Fort Washington
Investment Advisors, Inc.

A member of Western & Southern Financial Group

MONTHLY MARKET PULSE — SEPTEMBER 2024

HIGHLIGHTS

- **Cuts Are Here:** Continuing disinflation and a balanced labor market have led investors to expect the first rate cut in September.
- **Market Breadth:** The rotation to small cap stocks has been a theme in Q3 but will require a soft landing for the economy to persist.
- **Asymmetric Risk:** Current asset prices, in both stocks and credit, suggest more downside risk than upside to our base case expectations.

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MACRO INSIGHTS

Regime Change?

After a sharp sell-off to start the month, U.S. equities ended the month higher as exaggerated economic concerns following the July jobs report subsided and attention shifted to more soft-landing supportive data. Continued moderating of inflation data and commentary from the Federal Reserve (Fed) regarding the timing of interest rate cuts also supported risk assets in the month. Fed Chair Jerome Powell stated, "The time has come for policy to adjust," paving the way for the Fed to begin the process of normalizing rates at the September meeting (see this month's Spotlight on the following page for more detail).

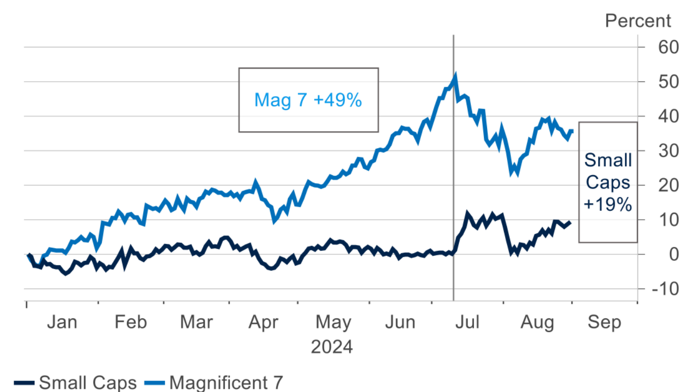
Eight months into the year, the S&P 500 has shown a nearly 20% total return, following a 26% gain in 2023. While the mega-cap tech AI-driven names are still comfortably leading the market this year, recent performance has shown a broadening of gains. The so-called Magnificent 7 trailed in August, while small caps outperformed. With the Fed on the cusp of lowering rates and the slowdown in the economy over the next year unlikely to prove recessionary, in our view, we like the outlook for relative performance from laggards such as small caps.

With inflation moderating and the direction of Fed policy seemingly well understood, we believe the focus of the market will shift to the durability of the labor market and economic growth. The nearly wrapped-up second quarter earnings season has highlighted a slowdown in consumer spending in discretionary categories, greater sensitivity to value, and a weakening of personal travel. We will be watching these trends closely to see if the issues remain concentrated among less affluent consumer cohorts or if we see a broadening that would more substantively impair economic growth. Consumer activity, combined with the trajectory of the labor market, will likely influence equity and bond prices more notably from here than the modest economic boost associated with the gradual lowering of front-end rates.

While our base case is a "soft landing" of slower, but non-recessionary growth, we see somewhat asymmetric risks to the market from here — the risk of the economy underperforming our expectations appears higher than outperforming. Valuations in equities appear rich at the index level, though valuations away from mega-cap tech look closer to long-term averages. As a result, we are cautiously optimistic about certain parts of the equity market landscape, including small caps.

Magnificent 7 vs Small Caps: YTD Returns

Relative performance pre-and post the July CPI print.



Source: Fort Washington, Bloomberg, and Macrobond.
Past performance is not indicative of future results.

Chris Shipley, Senior Vice President, Co-Chief Investment Officer
Fort Washington Investment Advisors, Inc.

WHAT TO WATCH

The focus of the month ahead will be labor market data as investors assess the magnitude of slowing for the U.S. economy. In addition, markets will seek confirmation that the trend of lower inflation will continue.

