trends any time soon. Such stagnation is weighing on the whole bloc.

The October purchasing managers index (PMI) releases were a source of further disappointment with the composite HCOB Eurozone Manufacturing PMI at 46, well below 50, the level that indicates an expansion in activity. The French composite PMI also fell into deeper contractionary territory in October as the services sector continued to deteriorate following the end of the Olympics.

Despite the weakness in core economies, the ECB faces the challenge of sticky inflation and an unusually tight jobs market, raising concerns over wage pressures. Headline and core eurozone inflation surprised to the upside in October, coming in at 2% and 2.7% respectively, while eurozone unemployment is at a record low of 6.3%. This leaves us anticipating a gradual easing cycle, as these factors counterbalance the outlook for growth.

The Bank of England: in 'wait and see' mode

The UK economy has proven stronger than most commentators expected, and this has enabled the Bank of England to articulate a more gradual approach to monetary easing. Recent activity has been relatively robust, bolstered by growing real wages as inflation moderates and by falling interest rates. In the three months to September, retail sales volumes grew by 1.9%, contributing positively to GDP.

Sentiment, however, remains depressed, with UK consumer confidence deteriorating markedly since the election. Much of the despondency has been attributed to new warnings about the poor state of government finances and the need for tax rises. The October budget raised taxes by more than £40bn while also increasing borrowing. This was not well received by financial markets with the spending boost only expected to have a short-term impact on growth, while the impact on inflation, employment and activity remains unclear.

With risks balanced, the Bank of England also seems likely to take its time to gradually bring rates lower.

The People's Bank of China: in full stimulus mode

The Chinese authorities announced multiple easing policies at the end of September. The stimulus package, including fiscal easing, policy-rate cuts and measures to boost liquidity, support the stock market and property sector at a scale that may, in time, be a stabilising force for the economy. Currently, we are awaiting the Standing Committee of China's National People's Congress to approve additional fiscal spending as part of the support package. Early indications suggest that recent announcements are having some impact. The Caixin services PMI data are the latest in a series of releases pointing to at least stabilisation, breaking the cycle of poor macro data feeding deflation, which in turn depresses demand and activity.

[2] Source: Insight and Bloomberg as at 31 October 2024.

Beijing still must address many of the deep-rooted problems of the property sector and while the shock-and-awe policy announcement of late September produced a sharp bounce in equity markets, it will take time to assess whether that translates into a much-needed improvement in business and household confidence. The likely lags between policy announcements and any improvement in economic activity are large and most economists recognise that the job of reflating the economy is likely to take years rather than months.

Nevertheless, the weakness in the Chinese economy has contributed to the weakness in the global economy, so efforts are helpful and when combined with a likely easing in policy elsewhere, recent developments in China certainly help reduce downside risks to the global economy.

Bank of Japan: the odd one out

In Japan, new Prime Minister Ishiba's decision to call a national election to secure a powerful mandate backfired. The Liberal Democratic Party lost its coalition majority, leaving Prime Minister Ishiba in a fragile position as he attempts to form a minority government. Even if this is achieved, the longevity of such a government is uncertain, and any change in leadership brings additional policy uncertainty.

The Bank of Japan held rates steady at the end of October but signalled that further rate hikes are likely. However, it aims to avoid a repeat of the extreme market gyrations that followed policy actions over the summer. The changing policy agenda from the government adds a new layer of complexity to the decision-making process. We anticipate that gradual hikes are still in the pipeline, but given domestic and international events, the pace of change is likely to be slow. This cautious approach is not necessarily a bad thing, as Japan is relatively less at risk from trade war-related concerns compared to China or mainland Europe.

SHIFTING TO A MORE POSITIVE REGIME

With central banks easing and economic data starting to improve, our macro regime framework has reached a tipping point, with our growth regime shifting from falling to stabilising, while the inflation and real-rate regimes remained unchanged, as both measures continue to fall.

