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The Certuity Q3 Economic & Market Outlook in 10 Charts or Less

July 2024

Scott Welch, CIMA®

"Every picture tells a story, don't it?"

- ROD STEWART, 1971

"I just dropped in to see what condition my condition was in."

- KENNY ROGERS & THE FIRST EDITION, 1967

When reviewing the current state of the global economy and investment markets, we recommend focusing on market *signals* and weeding out market *noise*. We believe the five primary economic and market signals that provide perspective on where we go from here are **GDP growth, earnings, interest rates, inflation, and central bank policy.**

This is not to dismiss geopolitical issues or political dysfunction in Washington, DC (especially in a chaotic election year). But these are the "known unknowns" – we are aware of them but have no way to forecast how they will turn out or what effects they will have (or not) on the economy or investment markets.

As we write this, these "known unknowns" include (1) the outcome (and therefore policy agenda) of the upcoming US presidential and congressional elections; (2) the ongoing wars in Ukraine and Israel; (3) increasing tensions between the US and Iran (and its proxies in the Middle East); and (4) simmering tensions on multiple fronts between the US and China and Russia.

Spoiler alert*:* We believe the risk of recession may be increasing, though perhaps not in the near term. The economic phrase "soft landing" still appears regularly in media and social media reports (which always makes us nervous).

Earnings appear to be in reasonable shape, so there is no obvious reason the market cannot continue to advance, though valuations are elevated, and expectations should be tempered accordingly.

Bond investors can probably breathe relatively easily for now, though we believe the total return potential is muted.

There continues to be high investor demand for private market investments, both direct through traditional drawdown facilities and, increasingly, especially in private credit, through "evergreen" facilities.

The massive investor flow into private credit may be resulting in a "loosening" of pricing, covenants, and deal structure, but we still like the space with the right managers. We also think there may be potential in opportunistic real estate and in secondaries.

Let's dive in.

