Macro Strategies Outlook

Disinflation and divergence

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In Brief

- Into 2024, we see greater economic variability by region and, for some regions, a greater spread across the range of potential outcomes.
- The US has shown impressive resilience in this hiking cycle, with growth data continually surprising to the upside and ongoing strength in the labour market.
- While we do believe the Fed will stand ready to defend any emerging weakness in 2024, we also believe it remains committed to combatting inflation and would not hesitate to act if it were to rise again.
- Conviction in our central case for Europe is higher but more negative, as we have so far seen growth deteriorate as we might expect from the constraint of higher rates.
- 2023 was the third consecutive year of disappointing growth for China. The year of the dragon may bring renewed vigour to consumers, though we struggle to identify the catalyst.
- In APAC ex China the recovery so far has been narrow, led by tech exporting countries. We expect recovery to broaden into 2024 amid US recovery and absent any structural imbalances.
- In our portfolios, we are reflecting the improvement in financial conditions and resilience of US growth, but balanced with our view that the market has been too optimistic in its pricing of rate cuts.
- We are also reflecting the divergence in growth outlooks across regions in equity and currency.
- Overall, we do not see the headwinds to equity of recent years as financial conditions loosen but do think the road might be bumpier than expected if we get disorderly rather than immaculate disinflation from here.
- We are excited about long-term investment opportunities, particularly in tech and healthcare, where 2023 showed that innovation is very much alive and kicking.

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Introduction

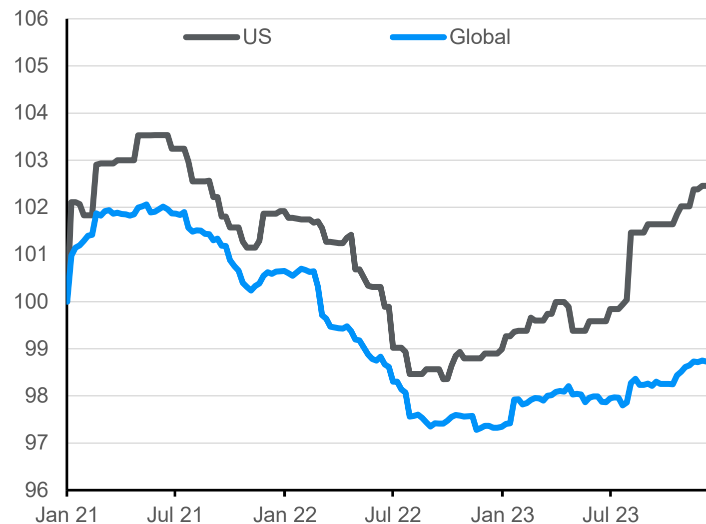
Policy rates at decade-long highs, a bank crisis, deteriorating Europe and China growth, and two wars marked the past year. However, 2023 also saw significant AI and drug developments, and the disinflation narrative take hold by year end, even if with some exuberant optimism. Into 2024, we see greater economic divergence by region and, for some regions, a greater spread across the range of potential outcomes.

The course set from 2023

We came into 2023 with a negative 3–6-month view on the US, expecting growth to be tempered by tighter financial conditions. By contrast, we were relatively positive on Europe and China, helped respectively by lower gas prices and post-pandemic re-opening. However, we shifted through the year to the opposite state of play as it increasingly looked as if the US might have engineered a soft landing, while growth in Europe weakened and in China even more so; the good, the bad and the ugly.

Exhibit 1 shows the widening gap in growth expectations for the US versus the rest of the world. Asia Pacific ex China cut its own course, enjoying a recovery thanks to the cyclical upswing in tech exports and a domestic recovery in Japan.

Exhibit 1: Rising divergence in US vs. Global growth revisions



Source: *J.P. Morgan Asset Management, Bloomberg as at 27 October 2023.*

US: Rate cuts and resilient growth

The US has shown impressive resilience in this hiking cycle, with growth data continually surprising to the upside and ongoing strength in the labour market. At the same time, inflation has trended down, leading investors to believe we have reached peak rates and to bring forward expectations for interest rate cuts in 2024. The shift in expectations was helped by surprisingly dovish comments from the US Federal Reserve (the Fed) at its December press conference.

In our view, the market may be too optimistic as we see limited evidence of disinflation in certain areas that are a focus for the Fed, specifically core services inflation and wage data. Furthermore, continued resilience in US growth may inhibit the disinflation process or even create upward pressure. While we do believe the Fed will stand ready to defend any emerging weakness in 2024, we also believe it remains committed to combatting inflation and would not hesitate to act if it were to rise again. We see this potential scenario as underpriced in markets and, if acknowledged, it may spark a correction down in risk assets and support bond yields.

