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Midyear Economic Insights

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Reaching the midpoint of the year is a good time to take stock of current inflation and macro trends which have the greatest impact on investment portfolios. We have also reached a milestone. It has now been a full twelve months since the Federal Reserve paused raising interest rates after embarking on one of the fastest paces of monetary policy tightening in living memory.

Whilst bond portfolios have been severely impacted by this rise in interest rates and equity markets experienced significant volatility, the broader real US economy has largely maintained above trend growth rates. Transmission effects were muted in the US as consumers and corporates termed out debt at ultra low interest rates – a prudent move which largely insulated the economy. However, US monetary policy has had a significant impact on the rest of the world with most major economies, apart from China and Japan, forced to follow the path of US interest rates in fear of currency weakness which would further stoke imported inflation – as witnessed in Japan with the yen depreciating by 40% against the US dollar during this time.

In an example of the globalisation of financial markets, the US exported its inflation problem and the heavy lifting that was required (lower demand) to the rest of the world whilst expanding fiscal deficits to wartime spending levels that further supported the US economy. In short, the traditional monetary policy effects such as lower demand and falling asset prices which we would have normally seen by now have been postponed in the US. The 'lags' in the transmission of policy have been exceptionally long during this cycle.

As risk assets continue to relentlessly rise, the market is growing confident that the US economy is heading towards a soft landing or that the Federal Reserve will lower interest rates rapidly in order to stave off a recession. I have some sympathy for this view given the fact that current real interest rates are high and there is plenty of easing available if needed. However, in a cautionary tale, other major economies such as Canada and the UK, which have much greater leverage and significantly lower demand pressures, remain very cautious in lowering base rates fearing a pent-up demand rebound in inflation.

Having said that, the US employment market is clearly weakening. Jobless claims are at their highest level in two and a half years, the overall unemployment rate has broken through 4% and the Sahm rule has been triggered in almost 40% of US states. The US real estate market, which has been extremely resilient to higher borrowing costs, is finally displaying signs of stress with inventory levels now rising rapidly. Although, this is good news for the shelter component of US inflation which is now finally slowing. Worryingly, US delinquency rates for auto loans and credit cards are also rising rapidly – with student loan repayments expected to also resume fully later this year.

As a result, the US will likely lower interest rates soon. The futures market is 90% sure a 25bps cut will arrive in September, but the size and pace of these cuts may disappoint if animal spirits rebound. Starting a cutting cycle with equity markets at all-time highs is a gamble.

If deciphering where we are in the global macroeconomic cycle was not hard enough, as we enter the second half of 2024 the winds of change continue to blow. The Cayman Islands not only looks set to experience one of the most active storm seasons in decades but the US election in November has the potential for major changes in US domestic and foreign policy that will significantly impact the entire world.

Based on current polls and economic activity the probability that the Republicans retake the White House and possibly also a clean sweep of the House and Senate is high – a supermajority. As we have recently seen in the UK a large majority brings stability to government, the recent positive performance of the pound sterling is testament to that, so an outcome of this magnitude in an economy the size of the US could well bring positive benefits to the world.

Whoever wins the White House will continue to run sizable fiscal deficits but it's likely that the deficit will be lower in 2025 than this year which will provide a further drag on US growth. The good news? Barring any major new US tariffs on imports inflation will also likely fall to the Federal Reserve's target allowing base rates to be cut by a meaningful degree. Energy prices could also fall as the global economy slows and US energy resources are tapped to their full potential. A negotiated end to the war in Ukraine will not only prevent further bloodshed but also bring much needed relief to global food prices being one of the world's leading exporters.

How does this impact the Cayman Islands directly? A slowing US economy will lead to weaker tourism but this impact will likely be mitigated by lower costs. With a large amount of debt tied to US interest rates any lowering of borrowing costs will immediately provide relief to homeowners. Development projects which have been paused will likely resume activity and electricity and food prices will fall.

From a market perspective the remainder of 2024 is likely to be volatile with much uncertainty and the potential for major moves in risk assets. The US economy still needs to work off the imbalances of the excessive stimulus provided in 2020-21 and fiscal spending needs to be lowered. But monetary policy stands ready to provide support if needed, although a return to ZIRP (zero interest rate policy) must be avoided in order to prevent asset bubbles from reforming. Bond managers such as myself have a bias toward negative macro news, with weak growth equating to capital gains, but I am optimistic that the outlook will be brighter for consumers and companies in 2025. Navigating this turn in the economic cycle that is likely upon us is the challenge for investors.

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