Sticky inflation + stubborn central banks = spirited markets.

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SEI recently released its first-quarter Economic Outlook, published in two installments. Here is a summary of our key perspectives from the second installment, focusing on inflation, its impact on economic policies, and how market performance reflects this.

- In the spring of 2021, we began to use the phrase "persistently transitory" to describe our inflation view. We believed at the time that inflation would stay higher for much longer than economists, central bankers, and market participants anticipated. Headline inflation has come down dramatically in the past year, raising hopes that the Federal Reserve (Fed) and other major central banks are succeeding in bringing inflation back to their 2% targets without undue economic pain. On a harmonized consumer-price index (CPI) basis, U.S. inflation was near target in February, the eurozone wasn't far off, and the U.K. was also moving in the right direction. The question is: Can inflation settle near 2% on a sustained basis? We are still doubtful.
- We remain focused on labor-market conditions and their impact on wage costs. Unit labor costs are a good yardstick of underlying inflation, since they measure increases in total employee compensation, offset by productivity improvements. Looking at the rise in unit labor costs for the U.K., Canada, the eurozone, the U.S., and Japan for both 2023 and the 10 years prior to the onset of COVID-19, each of the economies' unit labor cost gains were markedly higher in 2023. Although labor markets are not as tight as they were a year or two ago, they are tight enough to keep rises in unit labor costs, and by extension, underlying inflationary pressures, elevated. SEI believes this will present a major challenge for policy-makers.
- Earlier this year, participants in the futures and swap markets priced in an expectation that the Fed would reduce the federal-funds rate by approximately 150-175 basis points (1.50%-1.75%) by the end of 2024. We saw no reason for such optimism and stuck to our view that three 25 basis-point reductions totaling 75 basis points (0.75%) would be the actual outcome, consistent with the Federal Open Market Committee's (FOMC) own projections. Stubborn inflation data and a mixed employment picture have led investors to back away from their earlier predictions of aggressive interest-rate reductions. We believe that any surprises from the Fed would more likely come in the form of fewer, not more, rate cuts this year.
- The Bank of Japan's recent rate hike is the first change since January 2016, and the first increase in 17 years. Among other developments, Japan ended its years-long policy of yield-curve control. Japanese interest rates remain extremely low compared to other countries, keeping the yen relatively weak. It probably will take a dramatic rise in Japanese interest rates and monetary policy easing from the Fed before the yen can appreciate meaningfully against the U.S. dollar. In the meantime, traders are betting on the yen weakening further. When and if those positions are unwound, the yen could rise quite sharply. While the catalyst required for such a shift has yet to materialize, further downside in the yen appears limited for now.
- Equity markets in many countries and regions have been pushing higher in the past six months, approaching or achieving new all-time highs in the process. The U.S. continues to be the leading economic engine for the world. Over the past 20 years, U.S. corporate earnings per share have nearly tripled, while the rest of the developed world's profits roughly doubled. Given this earnings performance, it is easy to see why investors have viewed U.S. equities as the "best game in town."
- Forward-looking earnings estimates have risen since the start of 2023, but the near 8% gain in forward earnings explains only a small portion of the 33% price return in the S&P 500 Index over the same period. Multiples have jumped, too, from 16.6 times earnings at the end of December 2022 to 20.5 times at the end of February. While the price-to-earnings ratio exceeded the current level for much of 2020 and 2021, these years were the highest point for earnings multiples since late 1990s/early 2000s.
- Broadly speaking, we think U.S. Treasurys are fairly valued. But heavy bond issuance, and the possibility that investors will begin to demand a positive term premium, suggest that bond yields will remain at elevated levels, even as short-term rates begin to fall. We forecast a steeper yield curve, in which short-term rates fall relative to long-term rates. Credit spreads also remain tight, reflecting investors' optimism that economic growth will continue unabated. Spreads on both investment-grade and high-yield bonds remain close to their historic lows. Investors may not be irrationally exuberant, but they are complacent.

A full-length paper is available if you wish to learn more about these timely topics.

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Glossary

Price/earnings (P/E) ratio is calculated by dividing the current market price of a stock by the earnings per share. Price/earnings multiples often are used to compare companies in the same industry, or to assess the historical performance of an individual company.

Term premium is the additional yield that investors demand to hold longer-duration securities.

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