Sticky inflation + stubborn central banks = spirited markets.

By: James R. Solloway, CFA, Chief Market Strategist and Senior Portfolio Manager

SEI recently released its first-quarter Economic Outlook, published in two installments. Here is a summary of our key perspectives from the second installment, focusing on inflation, its impact on economic policies, and how market performance reflects this.

- In the spring of 2021, we began to use the phrase "persistently transitory" to describe our inflation view. We believed at the time that inflation would stay higher for much longer than economists, central bankers, and market participants anticipated. Headline inflation has come down dramatically in the past year, raising hopes that the Federal Reserve (Fed) and other major central banks are succeeding in bringing inflation back to their 2% targets without undue economic pain. On a harmonized consumer-price index (CPI) basis, U.S. inflation was near target in February, the eurozone wasn't far off, and the U.K. was also moving in the right direction. The question is: Can inflation settle near 2% on a sustained basis? We are still doubtful.
- We remain focused on labor-market conditions and their impact on wage costs. Unit labor costs are a good yardstick of underlying inflation, since they measure increases in total employee compensation, offset by productivity improvements. Looking at the rise in unit labor costs for the U.K., Canada, the eurozone, the U.S., and Japan for both 2023 and the 10 years prior to the onset of COVID-19, each of the economies' unit labor cost gains were markedly higher in 2023. Although labor markets are not as tight as they were a year or two ago, they are tight enough to keep rises in unit labor costs, and by extension, underlying inflationary pressures, elevated. SEI believes this will present a major challenge for policy-makers.
- Earlier this year, participants in the futures and swap markets priced in an expectation that the Fed would reduce the federal-funds rate by approximately 150-175 basis points (1.50%-1.75%) by the end of 2024. We saw no reason for such optimism and stuck to our view that three 25 basis-point reductions totaling 75 basis points (0.75%) would be the actual outcome, consistent with the Federal Open Market Committee's (FOMC) own projections. Stubborn inflation data and a mixed employment picture have led investors to back away from their earlier predictions of aggressive interest-rate reductions. We believe that any surprises from the Fed would more likely come in the form of fewer, not more, rate cuts this year.
- The Bank of Japan's recent rate hike is the first change since January 2016, and the first increase in 17 years. Among other developments, Japan ended its years-long policy of yield-curve control. Japanese interest rates remain extremely low compared to other countries, keeping the yen relatively weak. It probably will take a dramatic rise in Japanese interest rates and monetary policy easing from the Fed before the yen can appreciate meaningfully against the U.S. dollar. In the meantime, traders are betting on the yen weakening further. When and if those positions are unwound, the yen could rise quite sharply. While the catalyst required for such a shift has yet to materialize, further downside in the yen appears limited for now.
- Equity markets in many countries and regions have been pushing higher in the past six months, approaching or achieving new all-time highs in the process. The U.S. continues to be the leading economic engine for the world. Over the past 20 years, U.S. corporate earnings per share have nearly tripled, while the rest of the developed world's profits roughly doubled. Given this earnings performance, it is easy to see why investors have viewed U.S. equities as the "best game in town."
- Forward-looking earnings estimates have risen since the start of 2023, but the 9.1% gain in forward earnings explains only a small portion of the 36.9% price return in the S&P 500 Index over the same period. Multiples have jumped, too, from 16.6 times earnings at the end of December 2022 to 21.0 times at the end of March 2024. While the price-to-earnings ratio exceeded the current level for much of 2020 and 2021, these years were the highest point for earnings multiples since late 1990s/early 2000s.
- Broadly speaking, we think U.S. Treasurys are fairly valued. But heavy bond issuance, and the possibility that investors will begin to demand a positive term premium, suggest that bond yields will remain at elevated levels, even as short-term rates begin to fall. We forecast a steeper yield curve, in which short-term rates fall relative to long-term rates. Credit spreads also remain tight, reflecting investors' optimism that economic growth will continue unabated. Spreads on both investment-grade and high-yield bonds remain close to their historic lows. Investors may not be irrationally exuberant, but they are complacent.

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

Glossary

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.

Term premium is the additional yield that investors demand to hold longer-duration securities.

Important information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Positioning and holdings are subject to change. All information as of the date indicated. There are risks involved with investing, including possible loss of principal. This information should not be relied upon by the reader as research or investment advice, (unless you have otherwise separately entered into a written agreement with SEI for the provision of investment advice) nor should it be construed as a recommendation to purchase or sell a security, including futures contracts. The reader should consult with their financial professional for more information.

