The 9 things to watch in 2024

Key catalysts for the economy and markets

February 2024

Summary

Every year we compile a list of “9 things to watch”, not in the belief that we will get everything correct, but to focus attention on the factors that will decide the fate of markets and provide a benchmark against which we can monitor developments.

This year, inflation and central bank policy remain high on our list. The US Presidential election will be a big discussion point in 2024 but geopolitics more generally, and its impact on oil prices will also be crucial. Domestically, the outlook for housing construction and wages will be vital. Table 1 outlines *The 9 things to watch* for the year ahead and we explore each item in the following pages.

Why predict?
Robert Armstrong of the *Financial Times* writes: The point of making predictions is “*to clarify and crystallise our current thinking about the market. Predictions also create an opportunity for accountability.*

“We all struggle under 2 powerful cognitive illusions. Looking forward, we think we can see the future better than we actually can. Looking back, we think we did predict the future better than we actually did. Making predictions helps control these twin biases.”

US interest rates and economy

US policymakers couldn’t have hoped for a better outcome in 2023 as inflation fell sharply even as growth remained firm, and unemployment only rose modestly. With inflation falling back towards the US Federal Reserve’s (Fed’s) target, the rationale for higher interest rates has disappeared but given healthy economic growth and low unemployment, what is the rationale for easier monetary policy?

Investors appear to think that lower inflation is not only necessary for lower interest rates but also sufficient. US interest rate futures point to the Fed cutting interest rates five times in 2024; if that occurred, it would certainly set the scene for stronger growth and profits in the year ahead. But with US wages growing at a pace that is not yet consistent with US inflation *remaining* around 2% and the unemployment rate still low, it seems likely that US policymakers will cut rates more cautiously than investors believe.

Key things to watch in Australia

The Reserve Bank of Australia (RBA) has made it clear that its credibility is on the line if inflation doesn’t return towards target over the next 18 months. Inflation outcomes, therefore, will be critical. When the RBA tightens monetary policy, it is usually the housing market that feels the most pain initially, yet house prices have largely shrugged off the RBA’s tightening campaign so far while building approvals have fallen sharply. Despite the decline in approvals, actual construction has remained buoyant as builders had a large backlog of work to keep them busy over 2023. In 2024, however, construction may fall as the pipeline of work shrinks – and it is only when construction falls that employment will begin to weaken.

While job vacancies in the construction sector have fallen modestly over the last year, for the broader economy they have declined by 30%. This partly reflects weaker labour demand, but also the very strong increase in labour supply mainly due to surging migration. One of the key effects of this shift will be on the ability of workers to obtain large wage increases. If evidence emerges that wages growth is retreating, then the RBA will also be much more comfortable with the inflation outlook.

Commodity prices, Chinese growth and geopolitics

An escalation of geopolitical tensions was once again evident during 2023 and there is inevitably a risk that this could block supply chains and lead to another increase in commodity prices, as we saw when Russia invaded Ukraine. In 2024, however, we think that oil supply will remain in line with demand and expect fairly steady prices.

Geopolitical tensions between the US and China do, however, appear to be having a substantial impact on Chinese investment. Together with a weak property sector, we now think that Chinese growth may again disappoint in 2024; sluggish Chinese growth is likely to have a significant impact on demand for several key commodities, such as copper. Thus, while structural developments – such as the transition to Net Zero – do have the capacity to support prices over time, this might highlight how cyclical developments can overwhelm those factors on a shorter time horizon.

Summary of key things to watch 2024

Table 1: The 9 things to watch in 2024

Item	Forecast
1. US inflation	Back at target
2. US monetary policy	The Fed cuts less than investors hope
3. Oil prices	Oil prices won't spike on geopolitical tensions
4. Elections	Won't change the trajectory of financial markets
5. US commercial property	Balance sheets cope with higher funding costs
6. Australian inflation	Lower than the RBA expects
7. Australian housing activity	The pipeline of work runs out
8. Chinese growth	Slower for longer
9. Commodity prices	Cyclical headwinds outweigh structural tailwinds

