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Redux Of The Late 1990s

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Our *2024 Outlook*, published on December 4, 2023, was entitled ***"Disinflation, Reflation And The Roaring 2020s"***. We laid out the case that the post-pandemic economic recovery in the U.S. would evolve into a productivity-led expansion with rising stock prices, falling inflation, a strong dollar and lower interest rates.

So far, our predictions have been mainly accurate: the S&P 500 has advanced 18% since the beginning of the year, while core PCE inflation has fallen to 2.6% from well over 2.9% early this year. The DXY has strengthened more than 5%. Bonds have gone through a roller-coaster ride, but 10-year Treasury yields have begun to fall.

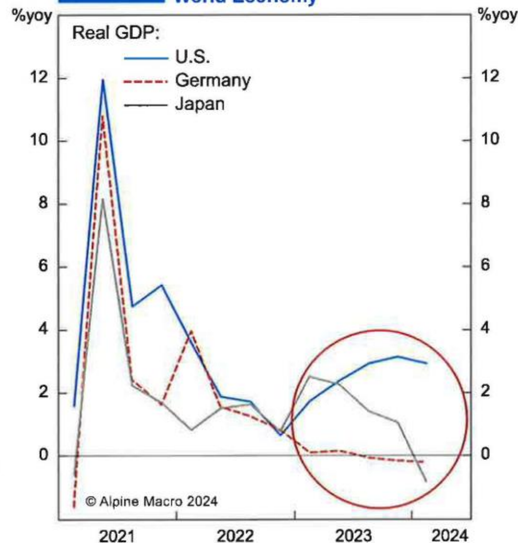
Going forward, we continue to project a dovish Fed pivot on the back of softer U.S. growth, falling inflation and only moderate improvement in the rest of the world. Longer term, a revival in labor productivity because of AI-related investment will continue to boost real income and corporate profits, while suppressing inflation.

The key risks to this bullish thesis include whether the U.S. economy will fall into a recession and policy uncertainty related to a second Trump presidency, should he win the November presidential election.

Macro Background: Global Convergence

Going into the second half of the year, the world economy will likely be more in sync than it has been since the post-pandemic economic reopening. **Chart 1** highlights the unusual divergence among the world's major economies since 2021.

Chart 1 A Widely Diverged World Economy



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Looking ahead, we see the U.S. economy softening to below potential, but European economic stagnation ending and growth strengthening somewhat. China's growth will likely stay flat due to the drag from the country's real estate implosion, oversaving and a lack of policy stimulus.

Overall, aggregate GDP growth for the world economy should be at 3-3.1% for the remainder of the year, though dispersion among major economies will be smaller than before. The resyncing of the world economy means that monetary policy among major central banks should move in the same direction towards easing.

Two unique factors propped up U.S. economic growth in 2023 – a falling savings rate and a rising fiscal deficit, with the former alone having added 1.3% of GDP growth last year. But these two factors are reversing.

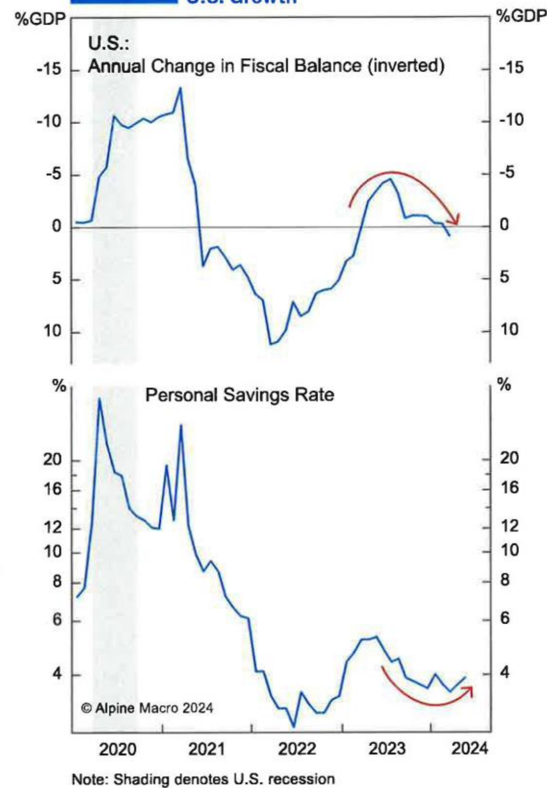
Chart 2 shows that the personal savings rate has begun to rise, while the fiscal impulse has turned to restraint. These two factors could push GDP growth down by 1-1.5% for the remainder of the year.

In Europe, the weakest spot has been Germany, which has been hit hard by three negative shocks since 2022:

- The Russia-Ukraine war has forced Germany to move away from cheap Russian energy, creating substantial dislocation for both businesses and consumers.

- China's economic downturn has also further shaved demand for German exports, adding economic plight.

Chart 2 Two Unique Factors Propping Up U.S. Growth



Note: Shading denotes U.S. recession

- The ECB's monetary tightening has further damaged domestic demand.