- August Employment Report (unemployment, non-farm payrolls, etc.), released September 6, will be closely watched following the weaker than expected July print that provoked volatility in the markets.
- CPI is released on September 11th, which will be the first inflation indicator for August. It would likely take a large miss to move markets materially, but investors will be looking for continued disinflation.
- The most noteworthy event of the month is the FOMC meeting on September 18th where the Fed is expected to begin the rate cutting cycle. However, Powell's comments about the magnitude and path of cuts will also be a focus.

MONTHLY SPOTLIGHT

DAN CARTER
Senior Portfolio Manager

Rate Cuts Are Here, but the Magnitude Remains Uncertain

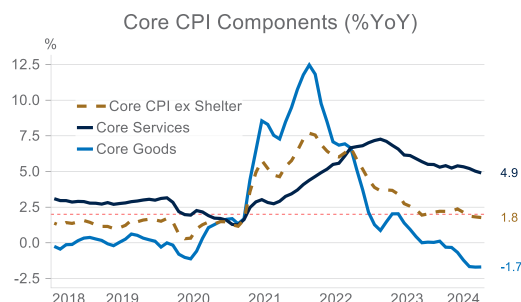
Expectations for the path of Fed policy has experienced significant volatility this year. Bond investors came into the year projecting over 150 basis points of cuts in 2024. However, expectations shifted multiple times due to incoming inflation reports and other economic data. During April, markets were anticipating as little as 25 basis points of cuts throughout 2024 after a string of higher-than-expected inflation reports. However, more recent inflation readings have provided the Fed with greater confidence that inflation will continue cooling. As a result, a rate cut in September has been largely solidified, especially as evidence of a cooled labor market also emerged.

Fed Chair Powell discussed this greater confidence in disinflation during his press conference at the July FOMC meeting, and effectively confirmed the markets' expectation for a September rate cut during his remarks at Jackson Hole. Rate cuts will also support the labor market, of which recent data suggests some softening. The Fed is increasingly sensitive to labor market conditions and would like to head off any further weakening. Now that the cutting cycle is here, we expect the market to increase its focus on the magnitude of cuts.

Currently the market is expecting about 225 basis points of cuts through 2025, indicating a terminal rate around 3%. We believe this is a reasonable forecast given our outlook for inflation and growth. The risk to this forecast is further weakening of the labor market, which would increase the size and pace of cuts.

Focusing on near-term cuts, we don't believe there is sufficient evidence to support a 50-basis point cut in September. Rather our near-term base case is for one cut at each meeting this year. The primary reason is that even though the labor market has cooled, we are not currently experiencing broad layoffs. This balanced labor market provides the Fed with flexibility to continue demonstrating patience and staying data dependent. However, we will be watching indicators, such as those below, for signs of further slowing in employment.

Disinflation & Layoffs



Source: Fort Washington, BLS, Challenger, Gray & Christmas, openICPSR, and Macrobond.

- Excluding shelter, inflation has been at or below the Fed's 2% target for about a year. We believe disinflation is likely to continue, especially as shelter cools further.
- Both the Challenger Job Cuts and WARN (Workers Adjustment and Retraining Notification) Factor indicate job losses have remained at reasonable levels.

Dan Carter, Senior Portfolio Manager
Fort Washington Investment Advisors, Inc.

Blake Stanislaw, Client Portfolio Manager
Fort Washington Investment Advisors, Inc.

