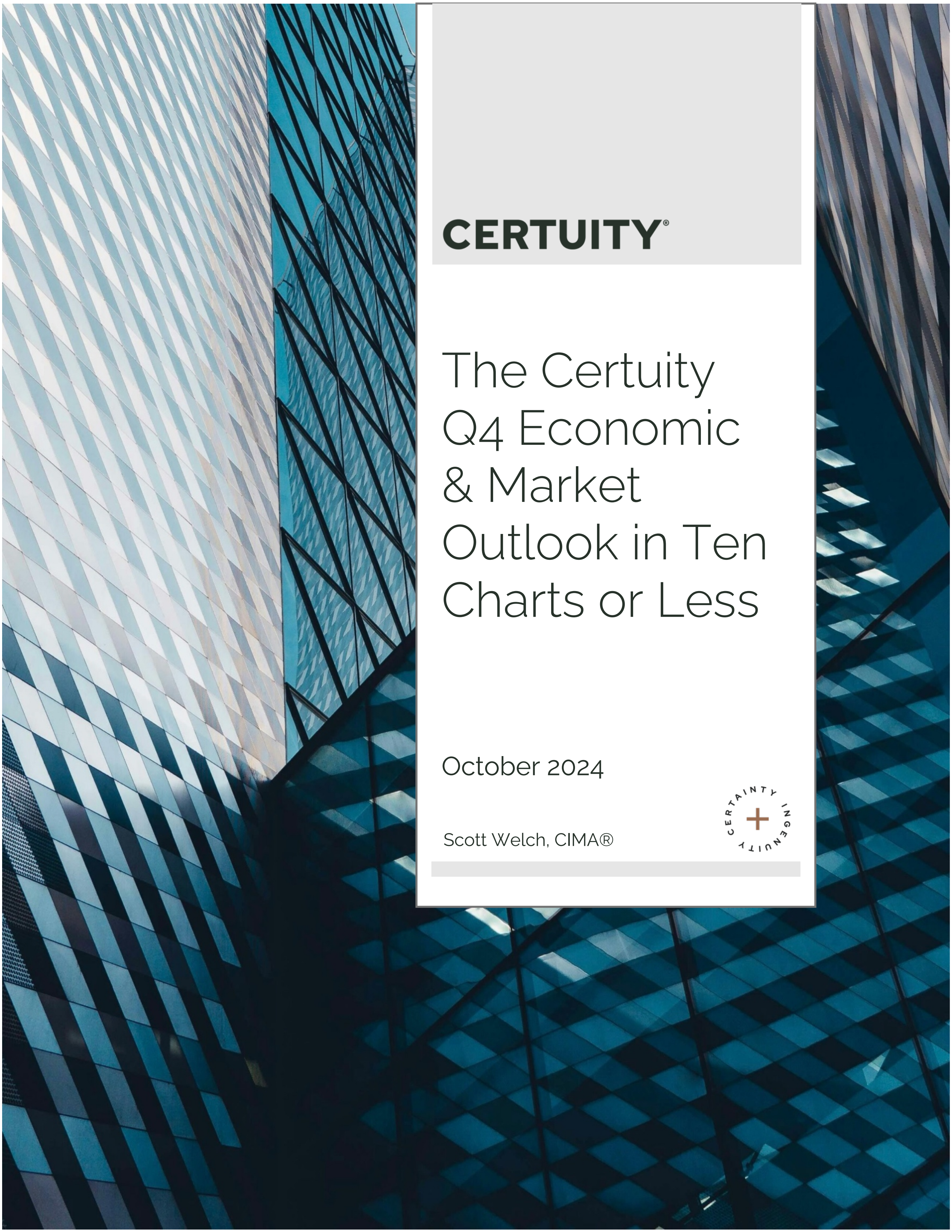


CERTUITY

The Certuity Q4 Economic & Market Outlook in Ten Charts or Less

October 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 national and geopolitical issues. But these are “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 – and tightly contested – 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 Fed has begun a rate cut regime in the hopes of providing the economy with the proverbial “soft landing,” but it remains to be seen if it will be successful in doing so.

As we write this, the Q3 earnings season has not yet begun but 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.

We are seeing renewed interest in the public bond markets as rates have risen, but credit spreads remain tight and, if we are correct in our view that the pressure at the long end of the yield curve is upward, not downward, total return potential is limited.

