

Q3 2024

EFG

InSight

Quarterly market review



Debt rising,
inflation receding

OVERVIEW

Political changes around the world

UK

A new Labour government

EUROZONE

Spread widening returns

SPECIAL FOCUS

Argentina

OVERVIEW

Global economic growth remains firm and inflation pressures are receding. However, political developments have unsettled some markets and will remain a theme in the second half of 2024.

Although a soft landing for global growth has materialised and inflation pressures are slowly retreating, the legacy of recent economic turbulence resonates with political developments worldwide.

1. Major elections in 2024

Country	2024 Date	Type	Outcome
 Taiwan	13 Feb.	Presidential/legislative	William Lai – President
 Indonesia	14 Feb.	General	Prabowo Subianto – President
 Russia	17 March	Presidential	Vladimir Putin –President
 India	01 June	General	Narendra Modi – PM
 Mexico	02 June	General	Claudia Sheinbaum – President
 EU	09 June	Parliamentary	EPP gains most seats
 UK	04 July	General	Keir Starmer - PM
 France	07 July	Legislative	Three-way split
 US	05 Nov.	Presidential/legislative	?

Sources: BBC, Reuters, *The Economist* and various national news agencies. Data as at 5 July 2024.

Political turbulence

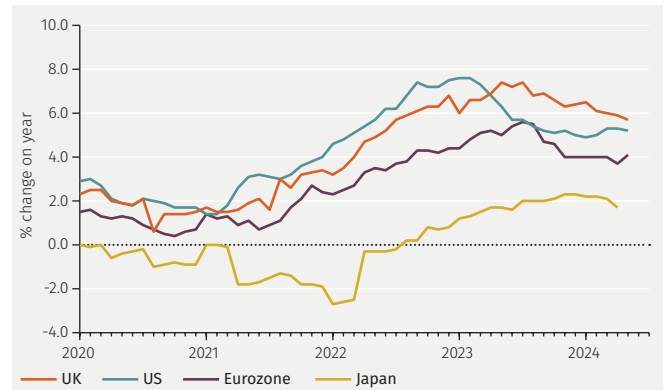
The prospect of political turbulence is one of the ten key themes in our *Outlook* for 2024.¹ It is fair to say that this has proved apposite (see Figure 1) so far, even before the US presidential election on 5 November. In European parliamentary elections, the surge in support for France’s right-wing party, the National Rally, led President Macron to call a snap parliamentary election. In that election, the National Rally was pushed into third place, behind an alliance of left-wing parties and President Macron’s centrists. In the UK, the election of a Labour government after almost 14 years of Conservative rule reflected a general desire for change. Even so, no radical change in the direction of economic policy is planned, not least because the new government has ruled out (for now) any major changes in government revenue or spending. In particular, unchanged rates of individual, corporate and value added taxes have been promised. Such stability from the opposition party is not the case in the US, where President Trump’s agenda includes potentially large changes.

Tariffs and trade

Most significantly, Trump plans either a 10% tariff on all US imports or a 60% tariff on imports from China or, indeed, both. That could partly finance a move to make the individual income tax cuts from the 2017 Tax Cuts and Jobs Act permanent. It remains to be seen whether he is elected (the chance is currently seen as almost 60%)² and whether such plans materialise. Almost certainly, they would prove to be inflationary. One estimate is that a 10% across-the-board tariff,

with full retaliation, would raise the US price level by 1.1%.³ It would therefore compound the difficulty of getting closer to the US’s 2% inflation target.

2. Services price inflation

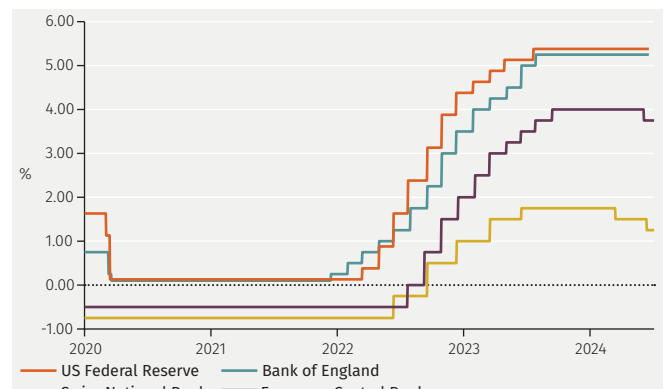


Source: LSEG. Data as at 5 July 2024.

Services: inflation and trade

In the US, and around the world, the main reason for a stickiness in inflation is that services price inflation has remained elevated (see Figure 2). US services inflation, as measured by the personal consumption expenditure (PCE) index, peaked at 6.0% year-on-year in January/February 2023 and declined to only 3.9% in May 2024. This stickiness has led to a cautious approach to reducing interest rates, notably in the US and UK (see Figure 3).

3. Central bank policy rates



Sources: LSEG and national central banks. Data as at 5 July 2024.

Many services prices have a high wage cost element. With wages generally reflecting past inflation (rather than being a predictor of future inflation) and labour markets remaining tight, wage pressures generally remain elevated across all the major

¹ https://www.efginternational.com/uk/insights/2023/2024_outlook.html

² Source: PredictIt. 5 July 2024.

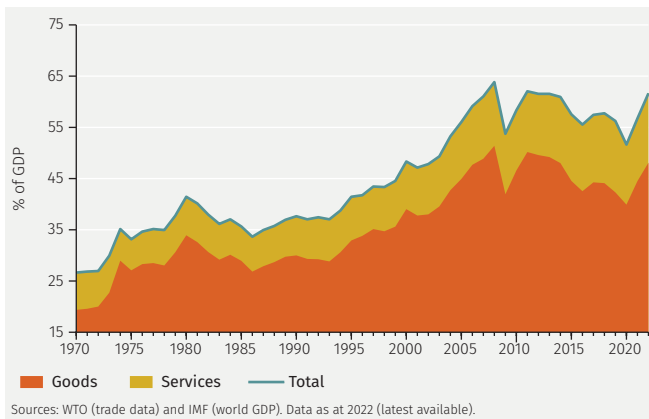
³ Jan Hatzius at the ECB Sintra Economic Forum, 2 July 2024.

OVERVIEW

economies. The importance of this is that the largest share of spending by consumers (almost 70% in the US) is on services (such as travel, leisure and entertainment).