Chart 3 shows that German GDP has stagnated since 2022, while industrial production has contracted nearly 13% from pre-pandemic levels, of which 6% of the decline has occurred since 2022.

Nevertheless, we suspect that the steep decline in economic activity may have reached an inflection point, setting the stage for some recovery.

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Chart 3 The Worrying State Of The German Economy

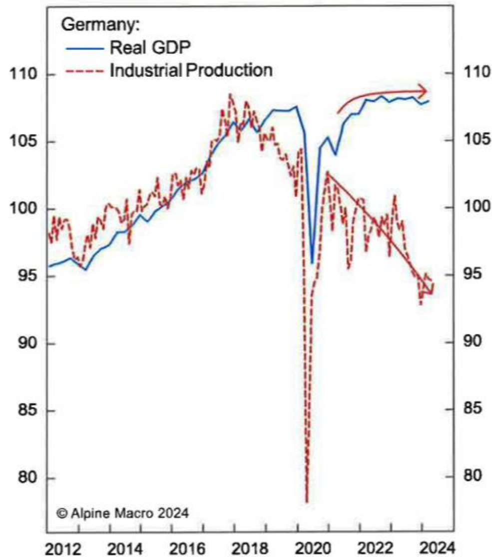
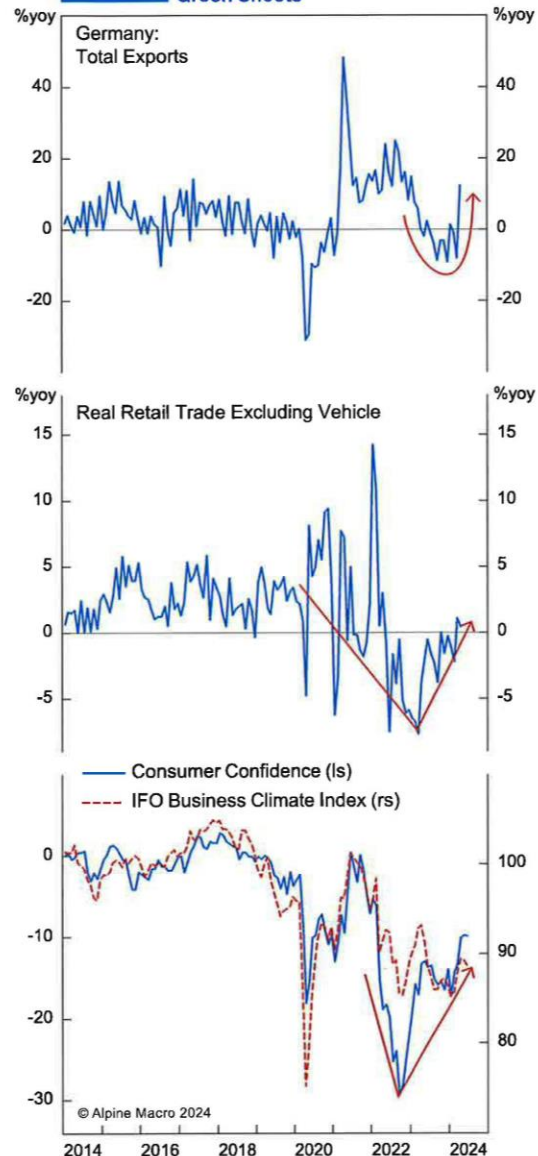


Chart 4 Germany: Some Economic Green Shoots



Germany's export growth is in a rebound after a steep fall last year, while consumer spending is also trying to recover from the deep freeze between 2022 and 2023 (**Chart 4**). Consumer confidence and the IFO Business Climate Index are also rebounding, though admittedly from extremely depressed levels.

Finally, the Chinese economy will likely continue to limp along, with economic growth still much below its potential rate. This means liquidation pressures among Chinese manufacturers will grow and deflationary pressures from China will intensify.

The meltdown in property has substantially shaved aggregate demand from the economy and this downturn is secular in nature due to a declining and aging population, and maturing urbanization.

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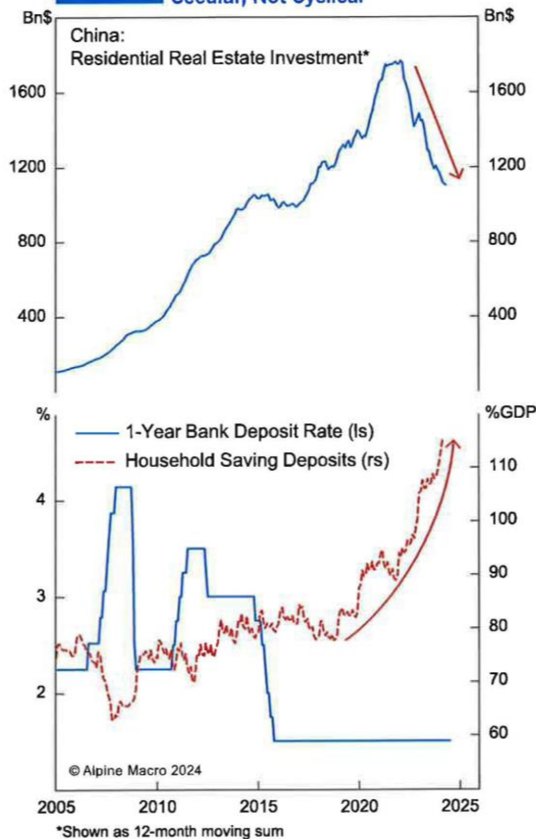
Chart 5 **The Real Estate Meltdown: Secular, Not Cyclical**

