Mason Stevens OCIO Yearly Outlook

February 2024

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Policy Perfection?

Falling inflation and prospects for easier central bank policy are underpinning the consensus view of a soft landing rather than a recession, hard landing, and bear market. Leading indicators point to slowing growth but not a collapse. There's still risk of recession, albeit comfort exists given significant headroom to cut rates assuming disinflation remains intact. US exceptionalism in terms of productivity supports the US economy above other developed market regions, with Europe likely to fall into at least a mild recession. In Australia there is growing evidence that ongoing cost-of-living pressures have begun to impact the consumer, driving higher confidence that inflation is on a sustainable path downwards, whilst China risks a deflation spiral and is staring down a real-estate crisis.

By their nature markets can be noisy, with investors often jumping at shadows on data that simply doesn't matter. Investor skill lies in determining what data matters and what is priced in at any particular point. In conjunction with determining what data will drive markets, is the recognition that new data will shift probabilities of likely scenarios that may or may not ensue. Rarely is it prudent to have a single view of what will happen, but rather we believe that estimates should be based on a range of scenarios, with assigned probabilities of each occurring.

As we face into 2024, we lay out the three macroeconomic scenarios for developed markets that we think investors should anchor to as 2024 unfolds, and our current subjective assessment of probability for each.

Macroeconomic scenario		Probability
One	Soft landing/ disinflation	55%
Two	No landing/second wave of inflation	10%
Three	Cyclical recession/deflation	35%

Source: Mason Stevens OCIO

2024 has been deemed the "Super Election Year" where half of the world's population goes to the polls, injecting additional uncertainty into the macro environment. Whilst developed market elections rarely change the course of equity markets, they do tend to see fiscal largess with high budget deficits and government intervention in different forms. The drum beat around government debt sustainability, especially within the US, is getting louder. On the one hand this may force the Fed's hand to cut rates more quickly, on the other hand the cost of capital over the longer term may drift higher as markets start to exert a greater price for that spending.

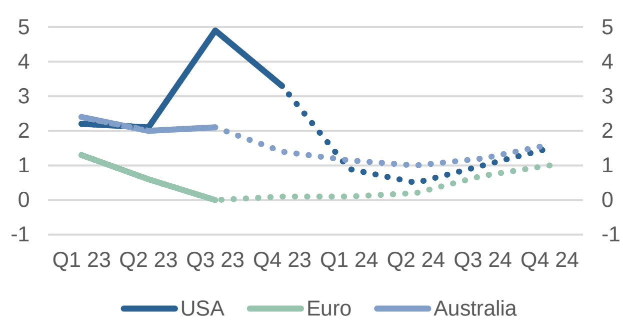
The world is always uncertain. Investors are likely to see many twists and turns this year. In some deep sense, the global economy is still normalising from the pandemic. The path being travelled is both unprecedented and unpredictable. As such, investors need to remain nimble and to be prepared for surprises.

The Global Economy in 2024

Falling inflation and prospects for easier central bank policy are underpinning the consensus view of a soft-landing rather than a recession[1]. Leading indicators point to slowing growth but not a collapse. There's still risk of recession; albeit comfort exists given significant headroom to cut rates assuming disinflation remains intact. US exceptionalism from productivity supports the US economy above other developed market regions, with Europe likely to fall into a mild recession. In Australia there is growing evidence that ongoing cost-of-living pressures have begun to impact the consumer, driving higher confidence that inflation is on a sustainable path downwards.

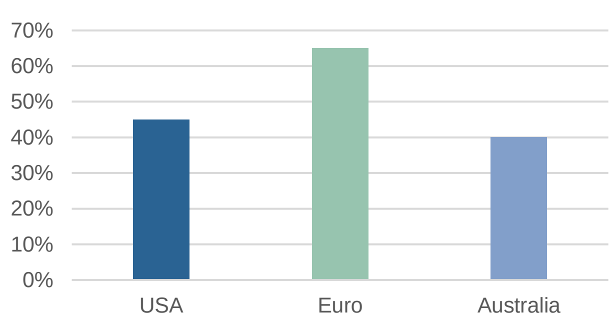
Current consensus estimates for GDP suggest that 2024 will see slowing growth but not a recession, whilst recession risks remain elevated. A cynical investor could argue that the market has a bet in two camps right now and we wouldn't blame them. This economic cycle is like no other and has defied all historical reference to date.

