Rothschild & Co
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Monthly Macro Insights

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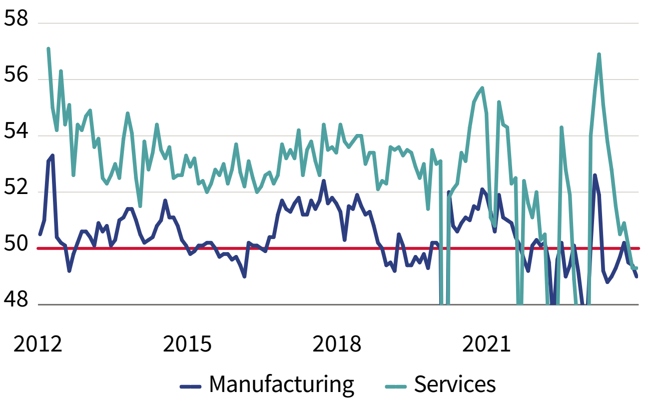
Global financial conditions have eased based on confidence that inflation will fall further and central banks will ease their monetary policies without a significant fall in economic activity. This wave of optimism has been boosted by the resilience of the US economy and the surprising shift in the Federal Reserve's communication. Is the US the canary in the coal mine?

China and the US surprise economists

At the beginning of last year, optimism was high that 2023 would see the Chinese economy rebound strongly, after stringent lockdowns put in place to quell Covid-19 outbreaks, which hammered growth in 2022, were lifted. In contrast, the expectation was that the US economy would come under significant pressure from the Fed's sharp increases in interest rates. Yet, as is often the case, this scenario did not proceed as planned.

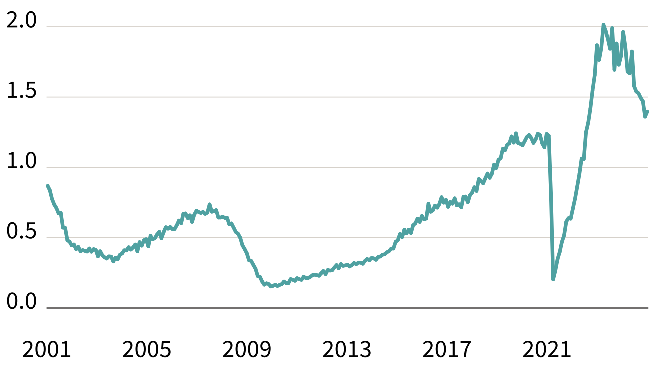
China's manufacturing PMI[1] ended the year on a very weak note, declining to 49 in December from 49.4 in November and marking the third consecutive month in which the reading has languished below 50, as decreasing overseas orders and insufficient domestic demand remain key challenges. In the services sector, the index was unchanged at 49.3, the lowest level (bar the pandemic period) since the survey began in 2012, which suggests that consumers remained wary of spending in the midst of anxiety over jobs and the property market.

China – Business confidence PMI
NBS index



Sources: Macrobond, Rothschild & Co Asset Management, January 2024.

US – Job openings
per unemployed



Sources: Macrobond, Rothschild & Co Asset Management, January 2024.

(1) Purchasing Managers' Index, an indicator reflecting the confidence of purchasing managers in a sector of activity. Above 50, it indicates an expansion in activity, below 50, a contraction.

Authorities have so far opted for a broad but piecemeal approach to stimulus, characterised by modest cuts to interest rates, looser restrictions on property purchases in some larger cities, and other small steps to put a floor under economic growth. Looking ahead, more help is likely coming, with pledges of new fiscal stimulus and supportive central-bank policy in the months ahead, but officials have signalled that stimulus will be measured rather than aggressive, reflecting caution over already-high levels of debt.

Conversely, economists have been consistently revising their 2023 US GDP forecasts. Indeed, in Q3-23 alone, GDP surged 1.2 per cent q/q – or 4.9 per cent q/q annualised – on the back of robust household consumption and public spending[(2)]. In fact, GDP's contribution of the latter in the past four quarters has been twice stronger compared to the 2016-2019 period average.