Source: TCorp

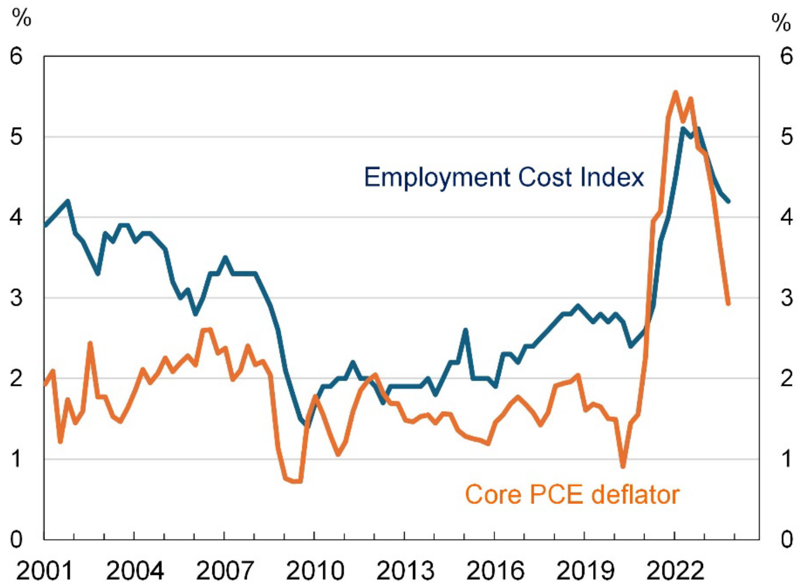
1. US inflation hits Fed target

US inflation peaked in 2022 and fell quickly over 2023 – faster than Fed policymakers expected at the start of the year. The Fed now expects its preferred measure of inflation – the core Personal Consumption Expenditure (PCE) deflator – will reach its 2% inflation target sometime in 2025. A key question for markets this year is whether the Fed will start cutting interest rates once inflation is at, or very close to, target. We think that inflation close to 2% is necessary before a data-dependent Fed seriously considers rate cuts, but that it's not sufficient.

Fed policymakers have repeatedly said they plan to keep interest rates high until they are certain that inflation is returning to target, but also need to be sure that inflation will *remain* low. Much of the fall in inflation over the past year has been due to the reversal of temporary factors that boosted inflation during the pandemic in 2021 and 2022.

What the Fed really needs to see to be convinced that inflation will remain low is slower wages growth. Although this has slowed from its peak, wages are still growing by more than 4%. Fed Chair Powell recently noted that wages growth of 3.5% would be consistent with the Fed's 2% inflation target (assuming labour productivity grows at around 1.5%, its average rate over the past 20 years).

Chart 1: Annual percentage change in core PCE deflator and Employment Cost Index



Source: Bloomberg

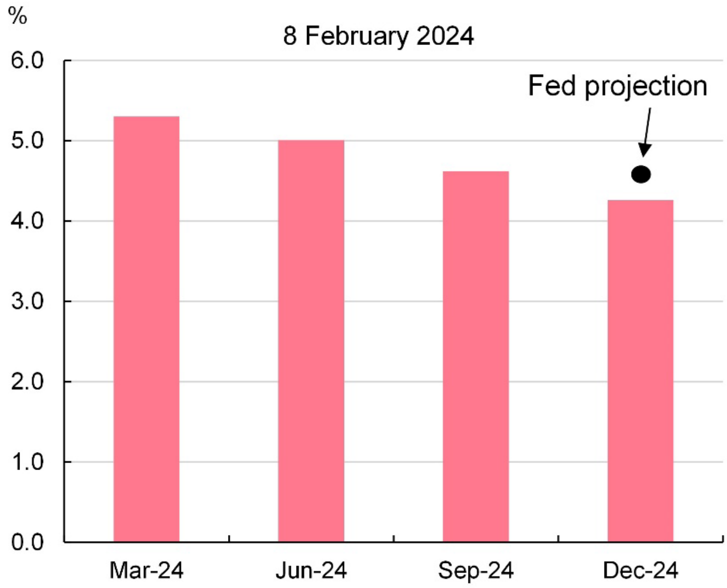
If wages grow faster than 3.5%, the Fed may not be convinced that inflation will remain low, even if actual inflation outcomes are around 2% at the time. The state of the labour market will be key to whether the Fed cuts rates in this environment. If the labour market remains tight and the unemployment rate remains low, the Fed will be reluctant to cut rates as this could again boost wages growth and inflation. If, however, the labour market weakens noticeably, the Fed will be more confident that rate cuts won't cause wages growth and inflation to reaccelerate.

As inflation continues to fall towards target, it will be increasingly difficult for Fed policymakers to navigate and communicate their policy decisions. If the US economy and labour market remain resilient, wages growth may not slow as much, or as quickly, as the Fed hopes. The Fed could then have the challenge of explaining why it's not cutting rates even with inflation back at target.

2. The Fed easing cycle disappoints

After central banks raised interest rates aggressively in 2022 and 2023, the focus for investors this year will be on when and how quickly interest rates will be cut. The Fed expects to lower its policy rate by 75bps in 2024 and recent commentary by Fed officials suggests that cuts are most likely to take place in the second half of this year. In contrast, financial markets expect the Fed to start easing monetary policy as early as March and to lower rates by almost 125bps in 2024.

Chart 2: Market pricing – US Fed funds rate



Source: Bloomberg

Why do financial market expectations differ from the Fed's? It could be that investors view the 'inflation problem' as almost behind us. Investors think that the Fed has succeeded in achieving a 'soft landing' for the US economy, where inflation is convincingly falling towards the 2% target without a sharp slowdown in economic activity or a large rise in unemployment. Investors see this 'Goldilocks' combination as enough for the Fed to start aggressively cutting interest rates within a few months.

