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Economic Update

Intro

Like 2023, 2024 remains a two-horse economic race. The contenders are *Soft landing* and *Hard landing*, with *Soft landing* pulling ahead in the home straight of 2023. *Hard landing* increasingly looks like it will be found lame. Some bookies (like Goldman Sachs bank) scratched *Hard landing* from the 2024 starting gate.

Core PCE (Personal Consumption Expenditures) inflation, the Fed's preferred measure, is now at 1.9% over the last 6 months, bang on target. More and more bookies are saying, "the soft landing has arrived". It's becoming clearer that this is not a 1970's style inflationary breakout, it's a horse of a different colour.

But don't put the cart before the horse - BCA (a research house), PIMCO, David Rosenberg and a diminishing pool of bookmakers think *hard landing* is still in the race. Only time will tell if they are flogging a dead horse.

With *Soft landing* the short odds favourite from bookies, the punters (equity markets) went a step further in late 2023, declaring this a one-horse race. Indeed, should disinflationary forces 'strongly push inflation to target, allowing central banks to begin cutting rates, the horse will have indeed bolted, with *soft landing* taking line honours.

For those with more interesting lives, and thus not familiar with *hard/soft landing* phrasing, *soft landing* refers to inflation returning to the central bank target without a dramatic expansion in unemployment, recession, or material disruption to financial markets. Albeit a *soft landing* accommodates a slowdown in growth.

A *hard landing* means a recession and/or high unemployment and/or something collapsing in financial markets.

Snowgum Financial Services is not one to change horses midstream, and like previous quarterlies, we think there remains an even chance of a *hard landing* scenario emerging in the next 12 months. For those who have read this far, that will be our last horse idiom (hopefully putting readers out of their misery more humanely than an injured equine).

Why might a hard landing still be a possibility.

1. **Employment** - In the beginning stages, a *soft landing* and *hard landing* scenario show near identical data. Both show softening conditions with no material uplift in unemployment. Unemployment is a lagging indicator, as opposed to a leading indicator. Unemployment data, we believe, is susceptible to providing false confidence a *hard landing* has been avoided.
2. **Rates** - If we are in the process of a *soft landing*, asset price enthusiasm for this outcome is working against central banks. Many *soft landing* forecasts are premised on near-term rate cuts, an unreliable assumption as a successful soft-landing undermines the case for cuts.

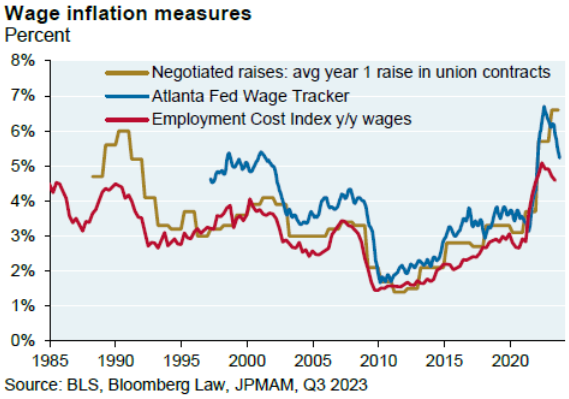
3. **History** - A *soft landing* scenario is not unheard of but would be an outlier event. This time may be different, but that phrasing rarely bodes well. Lags are often underappreciated.

