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Investment Outlook

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We believe the US economy is late in the credit cycle as US Treasury bond yields move to highs not seen since 2007.

Mortgage rates have been forced higher and lending standards tighter, while oil prices have moved above $90 per barrel and the US dollar has hit new highs for the year. These factors will continue to tighten financial conditions and help move inflation back toward the Federal Reserve's (Fed's) goal of 2.0%.

Will these late-cycle dynamics lead to a soft landing, no landing or a hard landing? So far, US markets do not seem close to pricing in a hard landing given resilient GDP growth in 2023, elevated equity prices and tight credit spreads. However, European GDP growth has stagnated close to zero for three quarters while China's economy remains mired in deflation as its property bust continues. Can the US remain an island of stability in an increasingly unstable global economy?

We will explore these credit cycle dynamics to provide insights as we start to look toward 2024.

PAGE 3 Macro Drivers

We see the US economy late in the credit cycle with heightened risks of heading into a downturn, while Europe appears on the brink of a downturn and China in a downturn.

PAGE 4 Corporate Credit

The Fed currently estimates 2024 US GDP to be 1.5%. Given the "risk-on" environment year to date, we view credit spreads as tight and likely to widen over the next six to twelve months. In our view, growth expectations seem too high.

PAGE 5 Government Debt & Policy

Economic growth expectations in the US have increased, contributing to investors anticipating a "higher for longer" fed funds rate.

PAGE 6 Currencies

Downturn phases of the credit cycle are most often associated with the US dollar outperforming foreign currencies. Recently, we have seen that interest rates in many markets have moved in favor of the US dollar.

PAGE 7 Equities

Notably, the market seems to be expecting a robust rebound in earnings for 2024, close to 10%. We expect a much more challenging earnings environment.

PAGE 8 Potential Risks

Most asset valuations are reflecting a soft landing scenario already. Our core view is that the global economy is currently in a vulnerable position and therefore at risk of entering the downturn phase of the credit cycle.

PAGE 8 Asset Class Outlook

We are constructive on duration and neutral on credit.
We would look to add growth equity exposure on weakness.

Macro Drivers

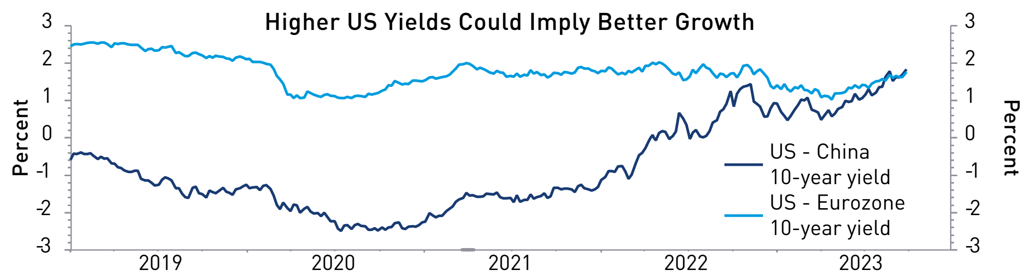
In our view, the shape of fiscal policy has been an important driver of where the major countries are currently in the global credit cycle. In terms of positioning, we see the US in late cycle with heightened risks of heading into a downturn, Europe on the brink of a downturn and China in a downturn.

