ZURICH

Mid-year Outlook 2024

An uneasy calm

Despite Covid becoming a distant nightmare to most of us, the impact on the global economy remains profound. Taking stock at the mid-point of the year highlights how the excesses and distortions are still being digested, in a period that we would characterise as the 'great normalisation'. An economic rebalancing is underway, with inflation and now interest rates falling and every data release commanding attention. It seems all too easy to look past war, geopolitical conflict and political change and embrace each tick lower in inflation as the key to prosperity and well-being. Financial markets are in rude health, with stocks up and credit spreads tight, and the US tech goliaths are vying for the title as the world's most valuable company. While global growth and financial market prospects look to be good, an uneasy calm is present as fragilities linger in the shadows.

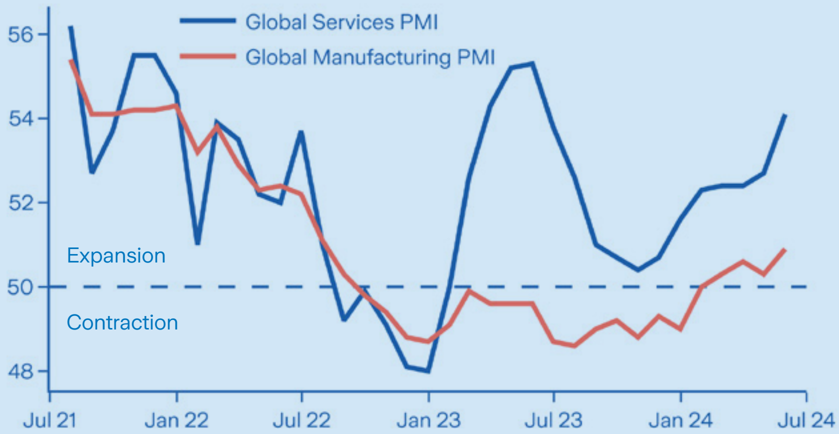
Inflation continues to determine prospects, with its protracted and obstinate grind back towards targets inhibiting the pace of rate cuts from painfully high levels. But cuts have been forthcoming. The Swiss SNB joined many developing regions as the first of the G10 central banks to cut rates – not just once, but twice – with the ECB, Bank of Canada and Sweden's Riksbank also taking their first tentative steps lower. Economic activity is also in the throes of normalisation, with manufacturing output finally emerging from its prolonged recessionary slumber while services activity globally has continued to hold up. At the country and regional level there is also some rebalancing underway as growth in the buoyant US economy fades, while Europe and a number of emerging economies gain a stronger foothold.

A dull but desirable growth outlook

Following the pandemic-induced rollercoaster growth ride, with depression only avoided by a tidal wave of fiscal and monetary stimulus, current global prospects seem almost dull. We see global growth to be trend-like for the remainder of this year and next, with weaker countries gaining traction, China continuing to muddle-along close to target, and the stronger countries, notably the US, slowing. With tight employment globally and limited spare capacity, however, growth is likely to be capped in aggregate close to current levels. Although unexciting, it's exactly what is needed if inflation is to be truly brought to target. Part of the rebalancing is also likely to see the beleaguered manufacturing sector improve, as inventory restocking and a mild technology cycle lend support, while demand for services should moderate from very elevated levels over the remainder of the year.

Manufacturing is growing once again while services activity remains very robust

Trend-like global growth is broadening



Source: Bloomberg

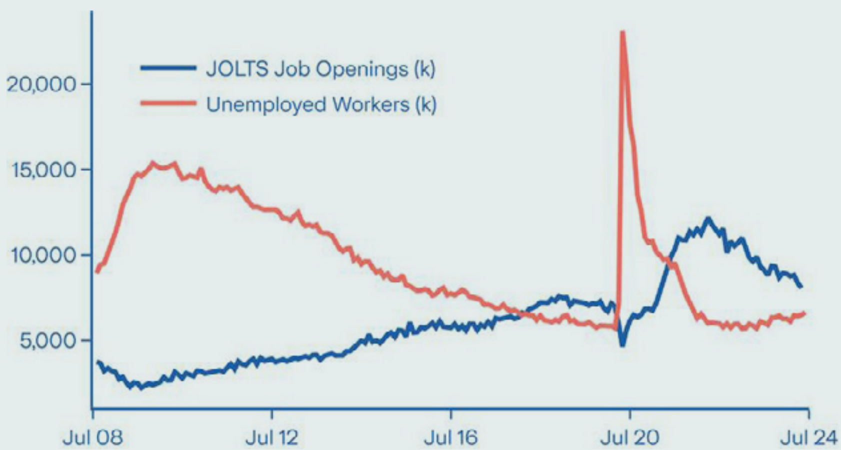
The US economy shifts to a lower gear

The resilience of the dynamic US economy is finally showing signs of tiring, but not derailing. Most notably, the labour markets are now normalising from excessively tight conditions. Initial jobless claims are moving higher, hours worked are moderating, and the quit rate returning to pre-pandemic levels. So far, it has been the excesses in the labour market that have been quelled, with the number of job openings compared with unemployed workers shrinking from a ratio of 1.9 to 1 in 2022 to 1.2 to 1 today.

