Quarterly Outlook

Are we in soft landing territory?

December 2023

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Introduction

The Ortec Finance Economic Scenario Generator is a global model that integrates short-, medium- and long-term investment horizons consistently across all asset classes and economies **[1: Ortec Finance Economic Scenario Generator].** This enables multiple investment and risk management applications like ALM, SAA, ORSA, and ECAP to be served with a single model. It provides realistic stochastic risk and return scenarios for all relevant time horizons and balance-sheet-level applications in a single calibration, bringing consistency and efficiency to enterprise-wide investment decision-making and risk management. The frequency domain methodology employed in the model isolates long-term ("trend" or 10-year horizon), medium-term ("business cycle" or annual horizon), and short-term ("momentum" or intra-year) return dynamics for better understanding and reflection of financial risk and return characteristics over time. This document describes the Ortec Finance economic outlook with the market data available at the end of December 2023.

Fading “higher for longer” fears fuel an extraordinary end-of-year rally

Q4 2023 began with broad negative market sentiment on the back of “higher for longer” interest rate fears, however sentiment turned positive in November and December after a series of softer than expected inflation readings in the US, EU, and UK. Besides declining headline inflation, core inflation also decreased in these regions, albeit somewhat less. The turnaround in sentiment was further supported by major central banks keeping policy rates stable and economic data reinforcing market expectations that central banks had finished hiking and even hinting possible rate cuts as early as Q1 2024 for the US. The combination of lower than anticipated inflation readings and stabilizing policy rates, led to a decrease in nominal and real interest rates, translating to an almost global rally in assets.

Besides these mainly positive developments, the Federal Reserve, European Central Bank, and Bank of England stated that they remain vigilant as their fight against inflation has not been concluded yet.

Although the US economy has performed surprisingly well, driven by low unemployment and robust consumer spending, weak producer confidence suggest that economic activity is slowing. In contrast to the US, Eurozone and UK economic sentiment and growth remained weak. In Asia, Japan’s economic growth disappointed and the central bank of Japan signaled that its loose monetary policy is under pressure as inflation seems to stabilize above target creating a difficult balancing act. Additionally, China continuously struggled to recover from the Covid aftermath. The People’s Bank of China repeatedly injected liquidity into the Chinese banking system, as the real estate sector slump persists and consumer spending remains subdued, resulting in deepening deflation.

All in all, global equities have experienced an extraordinary end-of-year rally despite concerns of slowing economic activity. Additionally, fixed income has performed well over the quarter on the back of falling long rates, as inflation continues to moderate. Although the end of the hiking cycle of most major central banks has likely been reached, and long rates have decreased across multiple regions, the impact of prolonged restrictive monetary policy on economies and financial markets is likely yet to fully unfold.

Momentum outlook worsens after a strong quarter for equities and bonds

During the fourth quarter, capital markets have rallied as inflation readings in several developed markets came in cooler than expected and major central banks signaled a stabilization of policy rates. As a result, long interest rates have retracted from their recent highs, decreasing over the quarter by roughly 65bps to 85bps for the US, UK, and Eurozone, leading to strong realized returns for high duration government bonds. Equities have performed strongly for most developed market regions, while UK and Japan were lagging. The energy-heavy UK equity index underperformed due to lower oil prices and sterling strength. Japanese equities underperformed other developed markets due to prospects of future monetary tightening and yen strength.

Equity market returns surprised to the upside compared to the relatively flat end-of-September equity momentum outlook. Consequently, the momentum outlook worsens by about 0.5% compared to end-of-September, reflecting already realized positive equity returns over the past quarter. Nonetheless, the equity momentum outlook is expected to remain slightly positive on the 12-month horizon on the back of decreasing interest rates.

In contrast, energy futures underperformed following the decline in oil prices. Declining oil prices were the result of a record daily US supply, OPEC's failure to adhere to production quotas, and relatively soft winter weather. On the other hand, gold prices strongly increased, reflecting safe-haven flows, following increasing geo-political tensions illustrated by the abrupt escalation between Israel and Hamas.