Figure 1 – Consensus Real GDP Estimates



Source: Bloomberg, Mason Stevens OCIO

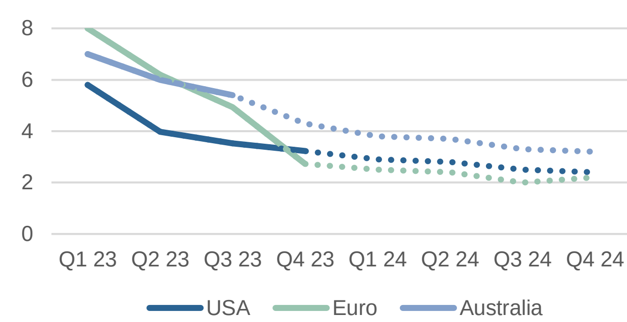
Figure 2 – Consensus Probability of Recession



Source: Goldman Sachs Global Investment Research, Mason Stevens OCIO

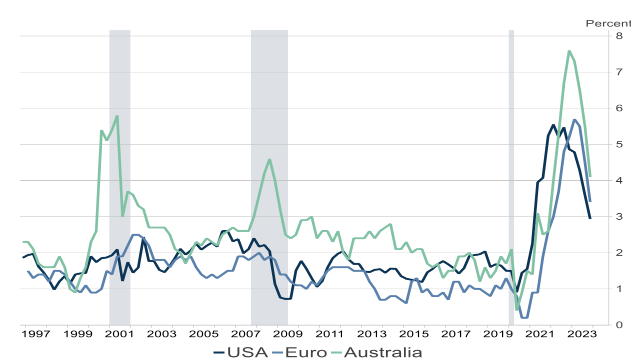
The path of disinflation has defied previous cycles as historically demand destruction has been required to tame inflation. The transitory nature of the pandemic and oil related drivers of inflation have now passed and importantly inflation expectations have remained well anchored providing confidence in consensus estimates.

Figure 3 – Consensus CPI Estimates



Source: Bloomberg, Mason Stevens OCIO

Figure 4 – Core Inflation

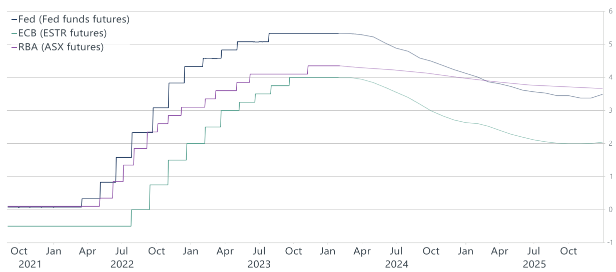


Source: Macrobond, Federal Reserve Bank of San Francisco, Australian Bureau of Statistics, ECB (European Central Bank), Mason Stevens OCIO

[1] Recession is defined as two quarters of negative GDP growth.

Monetary policy settings are now considered restrictive globally. As disinflation continues, continued real yields have room to fall. Current consensus estimates in most regions suggest we are on the brink of rate cutting cycles in much of the developed world.

Figure 5 – Central Bank Policy Rates and Market Implied Rate Trajectories



Source: Mason Stevens OCIO, Macrobond, Institute for Supply Management (ISM)

Fiscal policy settings were a dominant driver of persistent upside surprise in US growth in 2023. Whilst the level of stimulus may reduce, we are unlikely to see a fiscal cliff in the US in a general election year, especially with an incumbent president on the ballot.

2024 has been deemed the “Super Election Year” where half of the world’s population goes to the polls. Elections rarely change the course of equity markets; they do tend to see fiscal largess with high budget deficits and government intervention in different forms.

Figure 6 - IMF Estimates for Budget Deficits in the 2020s

Source: Mason Stevens OCIO, Macrobond, IMF

Australia appears to be on a similar path to the US. While slightly behind in terms of the disinflation story. The latest Australian CPI data continues a clear trend down that commenced in early 2023, and rate cuts are arguably on the horizon for the first time since the rate hiking cycle began. Growth estimates are generally soft, but not recessionary. High net migration, while beginning to turn, remains well above pre-pandemic levels and continues to support growth. A solid US economic story and modest China stimulus also provide positive impulses into the economy. Conversely, Australia is approximately 75% of the way through its “mortgage cliff” process as households roll-off low fixed rate loans onto higher floating rates. A key risk remains around how this is managed through 2024 as pandemic savings dwindle.

We introduce three key economic scenarios and the key data points that drive the probabilities of each. The case for a soft-landing at this stage is gaining momentum as incremental data continues to be supportive. Alternative endings include the risk of a ‘cyclical recession’, i.e. a demand driven recession as part of the normal business cycle, where the lagged effect of tight monetary policy results in unemployment rising and a far more material downturn than currently expected. On the right tail is the possibility of a ‘no landing’ scenario supported by an upturn in global manufacturing and housing. We would argue that this scenario whilst right tail in nature for the economy would be volatile for markets given the likely need to raise interest rates to cool the last mile of inflation.