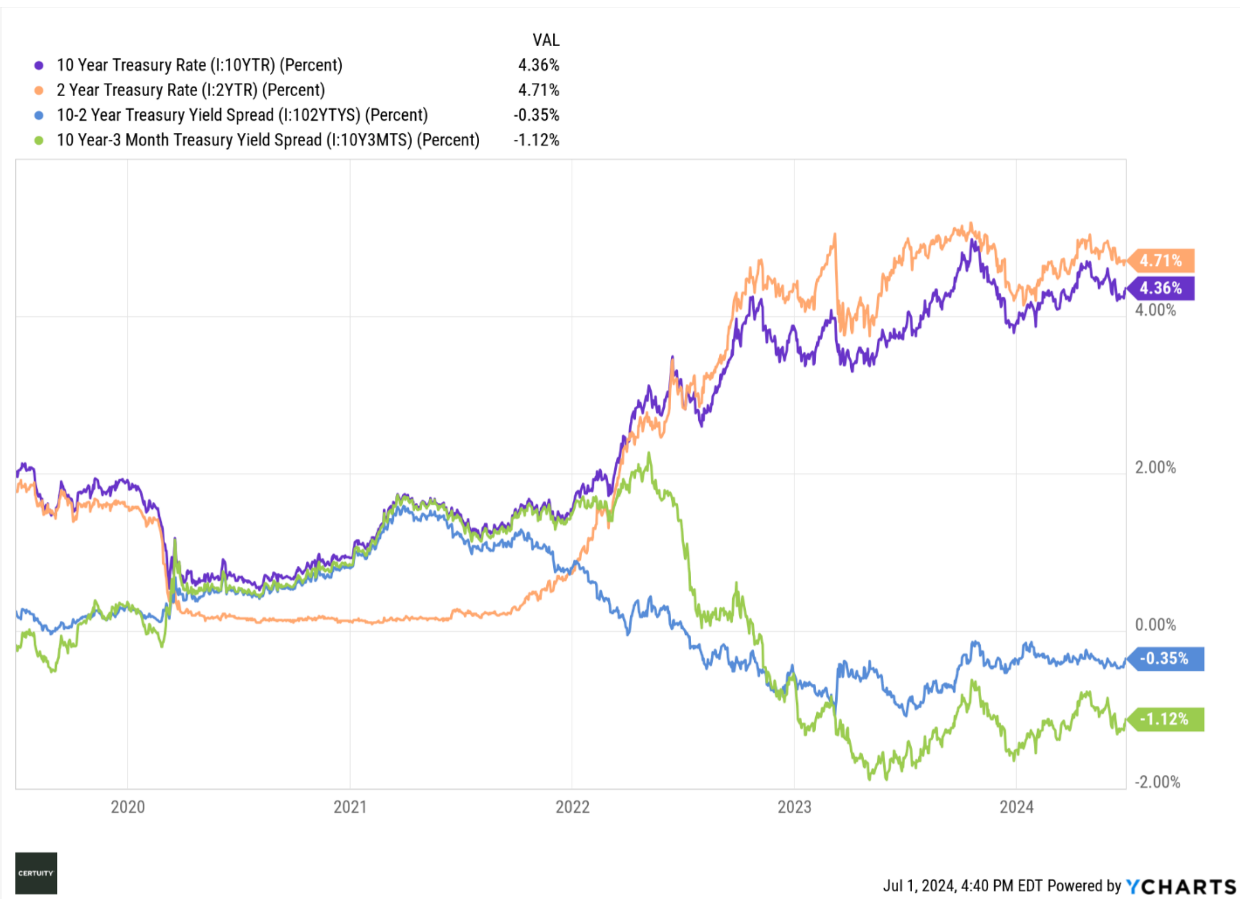
GDP, Inflation and Central Bank Policy

Let's start with the yield curve (i.e., interest rates), specifically two closely watched "spreads": the 2-Year/10-Year (2s/10s) and the 3-Month/10-Year (3m/10s).

While the yield curve remains inverted (historically, a leading indicator of recession), there is a reasonable argument to be made that this is due to Fed policy distortion versus a signaling of an impending recession.

We hate the expression "*this time it's different*," but until/unless the Fed makes a policy mistake, and/or the labor markets and retail consumption fall unexpectedly, the US economy should continue to chug along.

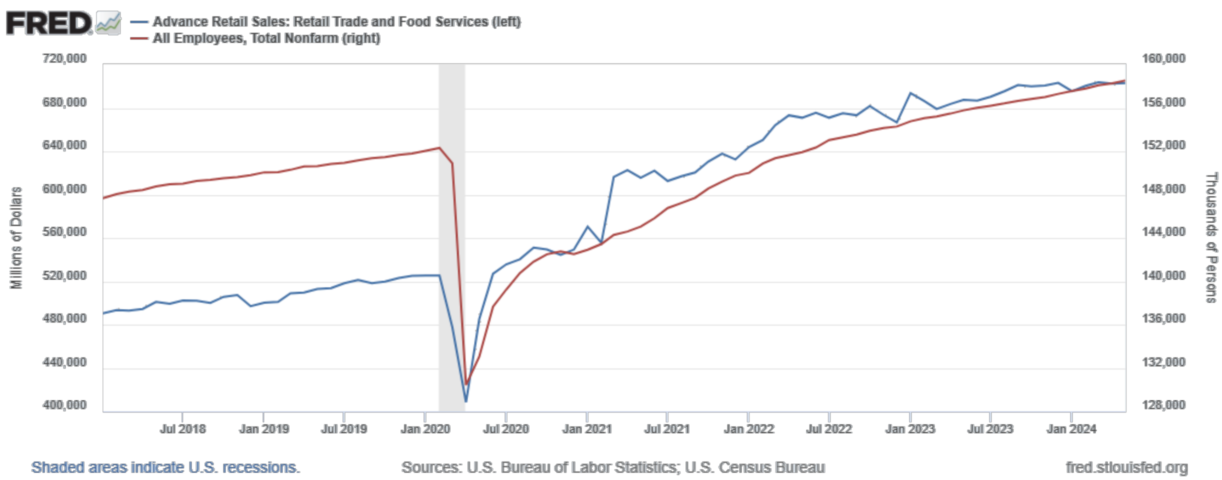
One caveat – the economy is still enjoying the flood of fiscal stimulus injected early in the Biden administration, and as that winds down we may see a corresponding decline in economic activity – but that phenomenon is not visible yet.