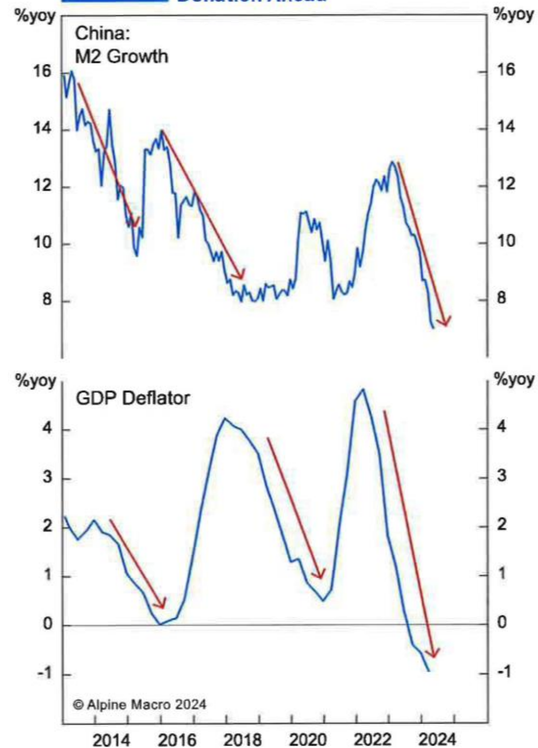


*Shown as 12-month moving sum

This means that the cliff fall in real estate investment will not recover (**Chart 5**, top panel), thus creating a permanent loss of demand.

Data show that the drawdown in real estate investment amounts to US$700 billion since 2022, or 4% of GDP, but the investment downturn is not yet complete. We estimate the total loss of investment should be around $1.3 trillion, or 7-8% of today's GDP, when all major adjustments are done.

Chart 6 **Falling M2 Growth: Deflation Ahead**



This massive hole of domestic demand needs to be filled up either by public sector dissaving (fiscal deficit) or by the household sector spending more and saving less. Nevertheless, with Chinese households in no mood to boost consumption (**Chart 5**, bottom panel), the burden of adjustment falls squarely on the shoulders of the government.

The problem is that the Chinese government has been extremely reluctant to step up to the plate and provide the necessary stimulus, for fears of a fiscal or debt crisis. Such fears have prevented

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Beijing from taking actions to rescue the economy from both the pandemic crisis and the fallout in real estate.

The bottom line is that deficient demand will continue to keep economic growth underneath its potential rate. This means more deflation, liquidation, and severe competition (**Chart 6**). China's total social financing is contracting, and stock prices have fallen anew. Both are warning signals that the economy is under increasing downward pressure.

Will The U.S. Fall Into Recession?

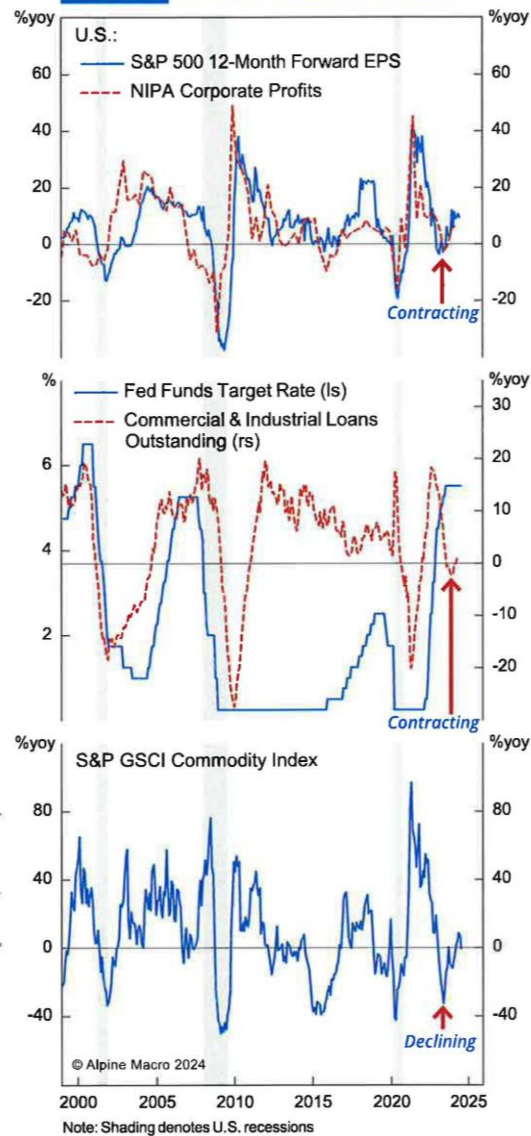
This is a contentious issue, as strategists have made bold calls in both directions. Our view has been that the odds of the U.S. economy entering a recession are not very high, for several reasons:

First, a "technical recession" already happened in 2022 when U.S. GDP contracted for two consecutive quarters, corporate profits declined sharply, commodity prices fell hard, and U.S. credit creation shrank (**Chart 7**).

