Rothschild & Co
Wealth Management

MARKET PERSPECTIVE | DECEMBER 2023 / JANUARY 2024

Economic crisis and resolution

Image sources: Euro bank note, detail © Getty Images.

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Foreword

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At this time of year, we remind ourselves that our investment views don't have to change just because the calendar does. Long-term portfolios which are appropriately positioned on 31 December probably still are on 1 January.

It's a good thing to take stock, but as wealth managers we should be doing that all the time, not just at New Year.

It's also the time of year when the word resolution features prominently. It signifies the making of promises to ourselves to do better. Whether we keep them or not, what's the harm in that? But the word has several meanings, and it can also denote the passing of – the *solution* to – a problem or crisis.

In this latter sense, resolution appeals to the contemporary economic mindset. But in doing so it reinforces a way of looking at things which may make us worse investors.

Seeking resolution to our macro uncertainties – a date and duration for that recession, an inflation rate back at target, a functional US political system, a convincing answer to a supposed productivity puzzle, a specified change in emissions – perhaps encourages us to think we can't move forward without it. But we likely can, and will. We usually do.

The jury is still out on how far inflation can fall without a big economic setback, for example, but markets may be moving on nonetheless. If we wait for the cost of living crisis to be *resolved* before we get on board, the train may leave the station without us.

We discuss the crisis mindset below. We also update our inflation watch, and offer a preview of next year's US presidential election and what it might – or might not – mean for portfolios.

We wish readers a peaceful festive season and 2024.

Kevin Gardiner / Victor Balfour / Anthony Abrahamian
Global Investment Strategists

The crisis mindset

The history of developed economies, as popularly reported during this last 50 years or so, is the account of a succession of crises.

Industrial unrest, deindustrialisation, exchange rate collapses, unemployment, recessions, inflations, stagflations, secular stagnations, inequalities, walls of debt and dependency, foolish banks, productivity shortfalls, environmental unsustainability and the AI singularity – to name just a few.

Some of them overlap. Some seem to be at odds: poor productivity *and* an AI revolution; unemployment *and* a demographic timebomb; depreciating currencies all round? Some are purely fictional (remember the deflation scare?); some are very real (climate change). But they all have something in common: none of them has ever been reported resolved.

Over the same period, countless millions have been born, schooled, married childhood sweethearts, started families and experienced lives of unprecedented material richness. Economies and investment portfolios have grown, and average living standards risen.

The progress has been largely unnoticed and unreported because it has been incremental and unsensational. But cumulatively, the gains have been large (US per capita real GDP, for example, has more than doubled since 1973). Waiting for resolution of all or any of those issues would have been a big mistake.

The crisis mindset is another aspect of the macro groupthink we discussed in November. It can shape tactical decisions in particular, and may be especially prominent at this time of the year, perhaps because as we collectively look forward to the New Year we can't help but do so with this year's concerns uppermost in our minds. But experience should tell us that this year's concerns will not necessarily last through the next.

They won't be resolved. But they may be mitigated and adapted to. They will be seen in a different perspective – and our collective attention will be drawn elsewhere, because other events will happen. Without public fanfare, the caravan will move on.

THE COST OF LIVING CRISIS – AND BEYOND

A clear reversal in both headline and core inflation is a little more visible now than it was just a month or so back. The cost of living crisis still grabs the headlines, but average spending power is at least partially rebounding in the US and Europe. Here in the UK, where we have relatively timely monthly data, 'real' (inflation-adjusted) basic pay in September was more or less back where it was in March 2022.

A clear reversal in both headline and core inflation is a little more visible now than it was just a month or so back.

Central banks seem to have got away with it. Their earlier negligence has not had drastic consequences. In the very long-term charts, this is not looking like a 'sixth wave' of inflation (as we guessed it wouldn't be), and 'Team Transient' seems to have won the day (though they will not be celebrating – see below).

Lower inflation in itself might not be remarkable. The point perhaps is that it is happening (so far) without a big rise in unemployment – probably because a significant portion of the inflation was driven by supply constraints rather than rampant demand to begin with, and probably because the Western workforce seems implicitly to have traded stabile real wages for stable employment. Figures 1 and 2 show near-term expectations for economic growth actually improving even as inflation has rolled over.

This might yet change. The full effect of higher interest rates is still percolating through the big economies, and we can't quite believe all of the potential financial debris has yet surfaced either. It is hard to imagine that one of the sharpest monetary tightenings in modern times will not have caused a financial accident or two, even if consumers are able to continue muddling through.

