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# Views from the desk

## Global Economic & Market Outlook 2024

**Habib Investment Limited**
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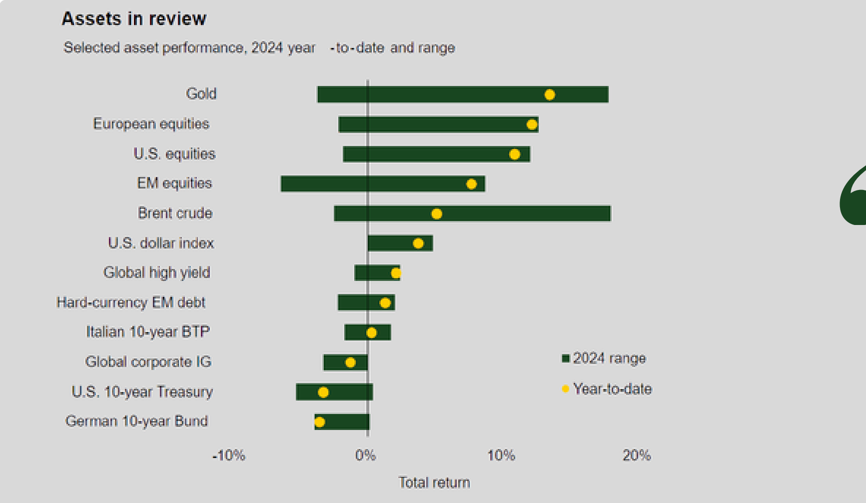
# Growth Asynchrony & Central Bank Divergence




## Macro Overview

*That's the thing about opportunity. It looks like risk when its an opportunity.*
*And by the time its risk free, its not an opportunity anymore."*

**— Sandeep Jadwani | ACSI, CIB**
**Head of Investment Advisory**

The global economy presents a tale of two halves. The US continues to enjoy exceptional growth, fueled by solid consumption and investment spending, albeit at a tempered pace. This resilience has fueled hopes of a potential rate cut by the Federal Reserve in September. However, across the Atlantic, European economies face a different reality. Lingering concerns about inflation and the prospect of central bank tightening cast a shadow over the eurozone. Emerging markets, on the other hand, display a surprising degree of resilience. A weaker US dollar offers them some breathing room, and China's ongoing industrial push to counter its domestic property woes provides a tailwind for global trade, benefitting export-oriented economies in Asia and Europe.

This growth divergence presents a challenge for central banks. The robust US fundamentals suggest the Federal Reserve may have room to ease monetary policy later this year. Conversely, the tamer inflationary pressures in the eurozone make a case for earlier rate cuts, potentially as soon as this summer. This asynchronous policy approach could have significant ramifications for currency markets and global liquidity conditions.

### Recent Market Developments:

May brought some relief to US bond markets, with yields down across the curve as PCE inflation came in line with expectations at 0.3% headline month-on-month and 0.2% core. The S&P 500 and Dow Jones Industrial Average rallied on the news, while the Nasdaq Composite remained slightly negative.

However, analysts view this as more of a short-term correction rather than a significant shift in market sentiment. September interest rate swaps suggest the market remains unconvinced about a September rate cut, highlighting the ongoing challenge for the Fed to balance inflation concerns with economic growth.

### Looking Ahead: A Summer of Uncertainty

The outlook for the summer markets remains uncertain. While the recent inflation data provided temporary relief, it likely won't be enough to sway the Fed towards a September rate cut. The biggest concern for investors, both equity and bond bulls, is the potential for a summer heatwave that could lead to commodity price volatility and potentially exacerbate inflationary pressures. This raises the specter of stagflation – a scenario of slowing economic growth combined with high inflation – which could force the Fed to remain on hold even if it desires looser monetary policy.

Adding to the global concerns are weak European inflation figures, with harmonized CPI for the EU reaching a substantial 3.8%.

### The Battle Between Bond and Equity Bulls:

For bond bulls, a significant decline in yields hinges on demonstrable economic weakness. Equity bulls, on the other hand, require a decrease in inflation sufficient to warrant rate cuts without triggering a recession. In the near future, the scenario envisioned by bond bulls appears more likely to materialize.

