# Global Investment Outlook and Strategy

Sit Investment Associates

July 2024

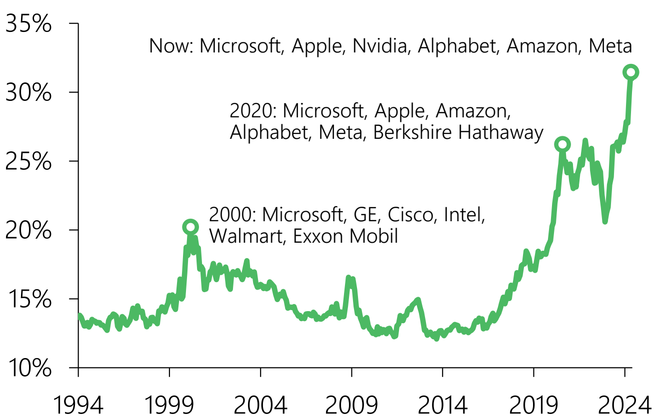
Key Points

- U.S. Growth Moderating as Tailwinds Dissipate & Consumer Demand Ebbs
- Euro Area's Sticky Inflation May Delay Much-Needed Monetary Support
- China Ramping Policy Support to Keep GDP on Track to Hit Growth Target
- Federal Reserve Will Cut Rates by Year-End as Inflation Continues to Slow
- Spreads on Tax-Exempt Bonds Continue to Tighten Despite High Supply
- Stock Market Gains Likely Limited Near-Term; Volatility Poised to Increase

## In Focus: Improving Earnings and Fed Rate Cuts Should Boost Market Broadening Prospects

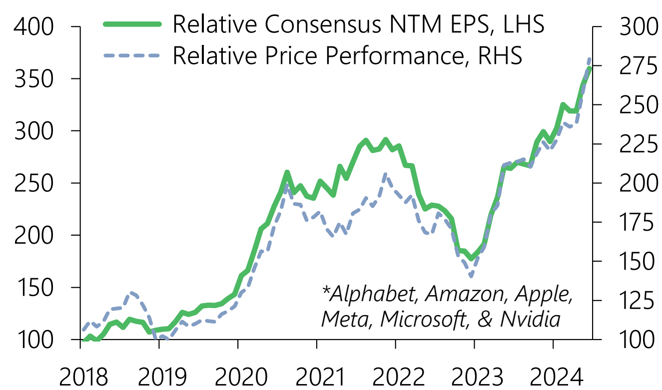
### 1 Highest Market Concentration Since 1960s

Top Six Constituents as a % of S&P 500 Market Cap



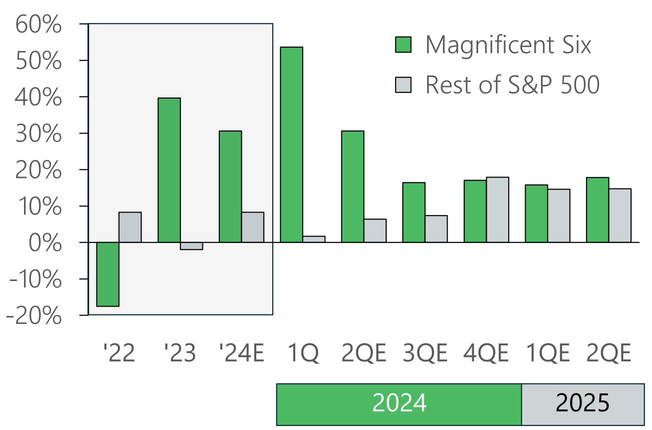

### 2 Driven by Mag 6's Superior EPS Growth

Magnificent Six* vs. Other 494 S&P 500 Stocks
Indexed Relative Earnings Growth & Stock Performance