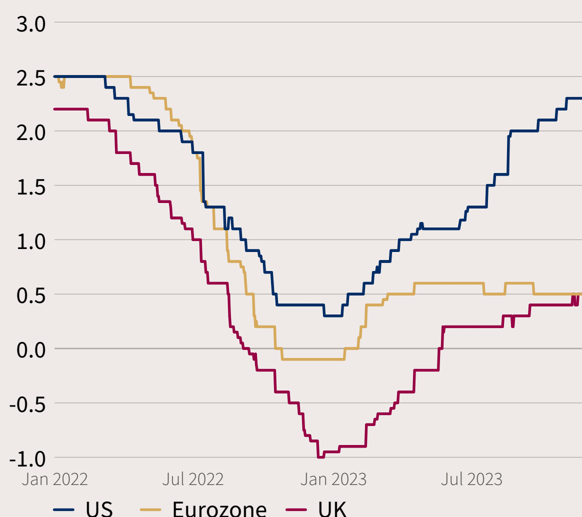
Moreover, we doubt Western inflation is headed sustainably back to target, but instead see it sticking in the 2–4% region for a year or two. And just as there are downside risks to this, we can also imagine reigniting global demand (and/or renewed supply constraints) pushing it up again.

But we have felt all along that there needn't be a big downturn in output and employment, and that there probably won't be. As yet, there has been hardly *any*.

And while inflation in the 2–4% region may not allow central banks to cut rates in 2024 quite as fast or far as the money markets currently assumes (remember, we started 2023 with the markets expecting rates to be falling *now*), it won't have an effect on corporate profitability. Portfolios could live with it.

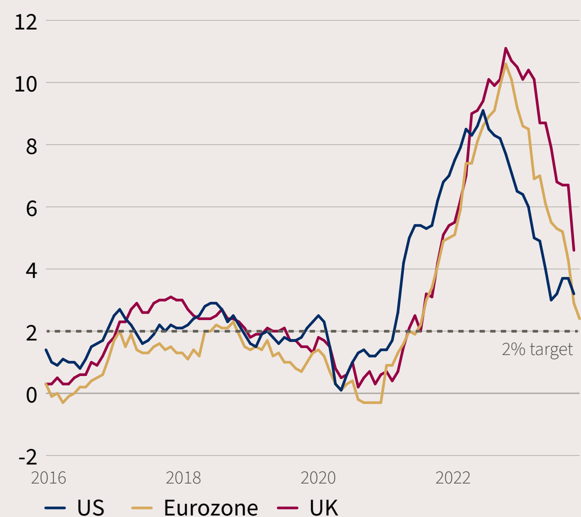
Already, the public debate is quietly refocusing, perhaps towards the perceived constraints on growth. US stock prices have regained more than half the ground lost to consumer prices since the end of 2021.

FIGURE 1: CONSENSUS 2023 GDP FORECASTS
(%)



Source: Rothschild & Co, Bloomberg

FIGURE 2: HEADLINE INFLATION RATES
Year-on-year (%)



Source: Rothschild & Co, Bloomberg

MONETARY POLICY INQUEST: TOO *MUCH* RESEARCH

This does not mean everything is rosy in the world of monetary policy. As the big central banks hold their inquests, they may still not quite 'get it'.

The mistake was not a technical one, a problem with process or the coefficients or specifications of their existing econometric models. Nor does it reflect their oft-cited failure adequately to 'model' money creation. When central bankers like Ben Bernanke conclude, as he surely will, that the Bank of England (for example) needs to do more research, he may be missing the point.

There is already too much research. Monetary policy is not a 'researchable' problem. The failure was instead surely one of judgement (groupthink, again). There is no world in which having both interest rates and unemployment at historic lows at the same time (which was the case as recently as late 2021) is a good idea.

Having belatedly responded to the horse's flight by loudly slamming the stable door, the big central banks may now be overlooking another key point. If the lags between changes in interest rates and the real economy's response are so long and variable as to be pushing two years, then we don't have a 'fine-tunable' monetary 'policy' in the accepted sense of the word.

Independence of action may not be much use without independence of thought.

ADAPTING TO CIRCUMSTANCE

The crisis mindset does not make for good investment advice. Macroeconomic life is not in reality a succession of crises and neat resolutions, but is instead an ongoing adaptation to circumstance and shifting public perception. Long-term investment is arguably not so much about decision making under pressure, as about choosing one's perspective and staying patient.

In a more sombre vein, we should continue to be wary of extrapolating the grim events in the Middle East into the narrow and impersonal world of finance. Those events, like the ongoing trauma in Ukraine, may not affect global energy costs or risk aversion materially, and indeed there are few signs of them doing so to date. Oil prices and the dollar are actually lower, and stocks higher.

If the next significant move in interest rates – even if it doesn't come until well into 2024 – is downwards, and if business surveys continue to stabilise, then capital markets are capable of rallying further.

We still think there is most long-term upside in stocks, but for the first time in many years we are not avoiding bonds. We are actively warming to longer-duration issues in particular. Bonds are not yet compellingly cheap, but they at last offer a meaningful yield again – even after the last month's rally – and more reliable diversification.

Inflation update

Both headline and core inflation rates have moved lower, particularly in Europe, since our last edition of *Market Perspective* (figures 2 and 3).

As our regular readers will know, we closely track the main categories of CPI (Consumer Price Index) inflation: energy, food, goods and services. Promisingly, inflationary pressures have continued to moderate across all four components.