Growth, inflation and real rates

Growth: Stabilising

- The growth relapse of the last few months appears to be stabilising, helped by better US data and signs of a troughing in activity in both Europe and China.
- The global manufacturing PMI increased over October, with Europe and emerging markets higher, however the US ISM remains notably weak. The orders/inventories ratio did improve in most regions and points to the potential for a more material improvement in coming months.
- That said, the direction of travel from here will clearly be influenced by the US election result and the speed with which the market anticipates policy change. A Trump administration promises stimulus and with the election in the rear-view mirror, the removal of event risk may also lift activity in the short-term.
- We acknowledge that a quick move to an extreme protectionist agenda in the US, while not our base case, is a tangible risk to global growth and hence we view a relapse into 'falling' as a potential alternative future regime.

Inflation: Above target and falling

- Headline CPI (year-on-year) in the US has now printed lower for six months in a row, with the most recent print at 2.4%.
- Alternative measures of core inflation and the Fed's own measure of sticky inflation have also moderated notably in recent months.
- We acknowledge that we are now moving past the point where base effects help inflation, and most forecasts point to a modest rise in headline rates in the coming months.
- A Trump administration could bring an inflationary pulse, and there was a notable move higher in breakevens over October as markets moved to reflect this.
- There is not yet enough evidence that inflation is rising, but the chance of moving into a higher inflation regime have clearly picked up, and hence we acknowledge this in our most likely next regime scenario.

Real rates: Falling

- There has been a sharp upward move in nominal rates in recent weeks, initially sparked by relief on US growth data but given further impetus by concerns around the fiscal/inflationary impact of a Trump win.
- However, it is notable that with breakevens being a key contributor to the move, the change in three month real rates is marginal. The current US real rate is just under 2% which is in the middle of recent ranges.
- The market is grappling with the offsetting forces of central bank easing and 'reflationary' fiscal policy.
- As with inflation, we believe there is an increasing risk that we move into a higher real rates regime, and hence we acknowledge this in our most likely future regime scenario.

Asset allocation implications

- We outline the current regime and what we believe are the most likely potential future regimes in Figure 3.
- As outlined above, we have moved into a 'DFJ' regime (growth stabilising, inflation coming down but above central bank targets, with real rates falling).
- **This has historically been one of the best regimes for risk assets, and hence we move from a neutral to a positive macro score.**
- However, our increase in score is tempered by PMI data which is thus far only showing 'green shoots' and an uncertain US policy path. If we saw growth data continue to improve, along with stable real rates, we have room to increase this further.
- Where we go from here (and indeed how quickly we get there) is policy dependent. Our most likely scenario is a 'reflationary' one, where growth, inflation and rates all move higher together. However, we acknowledge that there is a risk that in the US tariffs are prioritised over tax/stimulus which would be a much more negative scenario for risk assets.

Figure 3: The current regime and most likely future regimes[3]

Regime summary

As at: 11 November 24

Current Regime	DFJ
Growth:	Stabilising
Inflation:	Inflation > Target & Falling
Real rates:	Real Rates Falling
Start date:	31 Oct 24
Current length (months):	0.4

DFJ historic regime length (months)	
Min	1
Average	2
Max	3

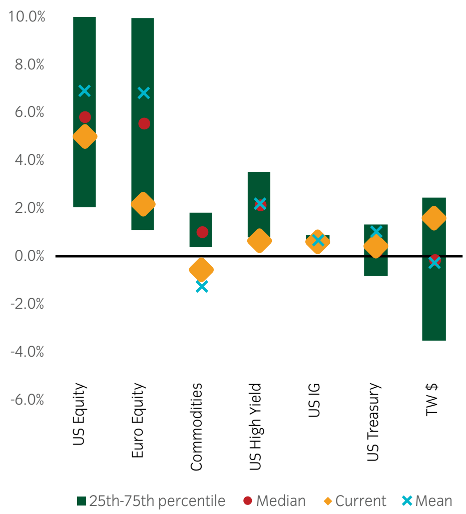
DFJ historic regime frequency	
No. instances	6
Total months in regime	14
Time spent in regime	2%

