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Global Growth Gets Going

Key Takeaways

- There is no reason for a post-pandemic economic recovery to follow an obvious path. Yet, there is a natural and understandable tendency to apply old norms to new circumstances. The Conference Board Leading Economic Index (LEI) is just one example. Based on their February data, their gauge of future economic activity had fallen for 23 consecutive months.
- The US stock market is signaling something quite different. From January 1, 2023 to the present, the S&P 500 and Nasdaq are up 33.8% and 55.5%, respectively. In 2024 year-to-date, they are up 7.7% and 8.4%, respectively. How is this possible? The short answer is earnings growth. We have raised S&P 500 EPS estimates, expecting a gain near 8% in 2024 (vs 5% previously) and +6% in 2025.
- We have revised our real GDP estimate for the US in 2024 from +1.6% to +2.0%. For 2025, we reduced from +2.6% to +2.4%. Our global GDP estimate was also raised from 2.2% to 2.3% this year and cut from 2.8% to 2.7% in 2025. This indicates that growth has been pulled forward so much that our “Slow then Grow” thesis looks more like “Grow then Grow” now.
- The January CPI seemed custom-made to interrupt bullish equity markets, but it did not. If there is a second hot inflation print, however, stocks could react poorly. And equity markets usually hate higher rates but have continued rising despite US Treasury yields being 40 basis points higher year-to-date.
- Bullish markets are not known for patience. If markets behave as they typically do, there may be a pullback after a 22% gain for US equities in a little more than three months. However, a setback is unlikely to derail broadening economic growth.

Potential Portfolio Implications

- Improving US and global growth has portfolio implications from interest rates to equity selection across regions. Investors have already begun to price in the cyclical recovery we see unfolding, but as with so much of this post-pandemic period, this is not a typical cyclical rebound. **This asynchronous recovery has allowed us to identify health care technology and mid-cap growth shares as undiscounted opportunities.**
- **Medium duration investment grade yields across various asset classes offer prospective real yields of 2%-4%, well above the average of the last 25 years.**
- **High US mortgage rates are creating compelling yields for Investment Grade structured debt securities, near 6%.**

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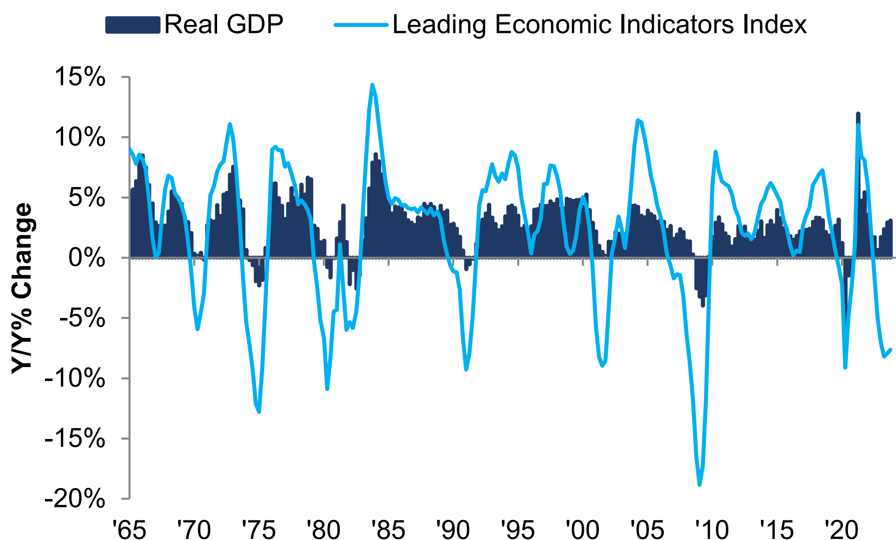
Fears Versus Facts: Our Forecast Update

There is no reason for a post-pandemic economic recovery to follow an obvious path. Yet, there is a natural and understandable tendency to apply old norms to new circumstances. The Conference Board Leading Economic Index (LEI) is just one example. Based on their February data, their gauge of future economic activity had fallen for 23 consecutive months. Nonetheless, this independent, nonpartisan think tank abandoned its long-running call for the US to fall into a recession with its February data release. The Conference Board cited above-trend job creation, resilient consumer spending and better than projected economic output as reasons why the US did not succumb to higher interest rates and higher inflation. Yet, they are still projecting zero growth for Q2 and Q3 (**FIGURE 1**).