Source: YCharts, 5-year data through March June 28, 2024. You cannot invest in an index and past performance is no guarantee of future results.

We see that the 2s/10s has been inverted since roughly July 2022, while the 3m/10s since October 2022.

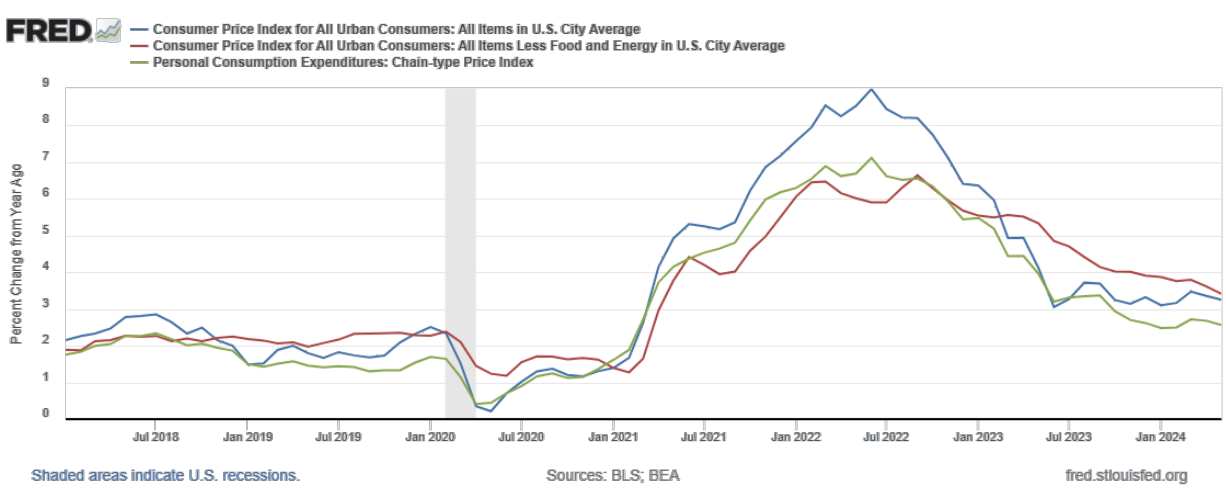
The inversion level, however, has been fairly stable since the beginning of the year, suggesting the market is responding to “re-priced” expectations of Fed policy going forward as well as ongoing economic resiliency, especially the continued resiliency of labor and retail sales indicators.



Source: St. Louis Fed (FRED), data through May 2024.

While some argue inflation remains a concern in 2024, it certainly is trending in the right direction. The Fed has signaled that, while it will remain “data dependent,” it is anticipating one rate cut this year (the market is pricing in *maybe* two).

The market expects the rate cut to come in September but, since this is an election year and any action the Fed takes will be viewed through a political lens, we would not be surprised if it waits until the December meeting to initiate its first cut. If there *are* two cuts this year, we expect them to come in September and December.



