Investment Clock – Economic Update

Issue #30, February 2024

Multi asset views

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We have six Global Multi Asset Portfolios (GMAPs) across the risk return spectrum with a full tactical asset allocation overlay.

*As at 30 September 2023

This month's contributor

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US: With looser financial conditions, the central case is more a patch of slower growth, rather than recession. Gradual Fed rate cuts are assumed from Q2 2024.

China: I assume the policy response won't be sufficient to significantly lift China's growth rate. Meanwhile, medium-term forces weighing and consumer confidence looks stubbornly low.

Eurozone: Lacklustre growth looks set to continue in H1, but faster than expected falls in inflation have opened the door to rate cuts. Real pay growth should help bolster the consumer.

Japan: Growth looks sluggish, but with CPI strong by Japan standards, I assume a modest rate rise in 2024.

UK: Despite a mild technical recession, I still assume no rate cuts until Q3 given the strong domestic inflation picture.

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(Gradual) rate cuts, lacklustre growth

I am expecting 2024 to be neither a great nor awful year for the global economy. European GDP growth starts the year looking flat to lacklustre and the recent pace of US GDP growth looks unsustainably strong. I have not pencilled in strong growth in major developed economies and expect a weaker patch at some point this year in the US, but I no longer assume even a mild technical recession there. Inflation should fall further this year, with services playing a larger role than before. That should help give central banks the confidence to cut rates, though gradually rather than sharply in the absence of significant recessions. However, there is a fair bit of disagreement among economists about what this year will look like and plenty of risk to central forecasts.

Summary

Lacklustre: The UK and Japan slid into mild technical recession in the second half of 2023. Business surveys in major economies to start this year look consistent with lacklustre growth; mild recession in the euro area and softer growth in the US than recent GDP figures. Given central bank rate hikes and tighter bank lending conditions, it's not surprising that some – especially smaller - businesses would be struggling.

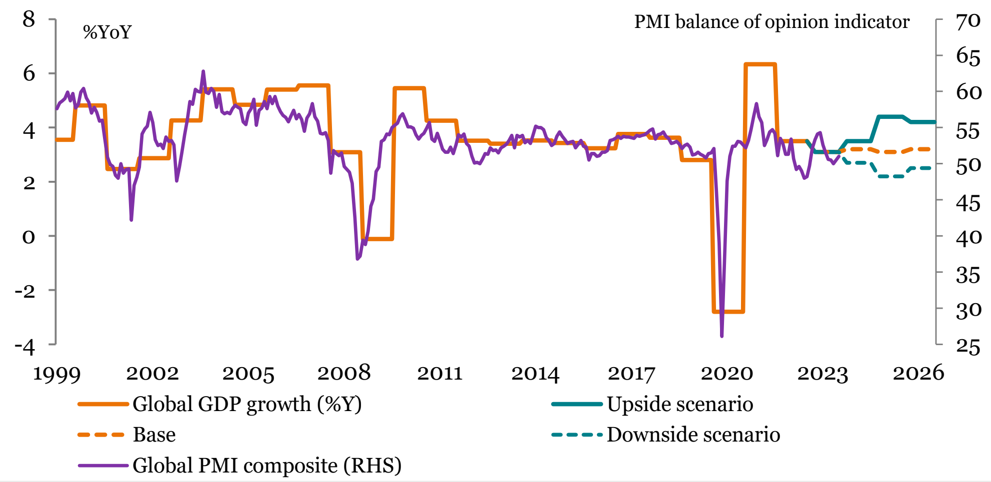
Modest growth ahead: Rate cut expectations have already led to improved business optimism and looser financial market conditions. Lower inflation is also boosting household real pay growth and providing some support for consumers. However, a period of strong growth isn't central case either: Bank lending conditions are tighter than they were a year ago, fiscal policy is set to contribute less to growth and unemployment starts the year at already (still) very low levels.

Inflation's fall not over yet: There are near-term upside risks brewing for headline inflation including from shipping costs and services inflation could still prove stickier than expected. However, services is the segment of inflation that seems likely to play more of a role in lowering headline inflation going forward (though with more downside to come from energy too in the UK).

Gradual rate cuts, with the risk that...they're not: Lacklustre growth (rather than significant recessions) plus lower inflation will likely lead to rate cuts this year and next year. However, without substantial downturns in the economy, progress seems likely to be gradual than sharp. Meanwhile, if we get too strong a growth and labour market picture over the next six months, then predictions of a 'sticky last mile' of inflation could well come to pass, limiting likely central bank rate cuts.

The multi asset team has been positive on equities over 2023 as the macro backdrop proved more resilient than expected. The team has maintained this view into 2024, with the prospect of rate cuts boosting hopes of a recovery in activity. For more, see the team's 'ClockWise' blog at www.rlam.com.

Chart 1: Global growth central case: Lacklustre



Source: IMF, S&P Global (past data); RLAM (forecasts). PMI data is to January 2024

Economic forecast summary

February 2024 base case

Region	2023e GDP growth	2023e CPI end Q4	2023e Policy Rate Q4	2024e GDP growth	2024e CPI end Q4	2024e Policy Rate Q4	2025e GDP growth	2025e CPI end Q4	2025e Policy Rate Q4	2026e GDP growth	2026e CPI end Q4	2026e Policy Rate Q4
US	2.5	3.2	5.50	2.0 *0.7*	2.8 *2.7*	4.75 *5.00*	1.6 *1.3*	2.3 *2.3*	3.50 *4.00*	2.2	2.2	3.25
China	5.2	– *–*	– *–*	4.9 *4.4*	– *–*	– *–*	4.5 *4.4*	– *–*	– *–*	4.3	–	–
UK	0.1	4.2	5.25	0.1 *0.3*	2.5 *2.7*	4.75 *5.00*	1.2 *1.1*	2.3 *2.6*	4.00 *4.50*	1.4	2.1	3.50
Euro area	0.5	2.7	4.50	0.3 *0.5*	2.2 *2.5*	3.75 *3.75*	1.4 *1.4*	2.3 *2.3*	2.75 *3.00*	1.2	2.1	2.50
Japan	1.9	2.9	-0.10	0.4 *1.2*	1.7 *1.6*	0.00 *0.00*	1.0 *1.0*	1.6 *1.5*	0.00 *0.00*	0.8	1.6	0.00
Global	3.1	– *–*	– *–*	3.2 *2.8*	– *–*	– *–*	3.1 *3.1*	– *–*	– *–*	3.2	–	–

Source: LSEG DataStream, national statistics offices, Bloomberg Finance L.P. for past actual data. All forecasts (e) are RLAM. Current data and forecasts are in black. Forecasts from the October 2023 forecast update are grey and in italics. Some of the 2023 figures are now past actuals. Note: US policy rate is the upper end of the Fed Funds target range. Euro area policy rate is the refi rate.

Key economic policy forecasts

- With taming inflation still the priority for central banks and with inflation now substantially lower, the central case is that peak rates have been reached (except in Japan) and that rate cuts will be triggered in 2024 starting in Q2 in the US and euro area and around the middle of the year in the UK, and at a roughly 25bps a quarter pace as central banks 'feel their way' amid significant uncertainty over the outlook and in the absence of more than mild technical recessions. In Japan, the forecasts assume that 2024 sees a rate hike (finally) from the Bank of Japan with further reform of yield curve control.
- Sharper than expected downturns and more unemployment would likely see further and faster cuts than in the base case (partly by sharply increasing concerns around over-tightening). Higher than expected inflation, particularly pay growth, could mean rate cuts come later and less sharply than expected.
- Fiscal policy is generally expected to become less supportive over the forecast. However, sharp spending cuts are not in the central case, partly as assumed spending to tackle longer-term challenges (e.g. climate change) steps up.

Global economic scenarios (Chart 1)

Upside scenario (20% probability): Growth picks up sharply

- Headline inflation falls more than expected, driven by lower core goods prices, exported deflation from China and a lack of further energy or food driven supply shocks. Higher labour market participation and productivity than in the base case help restrain services inflation.
- Consumer spending is much higher than in the base case, boosted by stronger real pay growth than in the base case. Labour markets remain very tight.
- Central banks prove less willing to cut rates and more inclined to keep rates high for longer as both pay growth and services inflation remain higher than pre-crisis norms.

Base case (60%): Lacklustre growth, lower inflation and lower rates

- 2024 sees relatively lacklustre GDP growth but with some improvement in the later part of the year. Bank lending conditions remain relatively tight well into 2024 and the lags of monetary policy are a bit longer than usual. Moving into the second half of 2024 and into 2025, consumer spending is likely to be supported by lower headline inflation alongside still relatively robust wage growth.
- Inflation falls further at headline level. Domestically driven inflation pressures ease somewhat through 2024. Gradual rate cuts follow.

Downside scenario (20%): Lagged impacts of rate hikes stronger than expected

- Monetary policy tightening in the developed world has a lagged, but much stronger than expected impact on economies. Growth is lower and unemployment higher than in the central case.
- Inflation falls, with differences against the base case driven more by services and measures of underlying inflation than in the upside scenario.
- Rate cuts are more rapid and go further than in the central case. Interest rates, though lower than in the central case, do not fully return to pre-pandemic levels in most developed economies.

Probabilities are subjective and indicative such that we'd broadly see a 20% chance that the economy performs in line with/better than the upside case and a 20% probability that the economy performs in line with/worse than the downside case.