The US stock market is signaling something quite different. From January 1, 2023 to the present, the S&P 500 and Nasdaq are up 33.8% and 55.5%. In 2024 year-to-date, they are up 7.7% and 8.4% respectively. How is this possible? The short answer is earnings growth. We've raised S&P 500 EPS estimates, expecting a gain near 8% in 2024 (vs 5% previously) and +6% in 2025. Such would be new record highs for US profits. In particular, we believe corporate profit estimates for 1Q 2024 may be too low. With inflation moderating almost everywhere and employment remaining stronger than expected, real income gains are sustaining consumer spending and real returns on bonds and cash are contributing to better personal income. After what investors endured in 2022, this recovery could hardly be better for portfolios.

FIGURE 1 Index of Leading Economic Indicators vs Real GDP Y/Y%



Source: Haver Analytics as of February 29, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

US and Global Growth Forecasts Going Up

We've revised our real GDP estimate for the US in 2024 from +1.6% to +2.0%. For 2025, the estimate was reduced from +2.6% to +2.4%. Our global GDP estimate was also raised from 2.2% to 2.3% this year and cut from 2.8% to 2.7% in 2025. This indicates that growth has been pulled forward so much that our "Slow then Grow" thesis looks more like "Grow then Grow" now, with little softness in US economy from higher rates, at least for now (see **FIGURE 2** and our latest *Quadrant*).

In our *Wealth Outlook 2024*, we identified "hidden recessions" in the US in real estate, manufacturing and health care, as well as in cyclical parts of the world economy. We thought the economy would bottom early in 2024 and rebound over the coming 18 months. Recent data suggest earlier improvements than we anticipated. This has portfolio implications from interest rates to equity selection across regions. Investors have already begun to price in the cyclical recovery we see unfolding, but as with so much of this post-pandemic period, this is not a typical cyclical rebound. While sectors tied to manufacturing and housing have surged, some normally high-beta segments, such as banks,

remain in the doldrums. This asynchronous recovery has allowed us to identify health care technology and mid-cap growth shares as undiscounted opportunities.

FIGURE 2: Citi Global Wealth real GDP and S&P 500 EPS estimates

	CGWI Real GDP Forecasts (%)					
	2020	2021	2022	2023E	2024E	2025E
US	-2.8	5.8	1.9	2.5	2.0 ↑	2.4 ↓
China	2.2	8.5	3.0	5.2	4.0	4.0
EU	-6.3	5.6	3.4	0.5	0.4 ↓	1.4 ↑
UK	-11.0	7.6	4.3	0.1	0.3 ↓	1.4 ↓
Global	-3.2	5.9	3.3	2.6	2.3 ↑	2.7 ↓
	CGWI EPS Forecasts (%)					
	2020	**2021**	**2022**	**2023E**	**2024E**	**2025E**
S&P 500	-13.5	46.9	6.0	0.6 ↑	7.6 ↑	6.3 ↓

Source: Citi Global Wealth Investments as of February 22, 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Market Upside Ahead, But It Won't Be a Straight Line Up

Whether forecasters and newscasters like it or not, markets are forward-looking predictors of the economy. An industrial recovery is evident in many share prices. It is not waiting to be discovered. Yet, there are many non-believers. Doubters have begun to short the US markets again (**FIGURE 3**) and they are joined by many bond bears who have placed large bets that future interest rates will go higher still.

Then, there are those that think they "missed it." Call options pricing shows that traders are paying unusual premiums to get upside exposure to share price gains (**FIGURE 4**). This is while the cost of insurance against share price drops (puts) is near an historic low. We suspect that the "runaway gains" in US large cap tech shares are pushing up equity call premia, particularly because of the historically high level of equity short positions.