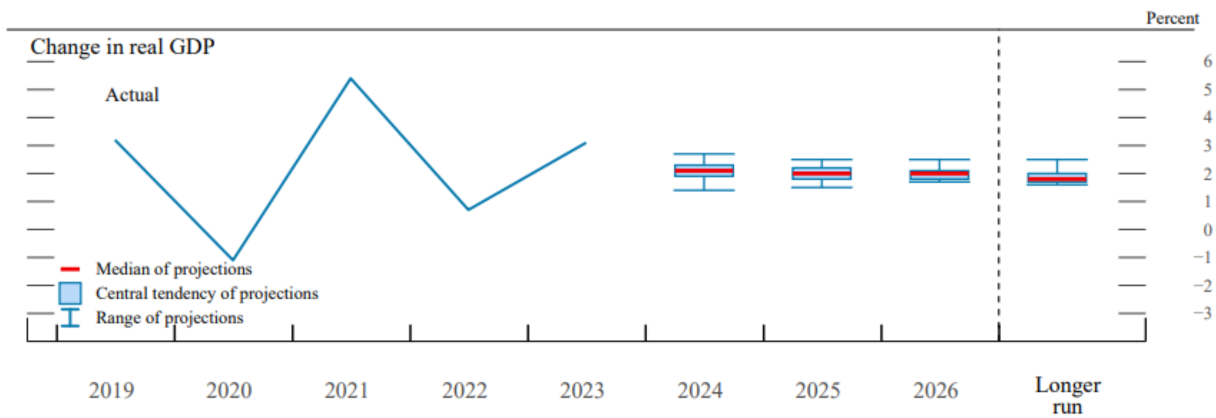
Source: St. Louis Fed (FRED), data through May 2024.

At the beginning of 2024, the market priced in an aggressive rate cut regime for the year (completely at odds with the Fed’s public announcements at the time), but seems to have finally learned (yet again) to not fight the Fed.

The consensus estimate for Q2 GDP growth is +/- 3% – a nice improvement over the 1.3% growth posted in Q1. The economy may be cooling but it is still expansionary.

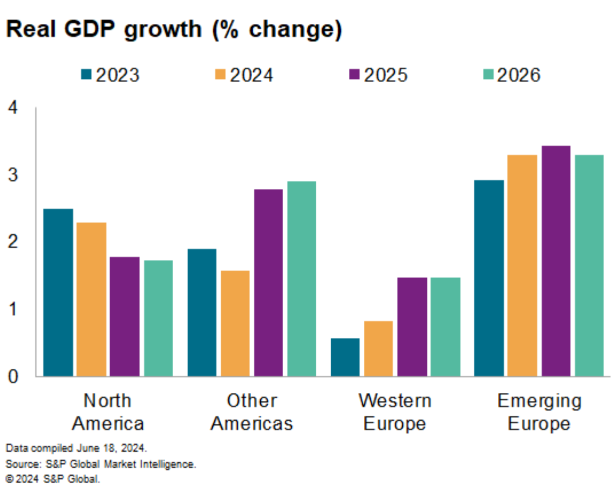
In its June 2024 "Summary of Economic Projections", the Fed estimated GDP growth of roughly 2% for both 2024 and 2025. [Note: The Fed is notoriously bad at forecasting economic activity, but it is helpful to know what they are thinking, as it will influence monetary policy decisions.]

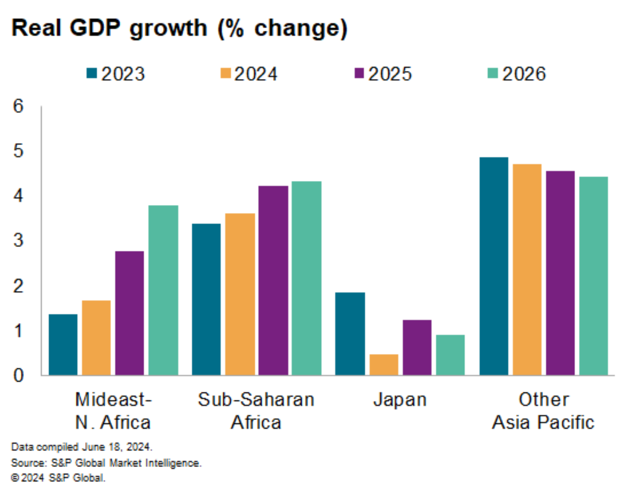
Figure 1. Medians, central tendencies, and ranges of economic projections, 2024–26 and over the longer run



Source: The FOMC "Summary of Economic Projections," as of June 12, 2024.