Services are important in another respect. Although international trade in services is still smaller than goods trade, it is growing more strongly (see Figure 4). Although goods trade has declined relative to global GDP services trade has not. On this basis, deglobalisation (a falling share of trade relative to GDP) is a myth, according to Richard Baldwin.⁴ Although increases in US tariffs are in prospect, imposing tariffs on services, many of which are digital, dematerialised and easily movable across national borders – is likely to be difficult.

4. World trade volumes

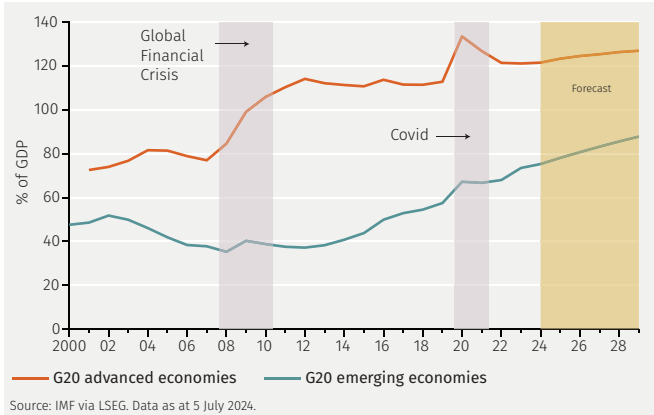


Deficits and debt

Around the world, the dislike of higher taxation is self-evident yet pressures on public spending – again, particularly services such as health, education and age-related care – are relentless. Additionally, the global investment required to reach net zero emissions by 2050 is estimated at around USD 4 trillion per year for the next 30 years. More tax could be raised (especially in developing and emerging economies) by removing fossil fuel subsidies, which amount to around USD 8 trillion a year, though removing such subsidies is likely to be very difficult indeed.

In the US, government budget deficits consistently in excess of 6% of GDP are projected for the next five years by the IMF. The outstanding stock of government debt, around one third of the level of GDP at the start of the millennium, has already exceeded 120% of GDP and is expected to rise to over 130% by the end of the decade. In advanced and emerging economies alike, a persistent increase in government debt levels is projected (see Figure 5). Five of the twenty members of the eurozone are judged by the European Commission to have excessive deficits. There are exceptions to this bleak fiscal

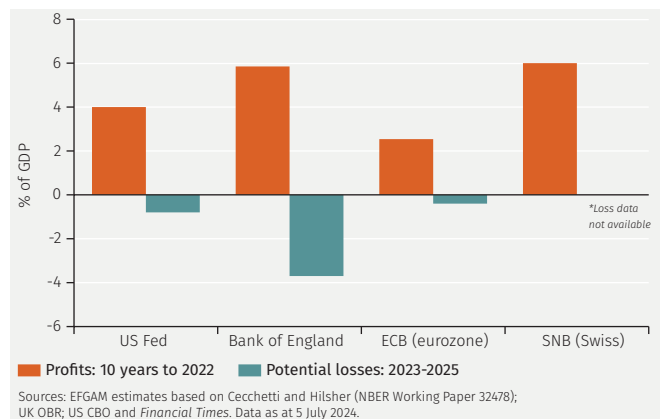
5. Government debt levels



landscape. Germany, most notably, perseveres with measures designed to bring its government debt level to 60% of GDP.

One fiscal issue, which is now receiving more attention, is central bank profitability. This has been undermined as a result of losses on central bank holdings on bonds purchased under quantitative easing programmes (see Figure 6). The accounting treatment of these losses varies between countries. In the UK, the Bank of England is indemnified by the Treasury for any losses. In the US, the transfer of Fed profits to the government is halted until losses are offset by future profits. Some see a risk of political pressures on central banks intensifying as a result.

6. Central bank profits and losses



The problem of high deficits and debt levels is that they can lead to a crisis of confidence among investors – as occurred during the brief premiership of Liz Truss. Capital flight, exchange rate weakness, lower bond prices and higher bond yields are the likely outcome when investor confidence dissipates. Whether that now happens elsewhere remains to be seen.

⁴ See Richard Baldwin <https://cepr.org/voxeu/columns/peak-globalisation-myth-part-4-services-trade-did-not-peak>

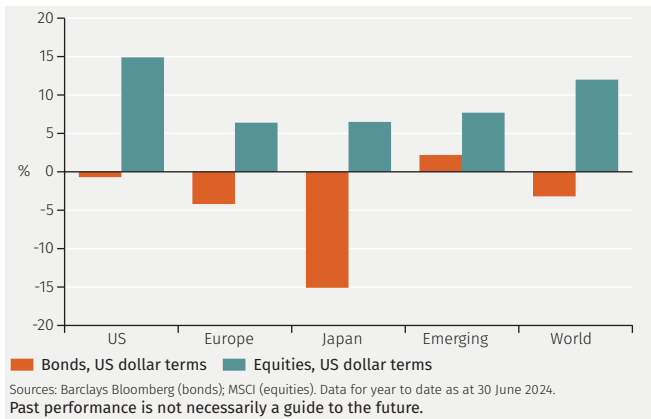
ASSET MARKET PERFORMANCE

Global equity market gains of over 10% in US dollar terms, led by the strength of the US market, were the most notable feature of the first half of 2024. The US dollar continued to strengthen against all major currencies.

Asset market performance

Returns from global equities in US dollar terms were 12.0% in the first half of 2024; global bonds returned -3.2% (see Figure 7).⁵ During the first half, inflationary pressures eased to some extent. That allowed a reduction of policy interest rates in the eurozone and Switzerland, but sticky service price and wage inflation meant policy interest rates in the US and UK remained unchanged. In all the main developed bond markets, returns were modestly negative in US dollar terms. The US dollar appreciated on its trade-weighted index, notably because of renewed yen weakness.

7. Asset market performance

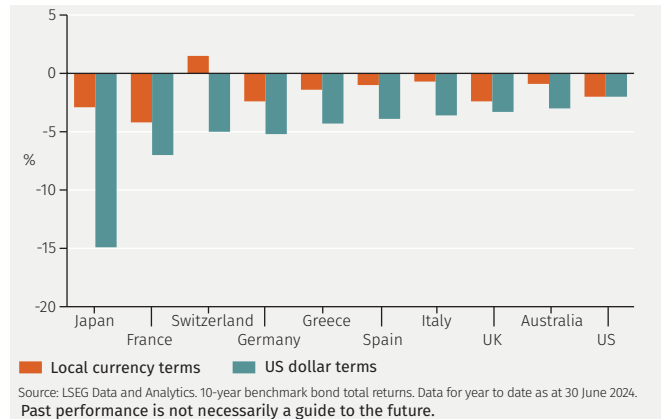


Bond markets

Returns from 10-year government bonds were generally marginally negative in local currency terms in the first half of the year (see Figure 8). In US dollar terms, returns were weaker as the US dollar continued to strengthen. There were two main exceptions to that general trend. In France, a rise in yields and a decline in bond prices followed heightened political uncertainty in June. In Switzerland, two 25 basis point cuts in the policy interest rate helped bring positive returns in the bond market in Swiss franc terms, but these were sharply offset in US dollar terms by Swiss franc weakness. Japan stood out as the weakest market in US dollar terms as the yen continued to slide in value against the dollar.