FIGURE 3: S&P 500 net short futures positions as % of short interest and S&P 500

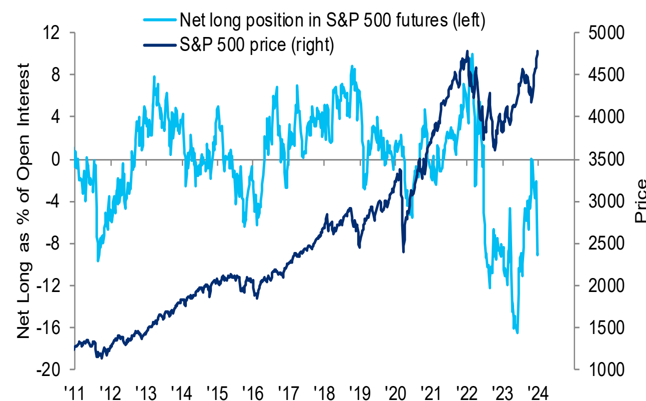
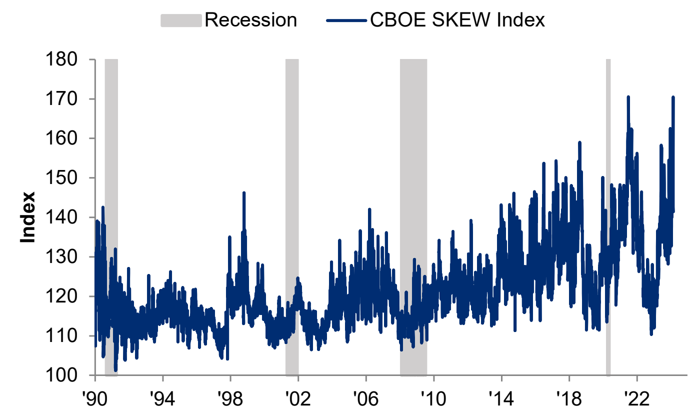


FIGURE 4: CBOE Skew Index: cost of calls relative to put options for the S&P 500



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If markets behave as they typically do, there may be some reason for a pullback after a 22% gain for US equities in a little more than three months. However, a setback is unlikely to derail economic progress. It should also not come as a surprise.

Bullish markets aren't known for patience. The January CPI seemed custom-made to interrupt a bullish narrative, but it did not. If there is a second hot inflation print, however, markets could become skittish. And equity markets usually hate higher rates but have continued rising in spite of US Treasury yields being 40 basis points in the year-to-date. "Fear of missing out" in the equity market might, for a time, give way to simply fear.

Portfolio Pragmatism: Where We See Undiscounted Value

This has been a close historical relationship between manufacturing sentiment and outperformance of Industrials versus defensive sectors like Consumer Staples. Performance over the past 12 months suggests that Industrials are already priced for a fuller cyclical recovery. Homebuilders, another highly cyclical group of stocks, have surged since mid-2022 despite a doubling in mortgage rates. Structural demand for housing, coupled with a shortage of supply and easing of cost pressures, have led to a de-coupling of the typical relationship between home builders and interest rates. Home builders have done much better than one would have expected.

Where does this leave us? Some cyclicals are already priced (or overpriced) for a stronger-than-expected macro environment. Others face ongoing property-related risks in the US and China. With growth headed higher, we can't count on a big bond rally bailing out the market's most rate-sensitive sectors. One place we see real value is health care.

Health Care is Getting Healthier

We see Health Care as major beneficiary of low expectations and improving conditions. Within this diverse sector there is defensive value in large cap pharma and highly speculative growth in small cap biotech. Straddling these two extremes are medical devices and life sciences tools companies, who focus on the equipment and tools needed to operate a hospital or undergo a drug trial. This group tends to be somewhat more cyclical than pharmaceuticals but, we believe, is well-placed to benefit from continued normalization in the health care sector post-COVID.

Last year, the health care sector underperformed the broader market by 24% (+2% vs +26% for the S&P 500), impacted by a perfect storm of US drug pricing reform, ongoing COVID overhang, and disruption from the excitement related to GLP-1 weight loss drugs. We now view health care innovation to be attractively valued. Various health care groups seemed poised to recover. Health care equipment and supplies, an industry with high current profits, fell sharply in 2023 with shares 15% below their late 2021 peak (**FIGURE 5**). Versus software, its gains lagged the most since the late 1990s (**FIGURE 6**).

Stock picking within pharma might have helped some investors. The two firms delivering GLP-1 weight loss drugs dramatically outperformed. This is why we believe "broadening" is particularly likely to occur in the health care sector. We believe that cash flow generation is a strong indicator of future investor returns. Health care equipment makers have grown dividends at a 9.2% compounded growth rate over the past three decades. While dividend growth for the industry slowed last year, we expect a return to trend as profits revive (see Healthcare: Slimmed Down But Healthier).