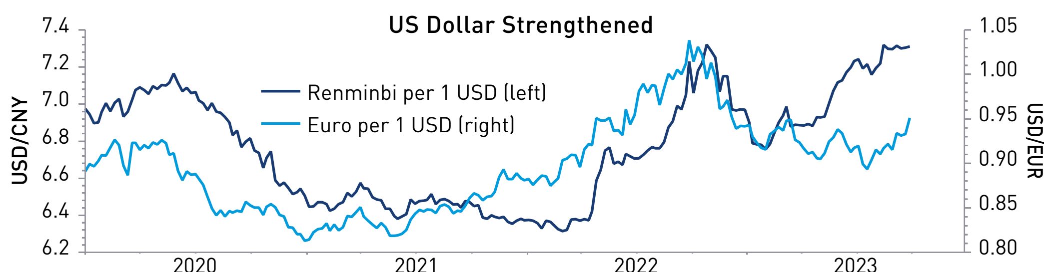
- Fiscal policy has provided significant support for the US consumer and corporate sector since the COVID-19 pandemic. In addition, both sectors took advantage of super-low interest rates in 2020 and 2021. These moves provided them with insulation during the most aggressive tightening cycle by the Fed since the early 1980s, which has brought the fed funds upper bound to 5.5%.
- Bond yields spiked higher in the third quarter largely due to economic growth optimism and uncertainty about necessary Treasury issuance to fund the growing fiscal deficit. The Fed confirmed the growth optimism by revising higher its 2023 GDP estimate to 2.1%, up from 1.0% in June.
- Postpandemic, European fiscal policy was generally geared toward incentivizing a green energy transition. This policy may have a longer-lasting impact on the economy as it incentivizes long-run energy investments, but it lacked the near-term shock and awe of direct payments. We believe that was a factor as to why eurozone GDP has only grown 0.5% in the last year, compared to 2.5% in the US (as of 30 June 2023).
- Chinese fiscal policy postpandemic was more oriented toward company production supports. Consumers have been forced to save to make up for lost incomes, plus the property bust is having a major impact on tertiary consumer spending. China is currently in a deflationary environment with consumer price inflation essentially at zero, producer prices deflating by 3% in the last year, the People's Bank of China cutting interest rates, government bond yields declining in 2023 and continued devaluing of the renminbi.

US YIELDS MOVED HIGHER YEAR TO DATE BASED ON ECONOMIC GROWTH AND UNCERTAINTY SURROUNDING FUNDING THE FISCAL DEFICIT

The focus of Chinese and European fiscal policies did not result in higher yields relative to those of the US.

Source: LSEG Datastream, data as of 27 September 2023.





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Corporate Credit

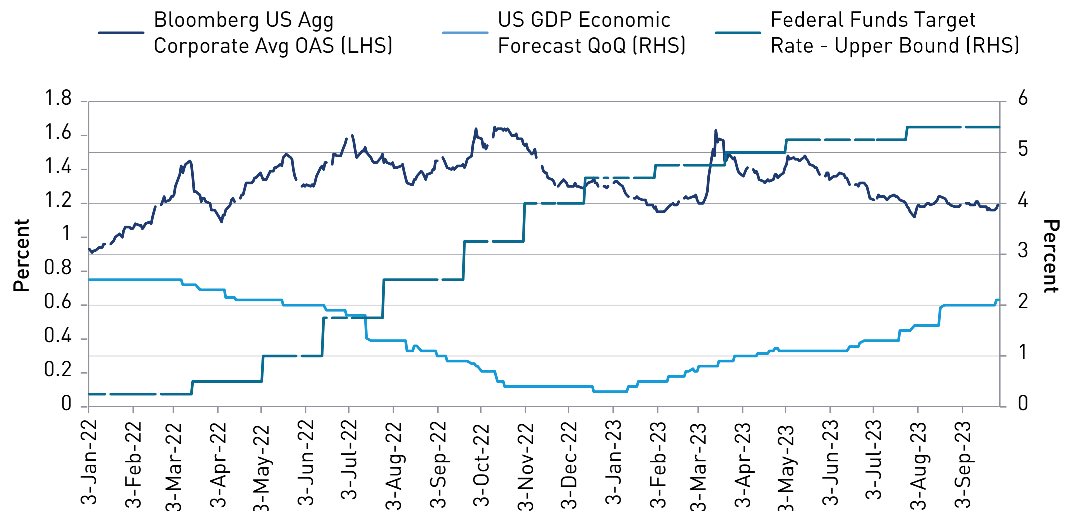
Despite the fed funds rate rising to an upper bound of 5.5%, GDP growth expectations for 2023 have steadily risen to 2.1%, which in our view has been a critical factor supporting riskier corporate credits.