Consistent with this, stock prices fell 22% from peak to trough. The key point is that the "technical recession" in 2022 reduces the odds of a severe recession now, barring new massive negative shocks.

Second, the household sector has a strong balance sheet. **Chart 8** shows that the household sector has gone through a prolonged deleveraging process and its debt-to-disposable income ratio is way down. In the meantime, the burden of net interest payments on consumers is at its lowest levels ever.

Chart 7 The 2022 Technical Recession



Note: Shading denotes U.S. recessions

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Chart 8 U.S. Households: Strong Balance Sheet

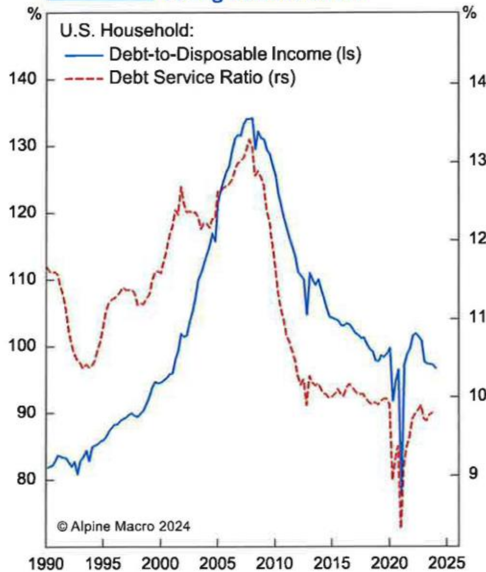
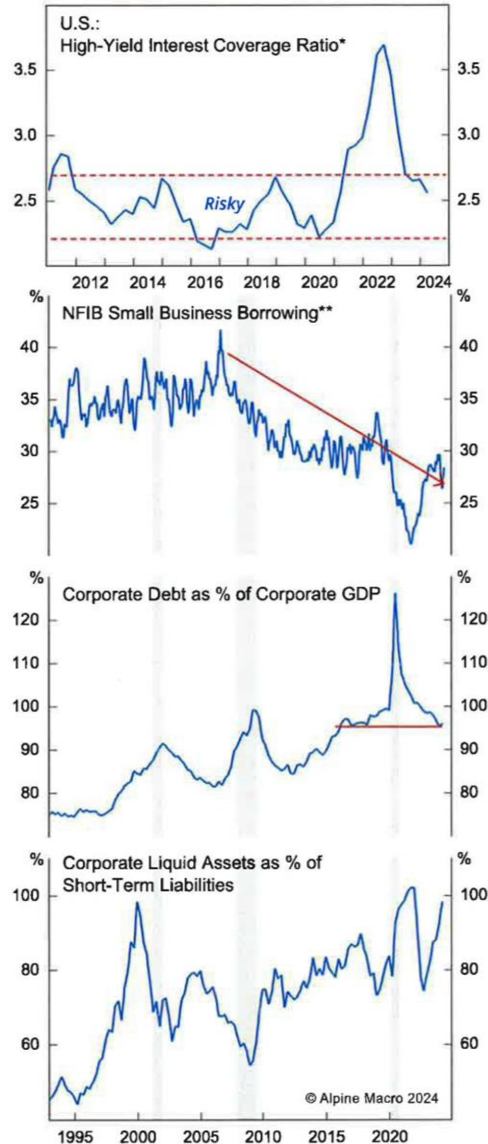


Chart 9 U.S.: Corporate Balance Sheet At A Glance



*Source: Bloomberg Finance L.P.
**Borrowing at least once every three months; shown as 3-month moving average

The corporate sector balance sheet is not as solid as the household sector, but corporate borrowing as a share of corporate GDP has also dropped (**Chart 9**). However, corporate interest costs have risen because of higher short-term interest rates, especially for small businesses.

The interest coverage ratio (ICR) for high-yield companies has fallen sharply since late 2022, but it is still above the danger zone. On a positive note, corporate liquid assets as a share of short-term liabilities have soared to very high levels (**Chart 9**, bottom panel).

All of this suggests that the corporate sector is under some stress because of higher rates, but it is not in a precarious state or at the precipice of another major recession.