Overall, although the US' outperformance was driven by temporary factors that are unlikely to be repeated, and while GDP weakness likely lies ahead amid the lags of monetary policy, US consumers helped to sustain growth despite the rise in borrowing costs, while China's performance underwhelmed.

The Fed acts as a lone ranger

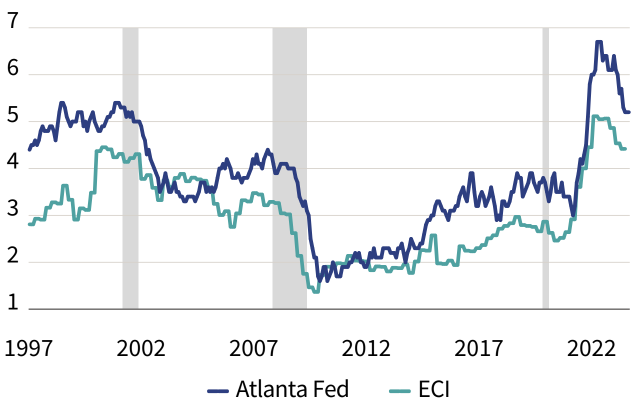
Headline inflation has come down quickly in most economies over the past year, but core inflation remains some distance from target as service price gains remain sticky. In fact, despite falling Q3-23 GDP in most advanced economies – Eurozone, Japan, UK, Canada – central banks have cautioned monetary policy likely needs to remain restrictive until there are clear signs that underlying inflationary pressures are durably lowered. The Bank of England and the Bank of Canada have insisted that interest rate hikes remain on the table, while the vast majority of ECB members have pushed back against expectations on imminent cuts. The Bank of Japan, out of sync with the rest of the world, is contemplating whether to hike rates and normalise policy. On the contrary, the Fed decided to go down a different road.

Although upwards revisions to US GDP growth forecasts have coincided with greater pessimism about the outlook for other major economies, the Fed surprised investors with a dovish communication. Coming into the final meeting of the year, one would have thought that Chair Jerome Powell would have warned he feels uncomfortable about the sharp fall in bond yields and the rise in equity markets, as this unwarranted easing in conditions jeopardises the Fed's efforts to cool off the economy.

Instead, it seems the Fed decided to execute its much-discussed pivot toward less restrictive monetary policy. Chair Powell explicitly stressed that the Fed would need to start cutting rates way before inflation reached its 2 per cent target, as failing to do so could lead to an overshoot and drastically slow activity. What's more, after previously trying to convince investors that it might keep interest rates higher for longer, he declared he was very much focused on the risk of keeping them too high for too long. He also admitted that the FOMC[(3)] had discussed when they should start cutting rates.

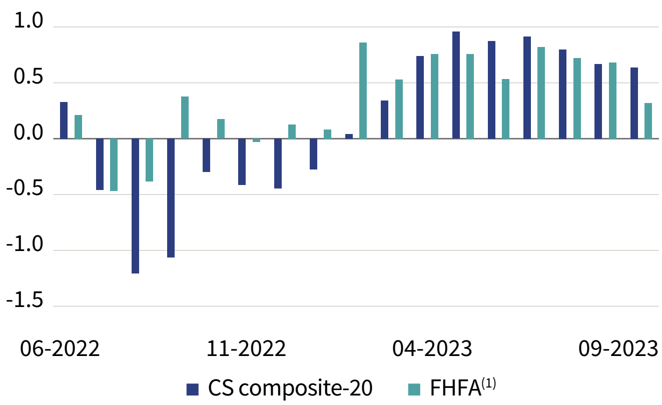
Correspondingly, the 2-yr yield, most sensitive to Fed's policy rate, fell significantly as investors now foresee almost six 25bps cuts in 2024. There was also a dramatic shift for the 10-year Treasury yield, the critical benchmark used for financial transactions across the world. After almost topping 5 per cent in the wake of the September FOMC meeting, it fell below 4 per cent[(4)], reflecting investors' belief the peak in rates have been reached for this cycle.