In this scenario, however, it is hard to see why the Fed would aggressively cut interest rates. As discussed above, we think that the Fed will be reluctant to cut rates until the labour market loosens enough for wages growth to slow to 3.5% or less. We don't see this happening until the second half of this year. If the Fed only starts cutting rates in the second half of this year, it is unlikely to lower rates by the full 125bps that investors currently expect. We think that the Fed's projections are more realistic and it is likely to deliver 75bps of cuts in the second half of 2024.

A development that would change our view is a large rise in the unemployment rate which would presage a 'hard landing' for the US economy. Wages growth would slow, and the Fed could ease policy aggressively, knowing that rate cuts wouldn't cause an unintended reacceleration of wages growth and inflation. In this scenario, the Fed would likely ease policy even more aggressively than investors currently expect. This would be consistent with the Fed's response in previous episodes where the unemployment rate rose sharply and the US economy entered recession.

> *"If the Fed only starts cutting rates in the second half of this year, it is unlikely to lower rates by the full 125bps that investors currently expect."*

3. Oil prices won't spike on geopolitical tensions

The spike in oil prices in 2022 following Russia's invasion of Ukraine was a timely reminder of how geopolitics can affect commodity prices and inflation. While the conflict between Israel and Hamas has not yet resulted in a sharp rise in oil prices, an escalation of the conflict to Iran has the potential to disrupt trade routes around the Red Sea and the supply of oil.

If that were to happen, it would be damaging to global growth and financial markets, but this is not our base case. Rather, we expect that oil prices will be fairly steady over 2024 and may even trend lower.

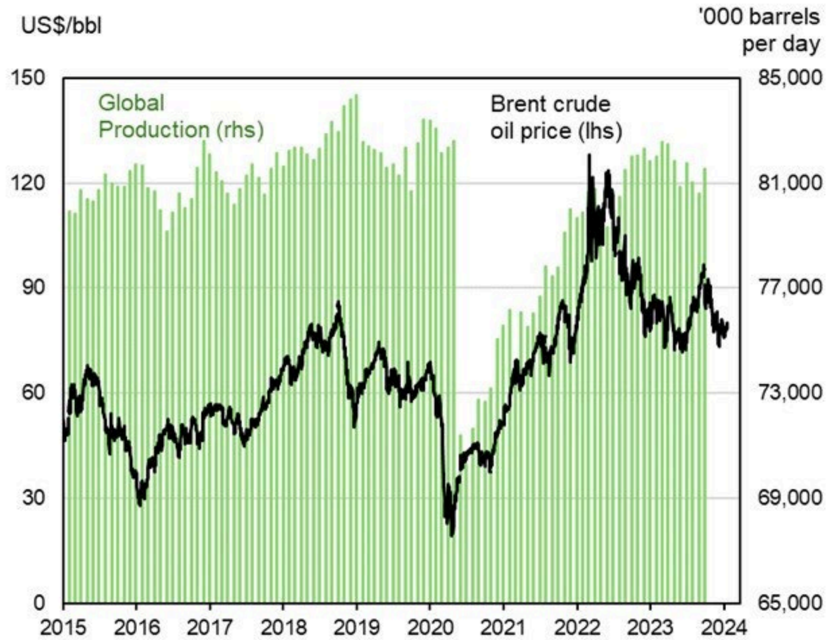
The first point to note is that Iran's economy would likely be most harmed by a serious conflict escalation, as Iranian oil production would be most affected. This suggests that Iran has an incentive to avoid that outcome.

Second, current oil prices have only been maintained because of deliberate production cuts from Saudi Arabia and Russia. In other words, there is ample global capacity at present. This suggests that even if Iranian oil production was affected, there is scope for Saudia Arabia in particular to offset that lost production.

It is also interesting to note that US production has increased sharply with producers substantially increasing the productivity of their oil rigs. Again, if prices spiked temporarily there is scope for US producers to increase production further.

Finally, oil demand also looks to be fairly tepid. China's underwhelming growth and a plateauing of holiday travel after economies reopened following COVID suggest that Saudi Arabia might need to maintain its production cuts over 2024, just to maintain prices.