1. Employment

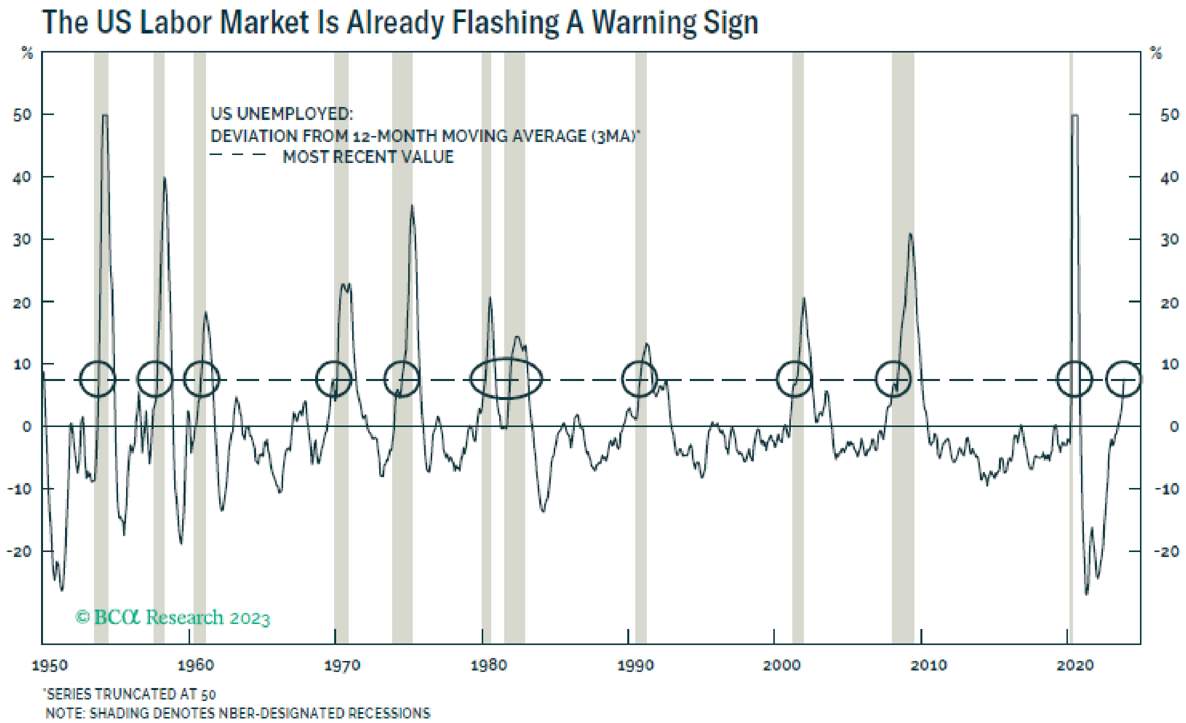
With regards to the first point above, recent [headline labour data from the US]() for December was better than expected with unemployment falling to 3.7%. However, the number of employed persons fell in December, with participation rate losses outpacing employment losses to give the stronger unemployment reading.

A closer look at leading indicators sees cracks emerging in labour markets, albeit these remain just cracks. US Quits (people resigning from a job) are back to pre-pandemic levels. Youth unemployment has crept up from a low of 6.6% in April 2023 to 8.0% in December 2023, falling back from being as high as 8.8% in October 2023, a mixed trend.

Wage growth has turned (graphs below), confirming cooling labour market conditions in the US. Forward indicators speak to a material wage growth decline that would ordinarily be accompanied by a recession. However, as wage growth is abating from historically high levels and is disinflationary, it is enhancing Central Banks capacity to cut rates; the signal remains mixed.



Finally, the below graph plots the percentage deviation in the 3-month moving average of unemployment from the 12-month moving average in unemployment. In each previous instance that employment conditions weakened at this cadence, a recession followed. However, the starting point in labour markets was unprecedently strong, potentially unreasonably amplifying the perceived change due to base effects (that is the denominator being unusually closer to zero than previous data series events).



In our view, leading labour market indicators remain the most important data set to watch. Contrary to equity markets and consensus, the current leading indicators only inform investors that the economy is cooling but offers no conviction this will be either a soft or hard landing, substantiating our mixed outlook. We are potentially just one more quarter away from data firming in either direction.

