Global economic growth and near-term prospects: A mixed track record.

By: James R. Solloway, CFA, Chief Market Strategist and Senior Portfolio Manager

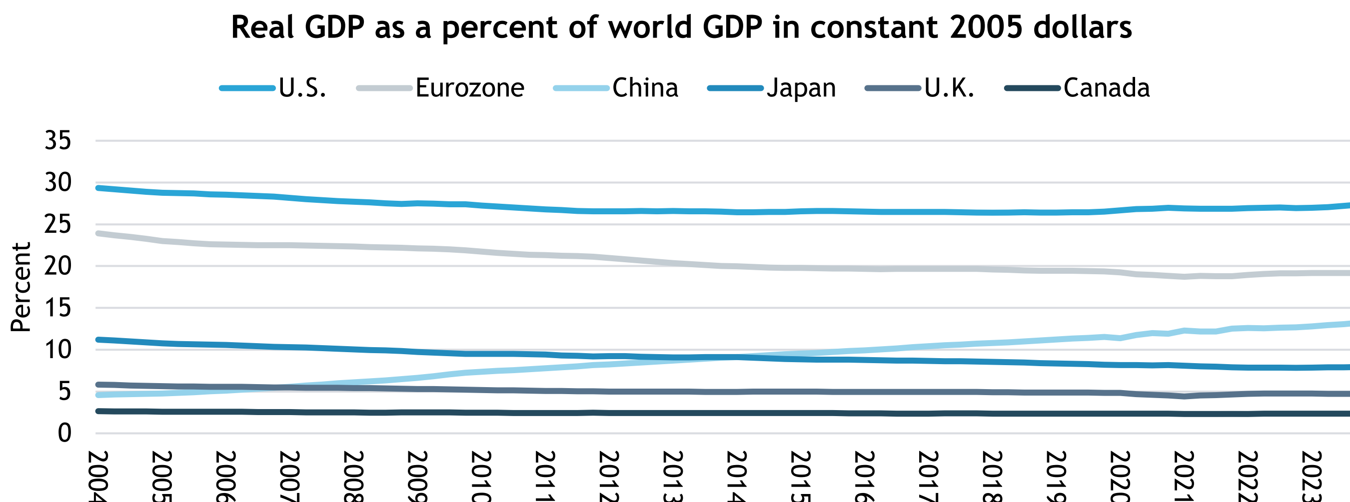
The Quarterly Economic Outlook will be published in two installments. The current report focuses on global economic growth and near-term prospects for selected countries. The next report examines the outlook for inflation, government-policy responses, and the implication for interest rates and equity markets.

The global outlook: Slowly gaining steam

In light of a major American aircraft manufacturer's recent struggles, it's time to take a break from plane analogies (soft landing, hard landing, no landing) when talking about the economic outlook. So, let's take a train instead. The U.S. appears to be chugging along quite nicely, posting solid gains that mostly have surprised to the upside. Most other major advanced economies, by contrast, seem to be stuck on a siding, hoping to at least hitch themselves to the mighty U.S. locomotive. The previous big engine in the world—China—still runs faster than the U.S., but it is no longer the bullet train that it once was.

Exhibit 1 tracks inflation-adjusted gross domestic product (GDP), in 2005 U.S. dollars, as a percentage of world GDP for the U.S., the U.K., Canada, China, and the eurozone. While China continues to gain share (13% of world real GDP), it still lags the U.S. (27%) and the eurozone region (19%) by a considerable margin. The U.S. has recorded a modestly increasing share of world GDP volumes in recent years, reversing the downward/flatlining trend that had been in place between 2003 and 2019. The eurozone and Japan (7%), on the other hand, have seen their economies lose ground on a relative basis over the past two decades against the rest of the world. The U.K. (5%) also has lost some ground, but the decline in its share of real GDP immediately following Brexit, when the U.K. officially left the European Union early in 2020, has been mostly recovered. Canada, meanwhile, has exhibited remarkable steadiness in its 2% share of world GDP.

Exhibit 1: Share and share unalike



Source: FactSet, SEI. All series expressed as four-quarter moving averages.

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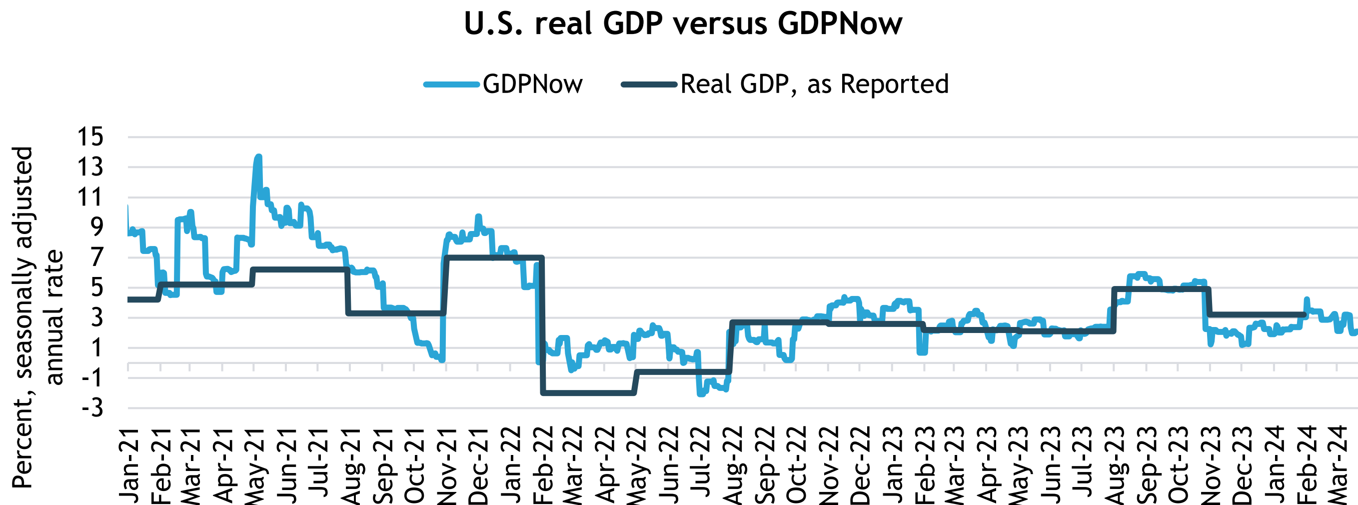
The U.S. economy got off to a fast start this year, as we highlight in Exhibit 2. According to the Federal Reserve Bank of Atlanta's GDPNow statistic, a running tabulation of inflation-adjusted GDP that gets updated as new data roll in, the economy isn't exactly a runaway train, but accelerated in January well above its long-term average growth potential of 2%. The most recent numbers have weakened somewhat, but U.S. growth is still running at a 2.1% annual pace so far this year as of March 26, 2024. In the fourth quarter of 2023, the U.S. reported a healthy gain of 3.1% from a year earlier, far outpacing most other major advanced economies.

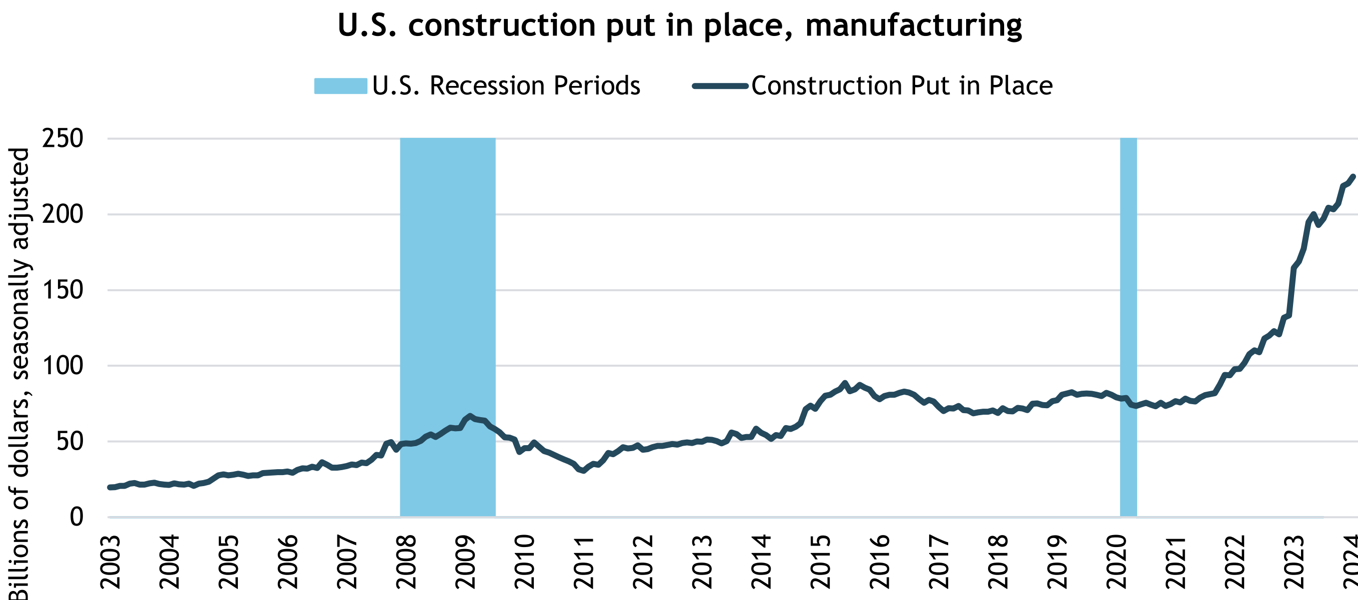
Exhibit 2: GDPNow wows



Source: Bureau of Economic Analysis, Federal Reserve Bank of Atlanta, SEI. Note: Reported GDP advanced one month to align with GDPNow data.

Although slowing from its previously fast pace, U.S. payroll employment continues to climb. The labor market remains tight, but quit rates are down and labor participation rates for prime-age workers (ages 25 to 54) are up. Total wages and salaries are still posting year-over-year gains of 5.5%. Depending upon the broad inflation measure one uses, this represents a real gain in aggregate incomes of 2–3% over the period. Government stimulus is also having a major impact. Not only are direct government expenditures rising sharply, but the incentives embedded in the Chips and Science Act and the Inflation Reduction Act have led to a massive spike in manufacturing plant construction, as we show in Exhibit 3. We should point out, however, that capital spending is more subdued outside of those industries favored by the Biden administration's policies; spending on equipment fell modestly last year.

Exhibit 3: Blooming plants



Source: NBER, U.S. Bureau of the Census.

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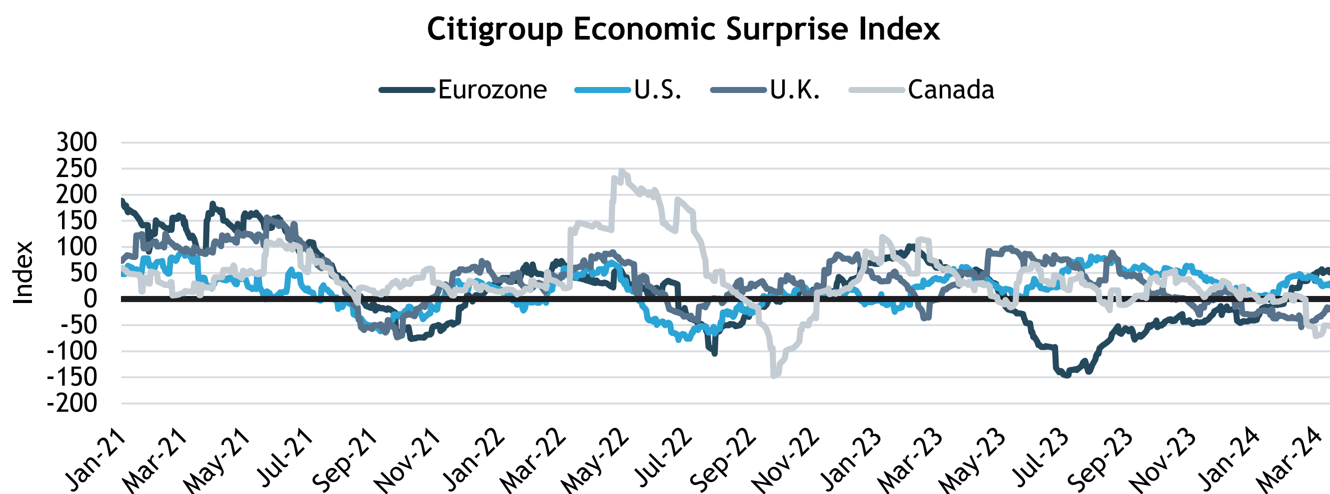
Economic growth in the U.S. will likely decelerate further, but there is little sign that a recession is looming. The steep rise in interest rates over the past two years will be felt to a greater degree as more households and businesses take out new loans or refinance existing obligations. In addition, the vast buildup of excess savings that occurred during the COVID-19 emergency has largely run out of steam. It has fallen to a level that no longer supports consumption in a meaningful way, at least for the lower-earning four-fifths of the population. They will now be dependent on the continued strength of the job market and income gains that exceed inflation. Note that delinquency rates on credit cards and consumer loans have been rising since the end of 2021, and are now above the levels immediately preceding the onset of COVID-19. This deterioration in financial strength probably is not enough to throw the economy off the rails and into recession. Until there is more substantial weakness in employment trends, we think U.S. consumers will remain on track.

Other major economies continue to struggle, although even here there are signs of modest improvement. The U.K. and Germany recorded slight declines in GDP in the third and fourth quarters of 2023, and for the year as a whole. Both countries were hit by downturns in manufacturing and construction, while stubborn inflation pressures limited the real gains in household incomes. Weighed down by the recessions in Germany, the Netherlands, and a few other countries, the eurozone region posted a mere 0.1% gain last year. On the other side of the Atlantic, Canada benefited from its proximity to the U.S., but grew at an annual rate of just 1% in the fourth quarter of 2023, and 0.9% for the year as a whole.

