

SEPTEMBER 2024

# S&P 500 EARNINGS BREADTH BROADENS

After a few volatile weeks, global equities ended up about 2.6% in August. Following a 15% plus decline in the first three days of August, Japanese equities ended the month up 1.8%. In the U.S., defensive equities performed better than the more cyclical areas and mega cap stocks. Fixed income returns have benefited from recent declines in interest rates. The 2s10s curve (yield curve) has un-inverted. The 2-year Treasury yield declined as the market began anticipating interest rate cuts over the next 12 months. Credit spreads widened somewhat, but it mostly reflected heightened volatility in the rates market and less about the health of the corporate sector.

U.S. economic activity is likely to cool from its brisk pace in the first half, but we don't expect a contraction in the near term. The recent payrolls report and revisions released last month show that the job market is cooling from its earlier hot pace with no evidence of a downturn. Recent data has been broadly consistent with our soft landing base case and if anything, probabilities have coalesced even more around the base case.

Inflation is decelerating to more normal levels. With a cooling labor market, we would expect more progress on services inflation. The Fed has communicated that the "time has come" to begin cutting interest rates in response to falling inflation and slowing growth. The June <sup>1</sup>SEP had the Fed Funds rate at 4.1% by the end of 2025, while the market expects an additional 125 basis points (bps) of cuts. Potential unwinding of rate cut expectations could be a source of volatility. Despite recent moderation, the U.S.

growth outlook is much more constructive relative to Europe and China where slowing continues.

The S&P 500 saw 11% year-over-year earnings growth in the second quarter, of which nearly half came from stocks outside of the Magnificent 7. This is a change from the prior 2-3 quarters when their contribution was negative. We see a similar picture in the bond market where credit spreads have remained contained. The High Yield (HY) picture remains constructive with low default rates.

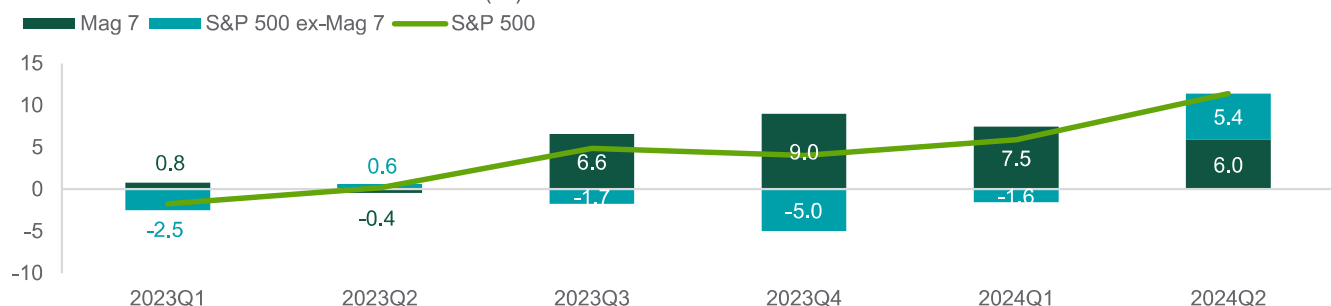
Our recommended 6-12 months tactical asset allocation broadly favors global equities over bonds. There are some valuation concerns around U.S. equities but strong earnings expectations and the broadening of equity markets keep us invested in them. Bonds may remain volatile if the market begins to price out rate cuts. This led us to go further underweight bonds. We do expect a bounce back in global equities but we removed our developed ex-U.S. equities overweight where the growth picture is a little muddy. The reductions in bonds and equities funded additions to Global Real Estate and Global Listed Infrastructure. Both asset classes should continue to benefit from the reduction in the rates environment. Investor sentiment was quite negative on Real Estate and we expect an improvement here as the asset class is highly leveraged to lower and declining rates. Further, Global Listed Infrastructure is particularly well positioned from an earnings and fundamentals perspective.

*Anwiti Bahuguna, Ph.D. – Chief Investment Officer, Global Asset Allocation*

## S&P 500 EARNINGS BREADTH BROADENED

S&P 500 ex-Magnificent 7 contributed 5.4% to 2Q S&P 500 earnings growth, the highest level since early 2023.

EARNINGS GROWTH CONTRIBUTION (%)



Source: Northern Trust Asset Management, Bloomberg, FactSet. Data as of 8/31/2024. Magnificent 7 = Mag 7. <sup>1</sup>SEP = Summary of Economic Projections.

## Interest Rates

The shape of the yield curve (as measured by the difference between 2-year and 10-year Treasury yields), historically a closely watched indicator of economic recession, was inverted (it's normally upward sloping) for more than two years. This is the longest such stretch in over 40 years. Recently, however, with all signs pointing to a rate cut at the September <sup>1</sup>FOMC meeting, the yield curve has shifted to be upward sloping again.

