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What comes after the soft landing?

OUR CURRENT EXPECTATIONS: Inflation has declined substantially and central banks are done tightening monetary policy. Moreover, a recession has been avoided and a soft landing is therefore within sight. But financial markets have already priced in the good news – so what comes next? We expect more of the same – falling yields and rising equities – albeit at a slower pace.

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After a massive increase in interest rates, there are now widespread expectations that interest rates have peaked and that we will see the first rate cuts from the central banks in 2024. This has led to yields falling and equity prices rising. Here, Fed Chair Jerome Powell.

Photo: Haiyun Jiang/New York Times/Ritzau Scanpix

THE PAST YEAR

US expansion wrong-footed many

Economic data in the opening weeks of Q4 2023 delivered an upside surprise in the US, epitomised by a rock-solid labour market report for September followed by still high inflation numbers. National accounts data for Q3 released on 24 October topped things off by revealing annualised growth of 5% for the quarter – more than double the economy's long-term potential.

> We can sum up 2023 as follows: Inflation fell sharply without a recession. The labour market is still strong but better balanced, and wage inflation has eased. The US Federal Reserve tightened monetary policy more than expected.

But the pendulum swung the other way in November as the data showed growth slowing to below the long-term trend. More benign inflation numbers were next up, resurrecting hopes of a soft landing after the late-summer shift to a mantra of 'no landing'. This was further cemented at the US central bank's final meeting of the year, when Fed Chair Jerome Powell stepped forward on 13 December and admitted that the leading members of the central bank had discussed when they could begin to cut the policy rate. That was a stark contrast to just a few weeks earlier when Powell had said rate cuts were not even op for discussion.

The final quarter thus encapsulates the year as a whole for the US economy. Fears of an imminent recession were raging at the start of 2023, but the economy surprised in the first few months of the year with solid growth. Then the banking crisis struck and sent recession fears soaring once more. But yet again the strength of the economy surprised, particularly the very resilient labour market. The narrative then

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switched over the summer to a soft landing – in other words, lower inflation but without a recession. That story proved short-lived, however, as the US economy suddenly appeared to take off and reach exceptionally high levels of growth. This then turned in November, with the year ending on broad expectations of a definitive soft landing in 2024.

Looking through the short-term twists and turns, we can sum up 2023 as follows: Inflation fell sharply without a recession. The labour market is still strong but better balanced, and wage inflation has eased. The US Federal Reserve tightened monetary policy more than expected, lifting the key policy ▸▸

rate above 5%, but the policy rate now seems almost certain to have reached its peak and the Federal Reserve is looking ahead to when and how it can commence normalising monetary policy.

Eurozone growth stalled

ECB President Christine Lagarde was at the lectern the day after Powell's dramatic comments. Despite widespread expectations that the ECB would deliver its first rate cut in the course of H1 2024, Lagarde directly stated that the ECB – unlike the Fed – had not discussed reducing interest rates. While inflation had surprised positively by falling considerably faster (especially in November) than expected, the ECB remained concerned about the still tight labour market and associated high wage growth.

Nevertheless, she again reiterated that the ECB is 'data-dependent', thus opening the door to the rate cuts that the market has already heavily pencilled in. Lagarde noted that the key data going forward would be wage growth, labour market data and the outcome of the collective bargaining rounds scheduled for the opening months of 2024.

Hence, Lagarde gave us a fine summary of 2023 – inflation in the eurozone has also fallen sharply, but unlike in the US, growth has disappointed. And while the economy did not slide into the recession most were expecting at the start of the year (driven by the energy crisis at the time), growth in the past 3-4 quarters has nevertheless been close to zero. But here, too, the strength of the labour market has surprised, with impressive employment growth overall in 2023, record-low unemployment and still high wage growth. The ECB can therefore not feel comfortable about getting inflation definitively down to 2% before they have a better picture of how the labour market will react to the now relatively long period of near zero growth.

China disappoints – massively

Optimism on China was running high at the start of the year. Covid-19 restrictions were gone and the great reopening was imminent. And indeed, growth was extremely strong in the first few weeks of the year but soon petered out. Housing market activity quickly retreated to historical lows and prompted the authorities to deliver one easing package after the other. Growth appears to have stabilised just below the long-term trend here at the end of 2023, and China will deliver growth of around 5% for 2023 as a whole. That is roughly on a par