Exhibit 4 tracks the Citigroup Economic Surprise Index for the U.S., the U.K., Canada, and the eurozone. While it is hardly a revelation that the U.S. has been surprising to the upside, the eurozone has been doing the same. This simply illustrates how low the bar has been set for these economies. Canada and the U.K., by contrast, have been posting disappointing economic data as of late, although both countries appear to have enjoyed a weather-related bounce in real GDP during January.

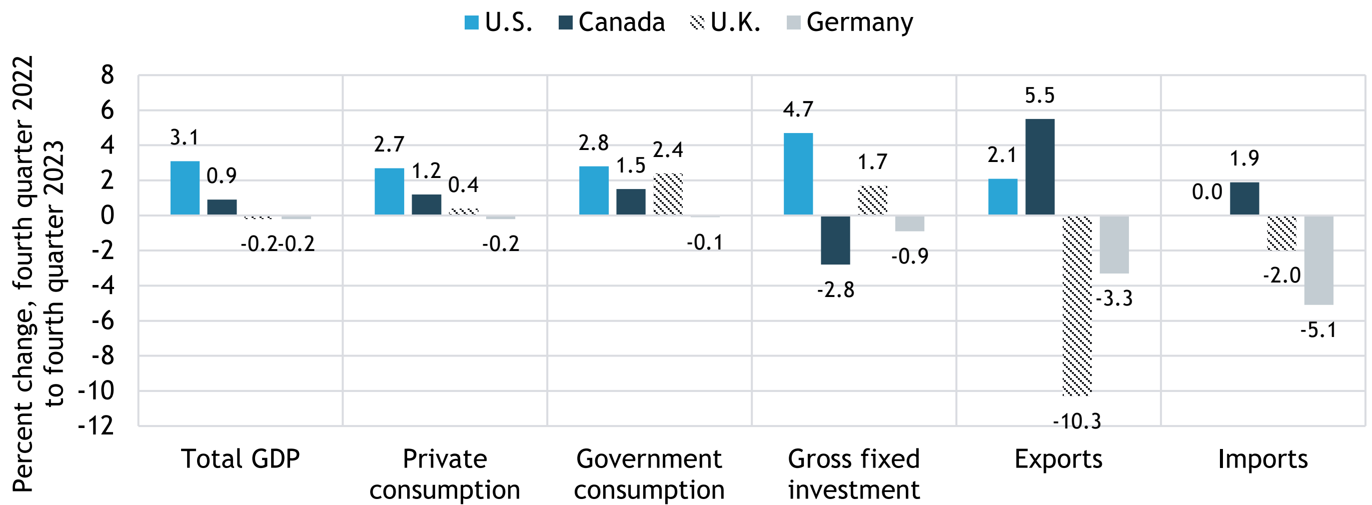
Exhibit 4: Surprise, surprise



Source: Citigroup, SEI. The Economic Surprise Index is defined as the weighted historical standard deviations of data surprises (actual releases versus Bloomberg survey median).

As we show in Exhibit 5, both Canada and the U.K. performed quite poorly last year across the major components of GDP relative to the U.S. One reason for the divergence in performance is greater sensitivity to the rise in interest rates, hurting household consumption. Fiscal policy also has provided a much smaller boost to growth compared the U.S. Unique factors to each country also have come into play. Canadian households, for example, never deleveraged their balance sheets following the Global Financial Crisis (2007-2009), and thus have been stressed by the sharp rise in interest rates over the past two years. Homebuilding in Canada has been hit hard, with home-construction spending plummeting from more than 9% of GDP in early 2021 to 6.4% by the fourth quarter of last year. The U.K., meanwhile, continues to struggle with strike disruptions and an inflation rate that continues to run at higher levels than those of other advanced economies. Brexit, and the train wreck it created with regard to trade with the European Union, also is an important factor constraining business activity.

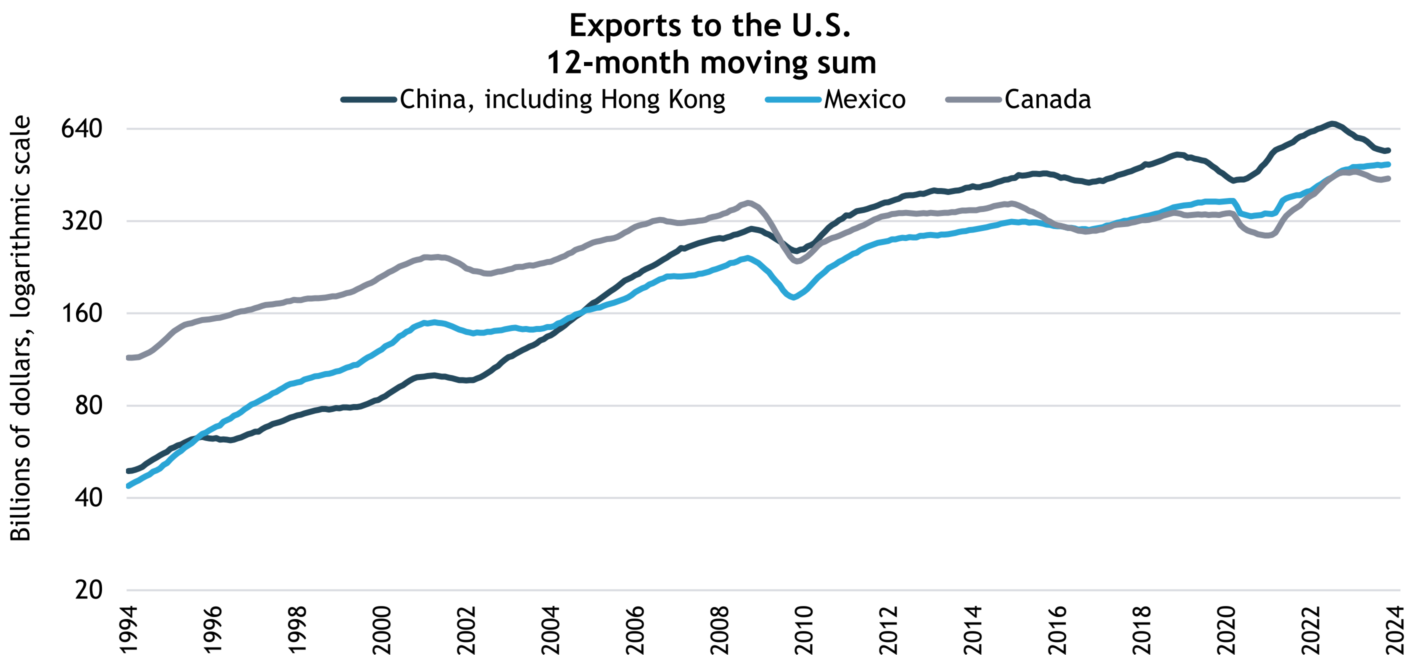
Exhibit 5: GDP compared



Source: NDR, SEI.

Canada historically has been coupled to the U.S. As we show in Exhibit 6, in the past, it exported more to the U.S. than any other country. However, it lost its number one position to China in 2009, and in 2022 fell into third place behind Mexico. Trade frictions between the U.S. and China, aggravated by COVID-19 lockdowns in the latter, have led to a sharp decline in Chinese exports to the U.S. since 2022. Mexico, by contrast, continues to gain export share. It will likely continue to be a big beneficiary of the trend toward nearshoring, given the competitive advantages bestowed upon it by the United States-Mexico-Canada Agreement on free trade (which took the place of the better-known North America Free Trade Agreement (NAFTA)).

Exhibit 6: Canada moves to the back of the train



Source: International Monetary Fund (IMF), SEI.

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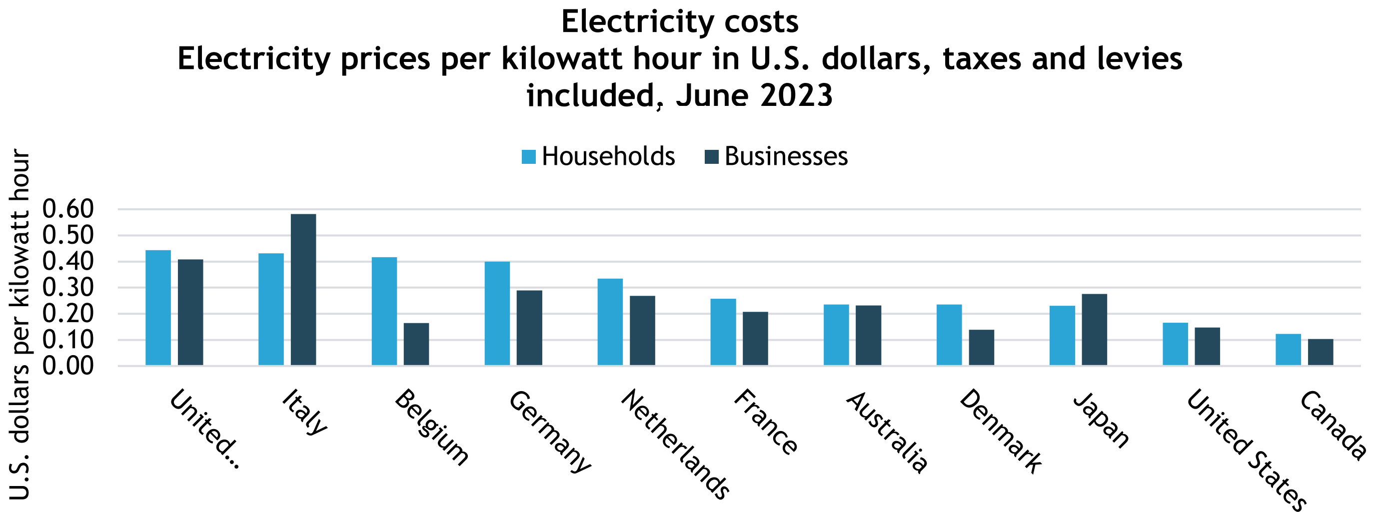
Germany: Struggling to engineer a way out

Germany faces serious challenges of its own. For the first time since the early 1990s, when the country struggled to integrate the former East Germany into West Germany, the economy appears to be in a multiyear morass. Although it has done a good job in building up its capacity to import liquefied natural gas from the U.S., Qatar, and elsewhere, it still is saddled with high electricity costs. Exhibit 7 highlights the price of electricity, including various environmental and fuel cost charges and taxes, facing households and businesses. Among the major economies, only the U.K. and Italy face higher household and business rates. Note that both households and businesses in the U.S. and Canada enjoy some of the lowest electricity prices among developed countries. This is a major competitive advantage that is unlikely to fade anytime soon.

Exhibit 7: A shock to the system

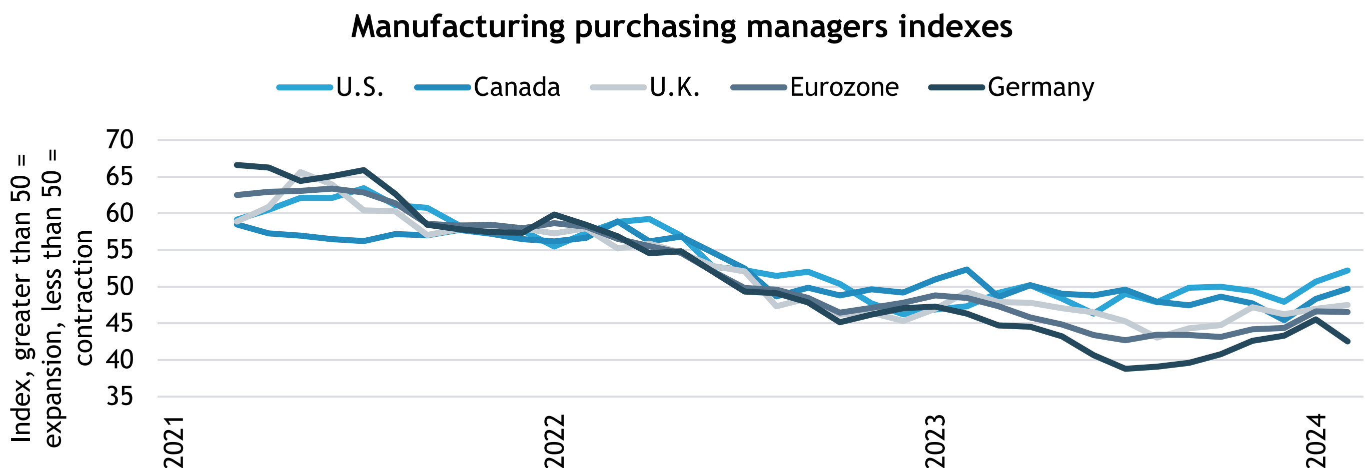


Source: GlobalPetrolPrices.com, SEI.

Germany's heavy exposure to manufacturing, previously an asset, has now become a liability. First came the massive disruption to supply chains caused by COVID-19. Then came the energy shock as natural gas prices soared in the immediate aftermath of Russia's invasion of Ukraine. China's economic woes have also hurt German manufacturing, reducing exports of cars and industrial capital goods to Chinese consumers and companies. Meanwhile, a rising tide of cheap Chinese electric-vehicle imports is adding to the pressures faced by German automakers.

Although surveys of purchasing managers in manufacturing industries across the developed world are indicating a contraction in activity (the U.S. is again the exception), Germany stands out as the weakest link. Exhibit 8 highlights how Germany endured a sharp month-to-month decline in February, while the U.S., the U.K., and Canada all showed improvement.