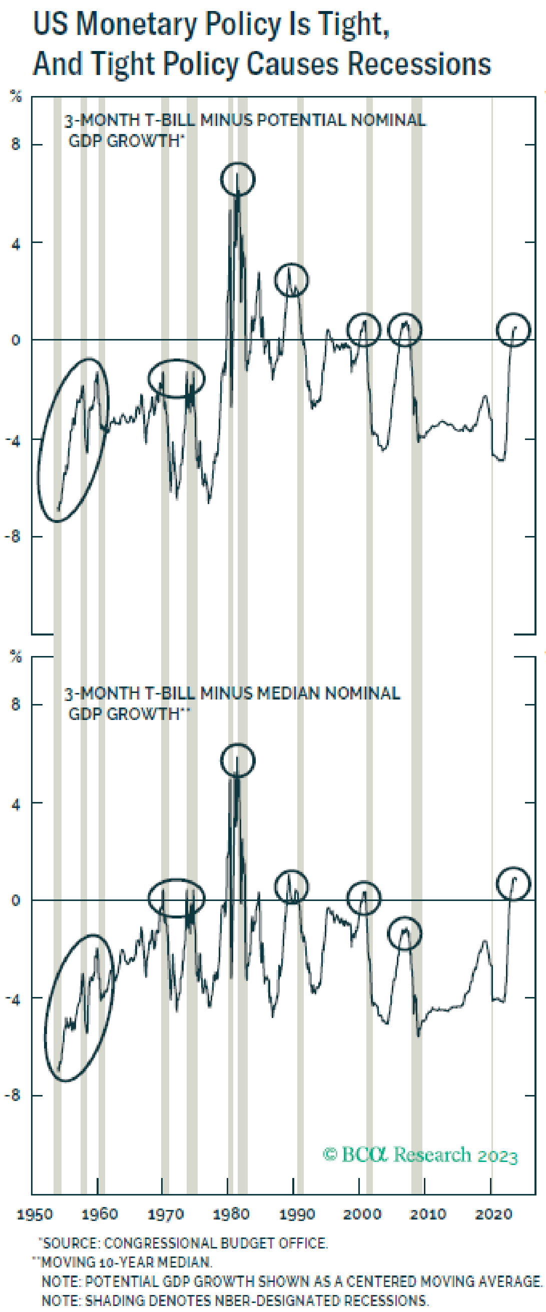
2. Rates

Core PCE inflation in the US on a 6-month basis is back to target, however, it remains elevated on a 12-month basis, with inflation data released in January showing some stubbornness in services inflation, particularly shelter (rents). Given the scale of the recent inflation upsurge, and Central Bank's credibility hit, rates are less likely to move pre-emptively lower without a *hard landing* emerging. On the other hand, if/when inflation gets back to target on a 12-month basis, so supporting a 'durable' (quoting the Fed) return to target without a *hard landing* arriving, the *soft landing* scenario outcome becomes increasingly likely. A durable return to target remains at minimum three months away at best.

A paradox in comprehensively sticking a *soft-landing* would be the need for interest rates to remain elevated for longer, increasing the risk of triggering an idiosyncratic market event that catalyses a *hard landing*.

Given the lags in monetary transmission, rates would ideally need to be cut soon to shore up a *soft landing* outcome, and this looks a challenging proposition for Central Banks.

3. History



"History doesn't repeat itself, but it often rhymes"- so the saying goes. It would be highly unusual for tight monetary conditions to not cause a recession. The graph shows previous tight monetary regimes since 1950. Except 1983 and the mid 90's, all tightening regimes have resulted in recession.

Long and variable lags saw investors asking where the recession was in 2000 and in 2007. They got their answer in 2001 and 2008.