In our view the key from here lies largely in the employment cycle and whether softness already seen gains momentum despite the likely start of a central bank cutting cycle. Additionally, housing cycle strength and a recovery in the manufacturing cycle are key areas to monitor.

Scenario One: Soft landing
Probability: 55%

A soft-landing scenario would involve positive but below trend growth across major economies. Current monetary policy settings are sufficient for inflation to continue to fall to within central bank target bands, allowing them to pivot and cut interest rates, easing pressure on indebted households, companies and, for that matter, indebted governments.

Soft-landing proponents point firstly to the strength of consumer and corporate balance sheets, the fixed cost nature of debt and the fact that the duration of debt is somewhat longer dated to past cycles, resulting in less refinancing risk. This combines with labour hoarding, migration and the fiscal thrust of government spending to have allowed the US economy to avoid recession in 2023.

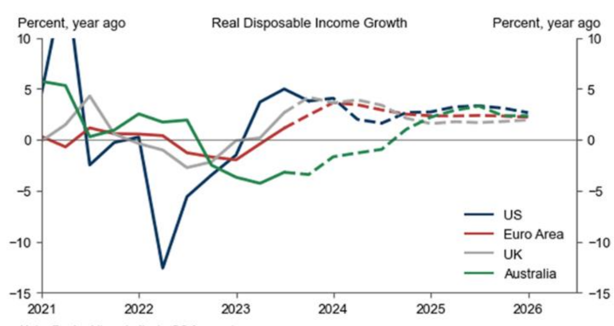
In Australia, excess savings, labour hoarding and migration have also featured however we have not had the same level of fiscal thrust and the nature of our debt structures means that monetary policy has a stronger impact on consumer spending.

Europe's economy has been less resilient given its reliance on manufacturing despite its excess savings, labour hoarding and labour force participation.

Global growth is expected to benefit from several tailwinds in 2024, including:

- strong real household income growth,
- a smaller drag from monetary and fiscal tightening,
- a recovery in manufacturing activity, and;
- an increased willingness of central banks to deliver insurance cuts if growth slows.

Figure 7 – Real Disposable Income Growth

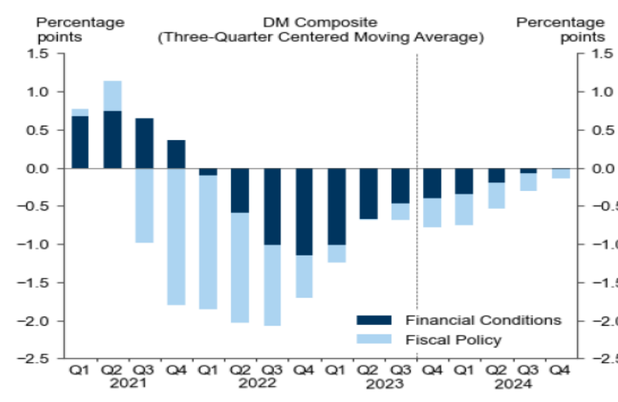


Source: Goldman Sachs Global Investment Research

Assuming unemployment remains steady, with headline inflation falling, then real disposable income will rise. This should be sufficient to support consumption and GDP growth. Europe should see a more significant rate of growth given gas price reductions. Given Australia lags the rest of the world in terms of inflation and the impact of interest rates, we believe that through the course of the year Australia will be a beneficiary of this trend as well.

Financial conditions have eased and hence the worst is over in terms of the impact on GDP growth of tighter monetary policy. Whilst fiscal policy is quite different across most developed economies, as inflation becomes more contained the ability of governments to support the economy improves. Additionally, as discussed earlier, with significant election activity around the globe, incumbent governments are incentivised to open the purse strings.

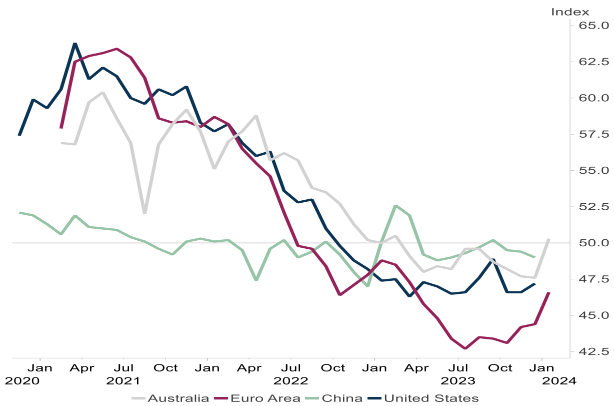
Figure 8 – Estimated Impact of Financial Conditions and Fiscal Policy on GDP



