

(The Process Of) Economic Normalization and What That Means for the Outlook

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We are in the process of normalizing the economy, but what does that mean? Positive economic growth, check. Full employment, check. Normal monetary policy via positive real interest rates, higher inflation, and (somewhat) reduced central bank balance sheets, check. Normal fiscal policy, noticeably absent.

Economic growth has been booming since the pandemic due to decisive action from both monetary and fiscal policy makers. In the U.S., annual GDP has been a shade better than 3% since 2021, over 1% higher than the estimated trend growth of about 2%. Other developed economies have lagged this standard but directionally have been on a similar path.

The unemployment rate in most major economies is at or near cycle lows even if the quality of that employment, in some cases, is lower as households take on multiple jobs to make ends meet. Consumers have employment income and have been keen to spend (YOLO), lifting the economy out of its pandemic funk. A paycheck and rising household wealth have been key supports to consumers, even in the face of uncertainties like faster inflation and the attendant higher cost of money.

Meanwhile, the past two years have seen monetary policy makers move from emergency policy settings to less accommodation by pushing real rates above zero for the first time since the start of the pandemic. Inflation pressures built during the pandemic were primarily due to supply chain disruptions but also in response to resilient demand through exceptional consumer and government spending. Real rates in a normal, functioning economy should be positive, helping ensure capital is allocated appropriately. Real rates are not only positive again but also the highest in a decade.

And while monetary policy is normalizing, the same can't be said yet for fiscal policy, which seems to be miscalibrated. Take the U.S., where economic growth is well above trend, but the government is running a budget deficit of 6%, which is far more typical of recession. So, as growth and inflation return, we are left to ask why fiscal policy seems poised to stay pro-cyclical and run the risk of a policy mistake instead of counter-cyclical as would be normal? It may be easy for fiscal policy makers to justify fiscal largesse when public health and safety is on the line and borrowing costs are negligible. But it may now be an excuse for politicians of all stripes to respond to other populist pressures of the day. War in Europe? Defence spending. Rising geopolitical pressure? Re-industrialization

spending. Wealth inequality? Regulations to favour labour. Regardless of who wins the White House, the budget deficit will persist. Milton Friedman said once that “nothing is so permanent as a temporary government program”, which seems to ring true.

Turning markets, volatility is surprisingly low given the potential for both inflation and fiscal policy regime shifts. Markets are putting a low probability on a 2022-like U.K. gilts crisis where bond vigilantes brought down the short-lived Liz Truss government in dramatic fashion. Could elections be the catalyst to see this risk play out elsewhere? Even excluding the surprise election result in Argentina late last year, we have had one election surprise after another, including in Mexico, India, South Africa, and the E.U. parliamentary elections. A poor showing for Macron’s party in the latter has triggered a snap election in France at the end of June, which could reshape Europe. Fiscal austerity or balanced budget proposals are nowhere in sight regardless of where you look on the political spectrum. This new trend is potentially dangerous and can be illustrated by the fact that U.S. interest expense is now higher than defence spending for the first time in history.

Against this backdrop, bold portfolio bets would seem to be ill-advised. We are still constructive on stocks, supported by the resilient economy and stickier inflation. We are still significantly underweight bonds and do worry about regime shifts, as mentioned, but we have added back modestly in recent weeks. However, we have kept duration exposure short due to higher yields and lower interest rate sensitivity. Cash, inflation-linked bonds, and commodities are also held.

Combined top 15 equity holdings as of May 31st, 2024 of the Assante Private Portfolios 40i60e Standard portfolio with Alphastyle exposure:

1. NVIDIA Corporation	6. Meta Platforms Inc. Class A	11. Rheinmetall AG
2. Microsoft Corporation	7. Schneier Electric SE	12. Eli Lilly and Company
3. Amazon.com, Inc.	8. ASML Holding NV	13. ASM International N.V.
4. Constellation Energy Corporation	9. Novo Nordisk A/S Class B	14. ServiceNow, Inc.
5. Constellation Software Inc.	10. Tawaian Semiconductor Manufacturing Co., Ltd. Sponsored ADR	15. Safran SA

Glossary of Terms

Duration: A measure of the sensitivity of the price of a fixed income investment to a change in interest rates. Duration is expressed as number of years. The price of a bond with a longer duration would be expected to rise (fall) more than the price of a bond with lower duration when interest rates fall (rise).

Volatility: Measures how much the price of a security, derivative, or index fluctuates. The most commonly used measure of volatility when it comes to investment funds is standard deviation.

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