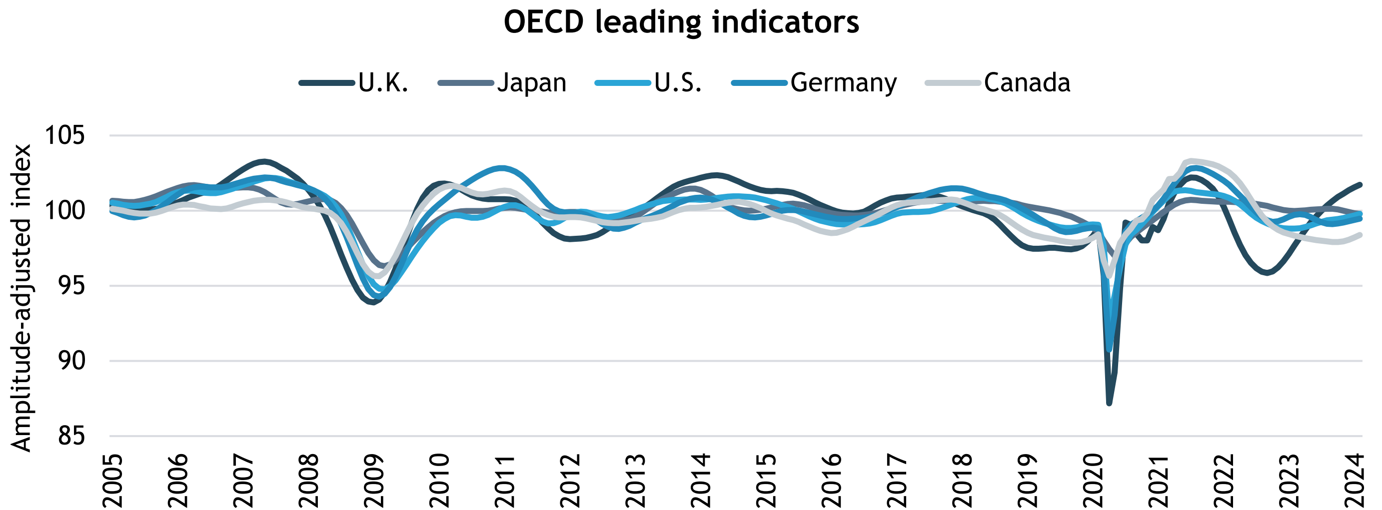
Exhibit 8: Germany becomes the economic caboose



Source: IHSMarkit, SEI.

While it is likely that the major economies will continue to be slow or stagnant, there are a few positive signs. The Organisation for Economic Co-operation and Development (OECD) reports a bottoming out of the Leading Indicators for the biggest countries, which we show in Exhibit 9. The U.K. has seen the sharpest improvement in its Composite Index of Leading Indicators (CLI), suggesting that above-trend economic performance might lie ahead. Among the positive straws in the wind: a recovery in the services-sector purchasing managers' survey, an improvement in business sentiment, and a decline in consumer debt as a percentage of GDP to a 20-year low. Stock prices, as measured by the total return of the MSCI United Kingdom Index, are up 12% over the past year in local-currency terms. The currency also has strengthened about 4% since October 2023.

Exhibit 9: Leading indicators look less leaden

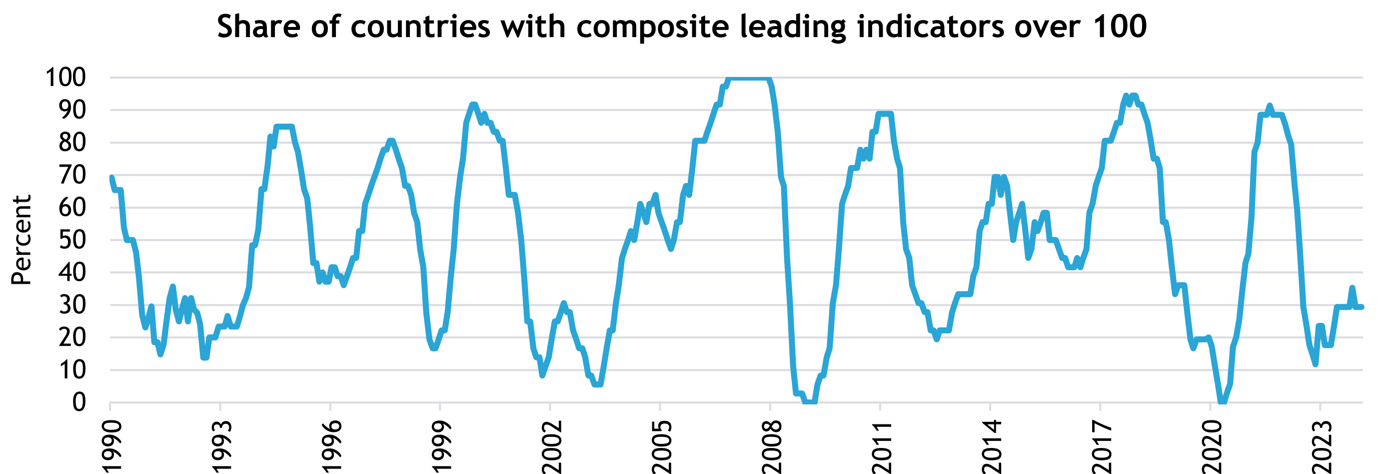


Source: OECD, SEI. Note: A reading above 100 predicts above trend economic growth, while a reading below 100 predicts below trend economic growth or recession.

The outlook for Germany appears less promising. Purchasing managers in the manufacturing, construction, and services sectors are still reporting contractionary conditions. Car production is bouncing along at low levels, with German manufacturers hit by the double whammy of surging imports of cheap Chinese electric vehicles and stagnant exports to China.

For a broader perspective, we highlight the OECD's Composite Leading Indicator (CLI) diffusion index in Exhibit 10. The statistic tracks 17 economies (12 OECD-members plus five large non-member countries) reporting a CLI over 100. The diffusion index shows that a slowly increasing percentage of countries is reporting an above-trend outlook since November 2022. However, at less than 30% of the countries in the survey, overall global economic prospects still appear tepid, at best. Besides the U.K., the other countries reporting CLIs above 100 include Korea and Mexico (both OECD-member countries), as well as China and Brazil.

Exhibit 10: An anemic but improving outlook



Source: NDR, OECD, SEI.

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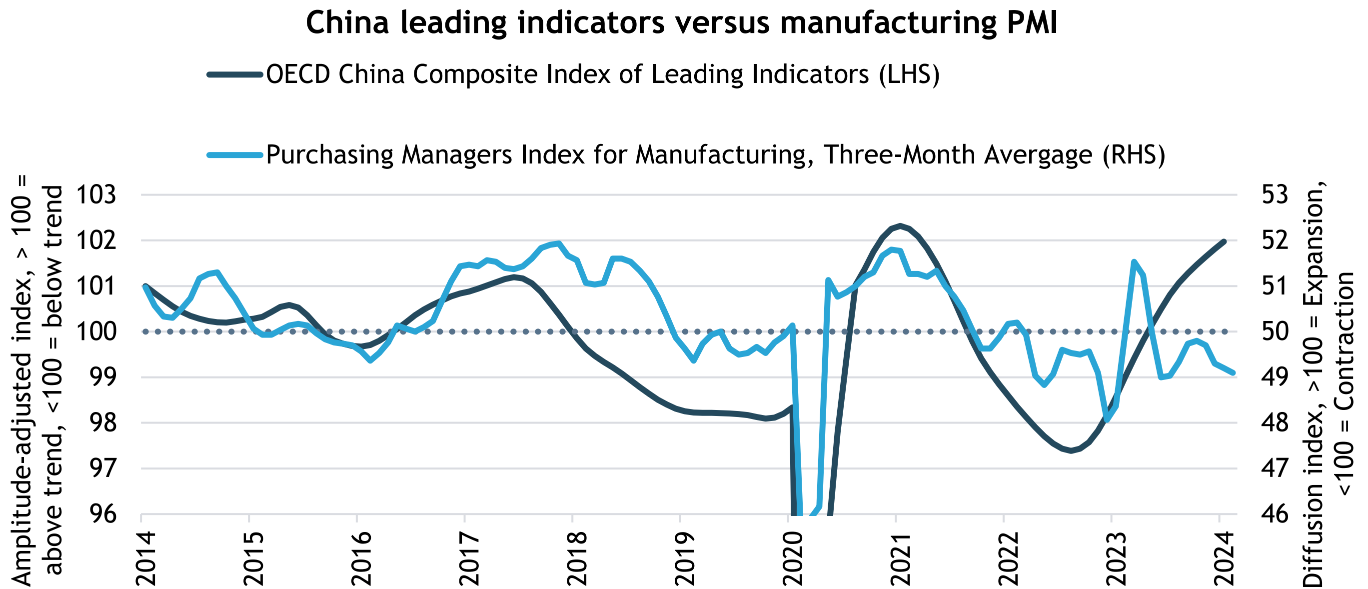
China: The big engine that couldn't

Although the China Composite Leading Indicator suggests improvement, we think it will take a while for that improvement to show up broadly and sustainably in the country's industrial activity. Exhibit 11 compares the OECD's CLI to China's Purchasing Managers Index (PMI) for manufacturing activity over the past 10 years. Movements in the OECD measure have tended to lead those of the PMI survey, although both series moved together during the COVID-19 downturn and subsequent recovery in 2020. The next cyclical downturn in China, at the start of the second COVID-19 wave in early 2021, also was concurrent. The leading indicators bottomed out in August 2022, while the manufacturing PMI didn't hit its trough until December 2022. The PMI series has been quite volatile over the past year, but mostly has been fluctuating below the 50 line, suggesting continued contraction in the manufacturing sector.

Exhibit 11: China's manufacturing continues to lag



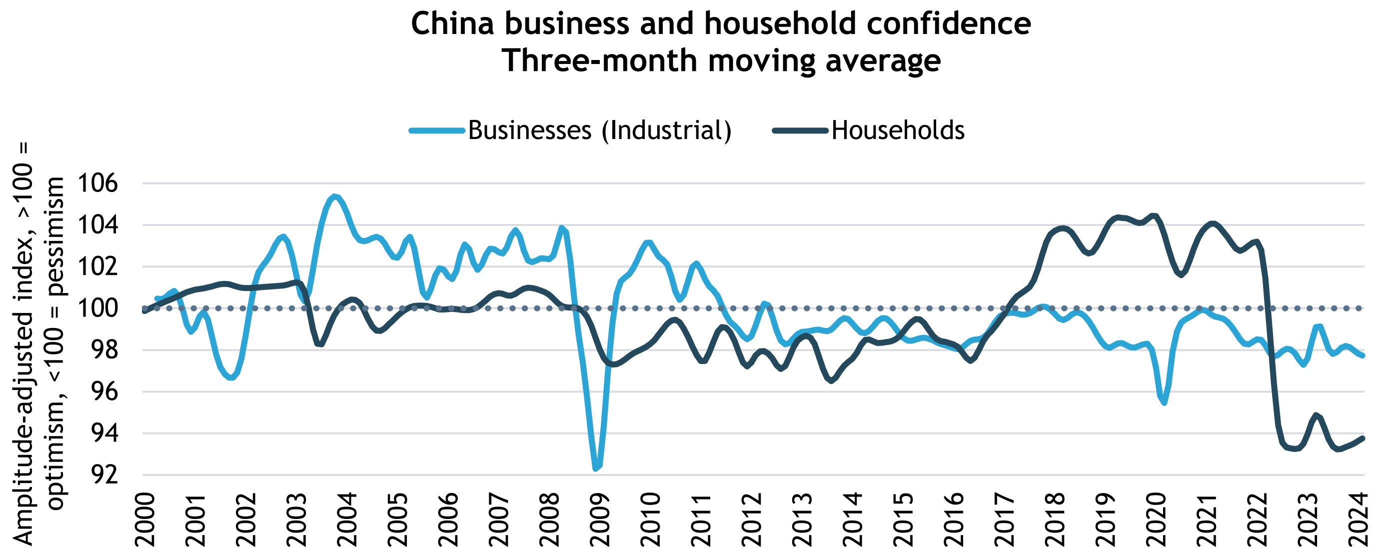
Source: National Bureau of Statistics (NBS), Organisation for Economic Development and Co-operation (OECD), SEI.

Construction also remains in the doldrums as China works through its property bubble and debt-related issues. Real-estate floor space under construction fell 7.4% last year, its worst annual decline of the past three years. All three major building sectors—non-office commercial (-9.7%), residential (-7.8%), and office (-5.1%)—lost further ground. By comparison, total real-estate floor space under construction grew between 20% and 40% annually between 2000 and 2012.

Consumer and business confidence, highlighted in Exhibit 12, also remain quite depressed. Household sentiment is especially poor, hovering near the lows reached during the last COVID-19 lockdown in the final months of 2022. The current pessimism contrasts quite sharply with the optimism expressed in the years just prior to, and even during, the COVID-19 outbreak. Business sentiment has been more stable, but nonetheless has been stuck at the low end of its historical range in recent years.

The sour mood helps to explain why the government's modest efforts to support the economy—through lower interest rates, reductions in banks' required reserve ratios, tax cuts, infrastructure spending, and measures to bolster the housing market—have yet to pay off. However, the central government has thus far been reluctant to devise an aggressive bailout of debt-burdened local governments or deal decisively with the property crisis. This hardline approach may be starting to change, however. The central government may soon begin to issue special long-term bonds in order to alleviate the balance-sheet pressures facing local governments, according to Oxford Economics. Since these governments have been running a deficit of more than 10% of GDP in recent years, the shift in budgetary financing under consideration is potentially quite impactful.