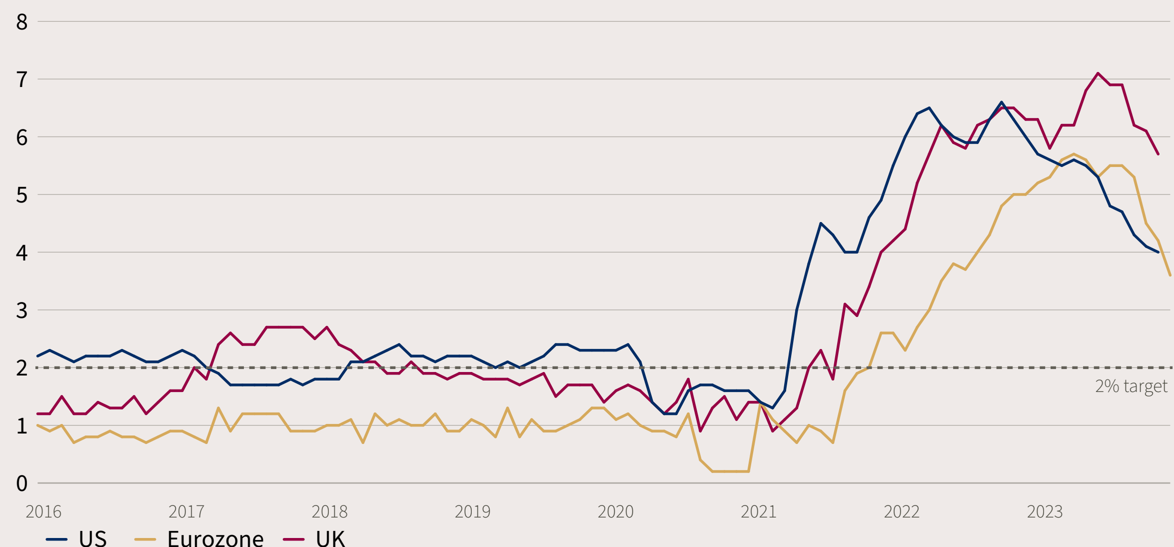
Encouraging developments in energy and food inflation continue to be big disinflationary drivers.

In the **energy** space, oil prices have fallen over the past month, and are actually below early October levels (when the grim events in the in the Middle East began to unfold). This is particularly beneficial for US energy CPI inflation, given its sensitivity to oil prices. It remained deflationary (in negative territory) for the eighth consecutive month in October, and is likely to do so again in November.

European energy costs had been squeezed higher by surging natural gas prices following Russia's invasion of Ukraine. However, gas prices subsequently collapsed (in wholesale markets they are down by around 90%), and both eurozone and UK energy CPI inflation have fallen further into deflation territory in recent months.

It's possible that we have seen most of Europe's energy-driven disinflation for now. For example, the UK energy regulator Ofgem announced that the energy price cap will rise modestly in January. But a significant increase in European natural gas prices – and subsequently energy CPI inflation – may be avoided, extreme weather notwithstanding.

FIGURE 3: CORE INFLATION RATES
Year-on-year (%)



Source: Rothschild & Co, Bloomberg

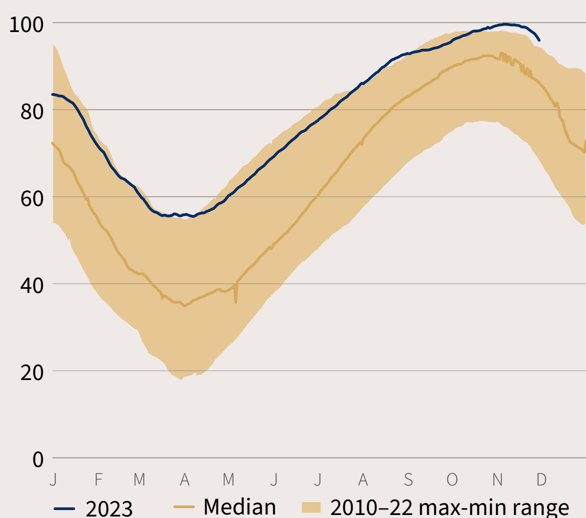
European countries have adapted and moved away from Russian gas imports, with storage levels currently at a record high for this time of the year (figure 4). It's also worth keeping an open mind about possible renewed price declines – wholesale natural gas prices were half of today's level only a few months ago.

Food disinflation has also continued, with wholesale prices trending lower. These are still above pre-pandemic levels – they may not return to that threshold – but they are a quarter below 2022's high, and 11% below their level a year ago, which is ultimately what matters for annual inflation rates (figure 5).

There are long lags between changes in wholesale prices and those which we see on supermarket shelves, and so food disinflation should continue in both the US and Europe through next year. That said, the declines may not be fully passed through. There are other costs associated with the finished product – such as processing, packaging and distribution costs – which may be less flexible.