Source: Goldman Sachs Global Investment Research

The manufacturing cycle driven by Covid has been more volatile than history and has the potential to recover in 2024. Weak industrial activity this year reflected a combination of unusual headwinds, including a rebalancing of spending back towards services from goods, the European energy crisis, an inventory destocking cycle that corrected for an overbuild in 2022, and a weaker-than-expected rebound in Chinese manufacturing. Most of these headwinds are set to fade this year, as spending patterns normalise, gas-intensive European production finds a trough, and inventories-to-GDP ratios stabilise, prompting a gradual manufacturing recovery as the lagged impact of easing financial conditions globally supports global goods production and consumption.

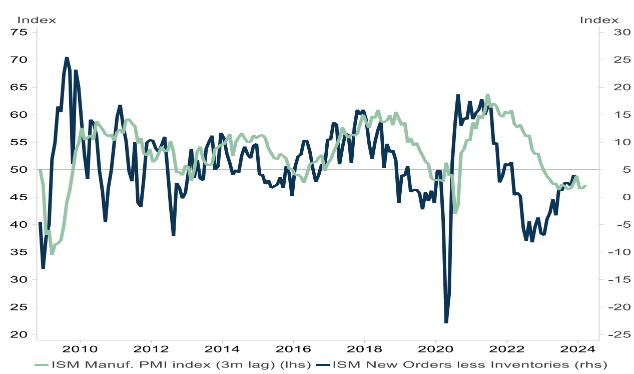
Figure 9 – Manufacturing PMIs



Source: Mason Stevens OCIO, Macrobond, Institute for Supply Management (ISM), S&P Global, China Federation of Logistics & Purchasing

Figure 10 below shows a leading indicator which measures the number of new orders from customers of manufacturing firms reported by survey respondents minus the level of inventories. It has been trending higher since 1Q23 and suggests we are likely to see the headline Manufacturing Purchasing Managers Index (PMI), which is considered to be a very reliable economic indicator, trend higher over the medium term, escorting residual "hard landing" holdouts into the "soft landing" or "no landing" communities in the process.

Figure 10 - US New Orders Less Inventories



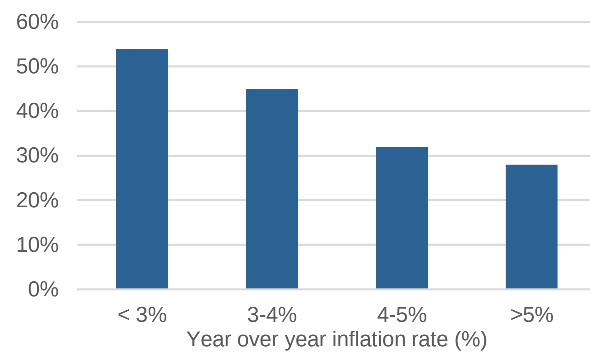
Source: Mason Stevens OCIO, Macrobond, Institute for Supply Management (ISM)

Finally, assuming disinflation trends remain intact there is considerable scope for central banks to cut rates. The US Federal reserve has recently pivoted away from talking about increasing rates to now indicating that rates could indeed come down. This has tipped the odds in favor of a soft landing. We expect that the Fed will shift from fighting inflation to managing the business cycle this year.

Additionally, we expect that there is an inordinate level of pressure for cuts to begin sooner rather than later given levels of government debt and the associated interest rate burden. We expect other central banks will follow suit once their respective disinflation paths reach appropriate levels. Importantly, however, we expect that this process will start without material softening in the economy.

Several of the emerging markets early hikers—including Brazil and Poland—have already begun to cut policy rates from highly restrictive levels and are likely to deliver ongoing steady cuts. Indeed, Goldman Sachs analysis of past hiking cycles confirms that major central banks are twice as likely to cut rates in response to downside growth risks once inflation has normalised to sub-3% rates relative to when inflation is above 5%. This is an important insurance policy against a recession.

Figure 11 - Effect of 1pp Unemployment Rate Increase on Probability of Rate Cut in Following Quarter, By Rate of Inflation



Source: Goldman Sachs Global Investment Research

Soft landings are not common, and there are no modern examples of a sustained growth phase following synchronised global monetary tightening. The US has, however, had three soft-landing episodes since 1960. The US Federal Reserve raised policy rates by more than 250bp during 1964-66, 1983-84, and 1994-95. The 1960s expansion lasted three years beyond Fed tightening, while the 1980s and 1990s episodes saw expansions extend for more than five years.

