NUS INVESTMENT SOCIETY

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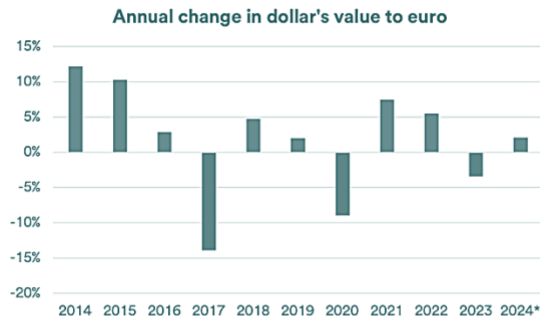
Basic Information (US)

Real GDP (USD)	26.6 trillion (2023)
M1 (USD)	18,085.5 billion
M2 (USD)	20,827.2 billion
CPI	310.3
PPI	143.4
Con. Confidence	106.7
Stock Index	S&P500
Currency	USD

Source: TradingEconomics

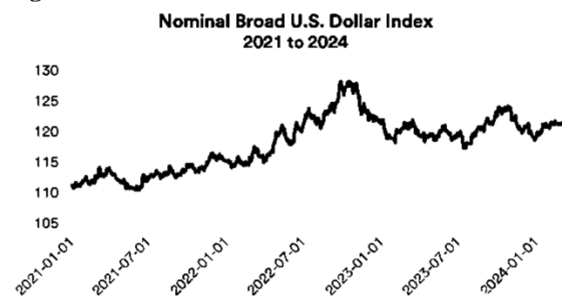
Chart info

Figure 1: Annual change in dollar's value to the euro



Source: usbank.com

Figure 2: Nominal Broad U.S. Dollar Index



Source: usbank.com

Figure 3: S&P 500 Index Price, 2024

Overview of the U.S. Economy

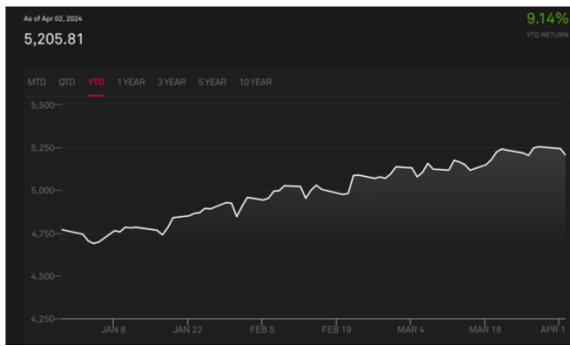
- GDP by industry: 20.7% Financial Services, 13% Services, 11.4% Government, 10.3% Manufacturing, 8.6% Education and Health Care, 6.4% Retail Trade, 5.9% Wholesale Trade, 5.4% Information, 4.4% Construction, 4.4% Arts, Entertainment and Food Services, 3.5% Transportation and Warehousing, 2.2% Other Services and 1.6% Utilities
- GDP by component: 67.7% Personal Consumption Expenditure (PCE), 17.4% Business Investments, 17.4% Government Spending, 10.9% Exports, 13.7% Imports
- PCE/Consumer demand is the main driver in the U.S. economy
- USD is the currency most used in international transactions and is the world's foremost reserve currency
- The Federal Reserve System is the central banking system of the U.S., and sets the monetary policy to promote maximum employment and stable prices
- World's largest economy by nominal GDP of USD 26.6 trillion in 2023, largest importers with USD 3.37 trillion in 2022, Second largest exporters with USD 2.06 trillion in 2022
- Main trading partners (as of Jan-24): Mexico (16.5% exports, 15.0% imports), Canada (16.4% exports, 13.1% imports), China (7.5% exports, 14.1% imports)

Highlights

- Despite high hopes of a soft-landing heading into 2024, Powell's three promised 2024 rate cuts seem nowhere in sight. With consumer prices slowing increasing, and the stock market hot as ever, investors continue to play Wall Street's favourite guessing game – when exactly will the Fed cut rates, and by how much? However, a new narrative has formed, with some believing that the Fed may hold rates throughout the year. Strong wages and stubbornly high core service inflation will keep the Fed on their toes, as cutting rates too early would surely lead a resurgence of inflation.

- The US Dollar has exhibited modest strength so far this year against the Euro (Figure 1). With March's disappointing inflation data pushing back rate hikes yet again, the Dollar continued to gain on other currencies, with USD/JPY bordering on the 152 level. As rate cuts delay, and rates remain high in the states, the influx of foreign currencies will improve demand for the USD, driving up its value. The dollar's relationship with the euro has generally been consistent with other currencies, as measured by the Nominal Broad U.S. Dollar Index. After slumping below 120.00 in Dec-23, the dollar regained its strength in Q1 2024 (Figure 2).

- US stocks continue to rally, with the S&P 500's relative strength index (RSI), climbing over 76 and the index gaining 9.14% this year (Figure 3). The index, that gauges whether stocks are overbought or oversold, has rarely reached this level since 2000. Fearing a bubble, investors will need to thread with caution, as the previous times the index exceeded



Source: S&P Global

Figure 4: Spot Gold Price

Source: LSEG

this level, significant sell-offs ensued: a 10% drop in Jan-18 and a 30% fall in Jan-20. Although the prospect of future interest rate cuts would surely fuel the rally, the market has been able to rally for the past 18 months despite higher rates. Investors seem to have adjusted to the new norm of high interest rates.

- Commodity prices in the US ticked higher in Q1 2024, contributing to some inflationary pressure faced by consumers. Representing 36% of the Consumer Price Index (CPI) utilised by the US Bureau of Labour Statistics, with energy and food taking up 7% and 13% of the index respectively, the movement of commodity prices will be a key determinant of inflationary pressure. The mild winter kept heating demand low, leaving reserves well above normal levels. Chesapeake energy, one of the US's major natural gas producers, cut their production outlook by 30% due to the plunge in prices to a 3.5 year low. This led to natural-gas prices jumping, with front-month gas futures rising 12.5% after the announcement.

- Rate cut expectations, safe-haven demand and central bank purchases have boosted gold by more than 8% in 2024. These tailwinds that drove the bullion rally largely neglected the rising dollar and treasury yields, that should have suppressed gold prices.

Summary of events in the past 5 months

December 2023 FOMC Meeting

- Despite remaining elevated above the Fed's 2% target, core inflation eased to 3.9%, showing slowing growth.
- In line with market expectations, the Fed held rates steady at 5.25-5.5% for its third consecutive meeting.
- Powell announced that they believed they were near the end of its tightening cycle, with FOMC projecting 75 basis points of rate cuts in 2024.
- Signalling hope for a soft landing, anticipation of the economy slowing in 2024 was reflected with growth expectations being adjusted down to 1.4% in 2024.

January 2024 FOMC Meeting

- Overnight Fed funds rate remain at 5.25-5%, with the committee holding back on rate cuts off the back of hotter-than-expected labour market data.
- The economy added 290 thousand more jobs (non-farm payroll) in Dec-23, more than a 60% increase from Nov-23.
- US equities trended lower, as Powell's comments deflated investors' hopes of rate cuts in the coming months.

