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Weekly Investment Commentary

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Summary:
Equities rose last week (S&P 500 +4.06%) with big tech leading the way. The big story was the bounce in stocks on the back of oversold conditions and upbeat headlines surrounding AI. Best sectors were technology (+7.34%) and consumer discretionary (+6.15%); worst sectors were energy (-0.68%) and financials (+0.52%).

Key takeaways:

1. U.S. headline CPI eased from 2.9% y/y to 2.5% in August in line with consensus predictions. However, core CPI unexpectedly accelerated from 0.2% m/m to 0.3%.

2. The unexpected uptick in August Core CPI complicates the picture of steady disinflation and diminishes expectations for aggressive Fed easing (e.g., 50 basis points instead of 25 basis points).

3. The combination of high consumer finance rates and large outstanding balances finally has consumers slowing their borrowing. Delinquencies will probably rise further as corporate revenues slow, loosening the labor market further, and cooling compensation gains.

4. There are three supports for consumer spending: 1) still positive job and wage gains, 2) consumer willingness to use credit cards, and 3) savings drawdowns. But the savings rate is down considerably and manufacturing continues to weaken—this leaves the weakening consumer as the key support to this economy.

5. Achieving the 2025 earnings estimate as it stands today requires margins next year to reach an all-time high of 13.9%. This would be more than one percentage point higher than any point in the last 35 years.

6. Thus far, the consensus estimate for 3Q earnings has been revised lower to 4.2% from 7.5% at the beginning of July.

7. 2025 earnings are expected to grow to 15%. Technology and healthcare are expected to contribute 50% of the growth.

8. It's been a tough year for active managers, with only a third of them outperforming the S&P 500 YTD through the end of August. Elevated market concentration certainly hasn't helped with the top 10 stocks providing nearly 60% of the index's return YTD. Higher volatility and a broadening out of performance should aid active managers.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	2.62	11.35
S&P 500	4.06	19.13
NASDAQ	5.98	18.43
RUSSELL 1000	3.41	17.45
RUSSELL 1000 GROWTH	6.05	21.51
RUSSELL 1000 VALUE	1.98	13.76
RUSSELL 2000	1.84	6.05

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	4.33	21.96
CONSUMER DISCRETIONARY	6.15	9.74
CONSUMER STAPLES	1.17	19.82
ENERGY	-0.68	4.40
FINANCIALS	0.52	19.34
HEALTHCARE	1.47	15.52
INDUSTRIALS	3.74	15.42
INFORMATION TECHNOLOGY	7.34	26.84
MATERIALS	3.17	9.34
REAL ESTATE	3.62	14.86
UTILITIES	3.46	26.15

9. One area where both political parties agree is their desire to pursue protectionism, specifically in the form of tariffs on goods from China and/or other major trading partners. We believe protectionism is bearish for risk assets, due in part to inevitable retaliation.

10. The future is always uncertain and so are markets. But one prominent technician writes, "Macro Remains Very Unsettled," implying that uncertainty levels are higher than usual.[1]

The rate rise cycle begins

Central banks are slowly reversing course and cutting policy rates, albeit with varying degrees of fundamental support. Cuts are warranted in the case of the weak economies, as their household sectors are struggling after the surge in debt-servicing burdens in recent years. ECB rate cuts, with another occurring last week, have validity, given that the region has a negative output gap and sluggish overall growth.

U.S. Fed rate cuts will be happening in the context of a positive output gap and growth still holding above the economy's long-run potential. There are only a few indications that monetary conditions are restrictive in the real economy, nor in credit availability or the performance of the equity and credit markets. Nevertheless, even in the absence of fundamental support, the dovish Fed is keen to cut rates, most likely by 25 basis points this week.

The main beneficiary of the rate cuts ultimately will likely be risk asset prices, rather than government bond markets, which have already aggressively front-run policy easing. Ironically, the persistent expectations for much lower policy rates over the past two years have muted the tightening impact on growth from Fed actions, and will now limit the downside in bond yields. Equity and credit markets may be able to grind higher given lower policy rates, a likely cap on government bond yields for the near term, and ongoing strength in global corporate profits.

After a bumpy start in August and again this month, equity markets have managed to grind higher even as enthusiasm toward the handful of former high-flying mega-tech and related shares has diminished. The average stock has held up well both in the U.S. and globally, with many indexes at or close to new highs for the cycle.

One unique feature of the rate-hiking cycle this decade is that the yields on corporate high-yield bonds are now lower than two years ago when the Fed and ECB were in the early stages of the tightening process. Corporate bond spreads over government debt are extremely tight, having never widened sharply as normally occurs when monetary policy shifts from tightening to easing. The positive backdrop for corporate profits (at least by the consensus) and low corporate defaults are not typical when the Fed is set to meaningfully lower rates and is not consistent with restrictive monetary conditions.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	2.39	14.35
MSCI ACWI EX U.S.	0.39	8.70
MSCI EAFE	0.26	9.07
MSCI EM	0.16	7.26

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.31	4.73
BLOOMBERG U.S. CORP HIGH YIELD	0.19	6.74
BLOOMBERG U.S. GOV/CREDIT	0.28	4.60
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.07	3.80

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	2.69	13.39
COMMODITIES (DJ)	2.73	1.25
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	3.66	11.94
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.30	6.55

Keep in mind that the starting point for the Fed rate cuts is an economy that, despite bearish headlines and cooling labor demand, is still growing faster than the economy's long-run potential.

Our minority view is that the economy is weakening (perhaps significantly), that corporate profit consensus estimates will not be achieved, and that the Fed's actions of raising rates have yet to fully impact the economy (and that currently contemplated rate cuts will have limited economic impact until late next year). As a result, we are more cautious than the consensus on the outlook for risk assets. Admittedly, these views are at best premature so far, and at worst, incorrect.

Conclusion

Rate cuts will continue, with the Fed expected to move next week, but the forward markets are too aggressive in terms of rate-cut expectations for the next 12-18 months. The global economy is in decent shape but is slowing. A legitimate debate still exists as to whether the Fed will achieve a soft landing or a more common hard landing.

1 Source: Strategas
Data from Bloomberg as of Sept. 13, 2024

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