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What to watch: The Fed's bumpy last mile, it's Bank of Japan's time and why the AI rally is a cash-rich version of the dotcom bubble

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Executive summary

This week, we look at three critical issues:

- **The Fed's (bumpy) last mile.** February CPI data show that US inflationary pressures have not dissipated yet. Year-on-year CPI inflation has now been stuck above the 3% threshold since June 2023, with services inflation remaining stubbornly high. Easing financial and credit conditions, as well as the accelerating monetary base, suggest that the Fed should remain cautious in an economy still running close to full capacity, with a still tight labor market. We now expect the Fed to pivot in July rather than June but continue to see four 25bps rate cuts by the end of the year.

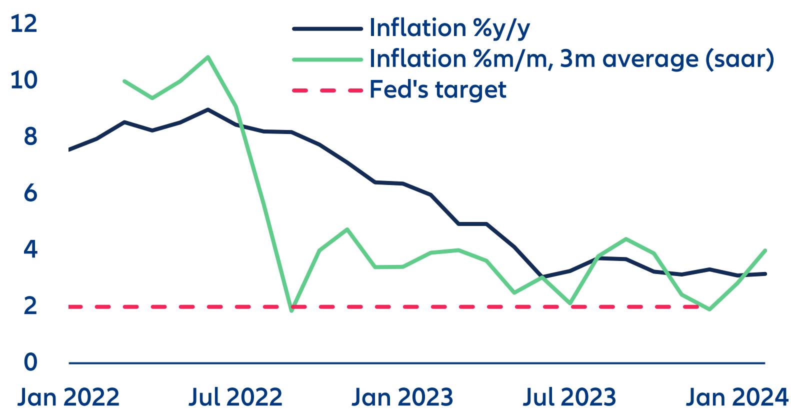
- **Bank of Japan: the art of going against the tide.** While most central banks are preparing to cut interest rates, the Bank of Japan (BOJ) will soon hike, ending nearly a decade of negative interest rate policy. While markets increasingly expect the first hike since 2007 at the 18-19 March meeting, we think the BOJ will only increase its policy rate to 0.1% at the 25-26 April policy meeting instead, when it also releases new growth and inflation forecasts. The BOJ will however maintain an accommodative stance, implying manageable impacts on Japan and the rest of the world. The US, France and Australia have been the top destinations for Japanese investors in overseas debt in the past years, but sovereign bonds in Ireland and the Netherlands seem the most vulnerable to the risk of Japanese investors pulling funds out. We expect Japan's GDP growth at +0.6% in 2024 and +1.0% in 2025, and inflation at 2.4% in 2024 and 1.6% in 2025.

- **US equity markets: dotcom déjà vu?** The exponential rise of US tech stocks is raising concerns of a repeat of the dotcom bubble. But today's tech companies have significantly stronger balance sheets, benefiting from record growth in profits and strong cash reserves. They have also adeptly navigated the rising interest rate environment – a feat given the sector's historical sensitivity to interest rates. At the same time, today's price-to-earnings ratios are also significantly lower than the ~50x PE ratios that characterized the dotcom bubble. This suggests that the current market enthusiasm is nowhere close to the fervor of the late 1990s and early 2000s. In this context, we continue to expect US equity returns at around 10% in 2024, followed by a cool-off towards 7% in 2025.

The Fed's (bumpy) last mile

The hot February CPI report confirms that US inflationary pressures have not dissipated yet. February CPI inflation came out a bit hotter than expected by the market consensus (+3.2% y/y and +0.4% m/m, +5.4% m/m annualized). This followed a January reading that already dashed hopes for a near-term normalization of inflation close to the Fed's 2% target. Year-on-year CPI inflation has now been stuck above the 3% threshold since June 2023, while the three-month average of sequential month-on-month readings has accelerated to 4% (Figure 1). At the sectoral level, goods and food inflation have fully normalized to the pre-pandemic norm since 2023 (though m/m goods inflation returned to positive territory), but services inflation remains stubbornly higher. In particular, shelter inflation has contributed to 2.1pps of headline inflation on average over the past three months, while services excluding shelter contributed 0.9pp.