February 2024 FOMC Meeting

- No sign of rate cuts in sight, as a stronger year-over-year (YoY) rise in headline CPI points to the labour market and economic growth remaining elevated.
- Although this should not change the Fed's "higher for longer" policy until inflation lowers, a sharp 3.8% rebound in gasoline prices will keep headline inflation high in the short term.
- Combating core services inflation, that has remained sticky, will be key as February's 0.5% MoM increase is more than twice its pre-pandemic pace. Energy and shelter inflation will need to come down significantly before any potential rate cuts.

- Overall, the Fed expects core inflation to taper down moderately, with consumer demand diminishing in the high and tight interest rate environment.

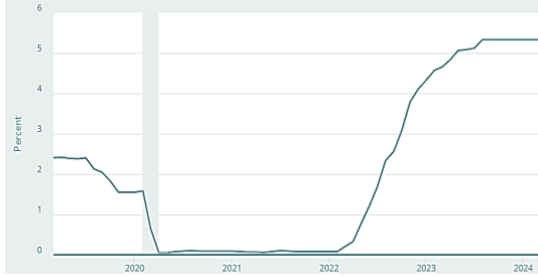
March 2024 FOMC Meeting

- As expected, the Fed continued to keep rates steady, amidst persistently high underlying indicators.
- Keeping in line with investors' sentiments, the S&P 500 rallied to a record closing high of US$5,224.62 on the day of the Fed's announcement. The Dow Jones Industrial Average and Nasdaq rose around 1% and 1.3% respectively as well.
- The Fed continues to watch out for data that instils greater confidence that inflation can sustainably move to its 2% target. Considerable uncertainty remains in the market, with persistent wage growth still above pre-pandemic levels.
- How well wages, employment and inflationary pressures continue to moderate in the coming months, will be a key determinant in the Fed's decision to hold, or cut rates in the coming months.

April 2024 (FOMC Meeting taking place on 30 Apr-24)

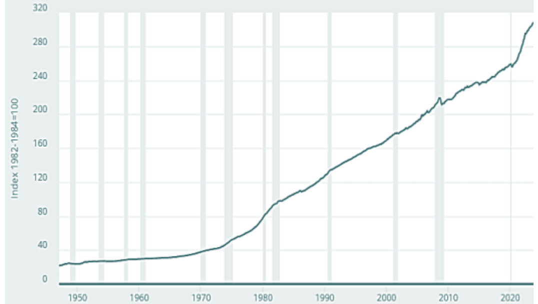
- With the three promised rate cuts nowhere in sight, Powell will have a tough time balancing the trade-offs between fighting inflation down, and the detriments of high interest rates that have worn down the US.
- Not wanting to loosen the brakes on the economy prematurely, such as in the 1970s, the Fed will be expected to keep interest rates level in April with a meagre 3.9% chance the Fed will raise rates at the next meeting (according to the CME FedWatch Tool).

Figure 5: Fed Funds Rate Hike



Source: FRED

Figure 6: Consumer price index

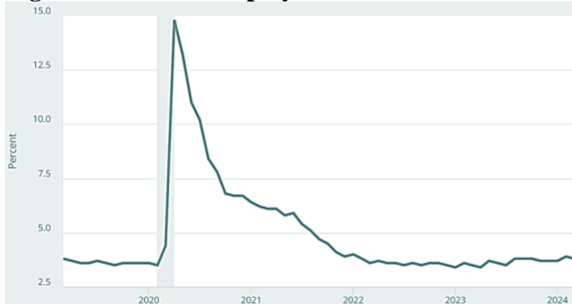


Source: FRED

Figure 7: U.S. 2 Year Treasury Yield

Source: CNBC News

Figure 8: U.S. Unemployment Rate



Source: FRED

Figure 9: United States GDP Growth Rate

Source: Investing.com

Figure 10: U.S. Dollar Index (DXY)

Monetary Policy: Federal Reserve's

In its latest meeting on 21 March, 2024, the Federal Reserve (FED) opted to maintain interest rates, sustaining the highest fed funds target rate since 2001 at 5.25%-5.50% (Figure 5). Fed Chair Jerome Powell(FOMC Speech) turned dovish for markets to price in greater rate cuts, which is different from the hawkish tone by the committee members (FOMC Press Release). This article delves into the significant shift in the Fed's monetary policy, its reaction to inflation, and the implications for investors in a changing economic landscape.

The Fed's current stance represents a departure from the era of "easy money" that persisted since the 2008 financial crisis, where the fed funds rate remained in the range of 0.00% to 0.25%. The abrupt shift in March 2022, driven by surging inflation, led to a series of rate hikes throughout 2022 and 2023. Additionally, the Fed reversed its quantitative easing policy, resulting in a substantial reduction in its balance sheet from a peak of nearly $9 trillion in April 2022 to approximately $7.4 trillion by April 2024.

The primary driver behind the Fed's policy shift is the need to curb the rapid rise in the cost of living. Despite progress, inflation remains above the Fed's target rate of 2%. Headline inflation, as measured by the Consumer Price Index (CPI), peaked at 9.1% in June 2022, decreasing to 3.2% for the 12-month period ending in Mar 2024 (Figure 6). Despite the significant monetary tightening, the U.S. economy has proven resilient. Fourth-quarter 2024 Gross Domestic Product (GDP) data revealed a robust 3.4% annualized economic growth rate.

The Federal Reserve's role extends beyond being the U.S. central bank, as it significantly influences the cost of consumer debt and shapes monetary policies. While Chair Powell garners attention, it is the Federal Open Market Committee (FOMC) that establishes and executes monetary policy, setting the fed funds target rate and influencing other aspects of the financial markets. As the Fed contemplates the possibility of another rate hike, market attention increasingly focuses on when the central bank might begin lowering rates. The challenge lies in the Fed's ability to navigate both demand and supply issues, with ongoing labor shortages representing a supply concern beyond the Fed's immediate control.

While the Federal Reserve is now likely at or near the end of its tightening cycle, the Fed's message of a higher-for-longer interest rate environment seems to have finally been absorbed by markets and investors.

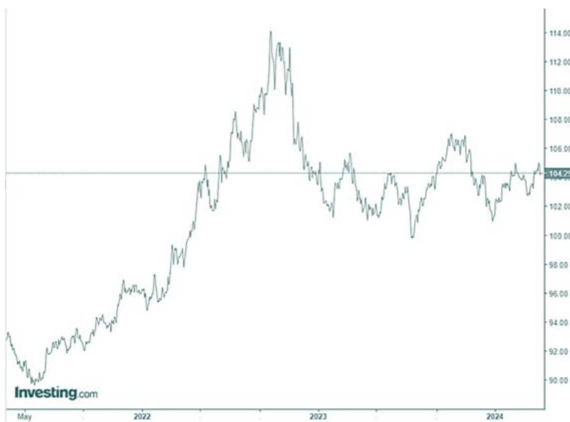
<u>Yield Curve Inversion</u>

Currently, the US is grappling with a significant economic phenomenon known as a yield curve inversion, which has consistently served as a reliable predictor of an impending recession. This occurs when the yields on longer-term bonds dip below those of shorter-term debt instruments. It is an atypical situation where investors who opt for longer-term investments are accepting lower returns compared to the available returns from short-term securities, despite the higher inherent risk associated with longer-term investments. This peculiar situation signals elevated short-term risk, which typically foreshadows an approaching recession.

However, it is vital to recognize that while market data provides dependable insights, they are considered lagging indicators, meaning they reflect economic conditions that have already occurred. Therefore, they may not offer a comprehensive understanding of the current state of the US economy.

