

# As global economies diverge, where are the investment opportunities?



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Last week we published our midyear investment outlook, with an overarching theme of finding opportunities amidst divergence. We have Western developed economies all moving in the same direction – generally declining inflation and at or near the start of rate cuts – but at different speeds. Much of this divergence can be attributed to how each major economy reacted to the pandemic, with the US leading the pack in term of stimulus, and how quickly each economy responded to the resulting surge in inflation. This is enough to create material divergences that are now playing out in how quickly respective central banks are beginning to cut rates.

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### The US signals comfort with keeping rates higher for longer

Last week, the Federal Reserve (Fed) decided to keep interest rates steady and suggested it is comfortable sitting at high levels for as long as it takes to feel confident that there will not be a resurgence of inflation. The “dot plot” released last week told us a lot about the Fed’s thought process – with median expectations for rate cuts this year falling to one. Equally interesting was the revision upward in the core Personal Consumption Expenditures Index, with the median year-end forecast increasing from 2.6% to 2.8% (it was just 2.4% in the December 2023 dot plot).

In his press conference following that meeting, Fed Chair Jay Powell described the US economy this way, “...the overall picture is one of a strong and gradually cooling, gradually rebalancing labor market.” In other words, the US is on the slower side of diverging plans for rate cuts.

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### Europe cuts rates while regional divergence accelerates

In contrast, over just the last two weeks, the Bank of Canada and European Central Bank (ECB) have initiated rate cuts, satisfied with disinflationary progress. However, the ECB suggested its pace will be slow and that the timing of additional cuts will be very data dependent.

There is a substantial amount of divergence going on in European markets right now. For example, the spread between the French 10-year government bond and the German 10-year government bond has recently widened substantially, rising to 80 basis points on June 14 – its highest level in more than a decade.<sup>1</sup> And since the start of June, the MSCI France Index has substantially underperformed the MSCI Europe Index.<sup>2</sup>

This divergence is largely a result of political uncertainty in France, exacerbated by a recent S&P downgrade of French sovereign debt as a result of concerns about France’s deficit.

French President Emmanuel Macron called snap parliamentary elections just after far right political parties performed very well in the EU Parliament elections. He explained his decision to dissolve the National Assembly and call for French elections, “The rise of nationalists and demagogues is a danger for our nation and for Europe. After this day, I cannot go on as though nothing has happened.”<sup>3</sup>

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There is a risk of significant political instability given how unpopular Macron's centrist political party appears to be. Marine LePen, leader of the far right National Rally party, tried to allay concerns, saying that she would not call for Macron's resignation if her party wins.<sup>4</sup> That should give rise to hope that if her party gains power, it could be similar to Giorgia Meloni in Italy, who has positively surprised with a center-right government after causing trepidation when elected as prime minister.

Still, current political uncertainty does present risks that European Union reforms, such as creating a capital markets union, may be harder to achieve. And plans for greater fiscal spending, coupled with nationalist opposition to the EU charter pledge of "ever deeper union," could prevent a fiscal union from being realized for the EU. All of the above may hold back innovation, competition, productivity, scale, and growth by undermining the EU single market. Having said that, this could represent an attractive buying opportunity for European equities if markets price in those risks – although UK equities appear more attractive now, in our view.

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### **In the UK, politics appear more certain as the election looms**

The UK is in a far different place from the EU. While the EU is in the throes of political uncertainty, the UK appears to have significant political certainty with the Labour party leading by a wide margin in the polls leading up to the July 4 election. It seems a fait accompli that Keir Starmer will be the next prime minister, and that the UK will shift to a center-left government. UK equities, like European equities, are attractively valued in our view, but don't carry with them near-term political instability risks.

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### **Japan and China hold rates steady**

The Bank of Japan decided to hold rates at current levels at its June meeting – but it also plans to soon begin reducing bond purchases. It is reaping the benefits of structural reforms that have helped normalize its economy, enabling it to start normalizing monetary policy.

Its neighbor, China, is in a somewhat different place. We are seeing a continued recovery in domestic demand, with May marking the fourth straight month of consumer inflation in China. The most recent retail sales report was encouraging, while industrial production has been robust; however the property sector continues to be a source of concern. The People's Bank of China decided at its June meeting to keep rates at current levels, likely because the disadvantages outweigh the advantages of a rate cut at this time.

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### **Emerging markets divergences**

We are also seeing divergences in emerging markets elections. In the last several weeks, we got election surprises in Mexico, South Africa, and India. South African and Indian voters showed decreased support for their incumbents, while Mexican voters showed increased support for theirs.