Unemployment has, however, started to drift higher, and it was notable that the Fed Chair emphasised that monetary policy would be eased should layoffs rise meaningfully, even if inflation were to remain challenging. This is clearly a sign that the growth component as well as the inflation one is gaining attention in the Fed's dual-mandate. We note that consumption has already started to slow, with latest readings showing savings rising and retail sales moderating. While the risk of a US recession is not immaterial, we think this will be avoided, at least in the short to medium term.

The US labour market is normalising as job vacances decline while unemployment inches higher

Job openings decline as the US economy cools



Source: Bloomberg

China battles a balance sheet recession, but not hard enough

In many ways the disappointing growth dynamic in China has taken some heat off global inflation and supply chains. However, poor domestic demand and surging output of electric vehicles (EV) and green technologies have attracted calls of 'dumping' excess goods into global markets and sparked another round of tariffs. The US was quick to initiate 100% tariffs on EV imports from China, an easy political move with almost no imports of such vehicles, but the much more significant imports by the EU have also been targeted with tariffs of up to 38% being applied. While the calls of dumping and of unfair subsidies may well be valid, making overseas suppliers less competitive, one can also claim that Chinese subsides in green technology are in effect subsidising other economies to make the green transition, at a time they need it most, as climate targets are missed. More important from a Chinese perspective is the ongoing implosion of the domestic housing market. Households are seeing their largest asset plunge in value as the authorities grapple with measures to absorb excess supply and bolster demand.

The issue, as with most balance sheet recessions, is that generally less rather than more borrowing is sought, and this can be seen with savings rates rising despite lower interest rates. With new and second hand homes still falling by an alarming 4.3% and 7.5% respectively YoY, confidence is low and a much more comprehensive approach is required to right-size the market. While we see GDP growth coming in at around the 5% target level for this year, this will be contingent on further support being forthcoming. Further out, growth is likely to be on a slowly declining trajectory in the years ahead.

Property prices in China are in fee fall

Source: Bloomberg

The housing market in China needs to be stabilised with further decisive policy measures

Improved prospects for Europe are well known, with limited room for upside surprises

With the UK taking the honour of the fastest growing G7 nation in Q1 and the services-led southern Eurozone countries surprising positively, the growth dynamic has improved for Europe. The industrial heartland, Germany, has remained under the cosh, but even here hopes and expectations of things becoming less bad have risen.

While we have been pointing out improvements for some time, much of the good news is now widely acknowledged, and we see the Eurozone bumbling along with around trend growth for both the remainder of this year and next. Rising defence spending and the ongoing green transition, along with the move to shore up energy supplies will help. But the region has a history of making life difficult for itself. The combination of fiscal deficits, with both France and Italy under scrutiny for the Excessive Deficit Procedure, the fiscal brake in Germany impeding spending and, of course, the political uncertainty brought about by the snap French election, will create headwinds for further positive surprises.

Eurozone economic data no longer surprising positively

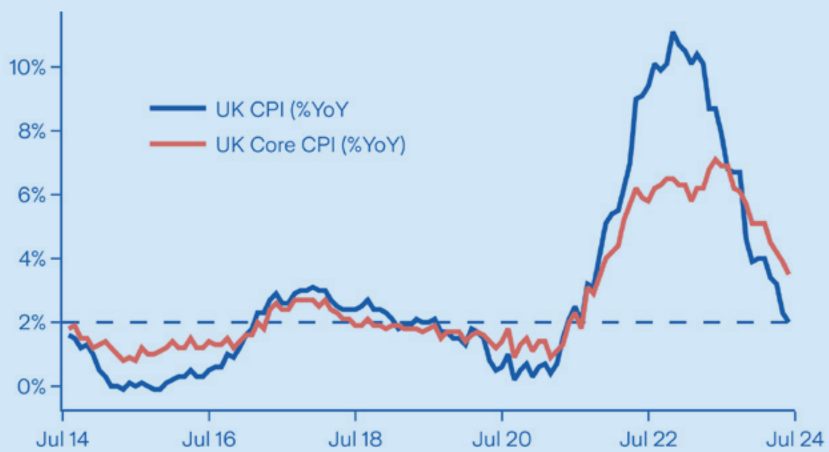
Source: Bloomberg

The Eurozone economy continues to gain traction with growth rising, but much of the good news is expected