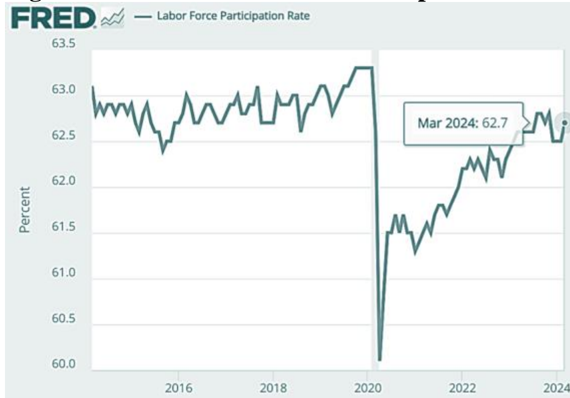
Examining historical trends dating back to 1950, whenever headline US inflation surpassed the 5% threshold, it has consistently triggered an accelerated tightening cycle followed by a recession. It is worth noting that the severity of these recessions has tended to correlate with the magnitude of rate increases and the levels of initial and peak inflation.

<u>Excess Monetary Easing</u>



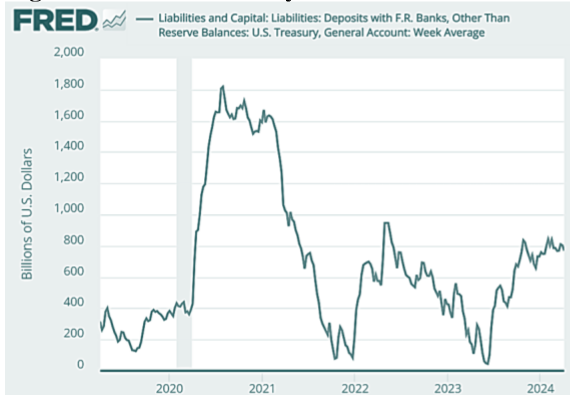
Source: Investing..com

Figure 11: U.S. Labor Force Participation Rate



Source: FRED

Figure 12: U.S. Treasury General Account



Source: FRED

During the period of 2022-2023, there was a notable shift away from the easy money policies that had been in place for over a decade following the 2008 financial crisis. This shift was observed among the four largest central banks, namely the Bank of England, Bank of Japan, European Central Bank, and the Federal Reserve, which experienced a significant expansion of their balance sheets from 5 trillion to 25 trillion.

Prior to the pandemic, interest rates were close to zero or even negative, leading to a staggering amount of over USD 20 trillion in negative-yielding securities. Consequently, concerns have been raised regarding the possibility of excessive fiscal stimulus. Under the Trump administration, a total of 5.4 trillion was allocated, and thus far, the Biden administration has provided 3.9 trillion, resulting in an overall fiscal stimulus of almost 10 trillion. This substantial injection of funds has led to excess liquidity in the system. However, it has also contributed to sky-high inflation and posed challenges to financial stability, intensifying the strain on the global financial system.

It is crucial to closely monitor the ongoing effects of policy adjustments, as they can have profound implications for the stability of the financial system and the overall economic landscape. We expect that central banks will be remain hawkish in 2024.

Fiscal Policy: Gorging on debt

Record Issuance of US Treasuries

Owing to the need to rebuild the TGA account after the potential government shutdown during June 2023. There was a record issuance of US Treasury as $1 Trillion worth of bonds was issued in the three months to October, raising immediate concerns over the significant increase in supply. In light of the sharp increase in yields across the US yield curve, where the 10y USTs jumped almost a full percentage point across 3 months. The US Treasury has opt for a more moderated increase in the size of its debt auctions towards long-dated bonds in the coming quarters.

We anticipate that the United States will have increased deficits and a higher debt-to-GDP ratio over the next two years. This is due to the escalating expenses associated with healthcare and social security, which are expected to continue to rise for the next decade. The next key date will be 12 April where the Quarterly Refunding Announcement (QRA) will show the level of issuance of both front and back-end debt.

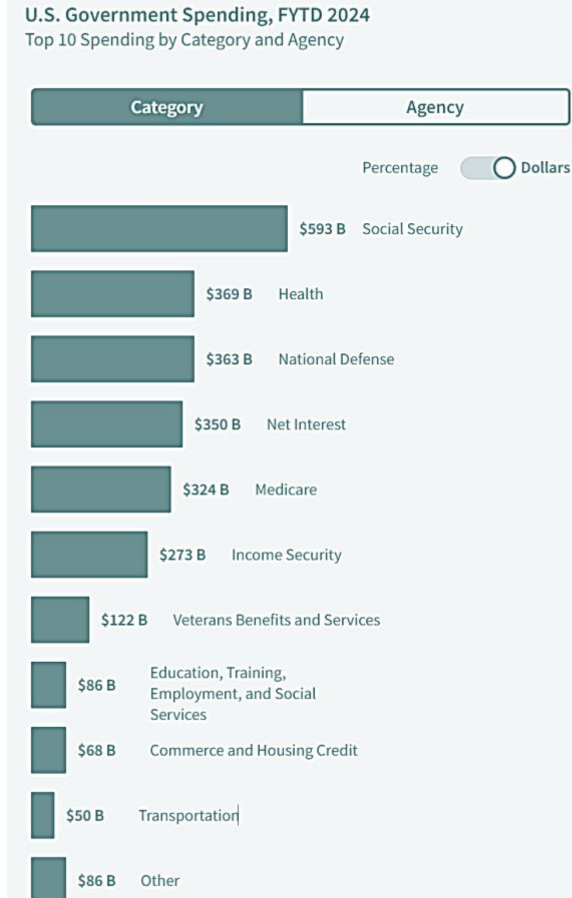
Rating Agencies downgrade of US government treasury

US treasury bills have always been considered the premier risk-free investment, as it is honoured by the full faith of the US government. However, given the current situation unfolding, it is uncertain if investors will still be able to view US treasury bills with the same amount of confidence. In August, Fitch downgraded the US Long-Term Ratings to from AAA to AA+ to reflect the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to 'AA' and 'AAA' rated peers over the last two decades that has manifested in repeated debt limit standoffs and last-minute resolutions. Likewise, Moody's Analytics has lowered its outlook on the US credit rating from stable to negative citing large fiscal deficits and a decline in debt affordability.

Removal of Debt Ceiling Jan 2025

Amidst weeks of negotiation, President Joe Biden signed a bipartisan bill into law, suspending the U.S. debt ceiling until January 1, 2025, thereby averting a potential government default. The passage of the Fiscal Responsibility Act of 2023, following negotiations between Biden and Speaker Kevin McCarthy, marks a significant display of bipartisan cooperation in Congress. The legislation includes measures to control spending, such as rescinding unspent funds and imposing caps on military spending, while also emphasizing the importance of safeguarding key social programs like Social Security and Medicare. However, the bill does not

Figure 13: US Government Spending



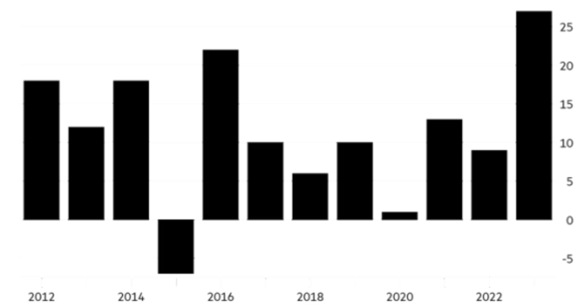
Source: US Treasury

extend relief measures like the freeze on federal student loan payments, posing potential challenges for borrowers. As Congress now shifts its focus to other matters, such as clarifying retirement legislation and confirming key appointments like Julie Su as Secretary of Labor, the implications of the debt ceiling legislation underscore ongoing policy debates and priorities shaping the economic and social landscape.