Estimates for economic growth outside the U.S. are also muted but positive, and roughly in line with historical levels of the past 15 years.





Source: Seeking Alpha and Markit, as of June 21, 2024. There is no guarantee that any projection, forecast, or opinion will be realized. Actual results may vary.

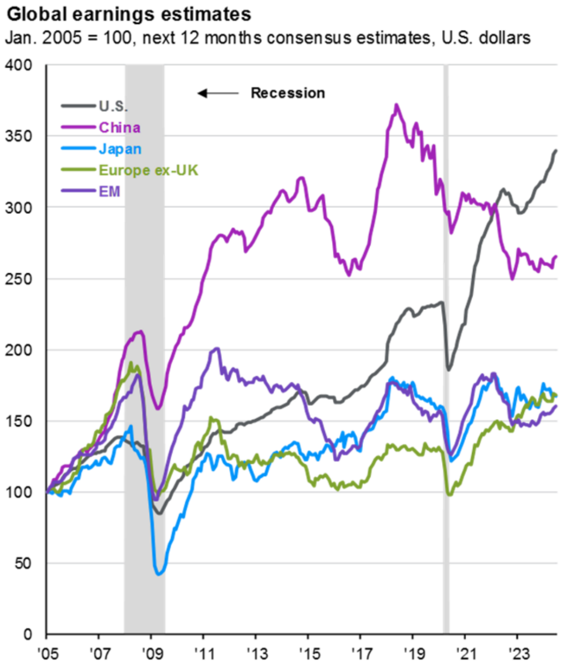
Earnings and Valuations

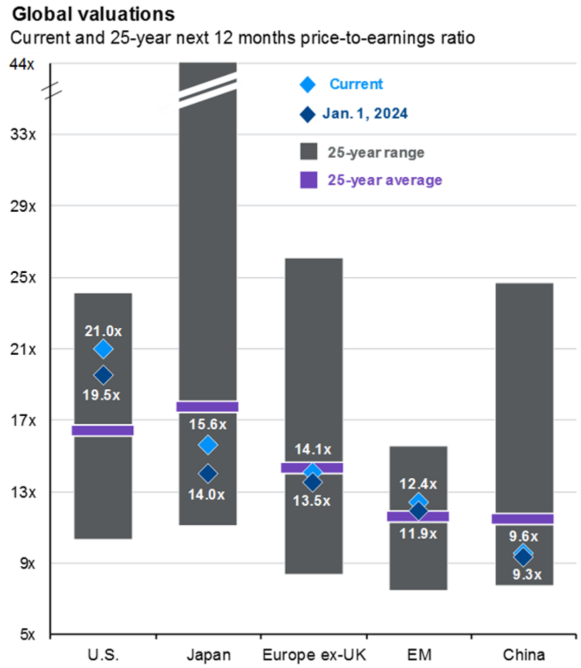
The Q2 earnings season will begin shortly. Q1 2024 earnings were solid, and the consensus estimates are for continued growth in both revenues and earnings as we move through 2024.

Source: Zacks Investment Research, as of June 26, 2024. Green bars are earnings and orange bars are revenues. Solid bars are actual results, while hatched bars are estimates and, therefore, subject to change.

Outside the U.S., earnings growth estimates are muted but positive, except for China, which, while showing signs of improvement, remains mired in a sluggish economic environment despite both fiscal and monetary stimulus injections from the central government.

Global valuations are more attractive outside the US (though the S&P 500 index valuation is skewed upward by the mega-cap tech stocks), but the global equity rally of the past 12-18 months has resulted in few, if any, "screaming buys" across the equity spectrum.