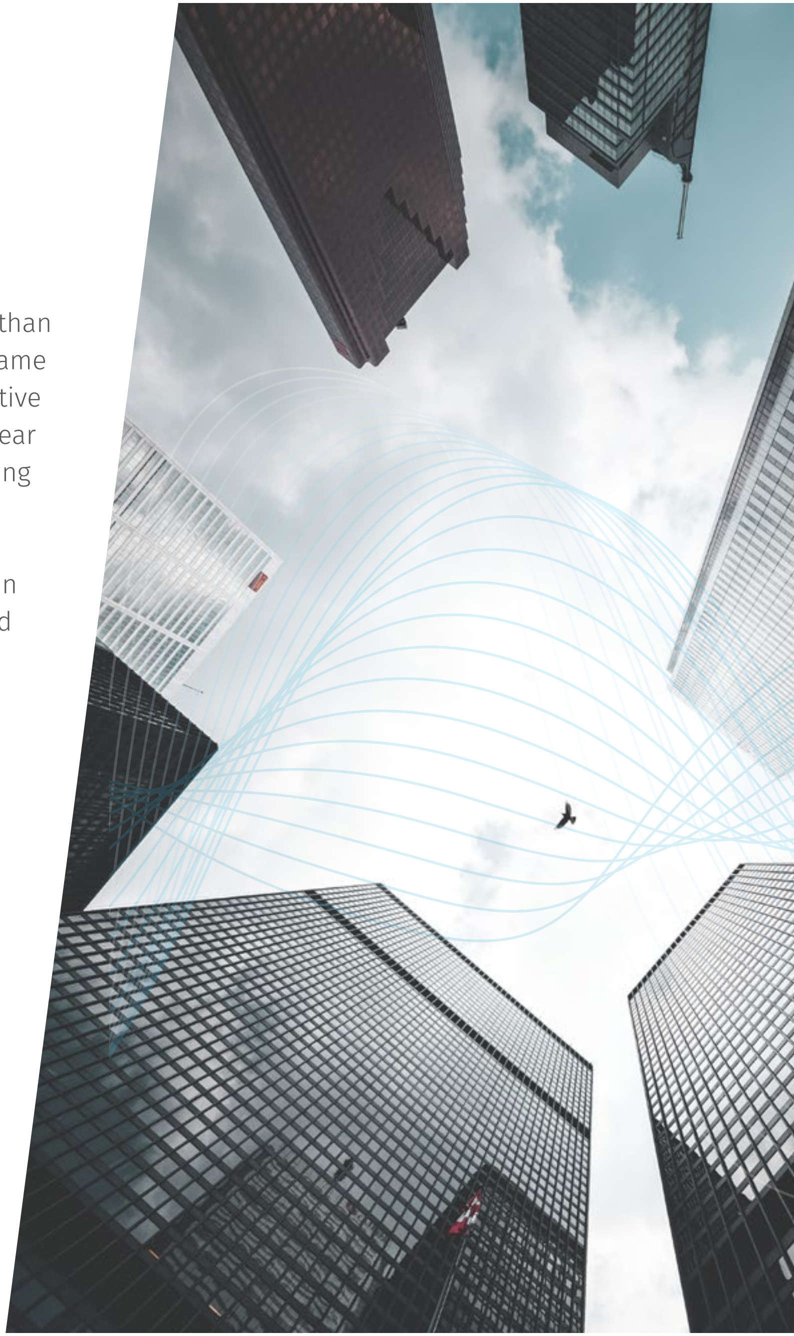
The momentum outlook remains clouded by elevated volatility and downside risk due to tight financial conditions and elevated geopolitical tensions.

