Allspring

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Macro Matters

Macro Matters provides a concise, comprehensive look at macroeconomic themes that matter to clients.

After paring back 2024 rate cut expectations, what's next?

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Key takeaways

01 **Growth: U.S. growth data remain too strong for rate cuts now.** Strong employment numbers and recovering services and manufacturing data suggest U.S. gross domestic product (GDP) is growing at a 2.8% year-over-year rate.

02 **Inflation: Rising services prices add upward pressure.** The latest inflation data confirm that inflation will likely be sticky this spring as services sector inflation offsets falling prices for core goods.

03 **Rates: The market has moved closer to the Federal Reserve's (Fed's) expectations.** The market has priced out two of the five rate cuts it anticipated in January and is now much closer to the Fed's forecast.

Growth: Very robust in January but losing some momentum in February

Employment numbers have remained strong since the beginning of 2024. Also, manufacturing and services survey data suggest the U.S. economy experienced a bounce in growth near the end of 2023 and in early 2024. Forward-looking growth indicators spiked up to a 4% growth rate in real (inflation-adjusted) GDP in January, but they've receded since then to a still-strong 2.8% rate as retail sales and weekly labor earnings weakened.

Outside the U.S., Europe and China have continued to struggle, although we saw some stabilization in their manufacturing and services data. Euro-area GDP was 0% in the fourth quarter of 2023, basically confirming no growth. China's authorities have stepped up efforts to support the ailing property and equity market beyond verbal intervention. Pre-announced reserve requirement cuts, banning short selling, and plans to fund an equity market support package are all part of planned monetary and fiscal support measures. With China's inflation at -0.8% year over year, however, more drastic measures—like interest rate cuts—might be needed.

Inflation: Sticky for now at around 3%

The latest U.S. inflation reading confirmed our overall outlook of divergent services prices versus core goods prices. While higher services prices put upward pressure on inflation, declining core goods prices exert downward pressure. Overall, inflation is likely to stabilize at around 3%, according to survey data by the Federal Reserve Bank of Cleveland and to Allspring's internal estimates. Despite further conflicts in the Middle East and higher shipping costs, commodity prices overall are trending downward. We believe moderating labor earnings and commodity prices should help bring inflation down slowly over the summer.

Internationally, Europe has made progress on inflation, with the headline (total) inflation down to 2.8% year over year. In our view, this should allow the European Central Bank (ECB) to cut rates early this summer to support flattish growth despite a robust labor market. China continues to struggle with deflation, which doesn't bode well for its economy. While more fiscal and monetary stimulus will be needed, China's central bank is wary of how stimulus could affect banks' profitability and China's currency, the renminbi: Weaker currency and bank margins might have a negative impact on capital flows and bank lending.

Rates: Central banks likely to cut—but when and how much?

Since our January update, we've seen a bit of a correction in interest rate cuts expectations (see chart below). In mid-January, the U.S. interest rate market priced cumulative cuts of 1.5%. This expectation has declined to 90 basis points (bps; 100 bps equal 1.00%) in February because employment and growth data remain stronger than anticipated.

International developed markets have made similar corrections for 2024 rate cuts. While growth is weaker than in the U.S. and inflation has fallen sharply, the labor market is too strong for the ECB's and Bank of England's comfort.

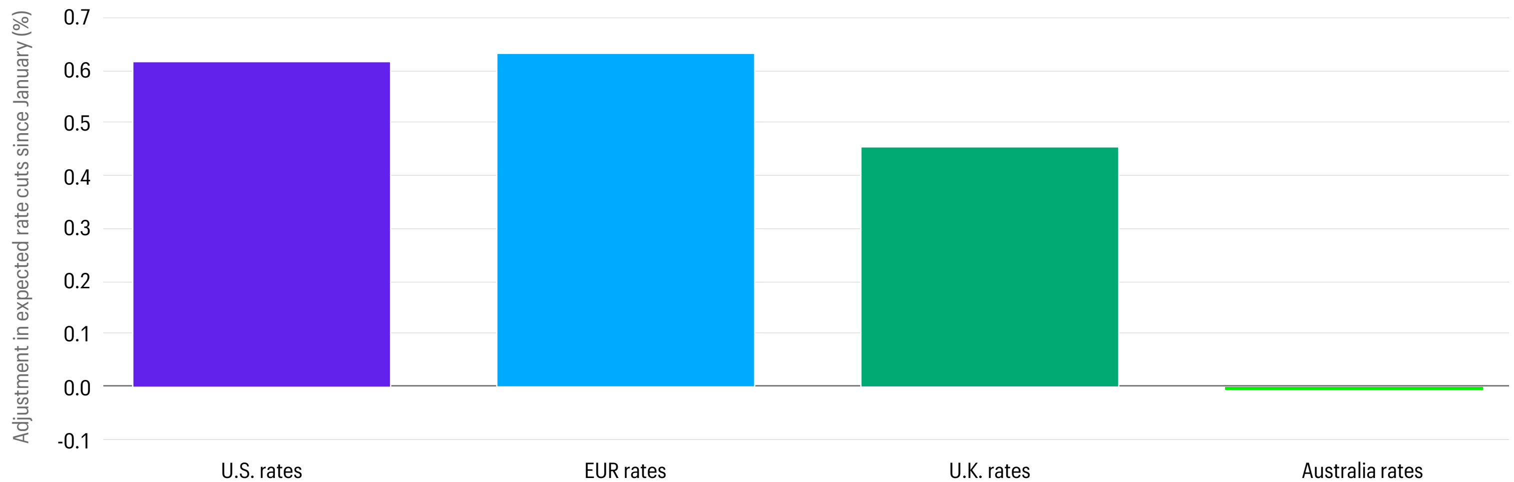
IMPLICATIONS FOR FIXED INCOME

Thus far in 2024, government bond yields have risen globally. Although expected rate cuts have been pared back, we believe the overall environment remains favorable for fixed income. Central banks will likely cut short-term rates later this year. While the yield curve has flattened lately, it remains in a steepening trend with shorter-term bonds outperforming longer-term bonds. As long as the economy avoids a recession—which seems likely for now—corporate and high yield bonds should continue benefiting from the additional yield pickup. We continue to see attractive real yields in emerging market bonds in 2024.