## *Strategic Portfolio Positioning:*

In this complex environment, our fixed income strategy prioritizes prudence. We maintain a negative view on ultra long-term government bonds, anticipating continued upward pressure on yields. However, acknowledging the recent moderation in inflation expectations, we have upgraded our outlook on short- and intermediate-term government bonds to positive. We believe these maturities offer a more attractive risk-reward proposition in the current environment. Investment grade credit remains neutral, but we hold a negative stance on high-yield local currency emerging market debt, which are more vulnerable to rising interest rates and potential economic slowdowns.

Equity markets, after a significant rally, have experienced some recent volatility. Nevertheless, positive nominal GDP growth forecasts and expectations of looser financial conditions and potential rate cuts bolster a neutral-to-positive outlook on equities. While valuations are not at bargain-basement levels, they appear reasonable in a historical context. Additionally, positive market dynamics, characterized by broad participation and healthy sector rotation, suggest a constructive underlying trend.

## *Diversification and the AI Tailwind:*

Our portfolio strategy prioritizes equities over fixed income, acknowledging the potential for continued growth, particularly in sectors poised to benefit from the ongoing technological revolution. We believe commodities and gold offer valuable diversification benefits, especially in times of geopolitical uncertainty and potential currency devaluation. A well-diversified approach is crucial for navigating the current market conditions.

Our investment thesis rests on three key pillars:

### 1 Disinflation Trend

*We anticipate a sustained disinflationary trend, preventing a sharp rise in bond yields and maintaining stable or lower borrowing costs for businesses and consumers. This would support continued economic growth and corporate profitability.*

### 2 Corporate Profit Growth

*We project double-digit corporate profit growth to persist throughout the year, fueled by a combination of factors such as pent-up demand, ongoing technological innovation, and a potential relaxation of monetary policy*

### 3 The AI Effect

*We expect artificial intelligence to play an increasingly transformative role across various market sectors over time. This AI revolution has the potential to unlock significant productivity gains and drive accelerated economic growth in the years to come.*

By considering these interconnected factors and strategically positioning our portfolio across asset classes, we aim to capture potential returns while mitigating risks in this dynamic and evolving global economic landscape.

## *Key Considerations and Potential Adjustments:*

- **Commodity Price Volatility**: We will closely monitor potential summer heatwaves and their impact on commodity prices. A significant increase in commodity prices could exacerbate inflationary pressures and force the Fed to remain hawkish, impacting both equities and bonds.
- **Stagflation Risk**: The possibility of stagflation requires a flexible approach. If economic data weakens considerably, we may increase our allocation to short-term government bonds to hedge against potential recessions. Conversely, if inflation picks up, we might reduce our exposure to certain equity sectors sensitive to rising costs.
- **Central Bank Policy Divergence**: The asynchronous monetary policy stances of the US Fed and European Central Bank will be a key factor to watch. We will adjust our currency positions based on evolving policy signals and their potential impact on exchange rates.
- **Geopolitical Developments**: Ongoing geopolitical tensions, particularly the war in Ukraine, remain a wild card. Any escalation could disrupt supply chains and further pressure commodity prices, requiring portfolio adjustments.

## *The Bottom Line*

The global economic outlook remains uncertain, with both upside and downside risks. Our diversified portfolio positioning allows us to navigate this complex environment. We prioritize tactical adjustments based on incoming data and evolving market dynamics while maintaining a core focus on long-term growth opportunities driven by technological innovation and potential disinflationary trends. We believe this approach will position us to capture potential returns while mitigating risks in the months ahead.

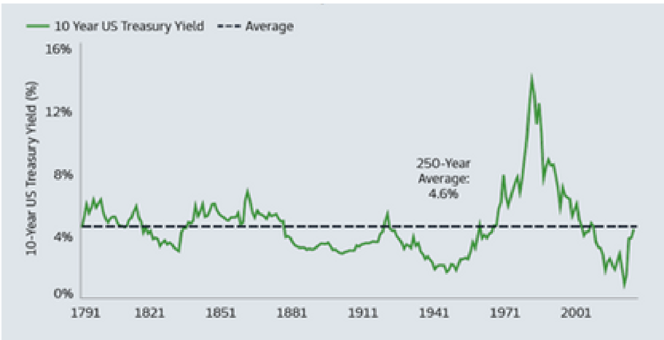
# *A Mid-Year Reset with Mixed Signals and Shifting Gears*

## Global Outlook

The first half of 2024 presented a complex picture for global markets. However, the outlook for the rest of the year offers a mix of cautious optimism and potential turning points, driven by evolving economic data and central bank policy shifts.

