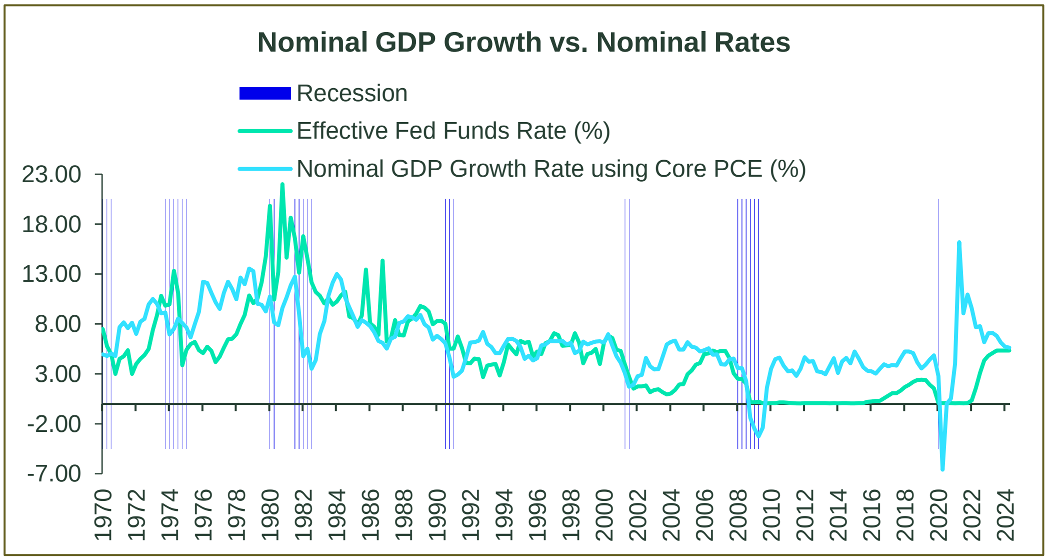
October 3, 2024
Commentary

Weekly Market Update

Insight of the Week

When Policy Rates Are Higher Than Nominal Growth

For the September FOMC meeting, the consensus across economists was for a 25bps cut, but the market was pricing in a steeper 50 bps cut. In the end, the market consensus predicted correctly. Moreover, the decision to cut by 50 bps vs the usual 25 bps was not a unanimous one, with Michelle Bowman becoming the first governor since 2005 to cast a dissenting vote by favoring a 25 bps cut. Chair Powell rationalized the decision by citing the continued progress on inflation while also acknowledging the softening in labor market conditions. While the decision was largely viewed as an effort by the Fed to preserve the soft landing, concerns remain that the Fed is “behind-the-curve” and may have kept policy tight for too-long.



Sources: Macrobond, SSGA, BEA, BLS, New York Fed, NBER. Data as of 10/1/2024.

In that regard, it is worth looking at the historical evidence by examining the relationship between the Fed Funds Rate and nominal growth, calculated as Real GDP Growth Rate (%) + Core PCE (%). As shown in the chart above, all recessions since the 1970s have either been preceded by or coincided with the Fed raising/holding interest rates above the nominal growth rate. Essentially, interest rates that are higher than the growth rate have proven to create a difficult environment. Put differently, barring the 90s, continued economic expansion has required the fed funds rate to be below the nominal growth rate. Currently, with inflation moderating and growth returning to trend, the fed fund rate is just now approaching GDP growth. Considering the Fed has already cut by 50 bps with more rate cuts to follow, coupled with the fact that the Atlanta Fed nowcast is pointing towards solid GDP growth in Q3 (>5% in nominal terms), conditions for a soft landing appear to be well in place and rates may remain below growth.

