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Market View
May 2024

Executive Summary

- Global equities ended their five-month rally in April. The MSCI World Index fell by 3.7% (total return in USD) last month, mainly due to expectations of prolonged higher interest rates in the face of sticky Q1 inflation, notably in the US.
- Both Japan and China have been in focus, given potential interventions in their currency markets. With volatility surrounding the yen, the Nikkei closed at almost -5% for the month. China's Hang Seng index, however, rose over 7%, boosting the MSCI Emerging Markets Index into positive territory for the month (+0.4% in USD).
- US policymakers remained busy, providing backstops to the economy and markets while trying to solve the inflation problem.
- The US Treasury's refinancing outlook was not as dovish as markets had hoped but did reduce uncertainty about the forward path for US debt issuance.
- In contrast, US Federal Reserve (Fed) Chair Jerome Powell reinforced his dovish stance, implying the Fed would be ready for an easing upon signs of economic weakness while holding off from tightening during growth or inflation upticks, for as long as possible.
- Stagflation concerns and warning signs resurfaced as US economic growth posted a surprise slowdown in the first quarter, despite the overall still robust pace of growth.

US bonds continue to suffer while China's equity market rebounds

- According to FactSet, the blended (year-over-year) Q1 earnings growth rate for the S&P 500 is 5%. Out of the 80% of the benchmark's market capitalization reported, 77% has beaten expectations.
- The US bond market has endured a 45-month drawdown, marking the lengthiest bond bear market to date. Apart from a brief four-five month rebound at the end of last year, yields have been on the rise. The preceding bond bull market spanned over 40 years, from the early 1980s to 2020/21. We may have entered a new market regime characterized by fluctuating, rising yields interspersed with temporary bull markets.
- Asset managers are the most long US equity futures in at least 12 years, according to JPMorgan Chase.
- As for China: After three consecutive years of equity market decline, which transformed it from a high-flying market to an underdog, the Chinese stock market is experiencing a resurgence. Chinese stocks took the lead in global markets last month and currently rank among the best-performing major markets over the past three months (according to Bloomberg Intelligence).

Market Development

World

- Bloomberg consensus predicts a robust 5%+ nominal GDP growth (i.e. including inflation) for the US in 2024, potentially surpassing previous records from 1996-1998 and 2004-2006 – and marking the longest period of 5%+ growth in the US.

- On the other hand, Bank of America (BofA) reports that this year, news counts on stagflation have soared to the highest level since 2022.

  » This is not entirely surprising in light of recent data that points to slowing growth and sticky inflation, a clear deterioration from the late 2023 "Goldilocks" data.

  » In April, both ISM Indices (Manufacturing and Non-Manufacturing) unexpectedly fell below the growth threshold.

  » US consumer confidence notably declined in April.

  » In Q1, US employment costs rose more than expected.

  » Still, Fed Chair Powell disagreed with this assessment in his May press conference: *"I don't see the 'stag' or the 'flation'… I don't really understand where talk of a stagflation scenario is coming from given US data."*

Europe

- Europe faces its fourth consecutive quarter of declining profits, yet signs of improvement hint at the potential end of the earnings downturn. The margins of European companies, though not as robust as the margins of US companies, exceeded expectations. BofA sees potential for earnings upgrades, fueled by an uptick in the Citigroup Economic Surprise Index over the past three months.

- In our view, a first reduction of the ECB key interest rate remains likely in June.

Switzerland

- In April, the KOF Economic Barometer rose to 101.8 points, following two consecutive months of decline. Since the beginning of 2024, it has remained above its long-term average of 100 points. However, other leading economic indicators suggest growth below potential – in particular the relatively sluggish recovery in industry so far.

Powell reaffirms the "Fed put" but Yellen makes clear that the Goldilocks days are over

Fed Chair Powell's May press conference surprised many with its dovish tone. Powell effectively tried to remove rate hikes from the distribution of Fed outcomes in 2024 while keeping the door open for cuts if the economy unexpectedly slows.

- Powell played down recent inflation increases and dismissed the likelihood of further rate hikes.
- He announced a significant adjustment to the Fed's balance-sheet runoff policy (quantitative tapering or QT), lowering the monthly redemption cap on Treasury securities from USD 60 to 25 bn starting in June – more than the consensus estimate and a mild but surprisingly proactive easing move.
- Powell also emphasized "supply-side healing", highlighting the positive effects of recent productivity growth and the slowdown in unit labor-cost inflation.
- Despite strong Q1private non-farm payroll numbers and core inflation above 3%, Powell also spoke about labor market fragilities and expected disinflation.

This dovish policy shift has created what can feel like a "good cop/bad cop" dynamic between the Fed and the US Treasury Department, especially since Treasury Secretary Janet Yellen released a surprisingly hawkish Q2 Quarterly Refunding Announcement (QRA) on the same day as Powell's press conference.

