LAZARD
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ECONOMIC AND MARKET OUTLOOK

September 2023

The US economy has proven remarkably resilient since it displayed signs of deterioration last spring, and the pace of inflation has significantly eased since hitting recent peaks. These factors are keeping hopes alive for a soft landing. So, will the economy continue to grow in the months ahead? Is an end in sight for global monetary tightening? And which asset classes look best suited to navigating the environment? Read on to find out more.

ECONOMIC OUTLOOK

UNITED STATES: A RESILIENT ECONOMY DESPITE POCKETS OF WEAKNESS

Following spring's downturn, a resilient US economy has defied expectations. The resilience is largely being driven by household spending (Figure 1). However, we believe that cracks are starting to appear.

The labour market is starting to lose steam. Although the acceleration in weekly jobless claims observed in the spring has eased, other indicators such as the unemployment rate are deteriorating (Figure 2). Typically, when this happens, the momentum continues until recession takes hold.

If unemployment continues to rise, household spending will come under pressure. In addition, US households are running out of pandemic-accumulated savings (Figure 3) and the student loan moratorium is scheduled to end shortly. Eventually, household savings rates will return to normal (currently 3.5% compared with a pre-Covid average of 7.5%), which will also drag on consumption.

Upward momentum in single-family housing starts has been a factor of resilience, yet we feel that this could be undermined by rising interest rates.

Furthermore, the full effect of monetary tightening on the US economy is still to come, typically in 12–18 months. However, interest rates stood at 2.5% a year ago compared with 5.5% today and the decline in credit impulse is already of a similar magnitude to that typical of recessions (Figure 4).

Our central scenario is that the US economy will tip into recession. If the economy continues to grow at pace, the Fed will have to raise rates further to combat inflation, prompting an economic downturn. Headline inflation has slowed, but still-high services prices are incompatible with a return to the Fed's target. Despite pockets of resilience, a soft-landing scenario seems unlikely.

Figure 1
United States: household consumption volumes (USD trillion)
Source: Bloomberg

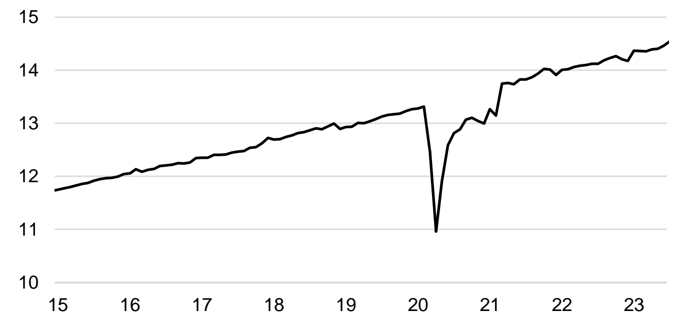


Figure 2
United States: consumer job-market confidence and unemployment rate, Conference Board
Source: Bloomberg

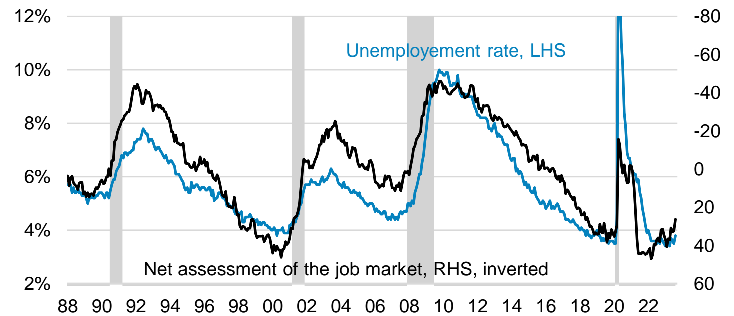


Figure 3
United States: monthly household savings (USD billion)
Source: Bloomberg