Figure 1: US CPI inflation



Sources: LSEG Datastream, Allianz Research

Easing financial and credit conditions, as well as the accelerating monetary base, warrant caution for the Fed in an economy still close to full capacity. As we have highlighted previously[1], the buoyancy of financial markets could support domestic demand and reignite inflationary pressures this year, given a still tight labor market. Besides, the credit cycle also seems to be turning up: According to the Q4 2023 Senior Loan Officer Opinion Survey, the net percentage of senior loan officers tightening lending standards is decreasing, though it remains elevated. Meanwhile, house prices are recovering. In this context, the FOMC is certainly not very pleased to see that the monetary base (M0 aggregate, the sum of currency) is picking up speed despite the ongoing reduction of its securities holdings (Figure 2)[2].

Figure 2: Fed securities holdings & monetary base (% y/y)

Sources: LSEG Datastream, Allianz Research

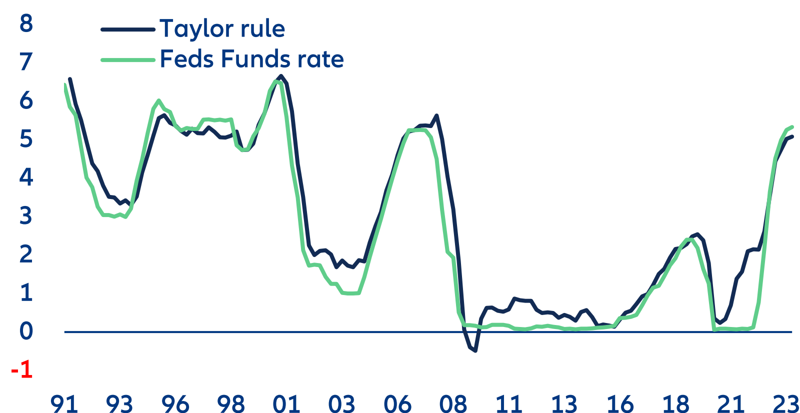
[1] *What to watch I January 26, 2024 (allianz.com)*

[2] *With the Fed gone, Treasuries issuances are being increasingly purchased by money market funds (MMFs), driving down the usage of the reserve repo facility. In contrast, banks' reserve balances at the Fed are increasing, pushing up M0.*

We now expect the Fed to pivot in July rather than June. But it will still deliver four 25bps cuts by the end of the year. As re-affirmed by FOMC members, the Fed's interest rate outlook remains highly conditional on the trajectory of inflation, though they will not wait for inflation to reach 2% before pivoting. As Chair Powell stated during his January press conference, the FOMC needs "a couple of 'good' inflation prints" before being convinced. Arguably, after the bad January and February reports, rate cuts in March and even in May are ruled out. Better inflation data in the coming months could convince the FOMC to pivot in June. However, we now think a July cut is slightly more likely.

Technical and economic factors also favor a later pivot. First, cutting in July would allow the Fed to cut by 25bps in each of the remaining meetings of the year (July, September, November and December), i.e., 100bps in total – close to its December 2023 projections (75bps) – without interrupting its easing cycle in one meeting. Second, even if inflation fell quite rapidly from Q2 2024, a Taylor rule[3] shows that very little easing would be warranted anyway (Figure 3). If we assume that PCE inflation (the Fed's preferred inflation measure) fell rapidly to 2.2% y/y in Q2 2024 and 2% in Q3 (from an estimated 2.8% in Q1), and GDP growth dips below trend (around +1.5% annualized in both Q2 and Q3), the Taylor rule indicates a moderate 28bps cut between now and Q3. This strengthens the case for the Fed to be patient before starting to ease. Under these circumstances, if inflation continues to disappoint in Q2, the Fed will have to pivot later, possibly in September.

Figure 3: Fed Funds rate & Taylor rule (%)