Global economy: Lacklustre

I expect sluggish growth in major economies in 2024 with enough cooling in economies to help guide inflation sustainably lower. That backdrop should see central banks engage in gradual rate cuts in 2024. These could be faster if we get more than mild technical recessions or wage growth is much weaker than assumed and/or global pressures on inflation lean much more to the downside than expected. 2024 risks for global inflation forecasts look mixed, but there are plenty of upside risks given geopolitics, trade disruptions and climate/weather factors. Risks to the outlook for activity growth look two-way with various cross-currents pulling economies in different directions. The effect of central bank policy tightening is still feeding through and fiscal policy seems set to be less supportive or a drag on growth in a number of places in 2024 and 2025. However, financial conditions have eased from their peak as markets anticipate rate cuts, and business confidence has picked up. Lower inflation is already helping to support household real income growth.

Status update: Global economy looking lacklustre

Using the global composite PMI business survey as a proxy for global GDP growth (Chart 2), suggest that, at the turn of the year, global growth is lacklustre. As of January 2024 there had been a pick-up in PMIs, suggesting improving private sector activity growth and business optimism had perked up too – likely helped by growing expectations of rate cuts. Lower inflation (Chart 3) has also likely helped (and bolstered those rate cut expectations). Although threatened somewhat by higher costs of trade with issues around the Panama Canal (drought/climate-related) and Suez Canal (attacks on vessels in the Red Sea), headline inflation fell substantially over 2023.

Summary outlook: Subdued growth, lower inflation…and gradual rate cuts

The forecasts on page 2 show lacklustre growth, largely reflecting the lagged effects of monetary policy tightening, but fewer than before and some might only emerge after back revisions. After downside inflation surprises and upside growth surprises, I am forecasting weaker inflation than before in 2024 and, in the US, stronger growth. With a convincing inflation decline to date, I assume that some central banks start to feel more comfortable cutting rates in coming months. However, stronger-than-expected recent activity data and insufficient progress being made so far in subduing domestically driven inflation means that rate cuts are unlikely to be quite as sharp or as soon as markets expect.

There are two-way risks to the outlook. Economists disagree on the lags of monetary policy and on the likely impact this year of fiscal policy. Forecasters differ too on how much reassurance on inflation central banks will need before cutting rates. There are differing views on how far labour supply is constrained in the medium term and therefore how far potential growth is going to be held back and whether labour markets stay tight. Things may not follow a neat historical pattern. The effects of Covid are still reverberating through economies. We've had huge fiscal and monetary policy changes over the last three years to absorb. Against all that there are several important structural shifts underway including ageing populations (Chart 21), AI and the impact of climate change. The multi asset team have continued to argue that inflation may prove a lot more volatile than generally was the case over the last couple of decades. Geopolitical and climate-related shocks or much faster than expected AI development could result in substantial two-way price shocks.

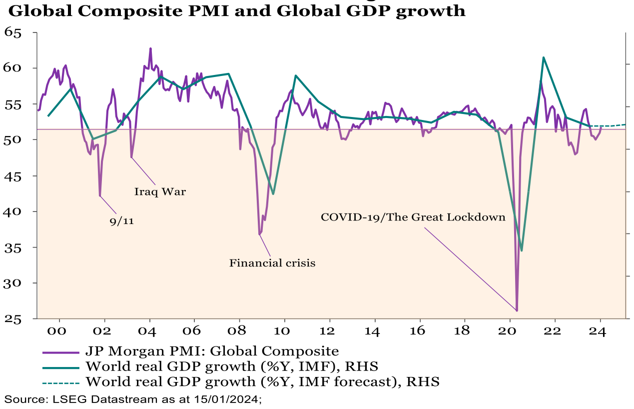
Lower inflation doesn't need big recessions

Inflation has already fallen sustainably, and is likely to fall further, without the need for marked recessions: First, core inflation tends to follow energy/food inflation lower with a lag (Chart 4) and lower headline inflation is likely to feed through to well-behaved inflation expectations and lower wage growth; Second, the labour market looks less tight than it did (e.g. falling vacancies in the likes of the US and UK, Chart 5) despite low unemployment rates. Participation rates have recovered significantly in a number of places (Chart 6). That should help keep a lid on wage pressure. Meanwhile, lower inflation should help economies avoid recessions. Lower inflation in turn is already bringing higher household real income growth (Chart 7), supporting consumer spending, and is likely to bring rate cuts this year, helping support business and consumer confidence.

The risk of a more serious slump

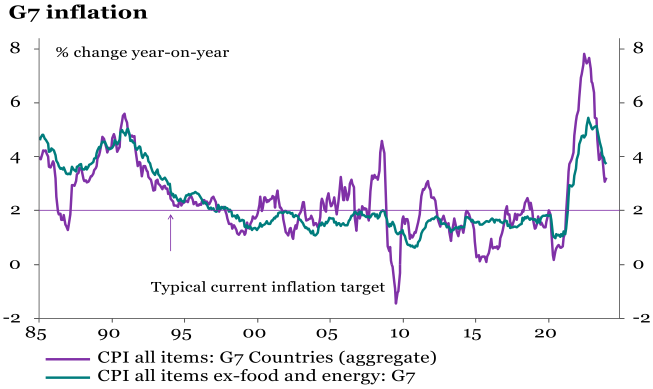
It remains plausible that central banks have already done *more* than enough. The UK economy is in (mild) technical recession and the euro area close. Banks have reduced credit availability (Chart 8). With a lag, businesses and consumers may still prove more sensitive to higher interest rates than most economists assume. 'Excess savings' built up during the pandemic have been seriously depleted, especially in real terms (Chart 9). Housing and construction activity data continue to look weak in a number of economies and arrears and corporate insolvencies have picked up. Even if big companies have termed out their debt and can access credit in the corporate bond market, the picture can look very different for small businesses who are relatively more reliant on bank funding and refinancing of debt will often be taking place at higher interest rates. If rate hikes have taken longer than expected to hit economies, then sharp rate cuts in response to a shock may not work quickly enough to avoid serious downturns either.

Chart 2: Global PMI: Lacklustre growth



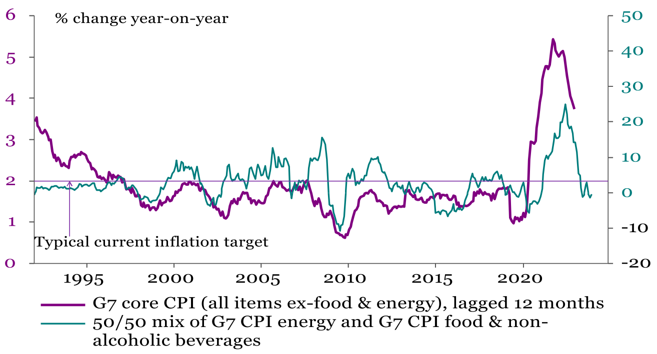
Source: LSEG Datastream, S&P Global as at January 2024. IMF forecasts from January 2024 update.

Chart 3: (Much) lower headline and core inflation



Source: LSEG Datastream, OECD. Data as at December 2023

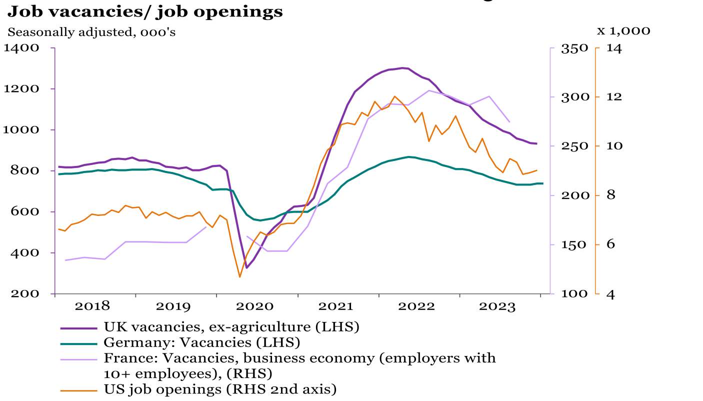
Chart 4: Core inflation tends to follow energy/food



Source: LSEG Datastream as at 15/12/2023;

Source: LSEG Datastream, OECD. Data as at December 2023

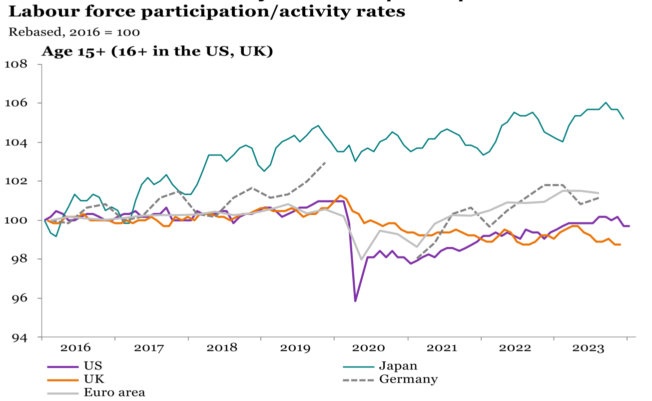
Chart 5: Job vacancies are well off their highs



Source: LSEG Datastream as at 15/12/2023;

Source: LSEG Datastream, ONS, Deutsche Bundesbank, Eurostat, BLS. UK data to December 2023, France data to Q3 2023, US job openings data to December 2023; Germany data to January 2024