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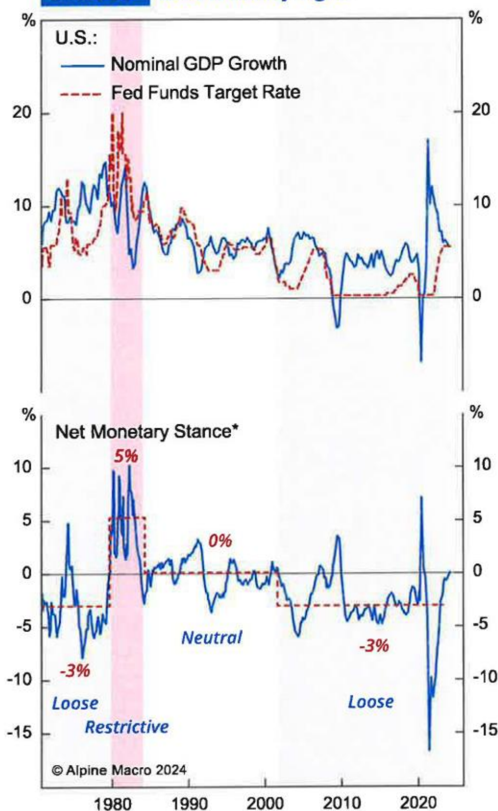
Chart 10 U.S.: Is Money Tight?

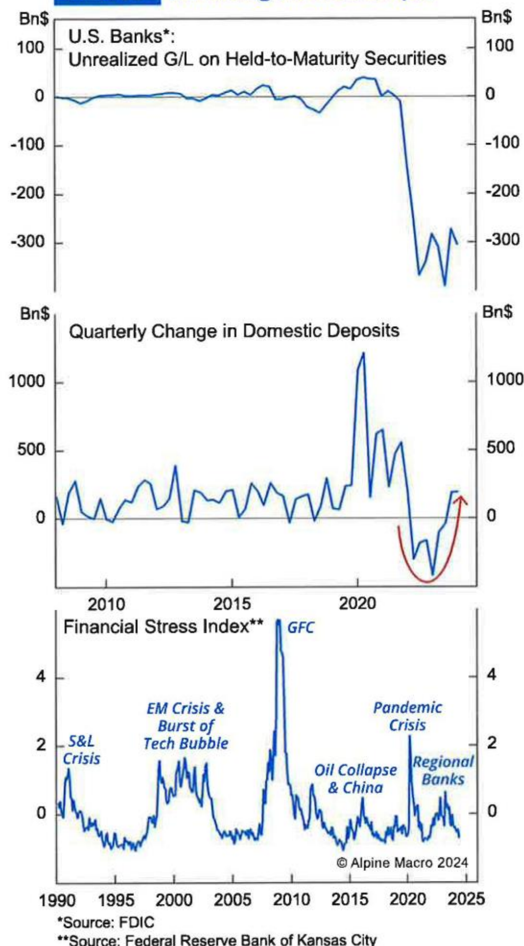


*Fed funds target rate minus nominal GDP growth rate
Note: Shading denotes periods when policy is neutral

Third, it is debatable how restrictive monetary policy is. **Chart 10** measures the distance between the Fed funds rate and nominal GDP growth. When the policy rate is lower than nominal GDP growth, monetary policy should be considered as easy because there is a positive markup above borrowing costs. And vice versa.

Although the Fed has tightened policy aggressively since 2022, the monetary stance seems to have only returned to neutral territory, judging by the distance between policy rate and nominal GDP growth.

Chart 11 Monitoring The Trouble Spot



*Source: FDIC
**Source: Federal Reserve Bank of Kansas City

Nevertheless, the Fed needs to cut rates sooner than later, because nominal growth will likely fall further as disinflation continues, making policy restrictive.

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Finally, U.S. recessions are always led by financial crises, and usually, these crises are provoked by Fed monetary tightening. The 2023 regional banking crisis could have become a systemic shock, but the Fed effectively clamped it down by opening the liquidity window.

Regional banks are on the mend, with the deposit base growing again and net interest margins rising (Chart 11). There will be more bank failures and mark-to-market losses remain big, but with the Fed on hold and bonds having rallied, the odds of the economy being struck by another systemic event are low, in our view.

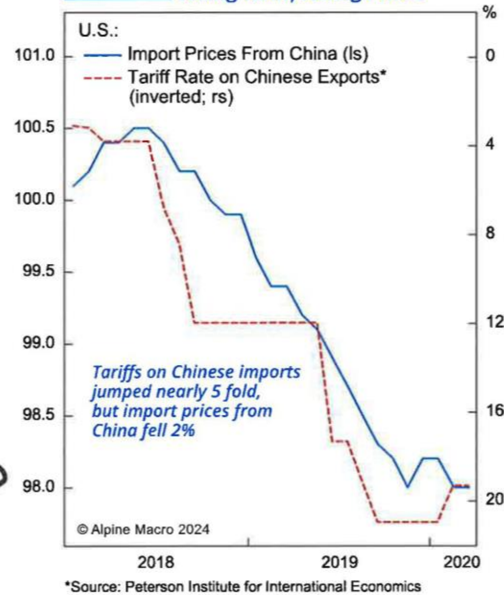
What About A Second Trump Presidency?