There continues to be high investor demand for private market investments, both through traditional drawdown facilities and, in private credit, through “evergreen” facilities. Investors are also looking at secondaries, infrastructure, and real estate.

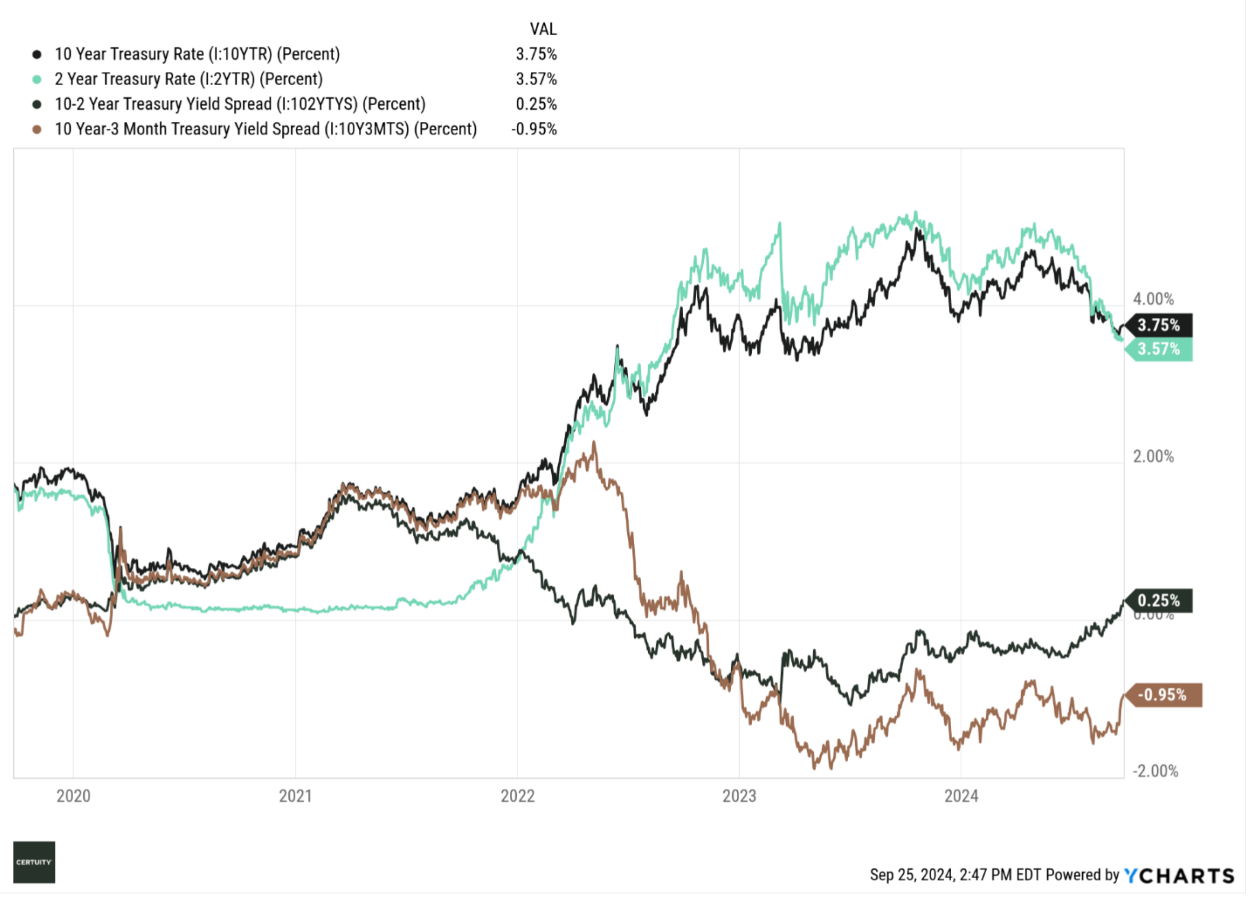
Let’s dive in.

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).

The yield curve, as measured by the 2s/10s, finally "dis-inverted", that is, moved slightly into a normal upward sloping curve. We expect this to remain the case as the Fed cuts rates and the short end of the curve falls more than the long end.

Note, however, that the 3m/10s spread remains inverted.