Chart 3: Oil prices and production



Source: Bloomberg

4. Elections don’t derail financial markets

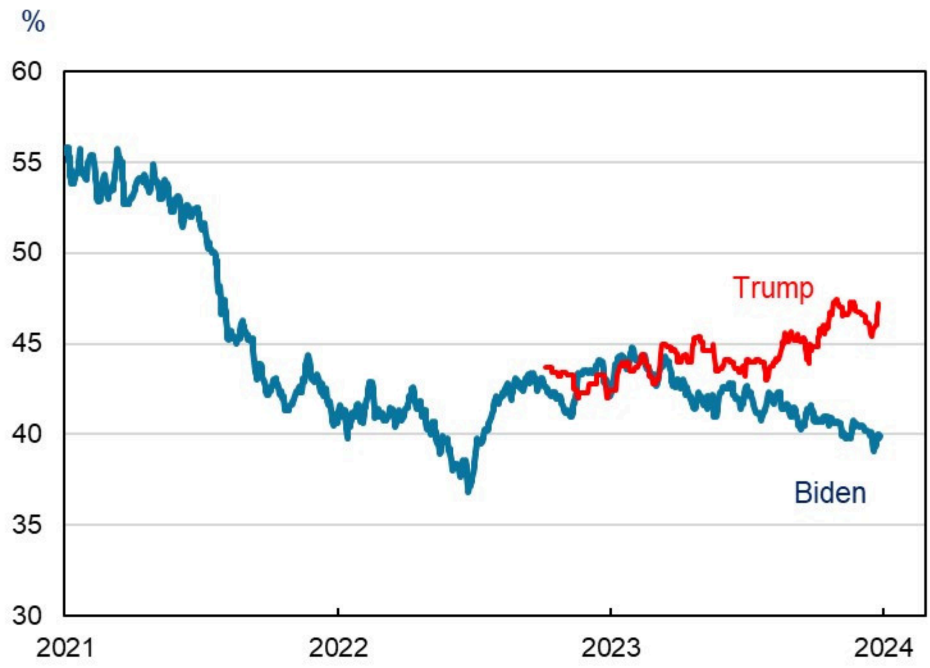
Many countries are holding elections this year, including the United Kingdom, South Korea, India, and Indonesia while elections will also take place in the European Union. There is, however, little doubt that the US Presidential election will dominate media and financial market attention.

The 2024 US Presidential election is likely to be a repeat of the 2020 event with Donald Trump expected to be the Republican challenger to President Biden. With President Biden recording fairly low approval ratings, it is plausible that Donald Trump might triumph. So, what would a second Trump presidency portend for the economy and financial markets?

We think that US governance and policymaking would be more erratic and chaotic under a re-elected President Trump, but we don’t believe that it would significantly change how the US economy or financial markets would perform – despite Trump having very different policy priorities than Biden. Additionally, there are things that Trump would change very quickly, including increasing tariffs on imports (which would increase inflation slightly), changing regulations (particularly regarding the environment) and how stringently they are enforced, and foreign policy.

In our view, however, if a President is unable to get legislation passed by Congress, they are unlikely to have a dramatic impact on the economy or financial markets. This is likely to be the key constraint on whoever wins the 2024 Presidential election – neither of the parties is likely to easily control both the House and Senate. Without the ability to push through legislation, the President won’t be able to change taxes or major spending programs. If, however, the Republicans did gain control of Congress and Trump also won the presidency, that would be a very different story.

Chart 4: US presidential approval ratings



Source: Bloomberg

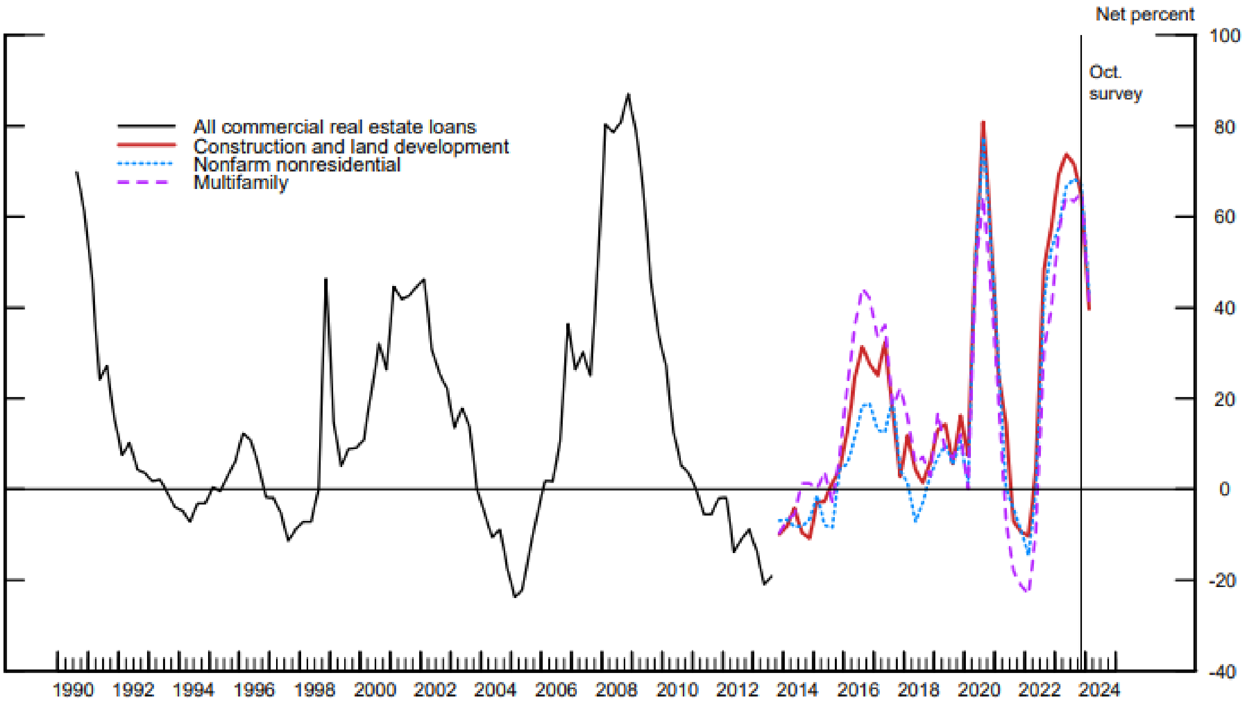
> *“If a President is unable to get legislation passed by Congress, they are unlikely to have a dramatic impact on the economy or financial markets. This is likely to be the key constraint on whoever wins the 2024 Presidential election.”*

