

Facing Risks, Markets Keep Rising

By: Reece Jarvis, VP, Group Head of Fixed Income, Asset Management, Butterfield

As we enter the final quarter of 2024, financial markets continue to brush off key risks and ignore the usual negative seasonality. We're approaching one of the most pivotal US elections in decades, with geopolitical tensions running high, yet risk assets are hitting record valuations. Why? The Fed "put" is back in play. Last month's larger-than-expected 50bps rate cut has jump-started the easing cycle, and it seems like only a matter of time before quantitative tightening is fully phased out too. Investors know the pattern—any dip in risk sentiment is countered by massive central bank intervention, which few dare to bet against.

However, with financial conditions easing rapidly, central bankers now risk overstimulating the economy. They seem to be settling for a "close enough" approach to inflation targeting. This could mean lower rate cuts than markets currently expect or alternatively bond investors in longer maturities may demand a higher term premium. The latter represents a bigger risk as it would drive borrowing costs sharply higher, triggering a meltdown reminiscent of the Liz Truss fiasco.

After a slow start to the hurricane season, the US economy also finds itself grappling with the effects of severe storms which have impacted Florida, Georgia, and North Carolina. This year is shaping up to be one of the costliest for natural disasters, potentially pushing the insurance industry's losses past the \$100 billion mark. The immediate impact is on residents and businesses who have to deal with rebuilding costs, disruptions to economic output, and the inevitable rise in insurance premiums.

In addition to hurricane-driven disruptions, recent strikes at US East Coast ports have further strained supply chains, contributing to inflationary pressures. While the strikes have now ended, wage increases granted to union workers are expected to drive up costs for consumers. The latest Consumer Price Index (CPI) for September shows an increase of 2.4%, nearing the Federal Reserve's 2% inflation target. However, beneath the headline figure, there are signs that inflation may reaccelerate.

Despite these developments, the US economy remains resilient, with growth forecasts exceeding 3% for the fourth quarter – significantly above trend. As the market anticipates an additional 200 basis points in rate cuts over the next year, the Fed faces the challenge of declaring victory on inflation too soon. If growth stays strong, easing too quickly could lead to a resurgence in price pressures.

Looking globally, China's economic slowdown continues to weigh on markets. While Chinese authorities have introduced stimulus measures to revive growth, it's unclear if they will be enough. As China exports deflation to countries like the US, it may temporarily ease inflationary pressures. However, Germany, heavily reliant on China as a key trading partner, is struggling with the ripple effects of China's slowdown, complicating the broader economic outlook.

With the upcoming US election, economic policies are a key focus for markets. Current polls suggest a highly competitive race, with former President Donald Trump recovering in the polls. From a market perspective, several potential policies stand out, including proposed tax cuts and the introduction of tax-deductible car loan payments—both of which could have far-reaching effects on US businesses and consumers.



Of particular interest to Cayman is the potential end to the “double taxation” of American citizens living abroad, a policy that has long been a point of contention. Should this policy change, Cayman could see a significant increase in its attractiveness as a destination for US expatriates. Middle-income Americans, who have traditionally been discouraged from relocating due to tax burdens, may find Cayman a more appealing option, boosting the local economy.

On the flip side, the potential introduction of tariffs on countries like China and Mexico brings its own set of risks. While these tariffs aim to protect US industries, they are inherently inflationary and could drive up the cost of imported goods. In the short term, we might see a surge of cheaper products as companies offload excess inventory, but over time, prices could rise, increasing the cost of living for neighbouring countries. However, if a deal is agreed this could also level the playing field for US businesses, especially as Europe imposes tariffs on American companies that many view as unfair and due for renegotiation.

Geopolitical tensions, particularly in the Middle East, also carry risks. The ongoing conflict between Israel and Iran raises the possibility of disruptions to global energy supplies, which could send oil prices soaring. In regions where energy production still depends heavily on fossil fuels, a rise in oil prices would directly push up electricity costs, putting additional pressure on households and businesses. With the US election just around the corner, it's unlikely that tensions will escalate significantly in the short term, but after November 5th, all bets are off. That's yet another reason to keep some inflation hedges at the ready.

When looking at the broader economic picture, the US finds itself in an unusual situation: strong economic growth on one hand, but weakening employment trends on the other. This disconnect in the data can be puzzling—what's really happening? Traditional metrics like GDP growth often miss the mark when it comes to reflecting the everyday experience of most people. The “misery index,” which combines inflation and unemployment, has historically served as a barometer of economic pain, but it's not without its flaws. In today's more complex economic environment, a more nuanced approach is likely needed.

A more refined approach would replace the headline unemployment rate with the U-6 measure, which accounts for underemployment, and emphasize real wage growth over inflation—since rising wages can mitigate inflation's impact. Factoring in mortgage rates also offers a clearer picture of household financial strain. By this measure, while the US economy is in a better place than during the inflation spike of 2022, it still faces significant challenges: U-6 is at 7.7%, mortgage rates hover around 7%, and although real wage growth has returned to positive territory (up 1.5%), it's not enough to fully offset broader economic pressures. Perhaps those rate cuts are warranted after all.

For Cayman, the intersection of global economic trends presents both risks and opportunities. The US tax changes, particularly the potential end of double taxation, could make the island an even more attractive destination for US citizens. Additionally, as insurance costs rise in the wake of natural disasters and other market pressures, Cayman has an opportunity to solidify its reputation as a captive insurance hub. With rising bond yields offering strong returns for insurance capital, Cayman's captive sector is well-positioned to offer solutions that provide both stability and profitability.

However, we must also be mindful of the potential risks posed by global supply chain disruptions and geopolitical tensions. The island's reliance on imported goods and fossil fuels makes it vulnerable to fluctuations in global markets, whether through rising energy prices or increased costs for consumer goods.



As the US grapples with inflation, interest rates, and unemployment, the ripple effects will inevitably reach our shores. By positioning ourselves as a global leader in captive insurance and maintaining a flexible, forward-looking economic strategy, Cayman can navigate these challenges while seizing new opportunities.

Disclaimer: The views expressed are the opinions of the writer and whilst believed reliable may differ from the views of Butterfield Bank (Cayman) Limited. The Bank accepts no liability for errors or actions taken on the basis of this information.