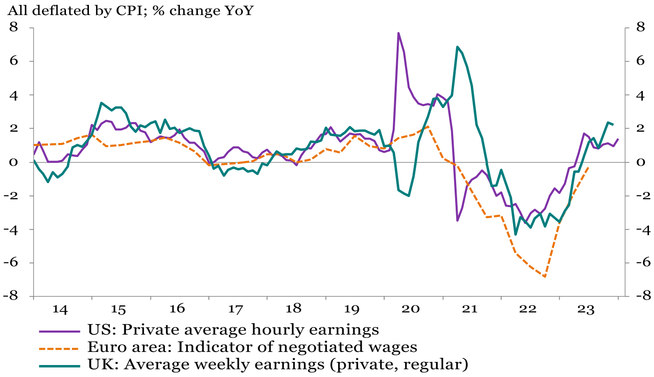
Chart 6: Some recovery in labour participation



Source: LSEG Datastream as at 15/01/2024

Source: LSEG Datastream, BLS, Japan Ministry of Internal Affairs and Communications, ONS, Eurostat, OECD. Euro area figures to Q3 2023, US to January 2024, UK to November, Japan to December

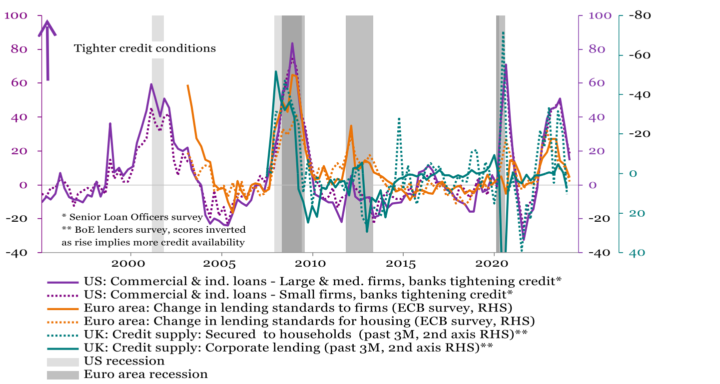
Chart 7: Household real pay growth improves



Source: LSEG Datastream as at 15/01/2024

Source: LSEG Datastream, BLS, ONS, ECB, Eurostat. Data is to January 2024 (US), December 2023 (UK), Q3 2023 (euro area).

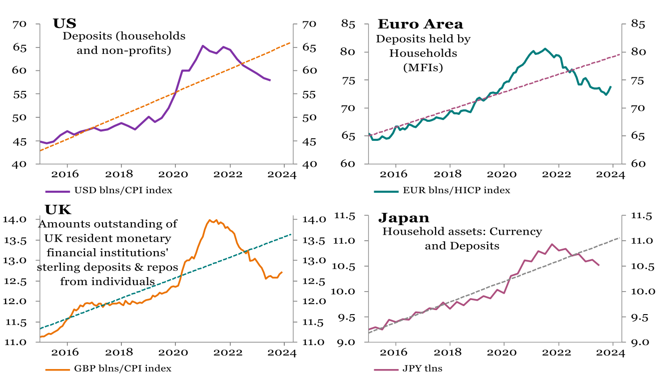
Chart 8: Banks have tightened credit conditions



Source: LSEG Datastream as at 15/02/2024

Source: LSEG Datastream, Federal Reserve, ECB, BoE. Data to Q4 2023 (UK); Q1 2024 (Euro area, US).

Chart 9: Excess savings depleted in real terms



Source: LSEG Datastream as at 30/09/2023

Source: LSEG Datastream, Federal Reserve, BLS, ECB, Eurostat, BoE, ONS, BoJ Ministry of Internal Affairs and Communication. Data to December 2023 (UK, Euro area) and Q3 2023 (US, Japan)

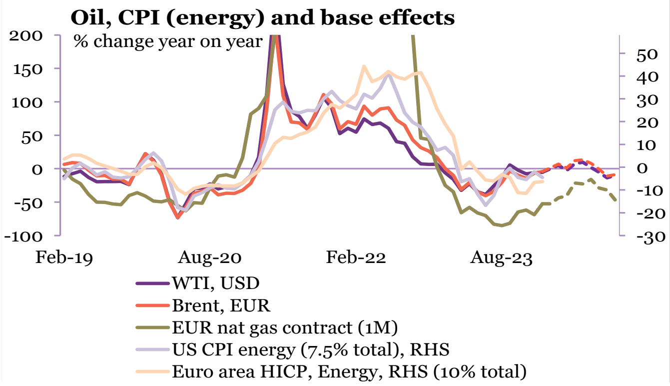
Inflation #1: Externally driven disinflation – not quite done

We have likely seen most of the downside pressure that we are going to get from external/global factors. The energy components of CPIs are sensitive to where energy prices go from here, but base effects (what would happen to energy inflation if oil and gas prices stayed where they are) look on track to push up on euro area and US inflation in coming months if anything (Chart 10). Meanwhile, focusing on goods inflation, the global PMI indicators for manufacturing output and input prices appear to have stalled in their downward progress and at levels above 50 (indicating rising prices). The falls we had seen in manufacturing input price indicators now mostly seem to have fed through into goods prices in the US.

However, in the euro area where goods prices have a good relationship with consumer goods import prices, the decline of core goods price inflation arguably looks not much more than halfway through (Chart 11). More generally, past falls in energy and food inflation likely still have further to feed-through into lower core CPI inflation (Chart 4) with energy and food key inputs for many goods and services too.

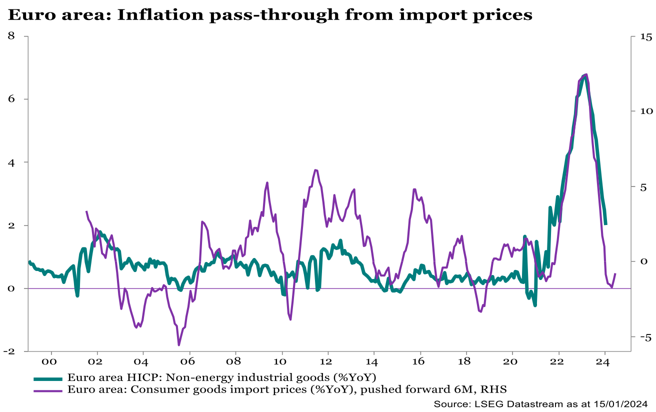
External risks to the inflation outlook include commodity prices/shipping costs as geopolitical tensions rise and fall; weather/climate affecting food prices in particular; tariff changes.

Chart 10: Oil base effects – not dampening inflation any more



Source: LSEG Datastream, BLS, Eurostat, RLAM. Chart shows path for commodity price inflation if levels remain at spot rates as of 14th February 2023. CPI data as of January 2024

Chart 11: Euro area: Import prices signal lower CPI goods



Source: LSEG Datastream, Eurostat. Data as of January 2024

Inflation #2: Domestically driven inflation: The maybe not so sticky 'last mile'

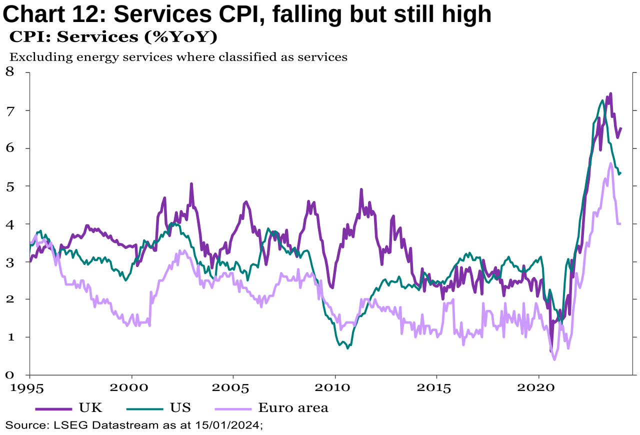
The most domestically-driven bits of inflation haven't slowed as much, but have cooled. In the US, euro area and UK, services inflation is well off the highs though remains strong (Chart 12). US month-on-month trends in core services inflation look more inflation-target consistent than they did. US pay growth trends are also relatively reassuring in that sense (Chart 13). European pay growth still looks too strong for central bank comfort, though has cooled at least in the UK where firms also expect to increase pay less than last year.

The forecasts assume a significant further fall in services inflation: Lower food and energy inflation should feed through to lower services inflation too with energy prices a key input. Lower headline inflation should also help moderate inflation expectations as well as wage demands/settlements. More labour market slack alongside lacklustre economic growth should help too.

Inflation summary view: Going down, with two-way risk

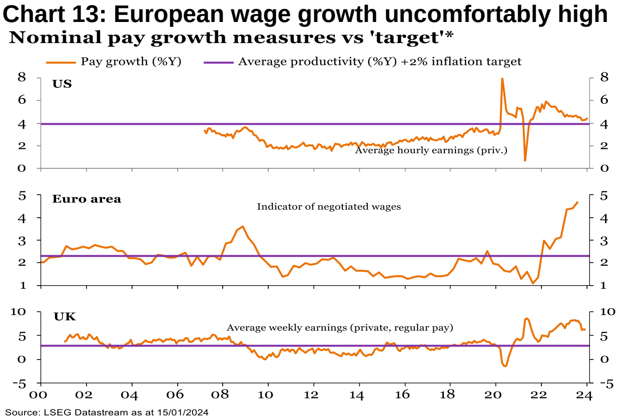
With a bit more downside pressure likely still to come on core goods price inflation – especially in Europe and a few factors likely to push services inflation down further, inflation looks likely to fall further again this year (Chart 14).

