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2024 Q2 COMMENTARY: THE ECONOMY & MARKETS AT MIDYEAR

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HIGHLIGHTS

- With the U.S. economy proving resilient to Fed rate hikes in 2022-2023, investors are focusing on the prospects for inflation. It stalled around 3 percent earlier this year but has recently showed signs of moderating.
- The Fed is keeping interest rates on hold until it is confident that inflation is headed for its 2 percent target. The latest "dot plots" show Fed officials now anticipate making only one rate cut this year followed by four cuts next year.
- Amid this, the stock market has set new highs on the back of strong corporate profits and optimism over AI. Investors have largely ignored the presidential election thus far, but it could become a factor when the campaign is in full swing.
- Bond yields may fluctuate in trading ranges in the second half of this year until there is clearer evidence on lower inflation. However, the upside for the stock market appears limited by current high valuations.

INVESTMENT RESULTS: BONDS FLUCTUATE WHILE STOCKS SET NEW HIGHS

Inflation has been top of mind for investors in the first half of this year as the U.S. economy continues to power ahead at a sustainable pace. Treasury yields surged in the first quarter when inflation readings were higher than expected, but they have eased recently as inflation prospects improved. Accordingly, returns for Treasury and investment-grade corporate bonds were moderately positive in the second quarter after being mildly negative in the first quarter (Figure 1).

Meanwhile, stocks have gone on to set record highs, even though investors have lowered their expectations for Fed rate cuts from six at the start of this year to only one or two recently. The stock market has been bolstered by improved corporate profits and optimism about artificial intelligence with Nvidia leading the way.

The S&P 500 Index posted a total return of 10.6 percent in the second quarter and 15.3 percent for the first half of the year. It has continued to outpace international and emerging market indices in local currency terms and even more in U.S. dollar terms owing to the dollar's strength against most currencies.

Figure 1. Investment Performance by Asset Class for 2024

Stock Market	Q1 2024	Q2 2024	H1 2024
US (S&P 500)	10.6	4.3	15.3
NASDAQ	9.3	8.5	18.6
Russell 2000	5.2	-3.3	1.7
International (EAFE $)	6.0	-0.2	5.8
Emerging Markets (MSCI $)	2.5	5.0	7.6

U.S. Bond Market			
US Aggregate Bond	-0.8	0.1	-0.7
Treasuries	-1.0	0.1	-0.9
IG Credit	-0.4	0.0	-0.5
High Yield	1.5	1.1	2.6
JPM EM Debt	2.0	0.3	2.3

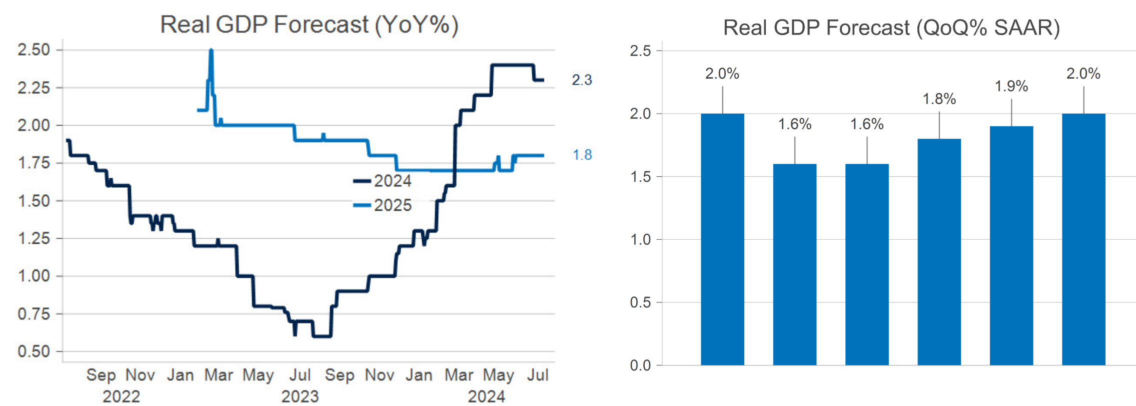
Source: Bloomberg

Looking ahead to the second half of this year, we anticipate that bond yields will fluctuate in trading ranges until there is clearer evidence about whether inflation is on course to achieve the Fed's 2 percent target. However, given current high valuations for U.S. stocks, the risk of a pullback has increased.