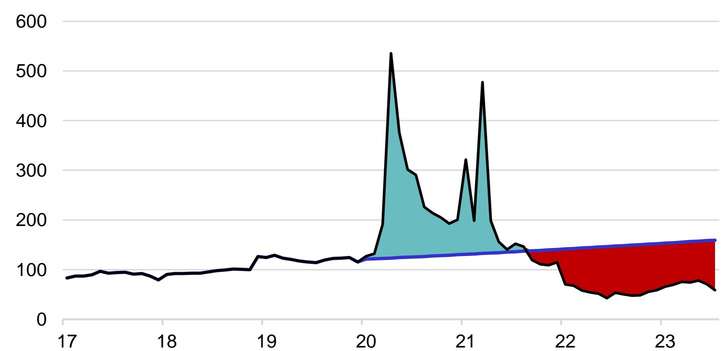
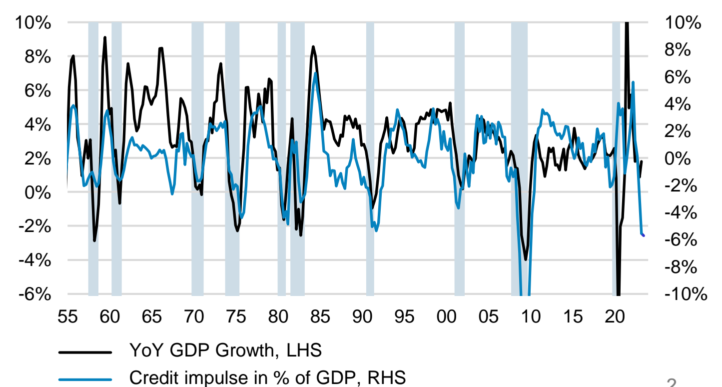


Figure 4
United States: private credit impulse and GDP growth (YoY)
Source: Bloomberg



Eurozone: demand is weakening

Resolving the energy crisis has not been enough to revive eurozone growth. Having recovered briefly at the start of the year, business sentiment plummeted during the summer and indices are now consistent with a decline in GDP (Figure 5).

The ECB's monetary tightening has been quickly passed through to lending rates, putting a break on credit creation. Households have found themselves exposed to strong inflation shocks despite significant wage rises.

Some of the factors that enabled businesses and households to take this double blow have disappeared, raising fears of more secondary effects on the economy.

During the pandemic, companies had built up bulging order books that made production insensitive to falling demand. Production has now caught up with orders and the slower demand observed in the indices could affect output more significantly (Figure 6).

Until spring 2023, companies had been inclined to keep employees despite falling demand in a bid to avoid the challenges arising from labour shortages. The situation now seems to have reversed, with the 'employment' and 'new orders' components of business surveys now back in lockstep (Figure 7). While unemployment remains at a record low, it is turning back up in some countries.

Leading indicators show that wages are still rising rapidly, but at a slower pace (Figure 8), and the economic downturn will undoubtedly slow growth further.

We see vicious circles between business levels and employment taking hold and pushing the eurozone economy towards recession.

Figure 5
Eurozone: GDP growth and composite PMI
Source: Bloomberg

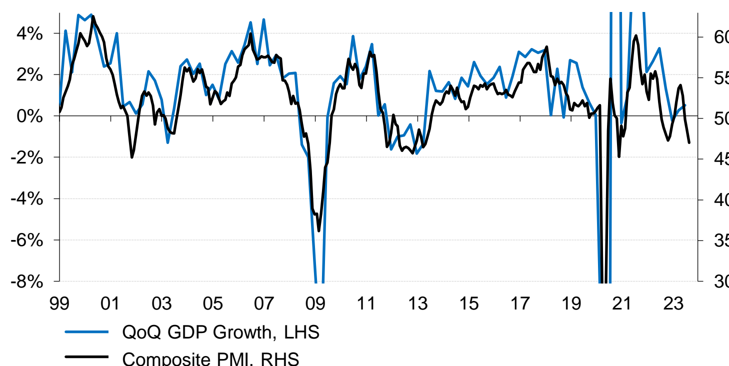


Figure 6
Germany: manufacturing orders and output (2015 = 100)
Source: Bloomberg

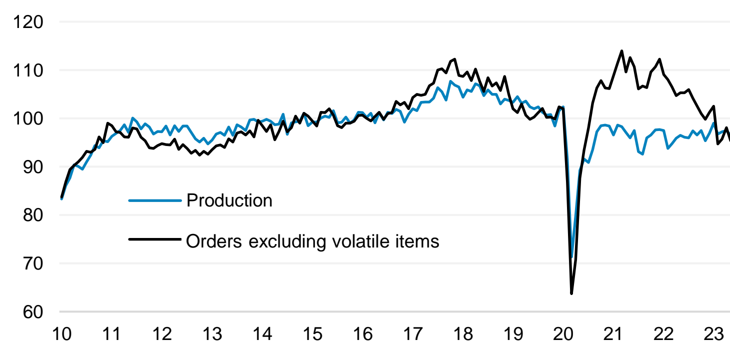


Figure 7
Eurozone: European Commission services producer price index
Source: Bloomberg