Chart 12: Services CPI, falling but still high



Source: LSEG DataStream, ONS, BLS, Eurostat as at January 2024

Chart 13: European wage growth uncomfortably high



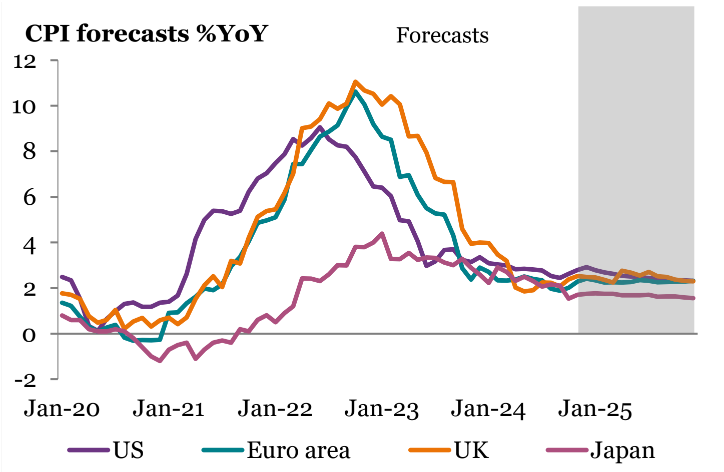
Source: LSEG Datastream, RLAM, BLS, ECB, ONS. Pay data to January 2024 (US), Q3 2023 (Euro area) and December 2023 (UK). *Productivity measures used are output per hour (US), Total economy labour productivity (euro area), Whole economy output per worker (UK) and series are averaged from 2000.

Risks are two-way though, from the impact of geopolitical risk on shipping costs, to stronger than expected pay growth against a continued backdrop of low unemployment.

Two-way medium-term risk (ageing vs AI): Potential medium-term risks to the upside of the forecast include ageing populations via channels such as: lowering labour supply relative to demand; increased bargaining power of labour; and potentially higher fiscal deficits to fund increased age-related spending demands. Climate change and associated transition costs also seem likely to lead to recurrent upside pressures (see Why you can't forecast inflation without considering climate change, January 2023).

On the downside, AI promises transformative effects on the labour market that seem likely to prove deflationary. AI may prove productivity enhancing for existing workers. In more disruptive scenarios it could also make some categories of work redundant and see wage compensation fall to the cost of the technology (see, for example, work by Anton Korinek).

Chart 14: Central inflation forecast



Source: Past data: LSEG DataStream, BLS, Eurostat, ONS, Japan Ministry of Internal Affairs and Communications. Forecasts are RLAM, consistent with forecasts on page 2

Central bank policy outlook: Cuts…soon(ish)

Central case – peaked, with cuts after a few months: Having hiked a lot (Chart 15) policymakers (ex-BoJ) have increasingly signalled that the next move will be a cut. Inflation has fallen a lot, lowering the risks of central banks missing their inflation targets on a sustained basis. Global activity data suggests that economies are only growing at a modest pace in general with plenty of signs that tighter monetary policy has had a dampening effect on at least some areas of economic activity. That combination of slower headline inflation and growth should give central banks the confidence to cut rates in coming months. In the central case though, 2024 rate cuts are about central banks cautiously starting to move policy to slightly less tight settings as inflation and inflation pressures ease, not responding sharply to big recessions.

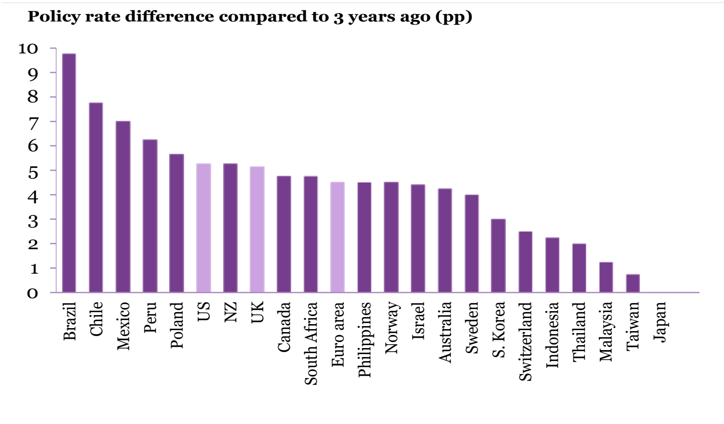
Reaction functions and data dependency: I have rate cuts as more of a 'mid' than early 2024 story. The later the first cuts though, the larger these could turn out to be. With several big cyclical and structural cross currents to contend with and having been through such an unusual and extreme economic episode in the shape of the pandemic, it is understandable that central banks say they will be data dependent. That does not mean that they won't use forecasts for the economy and inflation as a basis for decision-making, but they seem to want strong evidential backing for a decision to cut rates based on more than a central case forecast. That evidence will take a bit longer to accumulate. It will remain important to watch measures of domestically-driven inflation pressure particularly closely – particularly evidence of labour market slack, pay growth and settlements figures and services/core services inflation. As they were reluctant to abandon the 'transitory' label for inflation on the way up they may prove reluctant to revive it on the way down with policymakers keenly aware of the risk that domestically driven inflation proves sticky. With some of the activity and inflation data stronger than expected, it is also hard to *completely* rule out a further rate hike in the US (though that certainly wouldn't be my central case).

R* - in vogue, but not very helpful…: While there were plenty of discussions around R* or neutral rates doing the rounds last year, they remain unobservable and easy to disagree on. My estimates of a medium-term nominal equilibrium/neutral interest rate (r* plus the inflation target) are currently (only) around 3.00% in the UK, 2.75% in the US and 2.25% in the euro area, arrived at by averaging several different methodologies/sources rather than taking any one approach as the 'gold standard'. That acts as an anchor-point in my forecasts for the kinds of declines in policy rate we can expect over the next two to three years in a central case, but should be taken as being subject to a lot of uncertainty.

Fiscal policy: Different stories for different places

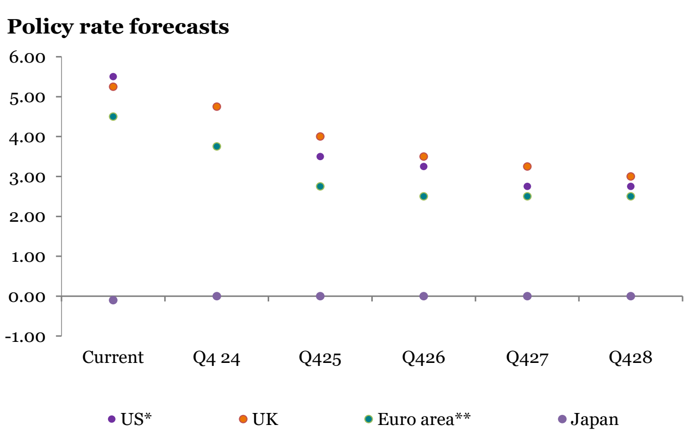
Fiscal support looks set to be a bit of a differentiator in 2024. China continues to look likely to add some further stimulus. In the US, the combination of the Inflation Reduction Act and CHIPS act looks to have had a significant impact on the US economy, but the incremental impact on investment seems likely to fade. Disbursements are ongoing in the EU under the NextGeneration programme, but fiscal policy looks set to be something of a drag overall (Chart 17). In general fiscal policy looks set to drag on/less of a boost to growth somewhat across several major developed economies. Relatively high debt levels (with associated significant debt service costs), see Chart 18, combined with substantial demographic challenges (Chart 19) continue to somewhat restrain governments' fiscal room for manoeuvre.

Chart 15: Central banks hiked a lot



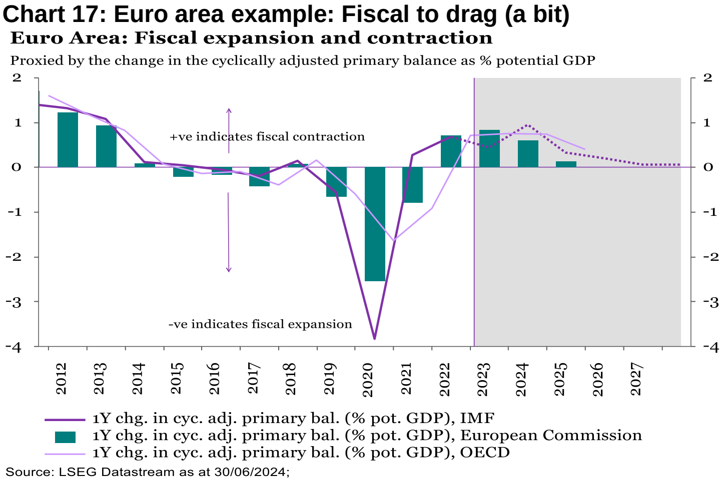
Source: Bloomberg Finance L.P. Data to 30th January 2024

Chart 16: Rate cuts



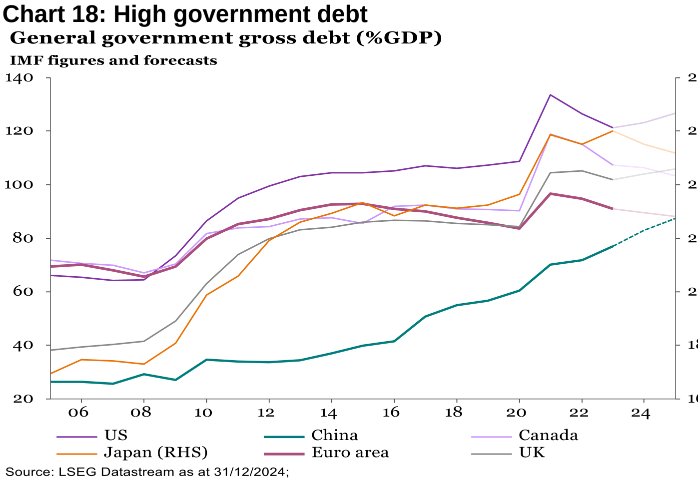
Source: National central banks/LSEG DataStream (past actuals). All forecasts (from Q4 2024 onwards) are RLAM estimates.