Exhibit 12: No one in China is happy

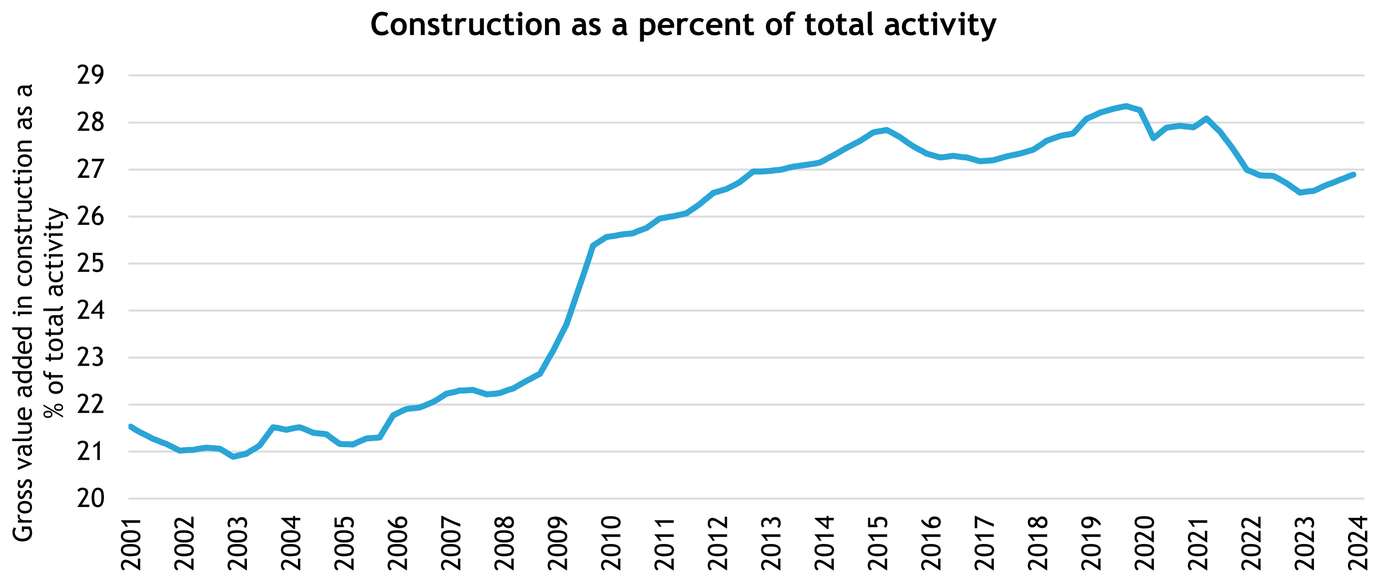


Source: Organisation for Economic Development and Co-operation, SEI.

Optimists on the Chinese economy can point to relatively robust consumer spending during the Chinese Lunar New Year celebrations. Internal travel and recreational activities such as going to see a movie, dining out, and gift-giving have been strong this year. The stock market has also rebounded nicely since late January, but it is recovering from exceedingly low levels. On a year-to-date basis, the total return of the MSCI China Index is basically flat, compared to a 6% gain in the MSCI All-Country World Index (ACWI).

The debt overhang at the local government level and the overbuilding that occurred in years past are now coming back to bite the country's economy. While China's problems are not an exact replay of the Global Financial Crisis, there are similarities because it will take time for households, businesses, and local governments to deleverage and repair their balance sheets. It took the U.S. close to 10 years to get out from under its debt and real-estate issues, as banks were forced to retrench and households reduced their debt burdens. Exhibit 13 shows that construction as a percentage of the country's gross value added remains quite high, especially compared to the levels that prevailed before the 2006-2015 housing and infrastructure boom. Even if the Chinese central government follows this train of thought and becomes more aggressive in its rescue efforts, it could take several more years before the economy achieves a better balance.

Exhibit 13: De-constructing the Chinese economy



Source: OECD, SEI.

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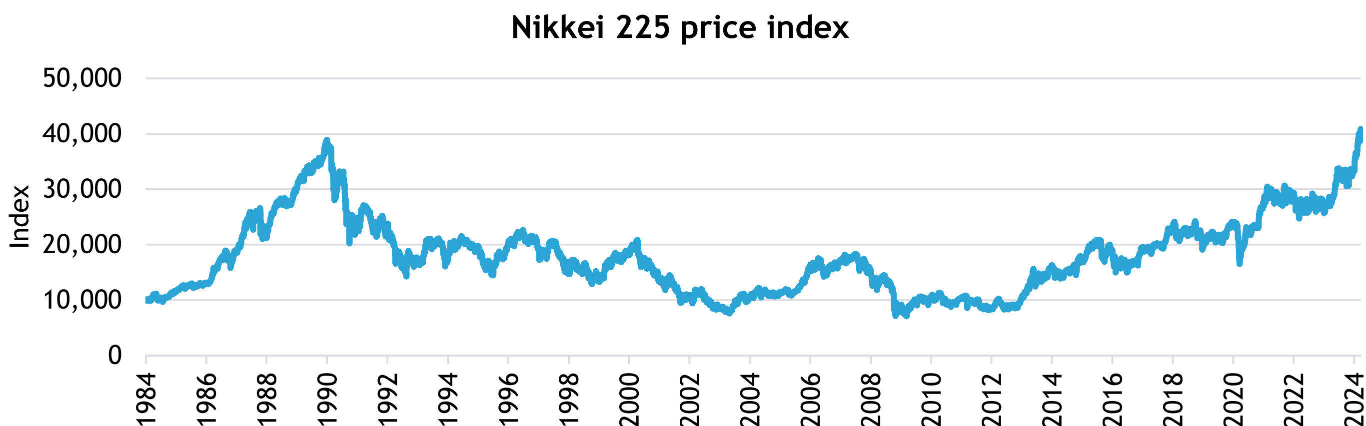
Japan: Back on track

Investors are starting to pay attention to Japan. Perhaps they should have done so sooner. The price-weighted Nikkei 225 index, highlighted in Exhibit 14, recently broke into record territory—for the first time since December 31, 1989. Back in the 1980s, equity and property prices were caught in epic bubbles. When these burst, it ushered in a long period of economic decline, deflation, and an 80% tumble in the broad stock market.

Exhibit 14: Japanese equities find a bid

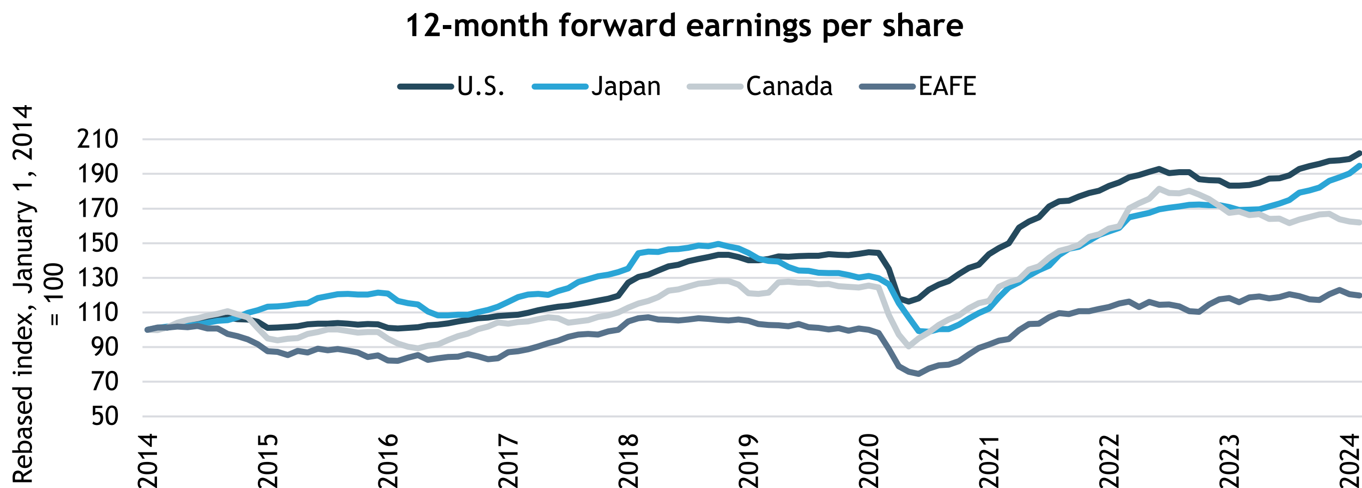


Source: FactSet, SEI.

The turnaround in equity prices began around 2013, with former Prime Minister Shinzo Abe's major economic and financial-market reforms, known as "The Three Arrows." This three-pronged approach emphasized aggressive fiscal expansion, easy money (including ultra-low interest rates and massive asset purchases by the Bank of Japan), and structural reforms (cutting corporate taxes, liberalizing markets, and instituting shareholder-friendly regulatory changes, among other initiatives).

The recovery from the bursting financial and property bubbles proved extremely difficult, however. The economy continues to be constrained by the country's poor demographics and conservative culture—not to mention some self-inflicted wounds, including increases in the national sales tax in 2014 and 2019. Nonetheless, analysts' year-ahead earnings-per-share estimates have risen vigorously over the past 10 years. Exhibit 15 compares the trend in forward earnings as calculated by MSCI for Japan, the U.S., Canada, and Europe, Australasia, and the Far East (EAFE). (EAFE covers 21 developed markets, excluding the U.S. and Canada.) Japan's forward-looking earnings per share in local-currency terms has almost kept pace with the U.S. over this time, while EAFE earnings have lagged badly. Of course, when currency fluctuations are taken into account, the earnings trend in Japan appears far weaker relative to the U.S., owing to the yen's 30% cumulative decline against the greenback over this 10-year period.

Exhibit 15: Japanese earnings on the move



Source: FactSet, SEI.

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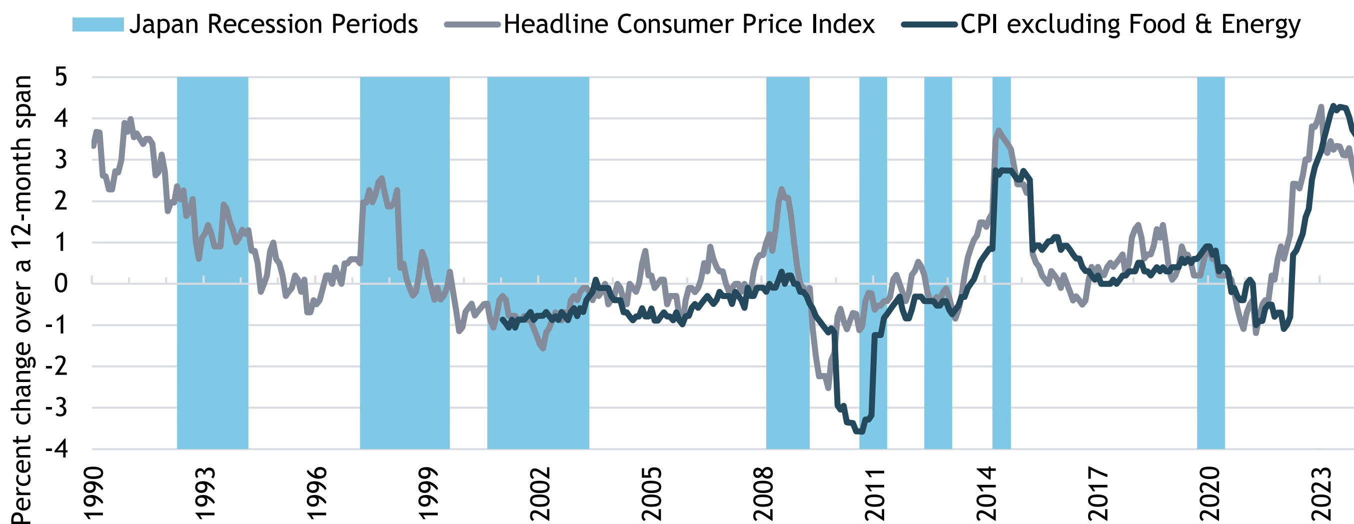
At long last, Japan has shaken off its deflationary tendencies. Although headline consumer prices have fallen sharply over the past year as a result of lower energy costs and an easing of food inflation, the recent rebound in petroleum prices suggests that overall inflation is unlikely to decline much further. Note that the headline consumer-price index rebounded in February, posting a year-over-year gain of 2.8% in February compared to January's reading of only 2.2%. More importantly, core prices are still quite elevated. This is highlighted in Exhibit 16.

The annual negotiations conducted between the country's biggest companies and their unions have led to some eye-popping wage settlements, with an average increase of nearly 5.3%. That would represent the biggest average wage hike in a generation. Since productivity growth has been growing at a subdued pace in recent years, we would not be surprised to see underlying inflation continue to run in a 3–4% range in the year ahead. Japan's inflation in the near term also may be exacerbated by the sharp decline in the yen against the U.S. dollar and other major currencies this year.

Exhibit 16: Inflation is here to stay



Source: ECRI, Ministry of Internal Affairs and Communications, SEI.

In summary, the global economic outlook still looks quite mixed, but there are scattered signs of modest improvement. The U.S. is the locomotive still leading the way, but other countries—the U.K., Canada, and Japan, for example—could pick up some steam in the months ahead. One big question mark is China. The cyclical outlook should improve, but the structural challenges are immense. If the government enacts more stimulative policy, it could provide an important boost to global growth.

Glossary

Brexit is a combination of “Britain” and “exit,” referring to the U.K.’s withdrawal from the European Union on January 31, 2020.

The **Global Financial Crisis (GFC)** refers to the period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.

Gross domestic product (GDP) is the total monetary or market value of all the goods and services produced in a country during a certain period.

Index definitions

The **Citigroup Economic Surprise Index** measures the degree to which a core set of economic data series has been coming in under expectations, at expectations, or over expectations.

The **MSCI All-Country World Index (ACWI)** is a market capitalization-weighted index that tracks the performance of over 2,000 companies and is representative of the market structure of 48 developed and emerging-market countries in North and South America, Europe, Africa, and the Pacific Rim. The index is calculated with net dividends reinvested in U.S. dollars.