Returns from shorter-maturity bonds, inflation-protected bonds and selected convertible bonds were generally higher than those of 10-year government bonds during the period. This reflected, respectively, still high short-term interest rates and inflation and equity market strength.

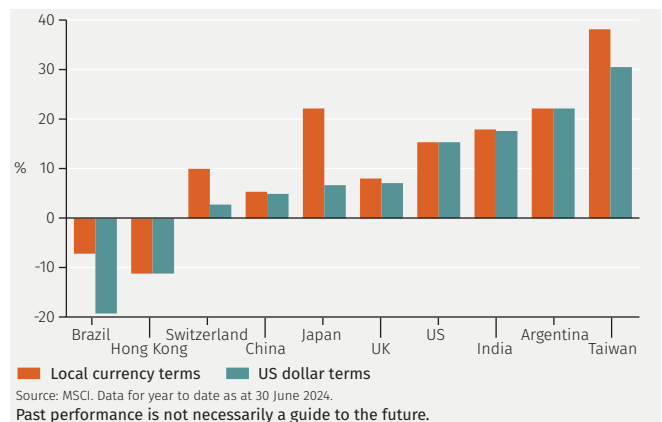
8. Bond market returns



Equity markets

In local currency terms, Japan produced equity market returns of over 20% in the first half of the year (see Figure 9). That partly reflected the benefit to exporting companies of a weaker yen but the domestic economy displayed little growth. Taiwan produced returns of 37% in local currency terms, modestly offset in US dollar terms by some currency weakness. The market benefited, in particular, from global optimism about Artificial Intelligence (AI) and related demand for semiconductors. Optimism about Argentina's reform programme helped the equity market there. After strong performance in 2023, the Brazilian equity market softened on concerns about stickier inflation and potentially weaker economic growth.

9. Equity market returns



⁵ The Bloomberg Barclays Global Aggregate Bond Index is a benchmark of government and investment grade corporate debt from developed and emerging markets issuers in 24 countries. The MSCI World Index represents large and mid-cap equity performance across 23 developed market countries.

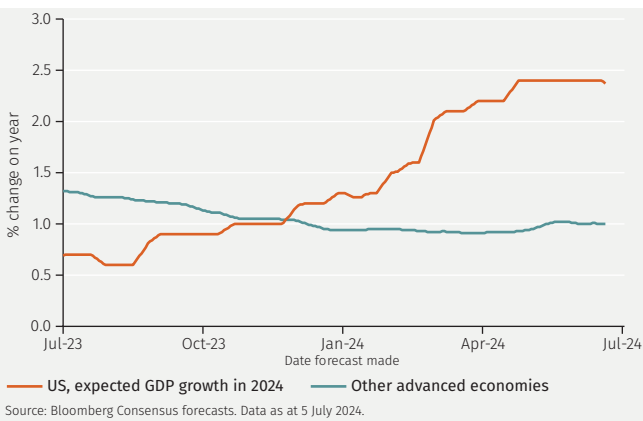
UNITED STATES

US economic growth, still stronger than in the rest of the world, seems to be faltering. The labour market is showing signs of normalising but the Fed seems to be in no rush to cut rates. Corporate earnings trends are encouraging.

US leads the world, but growth softening.

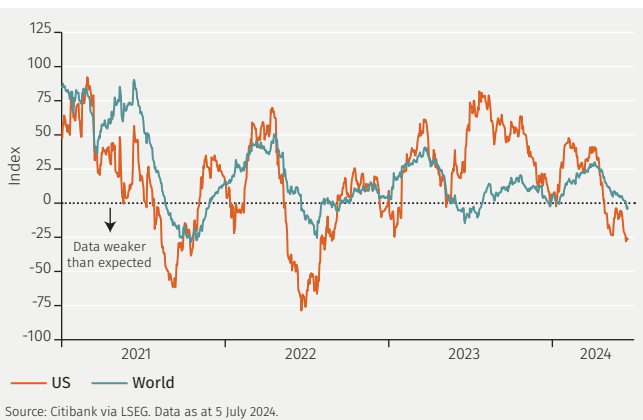
The US still leads the world in terms of GDP growth prospects (see Figure 10) for the current year. However, recent US economic data have generally come in weaker than expected (see Figure 11). Furthermore, the Federal Reserve Bank of Atlanta's *GDPNow* measure shows expected growth of just 2.0% at an annualised rate in the second quarter of the year.⁶

10. US GDP growth outstrips other advanced economies



In the labour market, Fed chair Powell recently commented on signs of normalisation.⁷ In particular, the Beveridge curve (the relationship between unemployment and vacancies) had “dropped vertically” to its pre-pandemic settings. This means that the job vacancies rate of 4.9% in June 2024 is quite closely aligned with the unemployment rate of 4.1%.

11. Economic surprise index: US and world



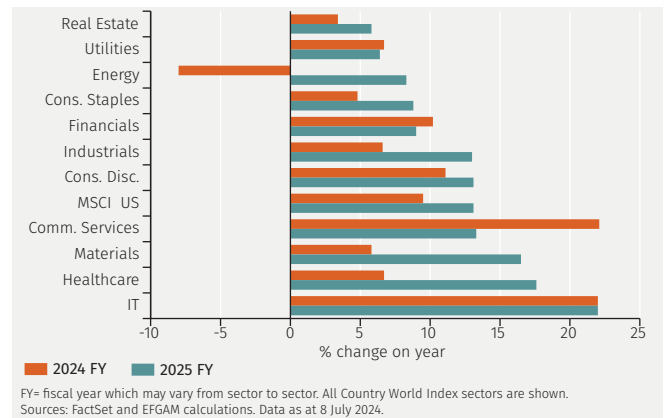
That better balance in the labour market will help ease wage and service price inflation pressures over time but the Fed still seems to be in no hurry to cut policy rates. Powell has

said the Fed wants to see “more data like what we have been seeing recently” before it can lower rates.⁸

Corporate earnings

In the equity market, corporate earnings growth is expected to be just below and just above 10%, respectively, in 2024 and 2025. The IT sector is expected to show the strongest growth in each year, but other sectors are expected to catch up, reflecting base effects (weak earnings in 2024) and the benefit of expected lower interest rates.