With President Biden's debate debacle on June 27, the odds of a second Trump presidency have risen sharply. In our view, a second Trump presidency is a mixed blessing for the economy and financial markets. In a nutshell, the extension of Trump's 2017 tax cuts and additional deregulations will likely excite a bull run in stocks, but his radical tariff policy could undo the positives.

Trump's proposed 60% tariff rate on Chinese imports can be a bargaining tactic, but it may not be. A sharp rise in import duties on Chinese goods is entirely possible. If so, how will financial markets be affected?

First, a rising tariff is no different from a tax hike, and its impact on the economy is similar to an oil shock – a higher tariff rate either robs corporate profits or siphons off purchasing power of consumers, leaving less for investment or buying other goods and

Chart 12 The 2018 Tariff War: Rising Tariff, Falling Prices



*Source: Peterson Institute for International Economics

services. A rising tariff is bearish for income growth and stock prices.

Second, protectionism can be deflationary rather than inflationary. The 2017/18 tariff war caused U.S. import prices from China to fall because of price cuts by Chinese producers and CNY depreciation (Chart 12). The tariff war also caused stocks to stumble, but bonds to rally.

Historically, massive tariff hikes always ended in price deflation and recession, and these include the 1922 and 1930 Smoot-Hawley tariff hikes (Chart 13). The key point is that a tariff hike drives down disposable income, dwarfing the relative price effect and causing price levels to fall.

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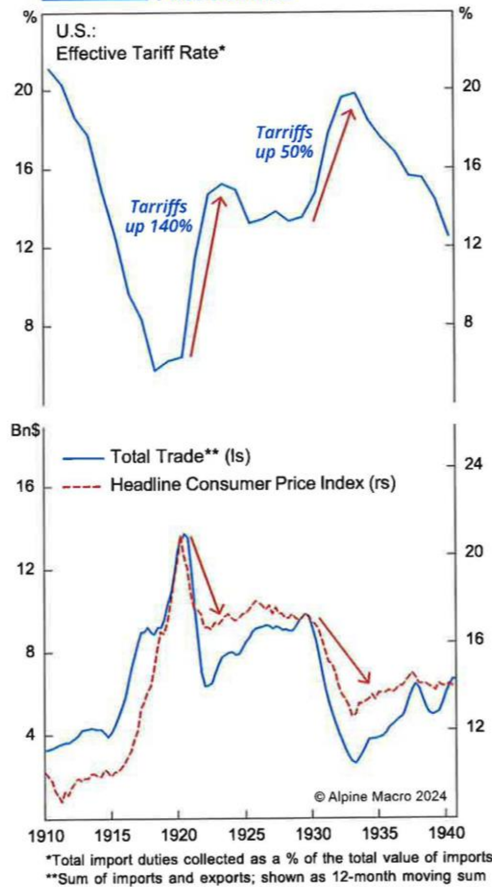
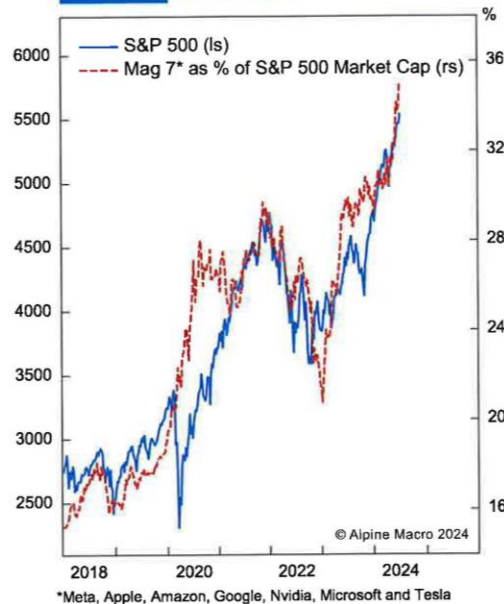
Chart 13 Protectionism Versus Price Declines



*Total import duties collected as a % of the total value of imports
**Sum of imports and exports; shown as 12-month moving sum

Bottom line: it is not a foregone conclusion that Trump will win. Even if he will, the campaign rhetoric and proposals will likely be watered down. Besides, which party controls the House and Senate also matters hugely. Overall, it is hard to give a precise assessment on market implications today, but a tariff war may well prove deflationary and bond bullish.

Chart 14 Increasing Market Bifurcation



*Meta, Apple, Amazon, Google, Nvidia, Microsoft and Tesla

Equities: Correction Now, Boom Later?

The powerful rally in mega-cap growth stocks has sharply increased the U.S. equity market concentration, evidenced by the soaring market share of the Mag 7 (Chart 14).

The consequence of this phenomenon is that the stock market is no longer sending accurate signals about the underlying economy. Importantly, the index itself is becoming more volatile and driven by idiosyncratic shocks to a handful of large companies.

Chart 15 shows the massive divergence between the Nasdaq 100 Index and the S&P 500 Equal Weight Index. While the former has soared more than 85% from its October 2022 lows, the latter has increased only 30%, with most of the gains having occurred this year.

