Global Risks Midyear Update 2024:

Hanging Together

MACRO STRATEGY | July 11, 2024

Developed-market economies are still hanging together. In our December forecast, we were too pessimistic about growth overall and too optimistic about the decline in inflation in the U.S. and the U.K. Our short-term rates forecasts remain mostly unchanged, with the major exception being the U.S., where we were too optimistic about the U.S. Federal Reserve's (Fed) ability to cut rates. U.S. debt sustainability concerns faded but could reassert themselves at the end of the year when the debt ceiling debate will begin anew.

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A few risks that concerned us in December did come to pass. We have seen a resurgence of inflation—in the U.S. at least. We have also seen nascent recovery of the manufacturing sector in both the U.S. and EU, and the U.S. business sector's strengthening over the last few quarters has meant that our base case has shifted from recession for 2024 to no recession.

Our main concerns for the rest of the year are geopolitical and election risks. In the U.S., an expected Trump victory could bring tariffs, import restrictions and a more hawkish Taiwan policy, straining the political relationship with China and putting pressure on U.S. firms doing business there. French and U.K. elections may create some policy changes as well.

Finally, while the Ukraine war is expected to continue at least through year-end, we remain more concerned over an escalation in fighting in the Middle East. We see a substantial risk of the Israel-Hamas conflict broadening by year end, most likely through a new front opening with Hezbollah on Lebanon's southern border. While the chances of a direct conflict between Israel and Iran are small, especially in the very short term, both countries have demonstrated the ability to strike within each other's territories, raising the worrying possibility of miscalculation and rapid escalation. Economically, an escalation could have broad energy market implications by disrupting both Iran's own oil production along with the production of countries that ship their oil through the Strait of Hormuz.

MIM Updated Forecasts

	Growth (%y/y)		10-year yields (YE, %)		Policy rate (YE, %)		Inflation (Dec, %y/y)	
	2023	2024	2023	2024	2023	2024	2023	2024
U.S.	2.5	2.0 (+2.0)	3.88	4.50(+0.5)	5.50	4.75(+0.75)	3.2	3.1(+0.3)
Eurozone *	0.4	0.6(+0.2)	2.02	2.30 (+0.3)	4.50	3.25 (+0.25)	2.9	2.2
U.K.	0.1	0.6(+0.4)	3.53	3.80 (+0.3)	5.25	4.75 (+0.25)	4.0	2.4(+0.2)
Australia	1.8	1.4	4.00	4.00(+0.25)	4.35	3.75	4.6	3.4
China	5.2	4.8(+0.3)	2.56	2.80	3.45	3.35	0.3	1.2(-0.8)
Japan	1.8	1.0	0.61	1.0(+0.2)	-0.1	0.1(+0.2)	3.7	2.0

Note: Cells in green were updated since the Global Risks 2024 (published December 15, 2023), with change listed in parentheses. Positive indicates upward revision.

Source: Source: Bloomberg, MIM U.S.: BEA, Treasury, Federal Reserve Board of Governors, BLS; Europe: Eurostat, ECB; UK: ONS, BoE; As of July 2024.

Risk 1: U.S. Debt Troubles

Over the first half of the year: In late 2023, there was much discussion that the pricing of U.S. Treasuries reflected worried about U.S. debt sustainability. Since then, acute concerns about U.S. Treasury debt have receded, and the 10-year Treasury yield declined from its Q4 2023 peak of 5.0%.

Updated risks: Toward year end, the debt ceiling will loom again. On January 1, 2025, the debt ceiling will be reinstated at the level required to accommodate all borrowings until that date. The date at which the debt ceiling becomes a constraint on spending will depend on tax revenues in 2025 as well as on the amount of cash on hand in the Treasury General Account. Toward the end of 2024, we are likely to get a better sense of when the new debt ceiling will begin to bind and the inclination of the newly elected Congress to address the ceiling.

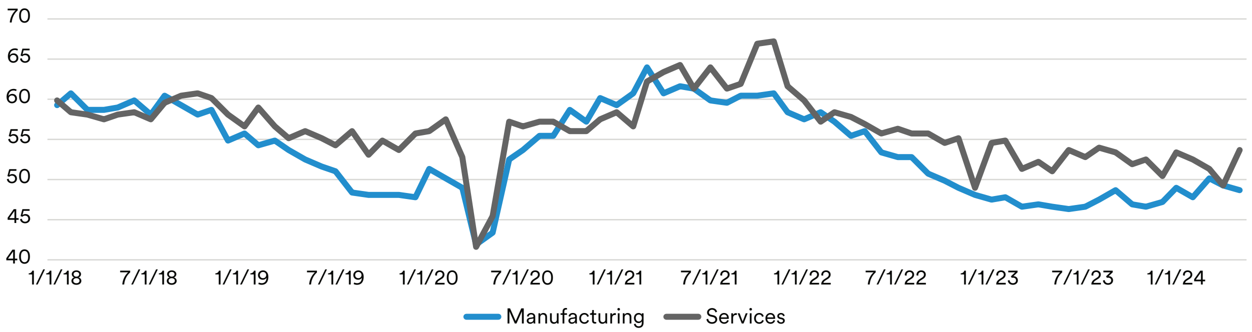
A meaningful credit rating downgrade appears to be a distant concern. With one agency (Moody's) still rating the U.S. as AAA, a downgrade to single-A—the only downgrade that may materially affect markets—is unlikely to be a danger before year end 2024. We remain concerned about the pace of government spending over the medium term.

