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Diverging economies

Divergence has re-emerged as a theme, with individual economies likely to see various growth and inflation experiences going forward.

“Gentle easing”

We expect falling inflation across most economies in the second half, but at a trajectory that elicits only marginal interest rate cuts.

Rate cuts?

In our view, the precise number of rate cuts is less important at this stage than the timing of them, especially as the market narrative remains highly volatile.

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Despite widespread expectations of a global economic slowdown in 2024, growth and inflation have continued to perform above expectations across most major economies. Our investment outlook for the rest of the year centers on the path of inflation and how central bankers weigh the balance of risks in beginning to ease monetary policy.

About this outlook

Every six months, we bring together some of Invesco’s key investment professionals and thought leaders to formulate our outlook. This is always a very collaborative effort, with a healthy amount of disagreement and discourse. At Invesco, we value diversity of views and think it ultimately strengthens our outcomes.

As part of this outlook process, we assess what we believe is the most likely path ahead. We also evaluate alternate scenarios that may unfold based around a selection of key variables.

Our base case: Below-trend (but resilient) growth and “gentle easing”

In our assessment, demand-side resilience has delayed the disinflation narrative across major western economies, particularly in the US. However, we continue to anticipate falling inflation across most economies in the second half, with disinflation realized more quickly in non-US developed market economies but at a trajectory that elicits only marginal interest rate cuts.

As supply and demand factors come into better alignment over time in Western developed economies, we expect inflation to continue to fall towards central bank targets and a gradual return to trend growth rates aided by marginal rate cuts from major central banks. However, we anticipate disinflation to be realized at a pace significantly slower than our previous expectations. The passthrough effects from the impact of central bank policy tightening has taken longer than expected, with effects beginning to be realized at the margins.

As part of our view, we see the global economy in a soft patch in the near-term, driven by a restrictive monetary policy backdrop that translates into below-trend but still resilient growth. With individual economies likely to see various growth and inflation experiences going forward, we believe divergence will be a core theme through the rest of 2024.

We believe divergence is now favoring non-US economies

We’ve seen different types of divergence. For a while now the US economy has been performing better than other major economies and we’ve heard terms like, “US exceptionalism.” But of course, if we look at the Citi Economic Surprise indices, what we now see is that the eurozone

economy is doing better and we're seeing emerging markets doing better, we're seeing China doing better. And that's all because the US, I think has already done a lot of its spending. It's gone through a lot of its savings and also it's feeling more of that pressure of high rates. At some point, I think we'll see convergence, they'll all be reaccelerating if we get central bank rate cuts sooner rather than later.

US: Growth has shown signs of weakness, two rate cuts expected

Thus far, the US economy has been less affected by tighter monetary policy. But after a series of upside surprises in US macro performance, underlying growth appears to be showing signs of weakness, including rising credit card balances and delinquencies¹, as well as a tick upward in the unemployment rate. We believe the US will likely grow at a modestly below-trend rate for the remainder of this year, constrained by the effects of restrictive monetary policy.

In our view, inflation is likely to continue a bumpy path downward through the end of the year, with the Consumer Price Index expected to end the year lower but still well above the Federal Reserve's (Fed) 2% target. The stabilization of inflation at above-target rates should likely limit the degree and pace of monetary policy loosening, in our view. We anticipate two rate cuts this year, likely beginning in the third quarter. The timing of rate cuts is unlikely to be influenced by the US election in November.

US equity markets have benefited from continued earnings growth and moderating inflation, as well as thematic stories such as the rise of artificial intelligence. We believe current elevated US equity valuations suggest a lot of positive sentiment is priced in, including narrow credit spreads and continued earnings growth.

In summary, our expectations for growth remain resilient, and we believe the risks for disappointment are elevated. We favor risky assets but with limited upside potential due to this backdrop.

The importance of looking ahead for a "data-dependent" Fed

I think it's very easy for them to just use that term "data dependent," but the reality is they need to be thinking about where the economy's going to be and trying to at least do some modeling. And I think they're doing that and that is what made them comfortable with stopping hikes in July of 2023. And I'm hopeful that then leads them to start cutting soon. Now that doesn't mean I think they should be cutting dramatically, but I do think the start of rate cuts of a very gentle easing cycle is called for soon just because I think we run the risks after a very aggressive tightening cycle.