Chart 17: Euro area example: Fiscal to drag (a bit)



Source: LSEG Datastream, IMF (October 2023); EU Commission (as of November 2023) and OECD (December 2023)

Chart 18: High government debt



Source: LSEG Datastream, IMF as of October 2023

Fiscal sustainability could become more of a focus for some developed economies. Lacklustre economic growth, relatively high debt service payments (compared to pre-pandemic) alongside upcoming tax and spending challenges relating to demographics (and even the potentially disruptive power of AI on the labour market and income tax revenue) could all help shift the focus back onto this theme. 2024 is an election year in a number of places which could increase or lessen the likelihood of market concern. So far, fiscal policy does not look set to be the centre of political campaigning in the US for example but could be more of a focus in the UK (see, for example, FT: UK chancellor signals he wants more tax cuts before election, 19th January 2024).

Politics: 2024 is an election year (in so many places)

The Economist have calculated that 2024 will be the biggest election year in history – more people will vote in 2024 than in any previous year. Into and through 2024, beyond the US election, elections are expected in the UK (PM Sunak has said his working assumption is than a general election will be held in the second half of 2024) and potentially in Japan too (Upper House and Lower House elections are set for 2025, but a snap election could be called before then). The EU (European parliament) also hold elections.

Elections always have the potential to bring about economic (and other) policy change. As a central case, however, 2024 elections are not assumed to be potential triggers for major economic policy changes in 2024 at least. Risks for 2025 will be easier to assess once campaigns (especially in the US) get fully underway.

Immigration and potential growth

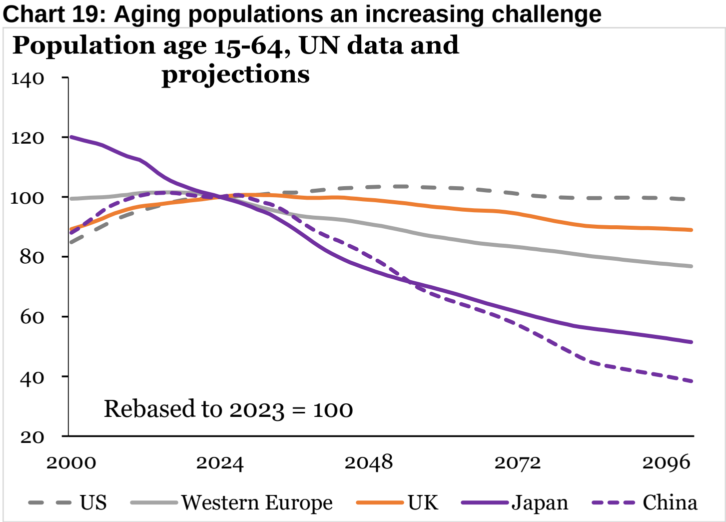
Immigration is economically important but difficult to predict. Economists sometimes predict – in broad brush terms – that developed economies will see more of it; It is sometimes seen as necessary to offset challenges being imposed on economies via ageing demographics (immigration can increase labour supply – though also increase demand – and bringing in more tax revenue) and reflecting pressures on certain regions from climate change. But immigration, despite being largely controllable by governments is difficult to predict. It can be – and has been – strongly affected by events (wars etc). Underlying demand may be largely driven by domestic economies themselves, but governments exert substantial control via policy and such policies can change quickly.

Medium-to longer term, unless immigration jumps or labour productivity moves significantly above the rates we've seen in recent years, potential growth looks set to continue on a slowing path in many economies. The chances of some form of productivity miracle have improved with developments in AI, but so have the risks of substantial disruption to patterns of work (and, by extension, pay growth and tax revenues). The forecasts on page 2 assume relatively low or slowing potential growth rates across the economies forecast and do not assume that developed economies try to address these issues by greatly increasing work-related immigration.

Climate and the economy: El Nino plus climate change spell trouble for food prices

According to weather specialists, it looks like we now have a 'strong' El Nino effect that may last through to April 2024, with the effect on prices still coming through after that time (see, for example, work done by the ECB). Large El Nino events make different parts of the world more likely to experience extreme heat, high rainfall and cold winters. Effects are likely to reverberate beyond food prices and interact with existing issues, e.g. climate change more broadly and droughts already affecting production and trade in some parts of the world (for, example, reduced traffic through the Panama Canal). The impact on global food prices in 2024 (into 2025) seems likely to be worse the more protectionist countries' responses are.

Chart 19: Aging populations an increasing challenge



Source: LSEG Datastream, UN 2022 population projections

United States: Robust-ish

Challenges include the lagged effects of monetary policy tightening, less of a boost from fiscal policy and the sluggish growth of some of the US' major trade partners. Some recession warning indicators are still flashing, but fewer and not as strongly. Meanwhile, GDP growth has been strong, the real pay growth backdrop has improved and financial conditions have loosened. Policymakers want more reassurance on the domestic inflation picture before cutting, but I assume that point is reached in Q2 (with a risk that it isn't).

Status update: Somewhat reassuring…

Real GDP growth was very strong in Q3 and robust in Q4. ISM and PMI business surveys, however, have looked consistent with more sluggish activity growth than the official data for a while (Chart 21). Housing-related activity remain mostly subdued. Overall, however, this continues to look like an economy that is not falling into recession, not least given strong non-farm payroll gains over the turn of the year. Meanwhile, inflation data has sent *some* reassuring signals to the Fed. In particular, between June 2023 and January 2024, the core PCE deflator was 0.2%M or below in every month bar one (where the PCE deflator at 2.0% year-on-year is the Fed's official target).

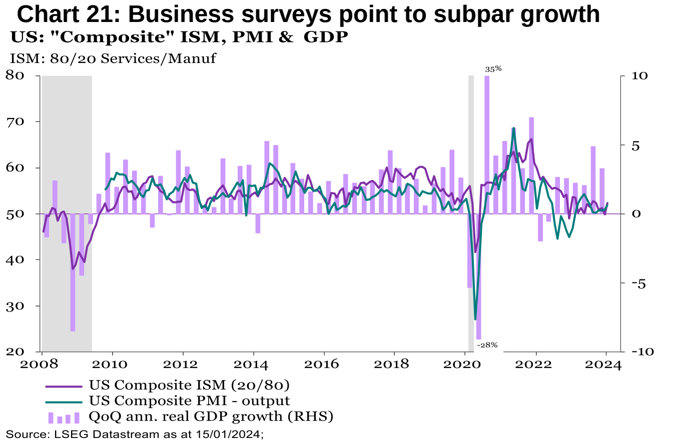
…though still some risk of (mild) recession

Bank lending conditions continue tighten (Chart 22) and banks are important for the financing of small businesses in particular. Many households and firms will have been shielded from the impact of higher interest rates having termed out their debt and financial conditions have loosened somewhat on lower bond yields. Real disposable income growth remains positive for now (Chart 23) helped by lower inflation. 2024 doesn't look likely to see a sharp recession or a booming economy. The central case is a year of subpar GDP growth, but where it is lower inflation rather than an economic downturn that opens the door for rate cuts. The US election in late 2024 may well bring about a change in US president, but that shouldn't have substantial implications for growth in 2024 and the impact on 2025 is difficult to pre-judge this far ahead. The forecasts no longer pencil in a technical recession in the US, but they do assume that a patch of slower GDP growth is still to come in 2024. Risks to that forecast look more on the upside than downside for now though.

Rate cuts gradual unless recession hits…with the chance of further delay

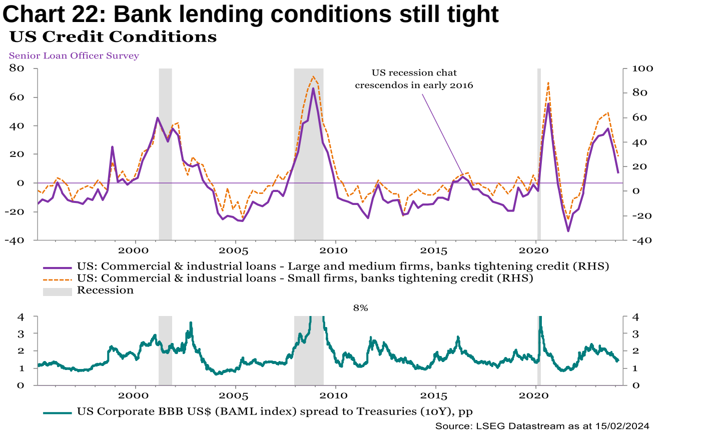
The US central bank has a dual mandate, but with the full employment goal still looking broadly met, its focus remains on the inflation part of the mandate…unless a substantial recession knocks the labour market entirely off course. Falls in payrolls and a more substantial rise in the unemployment rate would see the Fed cut rates more strongly than in the base case. In the absence of that, the pace will likely be determined by the level of confidence FOMC participants have in the US sustainably tracking a 2% inflation target. The domestically driven bit of US inflation continues to paint a more reassuring picture than in the UK, for example, but recent CPI data hasn't been entirely reassuring. In my central case, the Fed experience enough months of inflation-target-consistent core/super-core inflation (Chart 24), especially on the PCE measure, that they start gradually reducing rates from Q2. The forecasts assume a 25bps a quarter pace which would be roughly in line with FOMC participants' December projections. If GDP growth and jobs growth continues as is and the domestically driven inflation picture looks more mixed than soft, there is a decent probability the Fed will delay rate cuts further.