Previous Regime
CFJ
Falling
Inflation > Target & Falling
Real Rates Falling

Typical regime path (historic probability)

Rank	Regime Name	Probability
1	DFI	83%
2	AFJ	17%
3	-	-
4	-	-
5	-	-

Regime return distibutions



Regime Percentile

US Equity	100%
Euro Equity	100%
EM Equity	71%
Commodities	55%
US High Yield	100%
EMD (USD)	Not enough data
Convertibles	Not enough data
US IG	77%
US Treasury	59%
TW $	55%

Percentile ranking explained

For each asset class, this ranks current regime versus all other regimes based on return, sharpe, drawdown & hit rates.

75 to 100th quartile
50 to 75th quartile
25 to 50th quartile
0 to 25th quartile

Probable next regime (Insight view)

Regime Name:	DEI
Growth:	Stabilising
Inflation:	Inflation > Target & Rising
Real rates:	Real Rates Rising
Historic Probability	No Instances
Regime Percentiles	
US Equity	Not enough data
Euro Equity	Not enough data
EM Equity	Not enough data
Commodities	Not enough data
US High Yield	Not enough data
EMD (USD)	Not enough data
Convertibles	Not enough data
US IG	Not enough data
US Treasury	Not enough data
TW $	Not enough data

Alternative next regime (Insight view)

Regime Name:	CEJ
Growth:	Falling
Inflation:	Inflation > Target & Rising
Real rates:	Real Rates Falling
Historic Probability	No Instances
Regime Percentiles	
US Equity	14%
Euro Equity	9%
EM Equity	9%
Commodities	64%
US High Yield	14%
EMD (USD)	59%
Convertibles	13%
US IG	23%
US Treasury	64%
TW $	32%

[3] Source: Insight and Bloomberg as at 11 November 2024.

RATE-CUTTING CYCLES, ASSET-CLASS RETURNS AND THE IMPORTANCE OF GROWTH

Growth is key for asset returns, but not the only factor

The regime-based framework we employ helps us translate cyclical forces into asset allocation positioning. Normally a stabilising growth regime, when combined with falling real rates and inflation, has been a positive environment for risk asset returns. However, there are other factors which may influence returns and need investigation. These include the nature of the easing cycle, the valuation of asset markets and, in the US, the implications of the recent election.

Our work on asset-class behaviours in the wake of rate-cutting cycles reinforce the importance of growth, or rather the lack of recession, in terms of asset class returns – and we outline the results in Figure 4. Put simply, non-recessionary cutting cycles are typically:

- shorter and less aggressive in terms of rate cuts,
- benign for equities,
- good for US Treasuries, and
- bad for the US dollar.

In contrast, recessionary cutting cycles are typically:

- longer and larger,
- bad for equity (drawdowns c.20-40%),
- very positive for US bonds, and
- mixed for the US dollar.

Figure 4: Asset returns during US rate-cutting cycles[4]