- Credit spreads have tightened significantly during the past year. The US investment grade spread, represented by the Bloomberg US Aggregate Corporate Index average, peaked at 165 basis points (bps) on 12 October 2022, up from 116 bps as of 26 September 2023.
- As credit spreads to government bonds tightened, excess returns across the investment grade, high yield and bank loan sectors—in the US, Europe and emerging markets (EM)—were substantial.
- Looking back, when credit spreads peaked in October 2022, the Fed and other central banks were raising interest rates aggressively as economic growth expectations for 2023 were collapsing (see chart below). GDP growth expectations for 2023 collapsed to 0.4% by October 2022, very close to discounting an outright recession.
- So far, 2023 has been what we consider a "risk-on" environment with higher equity prices and tighter credit spreads. Even though S&P 500 earnings were negative for the past three quarters of 2023, they have not collapsed to the point where companies are shedding jobs, which typically heralds a downturn in the economy.
- We are watching 2024 GDP growth expectations closely. Bloomberg consensus estimates 0.9% for 2024 while the Fed currently estimates 1.5%. Currently, we would take the "under" on both those growth estimates. We view credit spreads as tight and likely to widen over the next six to twelve months. In our view, growth expectations seem too high as bond yields have surged, the US dollar has strengthened and energy prices have increased.

COUNTER TO EXPECTATIONS FOR 2023, AN ECONOMIC RECESSION DID NOT MATERIALIZE

When credit spreads peaked in October 2022 they coincided with a bottom in GDP growth expectations for 2023, setting up a risk-on environment.

Source: Bloomberg, data as of 28 September 2023.



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Government Debt & Policy

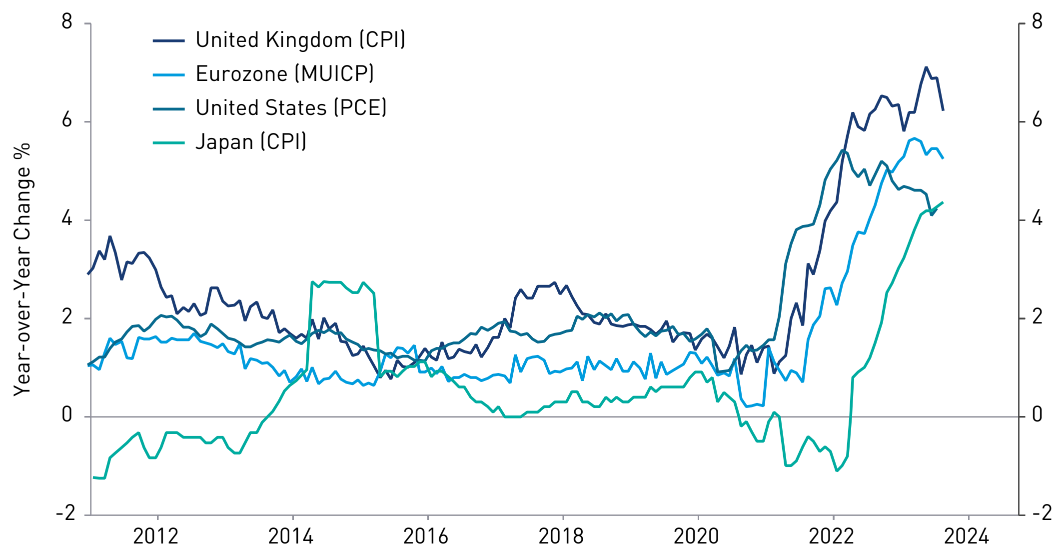
Economic growth expectations in the US have increased, contributing to investors anticipating a "higher for longer" fed funds rate.