5. Risks in US commercial real estate are contained

The US commercial real estate (CRE) sector has been under pressure in recent years as interest rates rose aggressively. Sharply higher borrowing costs and stricter US bank lending standards made funding conditions much more challenging. These difficulties were compounded by the acceleration of structural trends during the pandemic, particularly for offices, with more people working from home. This resulted in sizeable falls in office values.

Investors are understandably concerned about how bad the stress in the CRE sector could become. Higher interest rates are creating cash flow difficulties for some borrowers as they struggle to refinance in an environment of tighter funding conditions and lower valuations. With US$2.6 trillion of CRE loans maturing over the next 5 years, the greatest risk is that borrowers fail to obtain the funding they require and default on their debt. As banks own half of CRE debt, (three-quarters of which is in small and mid-sized banks), a rise in defaults could stress banks' balance sheets. This could cause fire sales and losses for investors, which could then spill over to the broader economy. The longer the Fed keeps rates high, the greater this risk becomes.

Chart 5: Net Percent of US Domestic Respondents Tightening Standards for CRE loans



Source: US Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

Although parts of the sector will continue to face challenging conditions, our view is that the sector won't experience severe stress that will propagate through the broader economy. Despite the headwinds discussed already, other factors are more supportive including generally strong operating performances and underlying demand for most commercial properties. Even within the office sector, severe stress is isolated to a smaller sub-class of assets, and the oversupply of offices is expected to correct itself in the medium term.

Banks' balance sheets also appear strong enough to manage risks in the CRE sector. Importantly, banks' exposures to the office sector amount to only 3% of total bank loans. We wouldn't be surprised to see some smaller banks fail if loan losses start rising, but we don't expect this to occur on a large enough scale to meaningfully tighten funding conditions beyond the CRE sector.

We also expect fire sales and large investor losses to be the exception rather than the norm. Banks have typically extended loans on troubled assets to avoid taking ownership or engaging in a fire sale. For as long as operating performance remains strong, we expect this to continue. Private markets have also been willing to step in and fill the funding gap created by banks. In our view, the largest risk is a sharp downturn in the US economy, which is not our base case. If this happened, more CRE assets would experience cash flow problems and banks would be less willing to extend loans if operating performance is weak. While private lenders may continue to provide funding, it would undoubtedly be more expensive and more difficult to obtain. Defaults would likely rise, and fire sales would follow. This could then be the catalyst for a broader credit crunch that would tip the US economy into recession.

> **“**US banks’ balance sheets also appear strong enough to manage risks in the CRE sector. Importantly, banks’ exposures to the office sector amount to only 3% of total bank loans.**”**

6. Australian inflation is less than the RBA thinks

The RBA has made it clear that getting inflation back under 3% is its key priority, which means that the inflation outlook will determine the path of interest rates. More broadly, however, the inflation outlook will also exert a key influence on consumer spending; households struggling with the cost of living are forced to cut back on discretionary spending as the price of housing, utilities, education, and insurance has risen sharply.

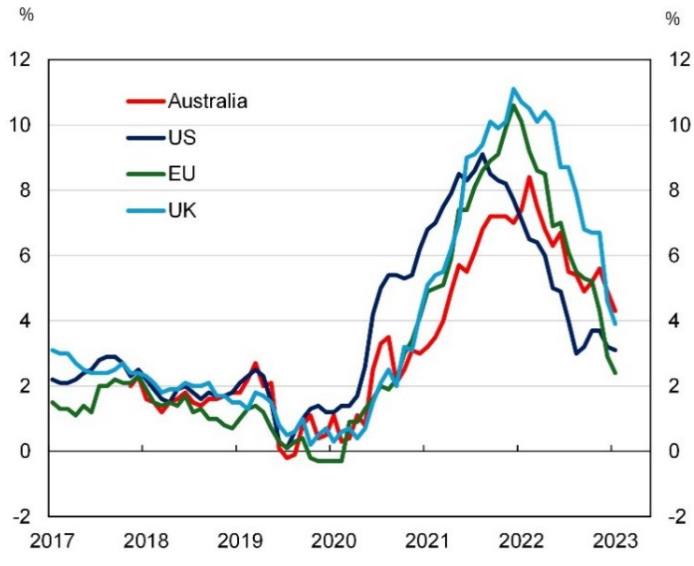
While Australian inflation fell sharply over 2023, from 8% to 4%, the RBA expects that future progress will be slower. In particular, the RBA has cited the experience of other economies that continue to see elevated levels of services inflation, even as the prices of goods have stabilised or even edged lower. The RBA also appears pessimistic that Australian firms will allow lower costs (from weaker commodity prices for example) to be passed on to Australian consumers. As such, the RBA thinks that inflation will still be around 3.25% at the end of the year.

