DECEMBER 2023

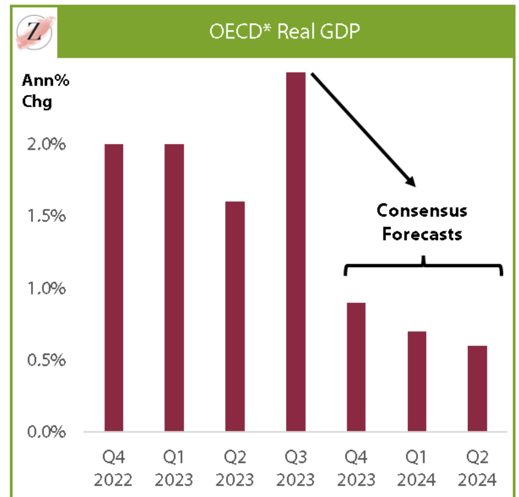
Zevin Asset Management
INVESTMENT UPDATE

A Silver Lining to the 2024 Outlook

PHILIP HERGEL, SENIOR QUANTITATIVE ANALYST

What a difference a year makes! According to the Merriam-Webster dictionary, the word of the year for 2023 was "authentic," which is certainly a major improvement over "gaslighting," which was the 2022 word of the year. Transitioning from the negativity of "gaslighting" in 2022 to the positivity of "authentic" in 2023 was mirrored in the global economy and financial markets. 2022 was best characterized by relentless and painful interest rate increases, stubbornly high inflation, and a global sell-off in equity markets with the All-Country World Index (ACWI) finishing 2022 down almost 20%. In 2023, central banks have paused and will soon be reducing borrowing costs, inflation worldwide is in decline, and equities have performed quite well for most of the year. But it's probably too soon to declare the global economy is "out of the woods" just yet. The likelihood of a global recession in 2024 remains elevated.

Chart 1

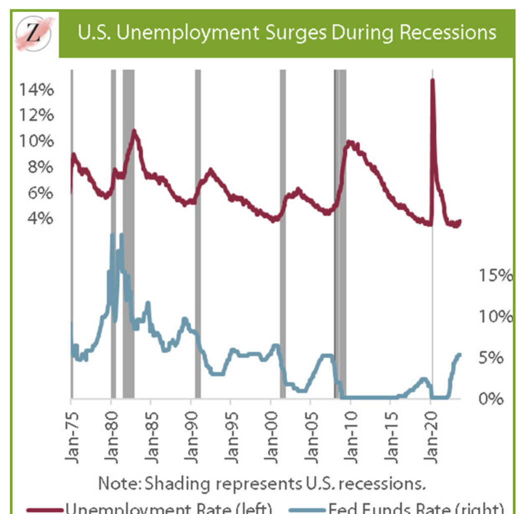


* Organization for Economic Co-operation and Development.

BOOTS OR HEARTS

The full impact of previous interest rate hikes is yet to be reflected in current economic conditions. It can take years until economies fully react to rising interest rates. For example, in the previous two global tightening cycles in 1999 and 2007, it took five and seven quarters, respectively, until global GDP began to stabilize once central banks stopped hiking interest rates and several more quarters after that until unemployment stopped climbing. All that to say, further economic weakness in 2024 is likely and is expected by professional forecasters as shown in **Chart 1**.

Chart 2



Note: Shading represents U.S. recessions.

The risk to economies around the world as we start 2024 is that there is considerably more economic slowdown already baked in due to the massive increases in interest rates in 2022 and 2023. When recessions hit, economies typically deteriorate very quickly. In fact, since 1970 there have been seven U.S. recessions. Each was preceded by severe tightening in monetary policy and the unemployment rate didn't simply rise in each episode, it surged as shown in **Chart 2**. The U.S. economy is already showing signs of slowing and the labor market, which is a lagging indicator, has also started to weaken with job openings and temporary employment in decline while the unemployment rate has started to tick up from a 70-year low. As the The Tragically Hip song "Boots or Hearts" goes: "See, when it starts to fall apart, man it really falls apart. Like boots or hearts, oh, when they start. They really fall apart." So, if the U.S. economy enters into recession, history suggests activity would deteriorate abruptly. And when the U.S. sneezes, the rest of the world catches a cold, meaning we should expect any weakness in the U.S. economy to have negative knock-on effects elsewhere.

Further contributing to increasing risks of a global recession in 2024 is the reversal of pandemic-era fiscal stimulus spending, rising energy costs should the Israeli/Hamas war spread throughout the region, and continued volatility in China's real estate market and broader economy. In fact, 41% of economies covered by Bloomberg Economics were contracting in the third quarter of 2023. In the U.S., there is also the unique situation of the resumption of student debt repayments contributing to weakening consumption, not to mention an unpredictable but likely very messy general election. So, 2024 might be a case of recession delayed but not avoided.

THE SILVER LINING: MADE IN U.S.A.

There is, however, one potential source of strength in the U.S. economy which may prop up growth and might even prevent the economy from entering a recession and dragging the global economy down with it: the manufacturing sector. For decades, the U.S. economy has trended towards a service economy while abandoning manufacturing. In the 1950s employment in factories made up almost 40% of the total U.S. workforce. As of November 2023, that number has dwindled to only 8.3% as relative costs of production outside the U.S. were too enticing to ignore.