- Current fed funds futures indicate only two cuts in 2024, compared to June 2023 when there were two cuts expected by the end of January 2024.
- Further bolstering the higher for longer view, the Fed's September Summary of Economic Projections raised 2023 and 2024 GDP growth forecasts, suggesting little to no risk of an economic downturn. The Fed also lowered its unemployment projections from 4.6% to 4.1% for 2024, which is the long-run equilibrium level.
- The Fed's September forecasts raised the median fed funds rate expected in 2024 from 4.6% to 5.1%.
- Large budget deficits coinciding with central banks reducing their government bond portfolios has led to much handwringing about who is going to purchase future Treasury supply.
- Globally, inflation remains far from the typical central bank's target range of +/- 2.0%. In our view, this adds to a growing belief that we are entering a higher for longer interest rate environment.
- Higher yields tend to tighten monetary conditions even further. We think this will eventually soften economic momentum, bring inflation down and help interest rates and bond yields fall as we move into 2024.

GLOBALLY, INFLATION RATES CONTINUE TO BE HIGHER THAN CENTRAL BANKS' PREFERRED TARGETS

Higher yields tend to tighten monetary conditions, which can undermine economic growth and slow inflation rates.

Source: LSEG Datastream, data as of 27 September 2023.



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Currencies

Downturn phases of the credit cycle are most often associated with the US dollar outperforming foreign currencies. We often remark that when bad things happen globally, the US dollar rallies.

- Interest rates in many markets have moved in favor of the dollar more recently. We have seen this in the spread of US yields over China's. The Chinese renminbi is an important anchor for many EM currencies and could be considered an important bellwether. The currency is an important tool for China to help escape deflationary pressures.
- While European gas prices have collapsed from their highs of €80 to €11 per megawatt hour in 2022, they are still above prepandemic levels, which averaged around €6 per megawatt hour. An energy shock in Europe would likely be a negative trade shock relative to the US, which could add downward pressure on the euro as we move into 2024.
- Many EM countries currently have much higher interest rates compared to those of the US. We believe that should support their currencies in 2024, even if a global downturn occurs. Once inflation comes under control, the Fed and other central banks could be positioned to cut rates.

EMERGING MARKET COUNTRIES ARE CURRENTLY POSTING HIGHER RATES RELATIVE TO THAT OF THE US

The Chinese renminbi is an important anchor for many EM currencies and could be considered an important bellwether.

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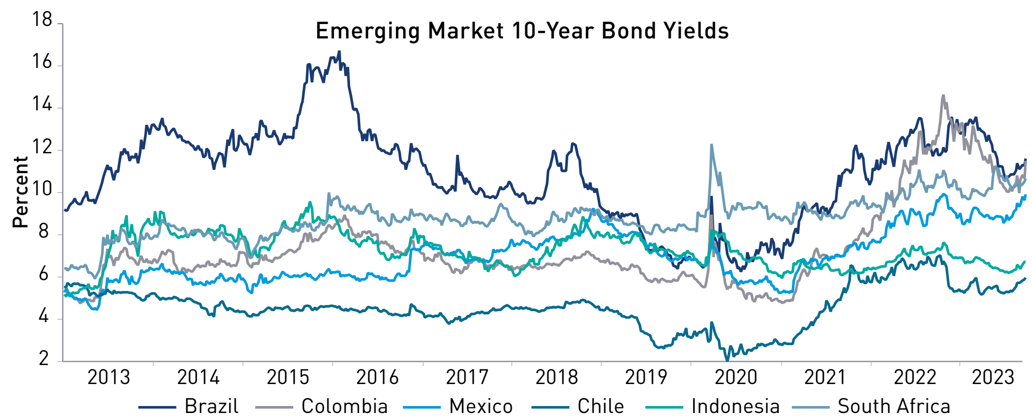