Chart 21: Business surveys point to subpar growth



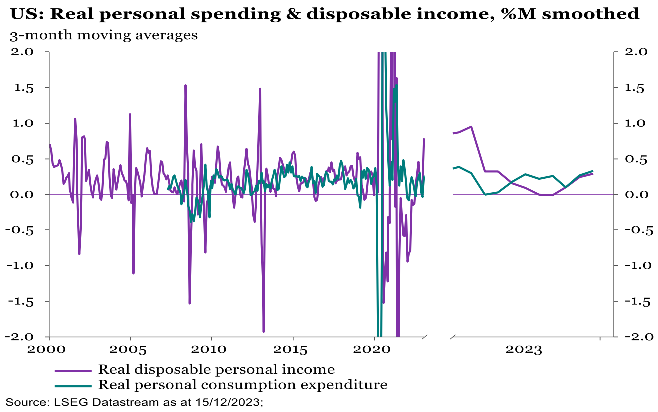
Source: LSEG Datastream, BEA, S&P Global, ISM. Data to Q4 2023 (GDP), January 2024 (PMIs, ISMs)

Chart 22: Bank lending conditions still tight



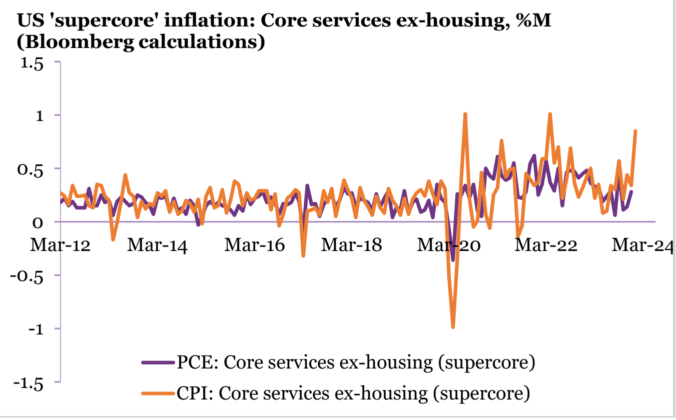
Source: LSEG Datastream, Federal Reserve, BAML. Senior Loan Officer survey data is for Q1 2024; Corporate bond spread figures are to 1st February 2024

Chart 23: Positive real income growth



Source: LSEG DataStream, BEA. Data to December 2023

Chart 24: Super-core inflation – very mixed



Source: LSEG Datastream, Bloomberg Finance L.P. as at December 2023 (PCE), January 2024 (CPI)

China: Mixed picture

China's economic data has remained mixed, while policymakers continue to provide support. There is still a question mark though around whether the policy response will be sufficient to really lift China's growth rate. China's drip feed of supportive policy measures is looking more substantial and incoming data has become mixed rather than universally disappointing. Still, there are medium-term forces weighing and my GDP growth forecast (page 2), though a bit stronger than previously for 2024, continues to slip in subsequent years.

Status update: A tendency to disappoint

China GDP growth picked up in Q3 on a quarter-on-quarter basis, slowing in Q4. 'Hard data' have been mixed versus expectations, with retail sales growth in particular disappointing towards the end of 2023. Meanwhile, CPI *de*flation adds to the impression of an economy struggling on the domestic demand front. Business survey data, by the turn of the year pointed to somewhat sluggish but positive activity growth. The January NBS PMI business survey composite came in at 50.9, consistent with flattish private sector activity growth. The Caixin business survey looked stronger though.

Confidence game?

Consumer OK? China's consumer spending picture looks in a better state than it was. Retail sales growth picked up year-on-year over much of the second half of 2023 (Chart 25). Domestic tourism-related figures look a lot stronger than they were. Consumer confidence (Chart 26), however, remains very weak and well below pre-pandemic levels and with a flattish rather than improving trend. Likely tied to that, activity in the primary property market sales growth still looks weak. There is likely some confluence of short-term cyclical and more structural factors playing a role in this mixed picture. Further policy measures would still be welcome.

Property still in focus: Low consumer confidence is likely being partly fed by problems in China's property sector and falls in house prices, but also the broader changes in policy backdrop seen over the past year or so – somewhat away from economic goals and towards a national security focus, alongside market volatility. If policy easing continues to fail to solve China's property problems and to significantly lift the overall growth rate, that lack of confidence may persist and with it a reluctance to run down savings and boost consumer spending. A buoyant property sector has been a key feature of China's economy, feeding into local government revenues with potential further dampening effects on the economy.

Deflation: China's year-on-year CPI inflation remains very low, moving into deflationary territory in the second half of 2023. PPI inflation is also negative. Food prices have played a role, but core inflation has remained below 1% year-on-year and likely partly reflects the demand backdrop. A deflationary backdrop in China remains helpful to developed economies still dealing with high inflation rates to the extent that low inflation is exported. It also continues to imply 'room' for (and the necessity of) monetary policy easing.

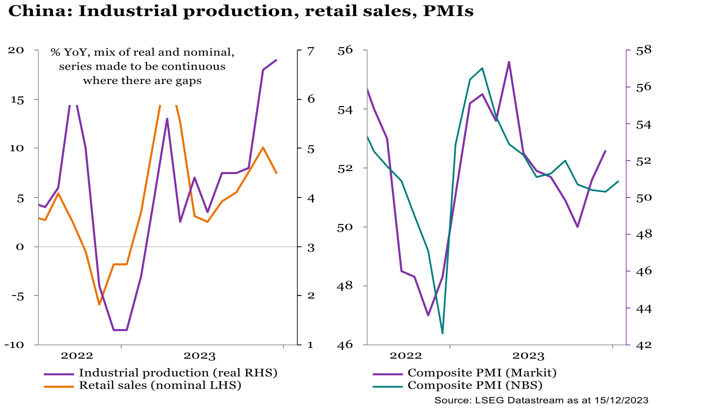
Long-term challenges remain substantial: Long-term challenges facing China still include an overhang of private sector debt and population ageing. Working age population growth has been negative for several years. China's stance towards Taiwan continues to present a risk to China's economic outlook should any action against Taiwan prompt a deterioration in economic relations elsewhere. Taiwan's upcoming elections and aftermath remain a key risk event from that perspective.

Policy action steps up: Supportive policy action seemed to step up in the middle of 2023 and more recent actions have included announcing infrastructure projects. Q4 also saw measures announced to support the property market including local steps to lower downpayment ratios in some cities. December's Central Economic Work Conference (CEWC) acknowledged that China's economy faced challenges and laid out several steps aimed at maintaining stability and promoting 'high-quality' growth including expanding domestic demand. December also saw large state-owned banks announce cuts to deposit rates.

Policy action needed

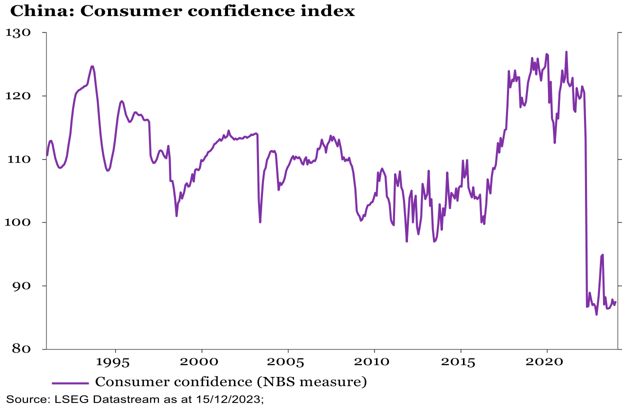
There seems to be widespread agreement among China analysts that further policy stimulus and support for the economy is necessary. Further monetary policy action seems likely. Stronger fiscal stimulus might help, as might a resurgence of structural reform. For now, however, the property sector remains large and struggling. China's authorities continue to have multiple levers they can pull but potentially painful structural reforms that could jolt the economy don't look a high probability.

Chart 25: Recent data mixed



Source: LSEG Datastream, NBS, S&P Global. Data is to December 2023 except NBS PMIs are to January 2024

Chart 26: Consumer confidence



Source: LSEG Datastream, NBS, S&P Global. Data to December 2023

Euro area: Rate rises subduing growth

The euro area economy may already be in mild recession, though on official data so far appears to have avoided it by the slimmest of margins. Business surveys still look consistent with falling private sector output. Tighter monetary policy is still feeding through to the real economy. Faster than expected falls in inflation have opened the door to rate cuts, although the ECB want to see more evidence of cooling domestically driven inflation first. Stronger real pay growth and rate cuts should help the economy grow faster into 2025.

