28 February 2024

Investment Institute Macroeconomics

Monthly Op-ed

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Exploring Exuberance

Key points

- US growth continues to surprise to the upside and there might be something structural at play there.
- The Fed remains prudent on the timing and magnitude of cuts. The market has – at long last – got the message.
- Equity markets have been driven by US tech stocks' earnings growth
- Bonds are also offering higher returns as central bankers have indicated monetary easing may take longer
- A balance of equities and fixed income should outperform cash returns

Something good may be happening in the US

There are two main explanations for the resilience of growth in the US. One focuses on an unusual delay in the transmission of the monetary tightening. The other on the possibility that a positive supply-side shock is lifting the US fundamental growth rate. Evidence can be found for both of them.

When looking at the flow of funds data produced by the Federal Reserve (Fed), it appears that the cost of servicing debt for non-financial corporations has not increased as fast as it did in previous episodes of monetary tightening. We must be careful because collecting data on interest payments in real time is not straightforward and there could be too much statistical inertia in the current estimates. Such a finding would, however, be consistent with the fact that businesses took the opportunity of the very long phase of extremely low interest rates before 2022 to lengthen the average maturity of their debt, which may now be diluting the impact of current rate hikes. There is also the possibility that the debt service starts from such a historically low level that even as it is now rising, it does not pass the "awareness threshold" to convince business leaders to revise down their expenditure programs.

On the supply side, the strong and persistent productivity gains of the US economy suggest that some structural shift is currently at work in the efficiency of the US economy. There is a lot of focus at the moment on the promise of Artificial Intelligence. It is however unlikely that this is already at work right now. But US businesses have stepped up their investment effort in Intellectual Property (essentially software and R&D) massively over the last 10 years. It is possible that they are now reaping the benefits of accelerated digitalisation, especially in a situation of hiring difficulties in which they could be incentivised to rationalise their production process.

Of course, the conclusions for monetary policy are quite different depending on which of these two explanations dominate. If the former, then the Fed should not lower its guard until a proper impact materialises. If the latter, then the Fed could count on these productivity gains to mitigate the effect of strong wage growth on consumer prices. There is an historical precedent which is likely to make the Fed prudent: in the late 1990s/early 2000s, in the face of an episode of strong IT-induced productivity gains, Alan Greenspan chose a relatively easy course for monetary policy which probably contributed to the accumulation of financial imbalances of the early 2000s which contributed to the 2008 crisis.

In any case, the latest developments on the inflation front do not argue for a quick adjustment in monetary accommodation. Jay Powell must congratulate himself for his cautious turn at the January press conference, since the first inflation print for 2024 confirmed that the Fed has some good reasons to remain prudent on the timeline of rate cuts. The Consumer Price Index (CPI) fell less than the market was expecting, coming out at 3.1%yoy against a consensus at 2.9%. This is still down (3.4% in December) but such a pace had already been seen in June and November 2023 and observers focused on the bad news on core inflation, which stabilised at 3.9%yoy in January, where the market had counted on another deceleration to 3.7%. As usual, we want to "vary the angles" to minimise the impact of old base effects. On a 3-month annualised basis, the picture that emerges is quite concerning. Since hitting a trough last summer, core CPI has been on an upward trend, and stood in the three months to January at a pace twice as high as the Fed's target. The much-derided notion that the last mile of disinflation may prove to be arduous is getting more and more support from the US data flow. The market's pricing of the Fed has finally converged towards the Federal Open Market Committee (FOMC)'s dot plot: there are now less than four full 25bps cuts priced in by the end of 2024, which happens to be our call.

Such positivity is unfortunately not to be found in the Euro area. Beyond the weakness in current GDP growth, what is striking is the absence of productivity gains at the moment, which may be the product of having completely missed the intellectual property investment effort of the last 10 years. As productivity stalls, the European Central Bank (ECB) remains preoccupied by the impact of strong wage growth, even if the very latest data tentatively point to some deceleration. In this configuration, the timing of the first-rate cut has also been pushed by the market, in line with our expectation.

Improved macro backdrop for investors

Despite the adjustment in policy outlooks, several stock markets hit record highs in February. Record equity prices and an extended peak for interest rates is not the market representation of the expected evolution of 2024's macro environment. US growth continues to surprise to the upside while corporate balance sheets and profit margins are healthier than imagined after a period of significant global monetary tightening. Inflation, while showing signs of stickiness in the services sector, is now closer to target levels than to 2022's highs. Interest rates are unlikely to go higher anytime soon. This all adds up to a so-called 'Goldilocks scenario' for investors. Valuations might not be cheap, but fundamental cash-flow generation and balance sheet resilience supports asset prices. Cash has looked like the only place to be for the last year but returns from risk assets have been rewarding and look set to potentially continue for some time. A balance of equities and fixed income should outperform cash returns.