**Growth Gears Shift, Inflation Cools:** The global manufacturing cycle is exhibiting signs of a turnaround, suggesting the global slowdown may be nearing a bottom. This, coupled with receding inflation in most economies (US core and headline PCE at 2.8% and 2.7% YoY, respectively, Eurozone inflation at 2.6% and 2.9% YoY), points towards a moderate uptick in global growth for the latter half of the year.

**Central Banks Pivot**: From Hawkish to Dovish: Recognizing the economic slowdown and softening inflation, central banks are starting to shift their focus. After a period of hawkish tightening to combat inflation, they are now considering easing monetary policy.




**Regional Deep Dive:** Here's a closer look at specific regions, incorporating the latest data:

**US:** The resilient US economy, driven by solid domestic demand, is experiencing a bumpy disinflation process. The Fed is expected to initiate rate cuts in September, potentially totalling 75bps throughout 2024. However, rising US consumer concerns about a potential recession (69% perceived likelihood over the next 12 months) suggest caution. A long USD/short EUR position might be a hedge against a potentially dovish ECB due to the Eurozone's higher core inflation. However, caution is advised due to rising US consumer concerns about a recession.

**Eurozone**: With external demand improving and inflation receding (Eurozone core inflation at 2.9% YoY), the Eurozone is poised to exit stagnation. The ECB is anticipated to begin rate cuts in June, for a total of 75bps in 2024. Travel, healthcare (GLP-1 theme), and defense (potentially benefiting from a shift in focus after elections) could be relevant investment themes, considering the Eurozone's low unemployment rate (6.4%) suggesting potential for increased consumer spending in specific sectors. Financials and European/Asian/EM USD bonds offer income potential and carry trade opportunities.

**UK**: The UK economy has witnessed a surprisingly swift recovery from the technical recession at the end of 2023. However, stickier services inflation may delay the Bank of England's rate cuts compared to its European counterparts. The first cut is expected in August.

**Japan**: The Bank of Japan (BoJ) has ended its negative interest rate policy but remains cautious about further hikes due to slowing inflation and an uncertain domestic demand recovery.

**China**: While Q1 witnessed growth acceleration fueled by net exports (China Manufacturing PMI at 49.5), a slowdown is likely ahead. The ongoing property downturn and subdued domestic demand are expected to dampen growth before potential stabilization.

**Switzerland**: Lower inflation and moderate growth enabled the SNB to cut its policy rate in March. An additional cut is anticipated in June this year, bringing the rate down to 1.25%.

**Emerging Markets (EM):** Despite slowing global growth, we believe emerging market (EM) equities will benefit from a friendlier macroeconomic environment towards the second half of 2024. We expect the broad EM equity universe performance to be in line with developed markets going forward and maintain a preference for individual markets: India (Nifty 50 YTD return of 2.11%), S. Korea, Taiwan, and Brazil. However, EM equity markets face headwinds from the ongoing USD strength trend and a slowing divergence in monetary policy vs developed markets, leading to a reliance on the Fed.

**Turkey:** Sentiment and prospects for a macro stabilization have improved with the new economic team and the shift to a more conventional policy framework. However, challenges remain substantial. Earnings are distorted by local inflation, and company financial statements may not fully reflect price increases. The defeat of the AK Party in local elections has led to optimism for policy continuation, potentially triggering foreign flows into bonds & equities.

**Commodities**: WTI and Brent crude finished last week slightly lower at $76.99 and $81.62/bbl, respectively, both experiencing their worst month of the year in May due to a government report that indicated weak demand in the US.. Meanwhile, gold prices stood, ending at $2345.80/troy oz.

**Materials Sector:** The sector is suffering from a combination of lower metal prices and the ongoing weakness in the Chinese economy (China's manufacturing PMI slipping into contractionary territory). We expect China's growth momentum to remain weak, limiting upside potential for the materials sector. Price/book ratios are our preferred valuation metric for this sector. After a recent pullback, they are back to historical average levels, leaving us neutral on the sector.

**Investment Considerations:** While risk tolerance may have peaked earlier, opportunities still exist:

**US:** A long USD/short EUR position might be a hedge against a potentially dovish ECB due to the Eurozone's higher core inflation. However, caution is advised due to rising US consumer concerns about a recession.