Status update: Surveys moved into recessionary territory during the summer…and stayed there

Activity levels – as measured by real GDP – have been roughly flat since Autumn 2022, continuing to walk a fine line between stagnation and mild recession. However, in July the composite PMI business survey measure of private sector activity slipped below 50, consistent with falling activity, and has remained there through to end-2023. The European Commission's economic confidence indicator continues to signal a weak picture too (Chart 27). Despite that downbeat picture and substantial falls in headline CPI inflation over 2023, pay growth has picked up and the unemployment rate hit new record lows.

In recession? Still a substantial risk

After a small fall in GDP in Q3 2023 and a flat Q4 2023 the euro area continues to escape technical recession. However, it would take only a small downward revision to change that and the euro area has seen a sequence of weak business surveys, alongside continued evidence of monetary policy feeding through to tighter bank lending conditions (Chart 28).

The global downturn in manufacturing has dragged on overall activity indicators and data indicates a struggling industrial and construction sector in Germany for example. Euro area construction output (usually one of the most interest rate sensitive parts of any economy) remains at similar levels to late 2021. The PMI services indicator has been consistent with mildly contracting services output since around the middle of 2023. Bank lending remains the dominant source of debt financing for firms in the euro area – especially smaller ones – helping the transmission of monetary policy.

However, savings rates in the euro area – at least by mid-2023 hadn't fully normalised to pre-pandemic levels suggesting some potential spending support. Stronger real pay growth and still low unemployment should support consumer spending (Chart 29) and there is still potential for fiscal spending to support growth in some countries. Recent data show some pick up in loan growth too and bond yields are off their highs.

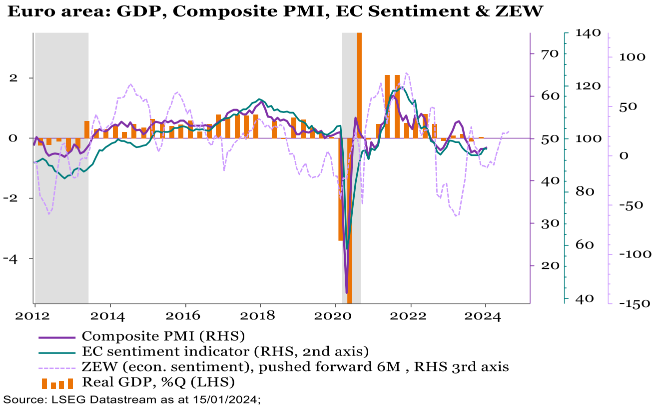
Fiscal drag

Fiscal policy looks set to drag on growth (Chart 17). That partly reflects continued unwinding of policies originally designed to support cost of living pressures in the wake of earlier high energy prices. However fiscal consolidation should be accompanied by some monetary policy easing in 2024, helping create a better backdrop for growth in 2025. Although Next Generation funding will still be flowing into investment spending, my forecasts don't assume that this steps up. The German Constitutional Court ruling adds some uncertainty into Germany's fiscal stance too but for now makes it more likely that Germany will end up running with a tighter fiscal stance than envisaged.

Has the ECB done enough? Too much?

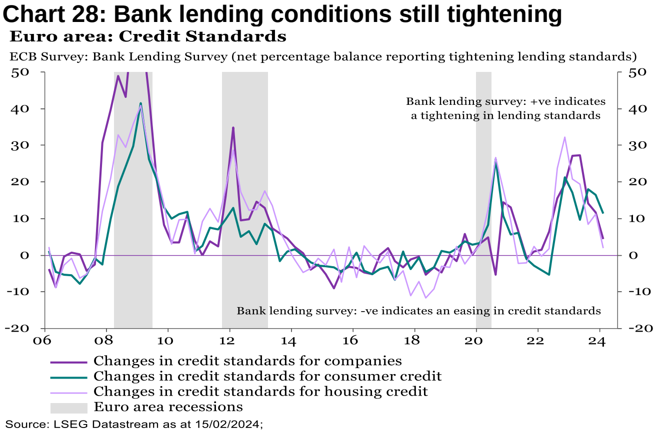
After President Lagarde signalled a "plateau… a whole beach" of on hold in December, the door seemed more open to rate cut in coming months after her January press conference. With more evidence of a dampening impact on economic activity and lower than expected inflation, I am assuming they start cutting rates relatively soon, but in Q2 rather than Q1 with the ECB signalling that they want to be further along in terms of disinflation first and wanting more evidence that pay growth is being tamed. With services inflation still strong and wage growth well above levels consistent with hitting a 2% inflation target there is a risk that cuts are even further away.

Chart 27: Surveys consistent with falling GDP



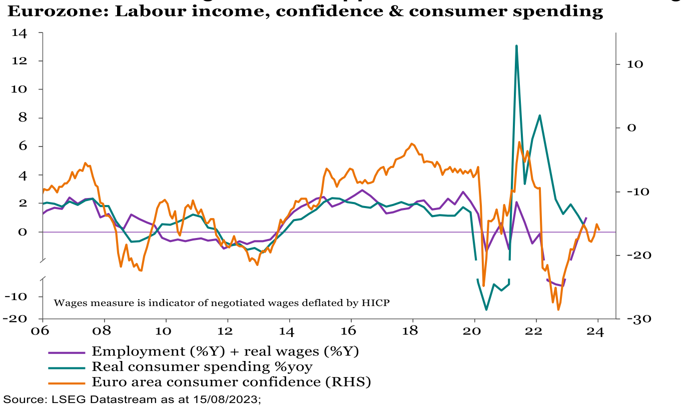
Source: LSEG Datastream, S&P Global, ZEW, EC, Eurostat. Data to January 2024 (except GDP to Q4 2023 and ZEW to January 2024).

Chart 28: Bank lending conditions still tightening



Source: LSEG Datastream, ECB (data to Q1 2024)

Chart 29: Real wages more supportive for consumers though



Source: Source: LSEG Datastream, Eurostat, European Commission. Consumer spending and labour market data is to Q3 2023; consumer confidence is to January 2024.

Japan: New paradigm…or not?

Having tweaked yield curve control policies in 2023, a modest rate rise in 2024 is still pencilled into the forecasts on page 2. Japanese policymakers continue to signal that they want more evidence that Japan will be able to sustainably hit its inflation target. Wage growth remains of key importance. Inflation remains high by Japan standards and the longer it remains there, the more chance that Japan's inflation dynamics/expectations shift in a sustainable way.

Status update: Inflation holding up, but technical recession

Measures of inflation remain elevated in Japan – by Japan standards (Chart 30). Notably, services inflation has continued to rise and so-called 'core core' inflation (inflation less fresh food and energy) is still at high levels. As elsewhere, services CPI should better reflect domestically driven inflation pressure than headline inflation and at levels above 2% is at its highest since the 1990s. Diffusion indicators show that the proportion of prices that are rising remains very high. Inflation expectations on the Tankan survey measure remain above 2% too (Chart 31). Upcoming wage settlements though will be key for perceptions of Japan inflation sustainability.

The picture coming from business surveys and some of the hard data has been mixed. PMI business surveys seem to be holding up better than in the Euro area for example, though has weakened over much of the year alongside indicators of global growth. Q2 GDP was strong, but Q3 and Q4 fell (Chart 32).

Looser policy settings paying some dividends, but growth isn't strong

Japan faces somewhat shallower cyclical challenges than elsewhere given its loose policy settings. The nominal policy rate remains negative, bond yields have risen but remain well below levels seen in other developed economies and real rates are negative. Fiscal policy remains supportive with debt sustainability worries for now supressed by low bond yields and high BoJ levels of JGB ownership alongside strong nominal GDP growth (by Japan standards). Stronger real pay growth and continued low unemployment should support household spending. Consumer confidence has also recovered substantially from its post-pandemic lows. Bank lending conditions remain accommodative according to Tankan survey indicators. As ever, however, given how low Japan's real trend GDP growth still is, there is still a good chance of at least one negative GDP growth quarter over 2024.

Japan's economy is arguably at something of a crossroads. The next couple of years could confirm whether or not Japan has seen a substantial *structural* shift in outlook towards sustained higher nominal growth and inflation. Sustained higher nominal GDP growth would also lessen some of Japan's longer-run overhanging fiscal risk and likely provide a more positive backdrop for investment decisions.

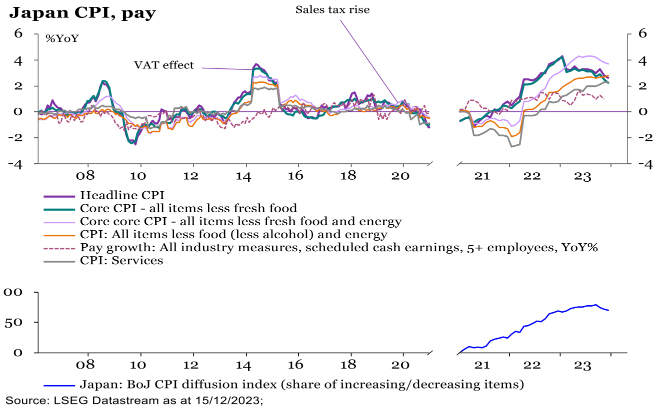
Longer-term prospects for Japan remain hampered by demographic challenges. The 'working age' population aged 15-64 continues to decline and average productivity growth has not been strong in recent years (see More rate hikes, less growth).

The case for higher rates

The BoJ continues to reiterate its accommodative policy message, but they moved further away from their yield curve control framework in late October 2023, (swapping their 1% upper limit for the 10-year bond yield for a 1% "upper bound…*as a reference*" [my italics]).