The Fed and growth				Equity (S&P 500 Index)				Rates (Treasuries)		Commodities		Currencies
US rate cutting cycle	Length (months)	**Fed funds rate** Start	**Fed funds rate** Change	**P/E (12m trailing)** Start	Total return (pa)*	Draw-down	Total return (prior 12m)	Total return	**2s10s** Start	**Gold** Spot return (pa)*	**Oil (WTI)** Spot return (pa)*	**USD (DXY)** Spot return (pa)*
Current	0	5.50	-0.50	24.1	2%	0%	29%	-1%	4	2%	-6%	0%
2001/03	30	6.50	-5.50	23.0	-9%	-38%	-7%	10%	-1	11%	4%	-6%
1998	2	5.50	-0.75	22.8	9%	-8%	12%	-1%	14	1%	-20%	-1%
1987/88	4	7.25	-0.75	21.2	-8%	12%	22%	16%	109	-5%		-6%
1971	4	5.75	-2.25	18.5	3%	-8%	24%	0	0	5%		-4%
2019/20	8	2.50	-2.25	18.3	-20%	-20%	9%	11%	21	4%	-51%	0%
1995/96	7	6.00	-0.75	16.0	18%	0%	26%	8%	65	6%	3%	7%
2007/08	15	5.25	-5.00	15.7	-30%	-48%	14%	18%	39	13%	-39%	1%
1989/92	39	9.75	-6.75	12.9	11%	-5%	27%	13%	-5	-2%		-7%
1974/76	29	13.00	-8.25	10.7	12%	-27%	-14%	8%	0	-4%		2%
1984/86	23	11.75	-5.87	10.1	29%	-2%	4%	26%	46	5%		-16%
1981/82	19	20.00	-11.50	8.9	7%	-17%	25%	28%	-91	6%		9%
1980	2	20.00	-10.50	7.1	12%	-2%	7%	16%	0	18%		-8%
Average												
All	15	9.44	-5.01	15.4	3%	-16%	12%	13%	17	4%	-21%	-2%
Recessionary	20	11.00	-7.11	13.8	-2%	-22%	9%	15%	-5	5%	-28%	-1%
Non-recessionary	8	7.25	-2.07	17.7	10%	-8%	18%	10%	47	2%	-9%	-4%
Hit rate												
All					67%		83%	92%		67%	17%	42%
Recessionary					57%		71%	100%		57%	14%	57%
Non-recessionary					80%		100%	80%		80%	20%	20%

[4] Source: Insight and Bloomberg as at 30 September 2024. * Non annualised if period less than 1 year.

Equity valuations do matter

Of course, each cycle is different. From an equity market perspective, US outperformance, high valuations, and the dominance of the Magnificent-7 all complicate historical comparisons. In recent years, US economic outperformance has translated into better corporate performance and earnings per share (EPS) growth and, in turn, US equity outperformance. Nevertheless, the S&P 500 Index is currently trading on a 24.5 times (historical) P/E ratio. Even excluding the Magnificent-7 the index is trading on a 21 times ratio which, in a historical context, appears expensive.

Does valuation matter, in the context of rate-cutting cycles? Figure 5 looks at US equity returns based on the P/E (trailing) at the start of a Fed easing cycle compared to the forward return (over that easing cycle). The results are not clear-cut, but lofty valuations are tricky starting points for equities, with a P/E >15 showing mixed results historically. As is usually the case with valuations, there are historical instances (1998) when an expensive starting point hasn't stopped further gains. Moreover, for the two worst experiences shown – the global financial crisis (2007/08) and Covid (2019/20) – it is hard to argue that high equity valuation was the main cause of the subsequent period of distress. Perhaps the main example where that reasoning applies is 1987/88.

Figure 5: Starting P/E of S&P 500 Index vs return during Fed cutting cycle[5]