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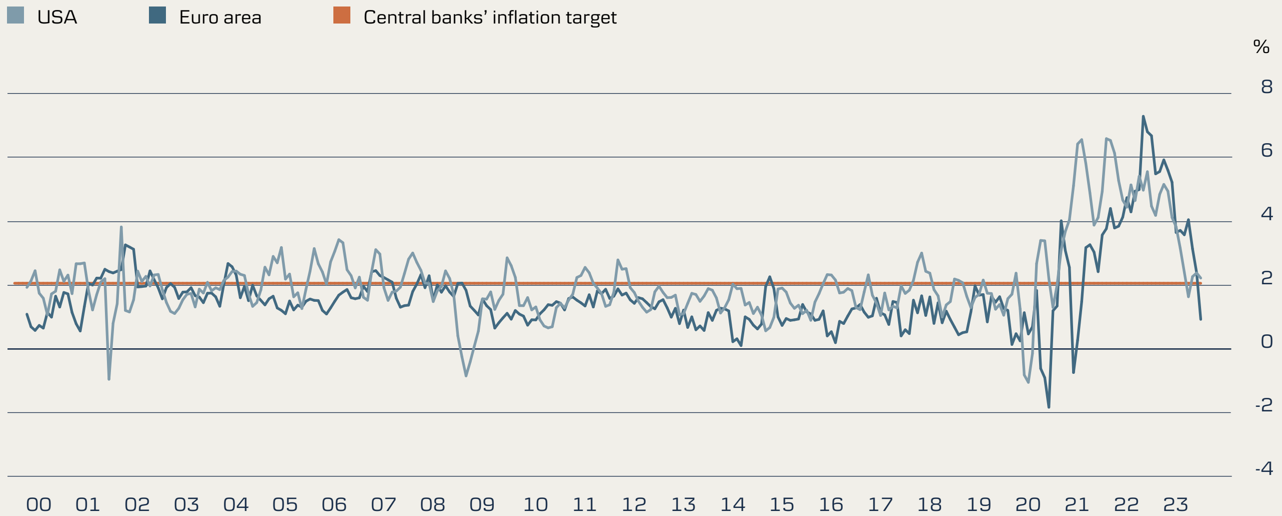
Core consumer price inflation: 3-month movements (annualised)



Note: USA: PCE ex food and energy, Eurozone: HICP ex food and energy from the ECB. Both seasonally adjusted.
Sources: Macrobond and Danske Bank Asset Management.

> Favourable inflation reports in November and December and then the Fed's signal that rate cuts were on the cards for 2024 sent bond yields into free-fall.

with the economy's long-term potential but should have been substantially higher given the many quarters of weak growth driven by Covid-19 restrictions.

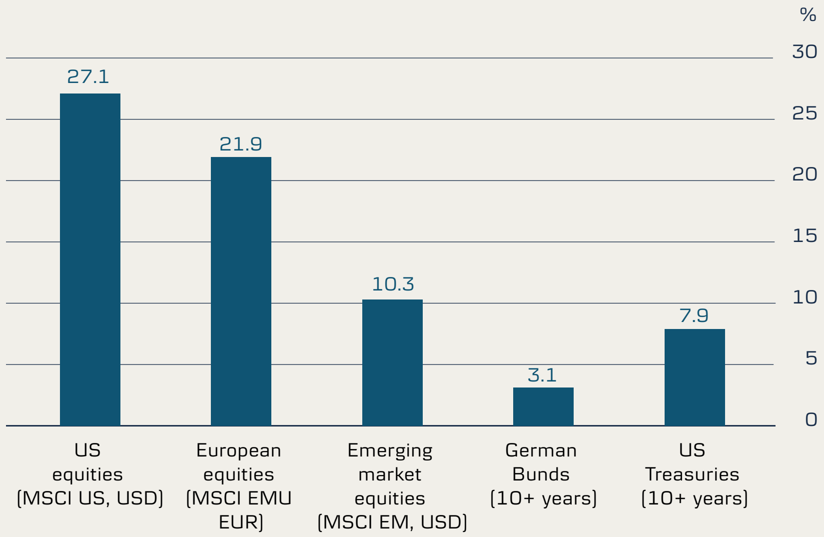
Financial market performance – pricing in the soft landing

Long bond yields continued to soar in the opening weeks of Q4, driven by surprisingly strong growth in the US. 30Y US Treasury yields topped out at around 5.1% on 19 October. However, not long after that the data began to indicate slowing growth in the US and interest rates peaked. Favourable inflation reports in November and December and then the Fed's signal that rate cuts were on the cards for 2024 sent bond yields into free-fall. Both short and long bond yields dropped like a stone and boosted equities significantly as financial markets priced in a soft landing.