Business cycle outlook slightly improves in the short run as inflation is expected to cool

Positive market sentiment, driven by what appears to be the end of the rate hike cycle, and cooler than anticipated inflation, improve the initial level of the *Ortec Finance Business Cycle indicator*. At the same time, today's reading of the business cycle still indicates a contractionary phase. These same positive effects accompanied by an increase in purchasing power improve the business cycle outlook on the 1-year horizon. This brings the *Ortec Finance Business Cycle Indicator* into slightly positive territory, transitioning from a contractionary- to an expansionary phase.

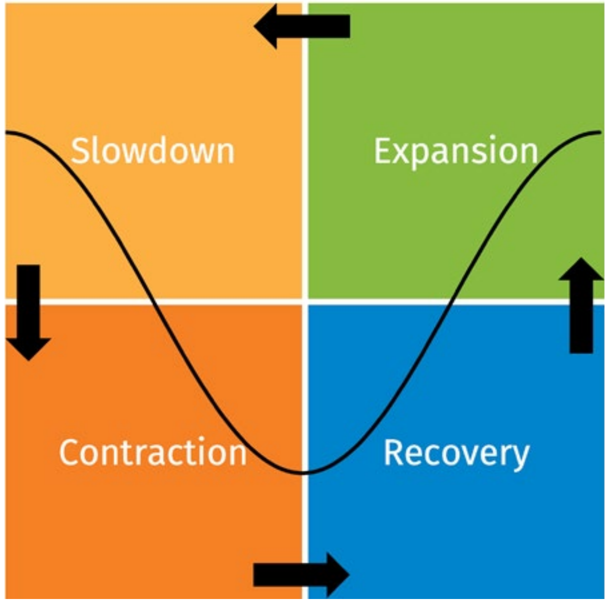
Additionally, the business cycle outlook worsened on a 3–5-year horizon and is anticipated to remain close to its neutral level, reflecting lower upside potential for above-trend growth and above trend interest rates.

Although uncertainty about the inflation outlook is declining, inflation risks are somewhat elevated as core inflation continues to remain above central bank target, representing a significant source of uncertainty for the business cycle outlook. On the upside, inflation continued to moderate against the backdrop of relatively robust economic activity, fueling hopes of moderating inflation without significant job losses. Additionally, an unanticipated de-escalation of the war in Ukraine or Palestine could potentially boost sentiment and the economic outlook.