- US Treasury funding plans now suggest higher long-term yields ahead, with the Q2 QRA showing that overall coupon issuance from Q2 to Q3 (USD 1.1+ tn) will reach its highest level since 2022.
- The size of 10-year Treasury auctions will remain steady but at a record high.
- Yellen also forecasted a higher Treasury General Account (TGA), in effect avoiding claims of politically driven bias that could be made if the TGA were drained right before the US elections – and possibly reflecting worry over an excessive US deficit amid sticky inflation.

The heavy long-end issuance poses challenges as it requires a larger risk budget for the private sector – e.g. large banks that act as primary dealers for treasury auctions – to warehouse on the balance sheet. This potentially limits the private sector's ability to allocate resources to credit or stock markets.

The bottom line is that the private sector looks to absorb more duration-weighted Treasury issuance, which will tighten liquidity conditions from loose Q1 levels. While this process should be gradual, markets will need to adapt. Continued rates volatility and a steeper US yield curve are reasonable expectations. It's clear that the Goldilocks days are over.

An interesting comment came from Robert Steven Kaplan, former president of the Federal Reserve Bank of Dallas, who talked about the need to "slow the implementation of the Inflation Reduction Act to slow inflation" hinting at the paradoxical call to ease off the very legislation designed to address inflation.

With the Fed announcement and Q2 QRA behind us – and the scales not tipping in a clear direction from a policy stance (Fed more dovish, Treasury more hawkish) – we believe that what equity markets now need is a return of disinflation.

In this respect, we can highlight recent comments from Morgan Stanley, who predict that inflation figures will likely see unexpected declines already in the next US CPI print as their indicators suggest a swift slowdown in rental market growth. It's also worth mentioning that inflation figures within financial services often correlate with stock market performance. The recent stock market correction could reduce this fluctuating aspect of inflation metrics. Persistent deflation in China is also expected to exert downward pressure on prices for US goods overall.

Positioning

Markets have pushed back the first Fed rate cut to November. It seems questionable, however, to think that the Fed would start a new cutting cycle in the same week as the US election. We believe that the Fed will move with a respectful distance, either by July (and only if there is sharp disinflation and/or an economic slowdown in the near term) or after November.

The Fed's proclaimed dependency on data could lead to challenges, particularly if supply-side data trends unfavorably. Powell might find it more difficult to dismiss persistently high inflation levels by referring to productivity as a neutralizing factor. There is concern that any pivot back to a hawkish stance could be ill-timed. For the moment, however, Powell appears determined to quash any possibility of future interest rate hikes.

We expect that near-term equity volatility could remain elevated until inflation momentum turns more negative again and rate volatility settles. Of note, we still believe disinflation could return in Q2.

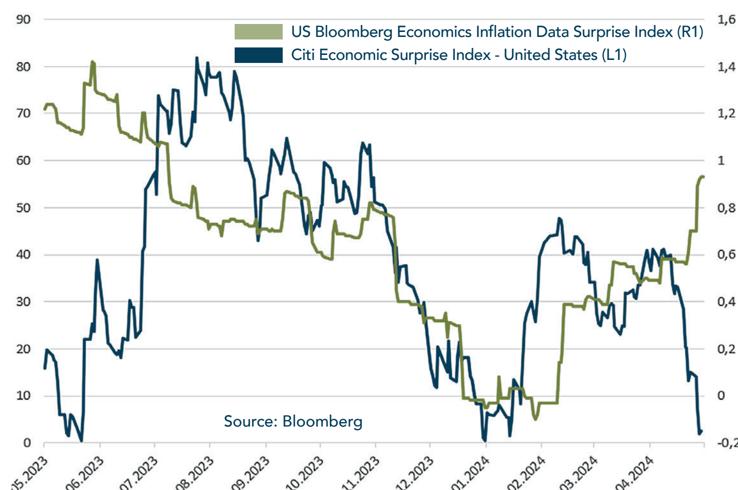
In short, the macro backdrop has become less friendly since March due to higher inflation and upward pressure on rates – but equities can still do well. Resilient earnings have also likely capped the downside for stocks in recent weeks, according to Barclays strategists.

Our view is that the equity correction started in April will conclude in May, with historical trends in election years indicating a strong performance in June, July and August.

- We expect investors to be more focused on the upcoming US elections, in particular with regard to taxes, tariffs and debt.
- In commodities, for the medium term we are still bullish on gold, which has rallied in a context of rising geopolitical tensions and increasing central bank purchases. Tactically, we expect gold prices to continue to consolidate between 2,200-2,400 USD/Oz until mid-year.
- Geopolitical risks remain the highest in decades. Amid escalating tensions in the Middle East, Bloomberg Intelligence warns of a potential global shock where oil prices could soar to USD 150/barrel and have a USD 1 trillion impact on global GDP.

The face of US stagflation fears

The recent divergence between the two lines can't be ignored. US economic data has surprised to the downside, while inflation data has surprised to the upside - reflecting an environment that could be described as stagflationary. However, this is not yet entrenched and could still change with Q2 data.



Sources: Bloomberg, Morgan Stanley, Bank of America, Goldman Sachs, The Macro Compass, The Market Ear, Steno Research, 42Macro, JPM, Hightower Naples, ZKB, Strategas, RBC Capital, FT, Yardeni Research

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