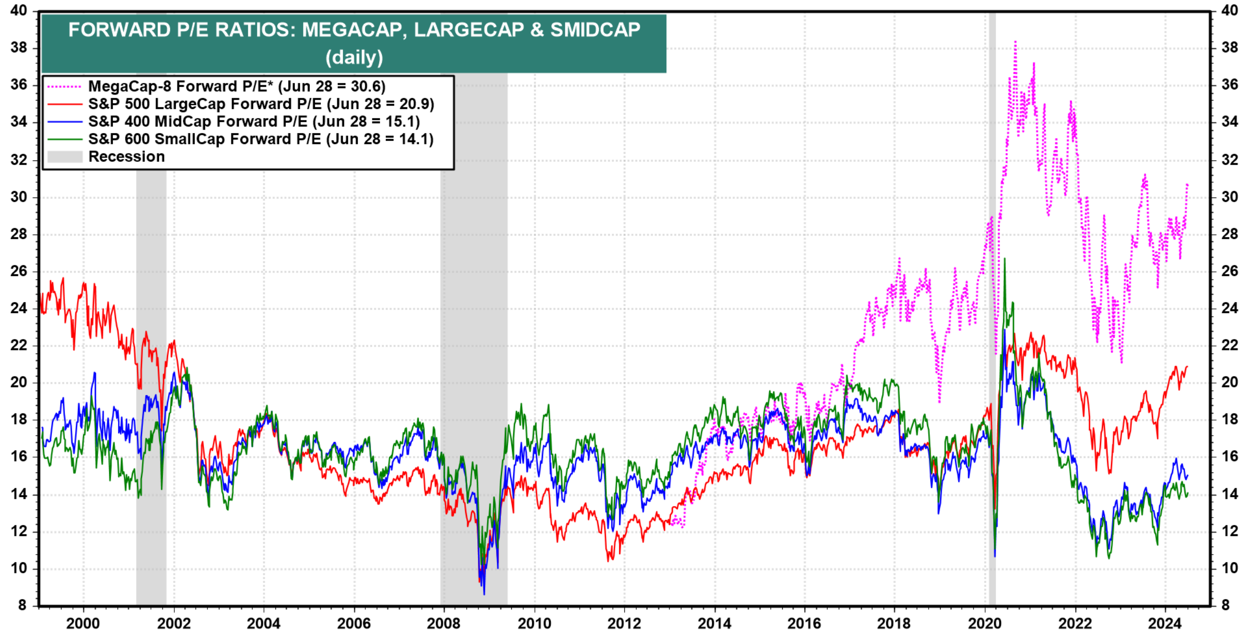




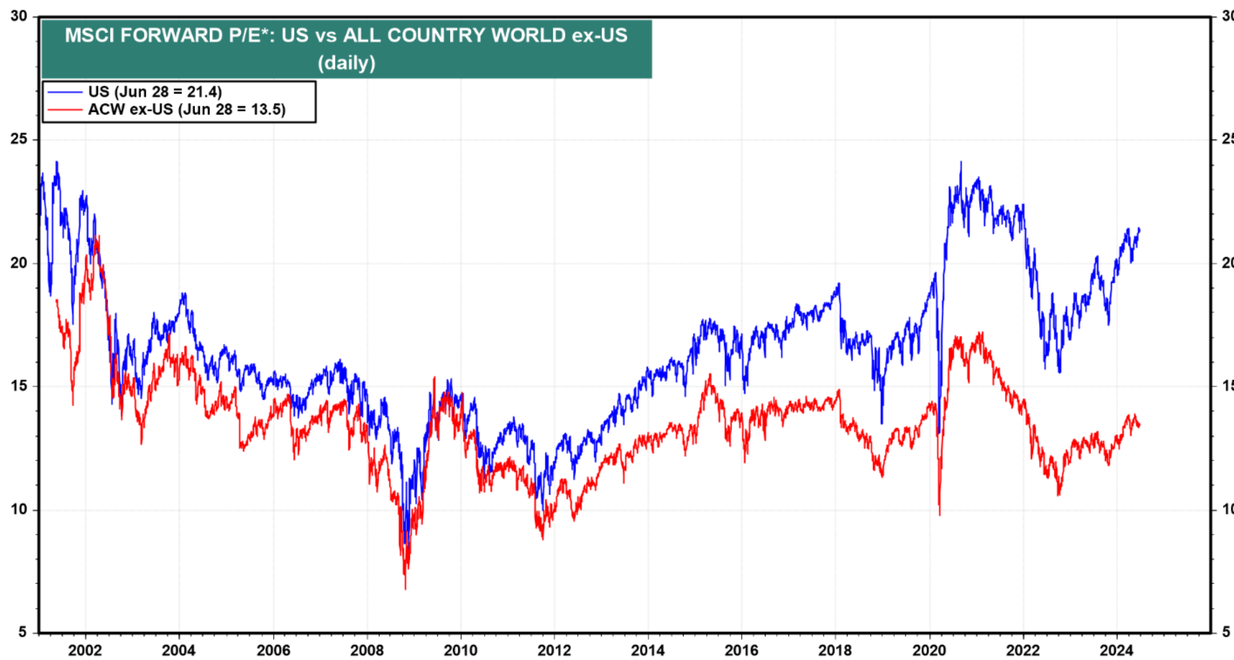
Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. Next 12 months consensus estimates are based on pro-forma earnings and are in U.S. dollars. Past performance is not a reliable indicator of current and future results. (Right) The purple lines for EM and China show 20-year averages due to a lack of available data. Guide to the Markets – U.S. Data are as of June 30, 2024.