US Fiscal Policy Budget

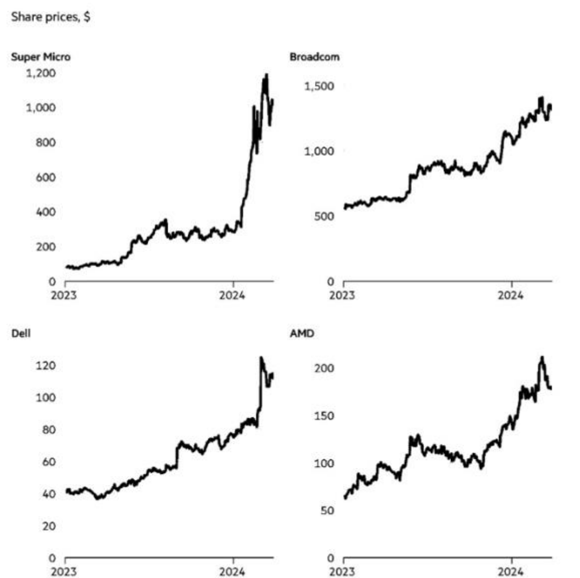
President Biden's fiscal policy for 2024 reflects a comprehensive approach to addressing economic challenges while ensuring fairness and sustainability. By prioritizing investments in America and advocating for growth from the middle out and bottom up, the policy seeks to reduce economic inequality and promote shared prosperity. The focus on making the wealthy and large corporations pay their fair share through measures like minimum taxes and closing loopholes demonstrates a commitment to equity. Furthermore, ending wasteful spending on special interests and modernizing the tax code are steps towards a more efficient and effective fiscal framework. However, while the policy aims to reduce the deficit by $3 trillion over the next decade, questions may arise regarding the feasibility and effectiveness of certain proposals. For instance, the impact of raising tax rates on large corporations and wealthy individuals on economic growth and investment remains a subject of debate. Additionally, the potential consequences of eliminating certain tax subsidies, such as those for real estate and cryptocurrency transactions, could have implications for specific industries and sectors. Therefore, further analysis and discussion are necessary to assess the overall effectiveness and implications of President Biden's fiscal policy for 2024.

Figure 14: S&P 500 Accounts for More Than a Quarter of Global Equity ETF Flows



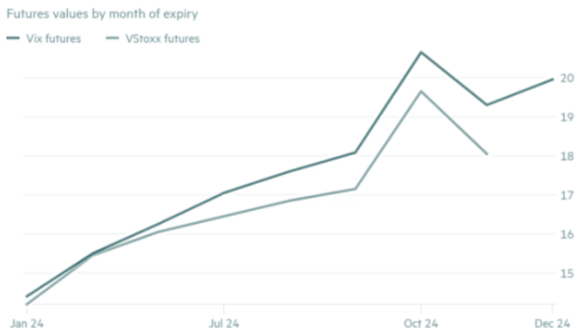
Source: Financial Times

Figure 15: The AI Boom Broadens Out Across Wall Street



Source: Financial Times

Figure 16: The Rising Futures Prices for Volatility Futures



Source: Financial Times

Figure 17: Russel 2000 Has Been Outperformed by S&P 500 Since 2021

Stock Market: Navigating New Peaks and Uncertainties

Secondary Market

Economic Growth and Market Resilience

The U.S. stock market, characterised by the S&P 500's remarkable 24.2% gain last year, continues to demonstrate resilience and optimism, reflecting the robust underpinnings of the U.S. economy. Investors are increasingly attracted to the allure of the 'Magnificent Seven' (Apple, Alphabet, Amazon, Meta, Microsoft, Nvidia, and Tesla) —a group of tech giants that have not only driven the index to new heights but also significantly shaped investor sentiment. This surge in the S&P 500, particularly within the technology sector, has reinforced the market's position as a bellwether of both technological advancement and economic strength.

Moreover, the substantial inflows into S&P 500 ETFs, which saw a record $137 billion last year (Fig. 14), underscore an optimistic outlook for the U.S. economy. This trend is a clear indication that investors are confident in the ongoing U.S. economic dominance and are leveraging this avenue to participate in the country's growth story. The escalating global market share of U.S. equities, which now accounts for an astonishing 60.5% of global market capitalization, mirrors the U.S. economy's unmatched scale and its companies' profitability. This robust influx highlights a market buoyed by strong corporate earnings and a strategic rotation into large-cap equities, which offer perceived safety amid global uncertainties.

Technological Innovations and AI Prospects

Another pillar bolstering market optimism is the groundbreaking potential of artificial intelligence, which has been likened to a new productivity revolution akin to the internet's rise in the 1990s. AI's integration across various sectors is not only enhancing efficiencies but is also poised to be a critical driver of the next economic boom, reminiscent of the dot-com era's transformative impact. However, unlike the speculative fervour of the late 1990s, today's technology investments are marked by more substantial earnings and cash flows, reflecting a matured market perspective that prioritises sustainable growth over unchecked exuberance.

Furthermore, the resilience of tech-heavy indices, such as the Nasdaq, despite various macroeconomic challenges, reflects a deep market confidence in technology as a cornerstone of future growth (Fig. 15). The strategic performance of AI-related stocks, alongside significant capital inflows into the sector, underscores a collective investor bet on high-tech as a safe harbour against potential economic turbulence, fuelled by continuous innovations and an expanding digital economy.

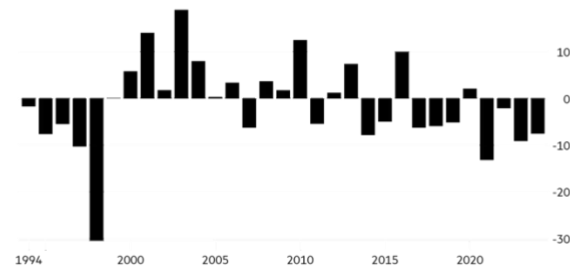
Market Dynamics and Potential Risks

While bolstering the market's upward trajectory, such investor confidence also prompts a reflection on the sustainability of current valuations and the potential for overextension, reminiscent of the late 1990s. The secondary market's dynamics were further complicated by anticipatory moves around the U.S. presidential election, with traders betting on volatility spikes (Fig. 16). The activity around Vix futures indicated a market bracing for turbulence, a testament to the political events' profound capacity to sway financial markets. This expectation of volatility, rooted in historical precedents such as the panic on Trump's unexpected victory over Hillary Clinton in November 2016, underscored the secondary market's sensitivity to external political forces, illustrating the intricate interplay between political landscapes and market dynamics.

