Navigating macroeconomic fog

The COVID pandemic and the subsequent recovery continue to distort the economic data, forcing economists who rely on traditional recession signals to continually revise their assumptions. As a result, the most anticipated global recession in history has become the most delayed recession in history.

To be sure, there are reasons for caution regarding the global economic outlook. Europe looks likely to endure stagnant growth in early 2024 before recovering in the second half. In Asia, China's economic outlook remains gloomy, with few signs of improvement in the country's property market. Commercial real estate sectors remain fragile in several other countries as well.

Meanwhile, the U.S., Japan, and Europe are at different stages in the balance between growth and inflation, meaning the Fed, the European Central Bank, and the Bank of Japan (BoJ) are likely to pursue increasingly asynchronous monetary policies in 2024, adding to the potential for increased market volatility.

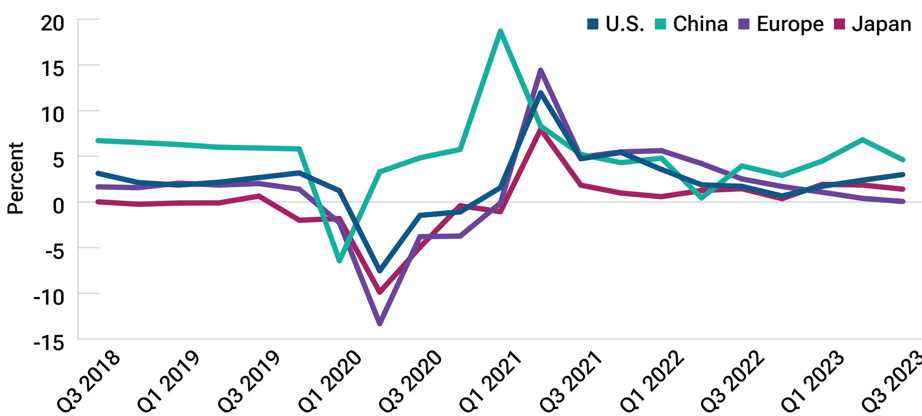
Geopolitical uncertainty also could bring further volatility, particularly if conflicts in the Middle East and Ukraine cause a resurgence in energy prices. Recent election victories for far-right populist candidates in Argentina and the Netherlands raise the question of whether further wins for populist parties could occur elsewhere, especially in the U.S., where the November 2024 election will be the most consequential currently known political event of the year.

As of late November 2023, most global economies were showing surprising resilience to higher rates (Figure 2), and the U.S. economy was performing better than expected. The unprecedented levels of cash generated by pandemic support and other fiscal stimulus measures have been a key support for U.S. household and corporate balance sheets. Excess consumer savings should continue to provide support for U.S. economic growth going forward (Figure 3).

“…the most anticipated global recession in history has become the most delayed recession in history.

Major global economies have shown surprising resilience

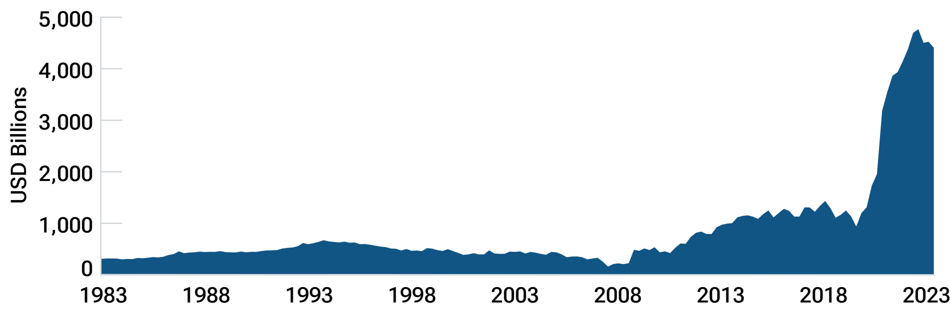
(Fig. 2) Real GDP growth at 2010 prices.



As of September 30, 2023.
Sources: U.S. Bureau of Economic Analysis, Statistical Office of the European Communities, Cabinet Office of Japan/Haver Analytics. T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

U.S. consumers are still flush with cash

(Fig. 3) Checkable deposits and currency holdings of U.S. households.