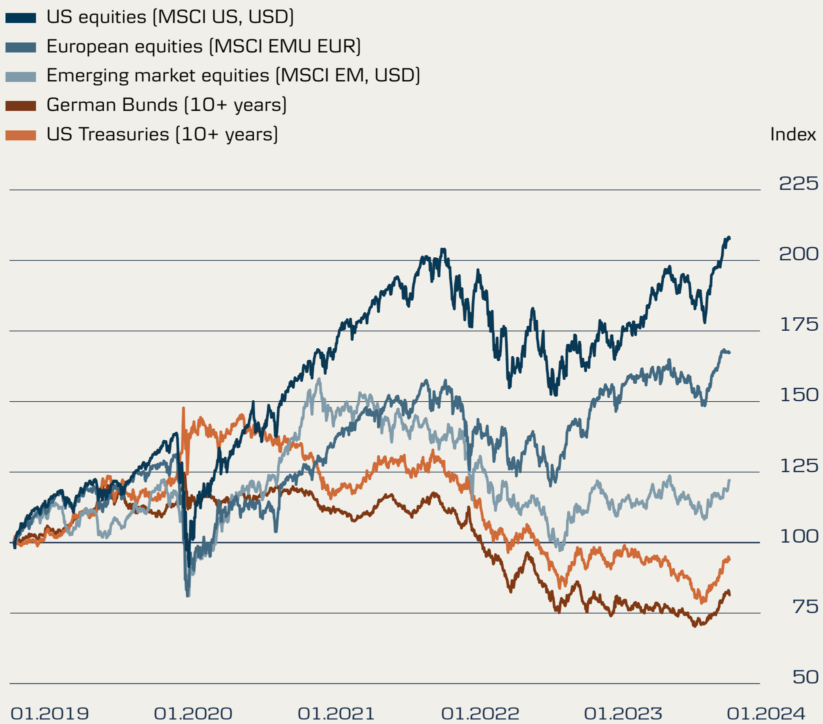
Hence, both short and long bond yields are ending the year noticeably lower than at the start of Q4. For the year as a whole, bond yields in the US og Euro Area are roughly at the same levels as when the year started. On the other hand, both Q4 and 2023 generally were excellent for equities, as the recession failed to materialise and inflation and interest rate uncertainty declined. The global MSCI equity index thus delivered a total return for the quarter of 9.5% for the quarter. For the year as a whole, the global index delivered c. 22% in total local currency terms.

Total return 2023

Historical return is not a reliable indicator of future return, which can also be negative.



5 years' accumulated return



Source: Macrobond, Bloomberg and Danske Bank Asset Management as per 02.01.2024

US consumers have helped support growth, and we see none of the traditional imbalances in the form of undue consumption for borrowed money, etc., which is positive for the coming years.

Photo: Caroline Brehman/EPA/Ritzau Scanpix

EXPECTATIONS GOING FORWARD – MACROECONOMY

Several years of decent growth ahead?

As Q4 kicked off, we argued that the surprising strength of the US economy in late summer and early autumn would be followed by a modest slowdown heading into 2024 and that inflation would fall further. Our expectations have largely been met.

On the margin, we have even been positively surprised about just how quickly inflation has fallen, and we have slightly toned down our expectations for future inflation. This is also a key reason why we now expect to see a tad more monetary policy easing in 2024 and 2025 than we did 3-6 months ago. Hence, we now expect 6-7 rate cuts by the Federal Reserve in total through the end of 2025, thus reducing the key policy rate to 3.5% to 3.75% by the end of 2025 from the current 5.25-5.50%

That is a little less than the market currently expects, but we are not much concerned about this disparity. Instead, we are more focused on our growth expectations. We are now looking for roughly 1.5% growth in the US next year followed by growth just shy of 2% in 2025, which is close to the economy's long-term potential. This is some way above consensus and is underlined by our expectation of just a marginal increase in unemployment to approximately 4% by the end of 2025 from the current rate of 3.7%.

Should our expectations pan out, the key question will then be – when will the next recession strike? For, if historically aggressive monetary policy tightening, a bank crisis and international geopolitical uncertainty could not push the US economy into recession, then what would?

This particular question is absolutely the most important to try and answer right now. Naturally, the soft landing is not guaranteed yet. Several things could go wrong in 2024, including political chaos driven by the upcoming US presidential election, or inflation could experience a resurgence due to a commodity price shock, for example.

Nevertheless, we are sticking to the analysis that we have essentially been using since summer 2022 as the basis for the entire debate about a potential imminent recession in the US – namely that the US economy is not experiencing the traditional imbalances that prompt recessions, especially when monetary policy is tightened. Hence, the US has not built too many homes, bought too many cars and discretionary consumer goods, or invested too much in capital goods (using borrowed money). Instead, too few homes have been built, meaning there is perhaps a 3-year shortfall in housing supply, consumer bank balances are healthy and indebtedness relatively low, while corporates have been eminently sensible. This reduces the chances of a recession both right now and in the medium term.