Eurozone: Substantial disinflation and improving economic momentum

Eurozone economic momentum has been improving despite tight monetary policy, a softer global economic environment, and numerous geopolitically induced economic headwinds. Purchasing Managers' Indexes, which are forward-looking indicators, suggest to us a continued pick-up in growth toward trend rates, though with some variation in experiences within the eurozone itself. While the eurozone labor market appears to have softened somewhat, real wage growth has improved as inflation has fallen appreciably lower.

Growth in the eurozone has been weaker than in the US, while disinflationary progress has been more substantial². With inflation close to

central bank targets, the European Central Bank (ECB) introduced its first cut at its June meeting, with more likely to follow but at an uncertain pace. This could also support growth going forward. Overall, the near-term European growth outlook has seen a modest pick-up, and we expect growth to gradually return to trend rates over the remainder of this year. We anticipate that ECB rate cuts should provide some catalyst to European cyclical assets and valuations.

We expect “gentle easing” from the ECB, which may help boost markets

I think that what we're likely to see though is a central bank that, like the others, is going to be very gentle in its easing cycle. So once one rate cut is done, the ECB, like other central banks, is unlikely to rush into another rate cut. I think it's going to assess the data. I think just letting a little air out of the tires is going to be enough and is going to provide some level of comfort and I think will be a boost to markets. So my expectation is maybe we'll see one or two more rate cuts after June, but I don't think it's going to be an aggressive easing cycle, at least not this year.

UK: A tepid recovery and limited easing expected

We expect the United Kingdom to perform similarly to the eurozone but on a delayed timeline and with less near-term monetary policy easing. Activity has recently been improving, reflecting a tepid recovery as forward measures have been picking up. Disinflationary progress has also been improving, but to a lesser extent than in the eurozone.

The Bank of England (BOE) is expected to cut rates at least once before the end of the year as activity remains soft, but high inflation remains a challenging backdrop that is likely to limit further easing.

The BOE may err on the side of caution given sticky services inflation

The most recent inflation print showed progress, not as much progress as had been expected. And so I think the Bank of England is more likely to err on the side of caution and wait until August to begin rate cuts. That's not a sure thing, but I think it's a pretty sure thing. Again, I think it's going to be a gentle easing process, very gentle because it still is seeing some pretty sticky inflation on the services side and it wants to manage that carefully.

Japan: Stronger inflation could lead to more tightening

In Japan, the Noto Peninsula Earthquake and a suspension of some automobile shipments due to a local scandal caused a disruption in manufacturing activities in the first quarter. However, we expect a rebound in economic activities, supported by wage increases, improved manufacturing output and fiscal stimulus. In fact, the latest spring wage negotiations indicated a significantly higher pace of wage growth versus recent history, which we anticipate should help support consumption growth and lend support to continued normalization of inflation.

With inflation moderately stronger, we anticipate that the Bank of Japan (BOJ) will implement at least one additional rate hike by end-2024 and possibly initiate quantitative tightening as it is likely to see a higher probability of sustained 2% inflation.

We believe these factors are likely to spur global investors to raise their allocations to Japanese equities, helping to bring about a potential

outperformance of Japanese stocks versus other developed market stocks in the second half. The weakness in the yen may continue in the short run, although policy easing by the Fed and tightening by the BOJ could mitigate the weakness in yen toward the end of this year.

The BOJ appears eager to start hiking rates

The data is indicating that the BOJ has achieved some of its goals and I think that it's eager given the situation with the yen to start hiking, and now it looks as though it's a good possibility that we see two more rate hikes this year, which I think was unheard of a few months ago.

China: On the lookout for positive growth surprises

In China, we anticipate an improving economic environment and ample room for positive surprises. Growth appears to be strengthening, helped by factors such as a recovery in exports and fiscal policy support.

However, property market-related problems — including further decreases in property investment, lower consumer sentiment, and a decrease in local government funding — pose significant structural challenges and risks to economic growth. Proper handling of property issues by the government will be even more important.

