Cuts are coming – but the market needs to be more patient

Key points

- Geopolitical risks may put the continuation of disinflation in doubt, but we remain reasonably confident
- Still, we think the market began 2024 with overly aggressive expectations for rate cuts
- High cash rates for now….
- … but more durable opportunities for the medium term
- Credit markets provide income and capital gains opportunities
- Technology to remain a strong theme in equities

Balancing the risks in early 2024

The "macroeconomic fate" of 2024 will depend on whether the disinflation process which started last year can continue swiftly, allowing central banks to remove some of their restriction. Disinflation in 2023 was primarily driven by exogenous factors – the normalisation of supply lines and energy prices. Unfortunately, we are seeing the return of "polycrisis" risks which could derail the general slowdown in the price of tradables in the global economy.

The recent developments in the Red Sea suggest that the inflationary impact of the Middle Eastern crisis could take a different form than the "usual' oil price shock, as supply lines are starting to be disrupted again. The election in Taiwan of a Democratic Progressive Party (DPP) President for the third time in a row forces us to confront again the possibility of another escalation of the Sino-American rivalry, with the potential to trigger another trade war.

Yet, we still see reasons to remain reasonably confident. The Red Sea disruption cannot be compared with the general seizure of supply lines when economies reopened after Covid. The fact that the Taiwanese President-elect did not secure a parliamentary majority – in a configuration in which China, faced with weak domestic demand, is not in the best position to take the risk to lose support from foreign demand as a consequence of some "geopolitical adventure" – could help avoid tension between Beijing and Washington escalating too far.

The structural causes of the rivalry remain, but it appears to be better managed, especially since the meeting between Joe Biden and Xi Jinping in November 2023 in San Francisco. The mere fact that direct communication was reopened between the military forces of the two countries illustrated the willingness, on both sides, to minimise the risks of incidents disproportionately flaring up.

Still, even if the exogenous inflationary forces are kept under control, the latest consumer prices print in the US suggests that the "last mile" of disinflation remains bumpy. On a 3-month annualised basis core inflation has been hitting a "resistance line" above 3% since September. In addition, what remains crucial for us is that the contrast between the largely exogenously determined manufactured goods prices and the domestically driven services prices remains stark. When looking at the details within the services sector, price momentum is broad and cannot be reduced to "statistical accidents" such as the change in the way medical insurance costs are computed. Another issue is that rents also seem to be quite resilient. They have been decelerating from their peak in March 2023 when they hit 8.3% year-on-year (yoy), but at 6.2%yoy in December they continue to provide a significant contribution to the overall consumer price resilience. The domestic engines of inflation are still switched on. The materialisation of the Bernanke-Blanchard sequence, where labour cost-driven inflation would take the lead once supply-driven shocks fade, cannot be ruled out yet. This calls for maintaining a fair degree of restriction for longer than the market was expecting at the very beginning of this year.

We are less worried about the Euro area, despite the continued decline in productivity which pushes unit labour costs up, as we expect the deterioration in economic confidence to take margins down. From a normative point of view (what we think the ECB *should* do) this would make us sympathetic to the early cut view… but from a predictive point of view (what we think it *will* do), given the hawkish analytical choices made by the European Central Bank (ECB), we still don't expect such a move before June. Indeed, the central bank will want to be certain wages have started to decelerate before lowering its guard, and data on this front only come with a long lag.

Rate expectations fuelled solid market performance in late 2023

The core driver of market performance in the last quarter of 2023 was market enthusiasm over the prospect of significant cuts in interest rates this year. In the bond market, the yield on the benchmark US Treasury 10-year note fell over 100 bps (bps) between October and the end of December. Global credit spreads dropped by around 30bps and the MSCI World equity index delivered a 14.8% total return in the final two months of the year. It was a good end to another difficult year. However, 2024 has got off to a more sober start.

But a more sober view prevails today

Interest rates are again the key focus. While we expect rates to be cut this year, that process is unlikely to start any time soon. Inflation remains above central bank targets and the near-term path of inflation is somewhat uncertain. It is true that underlying global goods price inflation has returned to its pre-COVID levels – core US producer price inflation was just 1.8% in December and was negative in the Euro Area. However, there remain concerns about wage growth and the potential impact on inflation from disruptions to global supply chains that could result from various geo-political tensions. Global shipping costs have already risen in response to attacks on tankers in the Red Sea, reflecting the cost of re-routing ships and higher insurance costs.

High rates today versus durable returns for the medium term

It has long been the view that central bankers want to see inflation back to target levels before they sanction any easing of monetary policy. The "table mountain" profile for interest rates in the major economies remains a valid one. In turn, this means investors continue to face the difficult choice of either keeping money in cash and cash-like investments which earn an interest rate close to official policy rates or taking a longer-term view and trying to find value in global bond and equity investments. The dilemma is vividly illustrated by the fact that yields on key corporate bond benchmarks are the same as interest rates on short-term treasury bills. For many investors, the question "why take the risk of higher volatility and the potential for risk asset cheapening when overnight rates remain elevated?" is a valid one.