It's still all about inflation

Despite current world events including wars, elections and some scary, televised political debates, all that really seems to matter is what the next inflation print will be. At least the direction of travel on this front is again lower. Indeed, one other thing the UK can lay claim to is that in June the BoE was the first of the leading central banks to have reached its inflation target, with headline inflation a mere 2% YoY. Other measures were a tad more troubling, but we do see the global inflation dynamic continuing to subside, which will support a lower interest-rate environment in the months ahead.

UK headline inflation hits the 2% BoE target



Source: Bloomberg

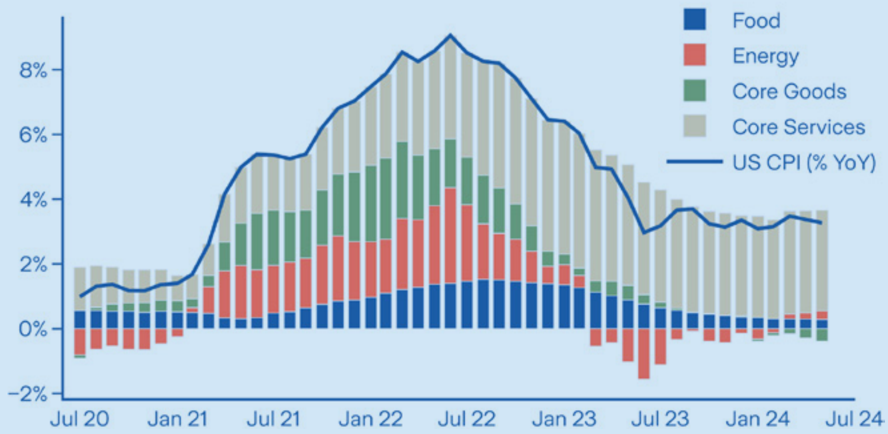
UK inflation falls sharply, though pockets of resistance remain, particularly in services

Inflation grinds lower but slower

Following a few months of worryingly higher prints from the start of the year, the down-track in global inflation has resumed for both headline and core inflation. In the US, headline inflation is still at 3.3%, but was flat MoM in May, with the core reading showing a similar dynamic. As the chart shows, the key problem has been that services inflation remains elevated, despite other cost pressures falling and goods prices actually declining.

Average hourly earnings, at 4.1% YoY currently, is easing and the cost of rents, a substantial part of services inflation, looks set to slow appreciably given the sharp decline in market rent prices. Of the key economies, US inflation has proven more troublesome than in Europe and certainly in China, where deflation is more of a concern with the CPI at only 0.3% YoY. Again, the weak Chinese economy has put downward pressure on export prices. The reason for the fixation on inflation is because of its influence on interest rates and the cost of financing the economy.

US inflation is proving stickier than in other regions



Source: Bloomberg

US core services inflation remains unrelenting, although expectations are for this to fall as home rental prices and wage growth slow

Policy rate cuts offer relief, albeit in a measured and reserved manner

A defining feature of the first six months of the year has been the pushing back of rate-cut expectations, following the rather surprising and ultimately misguided dovish Fed meeting back in December. From the seven rate cuts expected in 2024 to the current market pricing of just over one, borrowers have had to adjust their funding and refinancing schedules where possible as the pain of 'higher for longer' is felt. Having been overly dovish in December, the latest dot plot of rate expectations from Fed members implies only one cut by year end. To us this now seems overly hawkish given the inflation and growth dynamics, and we maintain that two cuts seems probable.

Market pricing of policy rate cuts for 2024 has moved from around 170bps back in January to now less than 50bps in total