Sources: LSEG Datastream, Allianz Research

Bank of Japan: the art of going against the tide

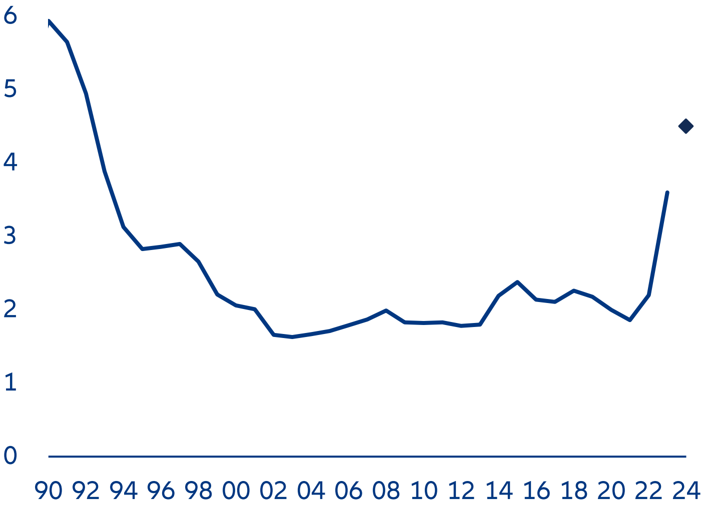
While most central banks are preparing to cut interest rates, the Bank of Japan (BOJ) will soon go in the other direction, ending nearly a decade of negative interest rate policy (NIRP). The question is, will it be in March or April? On the back of recent data releases and the ongoing annual wage negotiations (*shunto*), futures as of 12 March imply a 66% chance of a rate hike at the 18-19 March BOJ policy meeting, up from 41% a week earlier. But we think it is slightly more likely that the BOJ will instead stay on hold next week and provide the necessary signals to prepare for lift-off at the 25-26 April policy meeting, when it will also release new growth and inflation forecasts. Hiking after the start of a new fiscal year (which runs from 1 April to 31 March) would limit the risk of disruptions for financial institutions and allow time to see how companies adjust their prices. Moreover, by the April policy meeting, further data will be available to gauge the trend in prices and the impact of ongoing *shunto*, which Governor Ueda has indicated as "one major point" in deciding whether to end NIRP. In any case, be it March or April, the BOJ is likely very close to its first policy rate hike since 2007. When it happens, we think the BOJ will also end yield-curve control and provide guidance on government bond purchases to avoid sharp rises in the bond yield. The purchase of risky assets is also likely to be halted (note that the BOJ has not purchased ETFs since October 2023). At the same

[3] *A Taylor rule is a simple monetary rule that indicates the "optimal" level of the Fed funds rate based on the deviation of inflation from target and the output gap (i.e. growth relative to potential). We use an interest-smoothing Taylor rule with a parameter of 0.8 on the Fed's previous quarter policy rate. We take the HLW estimate of the neutral real rate and simple HP-estimated output gap.*

time, the BOJ is very likely to reassure that it is not starting a steep path of rate hikes and keeping an overall accommodative policy stance. Indeed, despite rising wages, the economy still retains areas of weakness.

Wages are set to rise significantly this year, but may not fully pass through to higher output prices and inflation, in a context of still fragile economic conditions. We expect GDP growth at +0.6% in 2024 and +1.0% in 2025, and inflation at 2.4% in 2024 and 1.6% in 2025. Although Q4 2023 GDP was revised on the upside (from -0.4% q/q annualized to +0.4%) and the Japanese economy thus avoided a technical recession, the recovery was extremely mild after the previous quarter's sharp drop (-3.2% q/q annualized). Furthermore, underlying data suggest that domestic demand is still weak, with private consumption showing a third consecutive quarter of contraction. We expect GDP growth to settle at +0.6% in 2024 and +1.0% in 2025, after +1.9% in 2023 (and +1.2% on average over 2010-2019). At the same time, recent data on wages have been more encouraging, with labor cash earnings rising by +2% y/y in January (up from +0.8% in December)[4]. The ongoing *shunto* negotiations suggest that wages could see their highest rise in more than 30 years in 2024 (Figure 4): the average wage demand announced on 7 March by the Japanese Trade Union Confederation (JTUC-RENGO, Japan's largest group of unions) was +5.9%, significantly higher than last year's +4.5%. After receiving responses from employers, JTUC-RENGO will announce the initial tally on 15 March, which could end up around +4.5% (up from +3.6% last year). Until early July, several rounds of data collection and releases will follow as more unions reach agreements, with 4 April being a key date as an industry breakdown will be made available. Particularly, it will be important to see wage growth in the services sector, which is more labor intensive (and saw less increase in the 2023 *shunto*). Beyond wage dynamics, a key question remains whether higher wages will pass through to output prices and thus translate into higher inflation. Companies may choose to take a hit on their margins to avoid hurting price-sensitive consumers. Output prices have indeed been rising particularly slower than input prices in Japan in recent years (Figure 5). We expect inflation to reach 2.4% in 2024 and 1.6% in 2025 (after 3.3% in 2023).