Look to income and capital gains opportunities

But we need time perspective here. Inflation should ease further. Short-term real interest rates are too high relative to expected real economic growth in the next two years. If forward markets are anything to go by, the current level of overnight rates relative to the medium-term equilibrium is extremely restrictive. There are scenarios that could see monetary easing proceed quickly once it starts. It may be possible to earn 5% on 3-month US Treasury bills (T-Bills) and 4% on French Treasury bills today, but will it be the same in April of July? There is no capital gain on cash when rates fall.

Credit markets offer close to the same yield as T-Bills. When monetary easing gets underway, yields are likely to fall, generating capital gains. Even if they don't, compounding current yields over 2–3-year period will deliver superior returns to holding cash over the same time. Of course, there are some risks around credit spreads in corporate bond markets. While outright yields are high, spreads are not particularly wide relative to their history. Any deterioration in corporate earnings could lead to some spread widening. Having said that, there is less need today to chase higher yielding, more risky credit opportunities than was the case 2-3 years ago. There is more opportunity to be exposed to better quality credit with higher yields. The 5-year to 10-year sector of investment grade markets look particularly attractive. It should also be pointed out, again, that average prices for corporate bonds remain well below par. Longer-duration parts of investment grade markets continue to see bonds trading with prices in the low 90s or even in the 80s. Most will redeem at 100, providing upside price potential over the medium-term.

It's not easy to embrace risk currently. There are huge political uncertainties facing investors with ongoing conflicts in Ukraine and the Middle East, with the US election being front and centre of these concerns. Risk assets aren't particularly cheap either, reflecting that major economies have not gone through a typical monetary policy tightening led recession. Growth is flat, corporate earnings will struggle to meet consensus forecasts (aggregate forecasts for 2024 have already been revised down a lot) and valuations are not convincing. However, there are core themes that should help guide investors. The first is that rates will fall and that is generally supportive for fixed income markets. Secondly, income is more of a theme. The rise in bond yields in 2022 and 2023 means income is a much more important component of total return. This suggests several opportunities, including a broad-based exposure to credit, including high yield with limited duration risk. On the same theme, there are a few equity opportunities for income investors, including European and UK markets where dividend yields are higher and more stable than in the US. Finally, technology is expected to remain a key theme. Overweighting the technology sector in the US market has been a winning strategy for several years now. With Artificial Intelligence becoming a theme across a growing number of companies and sectors, there will be strong demand for suppliers of hardware, semiconductors, networking and cloud computing, and cybersecurity. Despite high valuations, the technology sector is hard to ignore in a global diversified investment portfolio.

Quality income, technology focussed growth and being positioned for monetary easing are important investment factors for 2024. There are risks. Energy prices remain volatile, emerging markets are beset by numerous idiosyncratic situations, and populism in a number of developed countries risks both civil and policy uncertainty. But the good news is that the global economy is not in bad shape. Inflation is easing and that will allow relief on the interest rate front. Technology is delivering greater renewable energy supplies and AI will boost productivity. Although growth is weak, companies that have survived COVID, the energy shock and higher borrowing costs are likely to be good medium-term investments. Any downward correction in global equity prices or widening of credit spreads during the coming months is likely to prove to be an opportunity to put some of those huge cash balances to work in longer-term investments.

Download the full slide deck of our January Investment Strategy

Macro forecast summary

Real GDP growth (%)	2023*		2024*		2025*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.0		2.8		3.0	
Advanced economies	1.6		1.0		1.3	
US	2.4	2.4	1.4	1.2	1.6	1.8
Euro area	0.5	0.5	0.3	0.5	0.8	1.5
Germany	-0.1	-0.3	0.2	0.4	0.7	1.5
France	0.9	0.9	0.6	0.7	0.7	1.3
Italy	0.7	0.7	0.0	0.5	0.5	1.2
Spain	2.3	2.4	0.9	1.3	1.3	1.9
Japan	1.9	1.7	1.2	0.9	1.0	1.0
UK	0.3	0.5	0.2	0.3	0.6	1.2
Switzerland	0.6	0.8	0.8	1.1	1.3	1.5
Canada	1.1	1.1	0.5	0.5	1.7	1.9
Emerging economies	3.9		4.0		4.1	
Asia	4.9		4.8	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	5.0		5.4		5.5	
LatAm	2.3		2.3		2.4	
Brazil	3.0	3.0	1.4	1.6	2.0	2.0
Mexico	3.3	3.3	2.0	2.2	1.5	2.2
EM Europe	2.4		2.0		2.7	
Russia	2.2	2.7	1.1	1.7	1.0	1.1
Poland	0.6	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	2.3		3.5		4.0	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 24 January 2024
**Forecast*

CPI Inflation (%)	2023*		2024*		2025*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	4.7		2.9		2.3	
US	4.2	4.1	3.1	2.6	2.5	2.3
Euro area	5.5	5.5	2.7	2.4	2.2	2.1
China	0.4	0.4	1.1	1.4	2.0	1.9
Japan	3.2	3.2	2.2	2.3	1.6	1.5
UK	7.5	7.4	3.1	3.1	1.8	2.0
Switzerland	2.2	2.2	1.6	1.6	1.3	1.3
Canada	4.2	3.9	2.9	2.5	2.3	2.0

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 24 January 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	31 Jan 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)	-0.25 (4.75)
Euro area - ECB	Dates	4.00	25 Jan 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	1 Feb 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	24 Jan 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 24 January 2024

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

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