After the valuation adjustments during the 2022-2023 tightening period, the absence of a hard landing for the world economy has been a relief to investors. Last year saw asset class returns start to recover even if some - particularly on the fixed income side - remain below their total return peak value. Monetary policy has not had the expected negative impact on global growth despite interest rates being increased from extremely low levels. Indeed, it is because rates were so low for so long that global companies and consumers have been able to build a resilience to higher rates – they had secured low long-term financing costs and built significant cash and savings balances. With inflation slowly easing, it is likely that interest rates start to come down before the buffer of those cash balances is eroded.

It's one thing to acknowledge the macro backdrop has turned out to be more favourable for investors and for markets to generate better returns than in 2022, and the first half of 2023. It's quite another thing to take the view that current valuations are attractive enough to migrate from cash to riskier asset classes. There was much talk of a 'fear of missing out' psychology amongst investors in the final months of 2023. However, cash balances remain high – in US money market funds for example. It appears that flows have been positive in some areas, like investment grade credit, but signs of significant new allocations to global equities are difficult to identify.

US equities are driving the gains and the technology sector within the US equity market is driving the overall market. It is not hard to see why given the enthusiasm around artificial intelligence (AI) and broader applications of advanced digital and automation technologies. The combined 12-month trailing net sales revenues of the so-called 'magnificent seven' group of technology stocks was close to $1.8tn in 2023 – representing around 6.5% of US GDP. The group's increase in sales over 2023 accounted for around

10% of the increase in US nominal GDP. There is a massive amount of spending on technology and AI is driving corporate investment plans. The AI revolution is still at an early stage and the application of AI across broader economic sectors is not all guaranteed to be accretive to earnings potential. But the investment case rests very firmly on the ability of AI to boost productivity and profits for many enterprises. As we saw with the initial digital technology revolution, those firms able to protect and foster the intellectual capital required to sustain progress were able to sustain superior earnings growth. Hence the broad-based growth in the technology sector and its superior total return track record.

Shifting expectations on when the Fed and other central banks will cut interest rates by a quarter or so, or moving the magnitude of how much rates will be cut by 25 or 50 basis points is immaterial to the technology story. At this stage, only a hard landing requiring significant cuts to capex budgets would materially damage the sector. That does not seem likely. Meanwhile, a rising tide (AI) is lifting all boats, even if the performance of indices like the Nasdaq and the S&P 500 is concentrated. The equally weighted S&P 500 is up 21.4% in total return terms since last October's market low (as of 22 February 2024). Over the same period, the market cap-weighted index is up 24.1%.

Income and growth opportunities

Our key investment themes this year have been to look for income in corporate credit markets and seek growth exposure through US equities with a technology bias. In the minutes of the Fed's Open Market Committee meeting held on 31 January, the commentary was supportive of a positive view on corporate credit. It suggested credit quality remained broadly solid and sound for borrowers in the corporate bond and leveraged loan markets. Some may suggest that seems complacent given signs of rising delinquencies in areas such as auto loans and credit cards, and well publicised issues surrounding parts of the commercial real estate market, but fundamentals in the mainstream credit markets remain good. And yields are attractive again following the adjustment to rate expectations since the start of 2024. Total returns, year to date, have disappointed because of the back-up in interest rate expectations, but credit indices have outperformed government bond benchmarks across the board. In other words, investors have been rewarded for taking pure credit risk, highlighted by the very strong performance of high yield and leveraged credit strategies. If nominal GDP growth and, therefore, growth in top-line corporate revenue is going to hold up better than expected in 2024, then key fundamental metrics like net debt/earnings before interest, tax, depreciation and amortisation (EBITDA) and interest coverage ratios will remain at comfortable levels.

Large caps have outperformed small caps in the equity market. Large banks are better equipped than small banks to deal with peripheral credit issues. In the high yield market, where default rates continue to be lower than forecast, the expected risk-adjusted return to investors should continue to be more favourable than taking exposure to pure small-cap equity risk.

Valuations through the prism of a technological revolution

Investors should always be concerned about valuations. However, the improved US macro outlook suggests mainstream asset class valuations are not quite as prohibitive to decent total returns as was thought a few months ago. Earnings growth of 10% for 2024 is looking more achievable, while peak rates mean the risk of a negative duration shock in the corporate bond market has also diminished. The combined annual growth of sales revenues of the magnificent seven has exceeded 10% in all but two of the last 10 years. Current valuation snapshots, like high price-to-earnings ratios, should not necessarily be an impediment to concluding technology stocks are a good long-term investment.