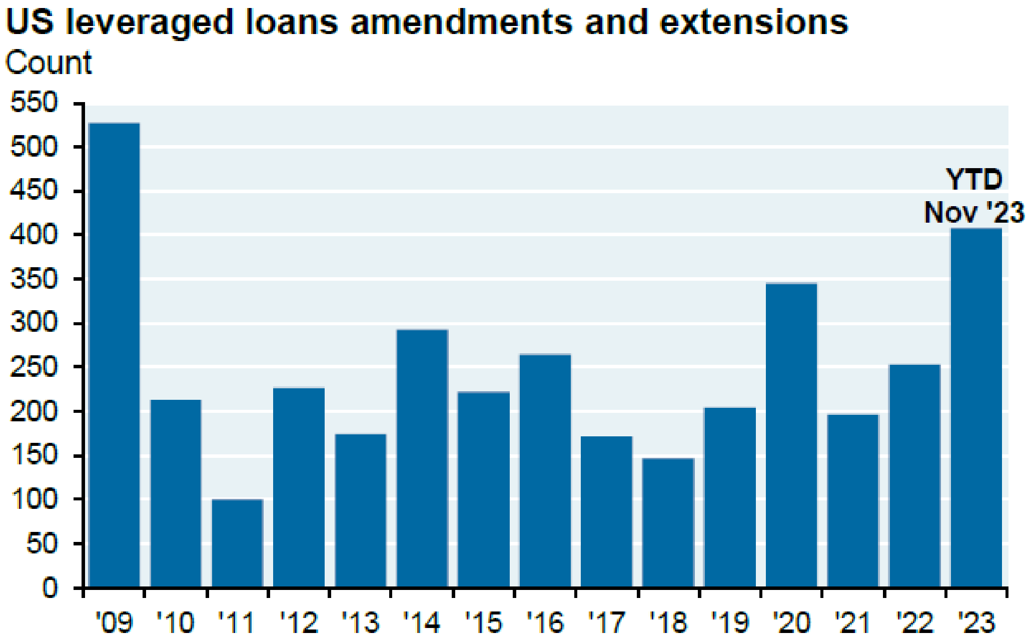
So why hasn't a recession arrived, and could this time be different?

Curiously, if this time is different, the unique starting point of the tightening cycle provides a possible context for why this tightening cycle might break from history.

Unorthodox pandemic-induced monetary and fiscal conditions led to:

- Exceptionally high household savings.
- Excessive government spending programs.
  - US Fiscal support added c. 4% to GDP in 2023. That is set to invert in 2024 and drag on US GDP by c. -1%, albeit nominal spending remains high (US still running large deficit).
- Market participants termed out debt (which means extending the length of their loan maturity to the more distant future) taking advantage of the opportunity to lock in unprecedently low interest rates.
  - *"S&P 500 debt is now 76% fixed compared to less than 50% in 2007"* – Michael Cembalest, JP Morgan.
  - The average rate on all outstanding US mortgages is still <4%.

With interest rate transmission blunted by the unique settings that preceded this tightening cycle, Central Bankers may be better able to massage a nuanced slowdown (i.e. soft landing).



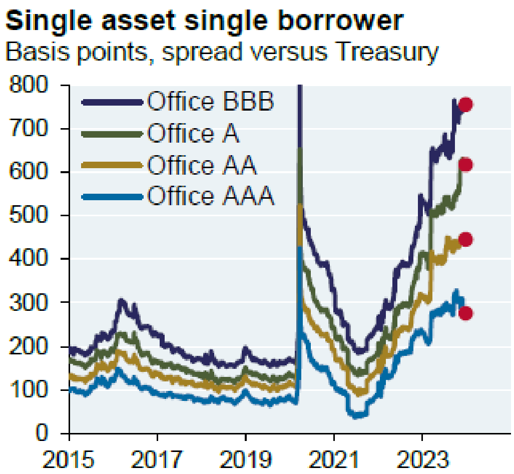
Source: LCD, Pitchbook, JPMAM, November 2023

Finally, those unlucky market participants whose debt wasn't termed out beyond 2023 are opting to amend and extend until, they hope, rates fall providing better conditions for refinancing.

Should rates remain high for longer, what might break (i.e. idiosyncratic risks)?