From a bottom-up perspective, there are certainly some reasons to be cautious. The tight rental market combined with very high levels of immigration suggests that rent prices will continue to be under pressure but eventually, affordability considerations will constrain rents as younger people remain at home for longer or share accommodation with more people. In other words, the average household size will increase. This doesn't mean that rents will decline, but a smaller increase in rents is consistent with falling inflation.

Affordability considerations will also influence whether firms pass on cost reductions to consumers. In our view, the very weak pace of consumer spending suggests that many businesses have already reached that point. Thus, we are more optimistic than the RBA about the potential for some goods prices to decline.

Finally, from a top-down view, there are also reasons why inflation might continue to fall. Wages growth appears to have peaked, and we expect a smaller increase in the minimum wage this year. This is consistent with sub-3% inflation. It is also worth noting that the Australian dollar fell by 11% in 2023 from January to October, boosting import prices and inflation. Since then, the Australian dollar has risen by 10% which will have the opposite effect. For these reasons, we think inflation will fall to 3% by the end of 2024, which should enable the RBA to begin cutting interest rates.

Chart 6: Inflation rates



Source: Bloomberg

> *"While Australian inflation fell sharply over 2023, from 8% to 4%, the RBA expects that future progress will be slower."*

7. Australian builders reach the end of the pipeline

The most interest-sensitive part of the economy is housing. Usually, when the RBA raises interest rates, credit growth declines and house prices moderate or fall. This typical relationship was broken during 2023 as prices recorded a solid gain. But, as shown in the chart below, the regular relationship between interest rates and building approvals did, once again, assert itself.

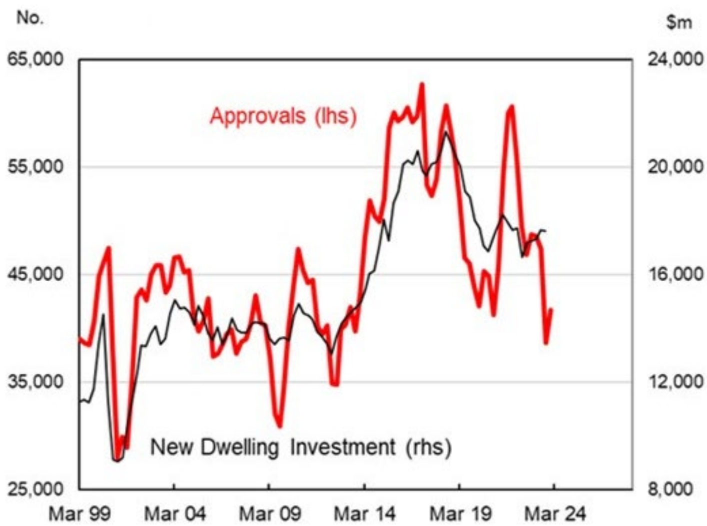
Building approvals are one of the leading indicators of housing construction, but the chart below shows that its relationship with what actually matters – housing construction – varies over time. In short, actual construction (or dwelling investment) is far less volatile than building approvals.

This reflects 2 things. First, is the time it takes to construct housing which means that it won't mechanically follow every spike and dip that might occur in approvals. Just as important is how builders smooth their work over time. This was evident in 2009 as household confidence shrank in the wake of the GFC and approvals plunged. Construction did decline a little in 2009, but builders were able to maintain activity at a decent level until sentiment improved and approvals rebounded, essentially restocking the work pipeline. Also critical during this episode were the actions of the RBA (large interest rate cuts) and the Australian Government (large fiscal stimulus) to bolster confidence.

To some extent, the current divergence between approvals and actual construction bears some similarity to 2009. Unlike 2009, however, the RBA has been raising interest rates aggressively. But on the positive side of the equation, builders have had the benefit of more work in the construction pipeline as labour and raw material shortages meant that they couldn't ramp up construction when approvals surged in 2021. So, what happens next?

In our view, the outlook will hinge on when the RBA begins cutting rates. If the RBA refuses to countenance rate cuts until inflation is below 3%, then they will be delayed until 2025. Builders will be forced to lay off workers to cut costs and bring expenses back into line with dwindling revenue. If, however, the RBA begins to cut rates in Q3 of 2024, then builders will likely focus on the potential for a rebound in demand in 2025 and be willing to endure a short period where they may have more workers than they need. In our view, construction will probably decline modestly in 2024, but there is a chance of a sharper decline, and that would significantly raise the risk of a recession.