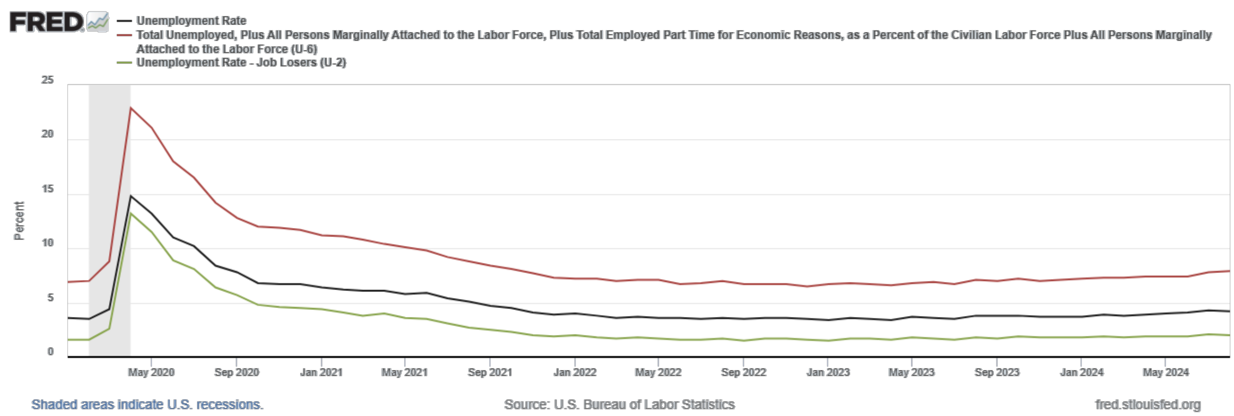
Source: Ycharts, 5-year data through March September 24, 2024. You cannot invest in an index and past performance is no guarantee of future results.

We see that the 2s/10s was inverted from roughly July 2022 until just recently, while the 3m/10s since October 2022.

The Fed somewhat changed its narrative beginning with the July FOMC meeting. The focus had been firmly on bringing down inflation, but starting in July the Fed began to remind people it has a *dual* mandate – to optimize both inflation and employment.

We anticipated that, if the Fed cut rates in September, it would cite a cooling labor market as a primary reason, and that is exactly what happened.

This is not necessarily reflected yet in the unemployment metrics. Unemployment remains below 5% – historically, the level many economists considered “full employment” for the US economy.



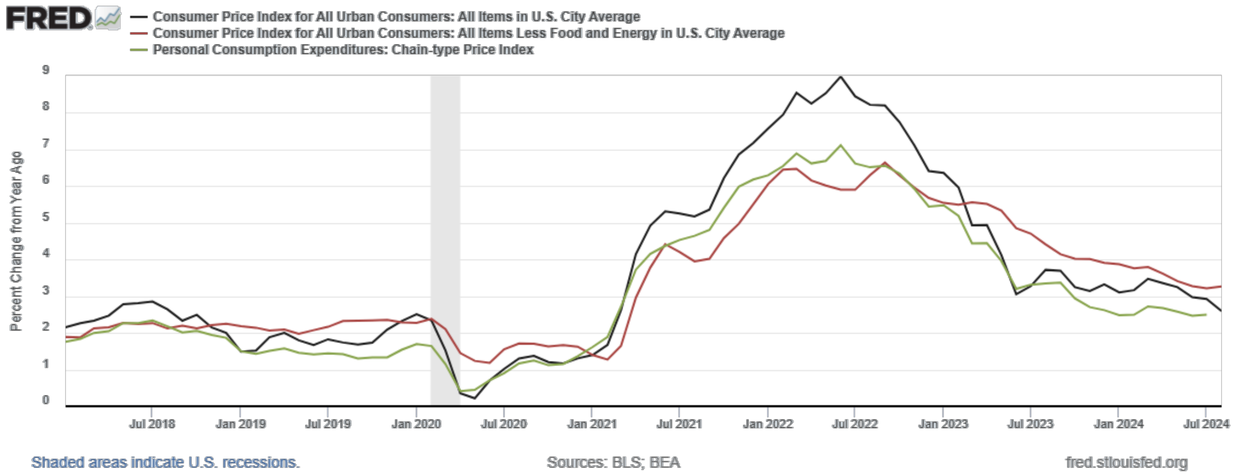
Source: St. Louis Fed (FRED), data through August 2024.

Inflation is trending direction though it remains above the Fed’s target rate of 2% annualized. After the somewhat surprising 50-bps cut at the September FOMC meeting, all eyes once again have turned to the Fed.