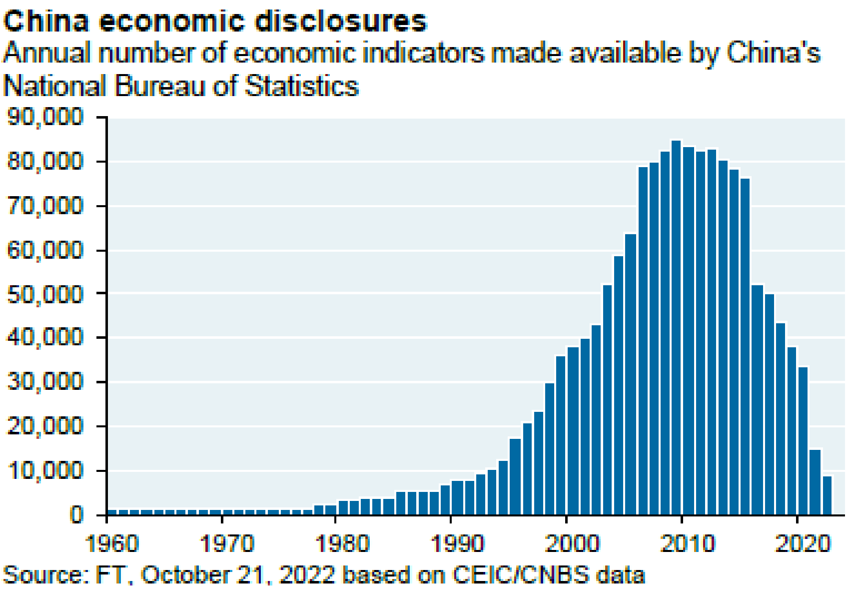
Some possibilities:

- **US Commercial real-estate debt.** Credit spreads in nearly all corners of the fixed income and credit universe compressed through late 2023. Investors' fear of default risks diminished as the *soft-landing* scenario was baked in- except in commercial office debt and regional malls.
    - *"Approximately USD $1-1.5T of US commercial Real estate loans are set to mature between 2023 and 2025, and the total amount of maturing debt rises to over USD $2.2T by 2027"* – *BCA.*
    - Commercial Real Estate loans in the US are commonly interest only and capitalising interest at that. Falling office values against growing debts with poor refinancing conditions have led some office investors to simply [hand back the keys to their lender and walk away.]



Source: Dataquery, JPMAM, December 26, 2023

- **Structural stagnation** might still emerge should inflation settle around 3%, forcing interest rates to remain elevated or even go up again. A low probability given the disinflation momentum, but one that risks a prolonged low growth cycle with no relief from central banks and fiscal support strained due to increased government debt servicing obligations.
- **Credit crises** in highly indebted countries. Contenders being, "Hong Kong SAR, Sweden, China, France, Canada and Norway" – BCA.
- **US consumer slowdown**. Consumers are anticipated to have exhausted pandemic savings sometime in the first half of 2024 at the same time as labour conditions deteriorate and sub-prime auto and credit card loan delinquencies rise.
- **China shadow banking contagion**. Although China is not tightening rates, higher rates in developed market have weakened demand for Chinese exports, contributing to a foreign capital exodus and depreciating Yuan. The prolonged property crisis (Chinese property remains heroically overvalued) and some near insolvent local governments continue unearthing frailties in the Chinese economy.
    - The largest shadow bank, Zhongzhi, moved into bankruptcy. More are likely to follow. Most major banks (i.e. not shadow banks AKA the trust industry) are state owned, so financial contagion risks appear low. But governments are not immune to markets forces… even the US treasury is not immune to intimidation from bond vigilantes.
    - China is increasingly an information Blackbox. With diminishing data releases, things may already be worse than they appear.



