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Global perspectives: Goldilocks returns?

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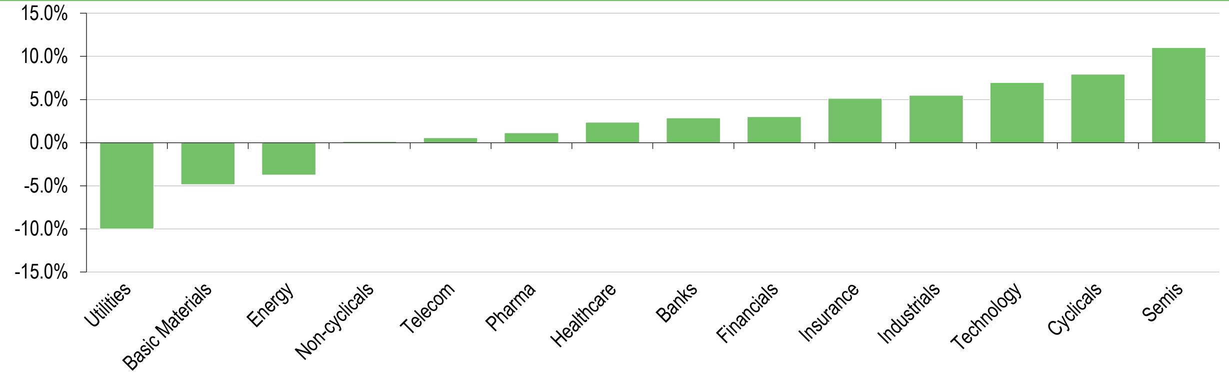
- **Positive momentum in global equities has continued during February.** Investors are sensing that the inflation genie has miraculously been put back in the bottle without causing a major financial accident or recession. US equities continue to lead global markets higher despite extended valuations, driven by a strong earnings season.
- **Below-trend but positive economic growth represents the 'Goldilocks' scenario for investors in 2024.** The absence of a recession in 2023, and more recently improving growth momentum in both Europe and the US, puts a floor under corporate earnings forecasts. Yet with growth still below trend, there is increasing slack in the economy, building the case for interest rate cuts later in the year.
- **However, stronger economic growth prospects and stubbornly high inflation readings have left global government bonds in limbo.** US two-year interest rates have risen as markets reappraise overly bullish expectations for US Federal Reserve rate cuts. Nevertheless, financial conditions overall have been loosening as credit market conditions have eased. Since Q323, the US high-yield bond spread has fallen sharply and at current levels of 3.2% is close to the lows of its 20-year trading range.
- **We maintain a neutral outlook on global equity markets. '**Goldilocks' may be supportive but equity valuations have already risen to discount the positive factors in play during 2024. We believe it may be time to consider taking profits in growth segments of the market, despite currently positive earnings momentum. For bonds, we believe that US 10-year yields of 4% or more will offer diversification benefits in the event of any unanticipated slowdown, while yields are likely to trend lower as interest rates and inflation fall later in the year.

2024: Goldilocks returns?

Global equity markets are now up 4.1% year to date in US dollar terms and up more than 20% since the lows of Q423. Initially, the rally was driven by an easing of global bond yields as investors anticipated the peak of the global interest rate cycle. However, during 2024 the focus has shifted. Recession fears are giving way to optimism in respect of a period of warm, but not too hot, US growth in 2024. This growth is sufficient to support earnings expectations but will also keep the US Federal Reserve on course to cut interest rates later in the year. A white-hot artificial intelligence investment boom, benefiting technology and semiconductors sectors, has led markets higher.

Exhibit 1: Semiconductors, cyclicals and technology-led markets in 2024

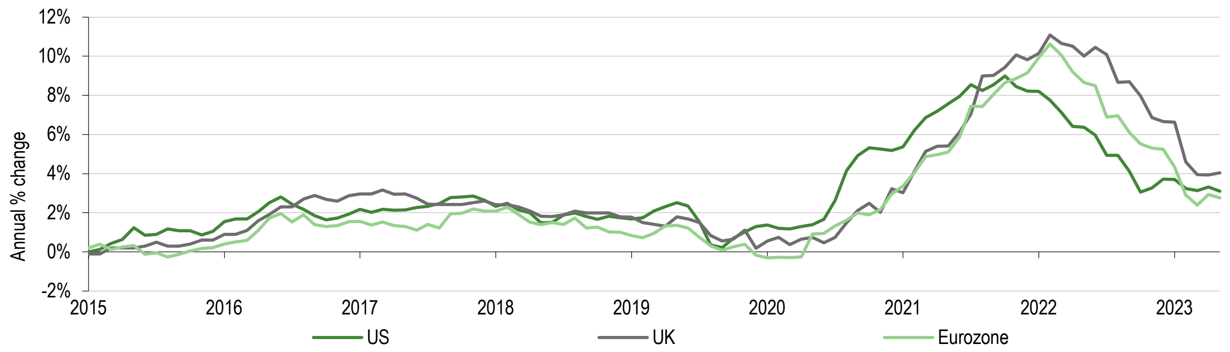


Source: Refinitiv, 31 December 2023 to 26 February 2024. Note: Returns in USD.