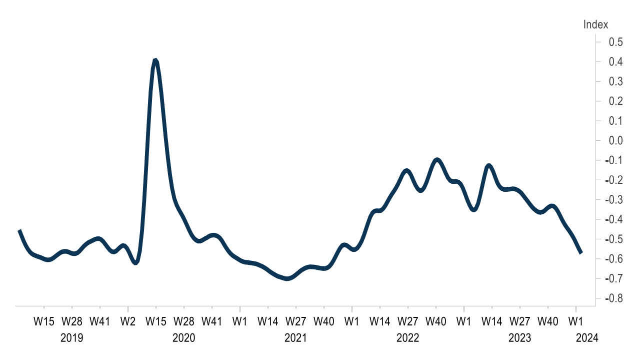
Two important features of these soft-landing episodes are worth highlighting. First, none of these episodes generated labour market slack or reduced wage pressures. Rather than cutting costs on labour, firms initially absorbed some of the impact of monetary tightening by accepting a margin compression. Second, in each of these soft-landing episodes, the Fed quickly reversed course, easing within six months of its final hike. This calibration away from restrictive stances, combined with other positive growth impulses, boosted demand and bolstered business confidence in a manner that extended the economic expansion.

Scenario Two: No landing
Probability: 10%

In a no landing scenario, recent loosening of financial conditions would result in US economic growth continuing to be at, or above, trend. Europe's current slowdown would reverse, and the Chinese economy would be supported by global demand, and potentially local stimulus. In this scenario, core inflation could prove stickier and settle one or two percentage points above central bank targets, resulting in monetary policy settings tightening (or not being cut in line with market expectations) to force inflation to target. Australia would likely follow the US economy's lead, however, given the lack of labour productivity and higher inflation the RBA may have more work to do than global central bank peers.

With the U.S. economy currently operating at full employment, a recovery in manufacturing when combined with any pickup in China, and the tailwind of lower policy rates, could lead to a meaningful reacceleration to above trend growth. Financial conditions over recent months have loosened, which some argue will re-ignite the global economy as opposed to simply supporting a soft landing.

Figure 12 – US Financial Conditions Index

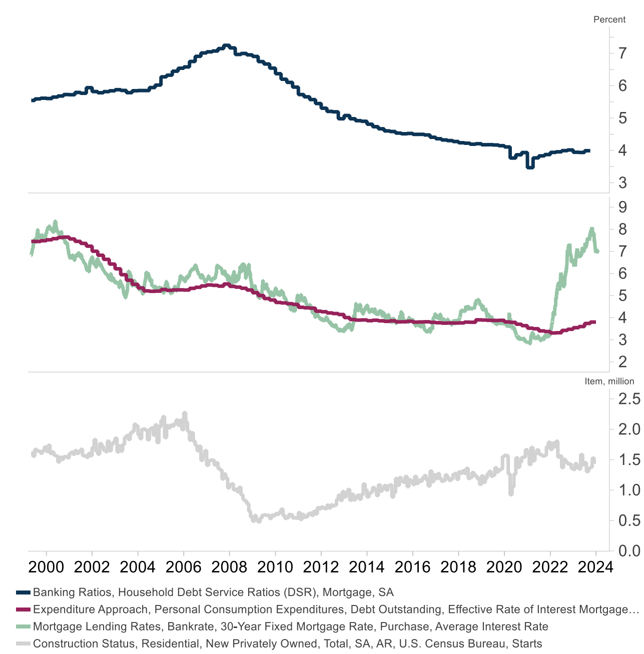


Source: Mason Stevens OCIO, Macrobond, Federal Reserve Bank of Chicago

The latest key economic data reduces the probability of a recession in the US economy. If anything, the data is much stronger than consensus expectations. As already discussed, the global manufacturing downturn is showing signs of bottoming. January PMI data from the major economies signaled green shoots in the global economy, which represent upside risk for risk assets over the medium term. With that said, we need to be mindful that the robust US flash PMI releases are at odds with the results of other recent business surveys. In particular, regional Fed business surveys are downbeat with some manufacturing and non-manufacturing indices deteriorating meaningfully in January.

Secondly the housing market is also providing green shoots. Given the healthy spread between what rates mortgagees are actually paying and the new rates, as well as a favourable household leverage profile, demand for new housing and therefore construction labour continues to support either the soft or no landing scenario.