Statements that are not factual in nature, including opinions, projections and estimates, assume certain economic conditions and industry developments and constitute only current opinions that are subject to change without notice. Nothing herein is intended to be a forecast of future events, or a guarantee of future results.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties, which in certain cases have not been updated through the date hereof. While such sources are believed to be reliable, neither SEI nor its affiliates assumes any responsibility for the accuracy or completeness of such information and such information has not been independently verified by SEI.

There are risks involved with investing, including loss of principal. The value of an investment and any income from it can go down as well as up. Investors may get back less than the original amount invested. Returns may increase or decrease as a result of currency fluctuations. Past performance is not a reliable indicator of future results. Investment may not be suitable for everyone.

Diversification does not ensure a profit or guarantee against a loss. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Narrowly focused investments and smaller companies typically exhibit higher volatility. Bonds and bond funds will decrease in value as interest rates rise. High-yield bonds involve greater risks of default or downgrade and are more volatile than investment-grade securities, due to the speculative nature of their investments.

Index returns are for illustrative purposes only and do not represent actual portfolio performance. Index returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index.

This material is not directed to any persons where (by reason of that person's nationality, residence or otherwise) the publication or availability of this material is prohibited. Persons in respect of whom such prohibitions apply must not rely on this information in any respect whatsoever.

The information contained herein is for general and educational information purposes only and is not intended to constitute legal, tax, accounting, securities, research or investment advice regarding the strategies or any security in particular, nor an opinion regarding the appropriateness of any investment. This information should not be construed as a recommendation to purchase or sell a security, derivative or futures contract. You should not act or rely on the information contained herein without obtaining specific legal, tax, accounting and investment advice from an investment professional.

SEI sources data directly from FactSet, Lipper, and BlackRock unless otherwise stated.

Information provided by SEI Investments Management Corporation, a wholly owned subsidiary of SEI Investments Company (SEI). They should not be construed as investment advice.

Information provided in Canada by SEI Investments Canada Company, the Manager of the SEI Funds in Canada.

Information issued in the UK by SEI Investments (Europe) Limited, 1st Floor, Alphabeta, 14-18 Finsbury Square, London EC2A 1BR which is authorised and regulated by the Financial Conduct Authority. Investments in SEI Funds are generally medium- to long-term investments.

This document has not been registered by the Registrar of Companies in Hong Kong. In addition, this document may not be issued or possessed for the purposes of issue, whether in Hong Kong or elsewhere, and the Shares may not be disposed of to any person unless such person is outside Hong Kong, such person is a “professional investor” as defined in the Ordinance and any rules made under the Ordinance or as otherwise may be permitted by the Ordinance.

The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

This information is made available in Latin America and the Middle East FOR PROFESSIONAL (non-retail) USE ONLY by SIEL.

Any questions you may have in relation to its contents should solely be directed to your Distributor. If you do not know who your Distributor is, then you cannot rely on any part of this document in any respect whatsoever.

Issued in South Africa by SEI Investment (South Africa) (Pty) Limited FSP No. 13186 which is a financial services provider authorised and regulated by the Financial Sector Conduct Authority (FSCA). Registered office: 3 Melrose Boulevard, 1st Floor, Melrose Arch 2196, Johannesburg, South Africa.

This material is intended for information purposes only and the information in it does not constitute financial advice as contemplated in terms of the Financial Advisory and Intermediary Services Act.

SIEL is not licensed under Israel’s Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755-1995 (the “Advice Law”) and does not carry insurance pursuant to the Advice Law. No action has been or will be taken in Israel that would permit a public offering or distribution of the SEI Funds mentioned in this email to the public in Israel. This document and any of the SEI Funds mentioned herein have not been approved by the Israeli Securities Authority (the “ISA”).

SEI Investments Canada Company, a wholly owned subsidiary of SEI Investments Company, is the Manager of the SEI Funds in Canada.

The information contained herein is for general and educational information purposes only and is not intended to constitute legal, tax, accounting, securities, research or investment advice regarding the Funds or any security in particular, nor an opinion regarding the appropriateness of any investment. This commentary has been provided by SEI Investments Management Corporation (“SIMC”), a U.S. affiliate of SEI Investments Canada Company. SIMC is not registered in any capacity with any Canadian regulator, nor is the author, and the information contained herein is for general information purposes only and is not intended to constitute legal, tax, accounting, securities, or investment advice, nor an opinion regarding the appropriateness of any investment. You should not act or rely on the information contained herein without obtaining specific legal, tax, accounting and investment advice from qualified professionals. This information should not be construed as a recommendation to purchase or sell a security, derivative or futures contract. You should not act or rely on the information contained herein without obtaining specific legal, tax, accounting and investment advice from an investment professional. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. There is no assurance as of the date of this material that the securities mentioned remain in or out of the SEI Funds.