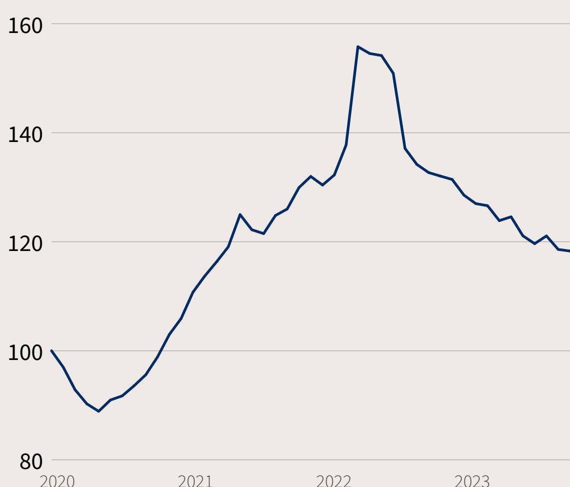
European countries have adapted and moved away from Russian gas imports, with storage levels currently at a record high for this time of the year.

FIGURE 4: EUROPEAN GAS STORAGE LEVELS
Total capacity (%)



Source: Rothschild & Co, Bloomberg, Gas Infrastructure Europe, AGSI+

FIGURE 5: GLOBAL WHOLESALE FOOD PRICES
Rebased index (Jan 2020 = 100)



Source: Rothschild & Co, Bloomberg, Food and Agriculture Organization of the United Nations

Core inflation, which excludes these volatile food and energy components, has also been falling, as noted.

Goods CPI inflation has continued to abate in both the US and Europe. This is likely mostly due to the ongoing recovery in supply logistics. The New York Fed's Global Supply Chain Pressure Index fell to a fresh low in October, reflecting a substantial freeing up of capacity (figure 6). What's more, producer price inflation has been muted in the US and has been negative in Europe, which should further contribute to lower consumer goods prices (assuming firms pass them on, rather than using them to boost profit margins instead).

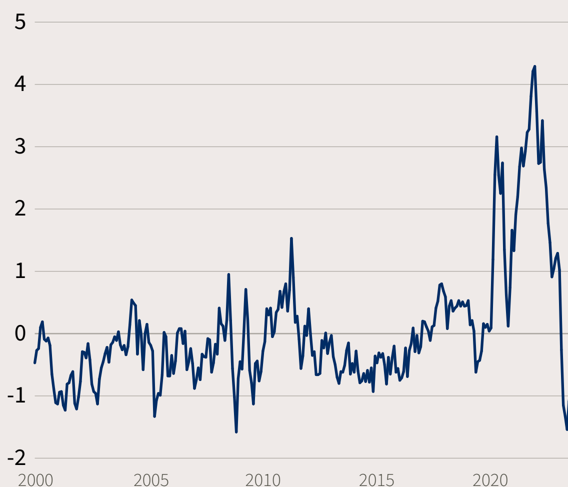
Services inflation remains the stickiest category, but it appears to have peaked in both the US and Europe. The stickiness has mostly been attributed to above-trend nominal wage growth rates. They remain elevated in the US, though are gradually moving lower, and have not yet peaked decisively in Europe. Still, a 1970s-style wage-price spiral looks increasingly unlikely. Real (inflation-adjusted) wage growth has only recently turned modestly positive, and is doing so because prices are slowing, not because wages are accelerating (figure 7).

It's also worth noting that within US services inflation, the shelter component (a gauge of housing and rental costs) accounts for more than a third of the entire US CPI basket. As mentioned in the previous edition of *Market Perspective*, it is the largest contributor. US headline inflation excluding shelter has actually fallen below the Federal Reserve's 2% CPI target. Even so, shelter inflation has at least peaked, and it should continue to roll over in the coming months given that it lags house price and rent price growth by roughly a year – both of which have slowed to pre-pandemic growth rates.

We have previously said that we expect inflation to settle in the above-target 2–4% range. Headline rates in the US and eurozone have now fallen into this range, with core rates likely to follow in the coming months. Still, amid heightened geopolitical risk, it is premature to conclude that this inflation episode – and its consequences – is fully over.

FIGURE 6: GLOBAL SUPPLY CHAIN PRESSURE INDEX

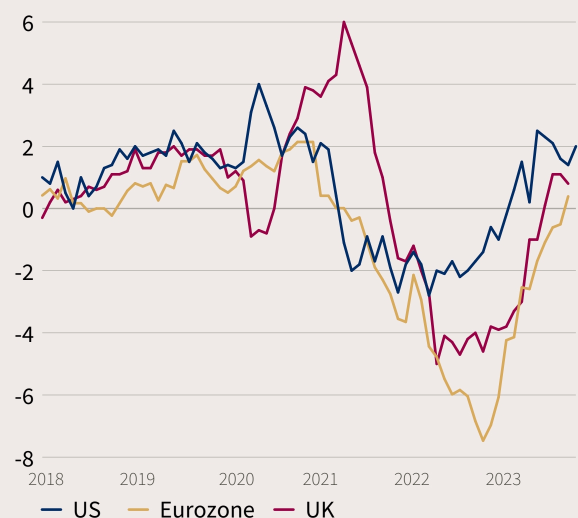
Standard deviations from long-run average



Source: Rothschild & Co, Bloomberg, Federal Reserve Bank of New York

FIGURE 7: REAL WAGE GROWTH

Year-on-year (%)



Source: Rothschild & Co, Bloomberg, Federal Reserve Bank of Atlanta, European Central Bank, UK Office for National Statistics

Note: Real wage growth is calculated as nominal wage growth minus headline inflation rate

The 60th US presidential election

It looks as if political noise is set to get a lot louder in 2024.

