Letter n°95

The global economic outlook, the risk of misunderstanding.

"If you do not know where you're going, remember where you came from" African proverb.

In our previous Letter, we combined geopolitics, monetary policy, and corporate results to encourage vigilance at the dawn of 2024.

In this Letter 95, we focus on the outlook for the global economy.

The year 2023 unfolded contrary to market expectations. Many feared a U.S. recession, and after the mishandled Covid situation, they anticipated a strong recovery in China. The opposite was observed.

Despite the fastest rise in interest rates in the last 50 years, the U.S. economy not only avoided a recession but recorded a growth rate higher than the long-term average.

Symmetrically, despite interest rate cuts and some stimulus measures, the Chinese economy posted a growth figure of 5.2%, among the lowest since the advent of Deng Xiao Ping at the end of the 1970s.

As a logical consequence of these divergent trends, there has been an appreciation of the U.S. market beyond the expectations of even the most optimistic investors and a further substantial decline in the Chinese market.

Behind these two major powers, the European Union displayed weak growth but resisted the consequences of the war in Ukraine better than expected. India, once again, achieved the highest growth among all major economies. Brazil, with a surprising growth of 3%, defied the predictions of those briefly concerned about the return of Lula. Russia, by transitioning to a wartime economy, averted the risk of recession.

Let's leave 2023 behind and look ahead to 2024. Our guiding principle, outlined in the previous letter, is vigilance, as market expectations are deemed contradictory – a global profit growth of 10% combined with 5 or 6 interest rate cuts.

In other words, a profit growth of 10% in 2024, following 0% in 2023, assumes an economic growth incompatible with such rapid interest rate cuts.

In fact, we believe in neither the first nor the second hypothesis. If there is profit growth, it will be weak, and if there are interest rate cuts, they will only begin in the second half of the year. Hence, there may be potential disappointments in both equity and bond markets.

The resilience of employment and growth:

The growth during the period 2020-24 is the weakest in the last 30 years since 1990-94. The factors contributing to this include Covid, war, inflation, and challenges faced by China.

In 2022 and 2023, the global GDP increased from $8 trillion to $105 trillion. While not spectacular, this is far from the recession that many feared at the beginning of 2023.

The interest rate hikes imposed by central banks, historic in their speed and unprecedented in their magnitude, except for the policy pursued by Paul Volcker in the early '80s, did not lead to a surge in unemployment. Disinflation was initiated without causing a recession.

This trend holds true in the United States and the rest of the world, except for poor emerging countries, which are currently in default or close to default.

- ***2023***:

In less than two years, interest rates in the United States increased from 0% to 5.25%, with no deterioration in employment as the unemployment rate ended the year at 3.7%. After creating 4.8 million new jobs in 2022, the economy added another 2.7 million jobs in 2023, and nearly ten million jobs remain unfilled.

In Europe, despite 10 interest rate hikes to move from negative rates (-0.5%) to 4%, the unemployment rate, at 6.4%, has never been lower.

In the United Kingdom, where inflation had surpassed 10%, interest rates were raised by 515 basis points. However, during 2023, the unemployment rate only increased from 3.5% to 4.2%, with Brexit being partially responsible.

The same observation applies to Canada and Australia.

With interest rate hikes without a recession, the global GDP, according to Fitch, is now 9% higher than the pre-pandemic levels.

- ***2024***:

A slowdown in global economic growth is likely, but unlike 2009 and 2020, there will be no recession. The World Bank anticipates a growth rate of 2.4% after 2.6% in 2023 and 3% in 2022. The growth of developed economies is expected to fall from 1.5% to 1.2%, far from the annual average of 2% between 2010 and 2019. Emerging economies' growth will not exceed 3.9%.

Some economies, benefiting from relocation movements, should continue to surprise positively. India, Mexico and Vietnam come to mind.

Conversely, the outlook for China remains uncertain, and Germany and England could experience a slight recession. The United States will witness a slowdown in growth.

However, as a continuation of the trend of the past two decades, American growth will remain higher than that of Europe.

Resistance of consumption:

U.S. economic figures, such as retail sales, +5.6% in 2023, continue to exceed expectations.

Several reasons account for this: households are in debt, but often at fixed rates and with long maturities. On average, in real estate, the interest rate is 3.75%, whereas the rates for new mortgages are around 8%.