The **MSCI China Index** (total return) tracks the performance (including reinvested dividends) of large- and mid-cap stocks in China. The Index’s 151 constituents comprise about 85% of the China equity universe.

The **MSCI United Kingdom Index** is a free-float-adjusted market-capitalization-weighted index that is designed to measure the performance of the large- and mid-cap segments of the U.K. market. With 111 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the U.K.

The **Nikkei 225** is a price-weighted index (i.e., each company comprises a percentage of the total index proportional to its share price) that tracks the performance of 225 stocks listed on the Tokyo Stock Exchange Prime Market.

A **purchasing managers’ index (PMI)** tracks the prevailing direction of economic trends in the manufacturing and service sectors.

OECD’s Composite Leading Indicator (CLI) diffusion index represents the proportion of countries whose OECD CLI is rising or unchanged. Composite leading indicators are designed to provide early signals of turning points in business cycles showing fluctuation of the economic activity around its long-term potential level. CLIs show short-term economic movements in qualitative rather than quantitative terms.

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Sticky inflation + stubborn central banks = spirited markets.

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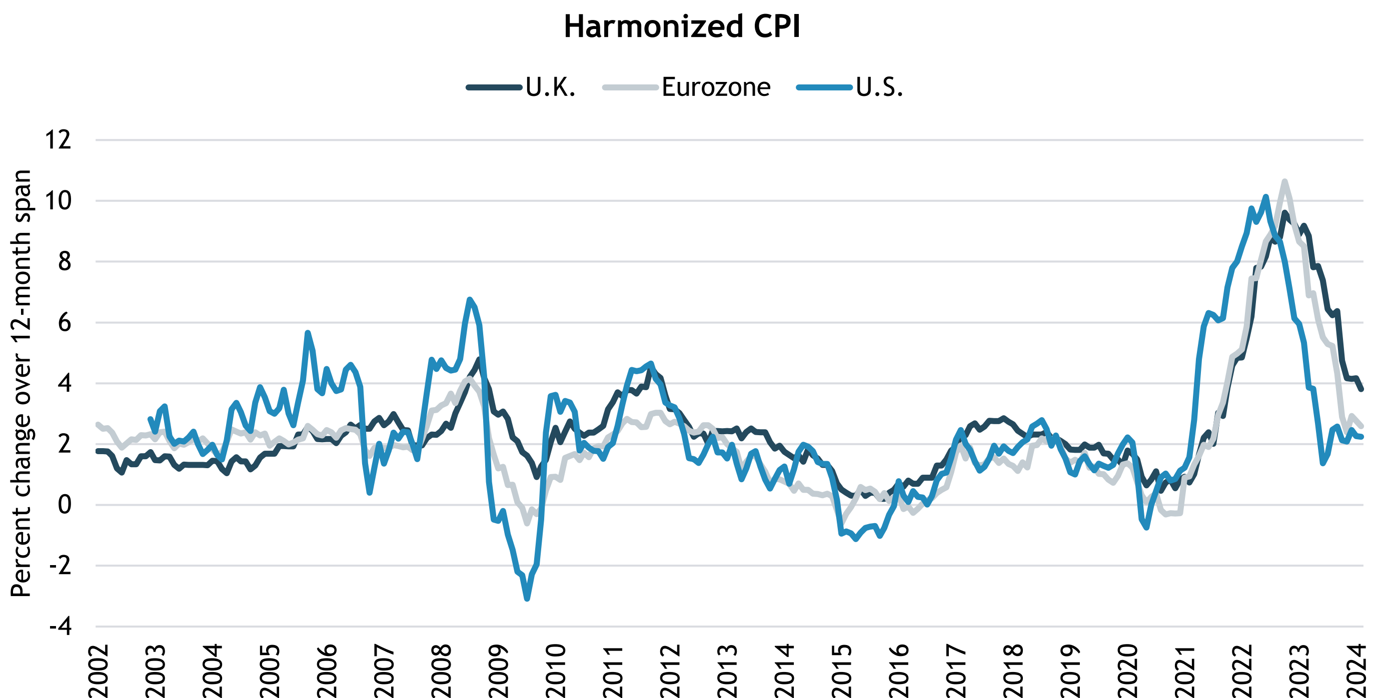
The Quarterly Economic Outlook will be published in two installments. In the first installment, we focused on the growth prospects of the global economy. In this report, we take a look at inflation and the impact it is having on economic policies and how this may be reflected in market performance.

In the spring of 2021, we began to use the phrase "persistently transitory" to describe our inflation view. At the time, we believed that inflation would stay higher for much longer than economists, central bankers, and market participants anticipated, owing to the huge stimulus packages provided by governments in response to COVID-19, the shortages of goods caused by the associated lockdowns, and what we viewed as a developing structural shortage of labor that would keep services inflation at a higher level for years to come. Unforeseen events, particularly Russia's invasion of Ukraine and the extensive and prolonged COVID-19 lockdowns in China, temporarily worsened the inflation picture beyond our expectations.

By the spring of 2023, Exhibit 1 shows that headline inflation had come down dramatically, raising hopes that the Federal Reserve (Fed) and other major central banks are succeeding in bringing inflation back to their 2% target without undue economic pain. On a harmonized consumer-price index (CPI) basis, U.S. inflation was already near target as of February 2024, with a year-over-year gain of 2.2%. At 2.6%, the eurozone isn't too far away either. The improvement in the U.K. is coming along more slowly, with the latest reading in February indicating a 3.8% increase from a year earlier.

Exhibit 1: Down the inflation mountain



Source: FactSet, SEI.

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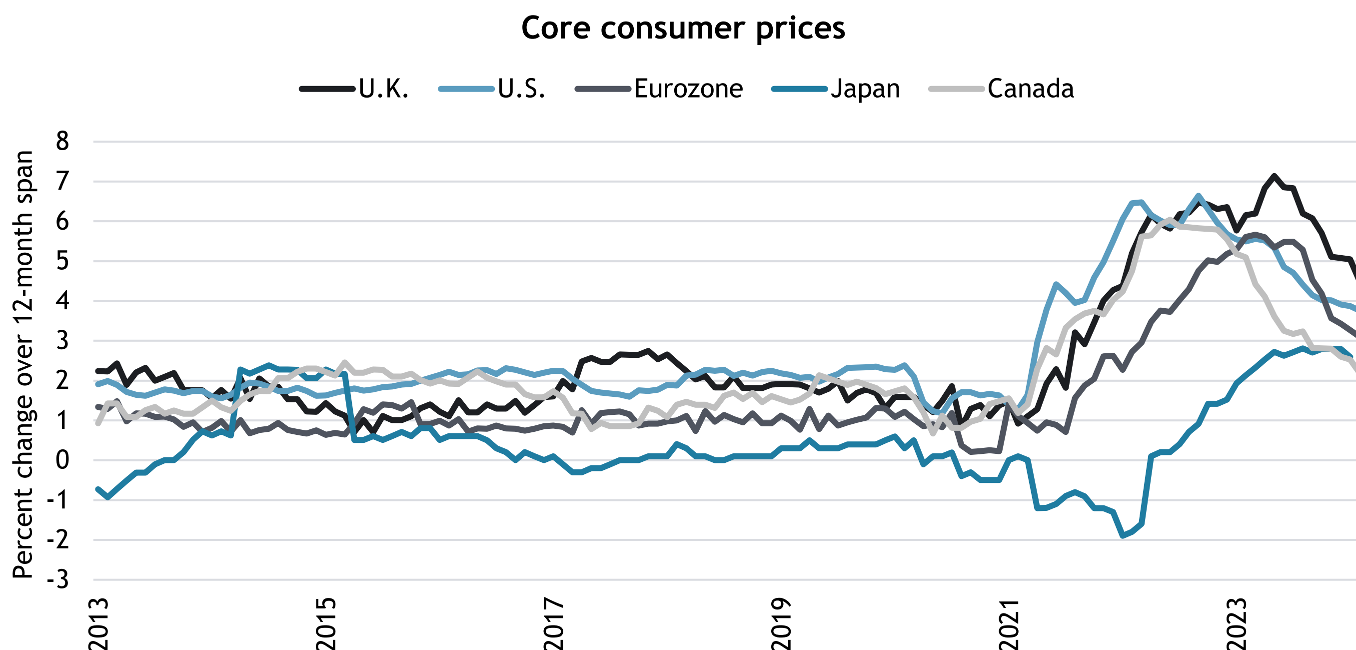
The question is: Can inflation settle near 2% on a sustained basis? We remain doubtful. The downward pressure on commodities and goods prices is already starting to ease as demand and supply come into better balance. We believe the rapid deceleration in inflation caused by the outright decline in energy and other goods prices should itself be viewed as transitory.

Core inflation, excluding food and energy, also has come down from peak readings, but generally remains well above the 2% level. Exhibit 2 highlights core CPI inflation across several major developed countries and the eurozone. By this measure, inflation remains appreciably above target in the U.K. (+4.5%), the U.S. (+3.8%), and the eurozone (+3.1%). Canada has registered the sharpest improvement in its core inflation rate, posting a year-over-year gain of 2.2%, but other measures of core inflation tracked by the Bank of Canada (BOC) are not nearly as benign, converging around 3.0%-3.2%.

Exhibit 2: Mission not accomplished



Source: FactSet, SEI.

We continue to obsess about labor-market conditions and their impact on wage costs. Unit labor costs are a good yardstick of underlying inflation, since they measure increases in total employee compensation per hour, offset by productivity improvements. Exhibit 3 highlights the rise in unit labor costs for the U.K., Canada, the eurozone, the U.S., and Japan for both 2023 and the 10 years prior to the onset of COVID-19. The comparisons are stunning. The U.K. registered an 8% gain in 2023, compared to an annualized increase of only 1.2% between 2009 and 2019. Canada and the eurozone experienced hefty increases in 2023, amounting to 5.7% and 5.5%, respectively; these gains are greater than their earlier 10-year periods by four percentage points or more. The U.S. recorded a rise of “only” 3.7% in unit labor costs last year, while the decade before COVID-19 saw annualized increases averaging 1.6%. Even Japan logged a notable acceleration in 2023, and appears set to accelerate further.

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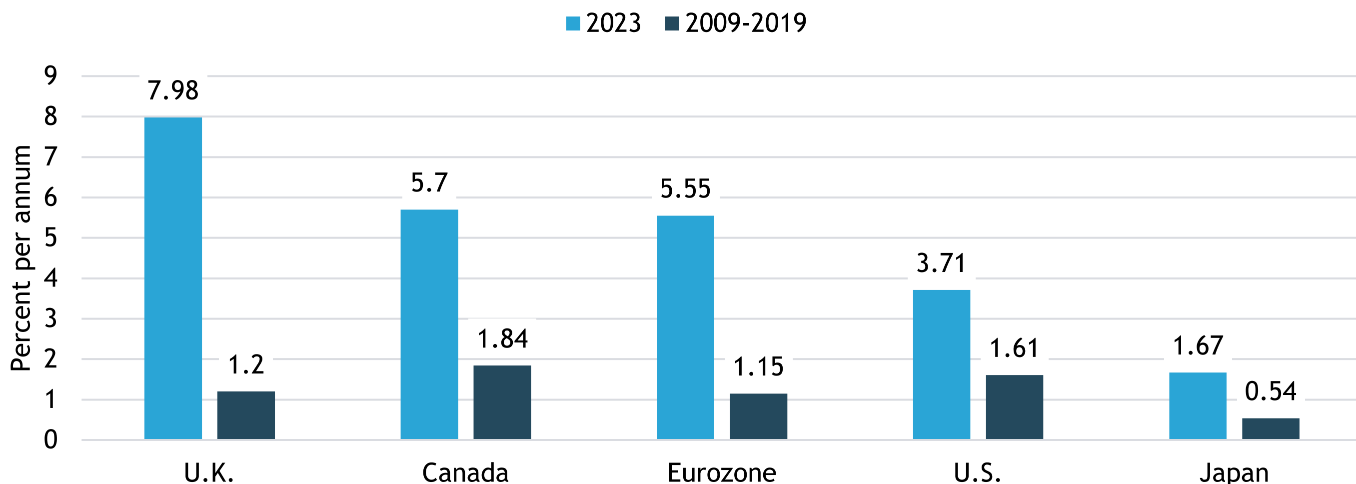
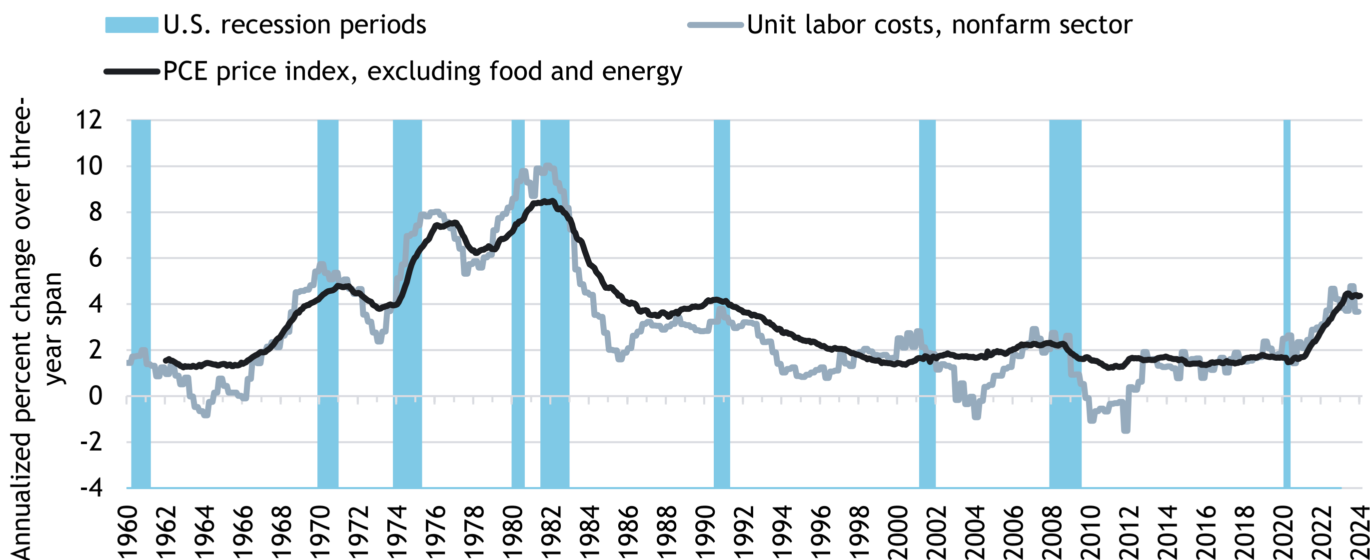
Exhibit 3: Labor costs provide no reason for inflation optimism



Source: OECD, SEI.