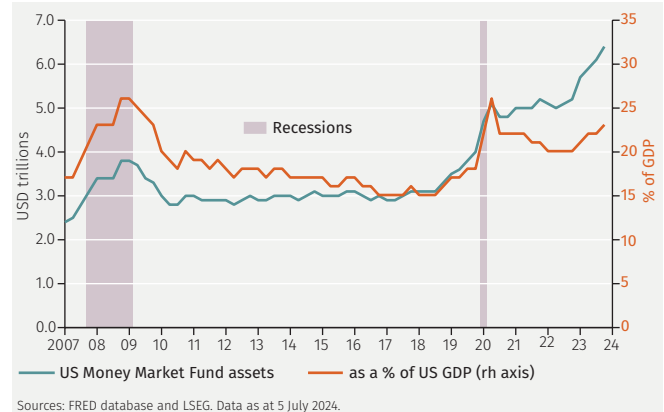
12. Sectoral earnings growth projections



Money on the sidelines

Although concerns about high overall equity market valuations remain, one potentially supportive factor cited by some is the large size of money market fund assets. However, relative to US GDP, these are not unusually high (see Figure 13).

13. US Money Market Fund assets



⁶ <https://www.atlantafed.org/cqer/research/gdpnow>. 10 July 2024.

⁷ At the ECB Sintra Forum on 2 July 2024.

⁸ Also at the Sintra Forum.

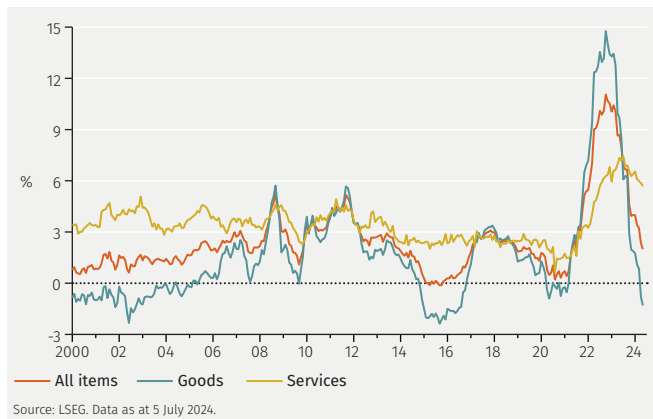
UNITED KINGDOM

The new Labour government will benefit, in its first few months in office, from a recovering economy, lower inflation and interest rate cuts. But two longer-term challenges – raising productivity and financing higher public spending – loom large.

Tailwind from favourable developments

In its first few months in office, the new Labour government will almost certainly enjoy the benefits of: inflation being back near target – the headline consumer price inflation rate is already at 2%; the start of interest rate cuts by the Bank of England; and positive GDP growth, after a brief, mild recession in late 2023. Certainly, there are some remaining short-term issues. In common with many other advanced economies, service price inflation, reflecting still strong wage growth, is still high. But there are good grounds for thinking that, as has typically been the case in the past (see Figure 14), low or negative goods price inflation can offset much of that; and wage growth should now moderate as headline inflation recedes.

14. UK Consumer Price Index (CPI) inflation



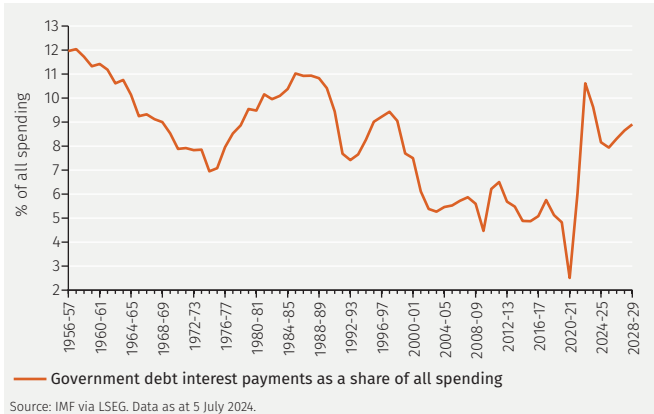
Productivity

Two much bigger longer-term challenges – raising productivity and financing higher public spending – are clearly identified by the incoming government. Growth of productivity (GDP per hour worked) was running at 2% p.a. before the global financial crisis of 2007/8. Since then, it has average 0.4% p.a. Part of this reflects low rates of investment, especially since the Brexit vote in 2016. The new government plans to stimulate investment through public sector support for private sector initiatives, especially through a freeing up of the planning system. There will be direct government spending as well, notably on housing and green investment. The latter is planned to be £15bn a year, 0.5% of GDP per year, similar in scale to the green provisions in the US Inflation Reduction Act.⁹

Public sector finances

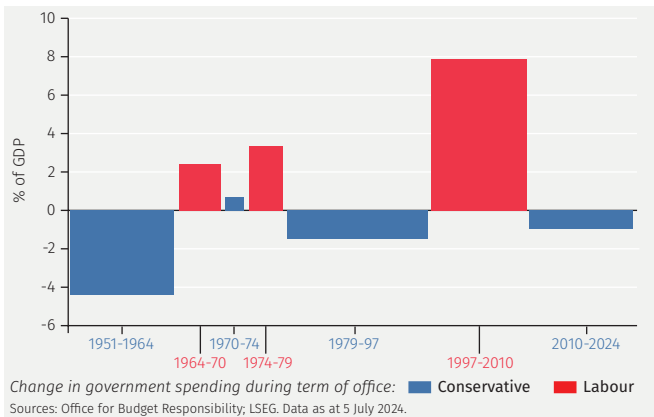
But the scope for expansionary fiscal policy is very limited. Debt interest payments, reflecting both a higher stock of debt and higher interest rates, are expected to take up almost a

15. UK: government debt interest payments



tenth of government spending in coming years (see Figure 15). In many other sectors – such as defence, health care, social care and education – following a period of spending constraints by the previous government, a catch up will be sought. That typically happens under Labour governments (see Figure 16).

