Sunpointe Investments

ILLUMINATIONS

Economic Review

May 2024

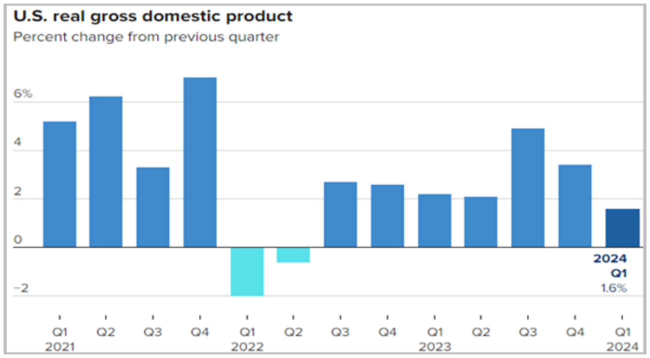
Is the U.S. economy finally starting to slow?

U.S. economic growth slowed in Q1 to a 1.6% annualized rate, below the consensus 2.4% estimate and the higher growth rates posted during the second half of 2023. Consumer spending increased 2.5% in the period, down from a 3.3% gain in Q4 and below expectations. Fixed investment and government spending at the state and local levels helped keep GDP positive for the quarter, while a decline in private inventory investment and an increase in imports subtracted. Net exports subtracted 0.86 percentage points from the growth rate while consumer spending contributed 1.68 percentage points.

The April employment report came in well below expectations with the U.S. economy adding only 175,000 new jobs – the consensus estimate was 240,000. Further, the previous two months were revised lower. The unemployment rate jumped to 3.9% and average hourly earnings were 3.9% higher year-over-year (Y/Y). The growth in average hourly earnings was below expectations and perhaps a sign of cooling inflation. This report, combined with the recent GDP reading, portrays a softening environment where growth appears to be finally slowing. Although wage pressure cooled a bit in April, the personal consumption expenditures price index, a key inflation variable for the Fed, rose at a 3.4% annualized pace in Q1 2024, its biggest gain in a year and up from 1.8% in Q4 2023. Excluding food and energy, core PCE rose at a 3.7% rate, well above the Fed's 2% target. April's CPI report showed some easing of inflation, but prices still rose 3.4% Y/Y. Core CPI increased 3.6% Y/Y, which is well above the Fed's target but is the lowest reading since April 2021.

Inflation still running hot, but are Fed rate cuts back on the table?

Slowing growth and hotter than expected inflation present a further conundrum for the Fed in terms of monetary policy. While the Fed has attempted to tighten monetary policy over the past two years, the surge in fiscal spending has provided a counterbalance. However, inflation has remained sticky. We believe Fed monetary policy is fluid and data dependent. Markets are currently pricing in two rate cuts in 2024 starting at the September meeting. Any unexpected inflation readings could result in a significant change to the Fed's timeline for cutting rates.



Source: CNBC, U.S. Bureau of Labor Statistics

ISM PMIs fall into contraction territory, Q1 earnings beating expectations again!

The ISM manufacturing index declined to 49.2 in April, below consensus expectations. The underlying composition was mixed, with decreases in the new orders and production components but an increase in the employment component. The ISM Services PMI fell into contraction territory last month with a reading of 49.4, down from 51.4 in March. Production, new orders, and employment all softened in April. Readings above 50 indicate expansion.

Through 80% of the S&P 500 Q1 earnings season, U.S. corporations have once again outperformed expectations. Aggregate EPS growth in the S&P 500 has been 5.0%, ahead of the 3.4% estimate at the start of the quarter. 77% of S&P 500 companies have reported a positive EPS surprise and 61% of companies have reported a positive revenue surprise. Eight of the eleven sectors are reporting Y/Y EPS growth, led by the Communication Services, Utilities, Consumer Discretionary, and IT sectors. On the other hand, three sectors are reporting a Y/Y decline in earnings (Energy, Health Care, and Materials). Earnings are forecast to improve throughout 2024 with full year estimates sitting at +11% and are forecast to grow 9.5% in 2025.

Eurozone growth/activity rebounds, ECB looks poised to start cutting rates!