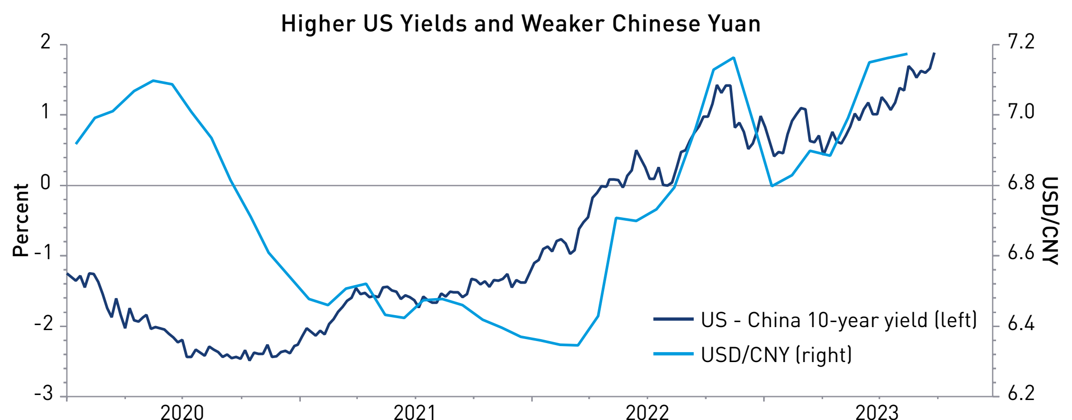

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Equities

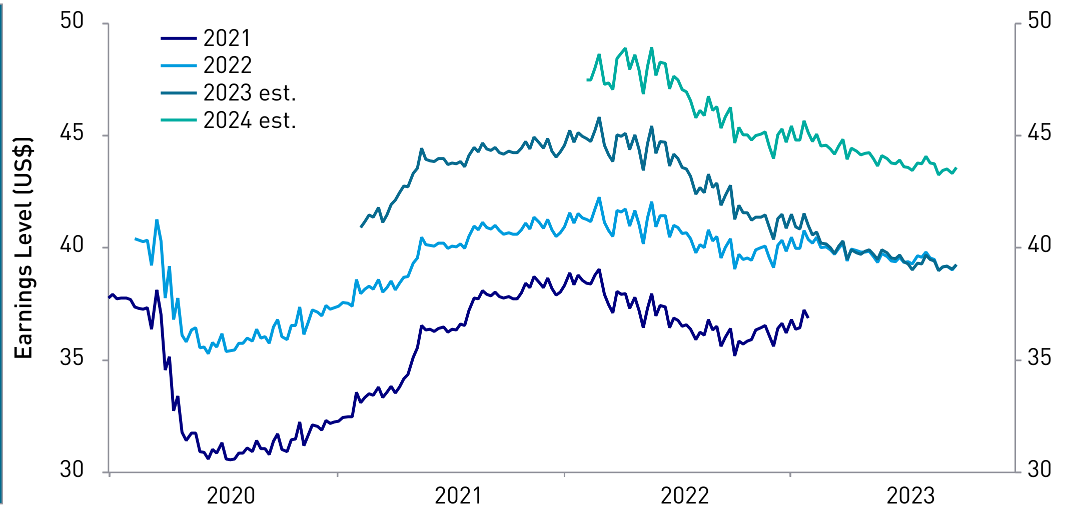
Notably, the market seems to be expecting a robust rebound in earnings for 2024, close to 10%. We expect a much more challenging earnings environment.

- Recent corrections in equity markets are coinciding with moves higher in bond yields, which in our view is not surprising as discounted cash flows decline with higher yields.
- Corporations have been losing pricing power and economic growth appears set to continue slowing. We believe top-line growth will be tougher to generate and we suspect further profit margin compression is ahead.
- Within the S&P 500, there is currently a huge divergence between the top-performing stocks and the rest. For example, year to date through 25 September, the equal-weighted S&P 500 Index returned 2.0%, versus 18% for the capitalization-weighted S&P 500 Index. Most stocks are seeing marginal performance in 2023.
- Equity market performance needs to broaden to include small-cap companies and less-defensive sectors, in our opinion. However, even if this were to occur, we would be reluctant to fully embrace such a trend at this late stage of the credit cycle.