Exhibit 4 highlights how closely core inflation (using the Fed's favorite inflation measure, the personal-consumption-expenditures (PCE) price index) tracks the change in unit labor costs in the U.S. We show those changes over annualized three-year spans to smooth out the year-to-year fluctuations. Note that unit labor costs tend to track below inflation both in the aftermath of recessions and in the early phase of expansions. As expansions press on, however, unit labor costs tend to increase at a faster pace than underlying inflation. This dynamic occurs because productivity tends to soar in the early stages of an expansion as output recovers faster than employment and hours worked. As the economic cycle matures, however, wages tend to accelerate while productivity gains fade.

Exhibit 4: No "immaculate disinflation" here



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, ECRI, SEI.

We think the current expansion is getting long in the tooth, yet there is still no sign of recessionary stress in the U.S. Although labor markets across the globe are not as tight as they were a year or two ago, they are still tight enough to keep compensation growth at a pace that is significantly above the gains in productivity. The rise in unit labor costs should stay elevated, as should underlying inflationary pressures. We believe this will continue to present a major challenge for policy-makers.

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Central banks walk a tightrope

We have been steadfast in our expectation that central banks, especially the Fed in the U.S. and the Bank of England (BoE) in the U.K., would be reluctant to cut policy rates against the backdrop of above-target inflation rates, resilient economic growth, or both. Earlier this year, the futures and swap markets priced in an expectation that the Fed would decrease the federal-funds rate by approximately 150-175 basis points (1.50-1.75%)—the equivalent of six-to-seven cuts of 25 basis points—by the end of 2024. We saw no reason for such optimism and stuck to our view that three 25 basis-point reductions totaling 75 basis points (0.75%) would be the actual outcome, consistent with the Federal Open Market Committee's (FOMC) own projections. In our view, any surprises from the Fed would more likely come in the form of fewer, not more, policy-rate cuts this year.

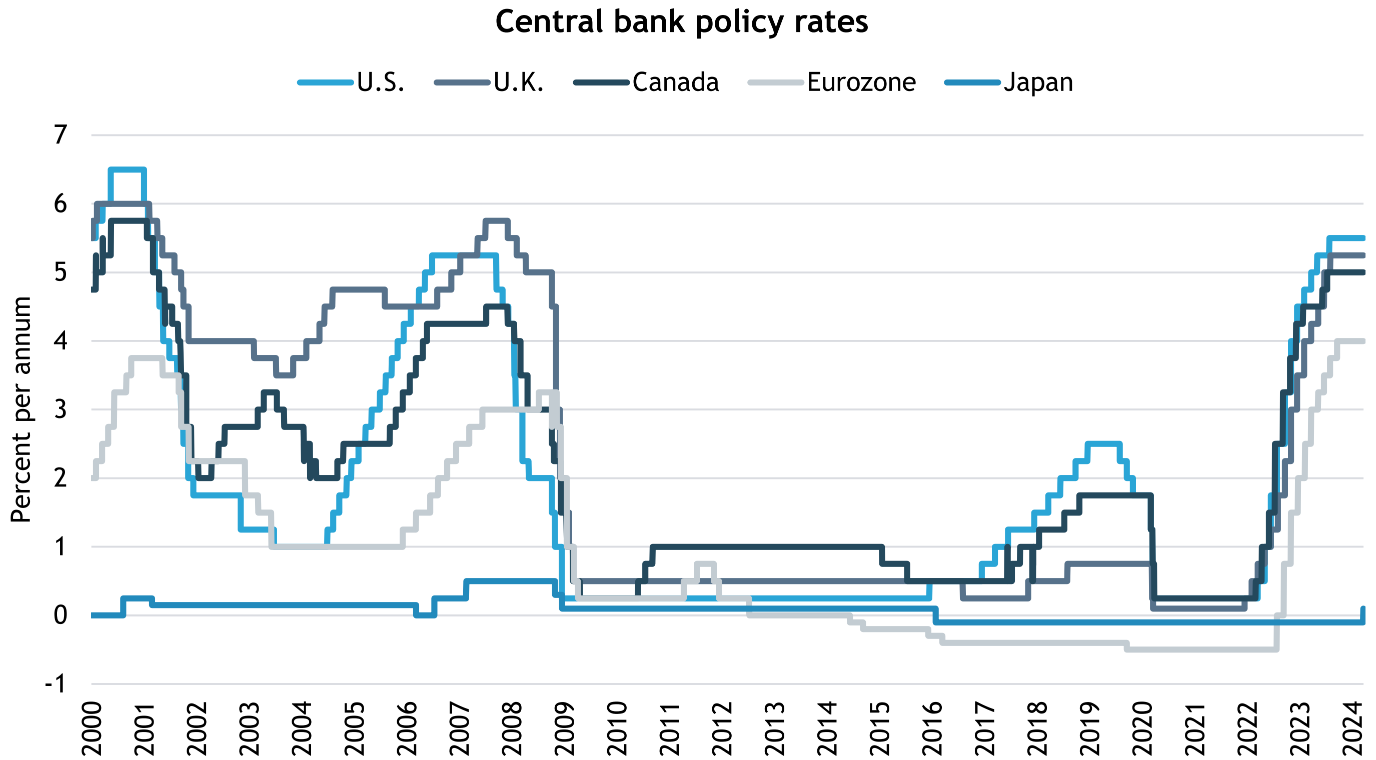
In March, the Fed updated its economic projections, including that of the federal-funds rate. The median forecast for real gross domestic product (GDP) in 2024 was revised to 2.1%, up sharply from the 1.4% expected in December. Forecasts of growth in GDP in 2025 and 2026 rose slightly to 2%. The unemployment rate was reduced to 4%, and FOMC members saw the jobless rate staying mostly stable over the next two years. Core PCE inflation for 2024 was revised up to 2.6% from the previous estimate of 2.4%. The median forecast suggests that inflation is still expected to decelerate to the longer-run target of 2% by 2026.

The median forecast of 4.6% for the federal-funds rate did not change, although we note that the central tendency range of predictions moved a quarter-point higher to a range of 4.6-5.1%. The median estimates for year-end 2025 (3.9%) and 2026 (3.1%) also have ticked up slightly. The decision-makers at the Fed still seem to be betting that they can safely cut rates three times this year and still see lower inflation against the backdrop of a resilient economy marked by a structurally lower unemployment rate.

The Monetary Policy Committee (MPC) at the Bank of England faces similar challenges as the Fed, emphasizing the need to wait and see before taking any policy actions. Although inflation has eased, underlying price pressures are unlikely to recede very much. The country's minimum wage was set to climb by 9.8% on April 1; services inflation remains quite sticky at a 6% annual rate. In the meantime, the BoE continues to reduce its portfolio of gilts (U.K. treasury bonds) at a time when the Conservative government is pushing through tax breaks in an attempt to improve its popularity ahead of the general election to be held by the end of 2024. Markets earlier this year were pricing in as many as seven Bank Rate reductions in 2024. As in the U.S., that unwarranted optimism has been mostly deflated.

Exhibit 5 tracks the policy interest rates of the major central banks. Except for the Bank of Japan, which has been the outlier throughout the rate-hiking cycle, all of the central banks highlighted in the chart have kept their policy rates steady this year after aggressive increases in 2022 and the first half of 2023. The Fed, the BOC, and the BOE haven't changed their target rates since last summer. The European Central Bank (ECB) last raised its deposit facility rate in September 2023.

Exhibit 5: Synchronicity



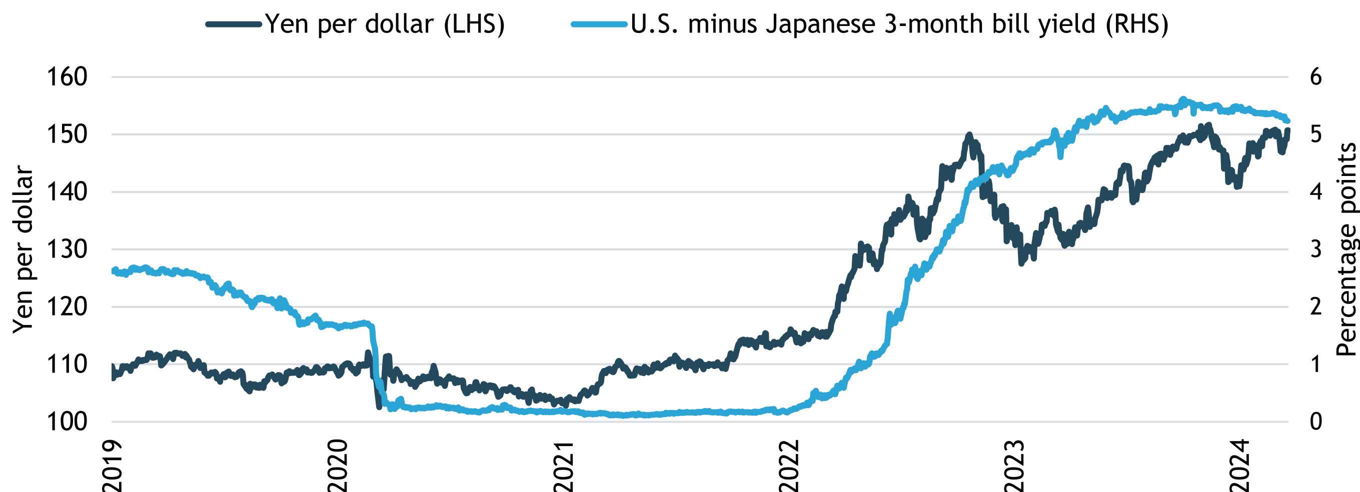
Source: FactSet, SEI.

Monetary policy moves by the major central banks have been fairly uniform since the Global Financial Crisis of the late 2000s. It probably will stay this way, given the similar challenges these countries are currently facing. The ECB might be the first central bank to cut its policy rate, given its weaker economic outlook relative to the U.S. and appreciably lower inflation rate than the U.K. The risks to growth still appear to be to the downside as Germany's manufacturing-oriented economy continues to sputter. Fiscal policy in the eurozone is also tightening rather dramatically (almost 1% of GDP), mostly due to the decline in energy subsidies and the reduction in various tax breaks. Of course, the ECB's policy rate is already below those of the Fed, the BoE, and BOC; reducing rates ahead of the others could put more downward pressure on its currency.

Japan's policy course, on the other hand, appears completely different. The Bank of Japan's (BOJ) recent rate increase is the first change since January 2016, and the first increase in 17 years. In addition to pushing its overnight rate into (barely) positive territory, the BOJ made several other policy moves. It discontinued its purchases of exchange-traded funds (ETFs) and Japanese real-estate investment trusts (J-REITs), and will gradually reduce its purchases of commercial paper and corporate bonds, ending those operations completely in about a year. The Bank of Japan still intends to be an aggressive buyer of Japanese government bonds, although it has now placed an upper limit on those purchases. Its policy of yield-curve control, through which the BOJ manipulated Japan's yield curve and specifically targeted a yield level for the Japanese 10-year benchmark bond, has ended.

The BOJ emphasized that it will still be slow to normalize monetary policy. Japanese interest rates remain extremely low relative to other countries, in both nominal and inflation-adjusted terms. This explains why the yen weakened against the U.S. dollar in the aftermath of the BOJ's announcement. Exhibit 6 shows that the yawning interest-rate differential that has opened up between Japan and the U.S. since the end of 2021, has led to an equally sharp depreciation of the yen. Going long the yen (buying yen, selling the dollar) is not very tempting when the cost of carry (borrowing at a relatively lower interest rate to invest in a higher-yielding asset, and reaping the difference) is so high.

Exhibit 6: Keep calm and don’t carry on



Source: FactSet, SEI.

It probably will take a more dramatic rise in Japanese interest rates and a clear trend toward monetary policy easing by the Fed before the yen can appreciate meaningfully against the dollar. But there’s no denying that traders are lined up on one side of the ship, betting on additional yen depreciation. Exhibit 7 highlights the percentage of speculators in the futures markets that are long the yen as a percentage of open interest. That percentage remains near all-time lows. When and if those positions are unwound, the yen could rise quite quickly. What is needed is a catalyst, but that is hard to find at the moment. Nevertheless, it is probable that further downside in the yen is limited at this point. The odds of intervention by Japan’s Ministry of Finance on behalf of the yen are rising.