Chart 7: Australian housing construction



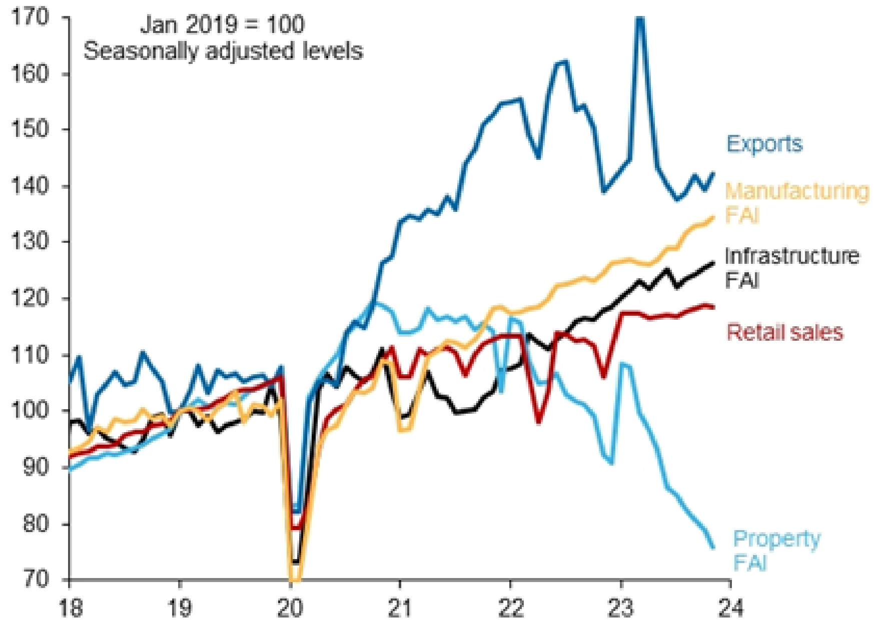
Source: Bloomberg

8.The Chinese economy goes nowhere fast

China's economic recovery in 2023 was disappointing after the economy reopened following strict COVID lockdowns. China's industrial sector performed strongly, boosted by resilient external demand for China's exports, but household spending was weak, and the property market remains in a severe downturn. Given the weak domestic demand, China's economy has faced deflation as companies lowered prices to boost exports and generate cash flow. China's equity market has also fallen over the past few years.

Despite a sluggish economy, Chinese authorities did not announce any large stimulus programs in 2023. A key question is how much policymakers will stimulate the economy this year and whether it will work. With a high level of public debt and interest rates already at low levels, the scope for policymakers to boost economic activity is more limited than in the past. China also faces some significant structural growth headwinds, including a rapidly ageing population and a difficult external environment due to strategic competition between the US and China.

Chart 8: China – economic indicators



"Despite a sluggish economy, Chinese authorities did not announce any large stimulus programs in 2023. A key question is how much policymakers will stimulate the economy this year and whether it will work."

Source: NBS, China Customs, WIND, Macquarie Macro Strategy

We think policymakers will announce a GDP growth target for 2024 of "around 5%" and will deliver just enough policy support to meet this target. We expect that the People's Bank of China will ease monetary policy, but that larger and more targeted stimulus will come from fiscal policy and measures to boost the property market, which would in turn support household spending. However, authorities will be reluctant to deliver large debt-fuelled stimulus to the property sector. Our base case is that stimulus measures will succeed in stemming the decline in property investment and house prices. Thus, while the property sector will gradually recover in 2024, it won't boost growth in a meaningful way.

A key risk is that stimulus measures fail to stabilise the property market and the sector continues to weigh on growth. Household spending is unlikely to pick up until the property market starts to recover and consumer confidence improves. Ongoing weakness in property construction could also dampen commodity prices, including for iron ore, which are particularly important for Australia's terms of trade and government revenue.

9. Cyclical headwinds outweigh structural tailwinds for commodities

The transition to net zero requires a major transformation of existing economic infrastructure including the introduction of renewable or zero-emission energy, new transmission lines to shift the power from where it is produced to where it will be consumed, retrofitting existing infrastructure to make it more efficient and the ‘electrification’ of economies including the shift away from internal combustion engine vehicles. Of course, this shift will require a massive amount of new investment and that, in turn, will generate increased demand for certain commodities, including copper, nickel and lithium (for batteries).