CURRENT OUTLOOK

Topic	View	MoM Change	Commentary
Macroeconomic Views			
Economic Growth		–	▸ Recent economic data has remained solid, led by consumer spending and improving business investment. ▸ Job and wage gains (4.7% YoY) along with large increases in net worth continue to support growth. However, consumer credit and delinquencies are above 2019 levels which, in addition to other datapoints, **suggest there are accumulating headwinds for consumers** looking forward. ▸ Lower mortgage rates are likely to **improve housing activity**, but further progress on rates is needed to make a noticeable impact.
Inflation		–	▸ **Inflation remains on a path toward 2%**, which is expected to continue as service inflation cools. ▸ This year's data has been volatile, but the most recent data suggests that inflation is subsiding with **Core PCE at 2.6%** YoY. ▸ Inflation is being driven by shelter and other non-discretionary categories, which are at 4.2% YoY while discretionary inflation is negative.
Monetary Policy		–	▸ The Fed has held rates steady at 5.25%-5.5% since July 2023, but investors believe policy is set to begin easing with expectations of an initial cut in September. ▸ Investors are **anticipating 100 basis points of cuts** through the end of 2024 and 125 basis points in 2025. We believe near term cuts are likely to underwhelm investors as the chance of a 50-basis point cut this year is not our base case. ▸ Forecasts for rate cuts will ease financial conditions, but we expect continued volatility in the forecasts for inflation.
Fiscal Policy		–	▸ Fiscal spending is expected to drag on GDP over the coming quarters, and potentially years, as the government is burdened by **higher interest costs**. ▸ Swings in election forecasts will cause volatility as investors assess the likelihood of different outcomes and the impact to spending and the budget.
Market Views			
Rates		↓	▸ Rates moved lower in August due to easing inflation expectations and slowing job growth. The 10-year Treasury has been range bound between 3.8-4.0%. ▸ We anticipate **magnitude of expected rate cuts will continue shifting** with new economic data, presenting opportunities for tactical adjustments. Following the first rate cut, investors will likely begin focusing more on the terminal rate. ▸ We believe longer rates are fairly valued but expect the yield curve to steepen as the Fed cuts.
Credit		–	▸ Credit spreads remained range bound **below historical averages** over the quarter as the market anticipates a soft/no landing scenario and plans for rate cuts from the Fed. ▸ We believe current fixed income valuations present increased downside risk with limited upside. ▸ Investment grade spreads (10yr BBB Industrials) ended August at their 22nd percentile and high yield (single B corporates) at their 6th percentile, since the 1990s.
Equity		–	▸ Volatility spiked in August and has remained elevated despite equity indices advancing. As a result, equity **valuations continue to be stretched** as the S&P 500 increases, up almost 20% this year and over 50% since 2022. ▸ Market breadth began improving in Q3 as small caps outperformed. ▸ 2025 earnings expectations may be difficult to achieve with a slowing economy.

MARKET DATA & PERFORMANCE | AS OF 08/31/2024

US Snapshot	Current	6 Months Prior	1 Year Prior
Core Inflation (YoY%)	2.6	2.8	3.7
Unemployment Rate	4.3	3.9	3.8
Real GDP (YoY%)	3.1	3.1	2.4
Retail Sales (YoY%)	2.7	2.1	3.0
30 Yr Mortgage Rate	6.4	6.9	7.2
10 Yr Treasury	3.9	4.3	4.1
US Corporate IG Yield	4.9	5.4	5.6
US Corporate HY Yield	7.3	7.9	8.4

Asset Class	MTD	QTD	YTD	1 Year	3 Years*
Equity					
Russell 3000 Index	2.2%	4.1%	18.2%	26.1%	7.9%
S&P 500 Index	2.4%	3.7%	19.5%	27.1%	9.4%
S&P Midcap 400 Index	-0.1%	5.7%	12.2%	18.7%	5.6%
Russell 2000 Index	-1.5%	8.5%	10.4%	18.5%	0.6%
MSCI World Index	2.7%	4.5%	17.1%	25.0%	7.4%
MSCI World Excluding US	3.4%	6.6%	12.3%	20.1%	4.8%
Fixed Income					
US Corporate Investment Grade	1.6%	3.9%	3.5%	9.0%	-2.0%
US Corporate High Yield	1.6%	3.6%	6.3%	12.6%	2.5%
Emerging Market Debt	2.5%	4.5%	6.5%	13.5%	-1.6%
US Treasury (7-10yr)	1.8%	4.1%	2.7%	6.4%	-3.2%
Cash	0.5%	0.9%	3.6%	5.5%	3.4%

Source: Fort Washington and Bloomberg. *The 3-year returns are annualized. Past performance is not indicative of future results.

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