### 3 EPS Growth Differential Will Close Into '25

S&P 500 Earnings Growth, Y/Y%




### 4 Rate Cut Prospects Foster Sector Rotation

Average Sector Relative Return Before/After First Rate Cut

| S&P 500 | -6M | -3M | -1M | +1M | +3M | +6M | +12M |
|---|---|---|---|---|---|---|---|
| Health Care | 0.8% | 1.2% | -1.9% | 2.3% | 4.2% | 3.5% | 9.0% |
| Staples | 1.8% | 2.6% | 0.0% | 2.0% | 1.8% | 2.2% | 8.5% |
| Cons. Disc. | -3.6% | -2.1% | -0.5% | -0.2% | -1.0% | -1.0% | 3.1% |
| Comm. Svcs. | -0.4% | 0.3% | 2.7% | 1.2% | 2.3% | 3.2% | 2.0% |
| Industrials | 1.4% | -0.8% | -1.3% | 0.5% | 2.0% | 1.0% | 0.5% |
| Materials | 0.3% | 0.4% | 0.3% | 1.2% | 1.3% | -0.5% | -1.2% |
| Financials | -0.4% | 0.0% | 0.5% | 1.3% | 1.5% | 1.5% | -1.3% |
| Tech | -1.6% | -2.1% | 0.7% | -2.5% | -2.5% | -7.9% | -4.1% |
| Utilities | -1.8% | 1.1% | 0.7% | 1.8% | 1.4% | 2.6% | -4.9% |
| Energy | 2.8% | 0.8% | -0.5% | -1.3% | -1.1% | 0.8% | -5.4% |
| Real Estate | -0.3% | 0.1% | 0.0% | 2.8% | -0.6% | -2.4% | -6.2% |

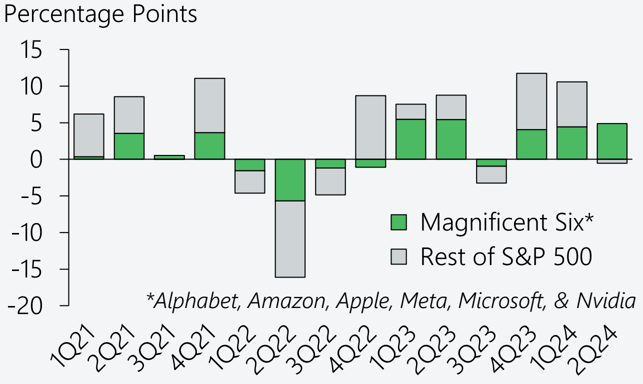
Sources: BofA Research, FactSet, 6/30/24

## What Breaks Equity Index Concentration?

The concentration of the S&P 500 Index rocketed to an all-time high as the Magnificent Six stocks (Microsoft, Apple, Nvidia, Alphabet, Amazon, Meta) continued to surge in 2024. Several factors have powered the strong relative outperformance: an acceleration in artificial intelligence (AI) investment boosting the earnings of the best-placed firms (Alphabet, Nvidia, Microsoft), cost-cutting programs improving profits (Meta, Amazon), and the possibility that AI-enabled devices trigger an iPhone upgrade cycle (Apple). In addition, investors have sought "safety" in the relative earnings stability of Big Tech as earnings have stagnated in many non-tech sectors for several quarters.

### Big Tech Underpinning Stock Market Gains

Contribution to S&P 500 Total Return




Source: FactSet, 6/30/24

The narrowness of equity gains has led to concern that it may indicate a market top. Yet, historical evidence shows the contrary. According to Empirical Research, there have been nine years since 1952 where five stocks contributed over 40 percent of the market's return. Overall market returns in the subsequent year were, on average, relatively "normal." Of course, there were notable exceptions in 2000 and 2008, and each market cycle has its own unique features that will determine its eventual course. This time, it appears it may be the fundamentals and sentiment around AI.

Our portfolios have benefited from significant positions in the Magnificent Six stocks. Still, the combination of higher valuations and earnings expectations can often spell danger, and we believe it is a worthwhile exercise to evaluate "what could go wrong" with those stocks as the investment and economic outlook unfolds over the next 12 to 18 months. While predicting the reversal of such powerful trends is difficult, we see three plausible scenarios that could shift and/or broaden stock market leadership. First, a soft landing or moderate recession with improving economic growth in 2025. Second, AI enthusiasm wanes and spurs a rotation into other areas of the market. And finally, a deep recession that causes a sharp sell-off in the more richly valued AI-exposed names (including the Magnificent Six).

In our view, the most probable scenario, and the one healthiest for markets, is that the Federal Reserve eases as inflation cools further and the economy reaccelerates in 2025. A softish-landing economic setting raises the likelihood that corporate earnings growth is consistent with current consensus estimates, greatly narrowing the earnings "gap" and driving improved equity returns for the other 494 stocks in the S&P 500 Index.

If consensus estimates are at least directionally correct, Magnificent Six's earnings will decelerate in the second half of the year and in 2025 as growth naturally slows and year-over-year comparisons become more difficult following rapid growth over the last 12 to 24 months. On the other hand, easing comparisons may become a tailwind for the other 494 stocks, particularly if macro conditions improve in 2025.

There is also a potential for the stock market to broaden as investors anticipate a profit margin and productivity boost as AI is widely deployed. We think a productivity wave will follow the surge in AI investment, much like the internet boom in the late 90s/early 2000s. Timing is highly unclear, however. We suspect it is more likely a 2026 and beyond phenomenon. Yet, it could happen earlier, given the huge investment occurring now. U.S. large-cap businesses will likely be the first beneficiaries, given AI's data intensity, required expertise, and high costs to invest and deploy.