Europe: Growth deteriorating as expected

Conviction in our central case for Europe is higher but more negative, as we have so far seen growth deteriorate as we might expect from the constraint of higher rates.

The European Central Bank has been stalwart in the face of weakening growth, maintaining a similarly hawkish stance to the Fed, but monetary tightening has had a bigger impact as Europe is more sensitive to interest rates.

The latest manufacturing data is disappointing, and the region risks falling into a technical recession if growth in Q4 is negative for a second consecutive quarter. Our outlook is darkened by fiscal tightening in Germany, which we see as a risk to the region into 2024.

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China: Structural weakness to persist

2023 was the third consecutive year of disappointing growth for China, and unfortunately, we see little change for now. The authorities have provided significant stimulus and delivered it in a targeted way to maximise impact, but we maintain the view we held for much of 2023 that it is still not sufficient to counter structural weakness.

The property market is challenged and private sector confidence has languished at all-time lows. The year of the dragon may bring renewed vigour to consumers, though we struggle to identify the catalyst.

APAC ex China: Tech-led recovery widening

APAC ex China, similar to the US, is experiencing a recovery. In 2023, the recovery was narrow, led by tech exporters that were benefiting particularly from rising DRAM exports, and Japan, which experienced a domestic recovery. We expect the recovery to broaden into 2024 amid US recovery and absent any structural imbalances. A key risk to this would be a worsening in China growth that may spill over to the rest of the region.

Exhibit 2: Our Macro Cycle Dashboard, summary 3–6-month views by region and component

	US	Europe	China	Asia Pacific Ex-China
Growth	Slowdown	Contraction	Contraction	Recovery
Inflation	Slowdown	Slowdown	Contraction	Slowdown
Sentiment	Recovery	Recovery	Contraction	Expansion
Liquidity	Recovery	Recovery	Recovery	Slowdown
Macro cycle phase	**Recovery**	**Contraction**	**Contraction**	**Recovery**

Source: J.P. Morgan Asset Management, as at 14 December 2023. US theme includes Canada. Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

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Portfolio implications

In our portfolios, we are reflecting the improvement in financial conditions and resilience of US growth, but balanced with our view that the market has been too optimistic in its pricing of rate cuts. This leaves us with net equity exposure close to zero, which we would expect to turn more positive following any pull-back.

We are also reflecting the divergence in growth outlooks across regions in equity and currency. We are long APAC ex China equity and short elsewhere. In the former, we are taking exposure specifically in semiconductor manufacturers and Japanese banks, as well as Indian private banks with a longer term view.

In currency, we are long the US dollar versus short European and China-centric currencies to take advantage of divergent growth outlooks, as well as to benefit from any reversal in the recent re-pricing of rate cuts, which weighed on the dollar.

Given this potential for a reversal, we hold only a modest amount of US duration. We may add to US duration in an environment where we have greater conviction in disinflation and growth shows signs of softening. We maintain our long gold strategy as we believe the next 12 months might require diversification into safe-haven assets if we do see further deterioration in growth and any flare-up in geopolitical events. A further support for gold is demand coming from central banks, particularly in the Middle East and China, who are increasingly diversifying their US dollar reserves into gold.

Equity tailwinds

The disinflation narrative has been a strong tailwind for our long-term equity holdings that largely have a quality, growth bias so are sensitive to interest rates. Our cloud computing and digital transformation equity holdings had a stellar 2023, not only thanks to this but also to significant advances in AI. We believe this will continue to present strong long-term opportunities, but also expect some re-set for the broader tech sector in 2024 as it becomes more apparent which companies can harness the advances to improve near-term revenue and which may be more challenged.

The other big development of 2023 was in healthcare. An emerging class of medication called GLP-1 saw increased products approvals and a growing supply of drugs that are used to treat type 2 diabetes and obesity. There are 530m adults worldwide living with diabetes and 650m with obesity, providing huge potential runways for uptake of these drugs, both supported by successful trials demonstrating positive outcomes in reducing co-morbidities, such as in cardiovascular disease and kidney disease.

Valuations for the two key drug developers moved significantly higher in 2023, but we see further upside from here and continue to hold exposure into the new year.

In summary: Disinflation and divergence

We expect divergence to be a dominant theme into 2024, with US growth holding up better versus other key regions going into the year. Rate cuts are most certainly on the cards, if only to maintain a constant level of restrictiveness, though perhaps not as much as the market is currently pricing.

Overall, we do not see the headwinds to equity of recent years as financial conditions loosen but do think the road might be bumpier than expected if we get disorderly rather than immaculate disinflation from here. We are also excited about long-term investment opportunities, particularly in tech and healthcare, where 2023 showed that innovation is very much alive and kicking.

Next steps

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