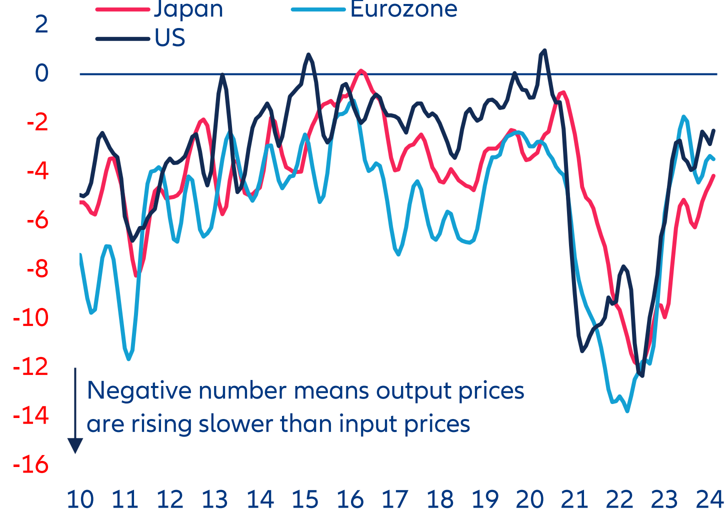
Figure 4: Annual wage increase at large companies in Japan (%)



Sources: Ministry of Health, Labour and Welfare of Japan, Allianz Research

[4] *Even when taking the BOJ's preferred gauge that excludes sample changes, wage growth held steady at +2% in January for the third consecutive month.*

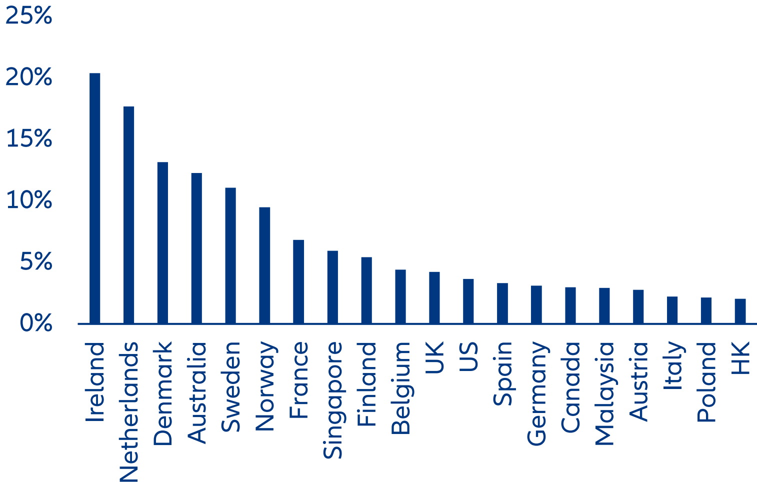
Figure 5: Composite PMIs, difference between output prices and input prices (smoothed)



Sources: S&P Global, Allianz Research

Despite the end of NIRP, interest rates are likely to remain low, implying manageable impacts on Japan and the rest of the world. The US, France and Australia have been the top destinations for Japanese investors in overseas debt in the past years, but sovereign bonds in the Netherlands, Denmark and Ireland seem the most vulnerable to the risk of Japanese investors pulling funds out. After raising the policy rate to 0.1% in April, the BOJ is likely to consider at most another rate hike for the rest of the year. Indeed, it may be difficult to justify much more increases in a context of mild economic growth, cooling inflation, and policy rate cuts by other major central banks. As such, borrowing costs are likely to remain low in Japan in the coming few years. This is likely to be confirmed by the BOJ's revised forward guidance and commitment to maintain accommodative monetary conditions. Rising but still low borrowing costs along with sustainable inflation that supports nominal GDP mean that public debt sustainability is unlikely to be put under question. Meanwhile, the divergence in BOJ and Fed policy means that the JPY is likely to appreciate against the USD going forward. The USDJPY rate had reached historical highs recently, and should come down towards 140 by the end of 2024, a level in line with the 2023 average. For the rest of the world, the end of NIRP in Japan raises concerns on how Japanese investments abroad will evolve going forward. Extremely low interest rates domestically in the past decade meant that Japanese investors sought higher yields abroad. Now, rising domestic yields could imply repatriation of funds to some extent – though it is likely to be limited as we expect interest rates to remain low for longer in Japan. The US, France and Australia have been the top destinations for Japanese investment in overseas long-term debt over the past years (accounting for around 60% of Japan's holding of foreign long-term debt securities since 2014), but sovereign debt in Ireland and the Netherlands seem the most vulnerable to the risk of Japanese investors pulling funds out, with nearly 20% of their government debt securities held by Japan (Figure 6).