CONSENSUS ESTIMATES FOR MSCI ALL COUNTRY WORLD EARNINGS

The consensus global earnings rebound of plus 10% for next year is very optimistic in our view.

Source: LSEG Datastream, IBES, data as of 27 September 2023.



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Potential Risks

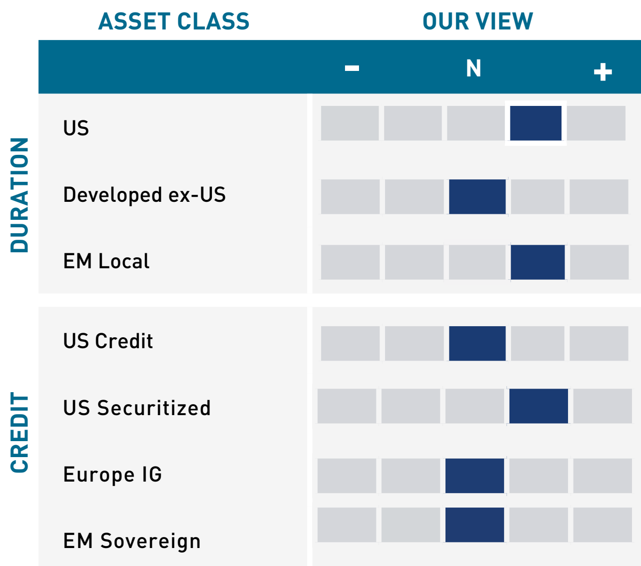
In our view, a cautious asset allocation stance with a tilt toward fixed income is warranted given macroeconomic headwinds and a corporate profits recession appearing to take hold.

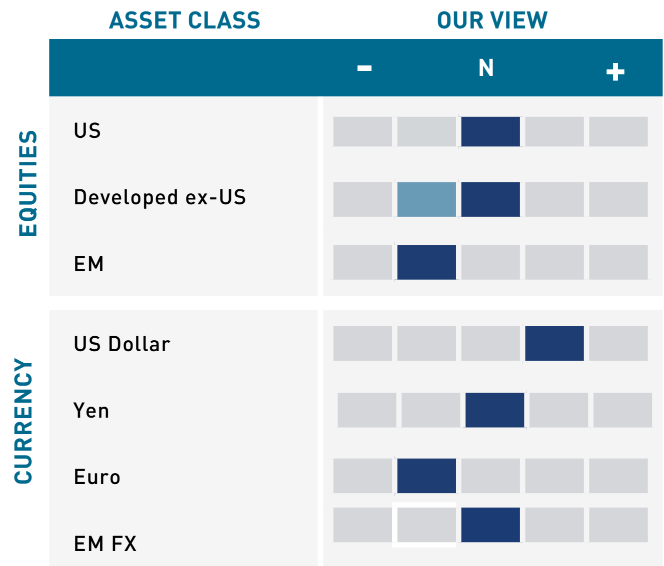
- Currently, our core view is that the global economy is in a vulnerable position and therefore at risk of entering the downturn phase of the credit cycle.
- Most asset valuations are reflecting a soft landing scenario already. We believe the probability of a soft landing is around 20% and therefore find markets optimistically priced.
- We anticipate a profits recession in the intermediate term. That said, corporations could find a way to manage through challenges and continue growing earnings despite economic weakness and higher interest rates.
- Inherent in a downturn scenario is a rising unemployment rate. If US unemployment doesn't head above 4.0%, then a soft landing could become the base case.
- Market performance suggests conditions are rosy. We are more cautious.

Asset Class Outlook

We are constructive on duration and neutral on credit. We would look to add growth equity exposure on weakness.

Current View Previous View





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Disclosure

All data and views are as of 30 September 2023, unless otherwise noted.

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