Recession fears recede.

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SEI recently released its third-quarter Economic Outlook. Here is summary of our key perspectives.

- Despite economists' predictions, the U.S. economy has exhibited strength in 2023. Over the past few months, it has surprised mostly to the upside. Strong July results for retail sales, services consumption, industrial production, and housing starts resulted in the inflation-adjusted gross domestic product reaching an annualized 5.9% rate of gain in August. We do not believe this trend is sustainable. Although the consensus has swung away from this view, there is a reasonable probability of a recession in 2024.
- Outside the U.S., other major economies are showing signs of weakness, despite advances during the first half of this year. Germany is already in recession and the U.K. may not be far behind. In these developed economies, businesses and consumers alike are feeling pressure from rising interest rates and persistent core inflation.
- Hopes that China, the world's second-largest economy after the U.S., would offset slowing growth elsewhere have proven to be elusive. Although Chinese domestic travel and services consumption experienced a post-COVID-19 bounce, the economic data have been mostly disappointing. Consumer sentiment remains extremely depressed, with the latest quarterly reading showing a partial reversal of the early 2023 post-lockdown bounce. Chinese consumers and financial market participants appear largely unimpressed with the government's efforts, both fiscal and monetary, to turn the economy around.
- Inflation continues to fall as COVID-19-era supply-chain disruptions abate. However, it is SEI's strong conviction that there has been a regime change when it comes to long-run inflation, and that it will run sustainably higher in the U.S. than the Federal Reserve's (Fed) 2% target. Structurally tight labor markets, the shifting of global supply chains away from China, higher financing costs, the disruptions caused by the transition to a carbon-neutral regime, and a likely boost in corporate tax rates in the years ahead suggest to us that an inflation rate over 3% is more likely than one under 2%.
- The Fed's rate-hiking cycle is nearing an end, but this does not mean that the federal-funds rate will be moving lower anytime soon. We believe there could be one more interest-rate increase from the Fed, but as labor-market pressures ease, even this appears increasingly unlikely. The latest Federal Open Market Committee projections indicate an intention to keep the federal-funds rate higher for longer. In our view, it is unlikely the central bank will begin cutting rates before the second half of 2024.
- Other major central banks are in similar positions. Given Europe's stubborn inflation and lower policy-rate stance, the European Central Bank may raise its key interest rate once or twice more this cycle. The U.K. is closest to a wage-price spiral, which may force the Bank of England to implement a monetary policy that is tighter than it would prefer. Meanwhile, the Bank of Japan is under increasing pressure to start raising its policy interest rate in order to firm up the yen.
- Bond yields have risen despite lower inflation rates. We believe markets are responding to the increase in government debt issuance at a time when central banks are adding to supply pressures via quantitative tightening (i.e., selling bonds out of their portfolios). Bond prices fall when yields rise.
- SEI expects bond yields to remain elevated as investors adjust their expectations regarding the probability of higher-for-longer central bank interest-rate policy. We also believe that the term premium (the excess yield required to offset the additional risk in longer-dated bonds) will turn positive as investors demand compensation for taking on a greater level of uncertainty around future interest-rate risk.
- Equity markets have entered a corrective phase. U.S. large-capitalization stocks are expected to trade in a broad range, with the S&P 500 Index currently closer to the upper end of this range. Growth companies with high price-to-earnings ratios are vulnerable to rising bond yields, and more cyclical and economically sensitive names within this cohort could face pressure from declining profit margins.

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

Glossary

The **federal-funds** rate is the interest rate charged to lending institutions on unsecured overnight loans. It is set by the U.S. Federal Reserve's Federal Open Market Committee. The rate is increased when the Federal Reserve wants to discourage borrowing and slow the economy and decreased when the Federal Reserve wants to spur economic growth.

The **Federal Open Market Committee (FOMC)** is a committee within the Federal Reserve System that is charged under United States law with overseeing the nation's open market operations. This Federal Reserve committee makes key decisions about interest rates and the growth of the United States money supply.

Gross domestic product (GDP) is the total monetary or market value of all the goods and services produced in a country during a certain period.

Real (or inflation-adjusted) gross domestic product (GDP) is the total monetary or market value of all the goods and services produced in a country during a certain period, adjusted for price changes.

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.

Index definitions

The S&P 500 Index is a market-weighted index that tracks the performance of the 500 largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market.

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