An Update from Our CIOs: How Durable Is the Economy?

Our CIOs discuss why the expansion is likely to stay durable even as it slows, why a sustained expansion with central bank easing isn't as good for assets as it might seem, and the opportunities they see.

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With growth moderating, how durable is the economy? When we look at the mechanics of the expansion—examining who is spending money, what is driving their spending, and how the spending is being financed—we see an expansion that is likely to be unusually durable. There isn't much spending that is vulnerable to rapid reversal (for example, the way rate rises can quickly cut off borrowing), and meaningful spending is driven by longer-term considerations. Growth looks likely to keep bumping along at roughly the pace supply can keep up with, with pockets of weakness less likely to spiral. This is reinforced by central banks' relatively unusual policy approach: beginning to ease based on forward projections when inflation is still falling but remains above their targets.

But for investors, easy policy and moderate growth and inflation are probably not good enough. This type of conditions is usually great, but financial asset returns are driven by how the future evolves relative to what is discounted in the price. Equity valuations are already accounting for both a durable expansion and a profitable AI revolution. The yield curve has inverted to a degree typically only seen in recessions, pricing that central banks will ease a meaningful amount; easing more slowly than discounted will be an effective tightening, creating a bearish ripple effect on all future cash flows. While the labor market and industrial base are less tight than they were at the peak of post-COVID supply constraints, the durability of the expansion will limit how much and how fast inflation can keep drifting down to achieve targets. Over time, we suspect central banks will find it very challenging to provide as much stimulation as is already priced into rate markets, and the cost of capital will need to adjust. A moderate expansion is also likely not to feel satisfying to voters expressing dissatisfaction with incumbents across much of the developed world.

Equities look on the margin more attractive than bonds, but the world is already over-positioned in equities, effectively collecting a smaller risk premium while exposed to the risk of a surprise recession or stickier-than-expected inflation. Concentrated portfolios imply that incremental strategic shifts can have outsize impacts: for example, adding investments that can do well if the economic cycle turns unfavorably, shifting investments to other parts of the world where the cycle is less synchronized with the US/Europe, and shifting to earn the equity risk premium in more resilient ways.

We continue to see opportunities and mispricings between countries' assets and currencies, as well as within the equity market. In the equity market, cross-company correlations have been unusually low, and we continue to shift our risk-taking away from equity markets in aggregate to more individual company views, reflective of how we expect the environment will influence individual companies based on their circumstances (e.g., demand they're exposed to, competitive position, debt and balance sheet health, etc.).

Below, we share some of our thinking around (1) how we're processing whether this expansion is likely to remain durable, (2) how we see the investment landscape in this environment, and (3) where we see alpha opportunities.

The Economic Backdrop: How Durable Is the Expansion?

In processing the economic backdrop, we find it useful to examine the mechanics of the expansion: who is spending money in the economy, what is driving their spending, and how that spending is being financed. Spending in the economy can come from one of three places: income growth, new borrowing, or drawing down savings. The three big spenders—households, businesses, and the government—tend to use a different mix of these sources of funds and are influenced by different factors in choosing whether to spend.

Households spend mostly from income, and this is how most of the spending in today's economy is occurring. Income growth tends to be self-reinforcing, as new spending becomes new income, fueling further spending growth. This process is humming along, with ample momentum to keep the economic expansion going at a moderate pace. Household borrowing to spend in excess of incomes typically adds fuel to the fire but also makes an expansion vulnerable to reversal, as interest rate rises will make borrowing less attractive and raise debt burdens. Today, households are not reliant on debt growth to spend. The small share of households with consumer debts are being crushed by high rates, but they are a minority. Overall, balance sheets are as healthy as they have been in decades, and spending is being financed from incomes and cash on hand.