Risk 2: Manufacturing Recovery Creates a Soft Landing.

Over the first half of the year, U.S. manufacturing did indeed improve from what was effectively a manufacturing recession in 2023. In our December risks piece, we argued that a plateauing services sector and a recovering manufacturing sector could engineer a soft landing, and the trend of the Institute for Supply Management (ISM) indexes support this theory.

Updated risks: A key risk to our current no-recession scenario is that the services sector continues to decelerate and falls into negative growth. Non-residential private investment overall remains quite cautious despite improving corporate margins—a puzzling development that could stall demand for labor. This may be a result of concerns about the fall elections and the potential changes to government spending and policy, in which case further investment hesitation would continue to be a threat until there is more political clarity.

ISM Manufacturing Is on an Upwards Trajectory



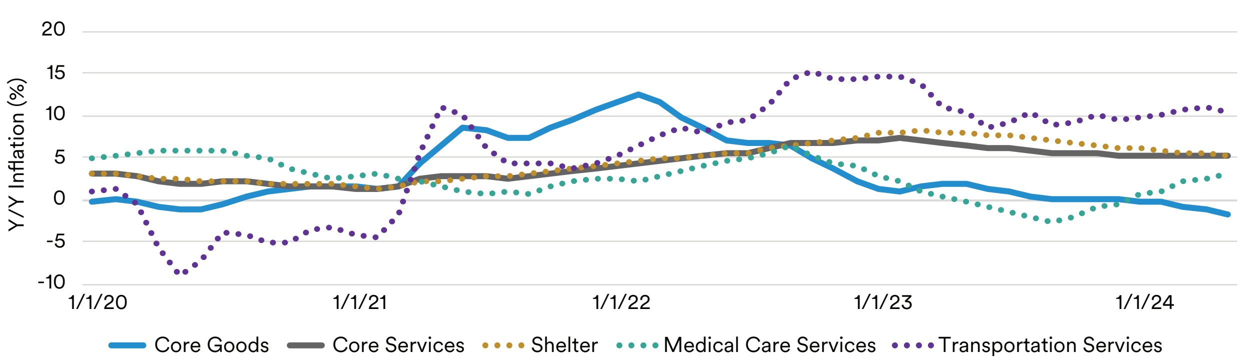
Source: BLS, Macrobond, MIM, as of July 2024

Risk 3: Resurgence of U.S. Inflation

Over the first quarter of the year, there was indeed a resurgence of inflation in the U.S. The inflation fight, particularly for services, is not over despite the markets and the Fed shifting toward that assumption at the end of 2023.

U.S. Bureau of Labor Statistics (BLS) data show that shelter inflation has come down from its 2023 high of over 8% year over year but remains over 5.5%, a rate last seen in the early 1990s. Medical services prices date chart have accelerated since the beginning of 2024. March's reading of a 2.6% month-over-month price increase in motor vehicle insurance is the second highest monthly increase since at least 1986, exceeded only by the pandemic. On a year-over-year basis, car insurance prices have soared almost 23%.

Core Services and Code Goods Inflation Has Diverged



Source: BLS, Macrobond, MIM, as of June 2024

Updated risks: If inflation progress continues to be sluggish, or worse, if it accelerates as it did in the first few months of the year, then the Fed would likely keep rates at current levels through year end. We see outright hikes as a remote risk.

The drivers of inflation that worry us particularly are transportation, medical services and homeownership costs, including mortgages and homeowners' insurance. The risk of goods deflation ending also remains a worry: In our December risks piece, we expressed concerns over the potential end of goods deflation amplifying the effect of services inflation in the aggregate readings. This has not yet been the case, but we expect these to converge toward zero in the near term, which could put upward pressure on inflation.

Geopolitical concerns (which we discuss below) also threaten to increase commodity and transportation prices, while continued government disbursements via the post-pandemic spending packages could also exert inflationary pressure.