Figure 6: Japanese holding of long-term debt securities, as share of general government debt securities (latest available)

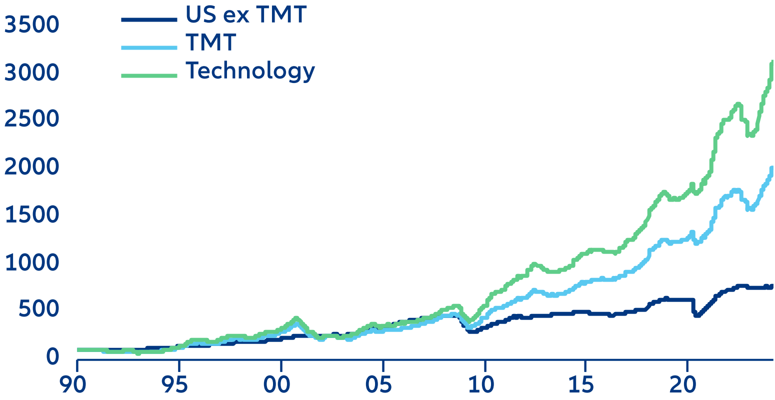


Sources: IMF, BIS, Allianz Research

US equity markets: dotcom déjà vu?

The exponential rise of US tech stocks is raising concerns of a repeat of the dotcom bubble. But today's tech companies have significantly stronger balance sheets. The ongoing US equity market rally is overwhelmingly concentrated in the tech sector, with tech-centric mega-cap companies accounting for 50% of the year-to-date returns. This has sparked concerns of a repeat of the dotcom bubble of the 2000s, when tech companies traded at exorbitant valuations and, like today, made up one-third of total market capitalization, despite lacking established revenue streams or profitability. This phenomenon is not unique: historically, each business cycle has been defined by one "star" sector. At the dawn of the 20th century, transportation took center stage, eventually giving way to energy & materials for the rest of the century. The baton was then passed to technology until the bubble burst, followed by finance and real estate leading up to the 2008 crisis. Since the 2008 financial crisis, technology has reclaimed its position as the dominant force in the market (Figure X). But this time is very different. Today's market leaders boast significantly stronger balance sheets across various metrics, including earnings, profit margins, debt levels and cash reserves. In this regard, since 2008, the tech sector has seen exponential growth in profits, with an additional boost from the shift towards “stay-at-home” consumption, given the rise of hybrid work environments during and after the 2020 pandemic. Moreover, in 2022 and 2023, tech companies adeptly navigated the rising interest rate environment – a feat given the sector's historical sensitivity to interest rates – and their robust cash reserves have also been reinvested efficiently, mitigating the adverse effects of increased borrowing costs. This underscores their resilience and strategic agility of the current equity market components in the face of financial headwinds (Figure 7).

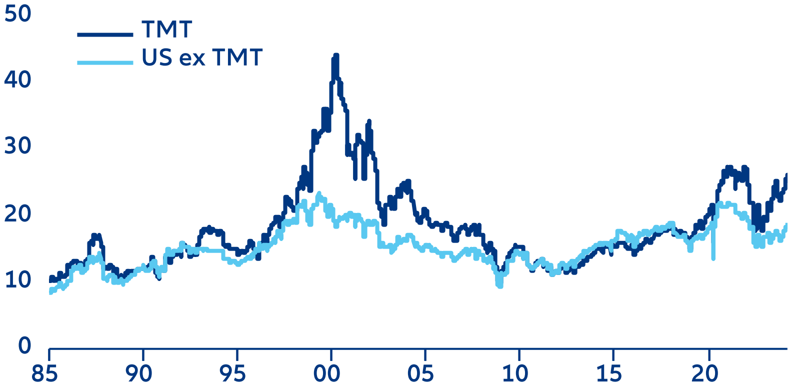
Figure 7: 12m forward EPS for US sectors and broad index ($ - reb 100 on 1990)



Sources: LSEG Datastream, Allianz Research. Note: TMT: Telecommunications, media and technology / EPS: Earnings per share.