THE U.S. ECONOMY: STILL SOLID

Our assessment of the U.S. economy is that it remains resilient to the spike in interest rates in 2022-2023, and the risk of recession has lessened. Although real GDP growth could moderate this year from the 2.5 percent pace in 2023, economic forecasts have trended steadily upwards over the past 12 months (Figure 2).

Figure 2. Consensus Growth Expectations Have Risen



Source: Bloomberg, Macrobond.

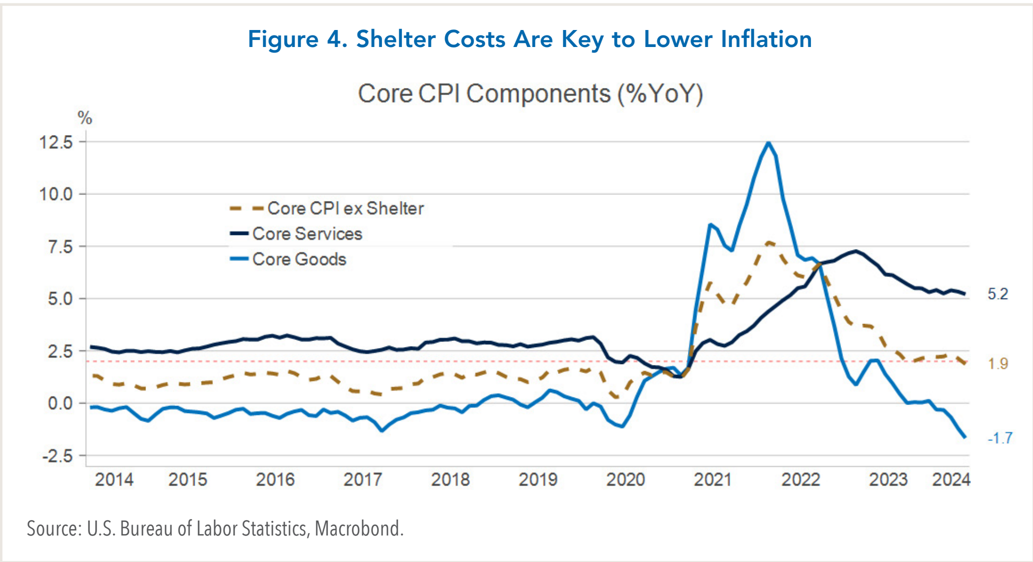
One reason for the optimism is the economy has been bolstered by consumer spending, which accounts for nearly 70 percent of aggregate demand. It is being supported by growth in real wages, increases in household net worth and low household debt service as many homeowners hold fixed 30-year mortgages. That said, consumer confidence has fluctuated with inflation readings, and consumer debt and delinquencies are rising for lower-income households.

Another consideration is that business surveys show that the services sector, which accounts for the vast majority of the economy, is relatively strong with readings that are well above recessionary levels. (Figure 3.) By comparison, the manufacturing sector, which is more cyclical, is in mild recession.

The labor market is also coming into better balance between demand and supply. Thus, even though non-farm payrolls based on the establishment survey have consistently been stronger-than-expected in the first half of this year, other indicators paint a different picture. For example, the household survey shows much weaker jobs growth, the ratio of job openings per unemployed has declined, and the average workweek and overtime have fallen below the pre-Covid trend.

The good news on the inflation front is that labor costs are moving toward sustainable levels. Key indicators such as unit labor costs and the employment cost index are declining, along with hourly wage and quit rates for employees.

The main reason why services inflation has been sticky is the cost of shelter has been elevated by rising home prices and high mortgage rates. Excluding shelter-related costs, the core rate of inflation is near the Fed's 2 percent target.



