Quarterly Macro Report – 3rd Quarter 2024

The business cycles in most major economies have become asynchronous, which is helping to stabilize global growth. Europe and China are likely to see higher growth in the winter quarters, while the US is likely to experience a slowdown.

The global economy continues to be dominated by regional trends. While the UK, parts of Europe, and Japan are struggling to emerge from a period of very weak performance, China is in outright recession, and the US continues to grow at or above trend.

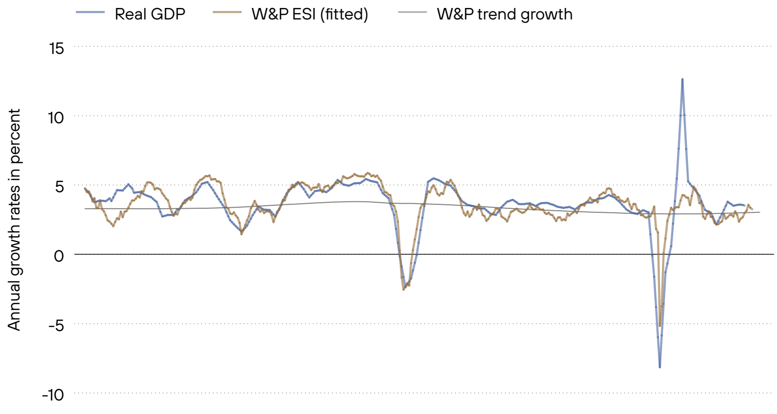
At the heart of these developments is the global cycle of demand for goods, which remains weak. The massive excess demand during and immediately after COVID has turned into an excess supply situation. Recently, however, we have seen the first signs of stabilization, at least in manufacturers' sentiment. This makes us optimistic that industrial production will be able to make a positive contribution to growth in the coming winter quarters. This should benefit industry-heavy economies such as China, Japan, Germany, and even Switzerland.

US growth to soften

At the same time, US growth appears to be cooling. After a very strong second half of 2023, growth fell to below trend levels in the first quarter of this year. Recent leading indicators point to further weakness in US growth. On the one hand, higher mortgage rates are taking their toll on construction activity, while on the other hand, the strong performance of the services sector appears to be moderating due to still relatively strong compensation increases. With real wages currently rising at a strong pace, tight labor market conditions are also expected to ease.

With the US slowing and China and Europe improving, the global economy will continue to grow at a steady pace of just below three percent. At the same time, we continue to see star performers in India and Indonesia, where growth this year will be above trend at close to six and five percent,

Fig. 1: Global economy dominated by regional trends



Source: LSEG, Wellershoff & Partners

While the US is still growing at or above trend, growth in the world's biggest economy seems to be cooling. The recent stabilization of the global industrial sector may benefit countries such as China, Japan, Germany, and Switzerland. Overall, the economic outlook remains favorable.

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This cannot be said of the geopolitical situation. The major conflicts in Ukraine and in Gaza are unlikely to end anytime soon. Political elections in Germany this September might destabilize the country, at least in the eastern part, and of course, the presidential election in the US provides major political uncertainty that might weigh on economic sentiment and growth going forward.

“A slowdown in the US would help prices return to sustainable levels.”

Slow progress on inflation

Inflation remains a problem in almost all industrialized countries. Recent experience has confirmed our view that further significant reductions in inflation are only possible in an environment of weak growth or recession. This has helped bring European inflation down significantly recently and explains why progress on inflation in the US is proving stubbornly difficult. Newest figures have shown some improvement there too, but at the cost of falling growth rates. In the Eurozone and in Japan, core inflation has started to increase again in the last few months.

With wage growth above core inflation in many countries, it remains difficult to see how central banks could feel comfortable loosening monetary policy more aggressively anytime soon. This leaves us with the uncomfortable observation that in all major currencies, except the yen, capital market rates are well below money market rates. Such an inversion of the yield curve can only be justified in two scenarios. One is an imminent global recession. The other is an aggressive policy of interest rate cuts. As we do not see sufficient evidence to predict either one of these, there is a high probability that capital markets will generate instabilities that could come as a great surprise to most market participants.