Conclusion

The key questions for investors are:

1. **Are we in the process of sticking the soft-landing, or is the soft landing just the beginning of a transition to a harder landing?**
2. **Can rate cuts commence soon enough?**

Although our 50% each way bet remains more negative than market consensus, in the event a *hard landing* emerges, we are optimistic that Central Banks have ample ammunition to cut rates quickly, preventing a hard landing becoming entrenched and unnecessarily deep. If so, this will provide a terrific buying opportunity.

Investment update

Soft landing

Equities - In the event we stick the soft landing, equities are likely to be positive for 2024, albeit much of the gains have been captured in Q4 of 2023. Small and mid-cap equities haven't yet greatly participated in the market rally and may benefit from a broadening out of positive sentiment. Historically, equities perform well in the 12 months after rate cuts begin, albeit rate cuts will be modest in a soft-landing.

Fixed income –The bond market is pricing in interest rate cuts in 2024 a touch earlier than is realistic in a soft-landing scenario (and nowhere near enough cuts are priced in if a hard-landing emerges). So, if there is a soft landing, a combination of government and investment grade bonds will deliver annual returns close to their starting yields (c.6-8%).

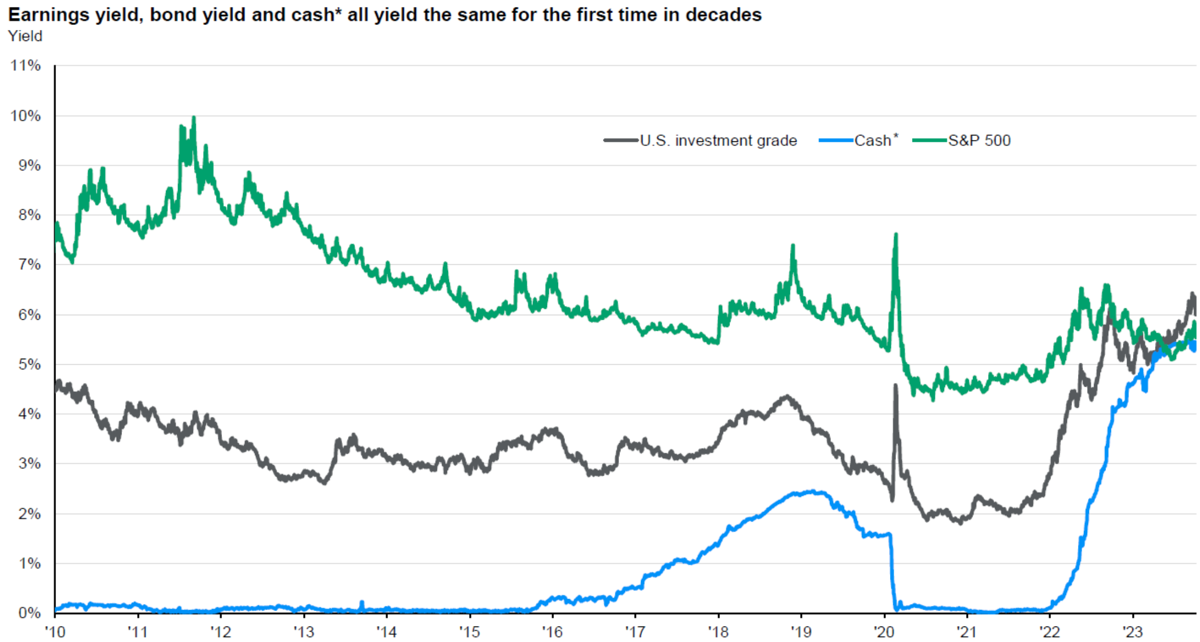
Hard landing

Equities – Equity markets would perform poorly in a recession as earning downgrades spread. Long dated income stream businesses, being those with higher earnings growth and a greater weighting of income flow value into the more distant future, would relatively outperform within equity markets as discount rates used in determining valuations (based on rapidly lowered interest rates) adjust down.