Within the US, there remains a significant valuation dispersion between the mega-cap tech, broader large cap, mid cap, and small cap stocks. We see a similar dispersion between large cap growth and value stocks. And the valuation difference between US and non-US stocks is as wide as it has been in more than 20 years.

Patient and fundamentally driven investors may want to consider this as they position their portfolios for longer-term time horizons.



Source: LSEG Datastream and © Yardeni Research.
* MegaCap-8 stocks include Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla. Both classes of Alphabet are included.



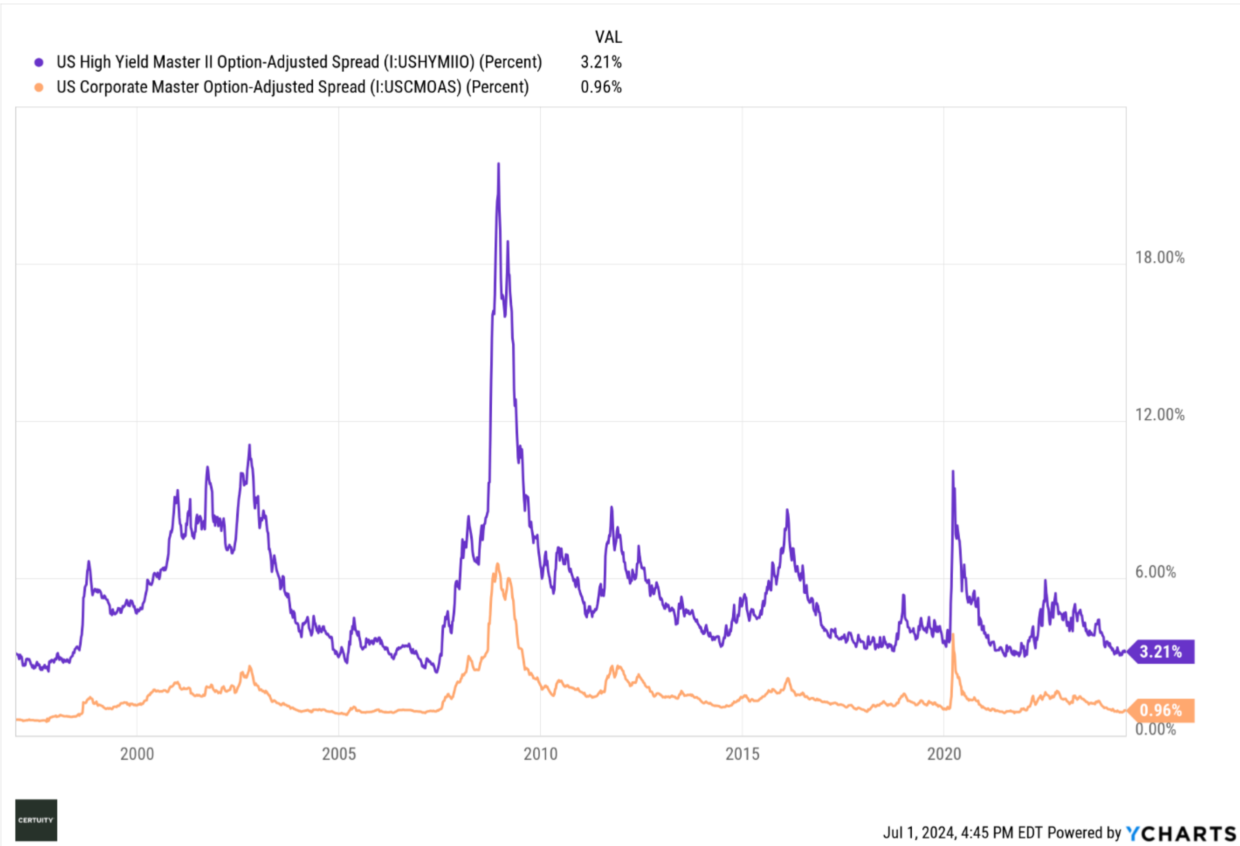
Source: LSEG Datastream and © Yardeni Research.