Meanwhile, we see less risk of ▸▸

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consumer price inflation getting stuck far above the Federal Reserve's target as we still estimate that underlying inflation is roughly around 2%, and as the tight labour market has loosened a little, thus reducing wage inflation.

Moreover, if the Federal Reserve can also reduce interest rates moderately in the coming quarters as a result of markedly lower inflation, the risk of a recession should fade further. We would therefore highlight the following: should the US manage to slip through 2024 without a recession, we see an increasing probability that the current expansion will continue well into the latter half of this decade. With significant wiggle room to ease monetary policy, the Federal Reserve can even give growth a nudge should it feel the need – just as Powell admitted at the Fed's watershed rate meeting in December.

Eurozone growth set to pick up – ECB keeps a watchful eye on the labour market

As of Q3 2023, eurozone GDP was around 1% higher than in Q2 2022 (before the energy crisis really kicked off). During the same period, employment rose by roughly 1.6%, while the unemployment rate declined modestly and remains at a historical low of approximately 6.5% here at the end of 2023. Wage growth remains very high. This illustrates the ECB's greatest challenge.

The good news for the ECB is of course that inflation has fallen fast – of late faster than they (and we) had expected. Declining inflation is due to global factors, including supply chains finally normalising and the pronounced shock from commodity prices easing. Should the ECB (and we) be surprised by a further dramatic fall in inflation, the central bank's job would be relatively easy – they could readily commence a (potentially swift) normalisation of monetary policy.

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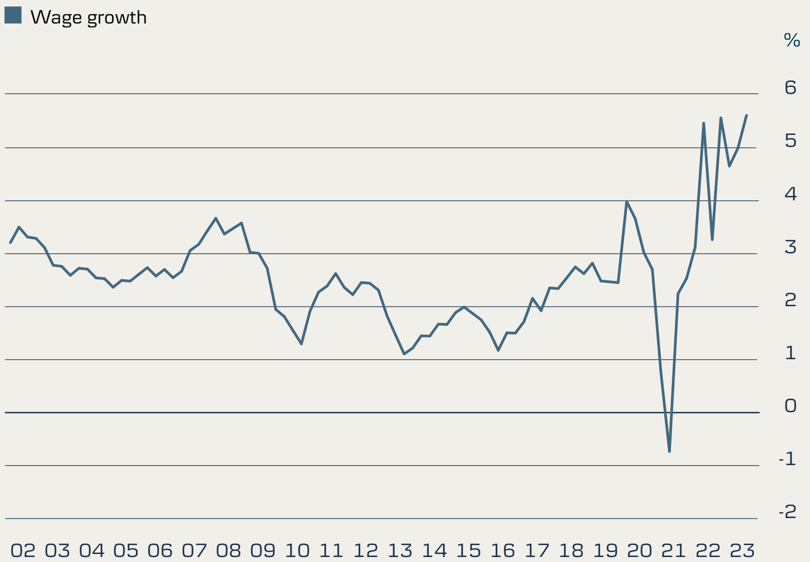
However, if the ECB (and we) are correct, inflation has become stuck slightly above the target of 2%. This means the easy part of getting inflation down is behind us and the ECB needs to engineer a bit more time with growth below trend. As Lagarde noted at the ECB's December meeting, domestic inflation, which is driven by the labour market in particular, is not yet showing any real sign of abating – and the ECB's updated forecasts point to just a modest increase in unemployment over the next two years. Such a scenario requires an extended period of tight monetary policy to ensure the labour market achieves a better balance and that inflation will very probably land on target at 2% a couple of years from now.

That is why Lagarde emphasised they had not yet discussed rate cuts and that H1 2024 will be decisive for when and how fast the ECB can ultimately reduce interest rates. We continue to estimate that growth in the eurozone has bottomed out and will slowly pick up in 2024. This is due to the most important negative growth shocks easing, including the ongoing inventory correction as well as the impact of tighter monetary policy and bank credit policies. Meanwhile, consumer purchasing power is rising again – quite quickly right now – as price inflation is falling steeply while wage inflation remains solid. This is giving the economy a positive shock at a

Eurozone: Annual wage growth

While inflation has fallen in the eurozone, high wage growth remains a challenge for the ECB.



Note: Labour Cost Index: Wages & Salaries.
Sources: Eurostat, Macrobond and Danske Bank Asset Management.

very opportune moment. Pulling in the other direction is the negative growth effect of tighter fiscal policy, which is why we only expect just modest growth in 2024 that is significantly below the economy's normal long-term trend. We do not expect growth to return to trend until some way into 2025.