Moreover, American households are benefiting from wage increases this year that outpace inflation, +4.1%. In Europe, salaries grew by 5.3% in 2023 and are expected to increase by over 4% this year, significantly faster than inflation. In the United Kingdom, wage increases were at 6.5%.

Additionally, unemployment rates remain low, and some individuals still have excess savings, for example, $290 billion in the United States and even more in Europe, as a percentage of disposable income.

The resilience of inflation:

Economies have proven to be less sensitive than in the past to interest rate hikes, as budgetary policies, especially in the United States with a budget deficit exceeding 6%, remained stimulative. Additionally, a portion of the inflation resulted from exceptional phenomena such as production interruptions or disruptions in trade flows during the pandemic.

In the United States, for example, interest rate hikes would only explain a quarter of the recent disinflation. From 9%, inflation has fallen to 3.4%.

Central banks' concerns and their reluctance to lower interest rates stem from fears related to wage developments in service sectors facing labour shortages.

Another reason for central banks' caution, especially at the Fed, is the economy operating at full capacity.

In December, there was a temporary uptick in inflation in the United States to 3.4% from 3.1% in November, in Europe to 2.9% from 2.4%, and in England to 4%, but these increases are partly due to base effects. In England, for instance, rates could be lowered from 5.25% to 5% as early as May due to a weak economic situation.

One might add a slight risk of renewed inflation if tensions in the Red Sea persist, and ships have no choice but to pass through the Cape of Good Hope. Already, freight rates have doubled or tripled. However, this should not be exaggerated, as the Red Sea represents less than 15% of global traffic, and freight costs are often a small percentage of overall expenses.

The movement of long-term interest rates, from 3.80% for the U.S. 10-year bond a few weeks ago to 4.10% today, reflects this peculiar concern.

More worrisome, in response to the continued rise in debt, especially in the United States, investors may seek protection with higher interest rates.

The Chinese disappointment:

China's contribution to global growth represented up to a third of global growth in the 2010s. In 2023, it was close to zero, marking a major cause of the slowdown in the global economy.

The growth, at 5.2% in 2023, was inflated by two points due to a low base effect, making it a disappointing figure following the modest growth of only 3% in 2022. In 2024, according to the World Bank, growth is not expected to exceed 4.7%.

The first factor is that the country will remain structurally handicapped by the decline in its population, with two million fewer in 2023 and seven million fewer each year in the active population. This trend is expected to worsen over the years as fertility rates have dropped from 6 children per woman in the 1960s to 1.09.

The second factor, situationally, surpluses in real estate and the bankruptcies of developers have a double negative impact, affecting both households and investment. How can one hope for a recovery in consumption when 70% of savings are in real estate, with losses difficult to assess? How can one expect an investment recovery in a sector that has long represented nearly a quarter of the GDP?

The third factor is the burden of debt. China, despite being an emerging country, already has the public debt of a developed country, at 1x the GDP. If local government debt is added to state debt, the overall debt exceeds 3x the GDP. The problem is exacerbated by deflation, making the debt burden even more challenging.

The fourth obstacle to growth, exports, which have been a growth engine for years, decreased by 4.6% in 2023, especially to the United States (-11%). This situation is unlikely to improve as Europe, upset by a €400 billion trade deficit with China, is now erecting its own trade barriers.

The fifth factor is overcapacity in many industrial sectors, which is a drag on growth and a reason for the lack of large-scale stimulus packages. Encouraging investment would exacerbate overcapacity.

From these difficulties in reviving the economy emerges the government's inability to create enough jobs and reduce youth unemployment, officially at over 21%. Although statistics are no longer published, many young people have lost motivation.

As a consequence of these poor figures, international investments in China have declined for the first time.

Conclusion: ***"Speculation is a luxury, action a necessity" Bergson.***

After speculating on various economic hypotheses, let's follow Bergson's advice and examine the stock market implications.

- ***From a margin perspective***, there are concerns about the cost of debt rising and the persistence of wage increases in a context of low productivity growth, which will penalize the expected earnings growth. Companies with high levels of debt should be avoided.

- ***From an equity perspective***, rate cuts will benefit growth stocks, renewable energy-related stocks that suffered in 2023, biotech stocks, and stocks from emerging markets. Small-cap stocks could also outperform.

- ***From a currency perspective***, the dollar, whose highs date back to the end of 2022, remains overvalued. It is weakened by twin deficits exceeding 10% of GDP and a net debt to the rest of the world, multiplied by four since 2000, corresponding to two-thirds of GDP.

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