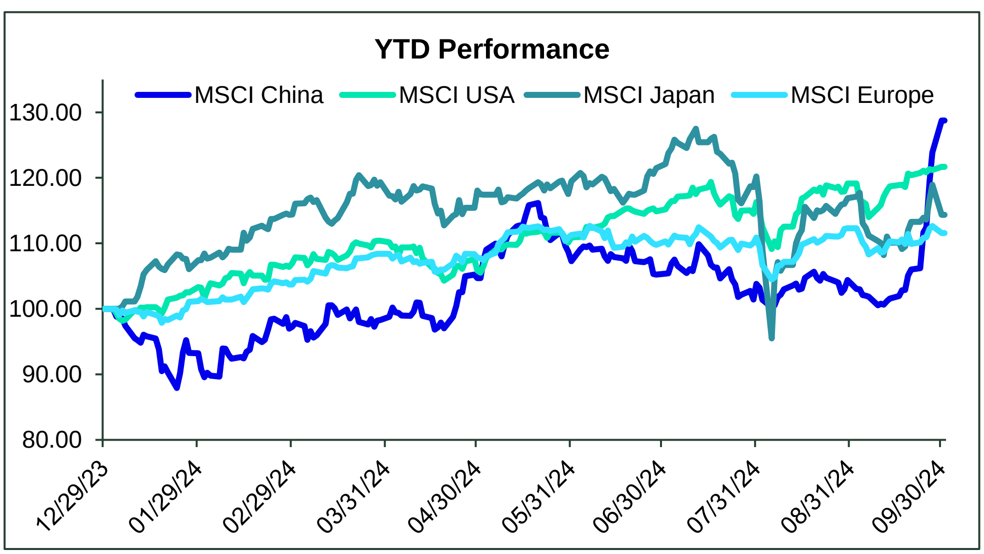
However, downside risks to the growth outlook remain in the form of a softening labor market, a weak manufacturing sector, and turbulence in China, particularly if recent stimulative measures aren't enough. Any further deterioration on the employment front could hurt consumption and require the Fed to step up policy support. The Fed shifting its focus to the employment part of its dual mandate is a step in the right direction to preserve the soft landing. Please refer our latest Global Macro Policy Quarterly update for our updated economic views and forecasts.

Source: State Street Global Advisors, Macrobond.

Equities

China Stimulus

Last week on September 24th, China unveiled its boldest stimulus package in years, aimed at revitalizing its ailing economy. The total size of stimulus packages announced this year, including the last week's measures, is possibly the largest in history, in nominal terms -estimated to be around 7.5 trillion yuan (US$1.07 trillion), and 6% of the country's GDP in 2024. As part of the new stimulus, the People's Bank of China (PBoC) introduced a series of support measures, including interest rate cuts, a reduction in banks' reserve requirements, enhanced incentives for home purchases, and funding aimed at bolstering the stock market and facilitating share buybacks. These announcements were well-received by the markets, with the MSCI China index experiencing a notable 5% surge on Tuesday—the largest single-day increase since November 2022. European equities also benefitted, particularly sectors with significant exposure to China, such as automotive and luxury goods manufacturers. Similarly, commodity markets responded positively; iron ore recorded its most substantial daily gain in over a year, increasing by 4% on the Dalian spot market, while copper and aluminum surged by 2.2% and 2.4%, respectively, on the London Metal Exchange.



Source: FactSet. Daily data from 12/29/23 till 9/30/2024.Returns in local currency.

In the wake of the stimulus announcements, Chinese stocks have risen over 21.2%, bringing year-to-date gains to 28.8%—outpacing other major regional indices: the U.S. at 21.7%, Japan at 14.3%, and Europe at 11.6% (all in local terms). Investors are pondering whether this momentum will be sustainable or will it be a temporary surge. A closer examination of the stimulus components is necessary to answer this question. Key actions within the stimulus package include a reduction of the 7-day reverse repurchase rate by 20 basis points to 1.5%, a 30 bps cut in the medium-term loan facility rate to 2.0%, and a 50 bps decrease in the reserve requirement ratio (excluding small banks). Existing mortgage rates are expected to decline by an average of 50 bps, and the down payment for second homes has been reduced from 25% to 15%. Furthermore, the funding support ratio for housing relending has increased from 60% to 100%, with RMB 800 billion (approximately $110 billion) allocated for preferential lending to facilitate stock purchases and buybacks.