Exuberant risk requires balance and diversification

There is a danger of over-exuberance. Monetary tightening might still work, it just might take longer. But the headline numbers for the US economy make comforting reading. Growth just below trend, inflation falling, record numbers of jobs, interest rates peaking and corporate earnings holding their ground despite the shocks of recent years. Today, investors have more scope for diversification with bonds offering higher returns, and value opportunities available in other equity markets – note the performance of Japan over the last year. If we extend the horizon beyond the present, cash returns will decline while fixed income assets and equities could get some capital uplift from lower interest rates. A more pessimistic view on the outlook may keep some investors in cash today, but if a harder landing emerges, bond markets will discount this and will generate stronger returns, offsetting some of the potential equity weakness. As such, a significant exposure to fixed income alongside equities would seem appropriate.

Download the full slide deck of our February Investment Strategy

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Macro forecast summary

Real GDP growth (%)	2023*		2024*		2025*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.1		2.9		3.1	
Advanced economies	1.6		1.2		1.2	
US	2.5	2.4	2.0	1.4	1.5	1.8
Euro area	0.5	0.5	0.3	0.5	0.8	1.5
Germany	-0.1	-0.3	-0.1	0.3	0.7	1.5
France	0.9	0.9	0.4	0.7	0.8	1.3
Italy	0.7	0.7	0.3	0.5	0.6	1.2
Spain	2.5	2.4	1.6	1.3	1.3	1.9
Japan	1.9	1.7	1.2	0.8	1.0	1.0
UK	0.3	0.5	0.2	0.2	0.6	1.2
Switzerland	0.6	0.8	0.8	1.2	1.3	1.5
Canada	1.1	1.1	0.5	0.4	1.7	1.9
Emerging economies	3.9		3.9		4.2	
Asia	5.1		4.9	4.0	4.7	
China	5.2	5.2	4.5	4.6	4.2	4.4
South Korea	1.4	1.3	2.2	2.1	2.3	2.2
Rest of EM Asia	5.3		5.7		5.4	
LatAm	2.4		1.6		3.0	
Brazil	3.0	3.0	1.4	1.6	2.4	2.0
Mexico	3.2	3.3	2.2	2.2	2.9	2.2
EM Europe	2.6		2.5		2.6	
Russia	3.0	2.7	2.6	1.7	1.1	1.1
Poland	0.2	0.4	2.8	2.8	3.5	3.4
Turkey	4.3	3.9	2.0	2.2	3.6	3.2
Other EMs	1.9		2.8		4.6	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 27 February 2024
**Forecast*

CPI Inflation (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	4.7	2.8		2.2	
US	4.1	3.0	2.6	2.5	2.3
Euro area	5.5	2.5	2.2	2.1	2.1
China	0.2	1.1	1.2	2.0	1.9
Japan	3.2	2.2	2.2	1.6	1.5
UK	7.7	3.1	2.6	1.8	2.0
Switzerland	2.2	1.6	1.6	1.3	1.3
Canada	3.6	2.9	2.5	2.3	2.0

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 27 February 2024
**Forecast*

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)						
		Current	Q1-24	Q2-24	Q3-24	Q4-24
United States - Fed	Dates	5.50	20-Mar	1 May 12 Jun	30-31 Jul 17-18 Sep	6-7 Nov 17-18 Dec
	Rates		unch (5.50)	-0.25 (5.25)	-0.25 (5.00)	-0.50 (4.50)
Euro area - ECB	Dates	4.00	7-Mar	11 Apr 6 Jun	18 Jul 12 Sep	17 Oct 12 Dec
	Rates		unch (4.00)	-0.25 (3.75)	-0.25 (3.50)	-0.25 (3.25)
Japan - BoJ	Dates	-0.10	18-19 Mar	25-26 Apr 13-14 Jun	30-31 Jul 19-20 Sep	30-31 Oct 18-19 Dec
	Rates		unch (-0.10)	+0.10 (0.00)	unch (0.00)	unch (0.00)
UK - BoE	Dates	5.25	21-Mar	9 May 20 Jun	1 Aug 19 Sep	7 Nov 19 Dec
	Rates		unch (5.25)	unch (5.25)	-0.25 (5.00)	-0.50 (4.50)
Canada - BoC	Dates	5.00	6-Mar	10 Apr 5 Jun	24 Jul 4 Sep	23 Oct 11 Dec
	Rates		unch (5.00)	unch (5.00)	-0.25 (4.75)	-0.50 (4.25)

Source: AXA IM Macro Research - As of 27 February 2024

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Our Research is available on line: www.axa-im.com/investment-institute

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AXA IM manages approximately €844 billion in assets, of which €480 billion are categorised ESG-integrated, sustainable or impact as at the end of December 2023. We are committed to reaching net zero greenhouse gas emissions by 2050 across all eligible assets, and to integrating ESG principles across our business, from stock selection to our corporate actions and culture.

Part of the AXA Group, a worldwide leader in insurance and asset management, AXA IM employed over 2,700 employees and operates from 23 offices in 18 countries globally at end of December 2023

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