

THEME ONE

Economic Resilience Tested

Economic reports in the first half of 2023 generally painted a grim picture, with many indicators posting declines similar to those seen heading into past U.S. recessions.

An inverted U.S. Treasury yield curve—with shorter-term yields higher than longer-term yields—is one of the warning signs that historically has signaled a downturn, Page notes. At the end of May, the yield on the three-month Treasury bill was 188 bps higher than the yield on the 10-year Treasury note—just below the all-time record set earlier in the month.

But those recession warnings could be misleading, or at least incomplete, Page argues. In many cases, the sharp declines seen in such measures as purchasing managers' indexes, consumer confidence, and the U.S. money supply have been from the inflated levels reached during the pandemic and its aftermath. "A lot of these indicators are flashing red because we're still unwinding COVID distortions," he says.

During the pandemic, Page notes, household savings soared as stimulus measures poured money into consumers' bank accounts faster than they spent

it. Now those balances are coming down. But they remain extremely high by historical standards, and debt service ratios are still low.

In the Fed's most recent survey of senior bank loan officers, nearly half said they've tightened lending standards in the wake of the banking crisis—a level also historically associated with recessions, Page notes. But healthy consumer and corporate finances could mitigate the economic impact of tighter credit. "The most important difference now is that the balance sheets are in better shape," he says.

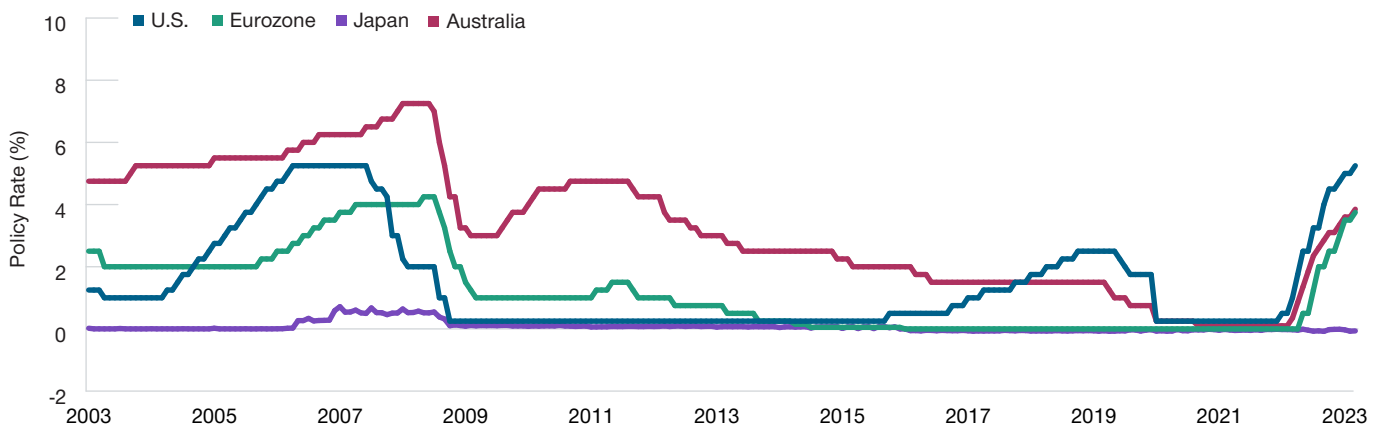
Husain suspects that some financial indicators also could be sending misleading signals about the near-term direction of central bank policy rates (Figure 2).

As of late May, Husain notes, interest rate futures markets were forecasting several Fed rate cuts before the end of 2023. He sees that as unlikely, barring a major liquidity crisis and/or an abrupt U.S. plunge into recession.

"I think the market is trying to reconcile two very different scenarios—one where the U.S. economy remains fairly strong

Interest Rates May Have to Stay Higher for Longer

(Fig. 2) Central bank policy rates



As of May 31, 2023.

U.S. = Federal Reserve fed funds upper limit. Eurozone = European Central Bank main refinancing rate. Japan = Bank of Japan overnight call rate.

Australia = Reserve Bank of Australia official cash rate.

Sources: U.S. Federal Reserve, Statistical Office of the European Communities, Cabinet Office of Japan, Reserve Bank of Australia.

I do think the Fed and other central banks will cut rates eventually. But the timing is tricky.

— Arif Husain
Head of International Fixed Income and CIO

and the Fed doesn't cut rates, and one where things go terribly wrong and the Fed has to cut by several hundred basis points," Husain explains. "That averages out as what's priced into the market."

Near-term rate cuts are even more unlikely in Europe, Husain adds. In fact, he expects both the European Central Bank (ECB) and the Bank of England to raise rates several times more, despite the economic risks. "I do think the Fed and other central banks will cut rates eventually," Husain says. "But the timing is tricky. Rates are going to remain higher for longer."

The Bank of Japan (BoJ) remains an outlier among the key developed central banks, Husain notes, as it still is in quantitative easing mode—including its policy of capping yields on long-term Japanese government bonds. But this could soon change, he warns.