We didn’t see the need to cut 50-bps (especially so close to a highly contested election), so we can only conclude the Fed saw more potential weakness in the labor markets than is visible in the current data. It certainly was what the market *wanted* – and now it wants more cuts going forward.

The next FOMC will be in November, after the election, and the Fed suggested it *will* continue its rate cutting regime well into 2025, which should make the market happy.

The potential downside, of course, is that overly aggressive rate cutting may reignite inflation, but the Fed seems to believe it has that under control and will remain heavily “data dependent” in the meantime.

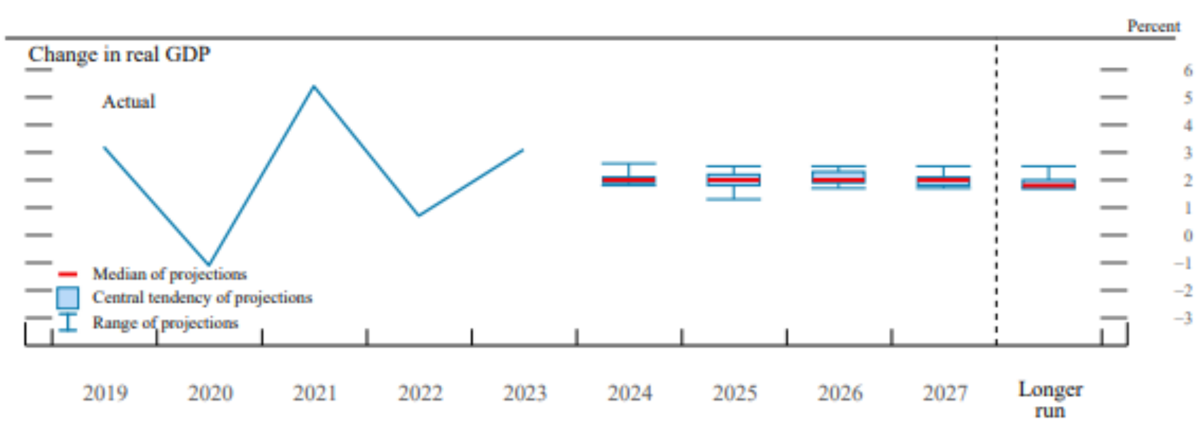


Source: St. Louis Fed (FRED), data through August 2024.

The current consensus estimate for Q2 GDP growth is 2-3% – not robust but still positive. The economy may be cooling but it is still expansionary.

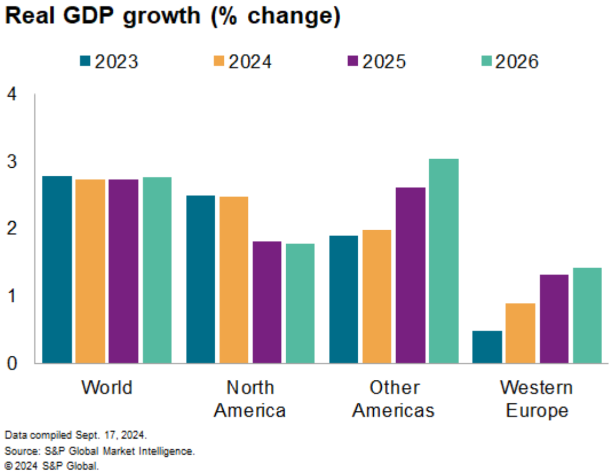
In its September 2024 "Summary of Economic Projections", the Fed estimated GDP growth of roughly 2% for both 2024 and 2025. [Note: The Fed is notoriously bad at forecasting economic activity, but it is helpful to know what they are thinking, as it will influence monetary policy decisions.]

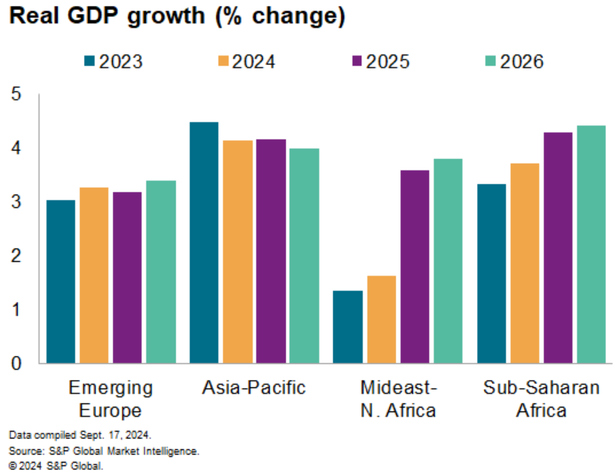
Figure 1. Medians, central tendencies, and ranges of economic projections, 2024–27 and over the longer run



Source: The FOMC "Summary of Economic Projections," as of September 18, 2024. There is no guarantee that any projection, forecast, or opinion will be realized. Actual results may vary.

