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BILBoard August 2024 – Stocks get that summer glow

Over the past few weeks, two important developments have played out for investors.

Firstly, US inflation was shown to have declined for a third consecutive month in June. The headline print came in below expectations at 3% YoY, and on a monthly basis, inflation actually declined (-0.1%) for the first time since May 2020. The all-important core CPI reading (which excludes volatile categories like food and energy) fell to 3.3%, the lowest level in over three years. Austan Goolsbee of the Chicago Fed concluded that “this is what the path to 2% inflation looks like”, while Jerome Powell has also expressed satisfaction with recent data. Can the trend continue? We think so. Global food and energy prices remain unthreatening, and a weakening labour market is weighing on consumer sentiment, making a consumption slowdown likely in the months ahead. The upside of this is that it could lead to further alleviation in price pressures. These observations give greater confidence that the Fed will embark on a protracted easing cycle soon. Markets now see a September rate cut almost as a done deal and place a high probability of another cut in December. For many market participants, the risk that the Fed waits too long to cut, leading to a hard landing, has faded.

Secondly, the rally which has seen the S&P 500 hit 38 new highs this year, has started to **broaden out** beyond mega-cap stocks with an AI halo. As the prospect of Fed rate cuts becomes more tangible, smaller cap stocks have flourished. The small-cap Russell 2000, for example, has reached a two-and-a-half year high. To illustrate the extent of the small-fry comeback, the same index has enjoyed a five-day streak of gains of 1% or more for the first time since 1979. This represents a promising sign for the current bull market, as concentration risk – one of the prevailing sources of fear about the market rally in 2024 – is dissipating.

INVESTMENT STRATEGY

EQUITIES

In light of the aforementioned developments, we have **increased our exposure to US equities** in all eligible risk profiles, bringing our overall stance to a **slight overweight**. From an economic standpoint, we believe that the weak Q1 GDP print masks some underlying strength and Q2 could come in slightly stronger. Thereafter, we do envisage a slowdown throughout the course of the year, but without a recession materialising. On a more micro level, the earnings season is off to a good start. For example, Wall Street has posted its best quarter for investment banking in more than two years, in what bankers said were the early innings of a sustained recovery. Beyond that, momentum around the AI theme and technological progress is still going strong. Recent market action indicates that there remains a wall of money that’s willing to buy, even if valuations are high.

In Europe, we maintain our base case for a weak recovery through end-2024, supported by a pick-up in consumption. PMIs pulled back in June, but this is perceived as a blip in the improving trend. In the services sector, firms are demonstrating a high degree of optimism about the future and domestic demand remains robust. In manufacturing, pricing power is very gradually returning to the market. In addition, manufacturing growth is seen in other parts of the world (US, UK, and India) and this global recovery provides a supportive backdrop for EZ manufacturers. We are holding fire for now with regard to topping up European equity exposure further, waiting for further clarity on the ECB’s policy pathway. A record-low unemployment rate (6.4%), and ongoing collective bargaining (IG Metall and Verdi in Germany, for example) could slow the disinflationary process this year, with meaningful progress towards 2% delayed until 2025. By closing some of our thematic positions, we have mechanically

reduced our European equity exposure, resulting in a slight underweight.

Looking to the Pacific, we decided to **cut exposure to Japanese equities** in all eligible profiles. The yen has strongly depreciated and any turnaround in that trend would likely be unfavourable for Japanese equities. As of now, the BoJ is reportedly acting to prop up the currency. Meanwhile, Shunto annual wage negotiations have resulted in some of the largest pay hikes in 33 years, while economic surprises have turned positive. This paves the way for the BoJ to continue lifting rates, which would also boost the yen.

FIXED INCOME

In anticipating a less robust US macro landscape in the second half of the year, and with credit returning to extremely tight levels, we decided to lock in profits and **bring our US high-yield exposure back to neutral**.

In turn, we **slightly increased exposure to US Sovereigns**. While the bond market has had a mixed start to the year, with only credit being able to post positive returns, recent trends are encouraging for Treasuries (slowing inflation, some macro weakness, and a progressively dovish Fed). We position ourselves on the **intermediate part of the curve (3-7 years). More and more stakeholders are predicting a victory for Donald Trump and are beginning to discount the impact of his pro-business agenda,** which is expected to boost the economy and increase already-large fiscal deficits, thus potentially pushing up the long-end of the yield curve. Historically, Treasuries have performed well going into US elections, before selling off in the aftermath. This effect should be magnified if the Fed cuts in September or strongly suggests a November cut.

Otherwise, we remain **overweight European Investment Grade corporates**, where spreads still have some room left to tighten. European credit risk which resurfaced after the decision to call for snap elections in France was short lived, and spreads returned to previous levels once it become clear that no party at an extreme end of the political spectrum could secure a majority in parliament. Overall, the asset class remains in a sweet spot, with an economy that is neither too hot nor too cold.

CONCLUSION

It’s the season when we recharge, to later return to the office sun-kissed and full of energy. Well, this summer, it seems the stock market is also getting a healthier glow about it. A thriving market requires participation from multiple areas, whether it be across market caps, sectors, or styles. So far in 2024, this was not case with returns almost exclusively driven by large-cap tech stocks. But now rotation, the very lifeblood of a bull market, is playing out. If that wasn't enough, dovish notes are beginning to emanate from the US Federal Reserve, in another good omen for stocks. In light of these developments, we have increased US equity exposure. But one should always wear sunscreen: we balance out the additional risk by replacing a chunk of our high-yield exposure with US Sovereigns.

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