As of June 30, 2023.
Source: U.S. Federal Reserve Board.

Consumer spending has been the most resilient driver of growth, due to the strength of the U.S. labor market. At the end of September 2023, there were 9.6 million open jobs available for the 6.4 million unemployed workers in the U.S. labor force.

Dealing with regime change

Even if the U.S. economy remains resilient in 2024, we believe investors will need to adapt themselves to a new market regime. To understand the implications of this shift, it is useful to examine the four historical regimes that U.S. markets have experienced since 1955, after the distortions created by World War II and the Korean War had largely dissipated.

While the post-pandemic regime may not align perfectly with any of these prior periods, it will include some factors that prevailed during those regimes. Given the shift away from the structural forces that supported disinflation and lower rates in the wake of the 2008 global financial crisis (GFC), a return to the post-GFC "new normal" strikes us as the least likely outcome going forward.

Heading into 2024, inflation risks are skewed to the upside. Energy prices are a concern amid supply-side pressures. As of third quarter 2023, U.S. wages were

Historical market regimes and their defining characteristics

Booming economy
1950s/1960s

- High GDP
- Low unemployment
- Low inflation

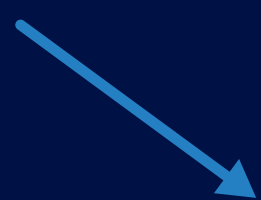
Stagflation
1970s

- Low/unstable economic growth
- Low stock returns
- Spiking inflation

Old normal
1982 onward

- Secular decline in interest rates

New normal
Post 2008 GFC



- Slow economic growth
- Low interest rates
- Low inflation

For illustrative purposes only.

still growing at almost a 4% annual rate. If U.S. consumer inflation changes course and reaccelerates while economic growth remains anemic, the risk of stagflation will rise considerably.

Which regime is most likely to prevail in 2024? Recent readings for the fed funds rate and inflation have been closest to the pre-GFC "old normal." But the regime second closest to recent conditions isn't stagflation, it's the postwar boom.

It remains to be seen how real (after-inflation) interest rates above 2% will play out in the markets. But we do not believe that high rates will kill the U.S. economy. Rates are high relative to the post-GFC period, but not relative to capital market history. The federal funds rate exceeded 5% for decades and stock markets still did well. Sticky inflation historically has been good for earnings.

Neutral on risk assets

Despite the macroeconomic uncertainties, we see no reason for investors to be excessively bearish. Market segments that don't trade at nosebleed valuations, such as small- and mid-cap stocks and real assets equities, look appealing on a relative basis. If we see a spike in volatility and a market sell-off, it could be an opportunity to buy stocks.

However, we also don't think this is the right time to take large tactical allocation bets. The recent "dis-inversion" of the U.S. yield curve could augur volatility in both stocks and bonds in the months ahead. We think the best approach heading into 2024 is to remain broadly neutral on risk assets, including equities.

With U.S. interest rates closer to their historical averages, a balanced portfolio could offer diversification benefits as bonds now provide higher income and ballast to stocks. However, interest rates are likely to remain volatile in 2024, so we favor maintaining an overweight to cash or short-term bonds. These assets currently offer attractive yields with minimal duration exposure and could be potential sources of liquidity if market opportunities arise.

For investors looking beyond the traditional 60/40 stock/bond portfolio, and willing to take on more risk, we also favor alternatives with lower correlations to traditional assets and to areas of the market that could benefit from market dislocations and higher yields, such as private credit.

"...we see no reason for investors to be excessively bearish.

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Investment Idea	Rationale	Examples
Emphasize areas with attractive income.	The global economy has been resilient despite higher rates, but strong growth is unlikely in 2024. This should limit the upside in asset prices, so income from higher yields is likely to be an important driver of returns in 2024.	– Short-term fixed income
Tilt toward asset classes where valuations are undemanding.	Small-cap equities trade at historically low valuations, reflecting economic growth concerns and the potential impact of higher rates. Small-caps could provide significant upside if the economy remains resilient.	– U.S. small-cap stocks – International small-cap stocks

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