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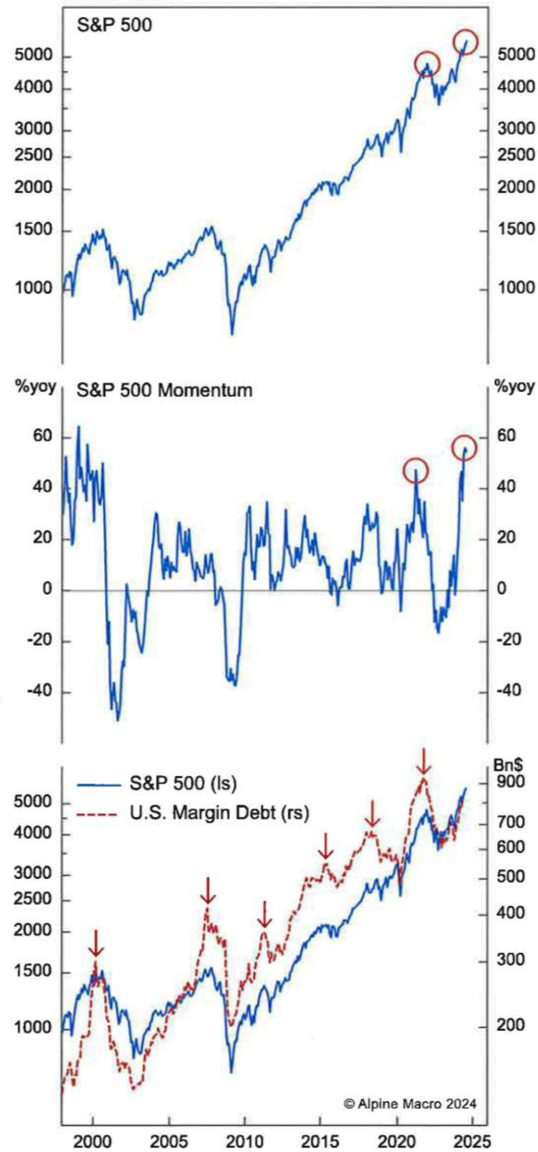
Note: Both series are rebased to June 20, 2022=100

The stock market seems to suggest that the U.S. economy is being driven by two speed engines: one by technology – moving fast, and the rest of the economy at a much slower pace.

Regardless, many indicators suggest the market should enter a corrective/consolidation phase:

- **Chart 16** shows that the momentum index has become extremely overbought, which usually signals short-term exhaustion in buying power.
- Margin debt has escalated, which historically has signaled rising vulnerability of a shakeout.
- The volatility index has fallen to levels that are too low, also setting the stage for corrective actions.



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Beyond the immediate term, however, we see potential for a redux of the late 1990s stock market boom, led by AI. This boom is likely to be triggered by the Fed's dovish pivot, continued disinflation, and positive surprises on the productivity front.

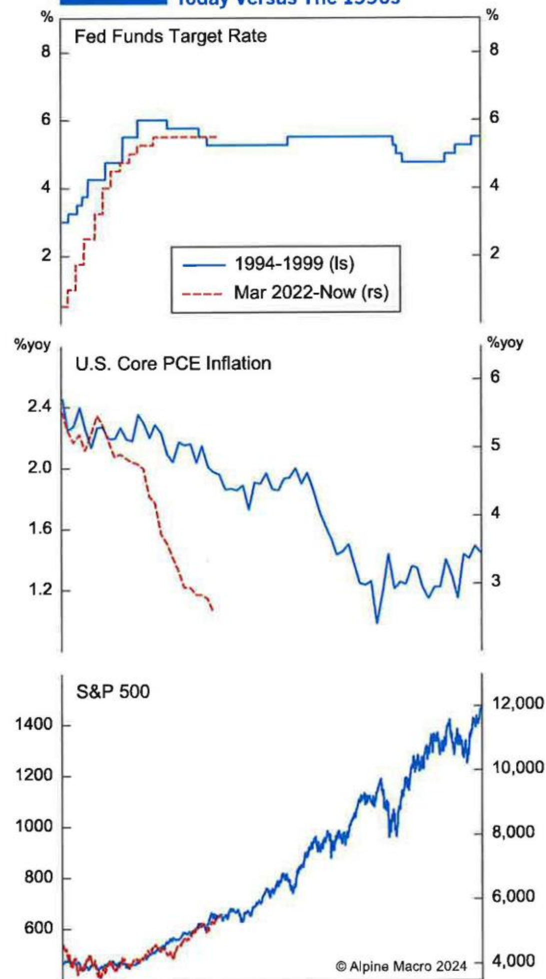
Echoes Of The 1990s

We continue to see stunning similarities between today's investment environment and that of the second half of the 1990s:

- Today's strong labor market and falling inflation are reminiscent of persistent disinflation and a strong labor market in the 1990s. Meanwhile, the Fed is in for "high for longer", which is similar to its policy setting in the second half of the 1990s (Chart 17).
- The economic boom in the second half of the 1990s was a unique phenomenon to the U.S.; the rest of the world economy was in deep trouble at the time. This is also very similar to today.
- The dollar was strong throughout the 1990s, which capped goods prices. This is almost identical to today's situation.
- There was a massive investment boom in technology-related equipment as the internet proliferated. This is akin to AI today (Chart 18).
- The U.S. stock market was very bifurcated back in the 1990s, with "Four Horsemen" accounting for 30% of stock market capitalization. This is similar to the dominant role played by the Mag 7 today.