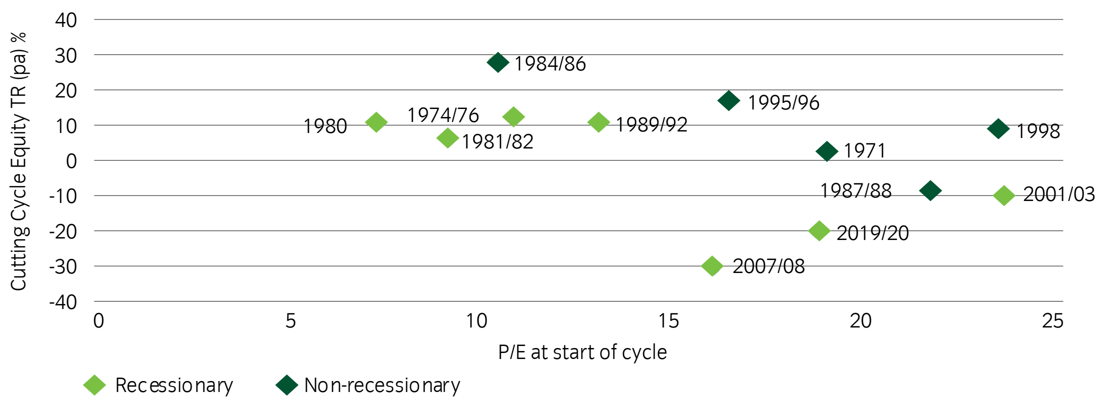
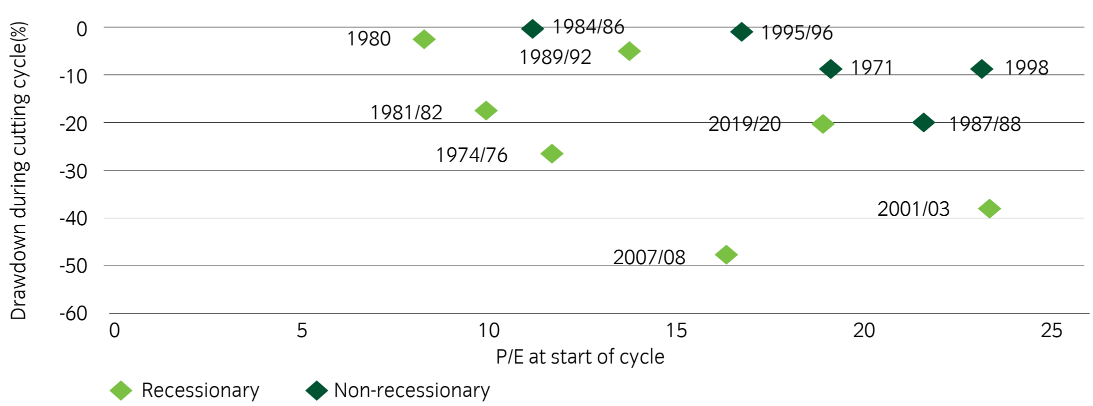


Figure 6 looks at the data in a different way: valuations versus drawdowns. It also shows that high valuation brings with it greater drawdown risk, but the distinction between recessionary and non-recessionary environments is more apparent.

Analysing the current economic cycle has its unique challenges, considering the pandemic and the policy responses to that crisis, but credit excesses and financial-sector fragilities are not obvious, leaving the main economic risks more of a classic macroeconomic nature, geopolitics notwithstanding.

Figure 6: Starting P/E of S&P 500 Index vs drawdown during Fed cutting cycle[6]



[5, 6] Source: Insight and Bloomberg as at 30 September 2024.