Recent growth has been supported by an improvement in external factors, as indicated by recent export growth³. We anticipate that market sentiment is overly pessimistic, indicating a higher probability of growth surprises versus consensus expectations.

Emerging markets: A striking difference in opportunities across countries

Outside of China, emerging markets (EM) as a whole have faced a challenging global economic backdrop. Arguably, they've been hit harder than major economies by the wartime global commodity price shock, high inflation, and rapidly tightening global monetary policy. The Fed's pivot back to a high-for-longer stance on interest rates, as well as a stronger dollar, have posed a challenge for many emerging markets.

Having said that, we continue to be constructive about relatively resilient growth and resolute efforts to bring inflation down. And once Fed rate cuts materialize, we anticipate lower rates and a weaker dollar should provide support to EM assets.

We emphasize a striking divergence in both macro and growth performance across EM countries as well as the compelling turnaround/hope stories among several important EM fallen angels. Accordingly, we argue for an active approach to EM to help capitalize on differences in fundamental macro features and country stories across the EM space, instead of a binary overweight/underweight passive style.

Investment Implications

We believe markets today reflect a relatively optimistic macro scenario. We anticipate volatility in the near term as markets react to shifts in the rates outlook, including any supporting or conflicting data points along the way. In our view, the precise number of cuts is less important at this stage than the timing of them, especially as the market narrative continues to be highly volatile. There could also be a significant risk that

some markets may be overly positive and have not fully priced in potential problems.

Given the positive macro backdrop, we favor an overweight to risky assets. However, we note the need to keep risks tightly controlled as very tight valuations limit the upside for risky assets.

Equities

With our belief that global economic growth is likely to improve, we favor cyclical and small cap equities given relatively attractive valuations and greater sensitivity to the economic cycle. We also prefer developed ex-US and emerging markets equities for those same reasons. As central banks cut rates, we anticipate that valuations should also see support from lower discount rates.

Bonds

We believe bonds also offer attractive opportunities despite tight spreads, especially for longer holding periods. In our view, strong fundamentals underpin many fixed income assets, helping to explain extremely tight credit spreads in both investment grade and high yield credit. We favor some credit risk to take advantage of this resilient and improving growth backdrop. We also like the diversification properties of bank loans, which tend to have similar volatility to investment grade credit but with greater return potential (in our opinion) due to the high current yield. Given the near-zero duration of bank loans, we expect them to be relatively immune to interest rate volatility compared to other fixed income asset classes. We also anticipate strong performance from emerging markets local and hard currency bonds.

Real estate

We are also finding more opportunities in real estate. We believe that significant negative sentiment is already reflected in the price, and there could be meaningful upside potential as the environment improves. For example, cuts in policy rates provide scope for reductions in real estate debt costs and capitalization rates, which we believe could lead to renewed transaction activity and progress toward price recovery.

Currencies

We anticipate the US dollar will begin to weaken this year as the Fed begins to cut rates and would favor currencies such as the euro, the pound and the Brazilian real.

What we favor in our base case scenario

Equities

- Cyclically-sensitive equities, including value and small caps
- Developed ex-US and emerging markets equities

Fixed Income

- Neutral duration
- Higher quality non-investment grade credit, including bank loans and high yield credit
- Emerging market local and hard currency bonds

Currencies

- Non-US dollar currencies such as the euro, British pound and Brazilian real

Should investors be concerned about financial accidents?

The most positive thing I can say, and it's a significant comfort to me, is knowing that policymakers are very, very sensitive to the potential for financial accidents happening. We saw really rapid responses and impactful responses to things like the regional banking crisis in the United States, or I should say mini crisis. Similarly, we saw a very swift reaction and response to the gilt yield crisis in the UK. So I think policymakers recognize that that accidents can happen in an aggressive tightening cycle, and they're very, very laser focused on recognizing them quickly and then of course reacting to them in an appropriate fashion. So while that remains a risk, I think it's less of a concern.

Alternative scenarios

Since our 2024 outlook was published late last year, growth has remained considerably more resilient and inflation more stubborn than we anticipated. The degree of divergence across economies has also increased, with inflation taking different paths in major economies. While we have revised our base case view to reflect these changes, we maintain the core ideas of our alternate scenarios while reviewing progress since the start of this year.