**EU:** Travel, healthcare (GLP-1 theme), and defense (potentially benefiting from a shift in focus after elections) could be relevant investment themes, considering the Eurozone's low unemployment rate (6.4%) suggesting potential for increased consumer spending in specific sectors. Financials and European/Asian/EM USD bonds offer income potential and carry trade opportunities.

S&P 500 vs bonds and gold

Outperforming bonds – watch the gold ratio closely


Source: Bloomberg Finance L.P., Julius Baer; MAV = moving average Note: 'Candle chart': Rectangles show price developments. White rectangles show positive developments; black rectangles show negative developments. Vertical lines show the highest and lowest price levels reached. Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as aresult of currency fluctuations. Technical analysis may be inconsistent with and reach different conclusions to fundamental analysis.

**UK:** UK equities might benefit in the short term from their overweight in cyclical "old economy" sectors. However, a lack of exposure to growth-oriented "new economy" and a reliance on commodities (expected to decline) limit their long-term potential. They could still be a portfolio diversifier for growth-focused investors, but with caution.

**EM:** While individual markets like India (YTD return lagging behind US) offer potential, the overall EM asset class faces headwinds from a strong USD and potentially slower policy easing compared to developed markets. Investors should prioritize diversification across EM economies with strong fundamentals.

**China**: China's Caixin PMI defied expectations, surging to 51.7 in May (highest since June 2022). Consumer demand fueled output growth, with strong new work inflows driven by interest in new products. Export activity remained solid, despite a slight slowdown in new order expansion. Backlogs rose to a 20-month high, but the sector grapples with a labor market contraction for the ninth month. While input costs climbed, average output prices held steady. Business sentiment improved. This PMI, focused on smaller, export-oriented firms, contrasts with weaker official data.

**Commodities:** Asia's willingness to pay, both from private investors and central bankers, seems to have become the dominant driver of the gold market for now.

**Conclusion**: The current market landscape, characterized by stickier inflation, higher rates, and increased equity concentration, has become the new "normal," in our view. Although the higher-for longer rate environment is unique relative to recent years, the spike in the 10-Year US Treasury has pushed the yield in line with the 250-year average of 4.6%. As structural uncertainties play out, we maintain our view to remain balanced across asset classes as dynamics inevitably shift.

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# Market Definitions 101

## M-o-M

Month on Month (MoM) is a metric that compares the performance of a specific metric, such as sales or revenue, from one month to the next, indicating short-term trends or changes.

## Q-o-Q

Quarter on Quarter (QoQ) is a metric that compares the performance of a specific metric from one fiscal quarter to the next, highlighting changes over a three-month period.

## Y-o-Y

Year on Year (YoY) is a metric that compares the performance of a specific metric from the same period in the previous year, providing insight into long-term trends and seasonal effects.

# Asset Class Views

| Asset Class | Sub-Class | View (FY '24) | View (Jun'24) |
|---|---|---|---|
| Main Asset Class | Equities | = | = |
| | Fixed Income | =▲ | =▲ |
| | Commodities | =▲ | =▲ |
| | Currencies | =▲ | =▲ |
| Equities | USA | =▲ | = |
| | EU (Ex UK) | = | =▲ |
| | UK | = | = |
| | EM (Ex MENA) | ▲ | = |
| | MENA | = | = |
| | Japan | ▲ | =▲ |
| | EM | =▲ | =▲ |

# Asset Class Views

| Asset Class | Sub-Class | View (FY '24) | View (Jun '24) |
|---|---|---|---|
| Fixed Income | US Treasuries | =▲ | = |
| | Euro (Bunds) | ▼ | ▼ |
| | UK Gilts | ▼ | ▼ |
| | US IG | =▲ | =▲ |
| | US HY | =▲ | =▲ |
| | Europe IG | ▼ | = |
| | EM | =▲ | = |
| Commodities | Oil | = | = |
| | Precious Metals | =▲ | =▲ |
| Currencies | USD | =▲ | =▲ |
| | EUR | = | = |
| | GBP | = | = |
| | EM | = | = |

