FEBRUARY 2024

Our answers to four recent client questions

Summary

What are the risks related to the various elections to be held in 2024?

- This year is a packed year for elections throughout the globe. The most significant one for the financial markets is the American election.
- In the US, there is a relatively high probability that control of the two Houses of Congress will be split between the Democrats and the Republicans. This will limit the new President's room for manoeuvre.

What factors could challenge your scenario of lower inflation and lower interest rates?

- The main upside risk to inflation is wage growth. Leading indicators for labour demand suggest a significant decline that should limit future wage increases.
- The US presidential election is an additional risk for 2025.

What are the risks of another sovereign debt crisis in the eurozone?

- Eurozone debt looks sustainable, with the average real interest rate on eurozone debt lower than the eurozone's real potential growth.
- Solidarity between eurozone member states has increased.
- The ESM and ECB have powerful tools to deal with a potential crisis.

Do you see more risks or more opportunities with regards to China?

- Many investors and asset managers remain severely under-allocated to China. Short covering and hence a decent bear rally can be expected.
- The property sector needs to show signs of stabilisation before the economy can be on a true path to recovery.
- There is hope that the monetary authorities can (and will) do more.
- In the near to medium term, more pro-growth policies can be expected. All eyes will be on the upcoming National People's Congress on 5 March, which may provide further indications of the economy's direction.

What are the risks related to the various elections to be held in 2024?

This year is a packed year for elections throughout the globe, from India to Europe to the US (see table below for more details).

The election most likely to have a profound and lasting impact on the global economy and financial markets is the November US Presidential election between the incumbent Democrat President Joe Biden and the (very likely) Republican candidate, and former President, Donald Trump.

Should President Biden be re-elected for a second term, then we would expect continuity of existing policies, although perhaps with lower budget deficits than at present, as government spending would likely be lower during his second term.

In the scenario of the Mr Trump being re-elected in November, then we would expect foreign policy to be far less interventionist than Biden's, with "America First" the prevailing mantra again. In addition, we would expect mounting trade tensions with China and Europe as seen over the 2016-20 Trump Presidency, along with a potential reduction of US financial and military support for the conflicts in Ukraine and the Middle East.

Will US Congress be united or divided?

Irrespective of which presidential candidate is elected, there will also be legislative elections for one-third of US Senate seats (33 out of 100) and for all the House of Representatives (435 seats).

Given the current very fine balance of power between the Democratics and Republicans in both houses of Congress, there is a relatively high probability that control of these two houses of Congress will be split between the two parties in November.

In such scenario, it would be difficult for any President to pass laws relating to domestic policy without bipartisan support, thus limiting the President's room for manoeuvre.

Edmund Shing, PhD

2024 Elections Overview

Date	Country	Political event	Overview	Implications
10 April	S. Korea	Legislative Election	Since the second week of November, available opinion polls have suggested a close race between the People Power Party (PPP) and the Democratic Party of Korea (DPK). Currently, the latter holds 168 of the 300 seats in the parliament and the PPP 111.	The conservative fiscal stance of President Yoon Suk Yeol's government could face hurdles if his party (PPP) fails to win a majority. Restructuring related to project financing is likely to occur after the election, regardless of its outcome, in our view.
April-May	India	General Election	Polls suggest that the ruling Bharatiya Janata Party (BJP) will stay in power, although the unification of the opposition could trim the majority (currently 61.5%) of the national Democratic Alliance.	For investors, the 2024 election in India bring not only the risk of a slight shift to the left in the economic stance, but also the risk of a more fractured mandate that would complicate delivery of current policy and further reform. We expect the government to announce further measures to boost the manufacturing sector.
2 June	Mexico	Presidential and legislative Elections	Early campaigning has begun, and the presidential candidate on the incumbent left/centre-left alliance, Claudia Sheinbaum, continues to lead the opinion polls. Opposition candidate, Xochitl Galvez, viewed as the face of centrist populism, follows closely on her heels but might not succeed in closing the gap.	The market focus could shift to Congress and the Senate: if Morena and her allies were to obtain an absolute majority (three-fifths) in both houses, it would give the AMLO and Sheinbaum parties (if Morena were to win) the latitude to approve constitutional reforms, including pending energy, electoral, and political reforms.
4 June	US	Last day to hold presidential primary elections or caucuses		
9 June	EU	Parliamentary Elections	Strong showing for right-wing populist parties could complicate EU decision-making.	
5 November	US	General Election	Contests for Presidency, 33 Senate seats, House of Representatives, governorships, state legislatures, etc.	A Democrat win would imply consistency of the current policy, and thus few surprises. A Republican sweep could give rise to radical shifts in foreign and domestic policy, leading to further tax cuts and heavy tariffs on foreign imports.