Risk 4: Geopolitical Tensions Escalate

Over the first half of the year, tensions in the Middle East continued to simmer, with the ongoing Israel-Hamas conflict, Houthi attacks on cargo ships and the Iranian-Israeli tit-for-tat in April worsening conditions. They have not yet boiled over. The Russia-Ukraine conflict has, as expected, continued without a clear breakthrough by either side. Russia has made some advances this year, stepping up attacks on Kharkiv, Ukraine's second largest city, and increasing the intensity of drone and missile attacks on Ukraine's energy infrastructure.

Updated risk: While the U.S. will likely continue to advocate for a ceasefire between Israel and Hamas, we continue to see a substantial risk of Israel's invasion of Gaza leading to a broadening of the conflict by year end, most likely through the opening of a northern front in the conflict with Hezbollah. Israel's tolerance for Hezbollah on the southern border of Lebanon has lessened since the outset of the conflict, driven by concerns that Hezbollah could launch an attack several magnitudes more severe than Hamas' October 7 attack. A much lower probability but higher impact risk would be a direct conflict between Iran and Israel and its allies. The risk of Iran's involvement is likely lower in the very short term as it sorts out its succession plans for the Presidency. However, both Israel and Iran have recently demonstrated both a willingness and ability to hit each other within their own territories—a concerning development that will increase the risk of an accident or miscalculation triggering a more rapid escalation of the scenario. This would have the worst impact on global energy markets, given the potential for disruption not just to Iranian oil exports but also to the Gulf Cooperation Council (GCC) producers exporting crude through the Strait of Hormuz.

In Ukraine, we expect the Kremlin to continue to take advantage of its relative strength in terms of manpower and ammunition during a period in which there have been delays to the deployment of international support to Kiev. Fighting is expected to intensify over the summer, following U.S. approval of ~$61bn of additional support for Ukraine and lagged delivery of military equipment to bolster its firepower. However, our base-case outlook remains for the conflict to continue without resolution at least through 2024.

Risk 5: 2024 Election Risk Creates Policy Uncertainty

Over the first half of the year: In Europe, MIM's central expectation that the center ground would generally hold despite an increase of support for far-right populist parties in June's European Parliament (EP) elections was realized. However, the outcome triggered a surprise call by President Macron for early legislative elections in France, following a strong showing at the EP elections for the far-right National Rally (RN), which repeated its 2019 outcome by coming first and poor results for Macron's Renaissance group.

In Asia, Taiwan election-related noise appears to have faded following Chinese military drills in the aftermath of President William Lai Ching-te's inauguration on May 20. The drills illustrate that cross-strait relations are tense; however, Beijing will refrain from measures and actions that could trigger a U.S. military response. In India, Prime Minister Narendra Modi was re-elected with a narrower margin of victory, requiring a coalition government to be formed. Modi retained his cabinet for all key portfolios and core ministries including economics and finance, implying policy continuity.

Updated risks: Election uncertainty will continue through the year in the U.S., and our expectation is that there will be a Republican sweep of the Presidency, the Senate and the House of Representatives. The polling for the presidency is relatively close but consistently indicates victory for President Trump. In our view, the greatest risk to our call is in the House of Representatives, as a split Congress would reduce the probability of extending the Tax Cuts and Jobs Act from President Trump's first term.

There has been some discussion about a second Trump presidency threatening Fed independence. We place a relatively low probability on a material takeover. First, only two Federal Reserve Board seats are expected to open in the next four years, and nominees would still require Senate approval. Federal Reserve Bank presidents are elected in an even more decentralized and difficult-to-capture process.

Even if President Trump were to successfully find a path toward influence, it is not clear in which direction he would prefer to push rates. Although he had previously advocated for lower rates, a dovish tilt right now could yield serious unintended consequences, given the possibility of inflation reacceleration. Moreover, a conventional Republican pick would generally be more hawkish, and the "Project 2025" document advocates removing unemployment as one of the Federal Open Market Committee (FOMC) mandates, also implying a tighter monetary policy bias. Ultimately, a true Fed capture might be too difficult and messy to be worthwhile, while publicly haranguing the Fed without the responsibility of control could better suit President Trump's goals.

While further U.S. trade restrictions under President Biden would likely not be material, a second Trump presidency could exacerbate U.S.-China tensions due to significant risk of aggressive tariffs and export controls further disrupting trade and investment between the two countries. We believe these measures would come early in his presidency, despite any potential negative effects on the domestic economy or U.S. firms doing business in China. Trump's hawkish stance on Taiwan would further undermine U.S.-China relations, particularly if his administration supported President Lai's pro-independence leanings.

In Europe, the recent French election has raised policy uncertainty in France particularly around the course of fiscal policy.

Authors

Global Economy
Tani Fukui

Global Economy
Shan Ahmed

Asia
David Richter

Global Sovereigns
David Heslam

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