Estimates for economic growth outside the U.S. are also muted but positive, and roughly in line with historical averages.

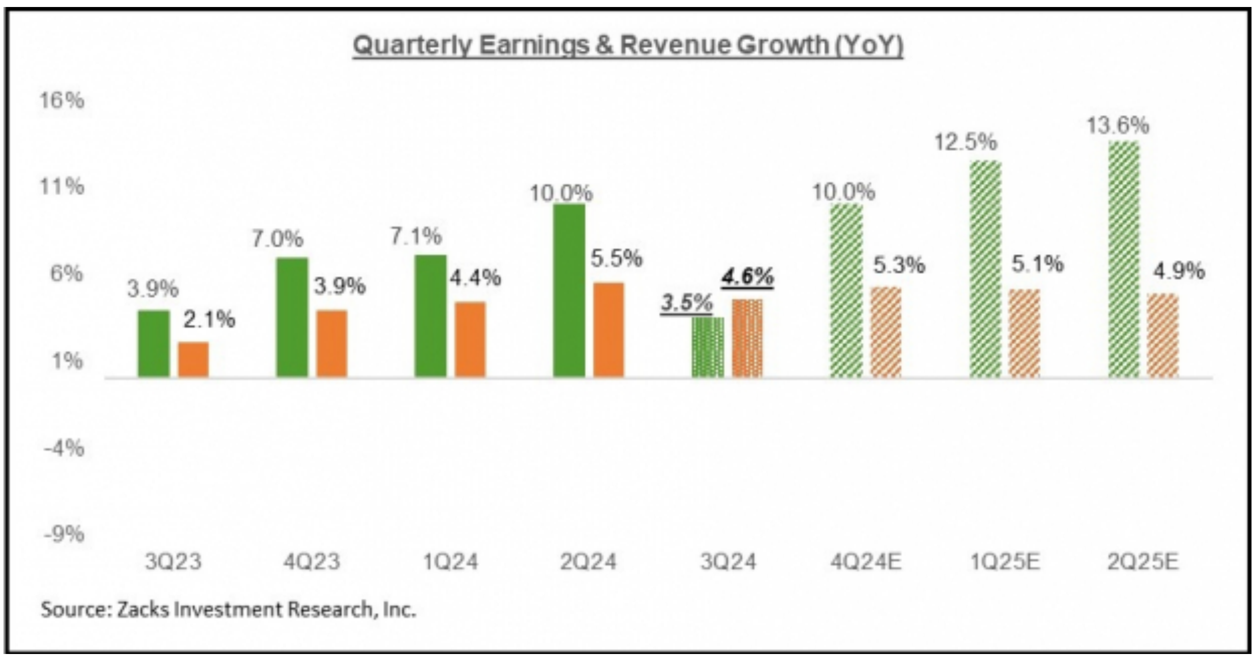




Source: Seeking Alpha and Markit, as of September 20, 2024. There is no guarantee that any projection, forecast, or opinion will be realized. Actual results may vary.

Earnings and Valuations

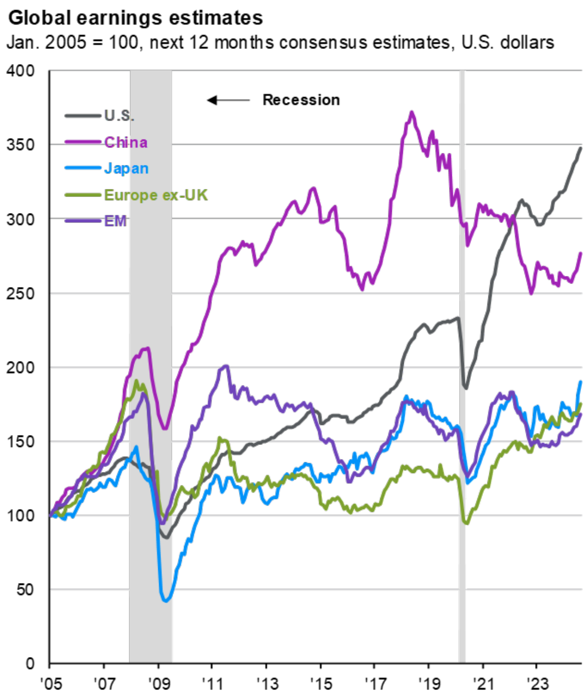
The Q3 earnings season will begin shortly. Q2 2024 earnings were solid, and the consensus estimates are for continued positive growth in both revenues and earnings as we move through the rest of 2024 and into 2025.