16. UK government spending: the electoral cycle



The key issue is whether it is financially viable. Labour’s plan envisages increasing tax revenue by £8.5bn per year by 2028/29, although a large contribution is expected to come from a reduction in tax avoidance. Maintaining the freeze on personal income tax thresholds until 2028, a measure introduced by the previous government, should contribute £15bn per year by 2028. Although, even maintaining the former government’s (somewhat soft) target – of debt falling between the fourth and fifth years of the budget forecast – will be hard.

⁹ Estimated at USD 900bn over ten years in *Brookings Papers on Economic Activity*, Spring 2023.

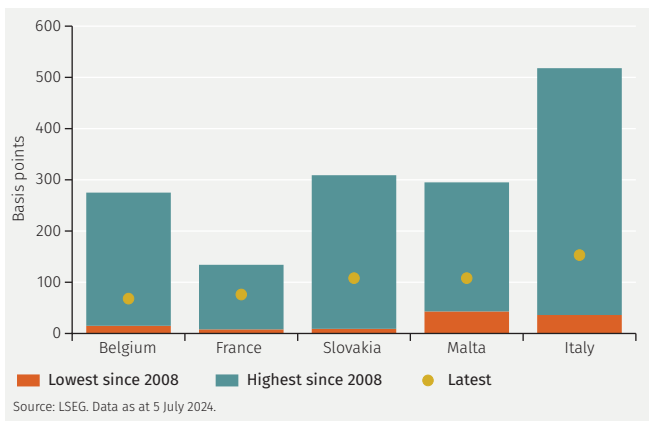
EUROZONE

Political turbulence in France has raised issues, once again, about the resilience of the eurozone.

Spread widening

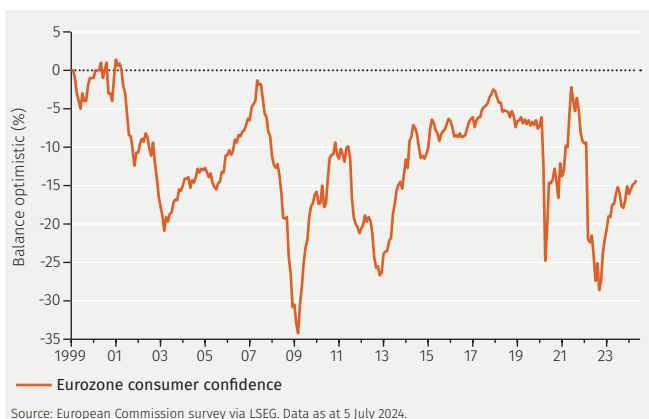
The snap general election in France called in response to the strong showing of the far right RN party led to a sharp widening of the yield spread between French and German 10-year government bond yields (see Figure 17) during June 2024. Concerns about the direction of the government failed to ease after the second round of French elections on 7 July.

17. 10-year yield spreads over Germany

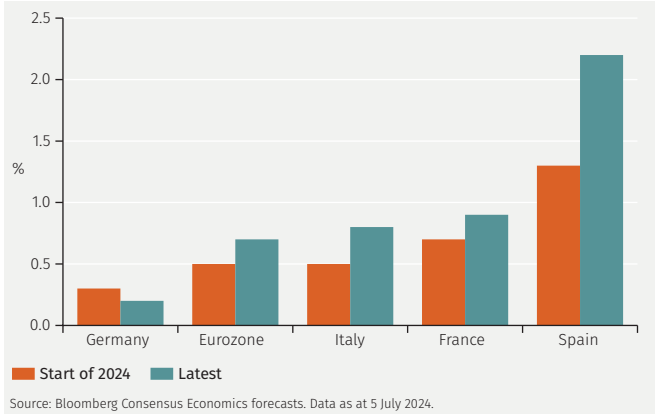


Since Christine Lagarde’s comment in the early stages of the Covid pandemic that the job of the European Central Bank (ECB) was not to close spreads between eurozone government bond yields, the issue has been a contentious policy area. The ECB now does have a tool that may be used to close spreads – the transmission protection instrument (TPI). It can be used to counter unwarranted, disorderly market developments, but only in cases of extreme country-specific problems. The issue now is that problems have arisen in five of the twenty eurozone members, which are considered to have excessive deficits (see Figure 17). Although spreads are well below those

18. Eurozone consumer confidence



19. GDP growth revisions



at the peak of the eurozone crisis, it would be unwise to rule out further pressures.

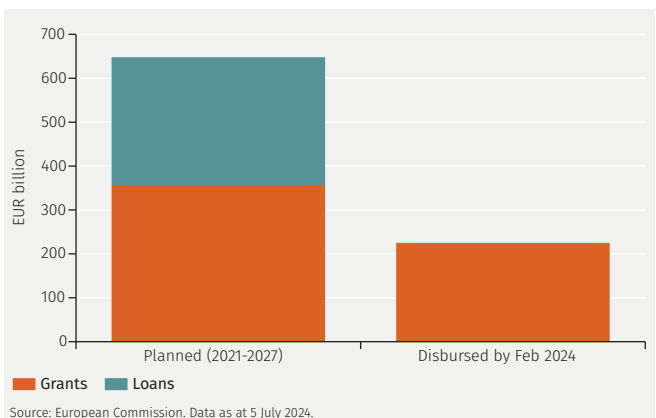
Consumer confidence

More broadly, the eurozone is not a happy place. Consumer confidence is at levels last seen during the Covid pandemic. Germany, the anchor of eurozone stability in the past, seems to struggle for direction, not least because of the government’s austerity policies. But there are some brighter areas. Since the start of the year, growth projections for Spain have notably been revised upwards (see Figure 19). This reflects a near-term boost from higher tourist spending.

Recovery and Resilience

Nevertheless, Spain also stands to gain significantly from take-up of the EU Recovery and Resilience Fund (RRF). This fund provides resources (see Figure 20) for the transition to green energy and new digital technologies.