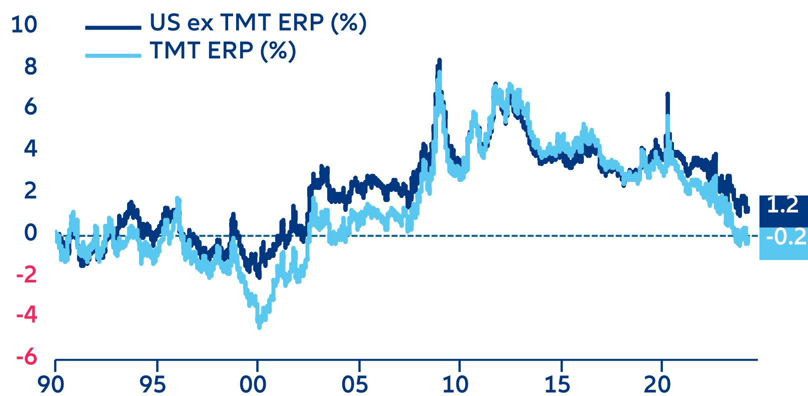
Today's price-to-earnings (PE) ratios are also significantly lower than the ~50x PE ratios that characterized the dotcom bubble. This suggests that the current market enthusiasm is nowhere close to the fervor of the late 1990s and early 2000s. This holds true when adopting a relative valuation approach as well: although modest, the equity risk premium (ERP) over treasuries for the tech sector has not plummeted to the extremes observed during the dotcom era, when ERP values hovered around -4%. In this context, while it is unrealistic to expect the market to maintain its current exponential growth indefinitely without risking bubble formation, the existing valuation and earnings landscape do not point to an imminent, deep technology-driven market downturn akin to what was experienced in the early 2000s (Figure 8 and 9).

Figure 8: 12m forward Price/Earnings ratios



Sources: LSEG Datastream, Allianz Research. Note: TMT: Telecommunications, media and technology

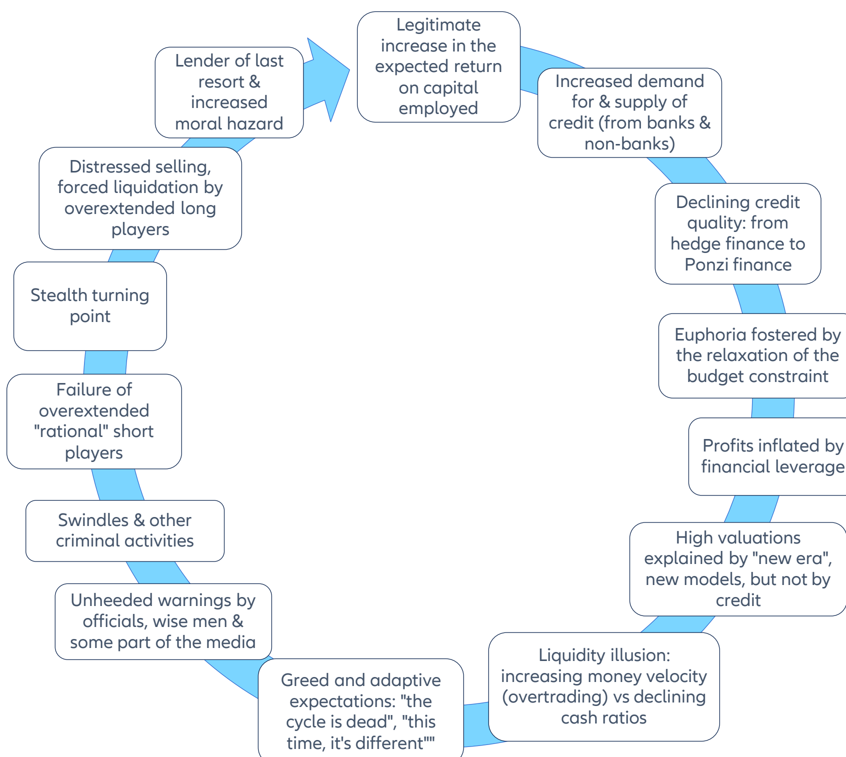
Figure 9: Equity Risk Premium ratios (in %)



Sources: LSEG Datastream, Allianz Research. Note: TMT: Telecommunications, Media and Technology / ERP: Earnings yield – 10y UST yield

In this expensive but still manageable market context, we continue to expect US equity returns at around 10% in 2024, followed by a cool-off towards 7% in 2025. We also base our non-bubble-like market prescription on the Kindleberger financial crisis clock framework which continues to suggest that US equity markets are not close to a financial crisis but closer to a mid-cycle state (Figure 10). With this in mind, we do not expect the technology sector and overall US equity concentration to face big downside headwinds in the short run on the back of strong financials and still resilient earnings generation. However, shifting economic trends, especially following the results of the US elections, could trigger some sectorial rotation out of the current market leaders, favoring other sectors (eg. those that stand to benefit from reshoring) and thus limiting market upside potential moving forward.

Figure 10: The Fisher-Minsky-Kindleberger model



Source: Adapted from Charles Kindleberger's Manias, Panics and Crashes a history of financial crises, 1978

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