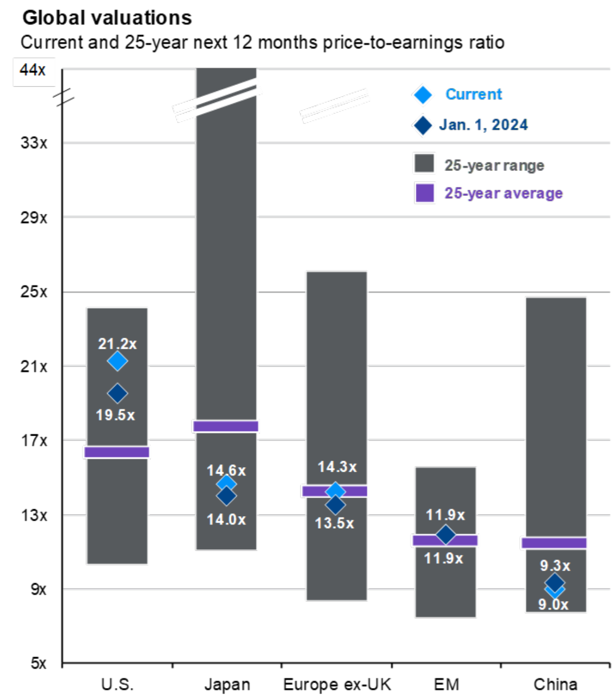


Source: Zacks Investment Research, as of September 18, 2024. Green bars are earnings and orange bars are revenues. Solid bars are actual results, while hatched bars are estimates and, therefore, subject to change.

Outside the US, earnings growth estimates are muted but positive, except for China, which, while showing signs of improvement, remains mired in a sluggish economic environment. The government recently launched an aggressive series of both fiscal and monetary stimulus programs but, as we write this, it is too early to tell if it will be effective in catalyzing the Chinese economy.

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.