Fixed income – Fixed income would perform well. The rapid change in interest rate expectations against what is currently priced provides reasonable upside to investors. The duration of the fixed income investment needs to be carefully considered given the risk that longer term inflationary mega-trends (demographics, energy transition, fiscal profligacy) may pressure yields up in the long term, whilst near and medium-term yields are preferred to capture value in a downside surprise. Balancing the right amount of duration is better outsourced to a fixed income manager, in addition to the benefits of credit risk diversity.

Best graph from 2023

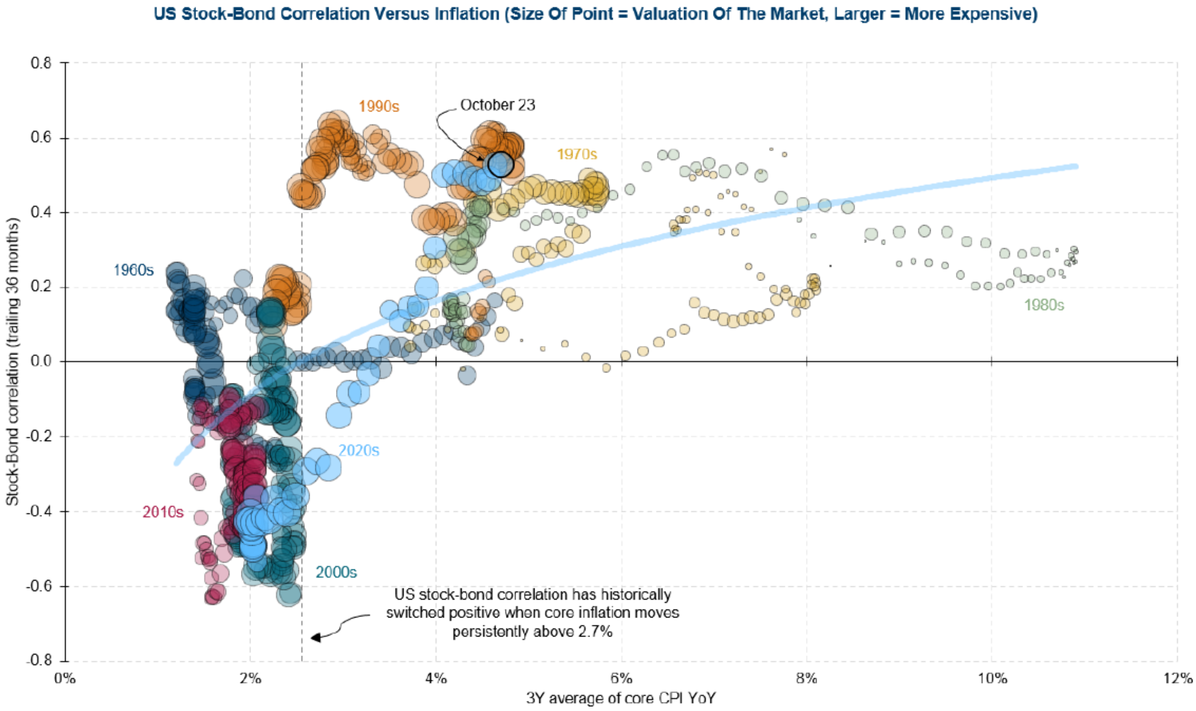
Vanishing risk premia. Looking at the graph below your brain isn't foggy from too much Christmas trifle, yields really are virtually the same across asset classes. This begs the question – Are cash yields too high, or is it equity values and bond yields that are too high? (remembering that high bond yields mean lower bond valuations)



Source: Bloomberg, FactSet, J.P. Morgan Asset Management.*Cash proxied by U.S. short-term treasuries. Data reflects most recently available as of31/10/23

Equities and fixed income correlations

One of the challenges for investors over the last two years has been the correlation in investment returns from equities and fixed income. Both performing negatively in 2022, then both modestly positive in 2023.