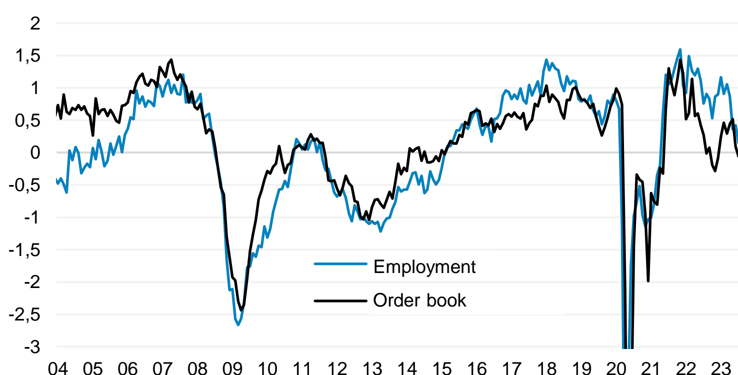
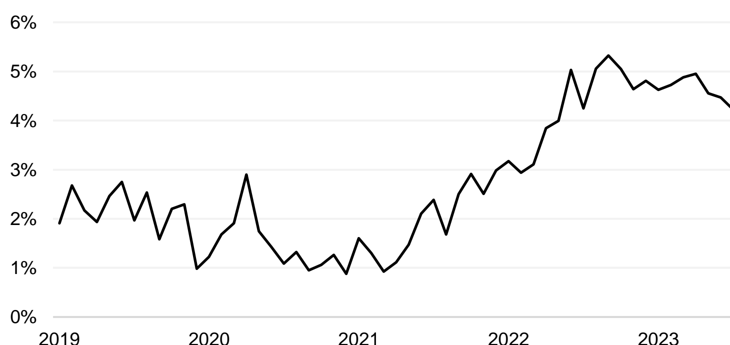


Figure 8
Eurozone: wage tracker (year-on-year change in starting salaries)
Source: Bloomberg



China: limited growth prospects

While the door to sustainable economic recovery seemed to open when China's health restrictions were lifted, growth began to lose steam in the second quarter and business surveys suggest that a slowdown is ongoing (Figure 9).

Weaknesses are appearing in the property sector (Figure 10), which accounts for around 25% of Chinese GDP when related industries are included. The situation is unlikely to improve in the short term, with property developer Country Garden facing difficulties likely to dampen homebuyer confidence.

Household spending is still below pre-pandemic levels, the savings rate remains high (Figure 11), and greater economic uncertainty will not encourage Chinese households to tilt the balance.

The government is stepping up its fiscal support yet stopping short of large-scale stimulus. While its target of 5% growth is still achievable, room for manoeuvre is more limited than in the past. Public debt has already risen sharply and the government is pledging to tackle it.

Against this backdrop, we believe that Chinese growth will be too weak to help offset recession in the Western economies.

Macroeconomic overview

Economic resilience in the US may not be enough to avoid a bumpy landing. Some weaknesses are intensifying and high interest rates are affecting the economic system. In our view, the most likely scenario remains the imminent onset of US recession because the prerequisites for sustainable economic growth are not in place. The most recent recessions kicked in after the Fed stopped raising rates, as the full effect of monetary policy tightening materialises with a lag. Elsewhere across the globe, the slowdown continues.

Figure 9
China: PMI indices (Caixin and NBS average)
Source: Bloomberg

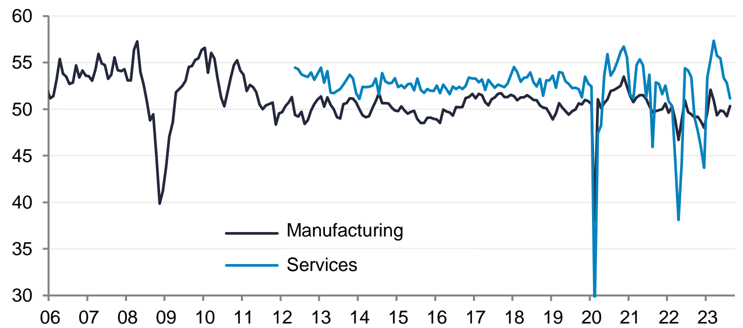


Figure 10
China: housing starts and sales (12-month rolling total in billions of m²)
Source: Bloomberg