While some are viewing this normalization as still a sign of imminent recession, we aren't seeing such a scenario as very likely when looking at the totality of economic data recently. Indeed inflection points in the economic cycle are often confusing and difficult to predict, but we would caution against reading too much into signals from a single indicator like the shape of the yield curve. In fact, some other, less frequently watched, measures of yield curve shape like 2-year/5-year remain inverted as markets continue to wrestle with their outlook for the economy and monetary policy. While we'll continue to monitor the yield curve, we suspect we won't be writing about yield curve inversion (again) or recession any time soon.

- Dan LaRocco, Head of U.S. Liquidity, Global Fixed Income

## INVERTED NO LONGER

The 2-year Treasury yield has fallen on rate cut expectations.

10-YEAR / 2-YEAR SPREAD (BPS)



Source: Northern Trust Asset Management, Bloomberg. 10-Year / 2-Year spread = 10-Year Treasury yield minus 2-Year Treasury yield. BPS = basis points. Data from 9/10/2021 through 9/13/2024. <sup>1</sup>FOMC = Federal Open Market Committee.

- The yield curve has begun to normalize after being inverted for over two years.
- Inflection points in the economic cycle are often difficult to predict.
- We would caution against reading too much into any one indicator like curve shape.

## Credit Markets

High yield saw another strong month of performance, despite the uptick in volatility. Volatility increased significantly at the beginning of August, as markets encountered a “growth scare” from an unexpectedly weak employment report early in the month. High yield recovered quickly alongside equity markets as the month progressed, with additional economic data giving investors comfort that the economy was still broadly on solid footing.

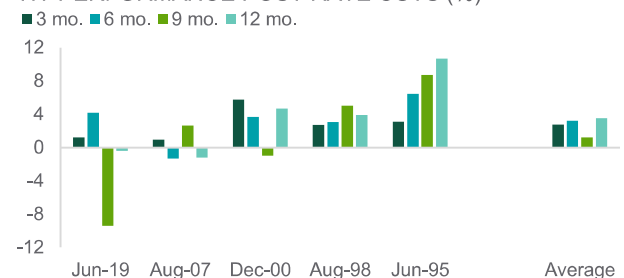
High yield bonds have historically performed well following the first Fed rate cut. In the past, all five examples of rate cuts were accompanied by positive returns over the following three months for high yield bonds. Historically, higher quality credits typically outperform lower quality credits during a Fed easing cycle due to two primary factors. One is higher quality credits tend to have longer durations hence higher sensitivity to a decrease in rates, and the other being the Fed easing cycle has historically coincided with a steadily weakening economy leading to outperformance in higher quality companies. Given the high yield index is of higher credit quality versus prior Fed cutting cycles, this could be an additional tailwind for the asset class.

- Eric Williams, Head of Capital Structure, Global Fixed Income

## HY TENDS TO OUTPERFORM POST RATE CUTS

High yield bonds have historically performed well following the first Fed cut.

HY PERFORMANCE POST RATE CUTS (%)



Source: Northern Trust Asset Management, Bloomberg, JP Morgan Research. HY = High Yield; proxied by the JP Morgan High Yield Index. Data as of 9/11/2024. Historical trends are not predictive of future outcomes.

- In the past, all five examples of rate cuts were accompanied by positive returns over the following three months for high yield bonds.
- Higher quality credits typically outperform lower quality credits during a Fed easing cycle.
- Given the high yield index is of higher credit quality versus prior Fed cutting cycles, this could be an additional tailwind for the asset class.

## Equities

In August, U.S. large cap stocks were down 6.1% over the first three trading days before rallying 9.1% to finish the month 2.4% higher, as concerns about the yen carry trade and U.S. growth dissipated. Defensive stocks performed well, while value modestly outperformed growth. Developed ex-U.S. equities were up 3.3% getting a significant boost from dollar weakness. Volatility roared loudly before hastily retreating, although it has picked up again in September. Increased volatility is not unusual in a run up to the start of a Fed rate cut cycle. September, historically the weakest performing month, has lived up to its reputation thus far with semiconductors once again leading the way down and defensive stocks outperforming.

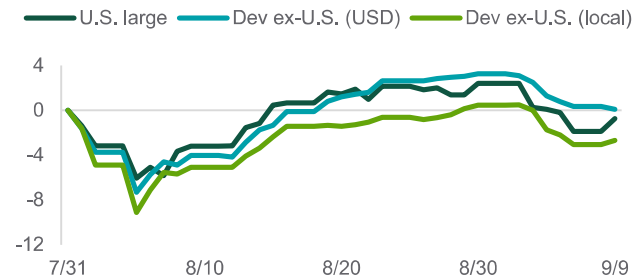
Recent data and market events have not altered our constructive fundamental views of a soft landing and solid corporate profits – second quarter earnings season wrapped up with 11.3% earnings growth, broad sector participation, and a strong outlook for the next 12 months. We reaffirmed our overweight equity positioning in the U.S. and emerging markets, but removed our overweight to developed ex-U.S. equities given a less-favorable economic growth outlook in Europe.