We believe these stimulus measures would provide a marginal boost to growth and a potential short-term lift in market performance. However, we do not foresee a fundamental shift in the underlying economic trajectory. Significant structural issues persist, such as an aging population and an unfavorable global environment for export-driven growth. Although this stimulus is poised to enhance liquidity in the financial system, the primary challenge is not a lack of liquidity—Chinese households maintain one of the highest savings rates globally. Rather, the issue lies in insufficient demand and, consequently, a deficit in confidence. Overall, we think that the stimulus measures target the price component in the price-to-earnings (P/E) debate, while doing little for earnings and hence we believe its impact will be modest. For a deeper understanding of our perspectives on China's stimulus strategy, please refer to our latest piece- China’s Latest Stimulus: Boosting Price, not Earnings.

Source: State Street Global Advisors, FactSet.

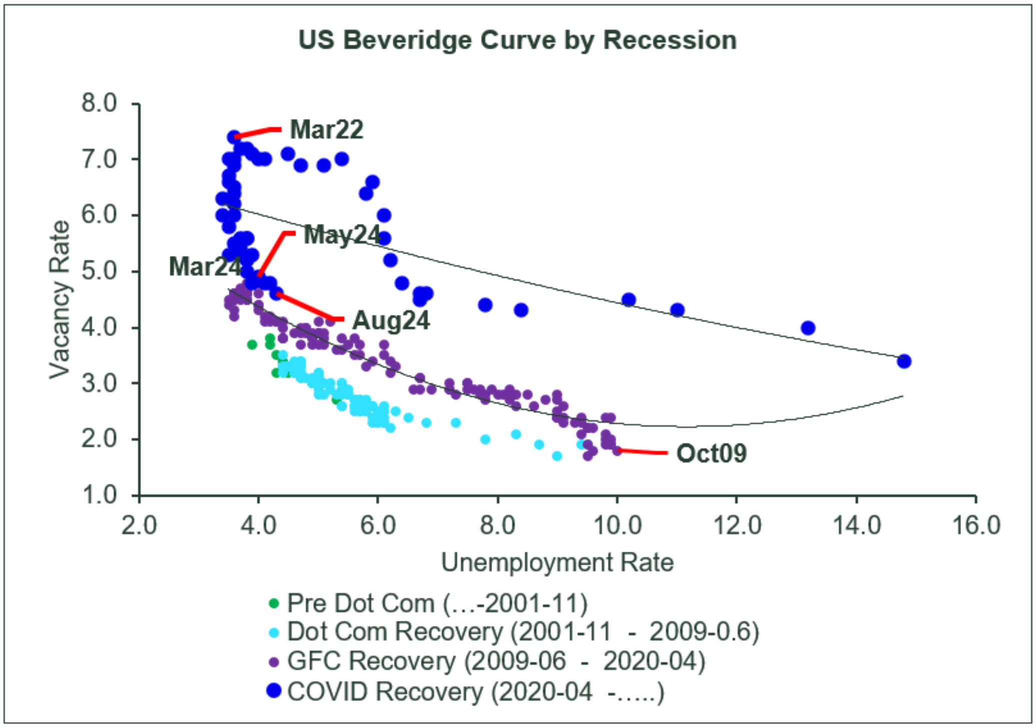
Fixed Income

Beveridge Curve Shows That Labor Is No Longer a Sweet Spot

The Beveridge Curve also known as the Unemployment Vacancy Curve was developed by Christopher Dow and Leslie Author Dicks-Mireaux in 1958 and named after the British economist William Beveridge. It represents the graphical relationship between unemployment and job vacancy rates, or the number of unfilled jobs as a portion of the labor force. Policy makers pay close attention to movements and shifts in the curve as they provide useful indicators pertaining to the current state of the economy.