20. EU Recovery and Resilience Fund



SWITZERLAND

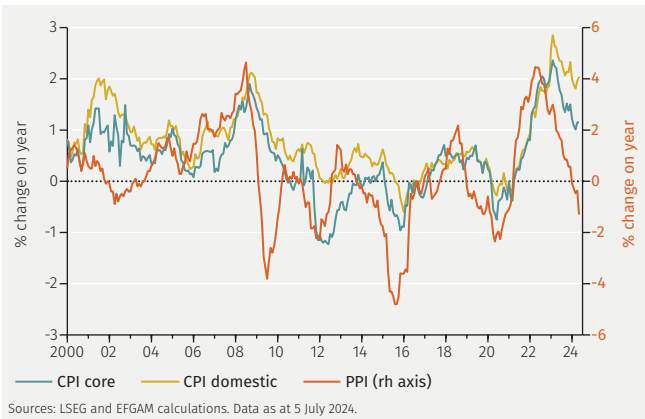
The Swiss National Bank (SNB) has cut its policy rate twice in 2024, taking the rate to 1.25%. A further cut, to 1%, is feasible even though the Swiss franc has weakened.

The SNB's second cut

Before the SNB meeting on 20 June, markets (according to futures contract prices) attached a probability of around 70% to the 25 basis point rate cut which took place. Despite this, the sell-off of the Swiss franc, which followed the announcement, suggests that it came as a surprise to many. Certainly, there were arguments for a pause in the easing cycle, especially as a first 25 basis point rate cut had already taken place in March. The arguments for waiting for a second cut were: a rebound in the CPI inflation from 1.0% year-on-year in February to 1.4% in April and May; GDP growth in the first quarter being slightly above potential; and the weakness of the Swiss franc following the first rate cut in March.

Set against these considerations was the sharp fall in producer prices (see Figure 21). Historically, producer price inflation has led Swiss core and domestic CPI inflation. In addition, the recent rebound in CPI inflation was mainly due to oil products and rents, the latter being reflective of past monetary policy tightening. Indeed, net of rents and electricity prices, Swiss inflation was only 0.4% year-on-year in May.

21. Swiss inflation trends



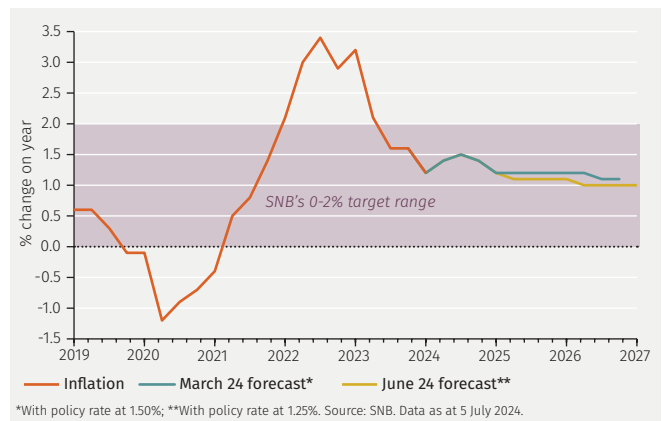
Weaker growth outlook

Looking at the growth outlook, two surveys of the business outlook for the April-May period showed activity and orders remaining below par. Moderate retail sales and services activity probably suggested to the SNB that domestic demand should not generate meaningful inflationary pressures. The tensions linked to eurozone political developments (particularly the snap French elections) pose the threat of a weaker eurozone economy. This would adversely impact Swiss growth.

Neutral rates

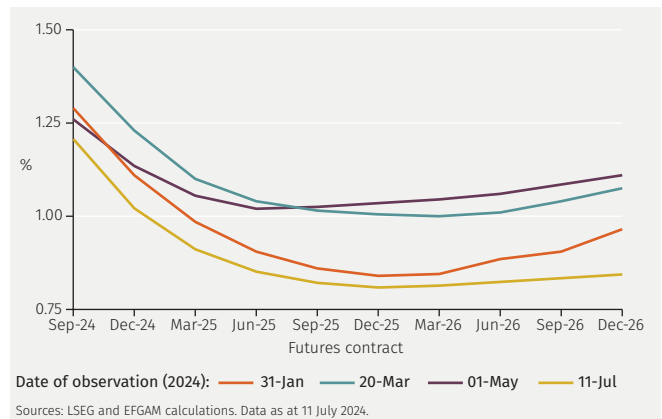
SNB President Jordan has recently noted that the neutral real interest rate in Switzerland may be around zero. If that is the compass for monetary policy in the medium term, the projected fall of inflation to around 1% in 2026 and beyond (see Figure 22) suggests there is room for one further 25 basis point rate cut. This could possibly come before the end of 2024.

22. SNB conditional inflation forecast



Interestingly, market expectations for the remainder of 2024 and 2025 (see Figure 23) are broadly in line with this assessment. Switzerland is clearly a leader in policy interest rate reductions. It remains to be seen when the rest of the world will catch up.

23. Swiss 3-month interbank rate implied by futures contracts



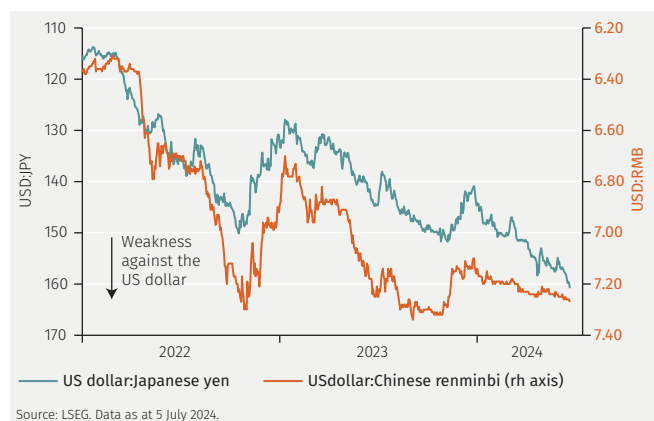
ASIA

Since the Asian financial crisis of 1997/98, currency movements have been important in Asia's performance. Currently, the weakness of the yen – formerly a safe haven – is the key issue.

Financial crises, past and present

The sharp weakening of the Japanese yen, since the start of 2022 (see Figure 24), follows a steady decline over a longer period. It has halved in value against the US dollar since 2012. Other Asian currencies – most notably the Chinese renminbi (see Figure 25) – have also weakened.