Our assessment of the economy is that it faces an extended period of sub-trend growth, thus creating a slightly better balance in the labour market. Given this, we also expect inflation to carry on normalising towards 2% by the end of 2025, albeit at a slower pace. If we are correct, the ECB will begin cutting interest rates in Q2 2024, reducing the policy rate to somewhere between 2 & 2.5% by the end of 2025.

Yet, we agree with Lagarde and the ECB – the labour market remains rock solid and risks inflaming the economy if wage growth fails to slow, which is something the ECB does not need and is why the strength of the labour market will be crucial for the ECB (and us) in the first few months of 2024.

Is China plain boring?

China, of course, will never be boring – the country continues to encompass huge opportunities and challenges, so 2024 is also sure to bring a few surprises. Our point, however, is that from a growth perspective, China will likely be quite dull in 2024.

Growth has recently stabilised at around 4%. By normal Chinese standards that is well shy of stellar of course, but in light of the challenges China faces, including an imploding property market and significant stress on bank balance sheets, it is rather impressive from an international perspective.

The reasons are relatively straightforward – the housing market faces long-term challenges from a sharply reduced need for new homes, as fewer and fewer are migrating from the countryside to the cities, and China has been building at a blistering pace for many years now. Chinese authorities are well aware of the structural downturn and will in our opinion do everything in their power to ensure the process is controlled. And indeed, control over the financial system is crucial in this situation. For, while a housing recession similar to what China is going through now would have resulted in a meltdown in many other countries through a dysfunctional banking system and potentially a bank crisis, China has for the past many years been the sole financier of the housing market boom. China's regular (and at times enormous) current account surpluses (i.e. China has been a de facto net exporter of capital) bear witness to this. And as the authorities control the banking system, they can prevent a bank crisis, as no-one can pull the rug out from under the Chinese system.

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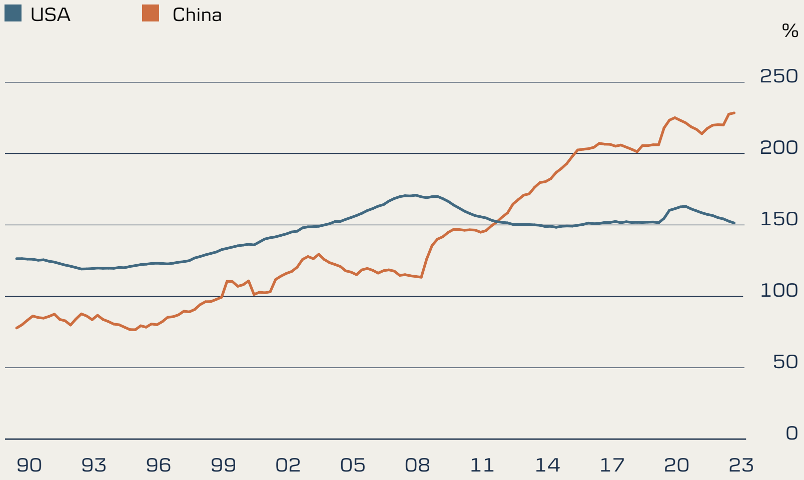
This is why we continue to expect that China will come through this enormous structural change relatively unscathed. On the one hand, the authorities will ease economic policy sufficiently for growth to hover around potential, i.e. 4-5%, for the next couple of years. On the other hand, they will be focused on not easing too much and at the same time continuing to clean up the financial system, something which has essentially been ongoing since 2015. Hence, the growth outlook for China is a tad dull – not too strong, not too weak.

Sounds too good to be true? That is because it won't work forever. ▸▸

Private debt relative to GDP

Whereas China has been experiencing soaring private debt for many years, that is not the case in the US – and the US economy is not suffering from the traditional imbalances that preage recessions, especially when monetary policy is tightened. For example, the US has not built too many homes or bought too many cars and discretionary consumer goods for borrowed money.



Sources: Bank of International Settlements, Macrobond and Danske Bank Asset Management.

Looking further ahead, we are focused on three issues: Geopolitics, long-term growth and currency stability.

The geopolitical situation is not set to get any better for China, quite the reverse in fact. Naturally, that will cast a shadow over all forms of investment in and related to China. Then the focus on stability will cost, of course. China needs reforms to facilitate high productivity growth now that the country has lost a vital growth driver, namely the housing market. In addition, China needs a financial system that can facilitate the investments needed to sustain high productivity growth. Right now – and for some time to come – the focus of the banks will be on ensuring stability, for example in relation to the significant amounts of badly performing debt that will have to be refinanced. This is not conducive to growth – and nor, we expect, is the regime's current treatment of the country's own businesses and citizens. Our conclusion therefore is that China will be struggling to deliver growth significantly above 3% by the end of the decade.