The curve can experience both shifts (inward and outward) and movements along the curve. Curve shifts are an indication of cyclical changes within the economy. An outward shift of the curve (to the right) indicates structural issues in the labor market such as a mismatch between skills, geography, or persistent long-term unemployment. This shift means that for a given level of unemployment, there are fewer job vacancies. (Note: A high level of unemployment and vacancies during periods of economic expansion also suggests structural issues within the labor market). An inward shift (to the left) indicates improved efficiency where workers are matched with available jobs and unemployment is lower for a given level of vacancies.

Movements from right to left along the curve indicate periods of expansion where businesses increase job creation, vacancy rates increase, and unemployment levels decrease. Movements from left to right along the curve are an indication of recessionary periods where unemployment levels are high and vacancy rates are low. During these periods, firms slow down hiring, vacancy rates decrease and amid layoffs unemployment levels increase.



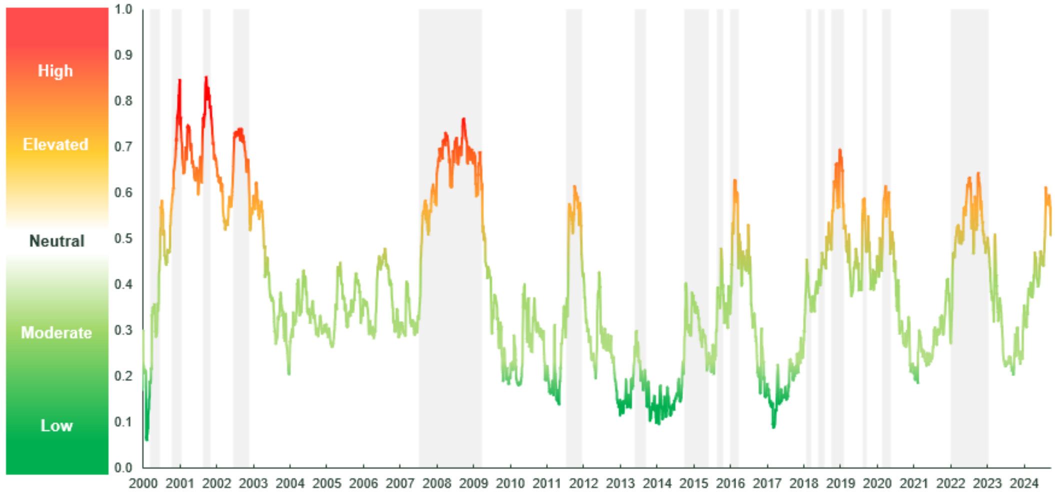
Source: Federal Reserve Economic Data (FRED) as of September 30, 2024.

The Beveridge Curve above shows that in March 2022 levels of unemployment were low and vacancy rates were high as businesses began to expand in the aftermath of the COVID pandemic, unemployment stood at 3.6% and the vacancy rate was 7.4% (or 12 million job openings). In August 2024, we saw the number of job openings decrease to 8 million, a 34% reduction from pandemic highs. The unemployment rate increased to 4.2% and the vacancy rate decreased to 4.8% marking a clear slowdown within the economy. The Beveridge curve along with other economic indicators are clearly pointing to a softer labor market and a decrease in economic activity. Given that markets are pricing in a higher probability of a soft landing, we favor duration over credit and continue to remain cautious within the spread sectors.

Source: State Street Global Advisors, Morningstar.

Market Regime Indicator

The Market Regime Indicator (MRI) represents a proprietary multi-asset class model designed to characterize risk appetites within the capital markets.



Source: State Street Global Advisors, Investment Solutions Group (ISG). As of October 2, 2024. The data displayed is not indicative of the past or future performance of any SSGA product. The above data represents a back-test of the MRI model, which means that those results were achieved by means of the retroactive application of the model which was developed with the benefit of hindsight. Data displayed beyond this date is not backtested, but is still generated by the model referenced. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The Market Regime Indicator (MRI) is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views of those markets. These factors are combined to create a single measure and used to identify one of four risk regimes: Low Risk, Moderate, Normal, Elevated and High Risk..

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*Pensions & Investments Research Center, as of 12/31/23.
†This figure is presented as of June 30, 2024 and includes ETF AUM of $1,393.92 billion USD of which approximately $69.35 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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