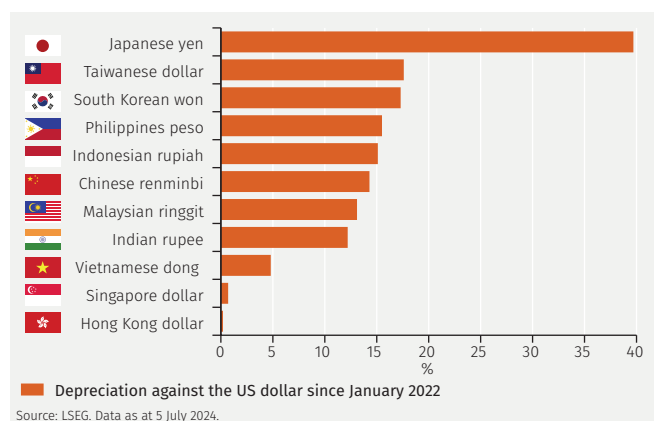
24. Yen and yuan



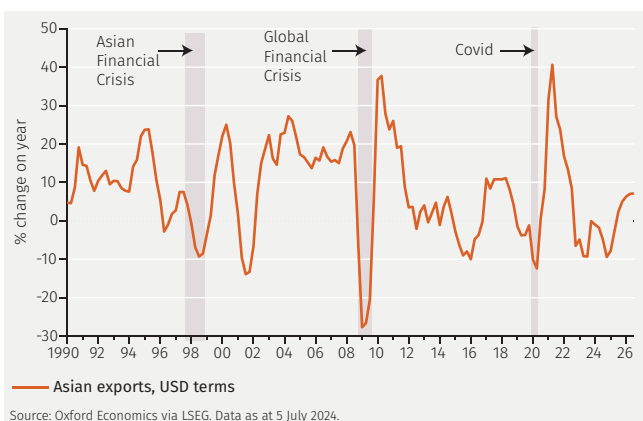
These currency developments have some similarity to those during the Asian financial crisis of 1997/98 when weakness in one currency, initially the Thai bhat, spread to others. Four Asian currencies halved in value against the US dollar at that time.¹⁰ Currency weakness helped resolve the crisis as more competitive currencies boosted exports; but significant structural reforms were the key to an improvement in longer-term economic performance.

So far, there has been no surge in Asian exports in response to currency weakness (see Figure 26). Indeed, Japanese and Chinese exports are lower than a year ago in US dollar terms.

25. Asian currencies: depreciation against the US\$ since 1 Jan 2022



26. Asian exports: broadly flat

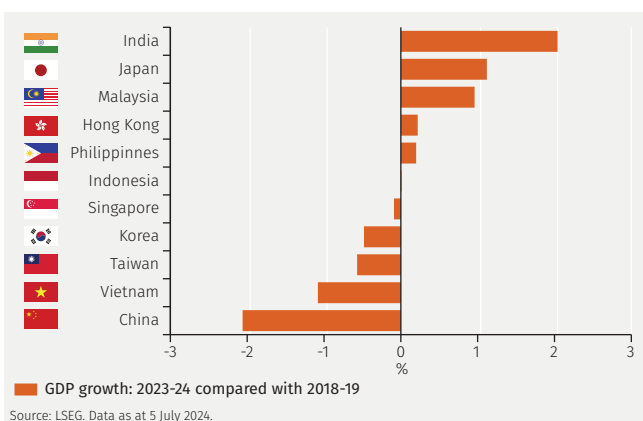


If President Trump were elected to a second term of office and the US were to introduce further trade tariffs, Asia's export performance would be further impeded.

Domestic demand and structural reform

However, the change in growth patterns across Asia suggests that the other lesson from the 1997/98 crisis – the importance of structural reforms in producing stronger growth – remains. Japan and India, the two economies where growth is notably higher in 2023-2024 than in the two years pre-Covid – have made important structural changes. In Japan, many of these can be tracked back to Prime Minister Abe's measures, in particular, improvements in corporate governance. In India, Prime Minister Modi's "Make in India" programme and an emphasis on infrastructure investment have been key to generating growth. At the other extreme, China's weaker growth performance reflects structural issues stemming from excessively high domestic savings, difficulties in the construction sector and an uncertain attitude to private enterprise.

27. GDP growth: 2023-24 compared with 2018-19



¹⁰ <https://tinyurl.com/2wzvuccu>

LATIN AMERICA

After strong performance in 2023, the largest Latin American economies face a number of headwinds in 2024.

Headwinds to growth

A number of headwinds are impeding growth across Latin America in 2024. The weakness of the Chinese economy, in particular, has impacted demand for the region's exports. China is the main trading partner of Brazil, as indeed it is for most of the southern part of Latin America (see Figure 28). Weak demand from China for the region's exports (notably iron ore) has impacted Brazil, in particular. This has contributed to currency weakness with the Brazilian real and Mexican peso depreciating by 16% and 8%, respectively, against the US dollar in the first half of the year. This currency weakness has raised inflationary pressures, contributing to a more hawkish tone from the central bank of Brazil.

28. Latin America: main trading partners

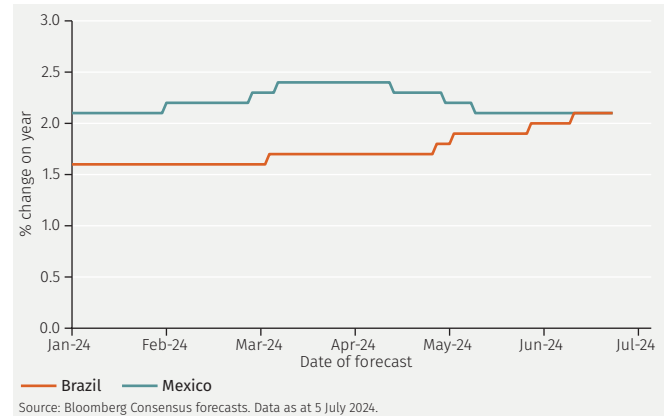


Fiscal developments are an additional challenge for Brazil. The fiscal target has been eased marginally for 2025 from a primary surplus of 0.5% of GDP to a balance on this measure (the primary balance excludes interest payments). Recent floodings in the state of Rio Grande do Sul are expected to reduce government revenues and also push up inflation.

However, Brazil's current account deficit has narrowed to just 1.4% of GDP in 2023 and is expected to remain around that level in coming years. Weaker metal and agricultural exports have been offset by stronger oil exports. Furthermore, domestic economic data have been strong, the manufacturing sector remains in expansion and the labour market remains

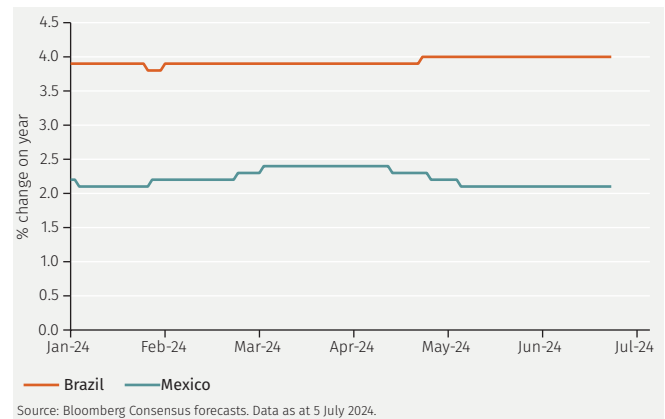
tight, with solid job growth and an unemployment rate of 7.5%, the lowest level since 2015.