> If China had had a freely floating yuan (CNY) and open international capital accounts, the currency would have weakened massively in recent years. But China cannot and will not allow this to happen.

That leaves our final point of focus. In order to achieve financial stability, the Chinese authorities are pumping massive amounts of liquidity into the system – both to ensure no significant institutions collapse and create financial instability, and also to ensure that the banks can support companies that have an acute need for help. Essentially, this means that broad measures of debt & liquidity in China continue to grow by 10% a year, while nominal growth has averaged around 5% for the past couple of years. In other words, China is printing too much money. And what is the safety valve in normal economic systems in such a situation? The currency!

If China had had a freely floating yuan (CNY) and open international capital accounts, the currency would have weakened massively in recent years. But China cannot and will not allow this to happen. China runs one of the world's most effective systems for keeping domestically generated liquidity in the country via multiple formal and informal capital controls. When this situation might become untenable is immensely difficult to predict, but we can conclude that in the next 10-15 years China will very likely have to choose one of two evils. Either liquidity & debt generation will have to slow to a more appropriate pace, which will probably harm growth or risk increasing financial instability at least for a while. Or, China will have to accept a significant weakening of its currency. The longer China delays this decision, the worse the repercussions will be. Nevertheless, the conclusion is the same – China faces considerable long-term challenges with respect to delivering growth, and so we would stress again that while the cyclical outlook for China, with growth hovering around 4-5%, is perhaps a little dull and maybe even a positive surprise for some, caution is warranted on China's longer-term prospects, and we note that the Middle Kingdom will face some difficult years further down the road.

USA: Expectations for growth. inflation and interest rates

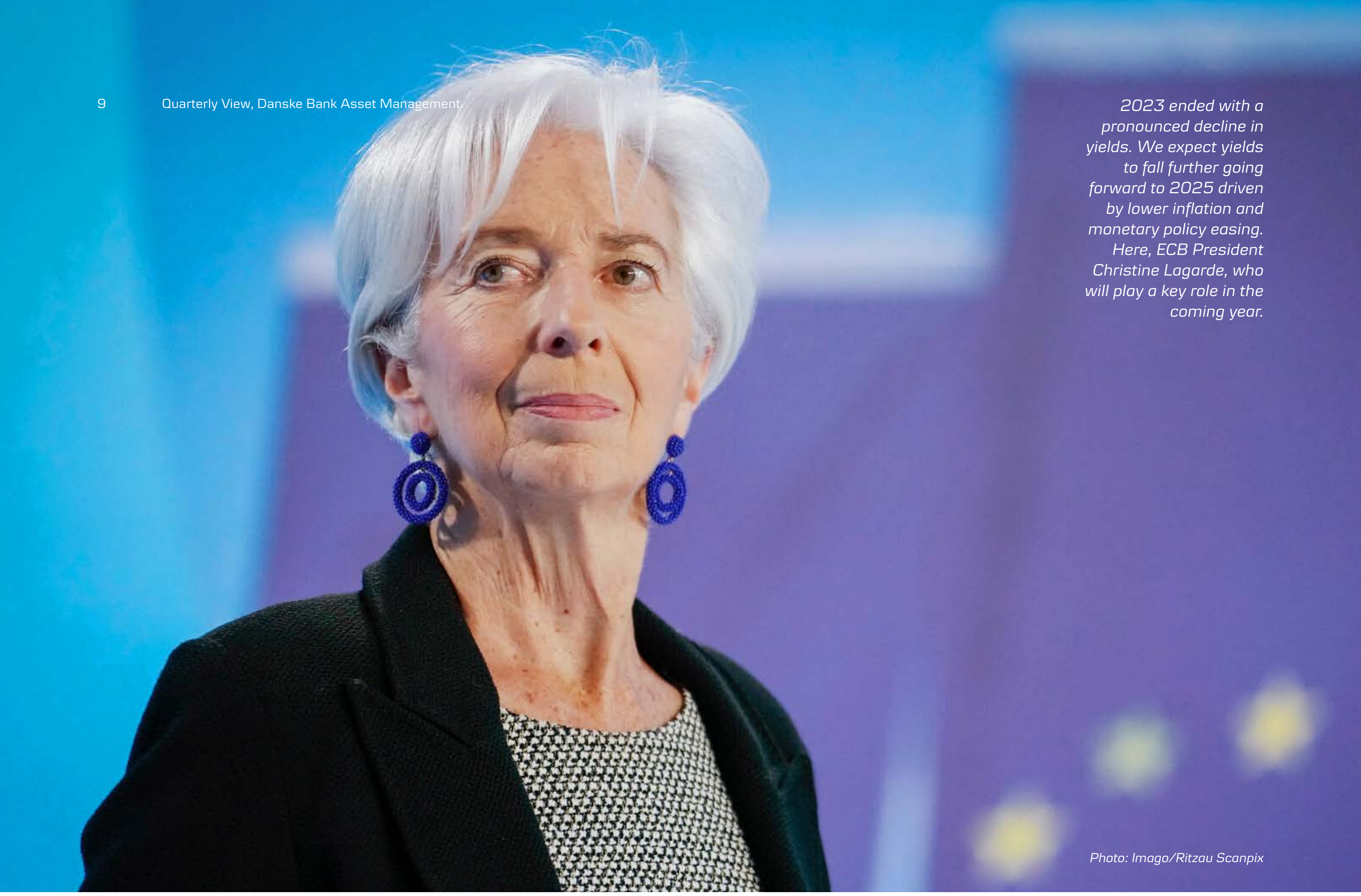
	2022	2023	2024	2025
Expected growth	0.65%	2.61%	1.56%	1.81%
Long-term growth potential	1.87%	1.88%	1.88%	1.88%
Unemployment rate	3.60%	3.81%	3.95%	4.00%
Core inflation (PCE)	4.72%	3.17%	2.22%	2.12%
Federal funds rate	4.38%	5.38%	4.41%	3.60%