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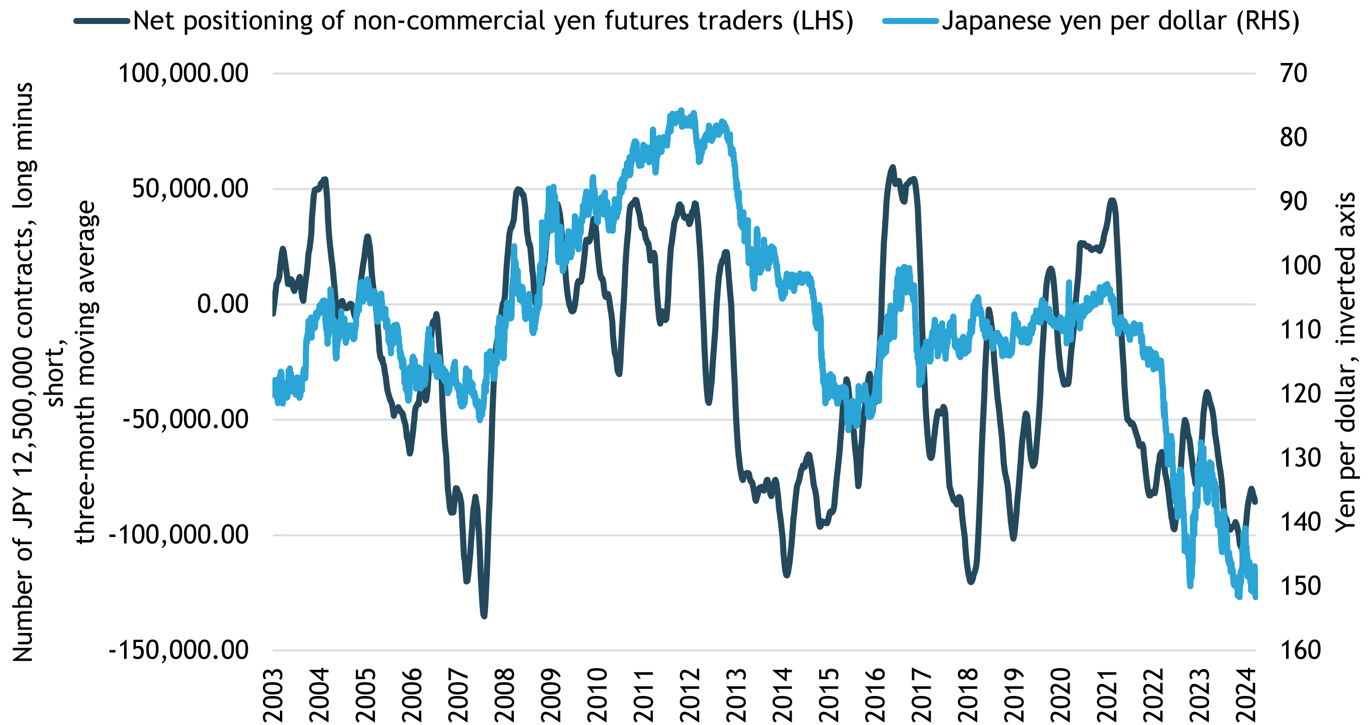
Exhibit 7: I'm just yen



Source: CFTC, FactSet, SEI.

Risk-on for markets

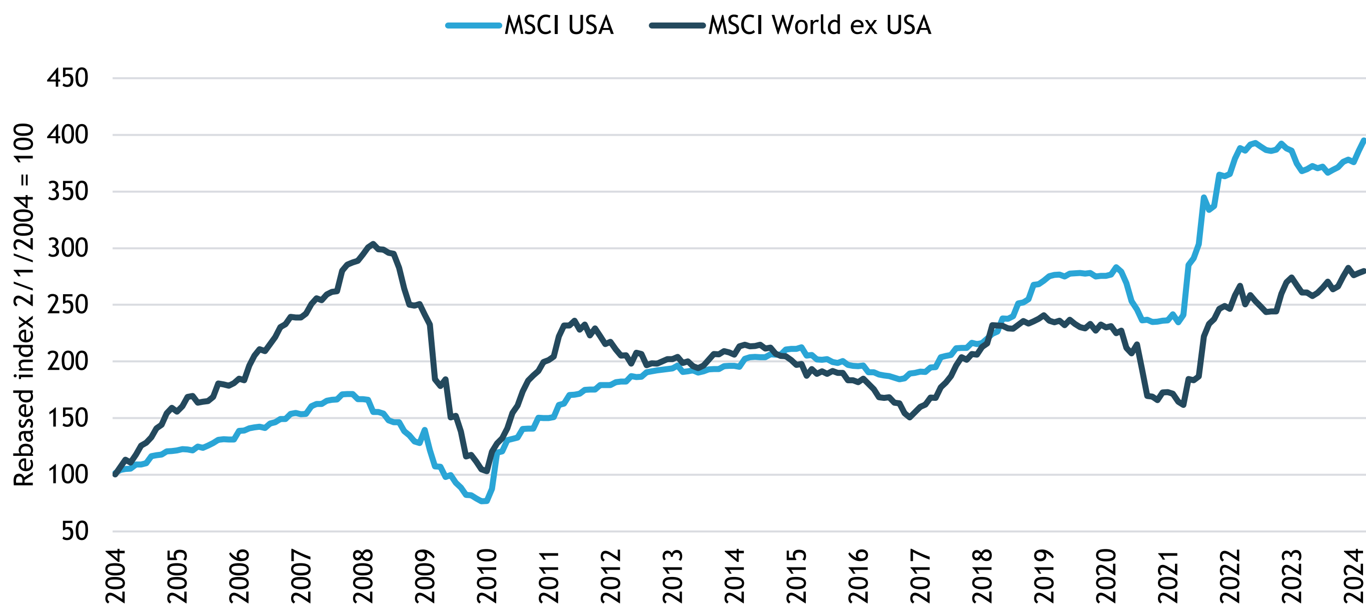
Investors have shrugged off any fear they may have had about economic growth, inflation, or the direction of interest rates. Equity markets in many countries and regions have been pushing higher in the past six months, approaching or achieving new all-time highs in the process. Exhibit 8 compares the total return of the MSCI USA Index since the start of 2021 against that of the MSCI World ex USA Index in both local-currency and U.S. dollar terms. Some may be surprised to learn that, in local-currency terms, other developed-world stock markets have kept pace with U.S. equities. From the perspective of a U.S.-based investor, however, that cumulative 40% return in the MSCI World ex USA Index is reduced by roughly 50% as a result of the dollar's appreciation against other currencies.

Exhibit 8: Livin' la vida local

Source: FactSet, SEI.

As we noted in our first installment of the Quarterly Economic Outlook, the U.S. remains the leading economic engine for the world, adding to current enthusiasm stoked by the artificial intelligence (AI) boom. Yet, actual 12-month trailing earnings were mostly flat from the early part of 2022 to the end of last year. In recent months, actual earnings in the U.S. have perked up sharply, while other developed markets tracked by MSCI have improved more gradually. As seen in Exhibit 9, U.S. companies have outperformed their non-U.S. counterparts on the earnings front since 2018. Over the full 20-year span illustrated in the chart, U.S. earnings per share have nearly quadrupled (+295%), while the rest of the developed world's profits advanced a cumulative 180%. Given this earnings performance, it is easy to see why investors have viewed U.S. equities as the "best game in town."

Exhibit 9: Happy trails



Source: FactSet, SEI.

It goes without saying that the strong performance of the U.S. stock market is not the result of what earnings have done over the past year. Expectations for future earnings are what counts. Exhibit 10 examines U.S. equity valuations in greater depth, using the so-called “Blue Angels” concept created by economist Ed Yardeni. It compares the actual price-return level of the S&P 500 Index against would-be levels of the index at different forward price-to-earnings (P/E) ratios. Yardeni refers to the chart as the “Blue Angels” because the ratio lines “fly” in parallel formation like the famed U.S. Navy squadron of the same name, while the actual S&P 500 Index (depicted here as the blue line with the diamond markers) cuts through the “contrails” of the various forward P/E ratio levels. The chart not only shows how expensive equities are at any given moment relative to history, it also highlights the current trajectory of 12-month forward operating earnings projected by bottom-up security analysts. Climbing contrails point to rising earnings estimates, thereby supporting a higher stock price at a given P/E ratio.

While trailing earnings have been flat over the past year or so, forward-looking earnings estimates have been on the rise since the start of 2023. That is good news in itself, but the 9.1% gain in forward earnings since January 2023, explains only a small portion of the 36.9% price return in the S&P 500 Index over the same period. Forward-looking earnings multiples have jumped, too, from 16.6 times earnings at the end of December 2022 to 21.0 times at the end of March 2024. The P/E ratio slightly exceeded current levels for much of 2020 and 2021, a time when earnings estimates were rising at an even faster pace than they are now. The only time in the past 28 years when earnings multiples ran even higher was during the dot-com bubble of 1998 to 2000.

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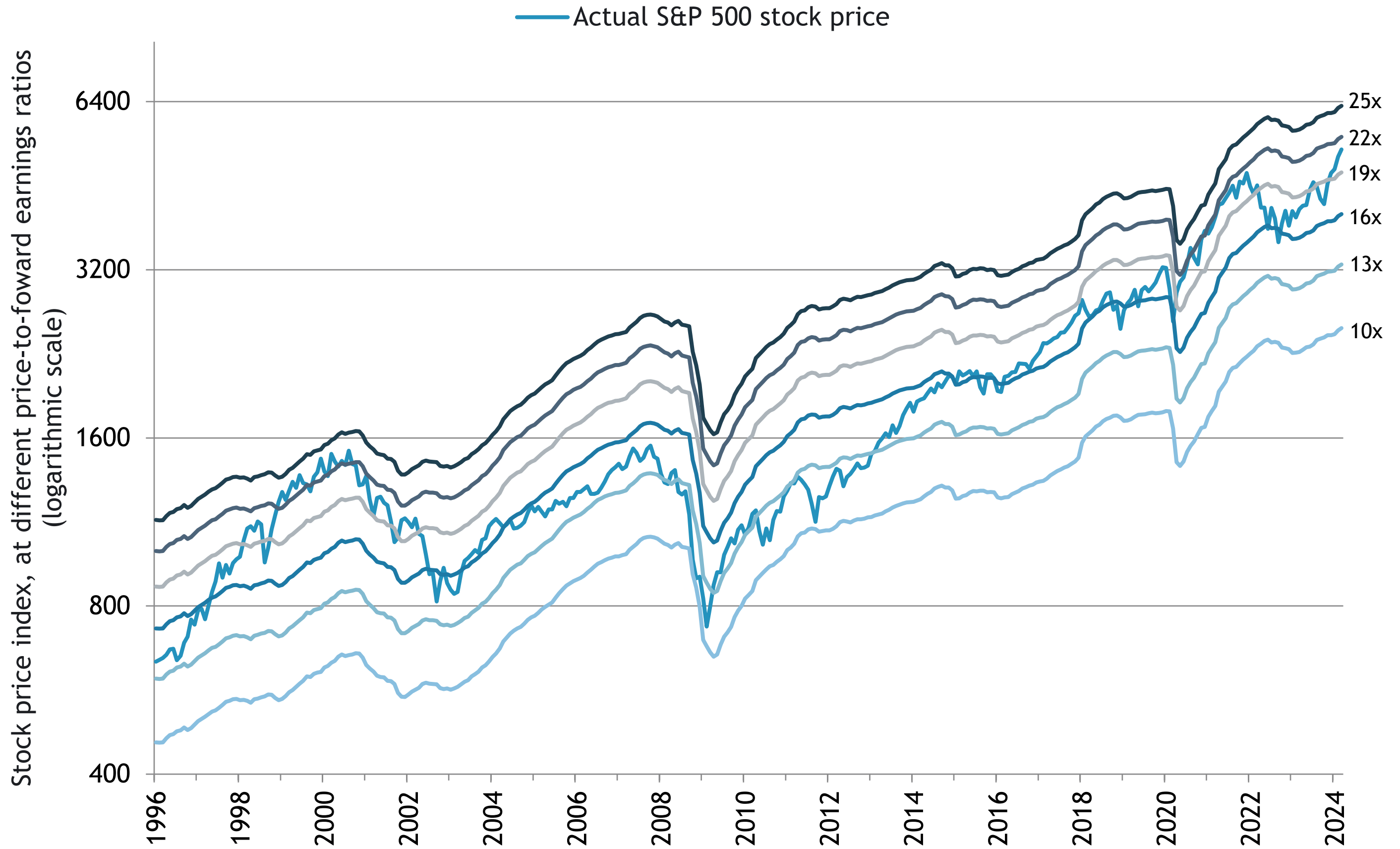
Exhibit 10: “Blue Angels” for U.S. equities



Source: Standard & Poor's, Yardeni Research Inc., SEI.

Thanks in no small part to the so-called “Magnificent Seven” mega-cap technology stocks, there is a fair degree of optimism built into the price of the S&P 500 Index. SEI believes it is important to remember that it’s a big world out there, and many other countries have their own equivalents of the Blue Angels. Similar to the previous chart, Exhibit 11 tracks the price-return level of the MSCI World ex USA Index against forward price-to-earnings ratios. Forward earnings outside the U.S. jumped 22.8% in local-currency terms from the end of 2022 through the first quarter of 2024, versus the 9.1% increase for U.S. companies. But the forward P/E ratio remains at a much lower valuation, amounting to just 13.3 times earnings as of March.