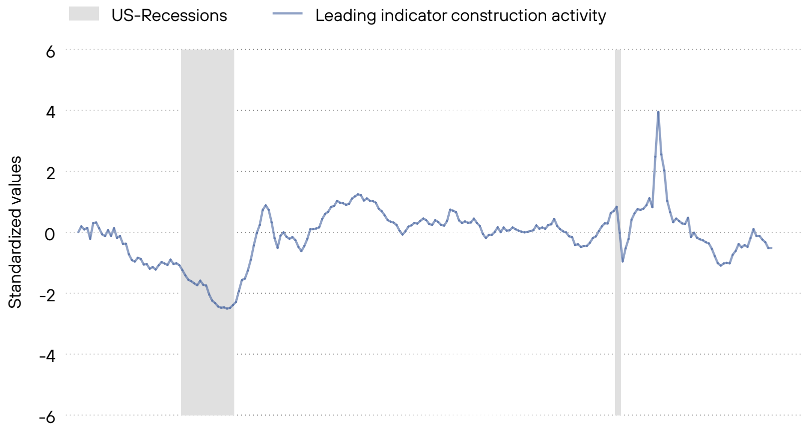
Table 1: Macroeconomic estimates (in %)

	GDP Growth			Inflation		Interest Rates	Money Growth M1
	Trend	2024*E*	2025*E*	2024*E*	2025*E*	Q3 2024	y/y 07/2024
USA	1.8	1.4	1.6	3.2	2.2	5.50	–3.6
Eurozone	1.1	0.6	1.4	2.8	2.4	3.75	–6.1
UK	1.7	0.6	1.5	3.2	2.8	5.25	–4.8
Switzerland	1.3	0.8	1.6	1.5	1.3	1.25	–12.6
Japan	1.1	1.0	1.2	2.0	1.5	0.10	2.8
China	4.5	4.3	4.5	0.8	1.5	4.35	-4.2
Brazil	1.4	1.8	1.8	4.0	3.2	10.50	10.1
India	5.0	6.3	5.5	4.5	4.2	6.50	7.9
Russia	1.0	2.0	1.0	6.2	4.5	16.00	9.5
World	3.0	2.8	3.1	4.4	3.6	–	–

Source: LSEG, Wellershoff & Partners

Fig. 2: Decline in US construction activity

Recessions and leading indicator for construction activity in the US

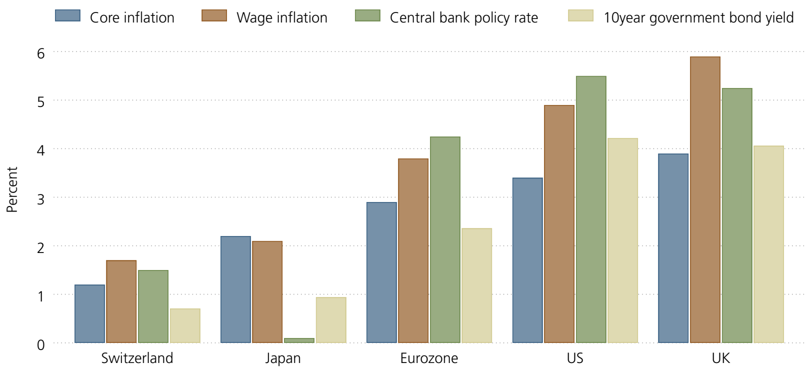


Source: Federal Reserve Bank of St. Louis, Wellershoff & Partners

The rise in US capital market interest rates this year has led to a significant fall in our leading index of construction activity. We have to assume that investment in real estate will be below trend in the second half of the year. As construction is very labor-intensive, this could have a noticeable impact on the labor market and hence on consumption.

Fig. 3: Inflation will remain a problem

Inflation, policy rates, and long-term bond yields in major currencies

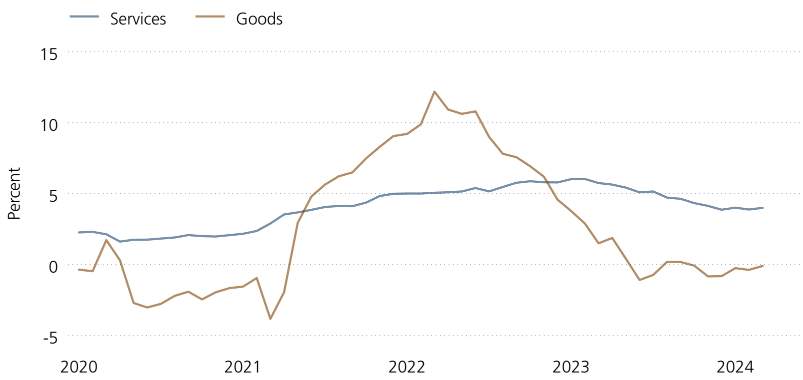


Source: Federal Reserve Bank of St. Louis, Wellershoff & Partners

In the major currencies, with the exception of Japan, core inflation is still below wage inflation. While implicit real wage increases are supporting consumption, the cost implications will make it difficult for core inflation to fall quickly in the future. The main problem for central banks remains inverted yield curves, which need to normalize before a new global expansion can take place.