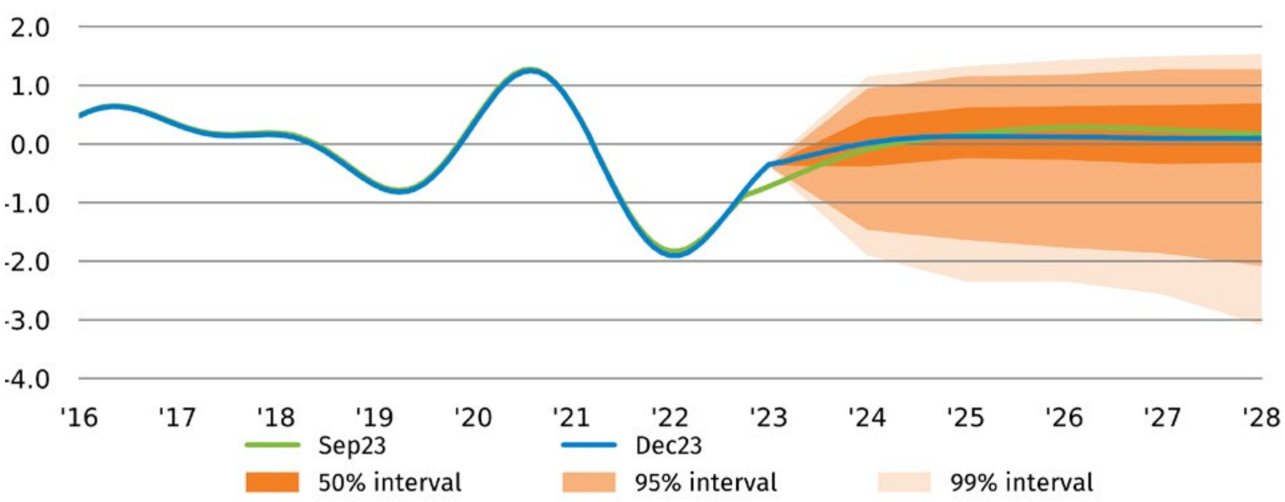


On the downside, impacts of higher interest rates on the global economy may have only started to unfold and are likely to weigh on economic activity, hiring and inflation. The impact of tight financial conditions is likely to emerge in a non-linear fashion, where corporates and governments with large financing requirements become increasingly fragile. One such example is the ongoing turmoil in the Chinese real estate sector, as declining home prices and refinancing difficulties exposed weakness in several large property developers. Additionally, a further (regional) escalation of the Israel-Hamas war could push up energy prices and severely disrupt global trade if freight carriers decide to avoid transit through the Suez Canal for a prolonged period.

While a further moderation of inflationary pressures improves the business cycle outlook in the short-term, above-trend interest rates combined with decelerating economic activity mean that risks remain tilted to the downside. Nonetheless, as signified by the continued moderation in inflation and limited job losses despite tight monetary policy, one could argue we are still heading towards a soft landing. However, as the effects of higher interest rates may have just started to materialize, core inflation is still above central bank target, and geopolitical tensions remain high with multiple wars raging at the border of Europe, a soft landing is not a given.



Ortec Finance Business Cycle Indicator (medium-term growth, equities and credits)



Beyond the cycle: faster normalization of interest rates to historical trend levels

Beyond short-term and medium-term cyclicality, the *Ortec Finance Scenario Set* covers the long-term outlook many decades into the future. This outlook is driven by structural global economic developments and accounts for regional differences.

Considering global events in recent years including the pandemic, the war in Ukraine, increased geopolitical tensions, and the subsequent shift in the financial and monetary landscape with the highest inflation and interest rates in decades, the dynamics of the *Ortec Finance Trend Indicators* have been updated. The effects of this update are pronounced for the *Ortec Finance Trend Indicators* for interest rates and inflation.

Accordingly, interest rates are anticipated to normalize faster to historical trend levels where expected interest rates have increased by 30 basis points on a 10-year horizon. On the other hand, expected inflation declined by 15 basis points on a 10-year horizon as implied by expected tighter medium-term financial conditions.

Ortec Finance Economic Scenario Generator

At Ortec Finance, we are committed to helping our clients manage the complexity of investment decision-making. Models in general – and scenario models in particular – are believed to be the most helpful tools to improve investment decisions, because of the consistency, objectivity, transparency, and efficiency that working with models in a proper way can bring **[2: Relevance of scenario models]**.

The Ortec Finance Economic Scenario Generator integrates short and long investment horizons consistently across all asset classes and economies. This enables our clients to apply one consistent risk management framework for long, medium, and short-term investment decision-making. To ensure that the scenarios are as realistic as possible, the data and model-driven approach is augmented with views and expert opinion **[3: Ortec Finance scenario approach]**.

The frequency domain methodology, combined with dynamic factor models, has been developed specifically to capture the complex realities of financial and economic markets for all horizons and asset classes at any point in time.

Our clients benefit from efficient, consistent, realistic, and independent scenarios, powered by the frequency domain approach of our Economic Scenario Generator. Scenarios are available for the end of every month or for horizons from one month to many decades. All scenarios are delivered via the software or scenario file service.

Contact Hamish.Bailey@ortec-finance.com for more information.

More information

[1] Find out more our Economic Scenario Generator

[2] Read more in whitepaper Relevance of scenario models

[3] Read more in whitepaper Ortec Finance scenario approach

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