"If the BoJ lifts its yield curve controls, it could end up being a lot more important for markets than whether the Fed hikes or cuts rates at its next meeting."

Inflation Remains a Sticking Point

Persistent inflationary pressures remain the primary global obstacle to monetary easing, Page and Husain both say.

Core inflation readings—which exclude volatile food and energy prices—remain stubbornly high (Figure 3). Service sector inflation is actually trending up, Page adds. Another energy price shock remains a risk, especially for Europe.

"U.S. inflation is probably going to get stuck at around 3%, maybe even 4%, for awhile," Page predicts. "A 4% rate would be double the Fed's target."

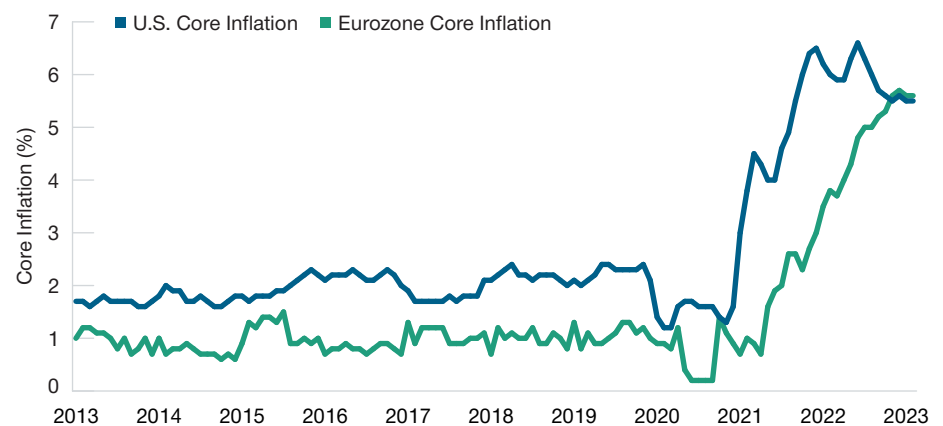
However, a convergence of factors could choke U.S. financial liquidity in the second half, Husain suggests, perhaps leading to a shift in the Fed's policy course.

Just as the Fed's rate hikes have not fully worked their way through the economy, the impact of the banking crisis on credit availability also will be felt with a lag—perhaps as long as two or three quarters, Husain argues.

Meanwhile, the U.S. Treasury will need to issue an estimated USD 1.4 trillion in debt in the second half to cover deferred payments and restore cash reserves. Those reserves are held in a special account at the Fed, and cash transfers into that account must be offset elsewhere on the Fed's balance sheet—in essence, shrinking the U.S. money supply.

Core Inflation Is Still Sticky

(Fig. 3) Consumer prices less food and energy, year-over-year change



As of April 30, 2023.
Source: Bloomberg Finance L.P.

Heavy Treasury issuance, a shrinking money supply, and the lagged impact of credit tightening could deliver a triple punch to liquidity in the second half, Husain warns, potentially destabilizing markets and spilling over into the real economy.

China’s Momentum Fades While Japan Accelerates

Other major economies delivered a welcome boost to global growth in the first half, Thomson notes. Falling energy prices helped eurozone economies avoid recession, while China lifted COVID restrictions faster than expected. A weak yen helped boost Japan’s export sector.

However, much of that momentum has faded, Thomson notes. China’s economy, he says, has remained stuck in “second and third gear,” reflecting a sluggish recovery in consumer demand and oversupply in the property sector. “China needs a new growth model,” he argues.

Japan’s economic outlook, on the other hand, appears more positive. “Corporate Japan is doing rather well,” he says. “There’s been a return of pricing power.”

A Less-Than-Almighty U.S. Dollar

U.S. dollar strength has been a headwind for U.S. investors in global ex-U.S. markets in recent years. But structural and cyclical factors both appear likely to curb U.S. dollar strength over the intermediate term, Thomson argues.

Cyclically, narrower interest rate differentials and tepid global economic growth should support other currencies—emerging market (EM) currencies in particular, Thomson says. “Historically, the dollar has tended to be strongest in ‘risk off’ environments and when the U.S. economy was growing very strongly,” he argues. “In a more mixed scenario, you’d expect the dollar to weaken.”

Structurally, relative valuations also favor other currencies, Thomson adds. As of the end of May, the U.S. dollar was at the 96th percentile of its 15-year valuation range against major developed currencies,¹ he notes.

ECONOMIC RESILIENCE TESTED

Investment Idea	Rationale	Examples
Maintain Flexibility and Keep “Dry Powder”	Global economies have been surprisingly resilient so far in 2023 but aren’t out of the woods yet. With short-term yields at attractive levels and economic uncertainty high, it makes sense to consider maintaining healthy cash balances and allocations to very short duration bonds.	<ul style="list-style-type: none"> ■ Cash ■ Very short duration fixed income ■ Dynamic global bond strategies

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¹Based on the U.S. Dollar Index, which measures the value of the dollar against a basket of six major currencies: the euro, the Japanese yen, the Canadian dollar, the British pound, the Swiss franc, and the Swedish krona. Monthly observations for the 15 years ended May 31, 2023.

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