Moreover, the stark divergence in performance between small-cap and large-cap stocks became increasingly pronounced, which may pose a threat to the sustainability of the stock market rally. The Russell 2000's subdued performance, relative to the S&P 500's robust gains (Fig. 17), mirrored investors' preference for the security and growth potential offered by large-

Small-caps endure worst run relative to large-caps since the late 1990s

Russel 2000 - S&P 500 (annual percentage change)



Source: Bloomberg
© FT

Source: Financial Times

Figure 18: Reddit's Co-Founder & CEO Steve Huffman (Left) with the Company's Mascot (Middle) at the NYSE

Source: Getty Images

Figure 19: TMTG's Highly Politicised Slogans

Source: TMTG

Figure 20: ARD-101 Started Its Phase 2 Study in 2022

Participants Needed!

Ages 17 - 65 Years
Bodyweight ≥50 kg
BMI ≥27 kg/m²
Confirmed diagnosis PWS

aardvark therapeutics

Phase 2 Study of ARD-101

a potential treatment for Prader-Willi syndrome

Participants will take ARD-101 orally for 28 days. The study will evaluate the safety and effectiveness of ARD-101 in treating hyperphagia.

STUDY SITES

Children's Hospital, CO
Stanford, CA

Source: Foundation for Prader-Willi Research

Figure 21: Global Venture Capital Fundraising Drops to 10-Year Low

cap entities. This preference was notably influenced by the prevailing high interest rates and inflationary pressures, which disproportionately impacted smaller companies with weaker balance sheets and less pricing power.

In conclusion, the U.S. stock market remains a beacon of optimism, driven by robust economic indicators, a strong technological foundation, and strategic market movements. While mindful of potential volatility, the prevailing investor sentiment is tilted towards a bullish outlook, betting on America's continued economic prowess and its companies' global dominance. The path forward, paved with AI innovations and strategic market adaptations, offers a promising horizon for those invested in the U.S. economic narrative.

IPO Market

In the realm of U.S. initial public offerings (IPOs), the landscape of 2024 marks a pivotal chapter in the narrative of innovation, adaptability, and market re-evaluation. At the forefront of this evolving scene are Reddit and Trump Media and Technology Group (TMTG), alongside other notable entities like Aardvark Therapeutics, Shein, Flutter, and Gympass, each playing a distinct role in reshaping investor perceptions and market dynamics.

Reddit and TMTG: A Dual Narrative of Market Realignment

Reddit's journey to the public markets encapsulates a broader trend of recalibration within the tech sector. Once valued at $10 billion during its zenith in 2021, its anticipated valuation at IPO underscores a significant adjustment to a more grounded $6.4 billion. This "down round" IPO reflects a broader acceptance within Silicon Valley of a new valuation paradigm, prioritising sustainable growth and market realism over previous speculative exuberance. Reddit's successful IPO, with shares soaring 48% on debut, not only revitalised IPO market interest but also illustrated the potential for companies to redefine their growth trajectories in alignment with market realities (Fig. 18).

TMTG's path to going public, on the other hand, showcases the interplay of celebrity influence and speculative investment, converging in a SPAC merger that catapulted its valuation and highlighted the speculative fervour that can envelop such ventures. With TMTG's listing under the ticker DJT, Donald Trump not only fortified his business portfolio but also signalled a strategic disruption in the social media landscape, underscoring the speculative enthusiasm inherent in marrying political identity with business innovation in the volatile realm of public markets (Fig. 19). This enthusiasm surrounding TMTG, despite its nascent revenue streams and ambitious projections, exemplifies a market segment willing to bet on the convergence of media, technology, and personality-driven branding.

Aardvark Therapeutics: Innovating for Health

U.S. biotech group Aardvark Therapeutics is gearing up for a pivotal moment with its planned IPO, aiming to raise up to $200 million to propel its innovative approach in the battle against obesity into the public markets. This strategic move is buoyed by the burgeoning interest in anti-obesity treatments, highlighted by Aardvark's development of ARD-101, a promising drug shown to suppress cravings in patients. The success of ARD-101 in early-stage trials not only positions Aardvark at the forefront of addressing a critical global health challenge but also serves as a significant value proposition to investors keen on contributing to a healthcare breakthrough (Fig. 20).

Shein: Redefining Fast Fashion's Market Footprint

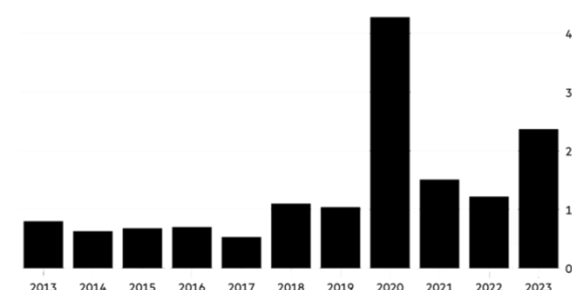
Online fast fashion group Shein's anticipated IPO in the U.S. represents a significant milestone in the fast-fashion sector, projecting a valuation that not only underscores its dominance in the space but also reflects the evolving consumer behaviours and digital commerce trends. With profits more than doubling to over $2 billion ahead of its planned listing, Shein's trajectory

Source: Financial Times

Figure 22: Yields on 2-Year U.S. Treasuries Climbed Above 4.70%

Source: Financial Times

Figure 23: U.S. Treasuries Raised More Than $2tn Last Year



Source: Financial Times

Figure 24: More Than $20bn Has Flown into U.S. Corporate Bond Market So Far This Year

emphasises the scalability of digital-first retail models and the global appeal of fast fashion. Founded in China and with substantial China presence, Shein's regulatory navigation, amidst Sino-American geopolitical tensions and U.S. market regulations, will be a litmus test for similar cross-border ventures contemplating public market entries, notably TikTok's parent company ByteDance.

Flutter: Betting on New Markets

London-listed Flutter's strategic pivot towards a U.S. primary listing reflects a broader trend of companies seeking to align their market presence with their operational footprint and growth prospects. With its subsidiary FanDuel's dominance in the U.S. sports betting market, Flutter aims to leverage this positioning to attract a broader investor base, including retail investors, by tapping into the vibrancy and liquidity of U.S. capital markets. This move not only highlights the importance of market alignment for growth companies but also the potential of regulatory and market dynamics to shape listing strategies.

Venture Capital: Navigating the New Terrain

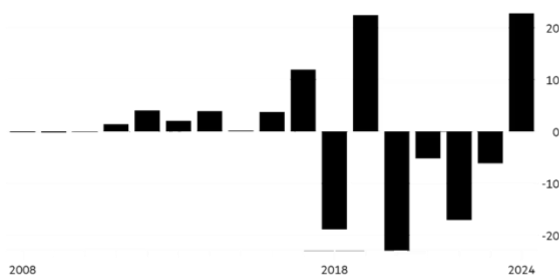
However, the U.S. IPO market is confronted with severe challenges as well. The venture capital landscape in 2024 presents a stark contrast to the feverish investment climate of previous years, signalling a recalibration of expectations and strategies in the wake of a prolonged market downturn. The significant decrease in venture capital fundraising, with figures drawing closer to those not seen since 2015 (Fig. 21), reflects a broader market sentiment of caution and a re-evaluation of investment paradigms, with U.S.-based venture capital firms such as Tiger Global, Coatue, and Insight Partners being hit particularly hard. This shift away from the era of "megafunds" and speculative bets on unproven startups to a more measured and strategic investment approach is indicative of the venture capital community's response to a lack of exit opportunities, diminished returns, and a more challenging economic environment. The emphasis is increasingly on sustainable growth, tangible innovation, and the potential for AI and other emergent technologies to drive future market disruptions. For startups and venture capitalists alike, the current climate demands a heightened focus on operational efficiency, market differentiation, and the capacity to navigate an increasingly complex regulatory and economic landscape. The venture capital sector's evolution reflects a broader maturation of the startup ecosystem, where success is measured not just in capital raised or valuations achieved, but in the ability to deliver real value, drive innovation, and sustain growth over the long term.