In South Africa, after losing significant support, it appears that the incumbent African National Congress (ANC) government led by Cyril Ramaphosa has been able to successfully form a centralist coalition, which includes his reappointment. This seems to be more appealing to markets than an unwieldy unity or left wing coalition that includes the Economic Freedom Fighter party. This outcome signifies stability, which is obviously important to investors.

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In India, the surprise loss of seats by Prime Minister Narendra Modi caused an initial negative reaction from markets given his popularity and expectations he could gain seats. Since then, Modi has formed a coalition that will enable him to still dominate India's political stage. He kept the four main ministries and ministers (Finance, External, Home, Defence) while enlarging his cabinet to 72 members in order to include coalition partners. I see this as a positive outcome that has and should continue to be well received by markets.

The most negative market reaction was to the Mexican election results. There is concern that Claudia Sheinbaum's administration, given its strong showing at the polls, has been given a mandate to move the country to the left. However, this is likely to be limited. Rogelio Ramirez de la O, a respected and steady hand serving as Finance Minister, is expected to stay on in this role, which should signal macro stability to investors.

In our view, India's markets look to be the most attractive of these three, though Indian bonds are more compelling than stocks because of high equity valuations. South Africa's relief rally may have legs. There is investor skepticism around Mexico right now; investors will likely need to see policies that are not perceived as too left wing in order to have greater confidence in Mexican assets.

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### What we're watching this week

This week we will be eager to see the US retail sales report, given differing views on the strength of the US consumer (and a weak consumer sentiment report last week). We will also get eurozone and UK inflation data and Purchasing Managers' Index data. We are also likely to get more central bank divergence this week. At the Bank of England and Reserve Bank of Australia meetings, rates are likely to stay put, while the Swiss National Bank is widely expected to cut at its meeting this week.

*With contributions from Arnab Das*

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### Dates to watch

Date	Event	What it tells us
Jun 17	European Central Bank President Lagarde speaks	Gives further insight into the central bank's decision-making process.
	Canada housing starts	Indicates the health of the housing market.
	Empire State Manufacturing Index	Surveys manufacturers in New York State by the Federal Reserve Bank of New York.
Jun 18	Reserve Bank of Australia decision	Reveals the latest decision on the path of interest rates.
	Germany ZEW Economic Sentiment Index	Measures economic sentiment in Germany for the next six months.
	Eurozone Consumer Price Index	Tracks the path of inflation.
	US Retail Sales	Indicates the health of the retail sector.
	US Industrial Production	Indicates the health of the industrial sector.
	Bank of Japan monetary policy meeting minutes	Gives further insight into the central bank's decision-making process.

Date	Event	What it tells us
Jun 19	UK Consumer Price Index	Tracks the path of inflation.
	UK Producer Price Index	Tracks the path of inflation.
	Bank of Brazil decision path of interest rates.	Reveals the latest decision on the path of interest rates.
Jun 20	Swiss National Bank decision	Reveals the latest decision on the path of interest rates.
	Bank of England decision	Reveals the latest decision on the path of interest rates.
	ECB Economic Bulletin	Presents the economic and monetary information which forms the basis for policy decisions.
	Eurozone Consumer Confidence	Measures consumer sentiment in the eurozone.
	Japan Purchasing Managers' Indexes	Indicates the economic health of the manufacturing and service sectors.
	Japan National Consumer Price Index	Tracks the path of inflation.
Jun 21	UK Retail Sales	Indicates the health of the retail sector.
	Eurozone Purchasing Managers' Indexes	Indicates the economic health of the manufacturing and service sectors.
	UK Purchasing Managers' Indexes	Indicates the economic health of the manufacturing and service sectors.
	Canada Retail Sales	Indicates the health of the retail sector.
	US Purchasing Managers' Indexes	Indicates the economic health of the manufacturing and service sectors.
	US Leading Economic Indicators	

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## Notes

<sup>1</sup>Source: Bloomberg as of June 14, 2024

<sup>2</sup>Source: MSCI. From June 1, 2024, through June 14, 2024, the MSCI France index return was -7.53% while the return for the MSCI Europe Index was -2.69%.

<sup>3</sup>Source: The New York Times, "Macron calls new French legislative elections," June 9, 2024

<sup>4</sup>Source: Politico, "France's Le Pen says she won't seek Macron's resignation if far right wins snap election," June 16, 2024

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## Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

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.

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

Personal Consumption Expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual US household expenditures.

The MSCI Europe Index captures large- and mid-cap representation across a universe of developed market countries in Europe.

The MSCI France Index is an unmanaged index considered representative of French stocks.

Purchasing Managers' Indexes measure the economic health of the manufacturing and services sectors.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

A basis point is one-hundredth of a percentage point.

Spread represents the difference between two values or asset returns.

The opinions referenced above are those of the author as of **June 17, 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.