The list can be easily extended, but the key point is that the economic and policy setup today seems to be very conducive to building asset bubbles.

Chart 17 Money, Inflation And Stock Prices: Today Versus The 1990s



Importantly, labor productivity tends to have very long cycles, and the U.S. experienced a dramatic drop in labor productivity growth due to a prolonged deleverage process. Today, we seem to be on the cusp of another major upturn, which could be led

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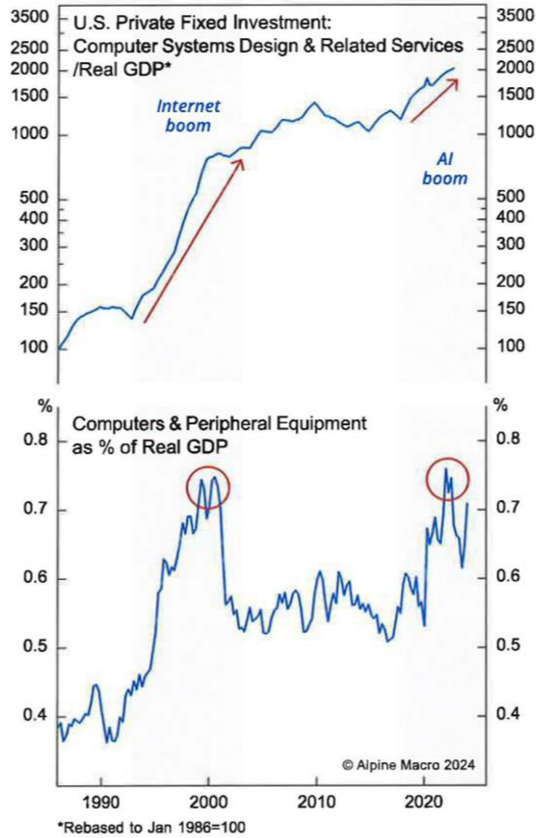
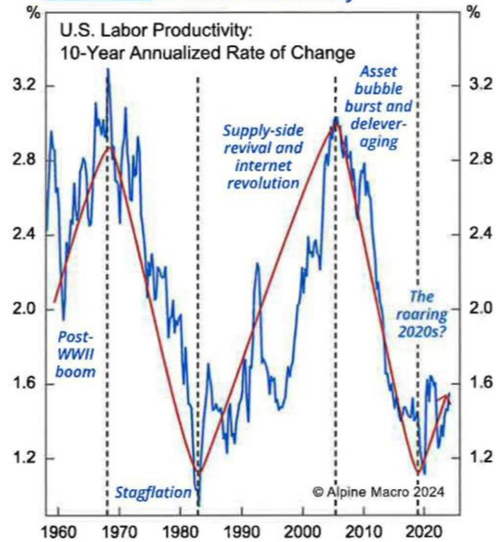
Chart 18 AI Versus Internet: The Echoes Of The 1990s



*Rebased to Jan 1986=100

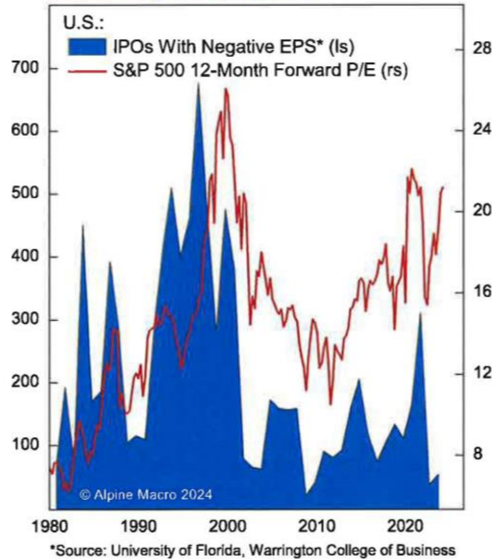
Chart 19 Long-Term Swings In Labor Productivity



by the unfolding AI revolution (**Chart 19**). All of this could create fertile ground for asset bubbles and market speculation.

We had a brief preview of speculative frenzy in 2021 when rates collapsed to zero and speculative assets such as SPACs, meme stocks, no-profit IPOs and crypto all skyrocketed, only to be clamped down by Fed monetary tightening (**Chart 20**).

Chart 20 Watch For Signs Of Market Froth And Speculation



*Source: University of Florida, Warrington College of Business