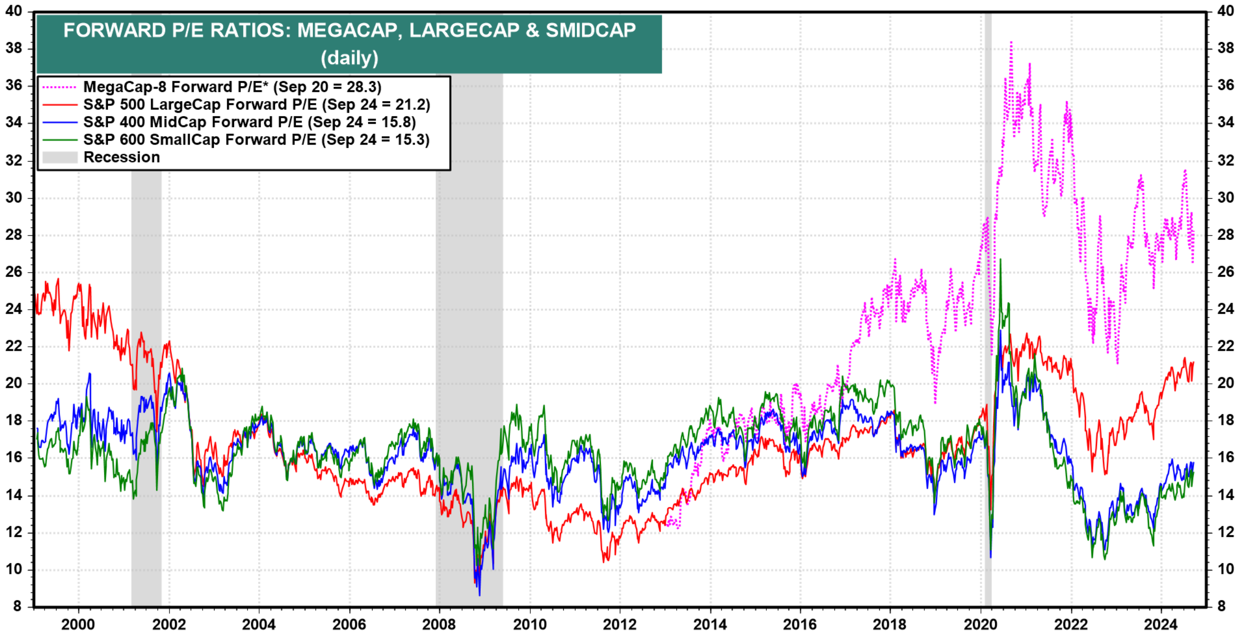




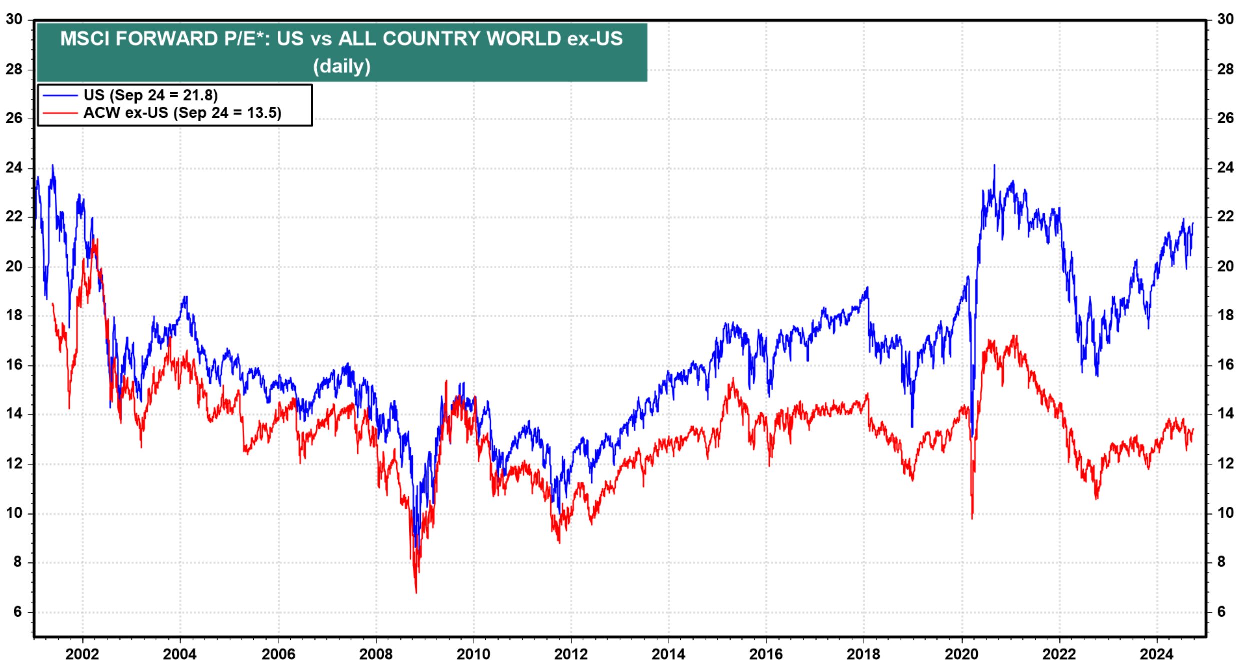
Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. Next 12 months consensus estimates are based on pro-forma earnings and are in U.S. dollars. Past performance is not a reliable indicator of current and future results. (Right) The purple lines for EM and China show 20-year averages due to a lack of available data. Guide to the Markets – U.S. Data are as of August 31, 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, and Standard & Poor's.
* 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, MSCI and IBES.

Source for both charts, Yardeni Research, through September 24, 2024. You cannot invest in an index and past performance is no guarantee of future results.