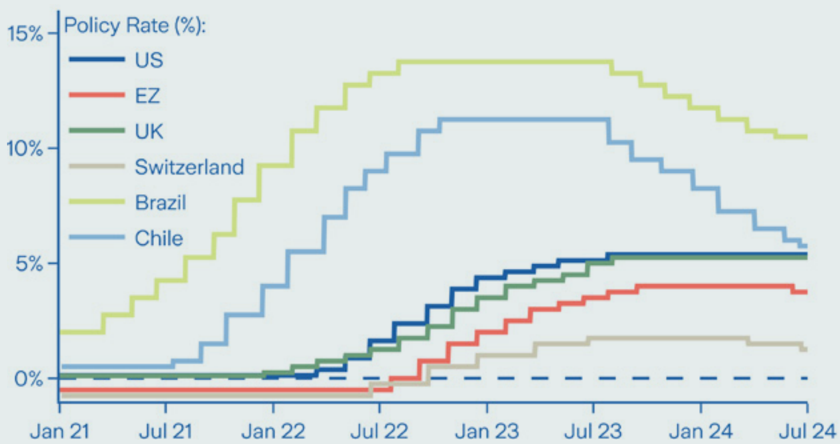
Markets have pushed back sharply on policy rates in 2024

Source: Bloomberg

Despite the delay by the Fed, a global easing cycle is now clearly underway. The LatAm region was the first to start easing, having previously been the first to hike, and the Swiss showed the way down for other G10 members. The tempered cut in June by the ECB, accompanied by cautious rhetoric, suggests that this rate cutting cycle, like many other developments of late, is different this time. While we see two further cuts this year by the ECB, they may not be linear, with July skipped in favour of September, then December.

The Fed is not yet comfortable cutting rates. Perhaps recent rises in Canadian and Australian inflation are a reminder of the asymmetric risks the policy makers face of being too early rather than too late in cutting rates. That noted, we are expecting a September rate cut by the Fed, a month after when we expect the first BoE cut will occur. This is critical as corporate financing has become stretched and the commercial real estate sector remains on life support.

Global policy rates are again taking on a similar pattern



Source: Bloomberg

Central banks are increasingly aligned with rate cuts just as they were on the journey higher

Stocks investors play momentum and ride the wave

The fact that financial markets, and equities in particular, were unperturbed by the repricing of rates is a function of the robust growth and earnings environment in the US. Higher rates could be tolerated, provided that profits and margins held up. It is perhaps also why US equity concentration continued to rise as investors sought out companies that were cash rich and immune to the uncertainty and cost of refinancing. While the S&P 500 posted a 14% gain in the first half, the small cap and more rate sensitive Russell 2000 index only managed 1%. Even within the S&P 500 it was again the biggest and best that outperformed, despite high expectations and multiples to match. Microsoft managed to reclaim the title as the world's largest company right at the end of June from Nvidia, a company whose stock had a remarkable 124% YTD gain, and now has a market capitalisation over USD 3tn. We maintain that this is not the bubble-like tech conditions of old. These behemoths are not only beating high earnings expectations, but are raising dividends and buying stock back from their war-chests of cash and gushing free cash flows. Clearly there is heightened risk of disappointing and an abrupt fall from grace, but these business models are truly remarkable, setting the US equity market apart from all others. It is also, however, widely reflected in their high valuations. While active institutional investors may be constrained from even having a market weight in particular stocks due to the size of their index weights, the US market itself shows its own concentration in terms of its share of the MSCI World Index. The US now represents 69% of the index.

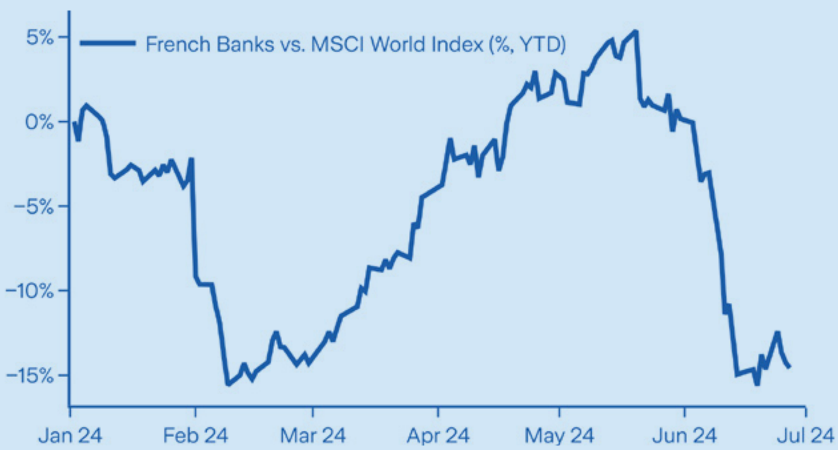
Consistent outperformance of US stocks, particularly in the technology field, has increased the dominance of the US within the MSCI World Equity Index

US stocks are the dominant force in global equity markets

Source: Bloomberg

We remain believers in structural US equity exceptionalism, but can see a broadening out of markets as inflation and interest rates normalise and idiosyncratic trading opportunities present themselves. The debacle in French politics has inflicted severe wounds to French stocks and to the French banks specifically, which have large domestic bond exposures. While we don't think the impact will be far reaching, patience will be required before committing to any opportunity for recovery.