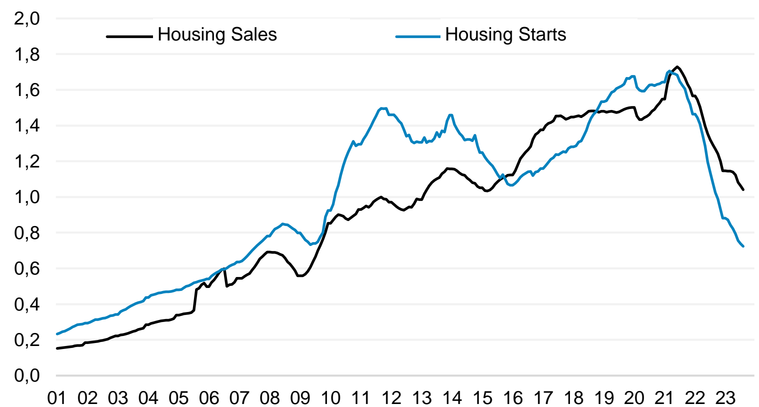


Figure 11
China: household savings rate (4-quarter rolling average)
Source: NBS:

FINANCIAL OUTLOOK

BOND MARKETS: AN ATTRACTIVE OPPORTUNITY

The Fed and the ECB seem to be nearing the end of their rate hike cycle.

The Fed held rates steady once again in September, while projecting another rise this year and fewer cuts in 2024. The central bank is still not confident that interest rates are high enough to bring inflation back to its target and is aiming to keep some pressure on the markets to avoid financial conditions easing too early.

On the other side of the Atlantic where the ECB raised rates in September, the central bank believes that a level has now been reached that can bring inflation down. While persistently high inflation could prompt hawks to call for another increase, the ECB is acknowledging the economic deterioration. The question now is how long rates will stay where they are (Figure 12).

Typically, when the Fed hits pause, long-term rates start to fall in anticipation of lower short-term rates (Figure 13), and European long-term rates are likely to follow suit.

This potentially makes bonds and money market instruments an attractive investment. Our preference is for European investment-grade bonds, which now offer a yield to maturity of around 4% (Figure 14). This level provides a buffer for absorbing any credit spread widening, as was the case during the European debt crisis in 2011.

High yield and financial debt are also offering attractive carry, but credit spreads are probably too small to compensate for the risk stemming from a weakening economy, especially in the United States (Figure 15).

Figure 12
€STER levels: implied path
Source: Bloomberg

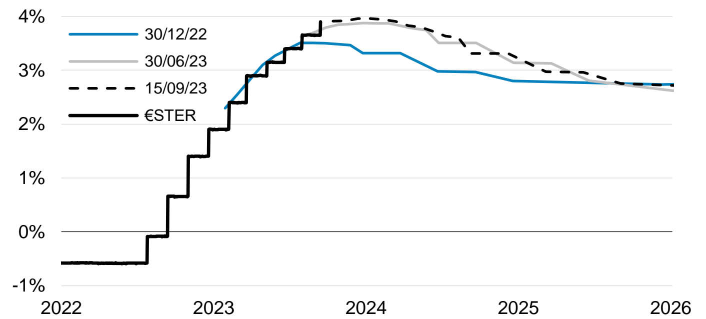


Figure 13
United States: Fed funds rate vs. 10-year treasuries
Source: Bloomberg

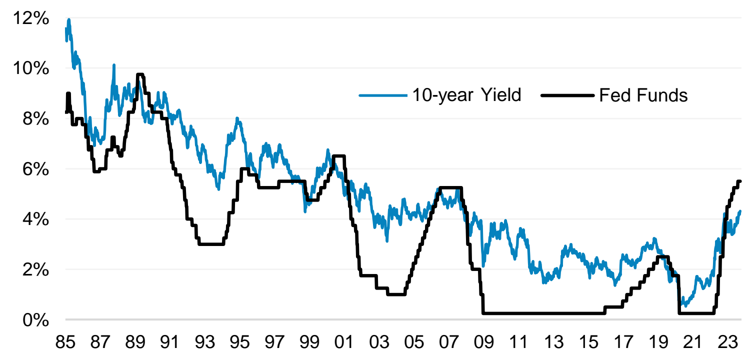


Figure 14
Eurozone: corporate investment grade yield excluding financials
Source: Bloomberg