In the eurozone, Q1 GDP growth of 0.3% quarter-over-quarter was above expectations. Business activity in the euro area grew at the fastest rate in nearly a year in April. The improvement indicates that the region continues to pull out of the recent downturn, but growth remains modest and not all sectors are participating in the rebound. Increasingly, robust service sector growth was accompanied by signs of a further moderation of the manufacturing downturn. The headline Composite PMI hit an 11-month high while the manufacturing PMI softened to a four-month low. Services continue to buoy the eurozone economy with expectations for another 0.3% expansion in Q2.

Source: HCOB, S&P Global PMI, Eurostat via S&P Global Market Intelligence.

Inflation in the eurozone eased to 2.4% in March, boosting expectations for interest rate cuts to begin in the summer. The core rate of inflation, excluding energy, food, alcohol, and tobacco, cooled from 3.1% to 2.9%, also below expectations. However, inflation in services remained stuck at 4% for a 5th straight month, pointing to continued pressure from wage growth.

Japan's economic picture remains uncertain; intervention necessary to stabilize the yen

Japan's core inflation slowed in March due to mild rises in food prices but remained well above the BOJ's 2% target. CPI rose 2.6% in March after increasing 2.8% in February. Core CPI rose 2.9%, marking the first time since November 2022 that metric fell below 3%. The BOJ seemed poised to increase rates with this string of higher inflation, but any declines could increase uncertainty. Interest rate differentials between the U.S. and Japan caused the yen to weaken to its lowest level since 1990 before BOJ intervention. The yen is likely to remain weak as long as the Fed holds rates steady.

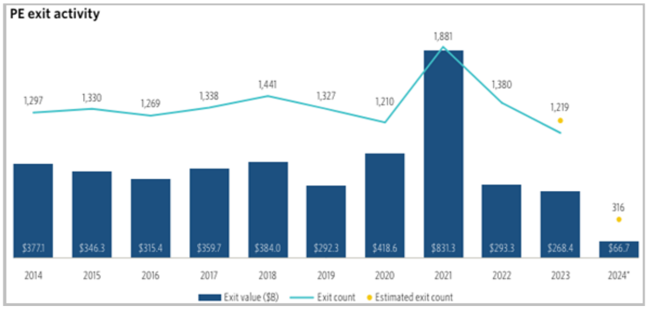
GDP surprises to the upside in the two largest EM countries

Growth in China surprisingly accelerated in Q1, driven by external demand. Q1 GDP surged 5.3%, above the 4.6% consensus expectation and the 5.2% expansion in Q4 2023. Export volume jumped 14% Y/Y in Q1, but property investments in the embattled real estate sector fell 9.5%. The PBOC has been providing significant stimulus and support for the Chinese economy over the past year to combat sluggish growth, deflation, and real estate woes. Industrial output for March grew 4.5% Y/Y, missing expectations of 6%. Retail sales grew 3.1% Y/Y, lower than expectations of 4.6%. Fixed asset investment grew 4.5% Y/Y over the first three months of 2024, versus expectations for a 4.1% rise.

Economic growth in India surpassed lofty expectations to end 2023. GDP jumped 8.4% in Q4, well ahead of expectations and the 7.6% rise reported in Q3. India is widely seen as an alternative to China for countries and companies looking to diversify supply chains, particularly as the relationship between the U.S. and China sours. Prime Minister Narendra Modi's government has been actively courting multi-national firms to set up factories in the country, as it spends billions to upgrade roads, ports, airports and railways.

PE exit activity remains very depressed

Private equity fundraising is coming off its three best years ever recorded. The overall PE fundraising environment has remained resilient in the face of headwinds that were expected to limit capital raised by sponsors, such as the denominator effect ballooning allocations to private markets and limited distributions to fuel new fundraises. A trend that has continued has been the increased time it takes to close a fund. To start the year, U.S. PE closed 63 funds on $76.8B in Q1 2024, consistent with 2023's pace. U.S. PE exit activity continues to be depressed, a trend that has persisted since the start of 2022. The unstable exit activity in Q1 2024 implies that PE exits are still finding a bottom and have yet to embark on a steady pace of recovery. GPs are being forced to hold on to portfolio companies for longer. Exit activity is crucial to the PE chain of capital formation and a leading indicator of industry growth because cash flows from exits recycle into fundraising that feeds into dry powder, fund deployment, and, most importantly, fund performance.



Source: Pitchbook