FIGURE 5: Health care equipment and supplies 12mo performance vs S&P 500

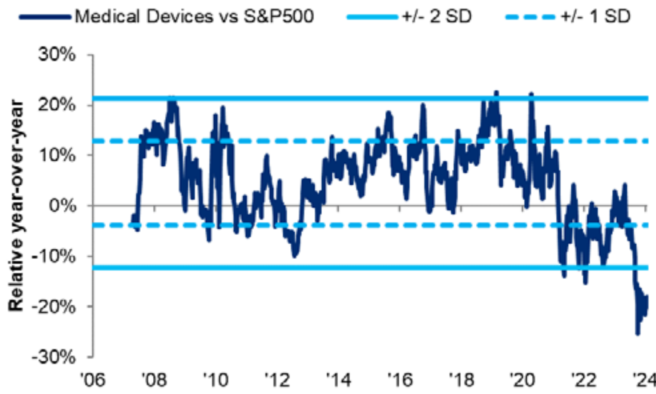
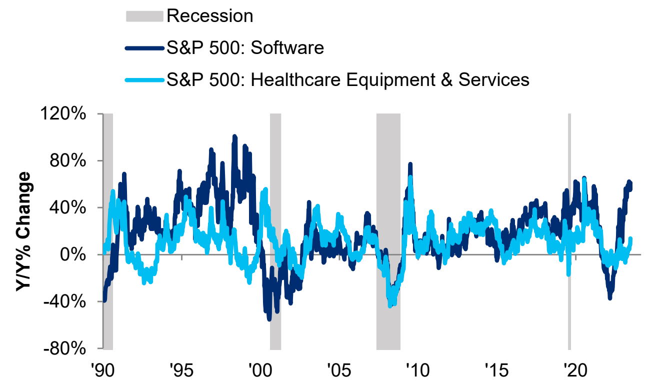


FIGURE 6: S&P 500: Software vs Medical Equipment



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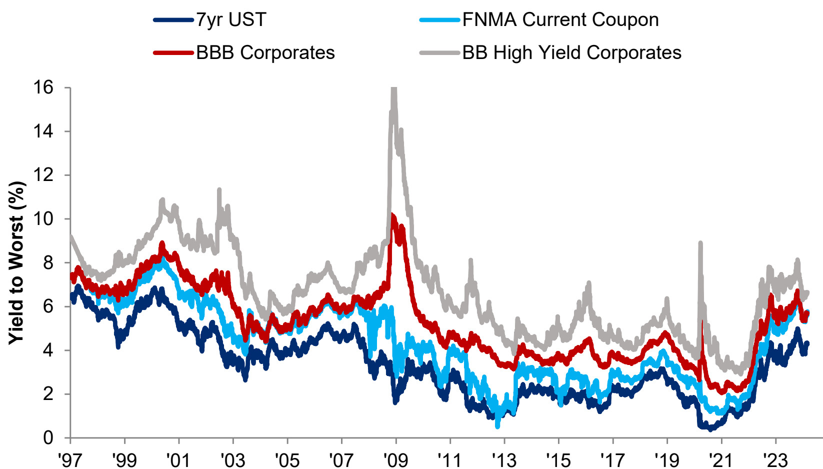
Yields are Back with More Staying Power

At our Global Investment Committee meeting last week, we debated the right actions implied by the new economic forecast, the looming election year noise, and the likely market reaction to short-term datapoints we discussed above. We believed the case could be made for hedging risk in the near-term while adding more equities for the longer-term. One reason we maintained our current equity overweight is the still compelling yield opportunity in the US bond market. We can't say the same for other developed markets fixed income, where we remain underweight.

As **FIGURE 7** shows, medium duration investment grade yields across various asset classes offer prospective real yields of 2%-4%, well above the average of the last 25 years. As we discussed in our Outlook, high US mortgage rates are creating compelling yields for Investment Grade structured debt securities, near 6%. While the Fed may not reduce US policy rates before mid-year, its forecast for the Fed funds rate average over the longer-term is just 2%. To take advantage of this opportunity, we have raised our allocation to medium duration structured securities and cut our overweight in short-term US Treasuries. Considering a firm economic forecast, yields are back and are likely to have more staying power.

FIGURE 7: US yields of average duration across fixed income assets



Source: Haver Analytics through February 28, 2024. BBB Corporates proxy is ICE BofA BBB Corporate Bonds. BB High Yield Corporates proxy is ICE BofA BB High Yield Corporates. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)			
Low grade (speculative)	Ba	BB	BB
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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