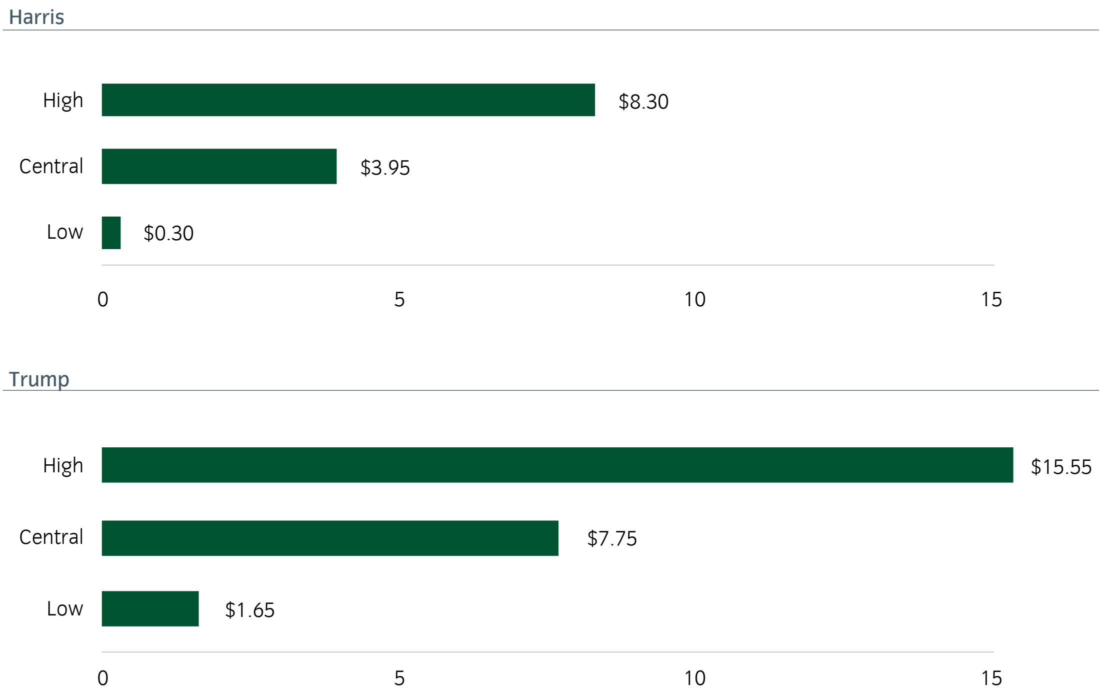
IMPLICATIONS OF THE US ELECTION

A second term for President Trump was partially priced, but not a clean sweep

The prior consensus was that a Trump victory would benefit domestic US stock markets, driven by fiscal stimulus, regulatory changes, and a pick-up in merger and acquisition activity. In contrast, Chinese and European equities were expected to be most adversely impacted by tariffs. Trump had raised the prospect of imposing tariffs of 60% on goods imported from China and 20% on goods from the rest of the world. Most economists agree that tariffs ultimately lower growth and raise inflation. Indeed, the speed and extent to which tariffs are implemented, along with retaliatory measures, present one of the greatest risks to growth.

However, it is the market reaction to fiscal expansion that presents one of the most immediate investment issues. The risk was particularly acute in a Republican clean sweep. The Committee for a Responsible Federal Budget, a non-partisan body in Washington, highlighted before the election that a Trump administration might raise debt by approximately US$7.75 trillion, compared to a US$3.95 trillion increase under the Democrats through 2035 (Figure 7).

Figure 7: Likely impact of fiscal plans (US$ trillion, 2026 – 2035)[7]



The upward surge in bond yields in the run up to the election was partly due to concerns about an increase in Treasury issuance during a second Trump term. With the Republicans securing a 'clean sweep', there is unlikely to be significant opposition to Trump's plans. The key question is whether the 'Trump premium' is already fully priced into yields or if yields will continue to rise. Leading up to the election, both sides offered limited policy details, and it will take time for the new administration to develop and implement its policies. While it remains uncertain how much of the pre-election rhetoric will translate into action, we anticipate that a substantial portion will be enacted, although it will take some time for the Trump administration to settle in.

The election has been a source of policy uncertainty for businesses, and clearing this event should help improve policy visibility, encouraging companies to invest in capital and projects. While the positive impacts of a fiscal boost need to be considered, they must be weighed against the likely negative impact of tariffs. The timing of these factors remains unclear, with the more negative forces likely to take time to become apparent.

The heightened geopolitical uncertainty, including reduced military and economic aid for Ukraine, a lesser commitment towards Taiwan, and a more adversarial approach to China and US allies in NATO, creates a challenging medium-term backdrop and suggests increased event risk compared to the previous administration. This adds to the challenges faced in other parts of the world where economic activity has been less resilient than in the US.

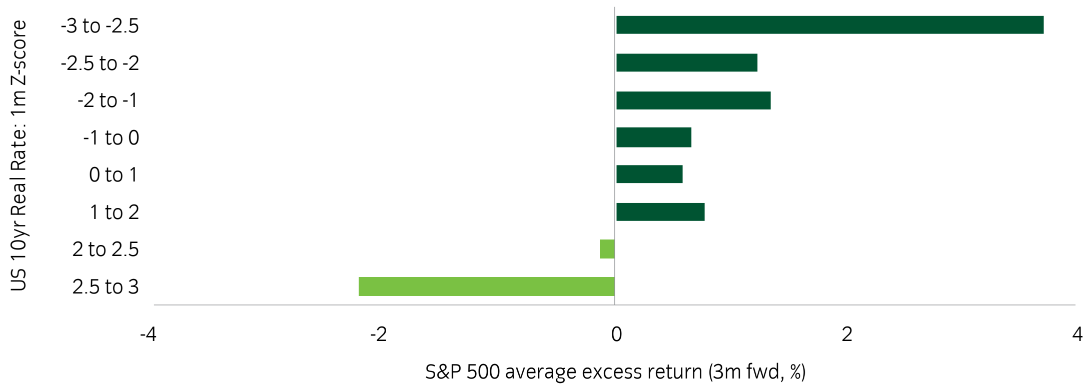
[7] Source: The Committee for a Responsible Federal Budget.

