Beyond the boom: the hidden Realities of the US economy

As 2024 progresses, central banks globally are diverging in their monetary policies. The Federal Reserve is expected to maintain higher interest rates for longer. At the same time, the European Central Bank (ECB) and Bank of England (BoE) are anticipated to begin cutting rates by mid-2024 to support their slowing economies.

Despite market expectations for rate cuts, the US faces the challenge of funding its deficits and attracting international investors concerned about the US's growing national debt and dollar weaponization.

Maintaining investor confidence requires offering competitive yields on US bonds, complicating the Federal Reserve's task of balancing inflation control with economic growth and debt sustainability.

Federal Reserve's Stance

The Federal Reserve remains committed to lowering inflation to its 2% target. However, despite aggressive rate hikes, inflation remains stubbornly high at 3.5% yearly. This persistent inflation trend is not unique to the US; it is observed globally, with services inflation gaining momentum due to tight labor markets. According to JP Morgan's April Consumer Price Index report, high rents, food, and energy prices continue to weaken consumer purchasing power, ultimately driving inflation lower in the long run.

The bank predicts a global core inflation rate of around 3% for 2024. This scenario poses a significant challenge for central banks as they balance the need to control inflation without stifling economic growth.

I**mpact of Geopolitical Tensions**

Geopolitical tensions, notably the conflicts between Israel and Gaza and Russia and Ukraine, are complicating the global economic trajectory toward a 2% inflation target. These conflicts have heightened risks, disrupted trade routes, and increased shipping times, and fuel consumption by 42% (Economics Observatory). Egypt has threatened to reconsider its relations with Israel if military operations near Rafah escalate. Additionally, Houthi missile strikes in the Red Sea are forcing ships to take longer routes, further impacting global trade and inflation.

Record High Dow Jones

The Dow Jones Industrial Average reached 40,000 for the first time in history, signaling what appears to be a robust economic environment characterized by low unemployment and a strong job market. This milestone is often perceived as indicative of a healthy economy. However, underlying concerns suggest that this might be a partial picture.

Economic Concerns driven by recent market movements

Despite the Dow Jones reaching a new high, several indicators point to potential economic troubles. Notably, China and other central banks actively sell US treasuries and purchase gold, a traditional haven during economic instability.

US Tariffs on China

President Joe Biden has implemented comprehensive tariffs on Chinese imports, including electric vehicles, batteries, solar panels, steel, and aluminum.

In response, China has been selling US debt, adding pressure to the US economy, which must sell approximately $1 trillion annually until 2030.

Debt and Interest Rates

The US's relationships with countries like China and Russia complicate the US's ability to sell its debt. As a result, interest rates may need to stay at current levels or slightly increase to attract buyers.

Maintaining or slightly increasing interest rates will affect borrowing costs for the government and consumers, potentially leading to higher mortgage, credit card, auto loan interest rates.

Gold as a Safe Haven

Gold prices have historically surged during periods of economic uncertainty. For example, they more than doubled during the 2008 financial crisis and saw significant increases in the 1970s.

Banking Sector Vulnerability

Economic pressures could lead to a significant increase in bank failures. Smaller banks are particularly vulnerable and may face the need to merge or risk failure.

Following the failures of Silicon Valley Bank, First Republic, Citizen's Bank, Heartland Tri-State Bank, and Signature Bank, many banks are experiencing heightened financial stress.

Government Debt and Deficits

Next year, $8.9 trillion of government debt will mature, requiring refinancing. Persistent budget deficits and reduced foreign investment in US bonds exacerbate this challenge.

Federal Reserve Lending and Banking Sector

The banking sector in the US has shown significant liquidity needs, with approximately 1,800 banks borrowing a total of $161.5 billion from the Federal Reserve's Bank Term Funding Program (BTFP). This substantial borrowing highlights the stress within the banking system and the reliance on the Federal Reserve for liquidity support.

Bank Mergers and Consolidation

The economic environment is likely to result in increased bank mergers. Estimates suggest that 500 banks may consolidate to enhance stability and efficiency. This trend toward consolidation is driven by the need to reduce operational costs and improve financial stability in a challenging economic environment.

Starwood Property Trust

Starwood Property Trust, led by Barry Sternlicht, is facing significant liquidity challenges. The company has been rapidly burning through its cash reserves, reflecting broader stress in commercial real estate.

Conclusion

We expected US interest rates to stay elevated to attract US Treasury buyers, reflecting a complicated scenario influenced by Federal Reserve policies and economic uncertainties. The inverted yield curve signals investor expectations of lower future growth, causing higher short-term rates than long-term ones.

This situation may persist as the Treasury ensures demand for its securities amidst strained consumer spending, high default rates among consumers, and risks of further American involvement in the geopolitical front. We forecast slight increases in both the 2-year and 10-year rates in an inverted tandem before the Fed eases rates in 2025.

Nabta Advisory Investment Recommendations:

We recommend focusing on exchange-traded funds (ETFs) for a diversified and strategic approach to investing. ETFs offer a way to build a resilient portfolio that can withstand economic fluctuations and inflation with lower expense ratios.,

Precious Metals: Investing in physical gold through the VanEck Gold Miners ETF (GDX) for example is advisable. Gold has historically been a haven asset during economic uncertainties, providing a hedge against economic uncertainty and a depreciation on the US dollar.

Water Resources: The Invesco Water Resources ETF (PHO) is recommended to capitalize on the essential need for water and its stable demand. Water is a critical resource with growing importance due to population growth and climate change.

Agricultural: The VanEck Agribusiness ETF (MOO) focuses on agricultural businesses, offering exposure to a sector fundamental to human survival. Agriculture remains a stable investment due to the constant demand for food and agricultural products.

For more detailed information or specific data points, don't hesitate to contact us at insights@nabtaadvisory.com.

Wishing you a prosperous remainder of 2024.

Talal Al Ghalib

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