In Europe, we note that fears of a major recession that were prevalent in early 2023 have proved wide of the mark. Purchasing managers' indices remain below 50 but are on an improving trend in the region, suggesting a modestly improving growth outlook for 2024.

As in the UK and US, eurozone inflation is slowly returning to target levels, Exhibit 2. Furthermore, the point of maximum stagflation (slow growth and high inflation) danger has passed in each of these regions. Central banks will shortly be in the enviable position of having inflation close to target and be able to cut rates to support economic activity as required, adding significant resilience to the economic outlook.

Exhibit 2: Inflation closing in on target levels during 2024

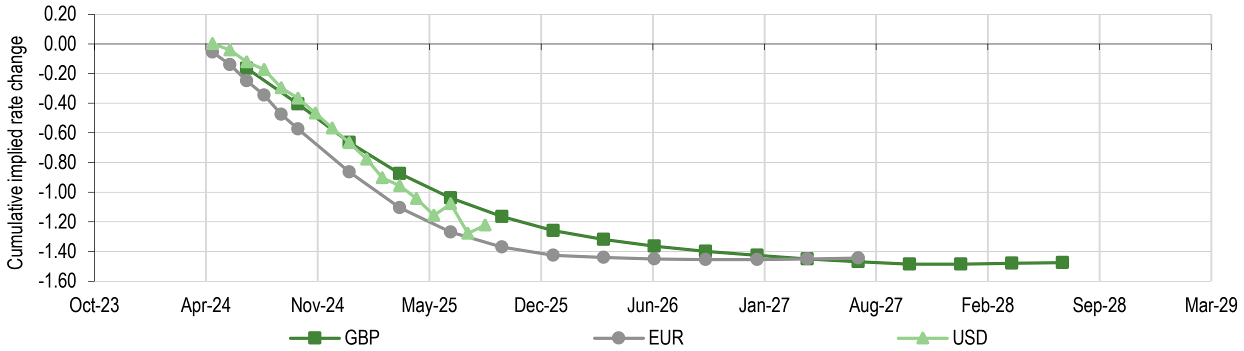


Source: Refinitiv

Nevertheless, the good news on interest rates has been largely anticipated by markets. Futures pricing currently expects interest rate cuts in each of the US, UK and the eurozone by mid-year, Exhibit 3. There even remains a possibility that this timing may prove overly optimistic if GDP growth surprises to the upside. Recent increases in equity valuations and falling spreads on corporate bonds represent an easing of financial conditions separate to any official policy actions. Such 'animal spirits' engender increased business investment, risk-taking and economic activity.

Furthermore, the economies of both the US and Europe have shown remarkable resilience over the past 18 months in the face of a quite extraordinary rise in interest rates, bringing to a close more than a decade of ultra-loose global monetary policy. Having navigated these changes, the risks to growth therefore seem skewed to the upside. As a result, the timing of cuts to interest rates should not be taken for granted, even if inflation falls as anticipated.

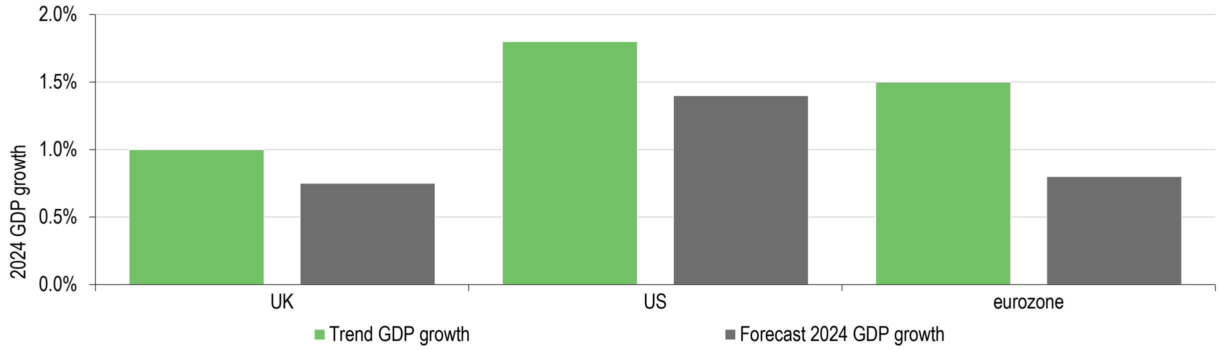
Exhibit 3: Futures markets expect sequence of rate cuts globally from H224



Source: Refinitiv

Central banks will be watching carefully for sufficient slack to be evident in the economy before cutting rates. At present, central bank forecasts are for below-trend growth in each of the US, UK and eurozone, although the margin is relatively modest, Exhibit 4. For the Goldilocks scenario to play out, inflation has to remain on a declining trend. In 2024, a rapid re-acceleration of growth may be a negative for equity markets if it means monetary policy shifts to a more hawkish stance.