The US election cycle – which commences in earnest in January with the first of the primaries – will likely coincide with a UK general election for the first time since 1992, when Bill Clinton and John Major were elected to their respective offices. But while the UK likely faces a changing of the guard in the next 12 months, the US outturn is far from certain.

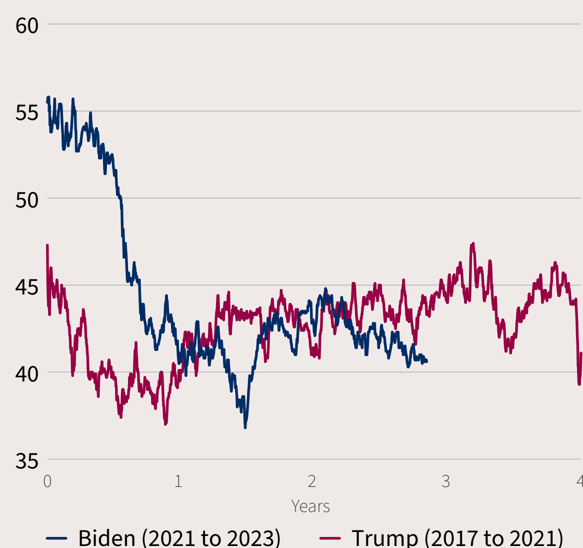
American exceptionalism has been a feature of its economy and stock market for most of the post-war period, but this does not extend to its politics – which is as complex as it is dysfunctional.

The main protagonists in the upcoming US race are familiar: Joe Biden and Donald Trump – a man currently indicted on 91 felony charges. If either wins their respective party primaries – which seems likely given the shortage of convincing alternative candidates – we will see the oldest presidential candidates on record. Donald Trump will soon be an octogenarian, while President Biden recently turned a spritely 81.

History tells us that the standing president often has an 'incumbency advantage', but Biden's (re-)election campaign has started slowly. His approval ratings are the second lowest of any post-war president at this point in his term (Jimmy Carter's were even lower in the late 1970s). Although Mr Trump didn't fare much better in his first term (figure 8), his 'Keep America Great' campaign is ahead in the latest opinion polls (figure 9). Although nationwide polling is far from infallible at this early juncture, some of the crucial swing states – namely Arizona, Georgia,

FIGURE 8: US PRESIDENT JOB APPROVAL

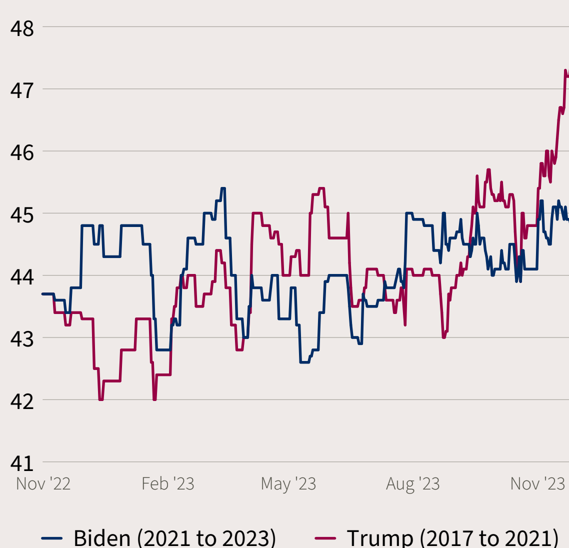
Average (%)



Source: Rothschild & Co, Bloomberg, RealClearPolitics

FIGURE 9: 2024 US PRESIDENTIAL ELECTION POLLS

Average (%)



Source: Rothschild & Co, Bloomberg, RealClearPolitics

Michigan, Nevada, North Carolina, Pennsylvania and Wisconsin – suggest he has the lead. Perversely, talk of a political witch hunt has served to embolden much of Trump's political base, which seems intent on rallying against the establishment and perceived 'wokeism'.

One thing is clear: Congress is very finely balanced, and likely to remain so. The Senate is split 50:50, which gives the Democrats control (the Vice President gets the casting vote), while Republicans have a very narrow majority in the House of Representatives. In recent years, ideology and partisanship has led to increasing political polarisation – not only across the aisle but within the fragmented parties themselves.

Notably, the Republicans have been unable to coalesce around a common economic and fiscal goal this year – as demonstrated by the protracted debt ceiling showdown and more recently the departure of the Speaker of the House. The ongoing deadlock over the annual budgeting process is a constant reminder of the risk of a federal shutdown. As it stands, it appears that both the Senate and the House may flip, given pending retirements and the shape of the polls, but if so, it simply means more legislative gridlock lies ahead.