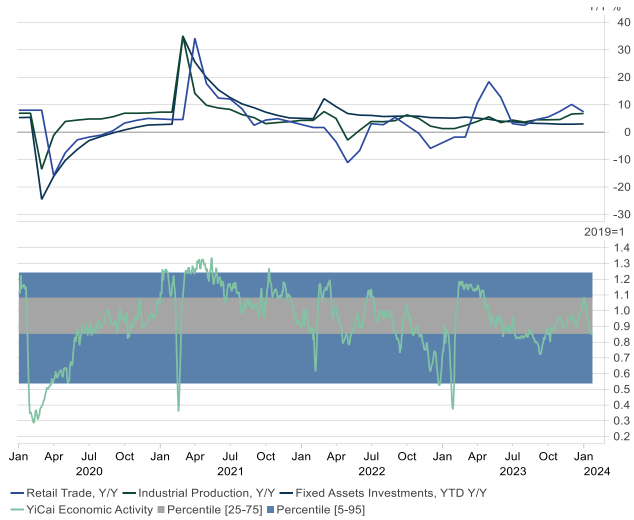
Figure 13 - US Mortgages and Construction Status



Source: Mason Stevens OCIO, Macrobond, Bankrate, Federal Reserve, U.S. Bureau of Economic Analysis (BEA), U.S. Census Bureau

The other key swing factor for this scenario is the economic path for China, a fundamentally imbalanced economy. To date China's central bank has undertaken a series of stimulus activities which have yet to take hold. However, a pick-up in global growth may be sufficient to support China's recovery. The chart below utilises a series of high frequency data to determine whether there are in fact green shoots in the Chinese economy. At this stage there is no evidence of a cyclical turn.

Figure 14 – China's High Frequency Daily Data



Source: Mason Stevens OCIO, Macrobond, NBS, YICAIRI

The weakness in China owes to a range of factors. Foremost is the real estate sector, where the legacy of years of borrowing is causing severe financial challenges. However, the impact is also felt in real activity, as private housing starts have plunged over the past two years and continue to move lower. More concerning, however, is the lack of private investment in fixed assets, which has moved sideways for two years with no sign of re-engaging. At the same time, household consumer goods spending is picking up after being severely depressed through the lockdowns, but the recovery has been far more lacklustre than expected.

Our long-term view on China is not positive given the lack of serious reforms to improve these productivity issues along with poor demographics which have seen their population decline for the second year in a row.

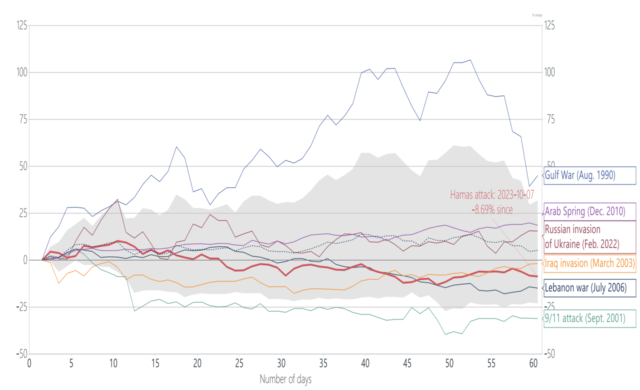
That said in the shorter-term authorities in China have just announced additional stimulus measures commencing on February the 5th, with a reduction in bank reserve requirements. In an environment where global growth is better than expected this may see local Chinese stimulus finally gain more purchase in the economy.

Most proponents of this overall 'No Landing' scenario argue that the 'last mile' of inflation would be difficult to achieve without central banks either keeping rates higher for longer or even raising rates from here. Such a positive growth outlook implies that employment in developed markets remains somewhere near current historic lows, which in turn would keep a degree of pressure on inflation numbers given strong wage growth and consumer spending.

This then brings into view the concerns of central bankers of ongoing waves of higher inflation as was seen in the 1970s. Strong growth may see inflation settle slightly higher than target, but in isolation may not be sufficient for another meaningful inflation spike. We do, however, currently have some obvious geopolitical catalysts that could change this. The current disruption of shipping in the Red Sea by Houthi rebels operating out of Yemen has caused significant disruption and delays in global trade as container ships take longer routes around Africa to avoid the area. The cost of shipping a standard 40-foot container from Asia to northern Europe has surged from less than $1,500 USD in mid-December to nearly $5,500 USD currently[2]. This is not as severe as during the COVID pandemic when these costs got to $15,000 a container, but current pricing is nevertheless clearly inflationary to the cost of goods. If these shipping disruptions are sustained through the first half of this year, we could see this flow into higher prices and therefore inflation numbers.