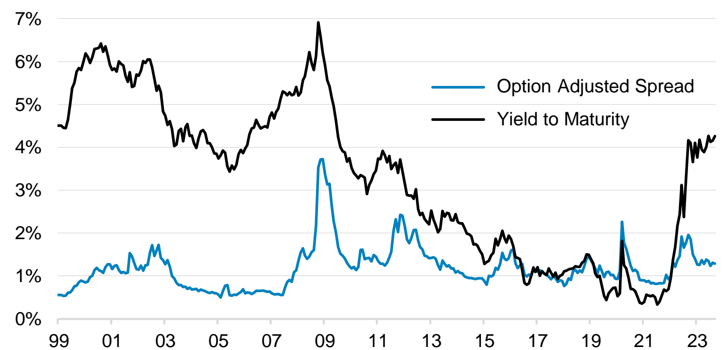
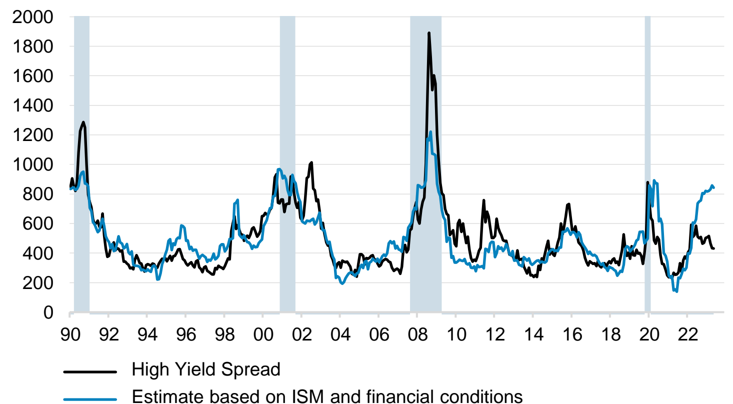


Figure 15
United States: high-yield bond valuations
Source: Bloomberg



FINANCIAL OUTLOOK

EQUITY MARKETS: OVER-OPTIMISM REIGNS

In Europe, most of the equity upswing occurred at the start of 2023, with the Euro Stoxx 50 index hovering in a narrow band since the end of January and lacking direction. In the US, equities took off at the end of May following a cautious start to the year (Figure 16).

A closer look reveals that the rise in the US market is highly concentrated, with technology stocks largely driving S&P 500 performance. A sharp rise in valuation multiples is fuelling the increase and they now exceed their post-Covid peak (Figure 17). We see these inflated multiples as thin ice in the US market.

Elsewhere, equity markets are offering little compensation for recession risk. Valuation levels in European and emerging markets match historical averages and are high in Japan.

Some complacency seems to have set in since the start of the year. One indication of the cost of insuring against market volatility, the VIX index, has returned to pre-pandemic levels and other indicators reveal that investors have been increasing their equity-market exposure.

Relative stock market valuations are not particularly appealing. The yield premium on US equity markets relative to bonds is now very low and, for the first time in over ten years, bond yields now outstrip equity dividend yields in Europe (Figure 18).

The key for us lies in company earnings momentum. Full year 2024 forecasts see net income rising approximately 10%, whereas recessions typically lead to slumps exceeding 20%. This leaves considerable room for disappointment (Figure 19).

Figure 16
2023 index performance (31/12/2022 = 100)
Source: Bloomberg

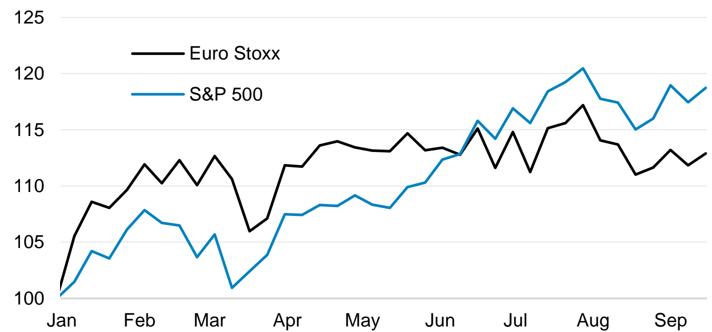


Figure 17
12-month P/E for tech stocks + Amazon + Meta + Tesla
Source: Bloomberg, Lazard Frères Gestion