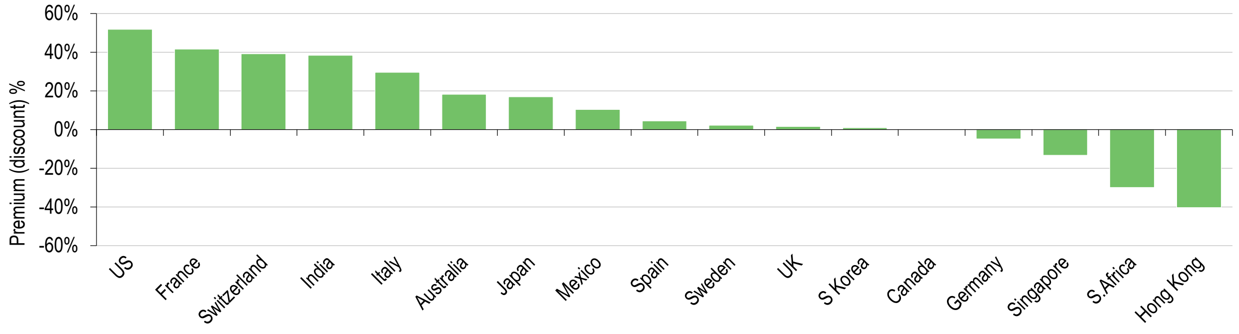
Exhibit 4: Central banks expect below-trend GDP growth in 2024



Source: Refinitiv, Bank of England, European Central Bank and US Federal Reserve

An improved, if muted, economic performance is also evident in consensus earnings forecasts which have been on a stable trend on a global basis since Q423. Currently, consensus forecasts anticipate 18% earnings growth in 2024 in Europe, representing a recovery from the declines of 2023 and 9% earnings growth in the US.

Exhibit 5: High valuations should temper enthusiasm for equities



Source: Refinitiv, Edison calculations. Note: Chart shows premium to 15-year average price/book.

Despite the strong profitability of the US corporate sector over the past decade, we note that the US market is trading at a 50% premium to its long-run price/book multiple, Exhibit 5. Such an overvaluation would be easier to rationalise in the context of a long period of ultra-loose monetary policy, which is clearly not our or the market's base case at present. We expect interest rates and long-term bond yields to be materially higher in future, compared to the previous decade. In our view, US long-term rates are likely to stabilise only modestly lower than current levels.

Therefore, to justify current US valuations. investors are required to assume that an above-average period of profits growth lies ahead. However, consensus expectations currently remain relatively modest, with a forecast for 0.7% US earnings growth in 2023 once Q423 earnings reports are in, followed by 9% earnings growth in 2024. A mid-single-digit compound average growth rate for the two years combined would appear to be insufficient to justify the current enthusiasm for US equities in aggregate. We therefore believe upward revisions to US equities will continue to be required during the year if recent market momentum is to be maintained.

Conclusion

We believe global equity investors are in a Goldilocks period of modest but positive economic growth, with the prospect of cuts in interest rates still in play for H224. The bias for economic growth appears to be modestly to the upside as easier credit conditions are likely to improve prospects for economic activity during 2024, raising the prospect of earnings upgrades. Nevertheless, any strong re-acceleration would risk reigniting inflationary fears and a potential sell-off in global markets.

Balanced against a generally supportive economic and monetary outlook are high US equity valuations which now account for 45% of global market capitalisation. Following the rally of Q423, US equity markets appear to be fully priced, notwithstanding the current investment boom in generative AI. Recent upward revisions to earnings estimates will need to be sustained to maintain the current market momentum. We maintain a neutral outlook on equities.

We are also observing increased corporate activity in terms of mergers and acquisitions, albeit from depressed levels, as financing becomes cheaper and more readily available as interest rates fall later in the year.

We believe at yields of over 4% US 10-year bonds should retain their traditional role as lower risk assets which diversify portfolios. In our base case, US rate cuts later in the year are likely to be associated with a lower trend in yields. Furthermore, at targeted inflation levels, a real rate of 2% is historically attractive, especially at a time when risk premia in equities and credit are becoming increasingly compressed.

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