NOTE: Projections of growth and inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. Our forecast for the federal funds rate is the expected level of the effective federal funds rate at the end of that particular year.

Euro area: Expectations for growth. inflation and interest rates

	2022	2023	2024	2025
Expected growth	1.86%	0.09%	0.59%	1.14%
Long-term growth potential	1.06%	1.27%	1.31%	1.29%
Core inflation (HICP)	4.97%	3.38%	2.10%	2.03%
ECB depo rate	2.00%	4.00%	2.85%	2.29%

NOTE: Projections of growth are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. Projections of inflation are percent changes from the last month of the previous year to the last month of the year indicated. The ECB depo rate is the expected level for the rate on the ECB's deposit facility at the end of the indicated year.
Source: Danske Bank Asset Management as per 29.09.2023.



2023 ended with a pronounced decline in yields. We expect yields to fall further going forward to 2025 driven by lower inflation and monetary policy easing. Here, ECB President Christine Lagarde, who will play a key role in the coming year.

Photo: Imago/Ritzau Scanpix

EXPECTATIONS GOING FORWARD – THE FINANCIAL MARKETS

Equity boom in full swing – but is it sustainable?

At the start of Q4 2023, we assessed long bond yields to be the key to higher equity prices. We expected a modest decline in yields and returns of 5-10% on global equities over the coming 12 months. We called the direction correctly, but the pace was much faster than we expected. Global equities rose by just shy of 10% during the quarter and long yields fell markedly.

Therefore, the question now is whether long yields are at fair values – and how expensive equities have become. If long yields can fall further against a background of decent global growth, easing inflation and the start of looser monetary policy, we estimate equity prices should rise further. Furthermore, we still stress that global equities risk becoming markedly more expensive if our short-term expectations for the global economy pan out.

EQUITIES:
Given the recent strong increases in both Q4 of 2023 and 2023 as a whole, we now estimate global equity valuations to be extremely expensive, led by US stocks. The recent upsurge in equity prices is of course part of the reason, but our assessment should also be seen against the increase in our expectations for the long-term US yield equilibrium level. In a nutshell, we have raised our discount curve significantly – especially at the long end, where much of the future value in equities resides.

We currently estimate US equity valuations to be 20% too expensive and to offer an ex-ante risk premium markedly below the long-term level that we assess investors require to invest in US equities. Equity valuations in the eurozone are around 10% too expensive. Under normal circumstances, such valuations would be a clear hindrance to future return potential.

However, if our macro expectations are met, global equities could and should be capable of sustaining these valuations for some time yet. In short – given the prospect of a soft landing in 2024 and at least a couple of years of decent economic growth in the US, Europe and China against a backdrop of lower inflation and looser monetary policy, equity markets risk not only becoming more expensive, but potentially historically expensive. At time of writing, we expect a return on US equities of 4-7% in 2024 and on eurozone equities of 6-8%, though we would stress that return could be lower (for example, due to political chaos in the US) or higher (if equity markets react to an ▸▸

economic nirvana and political chaos is avoided).