But borrowing is certainly fueling spending well above incomes; it is just coming in the form of **government** borrowing, with the largest fiscal deficit we've experienced outside of wartime. Government borrowing, unlike private sector borrowing, is subject to political choices and not directly sensitive to what the interest rate is. It's hard to cut off borrowing without political change, and it looks likely that government borrowing and spending will remain high no matter who wins the US November election; there is even a chance of renewed fiscal stimulus providing a jolt of adrenaline in 2025. Other countries have been more cautious, in part because they have more fear of the market disciplining high deficit spending (as we saw briefly in the UK in 2022). But as elections throughout the developed world have signaled voters' frustration with the status quo and incumbents, pressure to keep borrowing and spending will remain high. The structural backdrop of geopolitical competition with China, climate change and energy security challenges, and questions of technological leadership will keep pressure on governments globally to engage in expensive industrial policies. The US is least likely to face an endgame to rising government debt levels anytime soon due to "pent-up demand" for bonds after years of QE, low competition from private sector borrowing, and the enduring role of the US dollar.

Businesses are also behaving unusually this cycle. They typically borrow to make investments in response to rising demand. This cycle, they are not borrowing much—which means they are not sensitive to what the interest rate is—but are spending down their large cash flows and piles of accumulated cash. Spending down savings is typically short-lived, but businesses today are unusually willing to draw down their piles of cash because they see existential risks that require spending to mitigate them or turn them into opportunities: AI, remilitarization, the energy transition, energy security, and the rebuilding of the industrial base to be less reliant on China. The government is in many cases supporting these types of spending through subsidies and incentives. Not only are businesses not reliant on borrowing to finance these types of spending, they are also not driven by rising consumer demand—these types of spending are meant to mitigate risks or prepare the ground for eventual demand that may be many years away, making them quite durable to the inevitable ups and downs in sentiment.

These drivers of spending and how they're being financed add up to a late-cycle environment that looks unusually durable. By this, we mean the economy can keep bumping along at roughly the pace supply can maintain, with pockets of weakness less likely to spiral. The nature of the spending and how it's financed are such that creating self-sustaining downward momentum would likely take a meaningful shock or a meaningful tightening in response to sticky inflation—which central banks will gradually become less tolerant toward. In the near term, the durability of the cycle is reinforced by central banks' policy approach, which is to ease more preemptively than we've seen in the past, with inflation still above target. Central banks assess the current level of rates as restrictive—despite the outcomes they have produced so far—so with inflation moderating from prior bottlenecks and growth having slowed a touch to around potential, we're starting to see easing. Our examination suggests that the Fed and other central banks looking at the same circumstances in past cycles would have had less of a bias to ease into these conditions.

How does it end? As more time passes with growth around potential at these rate levels, it becomes harder to believe that this level of rates is unsustainably restrictive. In the meantime, the easing underway will only increase the odds that inflation remains higher than its target for an extended period. The labor market and industrial base are less tight than they were at the peak of post-COVID supply constraints but remain relatively tight, and the continued ability and desire to spend by households, businesses, and the government will create ongoing gradual pressure. **Over time, we suspect central banks will find it very challenging to provide as much stimulation as is already priced into rate markets, and the cost of capital will need to adjust** to be high enough to compensate for structurally higher fiscal borrowing and especially durable private sector demand, such that small increases in the cost of capital probably won't do much to slow the economy.

One release valve might be the emergence of deflationary forces from the adoption of AI. Currently, AI spending in the near term is particularly inflationary because it is building up capacity without line of sight to the productivity payoffs, but the deflationary potential is massive—and could hit fast. There is potential for even larger and faster impacts than we experienced in manufacturing over the course of the 1990s and 2000s, when about 10% of the US workforce was displaced out of manufacturing sectors through the processes of globalization and industrial automation—which kept inflation low, led to rising inequality, supported corporate profits, and contributed to political and social shifts, including rising populism and a broad rethinking of trade and economic policies. An even bigger event is likely ahead of us.

Investing in This Environment

We break down market returns into the return of cash, the return of assets relative to cash (i.e., accruing risk premiums holding assets), and alpha through timing the markets. Today, holding cash is relatively attractive and, on its own, can get a long way toward return goals. An environment where economic conditions are moving toward equilibrium and central banks are easing is usually a great one for earning risk premiums above cash, but right now, financial assets look only moderately attractive. Past asset returns have been great—engineered by central banks to be high following the financial crisis and supported more recently by AI enthusiasm—such that optimism about the future is already discounted. And if central banks ease just a bit less than is already priced in, this will trigger all future cash flows to reprice lower. Alpha is more important when risk premiums are squeezed, and we see a great environment for alpha precisely because risk premiums are not declining in synchronized ways globally.