US – Wage growth
in %, y/y



Sources: Macrobond, Rothschild & Co Asset Management, January 2024.

US – Housing prices
in %, m/m



Sources: Macrobond, Rothschild & Co Asset Management, January 2024.
(1) Federal Housing Finance Agency

(2) Source: U.S. Bureau of Labour Statistics, janvier 2024.
(3) Federal Open Market Committee.
(4) Source: Bloomberg, 29/12/2023.

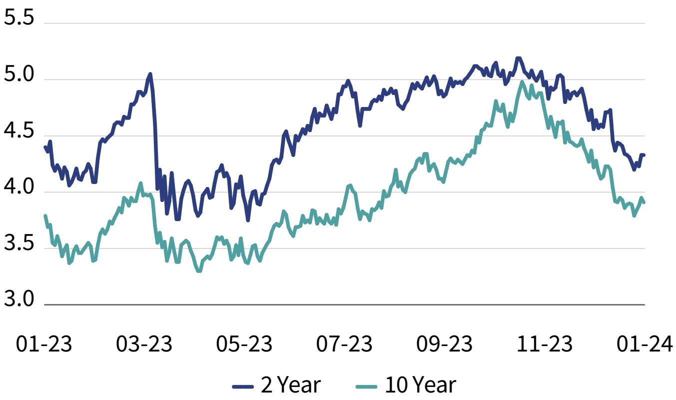
Whether the Fed is right to pivot depends mostly on the future course of inflation and the labour market. The latter is somewhat loosening as employment growth is easing, although it nonetheless remains tight while wage growth is still largely incompatible with the inflation target. Data from the last three months generally shows inflation is slowing, yet it remains too high for comfort especially as house prices have been reaccelerating in the past months, and core inflation in services ex-shelter remains elevated. In addition, measures showing easing supply chain pressures have reversed in recent months, with a notable increase in both air and shipping freight costs.

All of this feeds into the ongoing debate over whether inflation was always transitory, or if an immaculate disinflation, i.e. a reduction in inflation without a certain degree of pain on an economy, is possible. The jury is still out.

Completed writing on 4 January 2024

US - Sovereign yield

in %



Sources: Macrobond, Rothschild & Co Asset Management, January 2024.

World – Supply chain pressure

std deviations from average, NY Fed index

Sources: NY Fed, Rothschild & Co Asset Management, January 2024.

Performance of the indices and interest rate levels

	Price as of 31/12/2023	1 month % change	2023 % change
Equity markets			
CAC 40	7 543	3.2%	16.5%
Euro Stoxx 50	4 522	3.2%	19.1%
S&P 500	4 770	4.4%	24.9%
Nikkei 225	33 464	-0.1%	28.2%
Currencies			
EUR/USD	1.10	1.4%	3.2%
EUR/JPY	155.72	-3.5%	10.9%

Interest rates	Price as of 31/12/2023	1 month bp(1)	2023 bp(1)
3 month			
Eurozone	3.61%	-17	185
United States	5.33%	-6	99
10 years			
Eurozone	2.02%	-42	-55
United States	3.88%	-45	0

(1) Basis point.

Source: Bloomberg. data as of 31/12/2023. Performances in local currency.

Past performance is not a reliable indicator of future performance and is not constant over time.
Index's performance is calculated on the basis of net dividend reinvested.

About Rothschild & Co Asset Management
As the specialised asset management division of the Rothschild & Co group, we offer personalised asset management services to a broad client base of institutional investors, financial intermediaries and distributors. Our development is focused on a range of open-ended funds, marketed under four strong brands: Conviction, Valor, Thematic and 4Change, and leveraging our long-term expertise in active management with conviction as well as in delegated management. Based in Paris and established in 9 European countries, we manage more than 27 billion euros and employ nearly 160 people. More information at: www.am.eu.rothschildandco.com

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