BONDS:

Bond yields fell sharply towards the end of the year and are again approaching levels we consider fair. Financial markets are now pricing in more easing of monetary policy in the US and the eurozone than we expect, taking short bond yields to levels we view as perhaps a tad too low relative to ultra-short money market rates, which we estimate will remain elevated for some time to come.

Medium-term bond yields in both the eurozone and the US are trading roughly fair or slightly below. Only at the very long end of the curve in the US do we regard yields to still be a little too high. In other words, we continue to see the best risk-adjusted return in very long US duration risk. Common to both German and US yields is that we expect further declines going forward to 2025 driven by lower inflation and monetary policy easing.

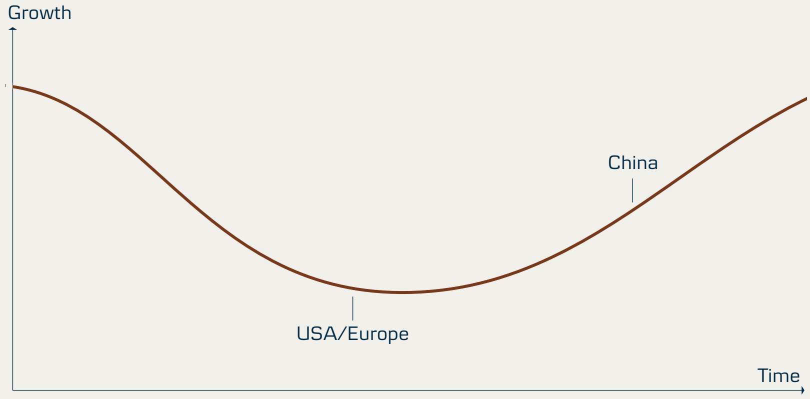
EMERGING MARKETS:

We would again emphasise that there are considerable differences across asset classes in emerging markets. Lower global inflation and looser monetary policy in the US and Europe should lend support to bonds issued by emerging market nations in both local and hard currency.

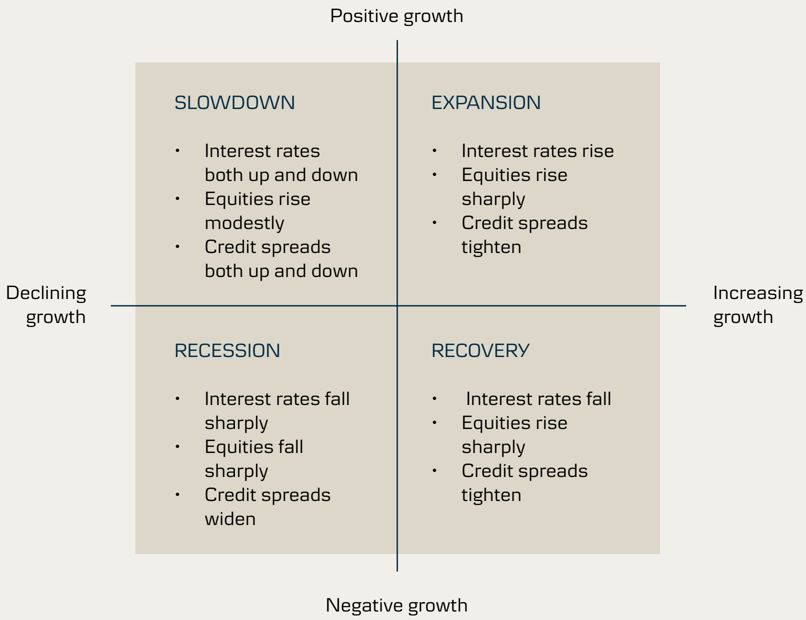
In contrast, we would urge caution on emerging market equities and especially Chinese equities, which continue to account for a large share of the broader emerging market indexes. Even if China is capable of delivering reasonable growth in the next few years and continues to avoid a full-blown crisis, Chinese equities will struggle to deliver the earnings growth required to justify the risk. All in all, we estimate emerging market equity valuations to be around 20% too expensive and we expect just a modest positive return on the asset class in 2024.

Macro barometer: Potential for increasing growth

Growth in China has stabilised. We expect a further modest acceleration driven by slightly higher activity levels in the housing market and higher global growth. US growth has slowed in recent months after a brief burst of speed in late summer and the autumn. Looser monetary policy and an improving housing market could lift growth back to trend. The negative shocks that struck the eurozone in the shape of a pronounced tightening of monetary policy, stricter credit conditions and the energy crisis are easing, while real wage growth is picking up due to lower inflation and a still tight labour market. We expect increasing but still low growth going forward to 2025.



ASSET CLASSES: Typical developments for various asset classes during the four phases of the economic cycle.



Source: Danske Bank Asset Management

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