Figure 18
European markets: dividend vs. credit yields
Source: Bloomberg

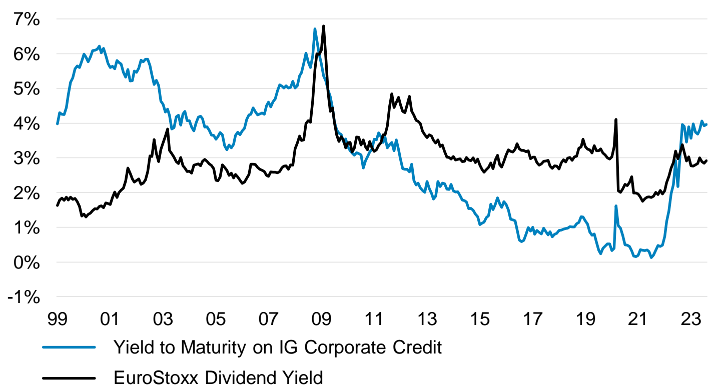
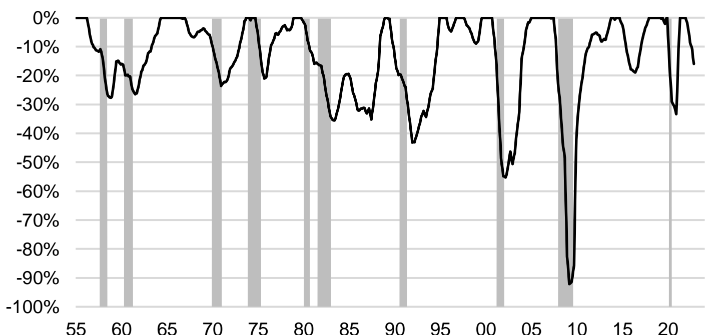


Figure 19
S&P 500: cumulative decline in inflation-adjusted corporate earnings
Source: Robert Shiller



MARKET OVERVIEW

Despite pockets of resilience in the US economy, the most likely scenario remains that of a widespread economic slowdown.

This scenario sees equity markets and offensive credit coming under pressure, especially as investors are less cautiously positioned than they were at the start of the year. Long-term interest rates can be expected to fall, pleading in favour of being overexposed to bonds, preferably investment grade, and underexposed to risky assets.

In the second scenario, high inflation would push the Fed into raising rates further. Such a move would be detrimental to bonds in the short term, while being underexposed to equities would undoubtedly be beneficial. The slide into recession would eventually push rates down.

The third scenario, which rules out a recession, seems highly unlikely and its impact on markets is difficult to predict. While slower inflation could push bond yields down, lower prices combined with a tight labour market would squeeze corporate margins and weaken earnings.

Glossary:

ECB: European Central Bank

FED: The Federal Reserve, the central bank of the United States.

GDP: Gross domestic product is an economic indicator that quantifies the total value of annual wealth produced by economic agents residing within a territory.

PMI indices: The Purchasing Managers' Index (PMI) summarises confidence levels among business purchasing managers who are surveyed to establish if market conditions are expanding, staying the same or contracting. A figure above 50 indicates positive sentiment, while a figure below 50 indicates negative sentiment.

PE (or P/E, PER): The price-to-earnings ratio is the measure of a company's market capitalisation relative to its earnings. In financial analysis, the ratio is used to assess the value of a stock relative to companies in the same sector.

€STER: The euro short-term rate is the overnight eurozone interbank rate in the money market.

Risk premium (equities): The equity risk premium reflects the additional return offered by equity markets compared to the bond market risk-free rate (usually 10-year sovereign bonds). This additional yield compensates the investor for taking more risk.

High yield bonds: Speculative-grade bonds rated below BBB- by Standard & Poor's or Baa3 by Moody's. They offer a higher yield in return for a higher level of risk.

Credit spread: The difference in yield between a bond and a risk-free loan with the same maturity. The term 'spread' therefore refers to a rate difference or rate differential. The better the perceived creditworthiness of the issuer, the lower the spread.

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