What are the risks of another sovereign debt crisis in the eurozone?

The key for debt sustainability is to avoid a so-called "snowball effect" (ever growing debt relative to GDP). The important condition is that the interest rate (i) paid on the debt is lower than the growth rate (g) of the economy[1]. With an average nominal interest rate of 2.01% on eurozone debt and target inflation at 2%, the real interest rate is about 0%, so far less than the eurozone real potential growth estimated at around 0.8% (see chart below).

Another key reason that limits the risks of a sovereign debt crisis is the increased solidarity among member states. In 2020 and 2021 we saw the issue of EU bonds in the context of two policy initiatives: the "temporary Support to mitigate Unemployment Risks in an Emergency" (SURE) and the "Next Generation EU" (NGEU) programme. This gives a clear signal of solidarity for the future and reduces the risk of speculation on weaker EU issuers.

Finally, the eurozone has other tools to deal with a potential crisis. The European Stability Mechanism can act as a lender of last resort for state members. The ECB can take monetary measures such as i) a bond buying programmes to inject liquidity into the economy and lower interest rates in all member states, ii) TLTROs (Targeted Longer-Term Refinancing Operations) to provide banks with cheap loans on condition they lend to businesses and households, and iii) OMT (Outright Monetary Transactions) which are purchases of government bonds from a eurozone member state under stress.

Guy Ertz, PhD

What factors could challenge your scenario of lower inflation and lower interest rates?

The main upside risk to inflation is wage growth. Leading indicators for labour demand suggest a significant decline that should limit future wage increases.

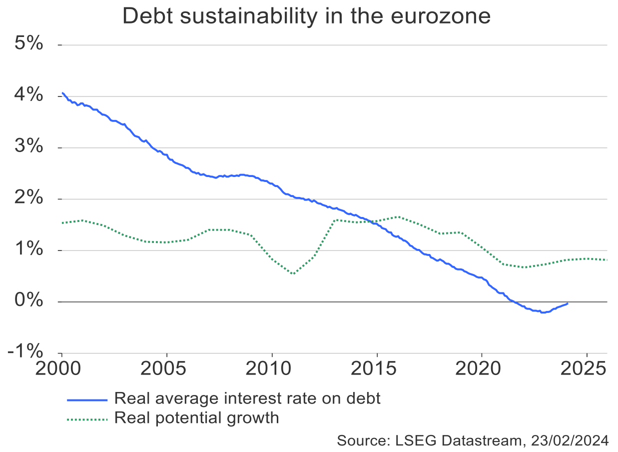
Indeed, the total number of job vacancies are falling sharply and the NFIB business survey of small- and medium- sized enterprises shows that fewer companies are concerned about finding workers. We see a similar trend in the equivalent survey in the eurozone (see chart).

The unemployment rate remains low, but probably because companies want to avoid redundancies, aware that they would find it very difficult to find skilled workers in the event of an economic recovery ("labour hoarding"). Given this diagnosis and relatively stable inflation expectations, we therefore believe that the risk of a wage price spiral is low.