### Artificial Intelligence May Boost Productivity

U.S. Productivity: Nonfarm Output per Hour


Source: Bureau of Labor Statistics, 6/6/24

The second scenario is that macro conditions play out like that described above, but AI expectations prove too aggressive as use cases (i.e., no "killer app") are slow to emerge. We expect AI to provide a substantial tailwind to economic and corporate earnings growth over time, with the potential for firms to reduce costs, enhance the R&D process, and improve sales productivity. Yet, we admit that the timing of how AI's impact unfolds is very difficult to predict. It is possible that the same fear of missing out driving enthusiasm in financial markets is also occurring in C-suites, possibly pulling forward AI investment as management teams evaluate its benefits across an organization.

A third and worst-case scenario is that a more severe or traditional recession materializes. As the economy has downshifted in recent quarters, investors have flocked to the large tech stocks as idiosyncratic drivers allowed the firms to post strong growth over the last couple of years, particularly against low expectations that were established after a challenging year in 2022. A deeper downturn will likely dent the key businesses that drive Magnificent Six's profitability, including consumer, IT, and advertising spending. Any reduction in enterprise spending budgets will have some impact, even on high-priority areas like AI, and pressure the earnings growth assumptions for the companies most levered to AI.

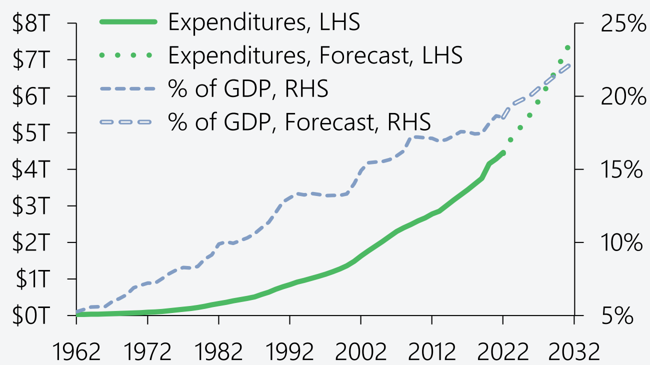
Although there have been secular underpinnings to the Magnificent Six's sales in recent years, we suspect their resiliency would be tested if there is economic turmoil. As these companies have grown larger in recent years, it stands to reason that they will be increasingly more susceptible to the whims of the economy. In short, the Magnificent Six stocks will likely underperform if their "bulletproof" status is questioned, especially given high valuations and earnings expectations. Of course, an aggressive Federal Reserve easing cycle could certainly come to the rescue. However, if history is a guide, this will benefit more cyclical/operationally levered firms within the other 494 that tend to outperform following a recession.

Although we cannot completely dismiss a more severe downturn or slower-than-anticipated AI adoption, our base case is the Federal Reserve succeeds in bringing inflation down, and the economy escapes a "worst case" outcome, setting the stage for better growth in 2025 (e.g., the first scenario). In terms of sectors, we believe both healthcare and energy stocks offer an attractive risk-reward. While many healthcare companies have generated consistent earnings growth in recent years, underlying valuations do not reflect growth prospects for companies with innovative products and services underpinned by powerful demographic trends.

Energy remains appealing as stocks discount sub-$70 per barrel oil versus the current $80+ level, provide a hedge against still-elevated geopolitical risks, and offer generous shareholder payouts paired with conservative balance sheets. Fed rate reductions, perhaps beginning in the fourth quarter this year, could also lift sentiment in sectors typically viewed as "early cycle" and most responsive to lower rates, including transportation and consumer cyclicals (particularly depressed retailing and housing-related stocks).

**Secular Investment Case for Healthcare Intact**

U.S. National Health Expenditures

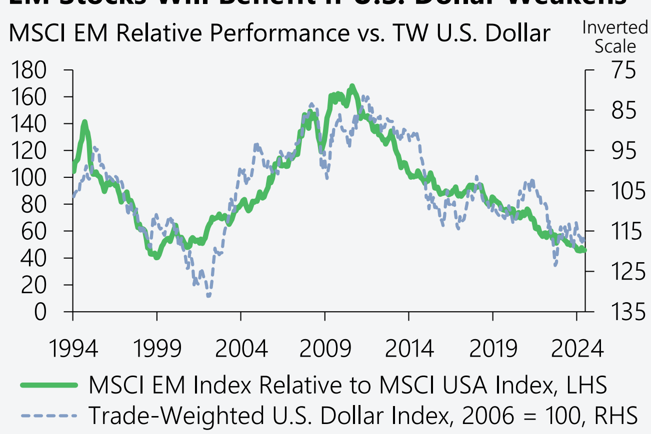



Source: Centers for Medicare & Medicaid Services, CBO, 6/30/24

An extended period of underperformance has driven small-cap stocks to steep discounts relative to large-cap peers, in part due to greater perceived cyclicality and exposure to high interest rates. Again, Fed easing and more optimism about economic growth in 2025 could spark animal spirits. Higher interest rates, economic growth fears, and a surging U.S. dollar have also dented emerging market valuations. These pressures should ease over the near to intermediate term, driving better performance next year. We favor India, South Korea, and Brazil based on strong economic fundamentals and attractive market valuations.