There is no shortage of big issues facing the next occupant of the Oval Office. From unresolved foreign policy issues – the Middle East, Russian hostilities, trade and Taiwan tensions with China – through to domestic policy and climate-related concerns.

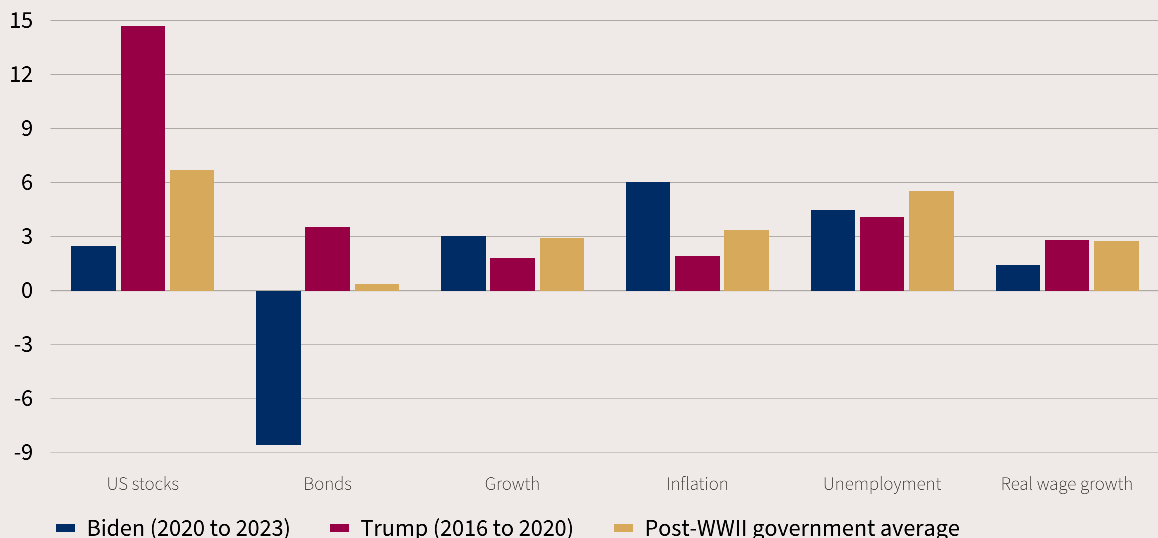
Biden and Trump's ideologically opposing views will be subject to much scrutiny in the coming months. Perhaps the biggest challenge for the current POTUS is less his age, or the similarly low approval ratings for his likely running mate, Kamala Harris, than his perceived economic competence. Conflict and fractious politics dominate the news cycle, but it's the health of the economy that will determine this election – ultimately, the cost of living and jobs matter most to voters. James Carville's Clinton-era quip still applies: 'It's the economy, stupid!'.

Despite Biden's low approval ratings, he has been relatively successful in passing legislation – including the environmentally tilted Inflation Reduction Act, and the semiconductor-focused CHIPS act – despite the challenging Congressional arithmetic. However, Biden's economic and market scorecard appears a little more mixed. US stocks have returned 2.5% per annum (adjusted for inflation) over the past three years (figure 10) – comparing unfavourably with the post-WWII average of 6.7% per annum.

For bondholders, the pain has been rather more acute.

FIGURE 10: SELECTED ASSET CLASS RETURNS AND ECONOMIC PERFORMANCE UNDER DIFFERENT PRESIDENCIES

Per annum (%)



Source: Rothschild & Co, Bloomberg
Note: US stocks and bond returns are annualised and in real terms. Growth, inflation and wage growth are also annualised. Unemployment rate is annual average.

