Opening Bell

An excess of pessimism about the economy, though not in markets.

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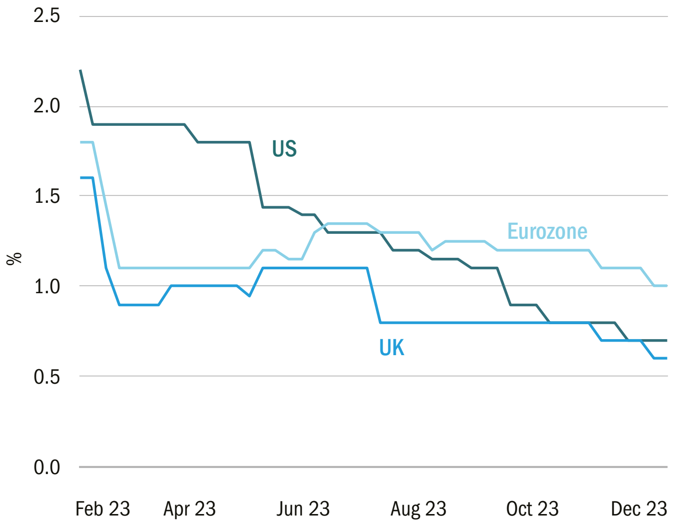
We expect 2024 to outperform the current pessimistic economic forecasts but struggle to beat the optimism priced into equity markets.

We believe that the US will be the first to put an official stamp on 'immaculate disinflation' by cutting rates. The UK and Europe are likely to wait for more proof that inflation has been defeated in the key area of wages. Forecasters seem to have pushed the slowdown we all expected last year into 2024 and I think that they're too pessimistic. Falling inflation is delivering a virtuous circle of improving real incomes and interest rate cuts which will support economic growth.

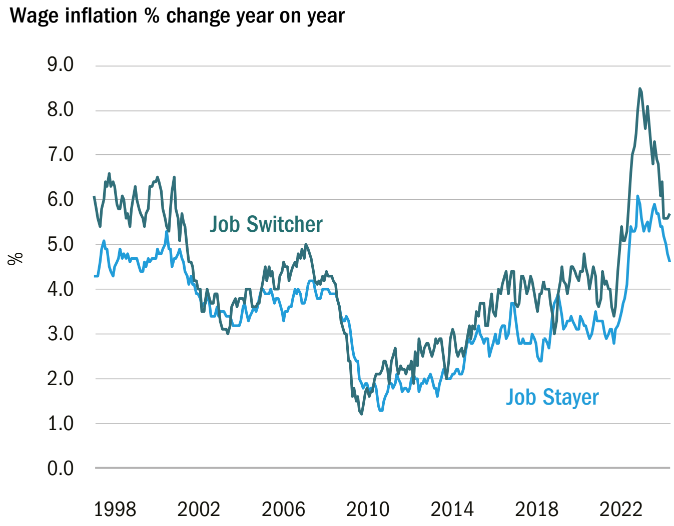
The prospect of lower interest rates will make bonds attractive and improves the equity outlook. However, excessive pessimism in economic forecasts is not reflected in rallying markets, which are notably more optimistic. That leaves the biggest risk a short-term setback on disappointed investor expectations, if the good news on the economy and rate cuts takes longer to come through.

…but forecasts for 2024 look too low for everyone



Source: Columbia Threadneedle Investments and Bloomberg as at 22 December 2023

US firms no longer losing staff to higher paying rivals



Source: Columbia Threadneedle and Atlanta Federal Reserve, as at 22 December 2023

US rate cuts will be official recognition that 'immaculate disinflation' has occurred.

The US saw the surge of inflation first, but also its peak. We expect the Fed to be the first to acknowledge the success of the 'immaculate disinflation' by cutting interest rates early in 2024.

Growth in 2023 was sustained by consumers spending their 'covid piggybanks'. US consumers won't be able to dip into their savings in 2024 to the same extent, but their real incomes are recovering so they won't have to.

A wage spiral operating in reverse is the key to both falling inflation and sustained growth. As inflation falls, this has translated into real income growth, but also into falling wage demands. This has been enabled by an easing of the labour market with employers no longer forced to pay more to stop losing staff to rivals.

Even before interest rate cuts, falling bond yields have translated to lower US mortgage rates and we are already seeing this feeding through into a stronger housing market. This is another factor which will support the US economy this year.