Interest Rates and Spreads

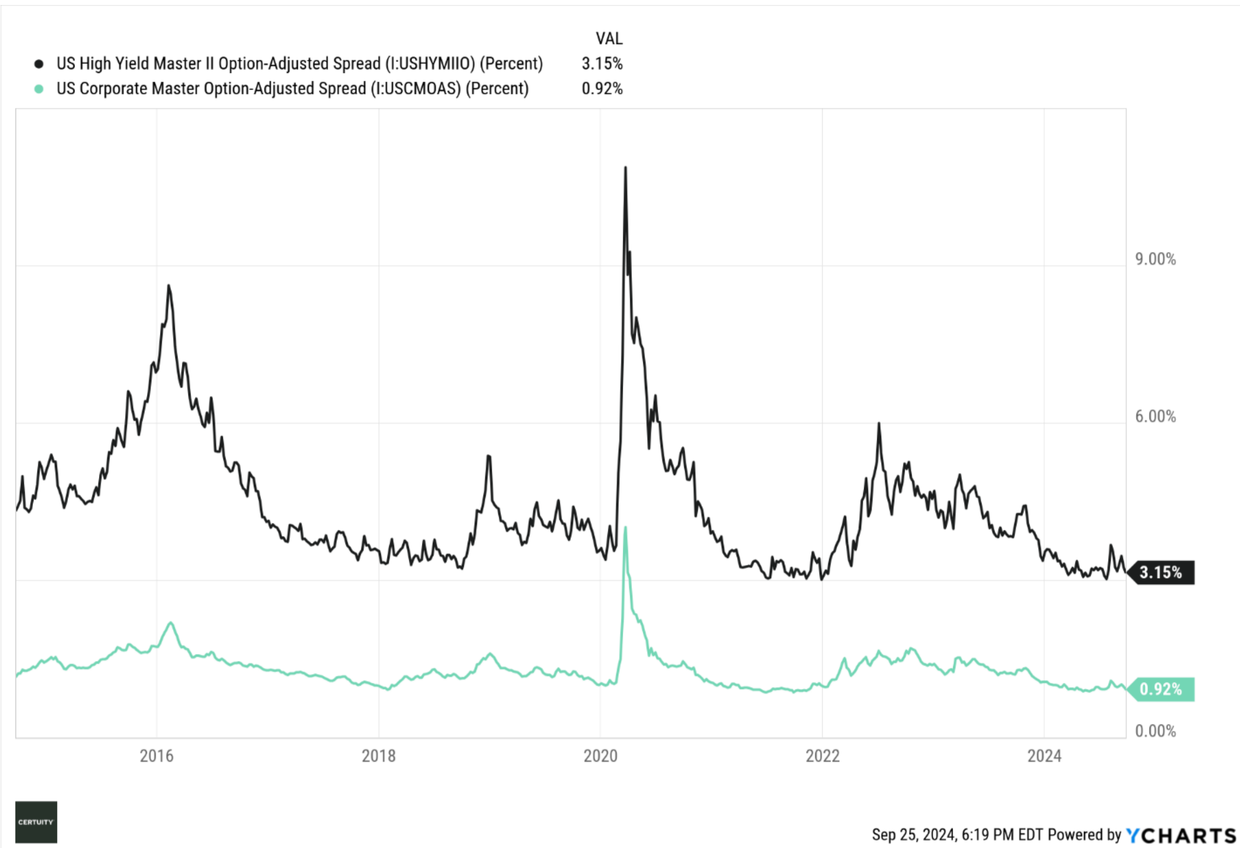
We discussed the level and shape of the curve above, but what about credit spreads?

Spreads are trading at the bottom end of their historical levels, driven partially by heavy flows out of money market funds and into investment grade and high yield bonds. Corporate balance sheets generally are in solid shape (though there are signs of increased delinquency and default rates).

Given what we believe is greater upward than downward pressure on rates, combined with the tightness of spreads (where the risk is definitely upward from current levels), we continue to hold modest expectations for the total return potential of public bonds.

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 still roughly the same as longer term bonds (though that will change if the Fed continues to cut rates).

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.



Source: Ycharts, data through September 24, 2024. You cannot invest in an index and past performance is no guarantee of future results.

Summary and Interpretation

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

To summarize our investment views for the remainder of 2024 and into 2025:

+ We believe the equity market can continue to rally from current levels, but not at the rate it has over the past 6-12 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 the end of 2024 and into 2025.
+ There is income available in fixed income, but the total return potential is muted. We continue to favor balancing short-term and longer-term allocations to manage duration risk without sacrificing yield. We much prefer investment grade versus high yield bonds at this point in the economic cycle. Investors seeking higher yields should consider the private credit market versus public high yield bonds.
+ 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 "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. Given the exponential growth in demand for energy from artificial intelligence and data centers, there may be interesting infrastructure opportunities in the energy generation and transmission spaces.
+ 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.

Enjoy the fall and holiday seasons…

Scott Welch, CIMA®
Chief Investment Officer
Certuity

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