Scenario 1: Hard landing

We believe a “hard landing” might have one of two potential drivers. In either case, the end result for investment implications would be similar, but the near-term experience would likely differ.

- We could start to feel the lagged impact of an already-committed policy mistake that proves to be too much for the US economy to handle. In this event, we would expect considerably weaker growth and sooner policy easing.
- Persistent inflation could require policymakers to keep rates higher for longer, resulting in a greater economic effect than we currently anticipate.

What we favor in a hard landing

- Cash
- Equities: Defensive equities, such as consumer staples, health care, utilities
- Fixed Income: Long-duration sovereigns
- Currencies: Non-US dollar, non-commodity defensive currencies, such as the Swiss franc and Japanese yen

Scenario 2: Soft landing

We also consider an upside scenario for the US in which already-realized cooling on the demand side helps lower inflation pressures, helping core inflation to fall with more certainty and at a smoother trajectory versus

the base case. We expect this would help enable the Fed to ease sooner and more, with a likely weaker dollar and a favorable bias for risky and non-US assets.

In this “soft landing” scenario, the US economy would be presently in (or even exiting) a midcycle slowdown and would reaccelerate in the second half of 2024. Outside the US, we would expect surplus economies like the eurozone, as well as twin-deficit emerging markets, to benefit in this environment.

What we favor in a soft landing

- Equities
- Europe, China, emerging markets
- Value and small caps
- Basic resources, industrials, financials
- Fixed Income: High yield credit
- Currencies: Australian dollar, Canadian dollar
- Commodities: Industrial commodities, especially metals

Notes

¹Source: Board of Governors of the Federal Reserve System, as of March 31, 2024

²Based on gross domestic product growth and consumer prices for the US and eurozone

³China’s exports rose 7.6% year-over-year as of May 2024. Source: China General Administration of Customs

Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

Diversification does not guarantee a profit or eliminate the risk of loss.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China’s dependency on the economies of other Asian countries, many of which are developing countries.

Investors whose primary currency is not in US Dollars should be mindful of potential exposure to fluctuations in exchange rates.

Stocks of small- and mid-sized companies tend to be more vulnerable to adverse developments, may be more volatile, and may be illiquid or restricted as to resale.

A value style of investing is subject to the risk that the valuations never improve or that the returns will trail other styles of investing or the overall stock markets.

The health care industry is subject to risks relating to government regulation, obsolescence caused by scientific advances, and technological innovations.

The profitability of businesses in the financial services sector depends on the availability and cost of money and may fluctuate significantly in response to changes in government regulation, interest rates and general economic conditions. These businesses often operate with substantial financial leverage.

Fixed income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer’s credit rating.

Junk bonds involve a greater risk of default or price changes due to changes in the issuer’s credit quality. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

Most senior loans are made to corporations with below investment-grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid.

Investments in real estate-related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate. Real estate companies, including REITs or similar structures, tend to be small and mid-cap companies and their shares may be more volatile and less liquid.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

The Consumer Price Index (CPI) measures change in consumer prices.

The Citi Economic Surprise indexes are quantitative measures of economic news, defined as weighted historical standard deviations of data surprises; a positive reading of the Economic Surprise Index suggests that economic releases have on balance been beating consensus.

Statements in the audio clip about the relative performance of the US economy versus the eurozone, emerging market, and Chinese economies based on these indexes as of June 6, 2024.

Purchasing Managers' Indexes (PMI) are based on monthly surveys of companies worldwide and gauge business conditions within the manufacturing and services sectors.

Credit spread is the difference in yield between bonds of similar maturity but with different credit quality.

Tightening monetary policy includes actions by a central bank to curb inflation.

Monetary easing refers to the lowering of interest rates and deposit ratios by central banks.

The discount rate is the interest rate a central bank charges commercial banks and other financial institutions for short-term loans.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. Duration is expressed as a number of years.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The eurozone (also known as the euro area) is an economic and monetary union of European Union member states that have adopted the euro as their common currency.

The opinions referenced above are those of the author as of **June 6, 2024**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.