Bond Market: Shifts in a Changing Economic Tide

U.S. Treasury

In recent developments, the U.S. Treasury market has faced significant shifts, with yields on U.S. government debt escalating to their apex in a fortnight (Fig. 22). This upward trajectory in yields, particularly notable in the benchmark 10-year Treasury notes and the two-year Treasuries, underscores a recalibration of expectations towards interest rate movements within 2024. These expectations have been moulded by persistent inflationary pressures and a surge in manufacturing activity, compelling a more cautious stance on the part of investors regarding the pace and extent of anticipated rate cuts.

The data revealing a year-on-year inflation at 2.5% in February, coupled with an increase in the ISM manufacturing index in March, has induced a re-evaluation among market participants. This re-evaluation manifests in a tempered forecast for rate reductions, with the market consensus now leaning towards two or three quarter-point cuts by year's end, a marked reduction from earlier, more optimistic projections. Such adjustments reflect a growing alignment between market sentiment and the Fed's cautious

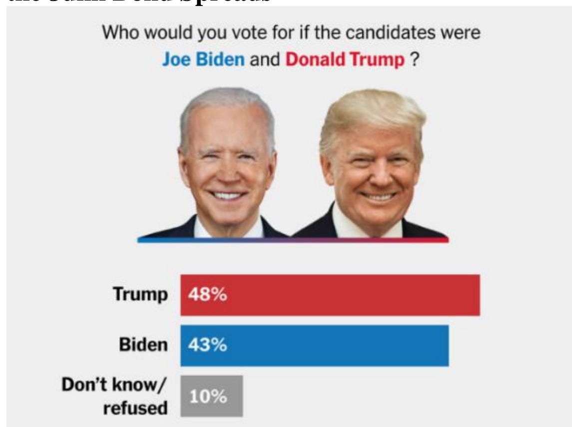


Source: Financial Times

Figure 25: U.S. Junk Bond Spreads Are Historically Low

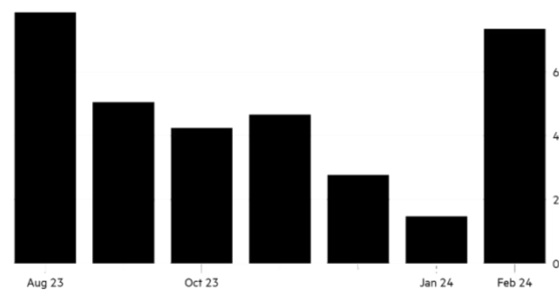
Source: Financial Times

Figure 26: The Biden-Trump Spread Is as Tight as the Junk Bond Spreads



Source: The New York Times

Figure 27: U.S. Firms Have Raised $7.4bn through Convertible Bonds in February 2024



Source: Financial Times

outlook, emphasising a gradual approach to interest rate adjustments in response to evolving economic indicators.

Moreover, the discourse surrounding U.S. fiscal sustainability has ignited concerns over the burgeoning public debt, now surpassing 97% of GDP (Fig. 23). This fiscal trajectory, characterised by rising deficits and a substantial public debt burden, poses a stark challenge to the U.S. Treasury market's foundational role in the global financial architecture. The potential for fiscal discipline, enforced by market forces or "bond vigilantes," looms as a critical consideration, threatening not only domestic economic stability but also the U.S. dollar's primacy as the global reserve currency.

Amid these dynamics, the Fed's steadfast position, as articulated by Fed officials, projects a narrative of caution and vigilance. The recent moderation in market expectations, aligning more closely with the Fed's perspective, underscores a mutual recognition of the intricacies at play. This includes the delicate balance between fostering economic growth and containing inflation, against a backdrop of substantial public indebtedness and global economic interdependencies.

As the U.S. Treasury market continues to navigate these turbulent waters, the confluence of inflationary dynamics, fiscal considerations, and monetary policy decisions will shape the trajectory of interest rates and, by extension, the broader economic landscape.

Corporate Bonds

The corporate bond market in the United States has experienced a remarkable surge in activity, underscored by an unprecedented influx of issuances and investments (Fig. 24), catalysed by a confluence of economic expectations and pre-emptive strategies ahead of the presidential election. Companies have expediently mobilised to capitalise on the favourable conditions, issuing a staggering $606 billion worth of dollar bonds thus far in the year, marking a significant uptick from the preceding period and setting a new benchmark since records began in 1990. This flurry of activity is attributed to historically low spreads (Fig. 25), offering an opportune moment for corporate borrowers to secure financing at attractive terms.

The impetus for this acceleration in bond issuances is twofold: the anticipation of market volatility surrounding the upcoming U.S. election and a strategic response to economic forecasts. Firms are advancing their financing plans to sidestep the uncertainties of a Biden-Trump electoral rematch (Fig. 26), preferring the current conducive market conditions over the potential for more prohibitive ones in the near future. This calculated manoeuvre is mirrored by the behaviour of traders in the derivatives market, where there is a noticeable adjustment in expectations for market volatility ahead of the election, indicating a broader market sentiment gearing up for unpredictable fluctuations.

The tightening of credit spreads, reaching near-historic lows, reflects a robust demand for corporate bonds, driven by investors' appetite for yield amidst a backdrop of declining issuance in preceding years. This dynamic has resulted in an environment where the cost of borrowing for corporations is markedly reduced, presenting a window of opportunity for diverse industries, from automotive to banking and construction, to tap into the debt market with increased fervour.

Moreover, the resurgence in convertible bond issuances (Fig. 27), particularly among technology firms, signifies a strategic pivot leveraging the current "frothy" equity market conditions. This trend underscores a broader market inclination towards innovative financing mechanisms that offer flexibility and potential cost advantages against the backdrop of high interest rates. Notably, companies with significant growth prospects, buoyed by the AI boom, have found convertible bonds an appealing option to meet their capital needs while minimising dilution.

The convergence of these factors - electoral anticipation, favourable borrowing costs, and innovative financing strategies - encapsulates a

moment of strategic recalibration in the U.S. corporate bond market. Companies are not only navigating the immediate economic landscape with agility but are also setting the stage for future financial manoeuvring post-election. As the corporate bond market continues to evolve, the interplay between market sentiment, economic policy expectations, and corporate financing strategies will undoubtedly remain a focal point for investors and policymakers alike.