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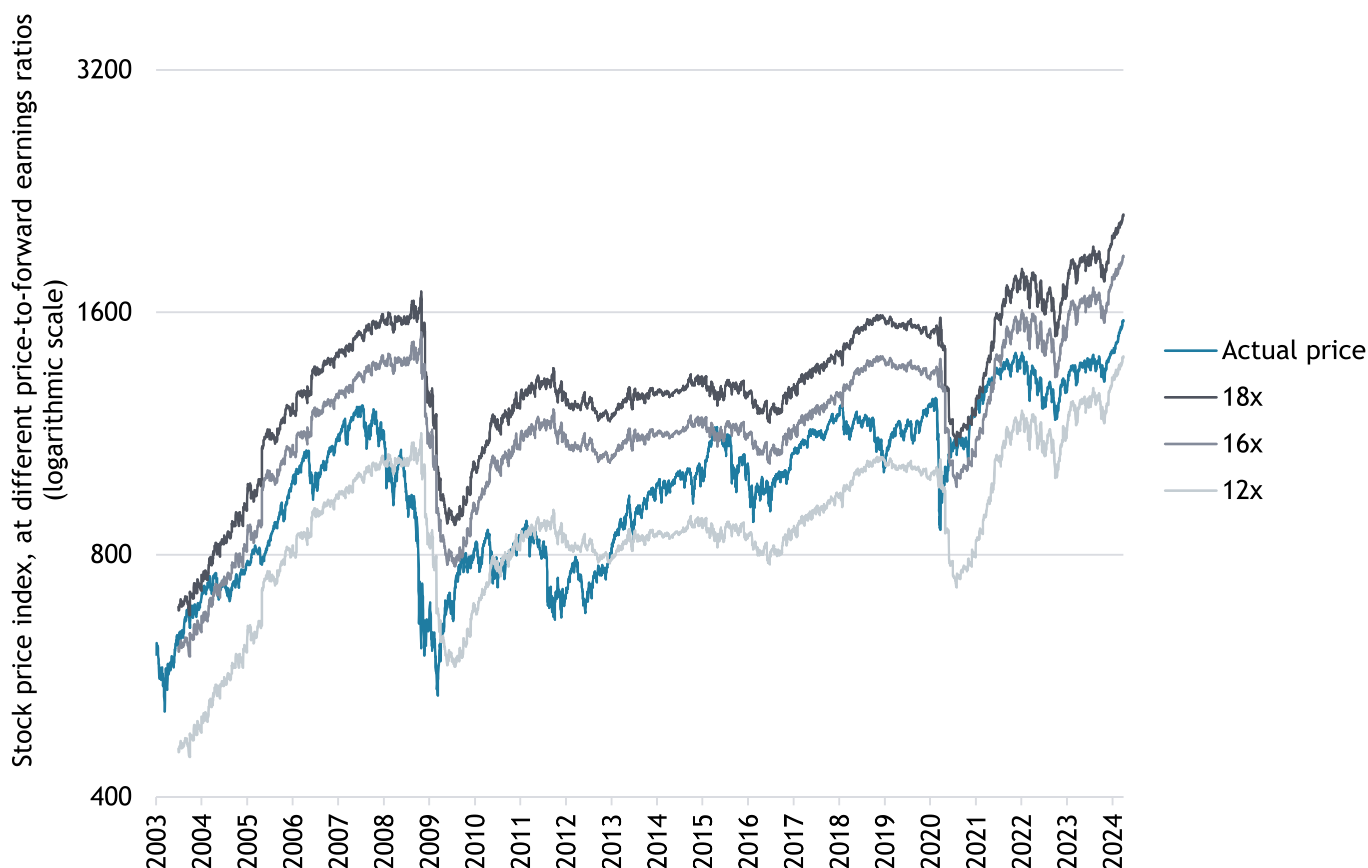
Exhibit 11: The Blue Angels have competition



Source: MSCI, Yardeni Research, SEI.

The more highly equities are valued, the more vulnerable they tend to be if negative surprises appear, or when bond yields move higher. So far, the growth surprises have been on the positive side, offsetting the rebound in bond yields recorded this year and in 2023. Broadly speaking, we think that U.S. Treasurys are fairly valued at present. Heavy bond issuance in the years ahead, and the possibility that investors will begin to demand a positive term premium as compensation for the risks associated with holding longer-dated paper, suggest to us that bond yields will remain at elevated levels even as short-term rates begin to fall. One of our higher-conviction forecasts is for a steeper yield curve, in which short-term rates fall more quickly relative to long-term rates.

Credit spreads also remain tight, reflecting investors' optimism that economic growth will continue unabated. As we show in Exhibit 12, spreads on both investment-grade and high-yield bonds remain close to their historic lows. Investors may not be irrationally exuberant, but they are certainly complacent.

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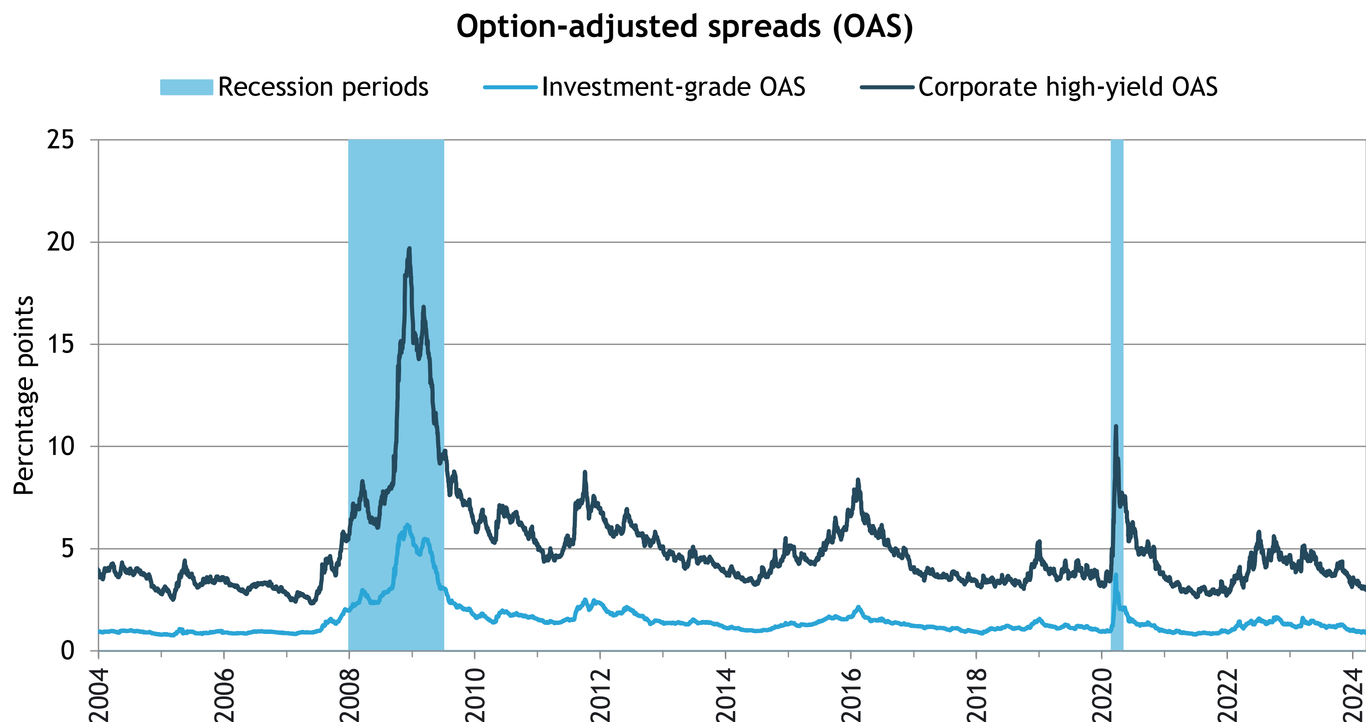
Exhibit 12: Not much room for error



Source: FactSet, NBER, SEI.

Jim Smigiel, SEI's Chief Investment Officer, sums up SEI's current market outlook this way:

- U.S. interest-rate expectations have converged thus far in 2024, as stubborn inflation data and a mixed employment picture have led investors to back away from predictions of aggressive interest-rate reductions from the Fed. As of now, roughly three rate cuts are priced in, most likely starting in June, putting market expectations only slightly ahead of our own. Nevertheless, risks to this view are, in our opinion, clearly on the side of fewer rate cuts.

- We would not be surprised to see mild weakness in the jobs data seize the attention of policy-makers and serve as a catalyst for the first rate cut in early summer, even if inflation remains above target. We hold the view that inflation will stay stickier than expected on a slower decline in service inflation and a continued rebound in goods inflation.

- Equity market performance has been strong, if not broad-based, thus far in 2024, on a solid earnings season—and despite aggressive Fed rate cuts being off the table for now. We prefer a more diversified approach in general, and a value orientation more specifically right now, as value spreads remain at historically wide levels. We are also interested in the relatively low level of equity volatility, and have been taking advantage of inexpensive insurance to protect against potential drawdowns.

- We also remain bullish on active equity management. Concentrated markets tend to be extremely difficult environments for active managers to outperform, and that has certainly been true over the past 12 months. As the Magnificent Seven begins to diverge in performance and concentration begins to fall, we see a tailwind for active management developing and believe that now would be an opportune time for passive investors to consider building positions in active strategies.

- The 10-year Treasury yield is down from the high of 5.0% reached in October 2023, but well above where it started the year. We see additional room for bond yields to move higher, not only on the aforementioned sticky inflation data, but also on the substantial budget funding pressures and the lack of term premium priced into the yield curve. We would not be surprised to see the 10-year Treasury yield retest the 5% level even with the prospect of rate cuts on the horizon.

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Glossary

Brexit is a combination of "Britain" and "exit," referring to the U.K.'s withdrawal from the European Union on January 31, 2020.

A **carry trade** involves borrowing at a low interest rate and then investing in an asset with a higher interest rate.

Global Financial Crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.

Gross domestic product (GDP) is the total monetary or market value of all the goods and services produced in a country during a certain period.

The Magnificent Seven (Magnificent 7) is a group of mega-capitalization technology-oriented companies that delivered strong returns in 2023. The group comprises Nvidia, Microsoft, Apple, Amazon, Meta, Alphabet, and Tesla.

Index definitions

The **Russell 1000 Index** tracks the performance of 1000 of the largest U.S. equity securities based on market capitalization. The index is a subset of the Russell 3000 Index, which comprises the 3,000 largest U.S. companies, and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

The Russell 2000 Index tracks the performance of the small-cap segment of the U S. equity market. The index is a subset of the Russell 3000 Index, which comprises the 3,000 largest U.S. companies, and includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

The **Bloomberg Commodity Total Return Index** comprises futures contracts and tracks the performance of a fully collateralized investment in the index. This combines the returns of the index with the returns on cash collateral invested in 13-week (three-month) U.S. Treasury bills.

The **Bloomberg Long Government/Credit Index,** the long-term component of the Bloomberg U.S. Credit Index, tracks the performance of U.S. dollar-denominated investment-grade (rated BBB- or higher by S&P Global Ratings/Fitch Ratings or Baa3 or higher by Moody's Investors Service) corporate debt and sovereign, supranational, local authority, and non-U.S. agency bonds with a remaining maturity equal to or greater than 10 years. The average maturity is approximately 20 years.

The **Bloomberg US Aggregate Bond Index** tracks the performance of U.S. securities in the Treasury, government-related, corporate, and securitized sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $250 million.

The **Bloomberg US Treasury Inflation-Protected Securities (TIPS) 1-5 Years Index** tracks the performance of U.S. Treasury Inflation-Protected Securities (TIPS) with maturities of one to five years.

The **ICE BofA US High Yield Constrained Index** is a market capitalization-weighted index which tracks the performance of U.S. dollar-denominated below-investment-grade (rated BB+ or lower by S&P Global Ratings and Fitch Ratings or Ba1 or lower by Moody's Investors Service) corporate debt publicly issued in the U.S. domestic market.

The **J.P. Morgan EMBI Global Diversified Index** tracks the performance of external debt instruments (including U.S. dollar-denominated and other external-currency-denominated Brady bonds, loans, eurobonds, and local market instruments) in the emerging markets.

The **J.P. Morgan Government Bond Index - Emerging Markets (GBI-EM) Global Diversified Index** tracks the performance of debt instruments issued in domestic currencies by emerging-market governments.

The **MSCI China Index** (total return) tracks the performance (including reinvested dividends) of large- and mid-cap stocks in China. The Index's 151 constituents comprise about 85% of the China equity universe.

The **MSCI Frontier Emerging Markets Index** is a free float-adjusted (i.e., including only shares that are available for public trading), market capitalization-weighted index that tracks the performance of stocks in 32 frontier emerging-market countries. The index includes 129 constituents, comprising about 85% of the free float-adjusted (i.e., including only shares that are available for public trading) market capitalization in each country.

The **MSCI World ex USA Index** tracks the performance of the large- and mid-cap segments of equity markets across 22 of 23 developed- market countries--excluding the U.S. The index's 887 constituents comprise approximately 85% of the free float-adjusted (i.e., including only shares that are available for public trading) market capitalization in each country.

The **S&P 500 Index** (price only) is a market-weighted index that tracks the performance (excluding dividends) of the 500 largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market.

The **consumer-price index** (CPI) measures changes in the price level of a weighted-average market basket of consumer goods and services purchased by households.

A **Harmonized Index of Consumer Prices** measures inflation is a consumer price index that tracks change over time in the prices households pay for a basket of goods and services. This metric eliminates Owner's Equivalent Rent from the standard U.S. consumer-price index.

The **personal-consumption expenditures (PCE) price index** measures the prices that consumers pay for goods and services to reveal underlying inflation trends. The **core PCE price index**, the primary inflation monitor used by the Federal Reserve, excludes volatile food and energy prices.

A **market-capitalization (market-cap) weighted index** assigns the weighting of its underlying stocks proportionally by size as measured by this total value. Many indices are market-cap weighted so that smaller companies (companies with smaller capitalizations) do not have a disproportionate impact on the performance of the index.

Important information

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No mention of particular securities should be construed as a recommendation or considered an offer to sell or a solicitation to buy any securities.

There are risks involved with investing, including loss of principal. Diversification does not ensure a profit or guarantee against a loss. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Narrowly focused investments and smaller companies typically exhibit higher volatility. Bonds and bond funds will decrease in value as interest rates rise. High-yield bonds involve greater risks of default or downgrade and are more volatile than investment-grade securities, due to the speculative nature of their investments.

Past performance does not guarantee future results. Index returns are for illustrative purposes only and do not represent actual portfolio performance. Index returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index.

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