Source for both charts, Yardeni Research, through June 28, 2024. You cannot invest in an index and past performance is no guarantee of future results.

Interest Rates and Spreads

We discussed the level and shape of the curve above, but what about credit spreads?

Spreads are trading at the bottom end of their historical levels, suggesting investors remain comfortable with both interest rate and default risks. Indeed, bond investors seem as "complacent" as equity investors right now – another sign of a *perceived* "goldilocks" market environment.



Source: YCharts, data through June 28, 2024. You cannot invest in an index and past performance is no guarantee of future results.

Given the shape of the yield curve, investors are still not being appropriately compensated for taking excessive duration (interest rate) risk – the yield on short-term bonds is roughly the same as longer term bonds.

We continue to recommend balancing fixed income exposures between the two in a "barbell" approach as a means of generating acceptable levels of yield while controlling duration risk.

Summary and Interpretation

When focusing on what we believe are the primary economic and market signals, the *"condition our condition is in"* is generally positive, with some uncertainties – mostly regarding the economy, future Fed policy, and continuing geopolitical tensions.

To summarize our investment views for the remainder of 2024:

+ We believe the equity market can continue to rally from current levels, but almost certainly not at the rate it has over the past 6 months. Most analysts are calling for only modest levels of further price increases from this point forward. At some point the market adage is true – how much you can earn on any investment is at least partially a function of what you pay for it today. Given today's valuations, we believe we will begin to see this phenomenon play out as we move through 2024.
+ There is income available in fixed income. We continue to favor balancing short-term and longer-term allocations to manage duration risk without sacrificing yield.
+ Fundamental and strategic asset class rotation investors should look at the relative value attractiveness of US value and small cap stocks, as well as non-US allocations (ex-China).
+ Active management and intelligent risk factor tilts should be rewarded versus passive management.
+ We continue to like the private markets for those investors who can access them. Private credit may be getting a little "crowded" due to massive investor inflows, and more opportunistic market niches may present better opportunities. Specific private equity segments – specifically VC, secondaries, and direct investments – may offer better potential relative value. After being beaten down for much of the past 3-4 years, there appears to be some relative value in opportunistic and distressed real estate. *As always with private market investing, manager selection is critical to longer-term success.*

As philosophically strategic investors, we continue to recommend focusing on a longer-term time horizon and the construction of "all-weather" portfolios, diversified at both the asset class and risk factor levels.

We wish everyone a happy and celebratory summer!

Scott Welch, CIMA®
Chief Investment Officer
Certuity

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