NUS INVESTMENT SOCIETY

Global Macro Department – Canada | Date: 7th April 2024

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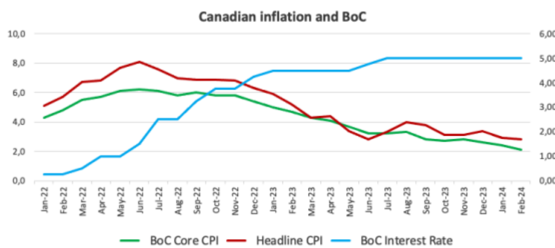
Basic Information (Canada)

Real GDP (CAD)	2.905 trillion (2023)
M1 (CAD)	1.5 trillion
M2 (CAD)	2.487 trillion
CPI	158.8
PPI	124.3
Con. Confidence	47.89
Stock Index	TSX Composite
Currency	CAD

Source: TradingEconomics

Chart info

Figure 1: Canadian Inflation, and Interest Rate



Source: FX Street

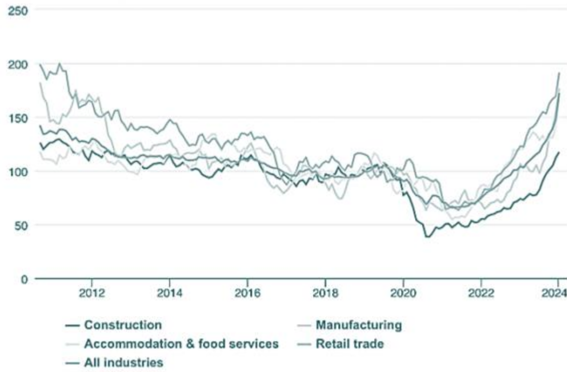
Figure 2: Government of Canada 5 Year Bond Yield

Source: Altrua Financial

Overview of Canada's Economy

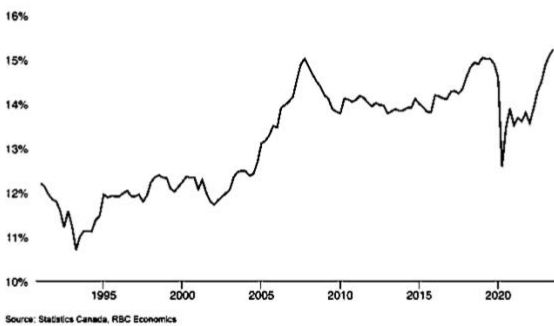
- Canada is the world's 10th largest economy, whose economy is service-based and highly dependent on exports and imports.
- Canada's international trade comprises about one-third of the GDP. Major trading partners include the US (77.6%), China (4%) and Japan (2.1%).
- Top 5 GDP per sector: 10.02% real estate, 7.26%, manufacturing, 6.02% healthcare and social assistance, 5.72% public administration, and 5.71% construction.
- Canada is one of the few developed nations that are net exporters of energy and one of the world's largest suppliers of agricultural products.
- The Bank of Canada (BOC) is Canada's central bank, and its core policy is 2% inflation targeting monetary policy.
- Canada's high household debt was one of two vulnerable domestic areas in Canada's economy; the second is its overheated housing market with rent inflation being one of the stickiest components in the CPI.

Figure 3: Canada's business bankruptcies



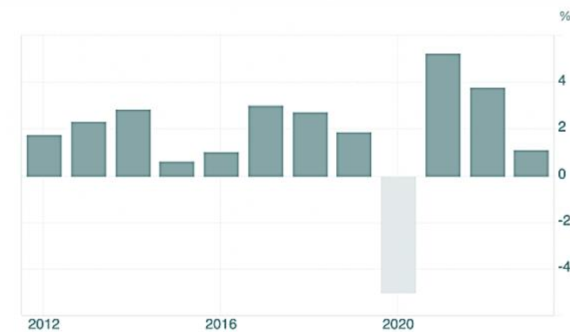
Source: RBC Economics

Figure 4: Canada's household debt service ratio



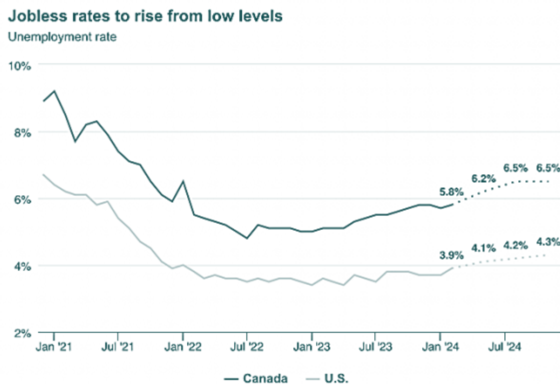
Source: RBC Economics, Statistics Canada

Figure 5: Canada's GDP growth rate



Source: RBC Economics, Statistics Canada

Figure 6: Canada's Unemployment Rate



Source: RBC Economics, Haver

Summary of Canada's Economy in the past 6 months

Much needed rate cuts on the horizon

- The BoC has kept rates steady at 5.0%, since Sept-23 (Figure 1), as the economy grapples with the potential of a technical recession.

- We expect the BoC to begin cutting rates by 0.25% as early as Jun/July-24, with markets reflecting the same consensus. As of March 2024, the Government of Canada's 5-year bond yield has reflected expectations of an imminent rate cut. In anticipation of the fall in rates, yields have gone down (Figure 2).

Dire situation for Canada's housing crisis

- Canada's housing problem has worsened, amidst the high interest rate environment. Compared to other G7 countries, Canada has the fewest homes per capita, yet has the highest home ownership rate, lowest affordability and rate of production for new housing. Taking the cake for the highest population growth rate serves no help either. Reports suggest that to restore home affordability by 2030, home production capacity would have to triple annually.

- Rent inflation has remained one of the stickiest items in the CPI, largely due to the surge of temporary foreign workers and students who are primarily renters. In an attempt to curb rent inflation, the government approved an annual intake cap on both foreign workers and students, with a 19% and 35% reduction respectively.

- Restoring the housing sector would require the help of the coming rate cuts. Lowering the cost of mortgage renewals would relieve some of the pressure off consumers, which remains a big source of inflation riding over 20% of the CPI. Compared to their American counterparts that boast 30-year fixed mortgage rates, Canadians must constantly renew their 5-year mortgages and the high interest rates have been hurting consumers.

- The ratio of household debt payments to disposable incomes sits at record highs and will continue to get worse as mortgages get renewed at higher rates. Business failures (Figure 3) and household delinquency rates have been rising sharply for the first time in decades. Canada's household debt service ratio will continue to climb higher, cutting into household purchasing power (Figure 4).

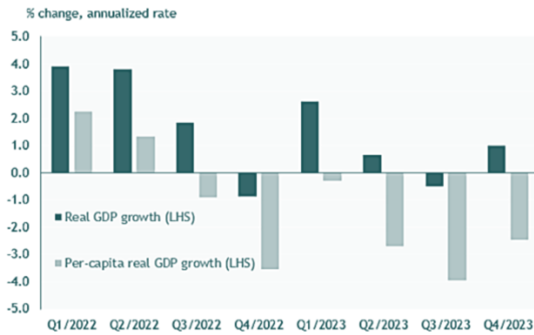
Economic slowdown far from over as businesses pullback

- Canada's economy continues to slow, as the impacts of earlier interest rate hikes start to materialise. Full year GDP growth fell once again, from 3.82% in 2022, to 1.1% in 2023 (Figure 5). Per-capita output fell for a sixth straight quarter, returning to 2016 levels.

- Domestic demand fell in Q4 2023, as the meagre increase in consumer spending was overshadowed by far lowered levels of residential investment and a second consecutive large pullback in business investment.