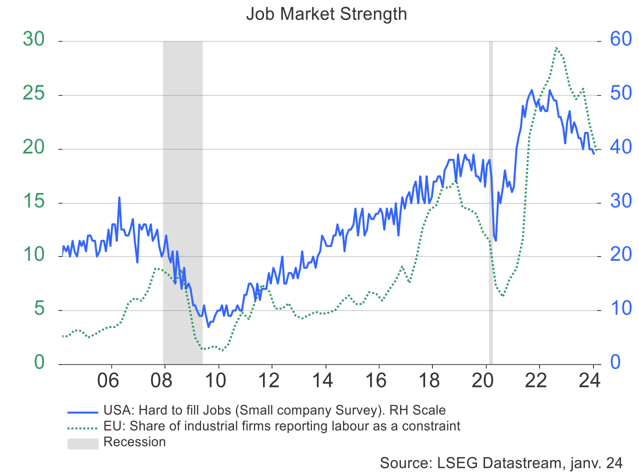
The US presidential election is an additional risk for 2025. Indeed, depending on the outcome, we could see a significant increase in import tariffs which could lead to higher inflation. In addition, we could see tax cuts, and in a context of nearly full employment, this would also have an inflationary effect. The amplitude of the effects is also highly dependent on the majorities in the House and the Senate.

Edouard Desbonnets

THE RISKS OF ANOTHER SOVEREIGN DEBT CRISIS IN THE EUROZONE IS LIMITED



JOB MARKET LOSING MOMENTUM (%)



[1] For more details see O. Bouabdallah, C. Checherita-Westphal, N. de Vette and S. Gardó (2021), "Sensitivity of sovereign debt in the euro area to an interest rate-growth differential shock", ECB Financial Stability Review, November 2021.

Do you see more risks or more opportunities with regards to China?

The current slowdown has been likened to the 2015-2016 China bear market after suffering from an equity meltdown along with debt/property crisis. Monetary response (interest rates and Reserve Ratio Requirements cuts) during the crisis was swift and significant. The strong credit impulse eventually aided China to turn the tide. This time round however, the PBoC seems to be on a weaker footing in view of the weaker Yuan.

Looking at the equity market, valuations reflect the weak sentiment. The 12-month forward P/E of HSCEI or China stocks trading in Hong Kong still currently trade at below 7x earnings, or close to 2 standard deviations relative to long-term averages, at similar levels when the market bottomed in 2016 after China's equity market bubble burst and October 2022 just before the U-turn on COVID policy.

The put-call ratio has also trended downwards over the last two years, suggesting a bottoming process is in the making. Many investors and asset managers remain severely under-allocated to China. Short covering, and hence a decent sized bear rally, can be expected given the extreme pessimism and positioning.

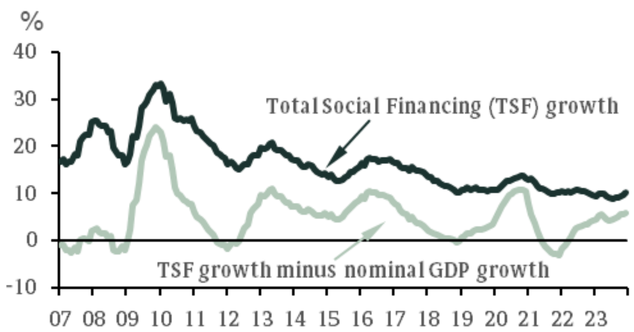
Given the structural nature of the current downturn, the property sector needs to show signs of stabilisation before the economy can be well on its way to recovery. There is also the additional risk of greater US-China trade tensions in future, with Donald Trump likely to be nominated as the Republican candidate for November's US Presidential election.

On the bright side, our forecast of a weaker greenback given the US rate cuts should play well for the Yuan. The PBoC has also intervened to ensure the Yuan's stability by orchestrating the purchase of the currency by state banks and giving market guidance to bankers. So, there is hope that the monetary authorities can (and will) do more.

In the near to medium term, more pro-growth policies can be expected as the government is likely to show serious intent with regard to preventing the economy from sliding further. Lately, we finally saw a more forceful and coordinated response. Therefore, all eyes will be on the upcoming National People's Congress on 5 March, which may provide further indications of the economy's direction.

Grace Tam

CREDIT IMPULSE VS THE 2015-16 CRISIS



Source: PBoC, JP Morgan, 7 Feb 2024.
Past performance is not indicative of current or future performance

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