Source – MAN GLG. Stock-bond correlation is between the S&P 500 Total Return and the Bloomberg Barclays US Treasury Aggregate Total Return indices. Valuation calculated as the percentile monthly P/E from January 1960 to October 2023. Core CPI from the Bureau of Labor Statistics. Data as at end of October 2023.

Portfolio positioning

The graph above informs investors that as inflation returns to or below target, diversification benefits of a mixed allocation are attractive. Given inflation looks set to return to central bank targets, 2024 is likely the year traditional diversification benefits return, making a suitable mixture of investments across asset classes appropriate for risk adjusted portfolios.

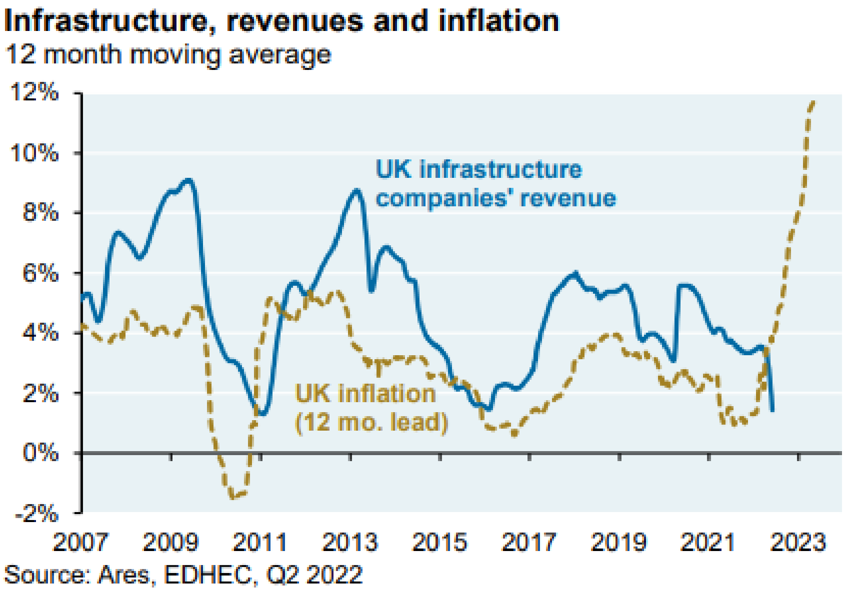
Further, given how baked in equities are to the positive *soft landing* outcome, bonds provide attractive risk-adjusted returns, particularly if you are more economically pessimistic than consensus. Investors might choose to retain a near benchmark equity allocation to ensure they are strapped in for a rally if rate cuts begin without recession, but preference a tilt to *quality growth* and less correlated equity return strategies.

Some ideas for less market correlated equity trading strategies are long/short, macro-event, tail risk or 'Buy-Write' equity strategies. For instance, a Buy-Write strategy generates income from selling option premium against an underlying equity portfolio to defer excess equity upside for guaranteed option premium income. This sees the strategy outperform in a flat, volatile or bear market (albeit underperform if equity markets perform strongly).

Infrastructure

As inflation emerged, infrastructure assets were stand-out performers in 2022 (after energy). Disinflationary forces, in combination with higher interest rates, weighed on infrastructure values (at least those publicly traded) in 2023.

Although inflation is coming down, inflation input costs and their corresponding charges to infrastructures users are delayed (as chart below shows). So, with an expected larger uptick in revenue and possible interest rate reductions, infrastructure investments look to have multiple valuation drivers. Even in recession, although usage charges fall with a reduction in economic activity, infrastructure investments are less cyclical than the broader equity market.



Conclusion

Like the previous few years, interest rates will again be a driving force in markets. In 2024 that hopefully will mean providing downside relief for mortgage holding millennials and Gen X's!! As rates remain high, and lags appear longer and more variable this cycle, 2024 is likely to throw out a few surprises.

The positive news for investors is that inflation looks close to being tamed. Real returns on most investment assets are again positive, with more pathways to favourably deploy capital than have been available for many years.

By Matt Vickers