▲ overweight = neutral weight ▼ underweight ■ negative tilt ■ positive tilt

## *Critical Future Events*

**June 6**: ECB Meeting

**June 14**: BoJ Meeting

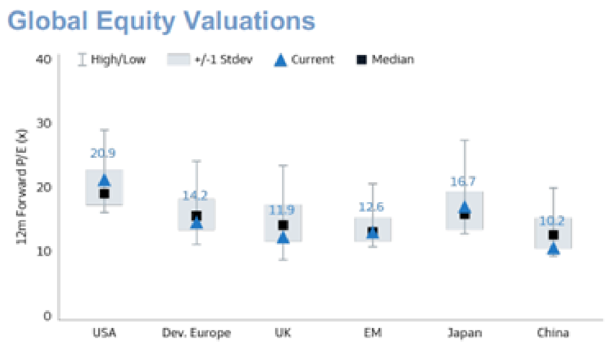
**June 12**: FOMC Meeting

**June 20**: BoE Meeting

# Eurozone Leading the Cuts (Maybe):

## *Will a Tiny Rate Cut Be Enough to Jumpstart the Economy?*

The European Central Bank (ECB) is about to pull the trigger on something it hasn't done in almost a year: cutting interest rates. This move aims to give the eurozone economy a much-needed shot in the arm, but there's a twist. Sticky inflation – prices just won't budge! – throws a wrench into plans for a rapid series of cuts. So, is this a small step towards a full-blown easing cycle, or just a lonely dance move?




### *Rate Cut on Deck, But Don't Get Too Excited..*

Imagine this: borrowing costs in the eurozone are about to get a tiny bit cheaper. Policymakers are expected to shave off a quarter percentage point on June 5th, bringing down the key interest rate from a record high. They've been pretty transparent about it too, so no surprises there. This comes after a period of intense tightening – think slamming on the brakes – to combat inflation fueled by the war in Ukraine and pandemic aftershocks.

### *Inflation Downturn? Not Quite There Yet..*

Remember that pesky inflation thing? Well, it's not quite going down without a fight. After ten interest rate hikes in a row, the ECB took a break in October. While inflation has come down a bit from its crazy 2022 highs (over 10%!), getting it back to the ECB's comfy 2% target is proving to be a stubborn beast. Recent data even showed inflation creeping up again in May, faster than expected.

### *Beyond the Headlines: What Worries the ECB*

The ECB isn't just looking at the overall inflation number. They're keeping a close eye on rising prices in everyday services, like haircuts and restaurant bills. Plus, worker wages are still growing quite strongly as people try to keep up with inflation. The eurozone economy is also showing signs of life after a recession, but its growth is sluggish compared to the powerhouse U.S. economy.

### *One Small Step for the ECB, But Maybe Not a Giant Leap*

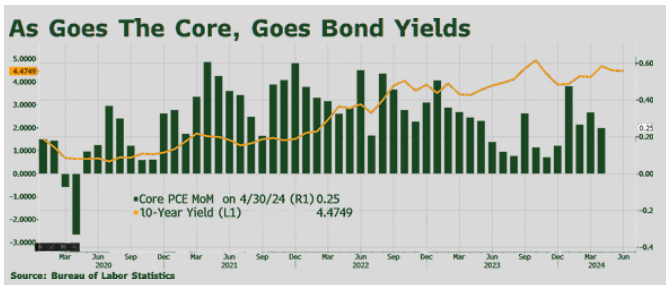
With inflation showing some fight, a second rate cut at the ECB's July meeting seems unlikely. In fact, policymakers are hinting at a go-slow approach even after the June cut. Buckle up for ECB President Christine Lagarde's press conference after the meeting – investors are eager to hear her thoughts on the future pace of cuts. The ECB will also be releasing updated economic forecasts, which will be like a game plan for their next move.

### *Europe vs. America: A Different Game*

The U.S. economy is booming, and that's pushing back expectations of rate cuts by their central bank, the Fed. But the ECB isn't following anyone's lead. They're determined to chart their own course based on the eurozone's unique situation. However, cutting rates faster than the U.S. could weaken the euro, making imports more expensive and – you guessed it – fueling inflation further.

### *So, will this tiny rate cut be enough?*

Analysts are scaling back their predictions for the number of cuts this year, with most expecting the ECB to take it slow and steady, bringing rates down just once per quarter. Will it be enough to jumpstart the eurozone economy? Stay tuned, because this economic drama is far from over.





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