IMPLICATIONS FOR EQUITIES

Thus far in 2024, U.S. equities have outperformed international equities. Most international market equities have been flat/slightly down, except for Japan (positive results) and China (negative results). Thus far, the equity markets have defied the more realistic interest rate pricing and cheered the more optimistic growth numbers. We haven't seen the U.S. equity market's strength broaden much beyond mega caps, and given the toned-down rate outlook, we believe focusing on quality and valuation is a prudent approach. Internationally, we see attractive valuation gaps among equities.

EXPECTED CUTS IN SHORT-TERM RATES HAVE ADJUSTED SINCE JANUARY 2024



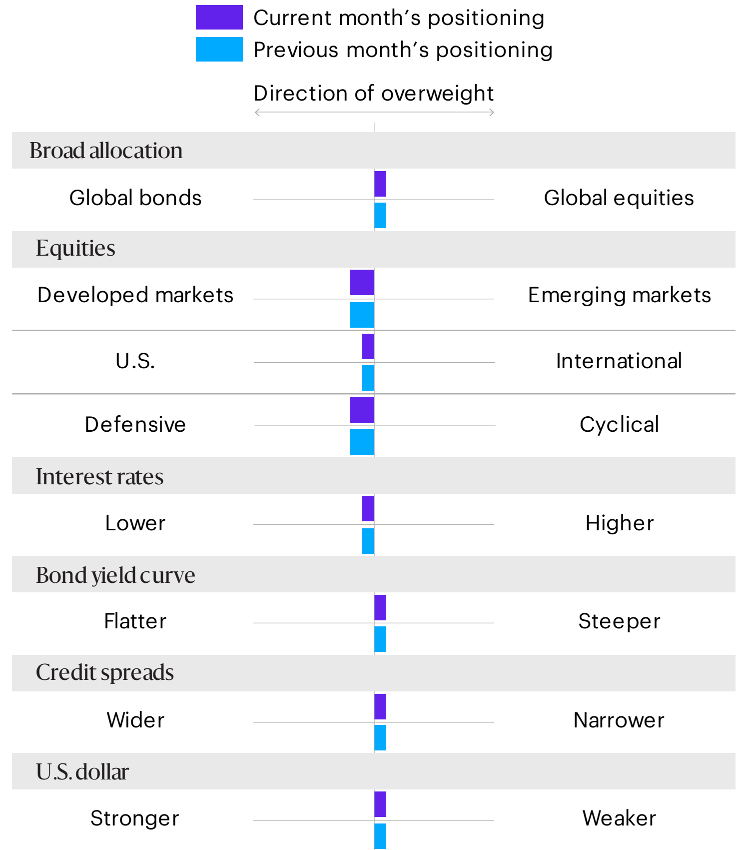
Sources: Allspring and Bloomberg Finance L.P. (calculated from the overnight indexed swap curves as of February 22, 2024)

IMPLICATIONS FOR MULTI-ASSET

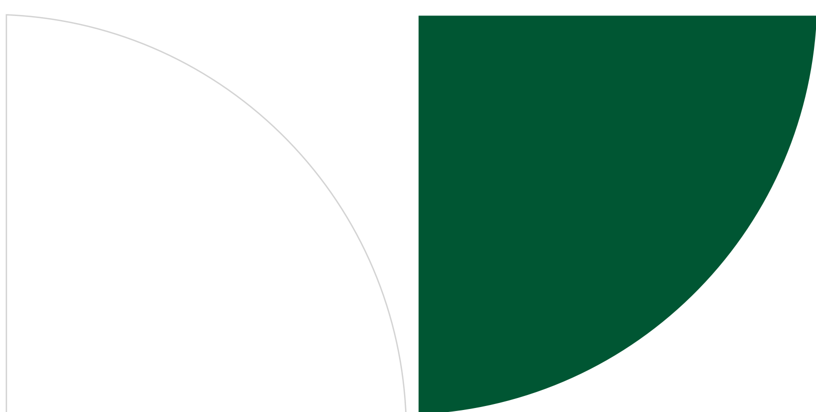
Within traditional U.S. multi asset portfolios, equities and bonds have continued to add diversification. While bonds have slightly underperformed thus far in 2024, equities have fully offset the losses. We still expect economic growth to slow and may see faster interest rate cuts, which would benefit both bonds and equities through looser financial conditions and a steepening yield curve. In fixed income, we continue to like duration and corporate spreads in high yield (though we've trimmed our overweight) and emerging market bonds. In equities, we think cheaper sectors and U.S. small caps could start benefiting as rate cuts get closer. On a cross-asset basis, we still prefer growth exposure via equities rather than commodities.

POTENTIAL ALLOCATIONS BASED ON TODAY'S ENVIRONMENT

The table on the right depicts our views on short-term trends. These perspectives are developed using quantitative analysis of data over the past 30 years overlaid with qualitative analysis by Allspring investment professionals. The positioning of each bar in the table shows the direction and magnitude of an overweight



For illustrative purposes only.
Source: Allspring Systematic Edge - Multi-Asset, based on the team's analysis of current data and trends for each category of assets



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