29. Latin America: GDP growth expectations for 2024



On balance, overall growth and inflation expectations have, however, remained relatively stable for both Brazil and Mexico (see Figures 29 and 30).

30. Latin America: inflation expectations for 2024



Politics

Politics have become an even more important influence in both Brazil and Mexico. In Brazil, the polarised political environment will limit the government's ability to make significant changes to discretionary investment. It is, however, likely that tax reforms will eventually pass. In Mexico, the election of Claudia Sheinbaum as the new president, with her party gaining a supermajority in the lower house (although not the upper house) raises the prospect of expanding welfare payments, in a continued effort to address inequality. Sheinbaum, as a former environment minister, introduced policies to reduce air pollution. A major uncertainty, of course, relates to any change in the US tariff regime, should Donald Trump be elected president in November.

SPECIAL FOCUS: ARGENTINA

Can President Milei successfully transform Argentina’s economy after many years of failed attempts? That is the crucial question for the country itself and the IMF as its main creditor.

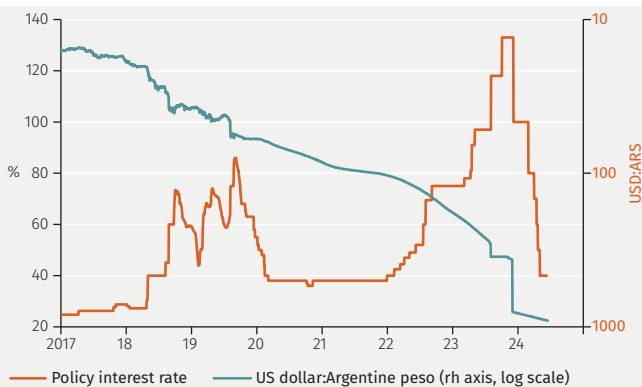
Four types of economy

Simon Kuznets, who won the Nobel prize in economics in 1971, said there are four types of economies — developed, undeveloped, Japan and Argentina. Two features that put Argentina in its special category are high inflation and weak growth. Milei’s policies aim to address these.

High inflation

Argentina has a history of high inflation and, indeed, hyperinflation: the rate reached 197% month-on-month in July 1989.¹¹ Bringing inflation down is President Milei’s top priority. The monthly rate has already declined from 25.5% in December 2023 to 4.2% in May. High inflation has meant that the Argentinian peso has generally weakened against the US dollar over time (see Figure 31) but the depreciation is currently limited to 2% per month – resulting in the real value of the peso recently appreciating and so hampering export competitiveness. Milei’s original plan for inflation control was dollarisation of the economy and abolition of the central bank. That plan has now been replaced with one which envisages “endogenous dollarisation”: restricting the supply of pesos (which would become a “museum piece”) and thereby encouraging a shift to the dollar. The peso was pegged to the dollar for more than ten years (from April 1991 to January 2002) before being abandoned, with dollar bank loans and deposits forcibly converted into pesos. That suggests only full dollarisation would eliminate currency risk. Zimbabwe reintroduced its domestic currency after ten years of dollarisation, so such policies can be reversed.

31. Argentina: policy interest rate and the peso



Source: LSEG. Data as at 5 July 2024.

Weak growth

In order to improve growth prospects, Milei plans to roll back the size of the state. Initial results have been encouraging, with the government budget likely to be balanced this year. Initially, as is typically the case with such reforms, there has been an adverse impact on growth (see Figure 32) and Argentina has fallen behind its close neighbours (see Figure

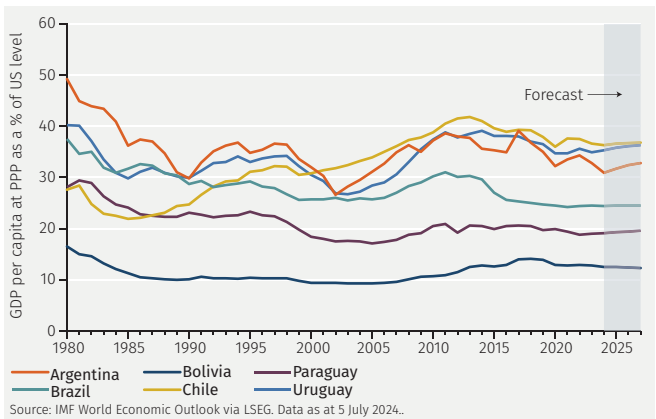
32. Argentina: GDP growth expectations



Sources: Bloomberg consensus forecasts and EFGAM. Data as at 5 July 2024.

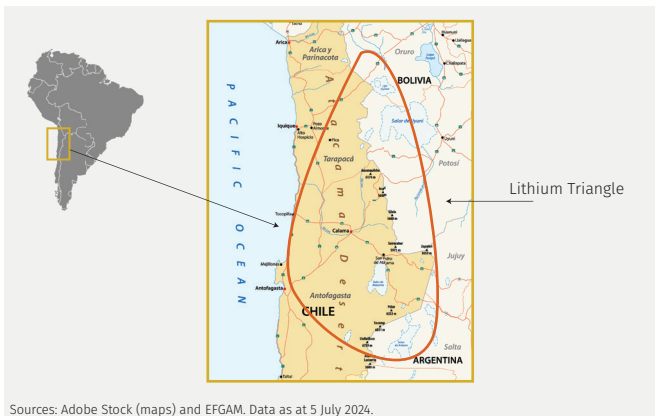
33). Argentina is rich in natural resources and its lithium reserves (see Figure 34) have the potential to boost exports and growth. Realising its potential has, of course, been Argentina’s perennial problem.

33. Argentina vs. its neighbours



Source: IMF World Economic Outlook via LSEG. Data as at 5 July 2024.

34. Lithium triangle



Sources: Adobe Stock (maps) and EFGAM. Data as at 5 July 2024.

¹¹ Source: <https://www.cato.org/research/world-inflation-and-hyperinflation-table>

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