- Jordan Dekhayser, Head of Equity Client Portfolio Management

## IN LIKE A LION, OUT LIKE A LAMB

Global Equities finished a volatile August on a high note.

### EQUITY RETURNS SINCE JULY (%)



Source: Northern Trust Asset Management, Bloomberg. Total return data from 7/31/2024 through 9/10/2024. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

- August was a volatile month for global equities, but finished on a high note. Developed ex-U.S. equities received a significant boost from a weaker dollar.
- Increased volatility heading into a rate cut cycle is not unusual as investors debate economic outcomes.
- We reaffirm our constructive view on equities, but removed our overweight to developed ex-U.S. equities given a less-favorable economic growth outlook in Europe.

## Real Assets

We have become more constructive on Global Listed Infrastructure (GLI), and have taken an overweight position in our tactical portfolio. Over the longer term, infrastructure can provide investors exposure to indirect ownership of necessity-based assets with defensive/quality cash flows and revenue agreements with regulated or contractual pricing. More recently, infrastructure has drawn investor interest due to positive short-term fundamentals with strong growth from increasing demand for global power as well as increasing attractiveness in a decreasing and lower rate environment. These positive fundamentals and a lower cost of capital are expected to lead to high single-digit earnings growth in infrastructure for each of the next few years.

From a valuation perspective, GLI screens historically cheaply, which bodes well for its expected intermediate and longer-term performance and could provide downside protection. Specifically, listed infrastructure currently trades at 17.4x forward earnings, while the ACWI trades at 17.7x. Historically, infrastructure has traded at a 16% premium to the broader market, reflective of the infrastructure sector's attractive attributes.

- Jim Hardman, Head of Real Assets, Multi-Manager Solutions

## OPPORTUNITIES IN INFRASTRUCTURE

Listed Infrastructure looks attractive on several metrics.

### P/E DISCOUNT VS. ACWI



Source: Northern Trust Asset Management, FactSet. Data as of 8/31/2024. ACWI = MSCI AC World, Infra = S&P Global Infrastructure. P/E = Price-to-earnings. Past performance is not a guarantee of future results. It is not possible to invest directly in an index. Diversification and asset allocation do not assure a profit or protect against loss.

- GLI has drawn investor interest due to a number of positive attributes and fundamental growth opportunities.
- The sector screens historically cheaply as well, providing a roadmap to longer-term outperformance.
- We have become more constructive on real assets and have taken overweight positions in both GRE and GLI while maintaining an underweight to GNR.

## BASE CASE EXPECTATIONS

### Sticking the Landing

Global growth will move below trend but remain positive, supported by ongoing U.S. economic strength and labor market/consumer resilience. Inflation will remain above target but continue to proceed toward 2%.

### Central Bank Transitions

Major central banks have started to cut policy rates and we expect more to follow suit as the year progresses. Economic growth may afford policymakers more time to confirm that inflation progress is sustainable.

## RISK CASE SCENARIOS

### Stubborn Inflation

Inflation does not move lower due to economic resurgence, tight labor markets, U.S. election induced pressures related to tariff or immigration policies, and/or disruptions from conflict in the Middle East.

### Lagged Impacts

A soft landing is taken off the table as easing economic growth evolves into a traditional demand-led recession. In this scenario, a shallow recession is more likely than a deep contraction.

## GLOBAL POLICY MODEL

Strategic Allocation and Tactical Over/Underweights	FIXED INCOME				EQUITIES			REAL ASSETS			
	Cash	Inv. Grade	Infl. Linked	High Yield	U.S.	Dev. Ex-U.S.	Emerg. Markets	GLI	GRE	NR	Gold
Strategic Asset Allocation	2	30	9	5	28	13	5	2	2	4	0
Tactical Asset Allocation	0	25	7	10	31	13	6	3	3	2	0
<b>Over/Underweight</b>	<b>-2</b>	<b>-5</b>	<b>-2</b>	<b>5</b>	<b>3</b>	<b>0</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>-2</b>	<b>0</b>

Source: Northern Trust Capital Market Assumptions Working Group, Investment Policy Committee. Strategic allocation is based on capital market return, risk and correlation assumptions developed annually; most recent model released 8/9/2023. The model cannot account for the impact that economic, market and other factors may have on the implementation and ongoing management of an actual investment strategy. Asset allocation does not guarantee a profit or protection against a loss in declining markets. GLI = Global Listed Infrastructure, GRE = Global Real Estate, NR = Natural Resources.

Indexes used and definitions:

MSCI ACWI: A free-float weighted equity index that includes both emerging and developed world markets.

S&P 500 Index: Widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

S&P Global Infrastructure Index: The S&P Global Infrastructure Index includes exposure to 75 companies from around the world that represent the listed infrastructure universe.

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