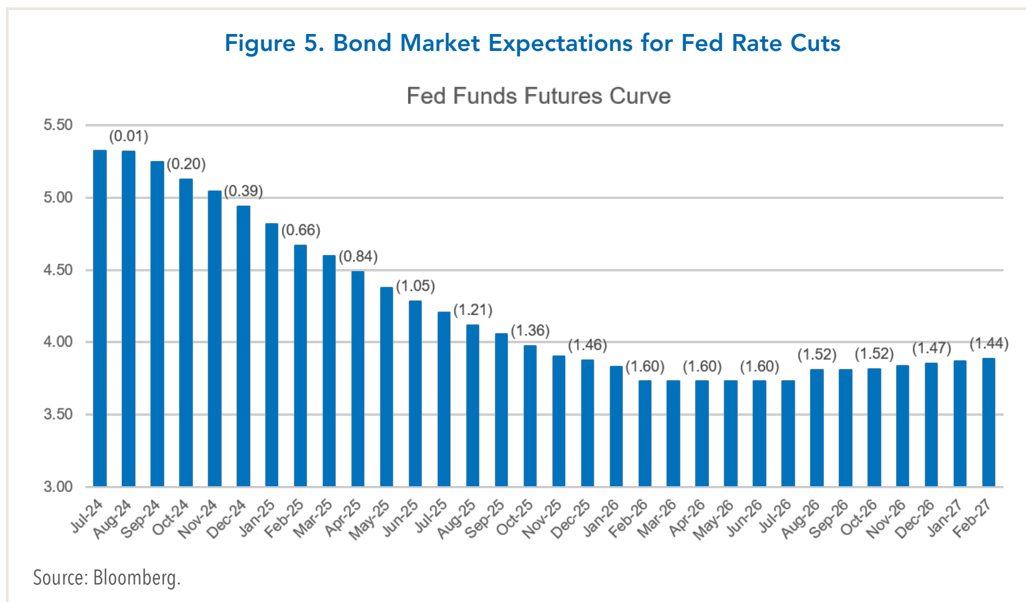
THE FED'S TWIN GOALS ARE WITHIN SIGHT

One reason why the U.S. stock market has performed so well is that the Fed's twin goals of price stability and full employment are within sight. The latest Summary of Economic Projections released during the June FOMC meeting call for core PCE inflation to fall from 2.8 percent this year to 2.3 percent in 2025, while the unemployment rate is expected to tick up from 4.0 percent currently to 4.2 percent next year.

These projections are consistent with a "soft landing" for the economy. Nonetheless, Fed officials are waiting for additional evidence to confirm that inflation is under control before they ease monetary policy. The so-called "dot plots" survey shows they have lowered expectations of rate cuts this year to only one from three previously. However, they continue to foresee four rate cuts in 2025.

By and large, the Fed's interest rate projections are now consistent with what is being priced into the bond market (Figure 5).

Figure 5. Bond Market Expectations for Fed Rate Cuts



Source: Bloomberg.

RISKS TO THE OUTLOOK

There are several risks to the outlook that investors should consider. One is that monetary policy works with long lags and the full impact of the Fed rate hikes may not have been felt yet. This is why in addition to inflation indicators, we are monitoring rising delinquencies in credit card debt and auto loans, weakness in small business sentiment and capital outlays and potential problems in commercial real estate.

Beyond this, geopolitical risks provide an added layer of concerns. Although many investors presume the current stalemate in the Russia-Ukraine conflict and the Hamas-Israeli conflict will continue indefinitely, these situations could worsen at any time. For example, support for Ukraine could wane both in Europe and the United States depending on the outcome of upcoming elections.

Through the end of the quarter, investors had not reacted to the U.S. presidential election, because polls indicated that the outcome is likely to be very close and will hinge on voters in a few swing states.

POSITIONING INVESTMENT PORTFOLIOS

Investment portfolios had a strong start to 2024, despite continued volatility. Looking forward, expensive valuations are likely to limit upside while the market looks for rate cuts to spur continued growth.

Despite our improved economic outlook, elevated asset prices result in only a modest overweight risk posture within balanced portfolios. Valuations generally reflect a high probability of a soft/no landing scenario with limited margin of safety at current levels, though there are still risks to the downside as policy remains restrictive.

In fixed income, we are positioning portfolios with a modest overweight to credit risk. Credit spreads widened a few basis points over the quarter but remain at historically tight levels, representing limited upside. However, the improving economic outlook should support tight spreads, and portfolios will seek to take advantage of periods of strength by incrementally improving credit quality and liquidity. Interest rates increased marginally over the quarter and represent balanced risk/reward. While the Fed is expected to begin easing monetary policy later this year, they are planning to move gradually and will remain in restrictive territory for some time.

Within equities, we are maintaining a cautious stance but are selectively finding bottom-up opportunities. Valuations have become stretched for the aggregate market following a strong start to the year, which was driven by limited market breadth, though showing signs of improving. Earnings are expected to grow by high single digits in 2024 following nearly flat earnings growth last year. We are prioritizing high barrier to entry businesses with high returns on capital and maintaining a moderately defensive posture within portfolios.

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