Relative to holding cash, equities look better than bonds (where the repricing of the cost of capital is likely to hit most directly). But **the challenge with concentrating in stocks** is that a durable economic boom, while it's what we expect, is already priced in, as are future profits from AI advancements—leaving investors to collect a smaller risk premium while exposed to the risk of a surprise recession or stickier-than-expected inflation. And after a long stretch of equity outperformance, allocations to equity and equity-like risk have never been higher, and many portfolios are more illiquid than ever. While every investor has unique constraints, circumstances, and vulnerabilities, there are incremental moves that investors can make to improve resilience and mitigate equity concentration: (1) add investments that can do well if the economic cycle turns unfavorably, (2) shift investments to other parts of the world with differentiated economic cycles, and (3) earn the equity risk premium in a more resilient way.

In terms of protection against the economic cycle turning, investors had meaningfully reduced their bond holdings in an environment where, with rates at zero, bonds couldn't play their traditional diversifying role of rallying when central banks eased into a surprise economic downturn. Now bonds can play this role again. Bonds look mediocre relative to cash, but they are a means of locking in the expected moderate cash rates that are likely to transpire with an option value if growth surprises on the downside, leading to easing. Inflation-linked bonds can play the same role while earning the actual inflation rate (which could easily end up higher than the moderate expectations embedded into nominal bonds). And with a little bit of alpha enhancement on top, returns can reach tolerable levels. Portfolio resilience is especially enhanced if the alpha isn't achieved by holding credit exposure, which exacerbates the concentration to corporate risk already in most portfolios.

In terms of shifting to investments exposed to differentiated economic cycles, we continue to find opportunities in the large Asian markets that have independent central banks and are experiencing very different conditions than those in the US or in Europe. A less synchronized economic cycle is a fundamental basis to diversify exposures. It is surprising to many that a balanced mix of Chinese assets, increasingly excluded from most portfolios, has been performing well—despite poor Chinese economic conditions. Even with what we expect are years of deleveraging and mediocre economic outcomes ahead in China, the Chinese yield curve is not inverted, equities are cheap, and the incentive to remain easy to support assets relative to cash will be in place in China for years. Regulatory, reputational, and geopolitical risks of investing directly in China can be mitigated by focusing on other diversifying Asian economies.

In terms of earning equity risk premiums more efficiently, the environment of low correlations across stocks in the public markets and illiquidity (e.g., challenging exits) in private equity and venture is an opportunity to revisit the nature of the equity risk premiums being earned in a portfolio, including the costs and benefits of managing relative to a benchmark and how closely one hews to it. We believe it is possible to build more reliable equity allocations and to reduce the traditional vulnerabilities of equities through thoughtful security selection and hedges.

Where We See Alpha Opportunities

Tactically, many of our strongest views are differentials. The decline in inflation is not happening in a synchronized way, and central bankers are able to pursue their own paths, creating opportunities in currency and bond markets. There are also meaningful cross-asset opportunities to capture the differentiation in the economic cycle—for example, in countries like Japan. In the equity markets, correlations across stocks are low, reflecting large divergences across companies exposed to different aspects of the economic machine. Companies we see as likely to outperform include AI beneficiaries with "winner takes all" dynamics, value laggards with large risk premiums and pressure for the gap to close, and past underperformers where moves look overdone.

These dynamics tie directly to key questions we're wrestling with in our research process. These include: how AI advancements are likely to hit companies and the economy at large; where inflation is likely to settle and shifting central bank reaction functions around the world; how to accrue risk premiums most efficiently in an environment of generally squeezed risk premiums; and how the political changes we're seeing around the world in recent elections are likely to flow through to changes in sources of uses of funds and ultimately economic and market outcomes.

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