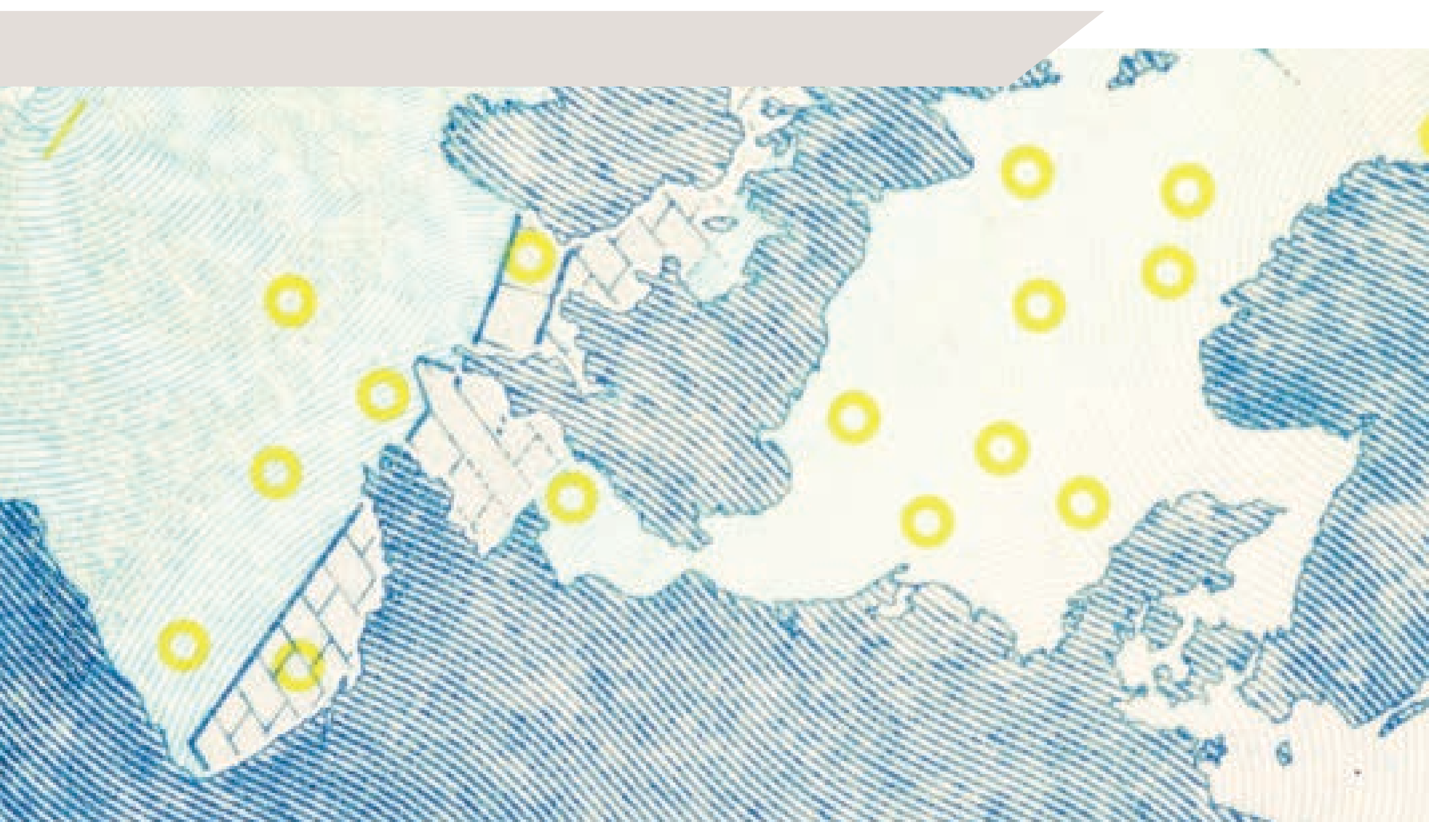
From an economic standpoint, growth has held up well, but it partly reflects the favourable starting point following the pandemic-related reversal in 2020. Most telling is that consumer confidence surveys remain deeply pessimistic, which suggests the challenging inflation backdrop has been in the driving seat where sentiment is concerned.

From an investment standpoint, the key point is that context is important. Received wisdom – the notion the Republican party is inherently pro-business and less interventionist, and that the Democrats favour a bigger state and more spending – is misleading. Other things often matter more – namely, the business cycle. Democrat presidents have often presided over better growth and market outcomes, but that likely tells us more about the economic climate than about policy success.

Political noise may well add to volatility in the coming months. But as we see it, it need not change ongoing economic trends, which we see as being broadly positive for capital markets, albeit more so for stocks than bonds.

For those apprehensive about the possible return of President Trump, we shouldn't forget that even his first term in office was not the economic calamity that many had anticipated. And there is nearly a year still to go until voters head to the polling stations – the evolving economic picture could yet shift polling momentum in either direction.

Conflict and fractious politics dominate the news cycle, but it's the health of the economy that will determine this election.



Appendix: Post-war US governments

KEY FOR CALENDAR YEARS

- Democrat-controlled congress
- Republican-controlled congress
- Divided congress