But then something occurred — Donald Trump was elected president and while China's unfair trade practices were already known, he pushed hard by imposing severe protectionist policies through punitive tariffs on imported goods. Donald Trump put in motion the reversal of U.S. manufacturing off-shoring. Meanwhile, the onset of the COVID-19 pandemic exposed global supply-chain vulnerabilities, raising the appeal of "nearshoring" for economic reasons. Under President Biden, the manufacturing renaissance has accelerated with the swift passage of the Creating Helpful Incentives to Produce Semiconductors (CHIPS) and Inflation Reduction (IRA) acts. These were designed to support and grow domestic production of semiconductors as well as green products such as electric vehicles, batteries, and renewable energy products such as solar panels and wind turbines. Through tax incentives and subsidies, these packages are encouraging the expansion of domestic manufacturing capacity.

The clear result so far of America's manufacturing rebirth is that construction of U.S. domestic manufacturing facilities is surging **(Chart 3, top panel)** and the contribution of manufacturing to the overall economy is already beginning to reverse the downtrend **(Chart 3, bottom panel)**. Further, these plans provide incentives for up to ten years, so one can expect growth in the manufacturing sector to be long-lasting. The McKinsey Consulting group published research recently estimating the new "made in U.S.A." trend will boost GDP by 15% over the next decade. Furthermore, the manufacturing jobs created, while fewer in number due to factory automation, are high-skilled, tech-heavy, and high-paying. This manufacturing renaissance will also lead to secondary and tertiary employment opportunities in shipping, logistics, suppliers, and related service industries needed to support manufacturing and will bolster consumption and the overall economy for years to come.

One intended consequence of creating high-tech employment opportunities in the manufacturing industry is to reduce inflationary pressures through increased productivity. The Federal Reserve and other global central banks have had much success with taming inflation by increasing interest rates. Mending global supply chain disruptions also contributed to the positive trend in inflation. But those two disinflationary forces are largely in the past. Going forward, productivity gains will be necessary to finish the last mile in the fight to return inflation to target levels. Here too, there is evidence of preliminary success, with labor productivity growing strongly, which typically coincides with falling inflation **(Chart 4)**.

Chart 3

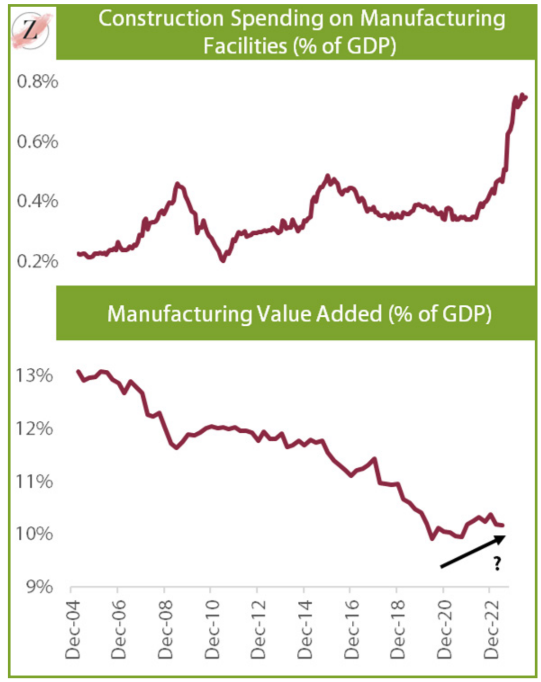
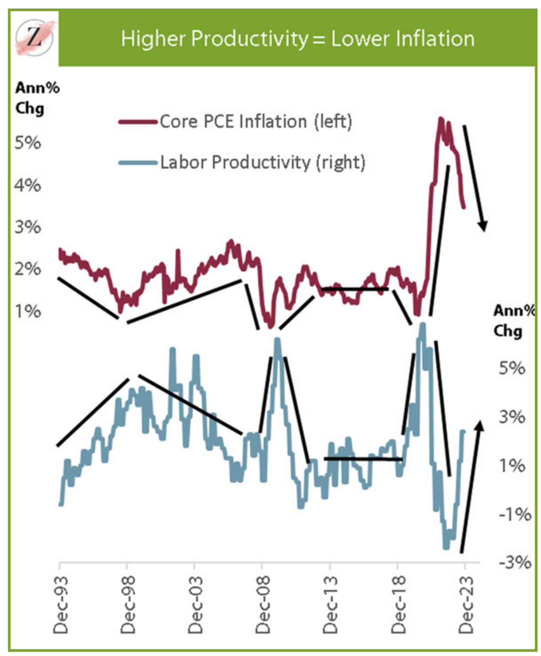


Chart 4



BOTTOM LINE

While a global recession in 2024 is likely, it is possible the rebirth of manufacturing results in the U.S. avoiding an outright technical recession and also manages to prop up foreign economies. However, the global economy will decelerate in response to the punishing tightening of monetary policy since early 2022. Fixed-income assets should perform well in this environment as inflation and economies cool down. Given the focus on U.S. manufacturing rebuild, some industries will benefit from increased spending in the industrial and material sectors.