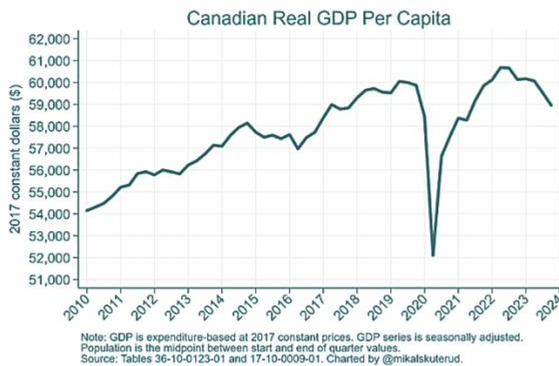
- Business investment fell by 7% in Q3-4 of 2023, replicating the decades of underinvestment dating back to the 08/09 financial crisis. Slow business investment today, will certainly impact

Figure 7: Canadian per-capita GDP



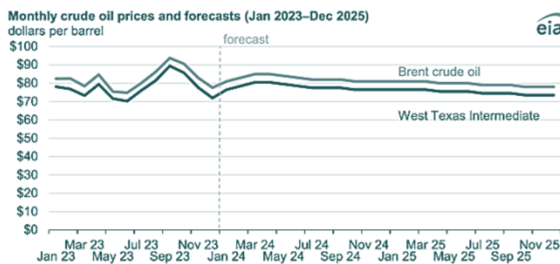
Source: RBC Economics, Statistics Canada

Figure 8: Canadian real GDP per-capita



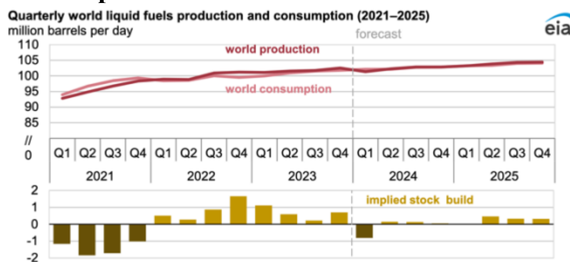
Source: RBC Economics

Figure 9: Monthly Crude Oil Price Forecasts



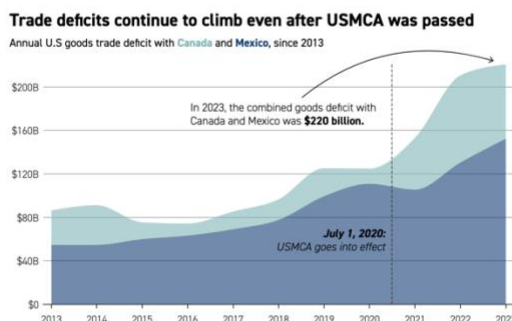
Source: US EIA

Figure 10: World Liquid Fuel Production and Consumption Levels



Source: US EIA

Figure 11: US Trade Deficit



Source: IG News

growth in the future by lowering productivity growth. Historically, this has been a key driver of economic rebounds, and will be needed to improve per-capita standards of living.

- Rate cuts in the second half of 2024 should help Canada's economy pick back up, albeit at a slow pace. Consumer spending will drive the resurgence as inflationary pressures around essential goods subside. The rebound will be subdued, as households remain cash-strapped, until the housing situation improves. Wage growth has shown signs of slowing as job openings fall and unemployment rises slightly (Figure 6).

<u>Brink of a recession?</u>

- As of April 2024, the economy is on the brink of the recession, with population growth and government stimulus preventing the recession.

- However, judging from GDP per capita, Canada is well into a recession. The per capita GDP figures suggest that there has been 18 months of economic decline (Figure 7). Canada has not seen real GDP growth since March-18, with over 6 years of economic growth erased (Figure 8).

- The Central Bank of Canada has previously stated that it takes 1-2 years for an interest rate hike to have its full effect on slowing an economy, and it seems as though we have only started to experience said effects. Food costs and housing costs will take time to cool its inflationary pressures off, before Canada can see substantial progress to its 2% inflation target. This points to rates being held in the coming months, minimally til Jun-24.

<u>Depreciation on the horizon</u>

Declining Crude Oil Prices

- Being a major exporter, the CAD and crude oil share a positive correlation coefficient of +0.30. A fall in crude oil prices could negatively affect Canada's economic performance with reduced export revenue, weakening the CAD.

- The US Energy Information Administration expects Brent crude oil prices to begin falling post Mar-24 (Figure 9). This is largely due to global consumption rates lagging behind the increases in production (Figure 10), despite factoring in the 2.2 million b/d of new voluntary cuts from OPEC.

US Presidential Elections

- The possibility of Donald Trump winning the elections and pulls the US out of the USMCA agreement would pose issues for Canada's exports. Despite implementing a host of tariffs on imports coming into the US in his first term, including Mexican and Canadian imports, the impacts of Trump's tariffs fell flat as demand for foreign imports rose. The US goods trade deficit with Canada and Mexico hit US$220 billion in 2023 (Figure 11).

- Trump publicly that to reverse those trade deficits, hiking tariffs are rather likely, raising duties once again on all imports coming into the country. Prioritising a healthy US balance sheet would be another key risk to the Canadian economy and dollar as more tariffs would certainly lead to less demand for Canada's exports.

Summary & Forward Guidance

In Q1 2024, the Canadian economy continues to slow, with several indicators suggesting the economy has been experiencing recessionary effects for a while. The relatively short-term nature of the residential mortgage market leaves many households bearing the brunt of the high interest rate regime, diminishing spending power. The dampened economy builds pressure on the BoC to cut rates sooner than their American counterparts, with the economy anticipating much needed stimulus. Rate cuts for Canada are desperately needed, far more urgently than their American counterparts. In light of this, we expect the CAD to continue to perform poorly against other currencies in 2024.

USD/CAD Price Chart

Source: Trading View

Trade Idea: Long USD/CAD (9 Months)

Trade Idea

Entry: 1.35
Take Profit: 1.39
Stop Loss: 1.33
Risk Reward Ratio: 2.00
Duration: 9 Months
Annualized Carry: 0.28% (SOFR: 5.32%, CORRA: 5.04%, Net Carry: 0.28%)
Breakeven level after 9 months: 1.347

Narrative

- As the US continues to post strong economic data, a healthy labour market, and elevated inflation levels, rate cuts will be delayed in fear of premature cuts sending inflation rocketing back to 2022 levels. The revision in rate cut expectations underpins the strengthening dollar, aligning with the Fed's cautious data driven approach to monetary easing.

- Mounting pressure of a recessionary risk on the Canadian economy and a growing population facing the brunt of high interest rates due to the short term nature of Canada's mortgage rates may force the BoC to cut rates prematurely. Markets price in a 75% chance of the first round of rate cuts to occur in Jun-24.

- The drastic differences in the state of both economies will be the key factor influencing the timing of both nations rate cuts. With Canada likely to begin cutting in the coming months, coupled with the depressed economy, depreciation almost seems certain for the Canadian Dollar. With the US economy expected to keep up its strength, we posit the USD/CAD to appreciate.

Catalysts

- Poor economic data from Canada

- Unexpected higher inflation data and strong economic growth from the US

Technical Analysis

- From the Bollinger Bands, we observe that the USDCAD crossed the 30-day moving average and did indeed continue its uptrend, approaching the upper band at 1.36.

- We believe that the current price movement is bullish and subsequently breaking the next main level of resistance at 1.39.

- We will thus enter the trade at 1.35, our take profit will be at the resistance of 1.39 (for 2.9% upside) , with our stop loss placed at the lower support of 1.33 (tolerance for 1.45% downside) giving us a trade with a risk-reward ratio of 2.00.

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