

Conditions are ripe for a Goldilocks economy, but dangers lurk

From the Field
February 2024

Key Insights

- Slowing inflation, combined with the current high level of interest rates, should give the U.S. Federal Reserve plenty of scope to cut rates this year.
- Growth should recover modestly, resulting in a “Goldilocks” global economy that is neither recessionary nor too expansionary.
- Risks to this benign outlook include the U.S. presidential election, the war in Ukraine, and continuing tensions in the Middle East and South China Sea.

What a difference a quarter makes! At the end of October, the yield on the 10-year U.S. Treasury bond touched 5%. By late January, it had plunged to 4.1%. Over the same period, the yield on the German counterpart fell from almost 3% to 2.3%. Risk assets, which were under pressure when yields were rising, surged in response to the rally in government bonds (Fig. 1).

Digging deeper into the causes of the bond market rally should help us to understand the implications for the global economy and the world’s central banks and, by extension, the likely path for risk assets in the period ahead. The third-quarter sell-off in bonds was largely driven by anxiety that the combination of high government financing needs and the reduction in central banks’ sovereign bond portfolios

(quantitative tightening) would trigger a buyers’ strike. There was also concern that stubborn service sector inflation would prevent central banks from cutting rates.

Two major developments changed the narrative: First, in response to the pressures in the bond market, the U.S. Treasury slowed the pace of increase in quarterly long-term debt issuance and the Federal Reserve indicated it may have to adjust its policy stance in a more market-friendly direction; second, and equally important, softer-than-expected inflation data reinforced the perception that the Fed had the required policy space to accommodate the bond market sell-off.

Prior to these developments, the belief among many that the U.S. was heading for recession seemed to rest on the notion

that the Fed had overtightened monetary policy and would be slow to respond to mounting growth risks. The pivot in the Fed’s communication, therefore, significantly cut the tail risk that the U.S. economy would fall into a recession. As is often the case, the reduction of tail risk ended up having an outsized impact on the price of growth and risk-friendly assets such as equities.

Why I expect a downsize inflation surprise

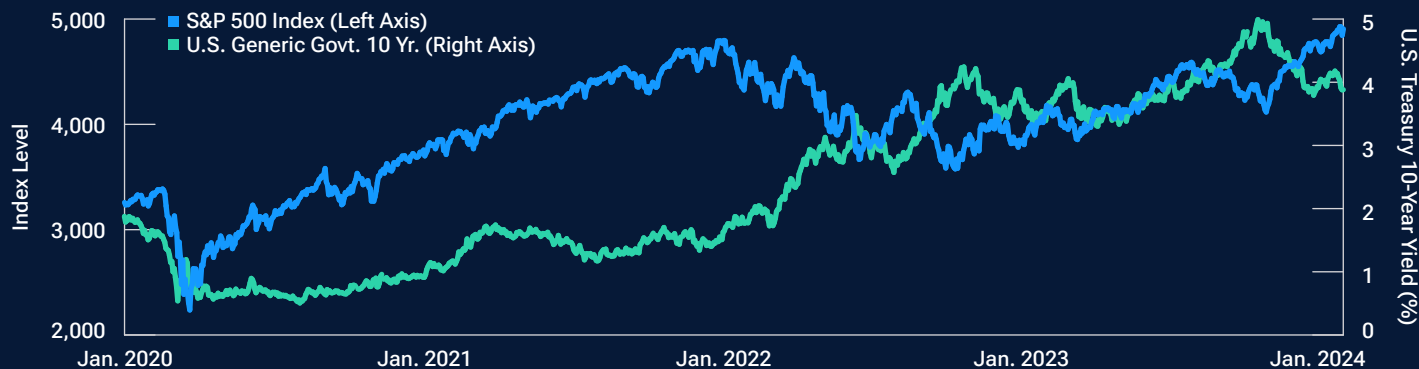
So where do we go from here? Will central banks be able to deliver on the lofty expectations for interest rate cuts that the market has priced in? Broadly speaking, I believe they will.



Nikolaj Schmidt
Chief International
Economist

Falling fourth-quarter rates sparked an equity rally

(Fig. 1) The S&P 500 surged as Treasury yields declined



As of January 31, 2024.

Past performance is not a reliable indicator of future performance.

Source: Bloomberg Finance L.P. (see Additional Disclosure).