PRESIDENT	POLITICAL PARTY	INAUGURATION	S&P 500 INDEX REAL RETURNS (%) YEAR 1	2	3	4	WHOLE TERM (AN.)	US TREASURIES (REAL, AN.)	ECONOMIC INDICATORS (%) GROWTH (AN.)	INFLATION (AN.)	UNEMP. RATE (AVG.)	REAL WAGE GROWTH (AN.)
FDR / Truman	Democrat	1945	34	-26	-3	3	-0.5	-4.4	-2.4	2.9	3.3	—
Truman	Democrat	1949	25	27	18	-17	11.6	-1.2	5.6	2.7	4.4	6.4
Eisenhower	Republican	1953	-2	53	31	4	19.5	0.5	2.9	0.9	4.2	4.3
Eisenhower	Republican	1957	-14	41	10	-1	7.5	1.0	2.1	1.9	5.4	-0.1
JFK / Johnson	Democrat	1961	26	-10	21	15	12.2	2.1	5.2	1.2	5.8	5.6
Johnson	Democrat	1961	11	-13	21	6	5.2	-1.5	5.1	3.3	4.0	6.1
Nixon	Republican	1969	-14	-2	11	16	2.0	1.0	3.3	4.5	4.9	3.9
Nixon / Ford	Republican	1973	-24	-39	30	19	-7.7	-1.9	2.2	8.3	6.6	0.6
Carter	Democrat	1977	-14	-2	5	20	1.6	-9.5	3.2	10.3	6.6	1.4
Reagan	Republican	1981	-14	18	19	2	5.3	9.2	3.3	5.1	8.5	2.6
Reagan	Republican	1985	28	17	1	12	14.2	9.4	3.9	3.4	6.5	4.0
Bush	Republican	1989	27	-9	27	5	11.3	7.5	2.2	4.2	6.2	1.8
Clinton	Democrat	1993	7	-1	35	20	14.3	5.3	3.4	2.8	6.1	1.5
Clinton	Democrat	1997	32	27	18	-13	14.7	5.4	4.2	2.4	4.5	5.0
Bush	Republican	2001	-13	-25	27	8	-2.9	4.5	2.4	2.4	5.4	0.9
Bush	Republican	2005	2	13	1	-37	-7.4	5.8	1.1	2.5	5.0	1.4
Obama	Democrat	2009	24	14	-1	14	12.3	2.8	1.4	2.3	8.8	0.6
Obama	Democrat	2013	31	13	1	10	13.1	0.1	5.8	1.2	6.0	2.4
Trump	Republican	2017	20	-6	29	4	14.7	3.5	1.8	1.9	4.1	2.8
Biden	Democrat	2021	21	-25	18	—	2.5	-8.5	3.0	6.0	4.5	1.4
ENTIRE PERIOD	80		**7.9**	**0.6**	**15.3**	**3.4**	**6.7**	**0.4**	**2.9**	**3.4**	**5.5**	**2.7**
Democrat	40	50	18.8	-1.4	12.6	5.1	8.5	-0.3	3.3	3.3	5.4	3.3
Republican	40	50	-2.0	2.7	18.1	1.8	4.9	1.0	2.5	3.5	5.7	2.2

Source: Rothschild & Co, Bloomberg

Economy and markets: background

GROWTH: MAJOR ECONOMIES

Business optimism: standard deviations from trend

Source: Bloomberg, Rothschild & Co
Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP

G7 INFLATION

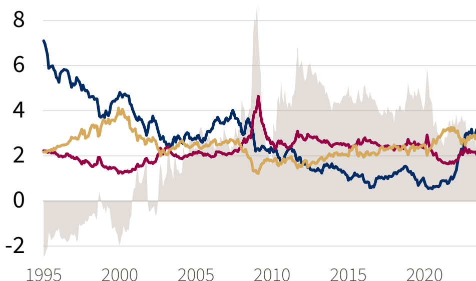
Year-on-year, %

Source: OECD, Bloomberg, Rothschild & Co

STOCKS/BONDS — RELATIVE RETURN INDEX (%)

Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

STOCKS/BONDS — RELATIVE VALUATIONS



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

SELECTED BONDS

Current yields, recent local currency returns

	YIELD (%)	1YR (%)	3YR (%)
10-yr US Treasury	4.3	-1.5	-18.1
10-yr UK Gilt	4.2	-2.7	-20.0
10-yr German bund	2.4	-1.1	-18.5
10-yr Swiss Govt. bond	0.9	2.7	-8.2
10-yr Japanese Govt. bond	0.7	-1.5	-3.1
Global credit: investment grade (USD)	3.9	2.6	-8.8
Global credit: high yield (USD)	9.0	9.5	1.9
Emerging (USD)	7.6	5.6	-11.4

Source: Bloomberg, Rothschild & Co

SELECTED STOCK MARKETS

Dividend yields, recent local currency returns (MSCI indices)

	YIELD (%)	1YR (%)	3YR (%)
World: all countries	2.1	11.3	23.3
Developed	2.0	12.2	27.5
Emerging	2.9	4.4	-4.8
US	1.5	13.7	27.5
Eurozone	3.3	11.0	25.4
UK	4.1	2.3	36.9
Switzerland	3.1	-0.8	7.5
Japan	2.2	22.5	44.3

Source: Bloomberg, Rothschild & Co

SELECTED EXCHANGE RATES

Trade-weighted indices, nominal (2000 = 100)

	LEVEL	1YR (%)	3YR (%)
US Dollar (USD)	116	-1.4	8.7
Euro (EUR)	135	5.6	2.8
Yen (JPY)	72	-6.0	-24.5
Pound Sterling (GBP)	83	3.9	6.2
Swiss Franc (CHF)	191	5.7	14.3
Chinese Yuan (CNY)	140	-0.7	4.5

Source: Bloomberg, Rothschild & Co

COMMODITIES AND VOLATILITY

	LEVEL	1YR (%)	3YR (%)
CRB spot index (1994 = 100)	274	-2.2	71.0
Brent crude oil ($/b)	83	-3.0	74.0
Gold ($/oz.)	2,036	15.1	14.6
Industrial metals (1991 = 100)	315	-10.7	11.5
Implied stock volatility: VIX (%)	13	-37.2	-37.2
Implied bond volatility: MOVE (bps)	115	-9.4	182.4

Source: Bloomberg, Rothschild & Co

Data correct as at 30 November 2023.

Past performance should not be taken as a guide to future performance.

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