Fig. 4: Services inflation outpacing goods inflation in the US

Services and goods inflation in the US



Source: Federal Reserve Bank of St. Louis, Wellershoff & Partners

A look at the inflation rates for consumer services and consumer goods illustrates the same point. As the post-Covid excess-demand for goods pushed up goods inflation to unknown heights, services inflation was slow to rise. Now, services inflation is outpacing goods inflation. As the US is a very services-heavy economy, headline inflation will remain stubbornly high for some time to come.

Capital Market

The markets had expected a broad loosening of monetary policy in the US and Europe. However, they were disappointed in the last quarter. The US Federal Reserve has left the policy rate unchanged, and only one interest rate cut, if at all, is expected this year. The main reason for this is that overall and core inflation rates are cooling more slowly than the US Federal Reserve would like. Although the US economy is still proving to be robust, the economic data suggests that it may have peaked.

> "Expectations of large interest rate cuts were again disappointed in the last quarter."

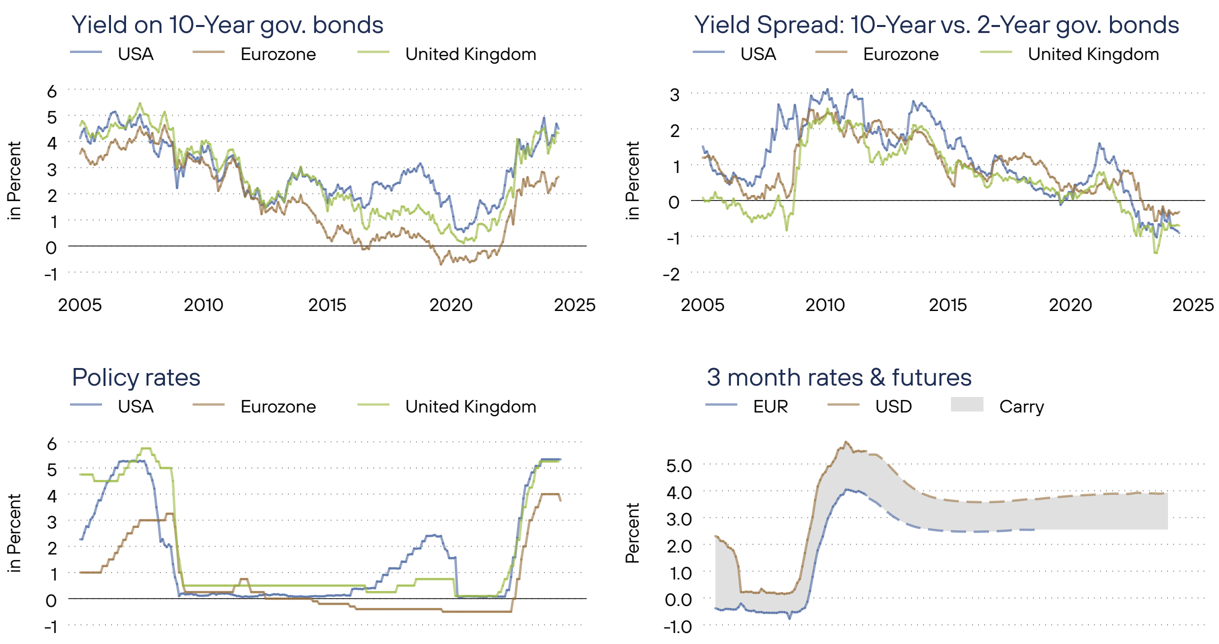
Long-term interest rates and corporate spreads unchanged

In Europe, some central banks have eased their monetary policy, albeit less than expected. The European and Swiss central banks cut their policy rate in the last quarter by one cut. The slowdown in inflation has proved to be more sustainable. Together with the rather weak economy, the interest rate cuts by both central banks appear to be justified. It is somewhat surprising, however, that the Bank of England is sticking to its restrictive policy despite falling inflation rates and a weak economy.

Nevertheless, capital markets appear to be largely unresponsive. Interest rates for 10-year government bonds are almost at the same level as at the end of the last quarter. In the US, the interest rate for 10-year government bonds is back at 4.2 percent, having temporarily risen to 4.6 percent in April due to increased tensions in the Middle East. Similarly, the interest rates for 10-year government bonds in Germany and Switzerland are back at 2.4 percent and 0.6 percent, respectively. As a result, the yield curves continue to be widely inverted. Only two scenarios can explain this untenable situation: Either a global recession is imminent, or policy interest rates will be cut aggressively in the near future. Both scenarios seem rather unlikely, which could lead to an unpleasant surprise in the capital markets.

The market for corporate bonds also appears unbothered. Credit spreads remain at an unusually low level, especially for lower-quality corporate bonds. It seems that hopes for a timely easing of monetary policy and thus improved financing conditions still prevail.

Fig. 5: Money market and capital market interest rates



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