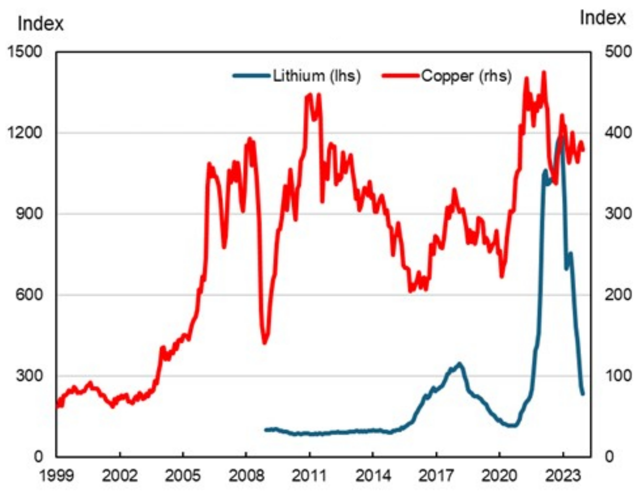
In 2023, however, the prices of many of these key commodities fell quite sharply (see Chart 9). In our view, this highlights that, while the transition to net zero is likely to be a major structural support to demand for these commodities, it doesn’t eradicate the boom-bust cycle that affects many commodities.

Take lithium, for example, which is used in the production of batteries for electric vehicles. As China ramped up its production of electric vehicles in 2021, lithium prices started to rise very sharply in 2022. Lithium producers responded to the price signal by increasing production to meet demand, but in 2023, sales of electric vehicles started to plateau in response to higher global interest rates and slowing activity. With this occurring just as lithium production was coming onstream, the result was a sharp fall in lithium prices.

But, of course, this sets the scene for the next boom-bust cycle. Responding to falling cash flows, lithium producers are now halting investment and closing some mines. This means that when electric vehicle sales begin increasing again, there is likely to be a shortage of available material and another spike in prices.

That said, the increased demand for commodities required to achieve the transition to net zero may lead to higher prices over time, even with considerable volatility from year to year. This can be seen in the price of copper over the last 25 years. Over that time, the price has clearly risen sharply, from an average of $100 per ounce over the 15 years to 2004, then up to $300 in the pre-pandemic period, and closer to $400 more recently. But even though the average price has trended higher, there have nevertheless been regular (and large) cycles around that average.

Chart 9: Commodity prices



Source: Bloomberg

> “*The increased demand for commodities required to achieve the transition to net zero may lead to higher prices over time, even with considerable volatility from year to year.*”

Looking ahead to 2024, however, the main influence on copper prices is likely to be China (and, in particular, its housing market). China consumes 55% of global copper production and much of this is used in housing, as pipes and wiring. While Chinese housing starts plunged in 2023, construction activity has held up as existing projects have been completed.

In 2024, however, that could change. A sharp fall in construction would likely see copper prices take another leg lower. This, however, would not be a reflection on the transition to net zero (or the potential impact of that on commodity prices over the medium term). Rather, it would reflect an even more disappointing year for Chinese growth.

Reflecting on 2023

Just as each year we peer towards the horizon to see what the next 12 months might deliver for investors, we also think it's worthwhile (if not always pleasant) to review last year's forecasts and discover what lessons we can learn. In recent years, the surprises came thick and fast, but 2023 was perhaps notable for how resilient economies proved to be, even as inflation receded quickly.

The trajectory of inflation was, in fact, one of the few things we did get correct about 2023. We argued that US inflation would fall to 2.5% over 2023 and it ended the year at 2.6%. In most other respects, however, the US economy was much stronger than we expected. We thought it would experience a recession and that the unemployment rate would rise towards 6%, whereas growth remained solid and the unemployment rate has remained below 4%. While corporate earnings did drift lower over 2023, optimism about the return of strong earnings growth in 2024 was the more important story for equities.

Despite the decline in inflation, we also expected that the Fed would remain cautious about loosening policy while wages growth remained strong. While the US central bank didn't cut interest rates, several members suggested that they were contemplating when that might be appropriate, which certainly supported lower bond yields at the end of 2023.

In contrast, we thought the RBA would respond to very weak growth, receding inflation and a softening labour market by shifting its stance on monetary policy. In fact, the opposite occurred as the RBA seemingly lost patience with sticky inflation when it raised interest rates again at its November policy meeting.

One factor that may have contributed to the RBA's hawkishness was the Fair Work Commission's decision to grant workers a very large increase in the minimum wage, adding 0.6ppts to overall wages growth. As a result, it rose 4% over the year to September 2023, which was stronger than our expectation of 3.5%. The resilience of the housing market was another positive surprise for the Australian economy. While we expected that house prices would remain weak in 2023, they defied the RBA's rate hike campaign and rose at a firm clip.

But while most economies were stronger than expected in 2023, the one major exception was China. Following the removal of COVID restrictions, we expected a strong growth rebound in 2023 with business investment expected to grow by 6%. Investment actually rose by just 3% over 2023 as the property market stayed exceptionally weak and Chinese consumers remained cautious.

Another factor that may be weighing on Chinese growth is the continuing deterioration of relations between China and the US. Our final thing to watch for 2023 was the imposition of more US sanctions on Chinese firms and that did eventuate. As a result, some firms appear to be switching investment away from China, or at least diversifying their supply chains, and this could become a long-term headwind for Chinese growth.

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