There is also a risk of further escalation in the Middle East. US troops have recently been killed in a rocket attack at a base in Jordan, seemingly by Iranian backed militants, and the US has stated it will retaliate. This will be something to watch closely in the first quarter of this year. This may well remain a conflict largely contained to Israel and Gaza, but there is an increased risk of direct conflict between the US and Iran. This scenario may lead to a short-term impact on oil prices, which if sustained could flow through to inflation more broadly.

Figure 15 – Short-term Impact of Various Geopolitical Events on Brent Prices



Source: Mason Stevens OCIO, Macrobond, ICE

Finally, if these waves of inflation do eventuate, it does bring into prospect a genuine hard landing, as central banks increase rates to bring down inflation. This is likely a risk late in 2024 and then into 2025.

[2] AP News, 28 January 2024

Scenario Three: Cyclical Recession
Probability: 35%

A mild to moderate recession driven by the lagged effect of tight monetary policy and a lack of credit availability would result in an economic downturn across developed and emerging economies. Central banks would respond by cutting interest rates aggressively, while inflation would also fall sharply as demand destruction delivers the last mile of disinflation.

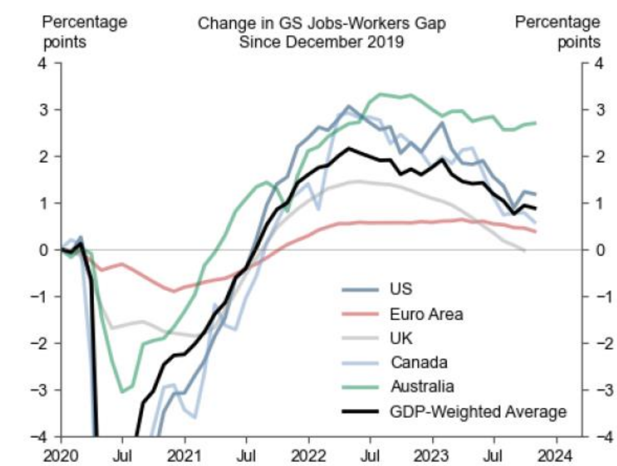
The thesis around a cyclical recession revolves largely around time. Over time, labour demand will continue to slow given the lagged effect of tight monetary policy settings. The Fed's tightening cycle was remarkable in both size and speed and as such the full lagged effects of the tightening have yet to hit the economy. The Chicago Fed[3] estimated in September 2023 that about one-third of the impact from past rate hikes had flown through to real GDP, and over half of the impact on aggregate hours worked still lie ahead.

With enough time, the labour demand curve will reach the kink in the supply curve. When that happens, any further decline in labour demand will push down employment. That is to say, the economy will slow once all the job openings that have insulated it from recession are depleted. The economy through this phase will shift from boom to bust.

Proponents of this thesis argue that this phase of transition will occur when investors least expect it. At the kink in the labour supply curve, everything looks wonderful: inflation is near target while employment is still high – the exact description of a soft landing.

Not surprisingly, the key data points with regard to this scenario relate primarily to the state of labour markets. Figure 16 shows the jobs-workers gap across the key economies. At present, the jobs-workers gap remains above pre-pandemic levels, however as job openings continue to fall this metric is coming back into balance. At that point, workers who lose their jobs will struggle to find new ones. Workers who are still employed will become increasingly concerned, causing them to raise precautionary savings. With most of the excess pandemic savings exhausted by then, the economy will start to suffer from a shortfall of spending. And since one person's income is another's spending, falling employment will feed on itself, culminating in a recession.

Figure 16 – Jobs-workers Gap Falls



Source: Haver Analytics, Goldman Sachs Global Investment Research

Other key planks of the cyclical recession scenario revolve around the inverted yield curve, i.e. the non-normal situation where short-term rates are higher than long-term rates, and the implications of this on credit availability and growth. The nominal 3 month – 10-year US treasury yield curve inversion is the most reliable leading indicator of recession. An inverted yield curve typically puts pressure on bank profitability therefore impacting the availability of credit for the economy to grow.

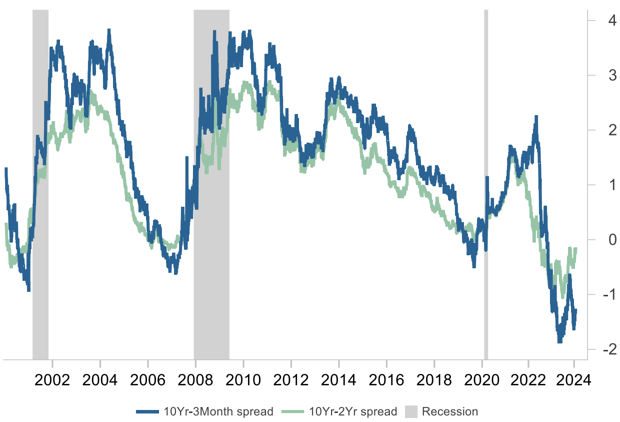
Bank lending standards for business loans have been tightening for a year and a half and interest rates have been rising. There are headwinds to consumer and business spending that we expect to strengthen in 2024, reflecting the lags from tightening in policy to slowing in activity.