French election hits the banking sector hard



Source: Bloomberg

With large exposures to French government bonds, French bank stocks have been shunned by investors

For now, global equity markets remain in a momentum fuelled ascendency, however, we expect bull market corrections to appear sporadically. Currently equites are looking a little stretched, with a healthy correction possible, perhaps as political risk garners more attention in the coming months. That noted, stocks remain our preferred asset class and are expected to continue to outperform credit markets over the remainder of the year.

Risk premia in credit markets is hard to find, buyer beware

The cut in policy rates has certainly been welcomed in the credit markets, but, as we anticipated, credit returns have languished relative to the strong gains in stocks thus far this year. The slower and more protracted pace of rate cuts remains a challenge for less credit worthy companies. In addition, credit tends to be exposed to the less dynamic and more indebted part of the corporate universe in contrast to key equity markets. Within credit markets there has also been notable divergencies. Investment Grade (IG) credit has outperformed High Yield (HY) on a relative risk-adjusted basis, but US credit, which we felt was trading at very tight spreads at the end of last year, has significantly lagged European credit. New issuance concessions had fallen, but have started to rise again, suggesting investor are becoming more circumspect.

High Yield has also witnessed significant divergence in performance, with weaker names, particularly those CCC rated, underperforming in the still very challenging interest rate environment. While US bankruptcies remain elevated, companies have been using investors' demand for yield and the liquidity in markets currently to improve their funding profiles. While CCC rated names remain largely absent, primary issuance has picked up in both the US and Europe in a bid to flatten the refinancing profile that is so apparent in European HY from 2026 onwards. More broadly, credit investors face further headwinds as we suspect that merger and acquisition activity will be on the rise given the stage of the economic cycle which, while generally shareholder friendly, is a further impediment to credit at a time when spreads leave little room for error. Consequently, already tight spreads offer limited gains, while a supressed risk premium implies an asymmetric risk reward profile.

Credit spreads sink lower, offering no risk premia

Source: Bloomberg

As investors seek higher yields, corporate spreads have been pushed close to 20-year lows, offering a poor risk/return trade-off

Volatile government bond yields to grind lower

A lacklustre performance from government bonds year-to-date belies heightened volatility in an asset class buffeted by the will-they-won't-they view on policy rate cuts. The higher inflation prints earlier in the year kept upward pressure on yields, with 10yr Treasuries retesting the 5% level back in April. Peaking at 4.7% as risk assets wobbled, their safe-haven qualities were again visible. We suspect that Treasury yields can tick lower over the remainder of the year as inflation subsides, growth moderates, and the Fed finally embarks on rate cuts, but it is likely that volatility will remain high and the trajectory of travel will be choppy. Greater fiscal focus is likely to keep yields structurally higher this cycle, with the US deficit at a record non-war, non-recession level, and both presidential candidates apparently supporting fiscal largess.

Eurozone bond investors have had more to contend with. While the populist tilt in the European Parliament elections was much anticipated, the resultant snap French election was not. French OATs were already under pressure from the mounting fiscal deficit that triggered a downgrade from rating agency S&P. While we feel strongly that the construct of the Eurozone remains robust, and point to the significant advances made in terms of policy framework, support mechanisms, and the overwhelming backing of the Euro by national populations, the latest developments are disturbing. It would appear that whatever the construct of the new government, fiscal deficits are likely to rise even further. OAT/Bund spreads are expected to remain higher given the deteriorating fiscal positions between countries and we see limited potential for improvement in the medium term, while the risk that President Macron decides to step down before the end of his term in 2027 presents downside risk.

Snap elections in France spook investors

Source: Bloomberg

French OAT spreads against German Bunds spike as investors demand a premia for political risks

Conclusion

After a number of distorted and volatile years, we have entered a period of normalisation, with inflation, interest rates, and growth gravitating towards more sustainable levels. While inflation remains the dominant theme this year, we do believe that the direction of travel towards target rates will allow interest rates to fall and the funding environment to improve. Rising real incomes in many regions will support consumption, while business investment and productivity are likely to rise. Financial markets are not immune to setbacks and overbought conditions in certain asset classes and sectors are likely to be repriced, but for the time being, a positive yet uneasy calm is evident in global economies and financial markets.

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Zurich Insurance Company Ltd
Group Investment Management
Mythenquai 2
8002 Zurich

P0774074 (07/24) TCL

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