Markets appear able to deal with higher real rates, to a degree

In a world of stabilising activity, we believe risk assets can handle higher interest rates. However, our research indicates that the rate of change is crucial. Before the election, we had already seen a 50 basis-point rise in the 10-year Treasury yield. We are mindful of the limits on how high and how quickly US Treasury yields can rise in response to the fiscal spending plans of a Trump administration before wider ramifications occur. For real rates, we use Z-scores to assess the rate of change. A Z-score measures the number of standard deviations the move is from historical averages.

After the election, the 1-month move in the real 10-year rate is currently at 1.4 times. As Figure 8 shows, when the Z-score has historically exceeded 2 times, the impact on equity returns has typically become concerning. This suggests that a 10-year US real yield above 2.2% would be a critical level to watch.

Figure 8: Rates of change in real rates matter[8]



A POTENTIALLY CONSTRUCTIVE OUTLOOK FOR FUTURE RETURNS

Taking all of this together, the shift in our macro regime framework makes us more positive on the outlook for equities in the short-term, despite the level of valuations in the US. We are particularly focused on the extent to which active managers de-risked ahead of the election. With the election now behind us, we are aware that if the macroeconomic backdrop remains stable, the fourth quarter has typically been positive from a seasonal perspective (see Figure 9), and many investors will have cash to deploy. Of course, not all equity markets are on premium valuations even in the US, with a significant divergence between tech megacaps and broader markets. For example, we believe the Russell 2000 Index stands out as offering better potential value.

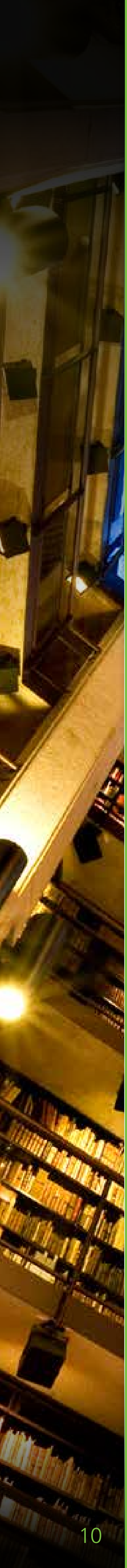
Figure 9: Seasonal sensitivity – MSCI World Index performance by quarter since 1970[9]

	Q1	Q2	Q3	Q4
Average return	1.2%	0.5%	-1.1%	3.0%
Volatility	17.5%	15.2%	17.6%	16.2%
Hit Rate	56.4%	58.2%	53.7%	74.1%
Drawdown	-21.8%	-19.3%	-25.4%	-22.4%
Drawdown (90th percentile)	-10.0%	-8.7%	-15.4%	-5.3%

However, the risk of higher US bond yields brings with it the potential for relapse, and other markets remain vulnerable to uncertainties surrounding trade, immigration, and US foreign policy. To mitigate these risks, we believe it is necessary to look for defensive strategies beyond the traditional investment toolkit.

The scenario that poses the greatest risk to most multi-asset strategies is when equities and bonds decline simultaneously. In such a scenario, we view the US dollar as a source of diversification. During periods of risk aversion investors often flee from minor (less liquid) currencies to major (more liquid) ones, and the US dollar has typically been the ultimate benefactor of those flows.

[8, 9] Source: Insight and Bloomberg as at 31 October 2024.



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