There have been signs that business fixed investment is being affected by policy tightening. In the Fed's Senior Loan Officer Opinion Survey (SLOOS), banks have reported falling demand for commercial and industrial loans (C&I) and for commercial real estate loans (CRE) since mid-to late 2022.

[3] Source: Stefania D'Ámico and Thomas King, September 2023
https://www.chicagofed.org/publications/chicago-fed-letter/2023/483

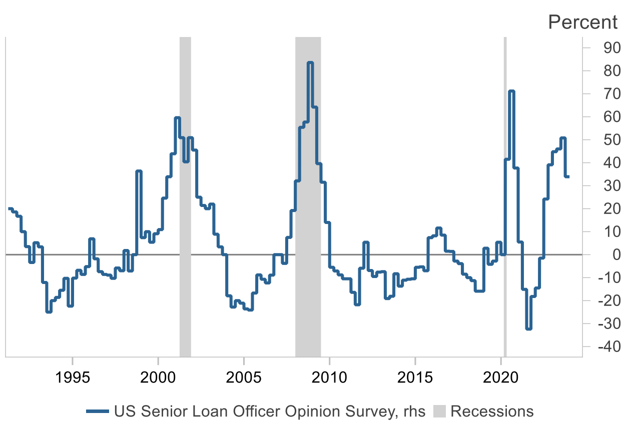
In each quarter of 2023, about 60% of banks reported falling demand for CRE loans – a similar share to 2009. About 40%-50% of banks saw weaker demand for large and small business C&I loans in each quarter. Typically, declines in loan demand are only that broad or long-lasting during recessions.

Figure 17 –US Yield Curve Inversion



Source: Mason Stevens OCIO, Macrobond, US Department of Treasury, NBER (National Bureau of Economic Research)

Figure 18 – US Senior Loan Officer Survey



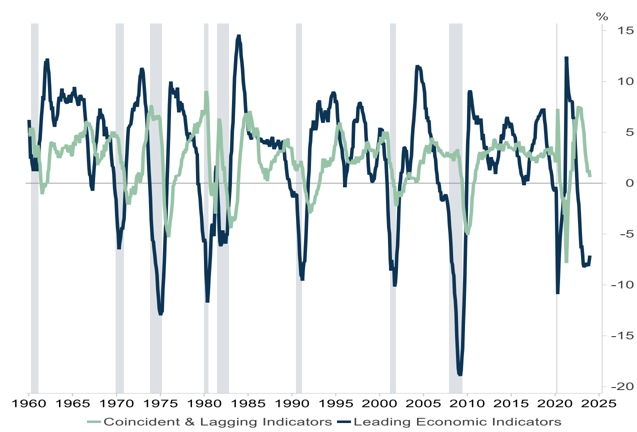
Source: Mason Stevens OCIO, Macrobond, Federal Reserve, Federal Reserve Bank of St Louis

Finally, the US Conference Board's Leading Economic Indicator (LEI) continues to provide a strong signal for a softening economic outlook. The index first started falling nearly two years ago. Whilst some solace can be found in recent data suggesting the rate of decline is slowing and in addition, six of the ten components of the indicator made positive contributions to the LEI in December.

Additionally, the Coincident Economic Index (CEI) is sending a sanguine signal about current economic conditions, rising 0.2% m/m in December. This is consistent with the message from the Atlanta Fed's GDP Now model which has real GDP growth tracking 2.4% in Q4.

To the extent that the LEI is heavily weighted towards goods-producing sectors, whose cycle was amplified during the pandemic, there remains an argument that the LEI's are less compelling as an indicator in this cycle and is therefore potentially overstating the weakness of the aggregate economy.

Figure 19 – US Economic Indicators



Source: Mason Stevens OCIO, Macrobond, Conference Board

That said, restrictive monetary policy remains a headwind for the economy. Labour demand is already softening which may, according to this argument, foreshadow an increase in unemployment later this year. Meanwhile, the tailwind to consumption from excess pandemic savings is fading.

Contact Details

Mason Stevens Limited

E: wealth@masonstevens.com.au

W: masonstevens.com.au