UK is set to surprise on all fronts

After only narrowly avoiding recession in 2023 and with sticky inflation, the consensus for the UK economy is for little improvement in 2024. However, inflation has finally started falling rapidly, while Purchasing Manager Indices are now indicating an upturn in economic activity.

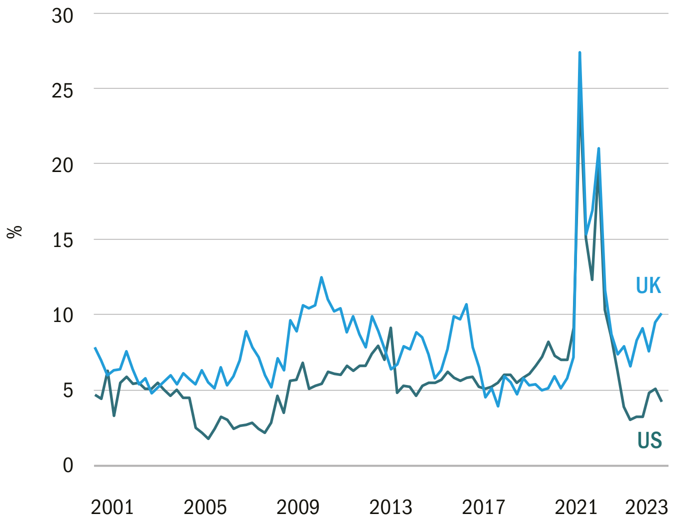
We believe that one-off factors held up inflation in 2023, from sterling weakness on import prices to the official figures not reflecting shop discounts. As these factors fall out of the calculation in 2024, inflation should surprise on the downside. That would allow the Bank of England to cut interest rates this year. Though the prospect of a Budget giveaway and another 10% hike in the minimum wage in the spring means that they are likely to wait for hard evidence of falling wage inflation before they make their move.

After a few terrible years, real incomes are rising in the UK. A virtuous wage spiral is set to play out in the UK as well, but with more oomph. The UK consumer increased savings even after lockdowns ended. With a boost from tax cuts in an election year, we expect consumer confidence and spending to rebound.

The shift to fixed-term mortgages means that the UK consumer also doesn't need to wait for interest rate cuts: mortgage rates have already fallen. I used to think we'd see a 10% drop in house prices and we've done half of that – and I now think that's it.

We expect Europe's economy to outperform pessimistic expectations

US saving less, UK saving more



Source: Columbia Threadneedle Investments and Bloomberg as at 3 January 2024

Wage growth accelerating in euro area

Source: Macrobond, as of 22/11/2023
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Europe remains a laggard, but even it will see 'immaculate disinflation'.

Almost everyone, myself included, expected aggressive monetary tightening to lead to significantly higher unemployment. But unemployment has remained very low and that is especially true in Europe by comparison with its historically high levels.

Despite this, European consumer confidence has improved to merely miserable, having been deeply depressed. This factor explains nearly all the difference between Europe and the US economic growth last year. The focus on Germany, which slipped into mild recession, hasn't helped. But Germany isn't the whole of Europe, Spain, for example has been a whole lot better.

Europe has seen a big fall in inflation. That means that real incomes are growing again. However, to convince the European Central Bank to cut rates, we need wage inflation to fall back significantly. All the signs are that wage negotiations will see much lower numbers this Spring. As a consequence, we expect Europe to outperform pessimistic expectations.

Markets, especially equities, have discounted some of the expected improvements.

Immaculate disinflation, with no recession and interest rate cuts, is positive for equites. However, the US equity market managed to be both resilient, and then rally strongly in 2023 as the news improved. So valuations indicate that it is expensive. That won't stop good news on interest rates and the economy driving it higher, but it does temper our enthusiasm, so we focus our overweights elsewhere.

Better valuations for the UK and Japanese markets, make them attractive, especially in Japan where we see catalysts in corporate governance improvements to unlock that value.

We like bonds, as inflation falls and interest rates are cut. Though fiscal imbalances are wide, we think that this is an issue for another cycle. Credit spreads for corporate bonds have tightened, but they could become more expensive still in a benign environment and will still benefit from the positive interest rate backdrop.

Gold should shine as interest rates fall. It has outperformed expectations since a significant chunk of Russia's foreign currency reserves were locked up. If this prompts other central banks to build up the proportion of gold in their reserves, this could potentially be a significant long-term driver.

Better valuations for the UK and Japanese markets make them attractive

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