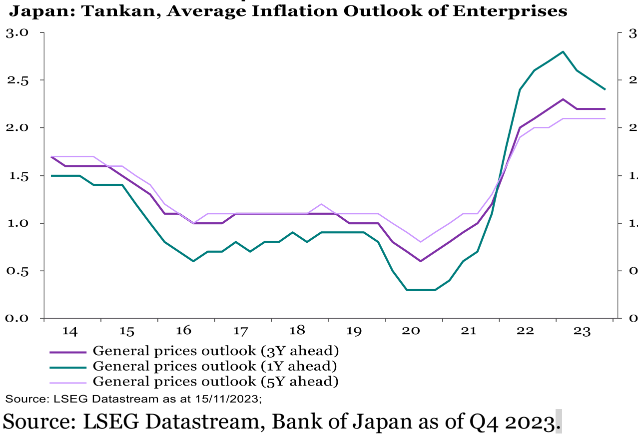
By October 2023, CPI had been above target for two years. It is somewhat unclear how much more evidence the BoJ will want before allowing a 10bp rate increase from negative to zero to go ahead. Arguably there is plenty to support that already with such a small move more symbolic than economically substantial. They will likely want more evidence of sustained/stronger pay growth and I assume that they would need to wait until after the Spring wage negotiations for that. A zero interest rate would still leave Japanese monetary policy looking accommodative. The case for interest rates beyond that will depend significantly on wage developments and ultimately whether evidence strengthens that Japan is now in some form of higher nominal growth/inflation paradigm.

Chart 30: Core core and services inflation above 2%



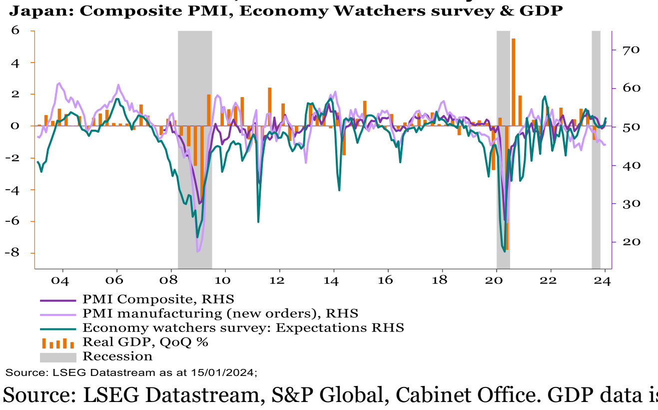
Source: LSEG Datastream, Ministry of Internal Affairs & Communication, Ministry of Health, Labour and Welfare, Bank of Japan as of December 2023 (pay series to November 2023).

Chart 31: Inflation expectations well off the lows



Source: LSEG Datastream, Bank of Japan as of Q4 2023.

Chart 32: Recession, but business surveys mixed



Source: LSEG Datastream, S&P Global, Cabinet Office. GDP data is to Q4 2023, Economy Watchers to January 2024, PMI to January 2024

United Kingdom: Still lacklustre

The UK economy was in mild technical recession in H2 2023 and I assume at least lacklustre growth continues for much of 2024 too. However, I don't expect the Bank of England to cut rates until Q3 (with a risk they cut earlier) with the Bank likely needing more convincing that upside inflation risks have faded. The effects of rate hikes are still feeding through to the economy and seem likely to dampen growth. However, the outlook isn't without positives including stronger real pay growth and we could yet see more pre-election fiscal support. The upcoming UK general election seems unlikely to dramatically change the near-term path of the economy though.

Status update: Mild technical recession

The economy – in GDP level terms – hasn't grown much since late 2021 and recorded a mild technical recession in H2 2023. Housing indicators still look particularly weak and retail sales volumes fell over Q4. However, the PMI composite business survey points to faster growth in private sector activity (Chart 33). While headline inflation has fallen and will fall further, 'domestic' inflation still looks strong.

Rising real incomes and a policy drag

Wage growth does not seem set to fall back to pre-pandemic levels yet – indications around wage settlements suggest that 2024 pay growth – especially when combined with a near 10% increase in the minimum wage – will be relatively robust. The labour market backdrop seems to have cooled, but not enough for a collapse in pay growth. Meanwhile, consumer confidence is well off its lows and mortgage rates are off their highs.

The worst of the drag on annual GDP growth from higher mortgage payments may be – or soon be – behind us especially with mortgage rates now off their highs. However, Resolution Foundation analysis suggests that while savers have earned income faster and more from higher interest rates than borrowers have been hit – that effect could be reversed fully by end-2024. Fiscal plans still indicate future tightening. Brexit remains a challenge for businesses, loan growth to businesses has been slow to negative and business investment intentions look soft. Bank lending conditions have tightened even if the latest BoE credit conditions survey suggested some reversal. Business insolvencies remain at high levels for now (Chart 34).

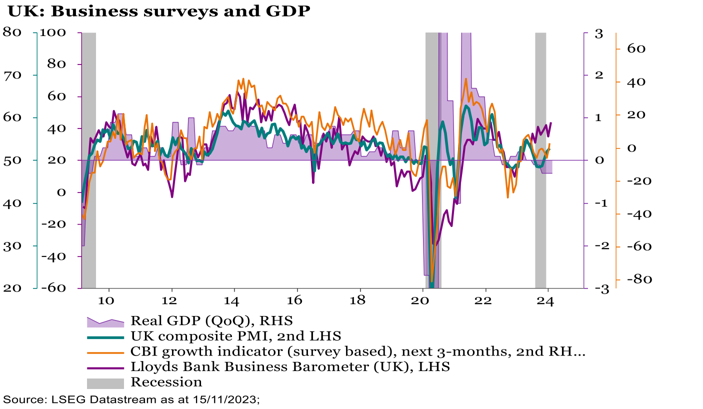
The UK still faces significant long-term challenges including projections for falls in working age population, fiscal challenges (longer-term fiscal estimates from the OBR still describe UK finances as on an unsustainable path and current government projections for the fiscal deficit build in what look like very tough – and potentially unrealistic – spending settlements while public services are already under strain). Productivity growth remains weak.

Inflation: Still a sticking point?

The forecasts assume that CPI falls significantly at headline level, and moves briefly to and below 2% year-on-year over April-June 2024. Energy inflation has fallen significantly. Core goods price inflation should fall further and towards zero given the usual relationship with producer price/import price inflation (Chart 35). Pay growth is at least off its highs and lower energy prices should feed through into lower services prices too. On my central forecasts, however, core CPI inflation remains above 2% in 2024 against a backdrop of still robust wage growth.

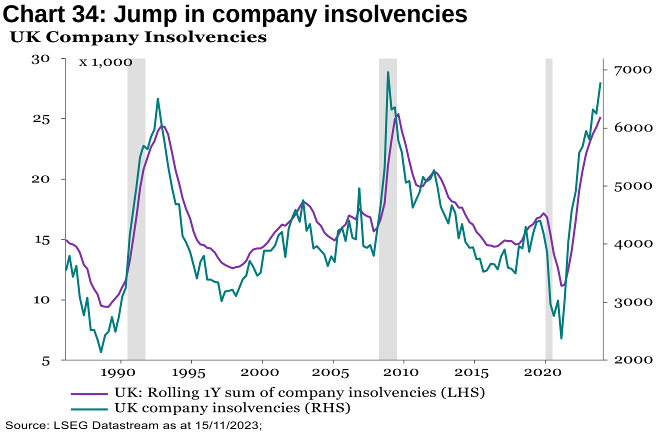
Recent BoE business survey data (the Decision Makers Panel) suggested that in Q4 2023 firms' expectation for wage growth over the following 12 months was 5.2%; a lot lower than in 2023, but higher than would be consistent with meeting a 2% inflation target. Past periods haven't shown a clean relationship with the unemployment rate; a bit more slack in the labour market may not be sufficient to bring CPI services sustainably back to inflation target consistent levels (likely to be around 4% year-on-year or so) and on the latest data the unemployment rate appears to be *falling*. The UK's limited potential growth rate and loss of labour supply flexibility post-Brexit may make the economy prone to domestically driven inflation.

Chart 33: Recession, but PMIs consistent with (some) growth



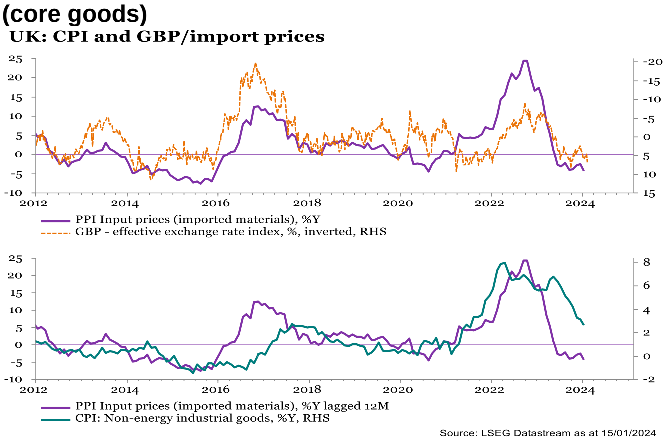
Source: LSEG Datastream, ONS, CBI, Lloyds, S&P Global. Data is to January 2024 except GDP which is to Q4 2023.

Chart 34: Jump in company insolvencies



Source: LSEG Datastream; The Insolvency Service. Data to Q4 2023

Chart 35: Import price trends still consistent with lower CPI (core goods)



Source: LSEG Datastream; ONS. Data to January 2024 except exchange rate which is to 9th February

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