In my view, inflation is likely to surprise on the downside. Growth in China—the preeminent source of demand for commodities—remains muted as the economy goes through a protracted deleveraging cycle and the authorities aim to reorient the economy toward new drivers of structural growth. Europe is already in a recession, and, given the European Central Bank’s resistance to rate cuts, it is only a matter of time before the recessionary dynamics spill out through the labor markets. The U.S. economy is resilient, but it is likely to slow throughout 2024.

These moderating growth dynamics, combined with the current high level of interest rates, suggest to me that the Fed can cut interest rates substantially without its policy stance becoming overly accommodative. As such, I don’t regard the interest rate market as grossly mispriced.

Regarding growth, I am looking for signs of improvement. Global growth remains subdued and a strong rebound is unlikely, but I am looking for the data flow to shift from bad to just weak (in financial markets, a reduction of a negative is often more powerful than the emergence of a positive). I also think we will see a risk-friendly rotation in growth from the U.S. to Europe. Overall growth will continue to look soft and monetary policy will remain a headwind—but marginally less so.

Geopolitical risks cannot be ignored

Yet amid this Goldilocks view of the world, risks lie in the shadows. Despite the Fed’s pivot, the markets could return to the October worries about bond supply fears. The outcome of the U.S. presidential election could further elevate this fear if the market expects the next U.S. administration to return to an expansionary fiscal stance (although this risk will likely be somewhat offset by the slowing of the Fed’s balance sheet tapering).

The risk posed by the U.S. presidential election is not limited to concerns over fiscal policy. The U.S. remains as polarized as ever, and the election will bring elevated uncertainty about the future of both U.S. domestic and foreign policy. Geopolitical risk is also rising elsewhere, from the war in Ukraine to the conflict in Israel and tensions in the South China Sea.

As has been the case for the past two years, financial markets remain volatile and difficult to navigate. It is important not to lose sight of the dangers, but in the near term, I believe the likely combination of softer central bank policy, moderating inflation, and a marginal improvement in growth will keep us on a positive course.

“ The risk posed by the U.S. presidential election is not limited to concerns over fiscal policy.”

INVEST WITH CONFIDENCE™

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

Additional Disclosure

The S&P 500 is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates (“SPDJ”) and has been licensed for use by T. Rowe Price. Standard & Poor’s® and S&P® are registered trademarks of Standard & Poor’s Financial Services LLC, a division of S&P Global (“S&P”); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC (“Dow Jones”). T. Rowe Price is not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the S&P 500.

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources’ accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

DISCLOSURE CONTINUES ON THE FOLLOWING PAGE.

Important Information (cont.)

Australia—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose only. Any strategy and/or any products associated with the strategy discussed herein has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

Colombia, Chile, Mexico, Peru, Uruguay—This material is prepared by T. Rowe Price International Ltd - Warwick Court, 5 Paternoster Square, London, EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority - and issued and distributed by locally authorized distributors only. For professional investors only.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd which is regulated by the Dubai Financial Services Authority as a Representative Office. For Professional Clients only.

EEA—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors. Not for further distribution.

Mainland China—This material is provided to qualified investors only. No invitation to offer, or offer for, or sale of, the shares will be made in the mainland of the People's Republic of China ("Mainland China", not including the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the Mainland China. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the Mainland China. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the Mainland China that are expressly authorized under the laws and regulations of the Mainland China to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the Mainland China. Potential investors who are resident in the Mainland China are responsible for obtaining the required approvals from all relevant government authorities in the Mainland China, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the Mainland China, or nationals with permanent residence in the Mainland China, or to any corporation, partnership, or other entity incorporated or established in the Mainland China.

Malaysia—This material can only be delivered to specific institutional investor. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—ANY STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING DISCUSSED HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—Issued in South Africa by T. Rowe Price International Ltd (TRPIL), Warwick Court, 5 Paternoster Square, London EC4M 7DX, is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (Financial Services Provider (FSP) Licence Number 31935), authorised to provide "intermediary services" to South African Investors. TRPIL's Complaint Handling Procedures are available to clients upon request. The Financial Advisory and Intermediary Services Act Ombud in South Africa deals with complaints from clients against FSPs in relation to the specific services rendered by FSPs. The contact details are noted below: Telephone: +27 12 762 5000, Web: www.faisombud.co.za, Email: info@faisombud.co.za

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, Warwick Court, 5 Paternoster Square, London EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2024 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.