**EM Stocks Will Benefit if U.S. Dollar Weakens**

MSCI EM Relative Performance vs. TW U.S. Dollar




Source: FactSet, 6/30/24

Finally, the Magnificent Six stocks have outperformed the market due to strong fundamentals and exceptional earnings, and it is difficult to see the trend breaking in the very near term. Since higher risk will accompany higher valuations and higher earnings expectations, we believe now is the time to evaluate what conditions may catalyze a change in market leadership.

## Global Macro Developments

### Fed Needs to Act Soon to Prevent U.S. Slowdown From Morphing Into Recession

We expect the pace of U.S. real GDP growth to slow into 2025 as tailwinds, such as a favorable fiscal impulse, robust nonresidential investment, and breakneck immigration growth, diminish or turn to headwinds. As we highlighted before, soft and hard landings typically follow similar paths until the lagged effects of interest rate hikes hit the broader labor market, which responds more slowly to policy changes. Soft landings are relatively rare, and since the 1960s, recessions have started an average of 25 months after the first rate hike – the Federal Reserve (Fed) began to tighten almost 28 months ago. Like clockwork, historic labor market tightness continues to ease, and leading indicators imply that the rise in the unemployment rate will accelerate. Then again, given the dearth of financial excesses (other than federal debt) and secularly constrained labor supply, we suspect job losses will be contained and that the overall economy will muddle through. Still, a contraction in the labor force via retirements and stricter immigration (notably a possible rise in deportations in 2025 and beyond) would put the onus on productivity to drive GDP growth and keep inflation in check. The upshot of a slowing economy is that the Fed will be more apt to cut rates aggressively, setting the stage for a re-acceleration in growth. The risk is that the Fed waits too long or is not forceful enough, and a negative feedback loop takes hold.

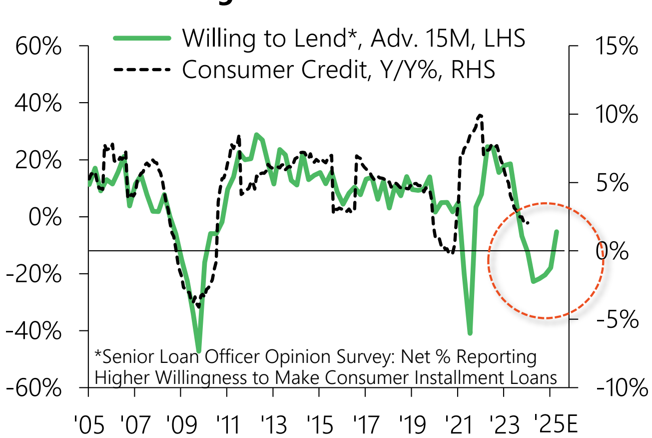
### U.S. Consumer Spending Growth Increasingly Skewed Toward Top Earners

Aggregate consumer spending has stayed incredibly resilient, growing at an annualized rate of +2.0 percent on an inflation-adjusted basis from year-end 2021 through May 2024. However, retail sales and credit delinquencies show that lower-income consumers are again strapped and that economic difficulties are moving up the income ladder as job growth slows, real disposable income growth wanes, excess savings vanish, and credit tightens. Meanwhile, households with annual incomes of $100,000 or more (top 40 percent of earners), comprising about 60 percent of total consumer spending, have seen a marked rise in net worth, buoying wealth-effect-driven purchases. Still, according to PYMNTS Intelligence, 65 percent of consumers live paycheck to paycheck, including 50 percent of those whose income exceeds $100,000 annually. Spending growth will likely moderate as households normalize savings rates in response to a somewhat less favorable wage and job outlook, with downside risks from a possible credit contraction and broad job losses. Loan officer surveys signal that consumer credit may soon contract modestly before expanding again in the second half of 2025 (Exhibit 1). In addition, the Beveridge Curve shows that the labor market is reaching a point where it may weaken more rapidly (Exhibit 2). Spending cuts could lead to weaker profit margins and then job losses – rinse and repeat.

### Small Businesses Continue to Lose Ground in Post-Pandemic U.S. Economy

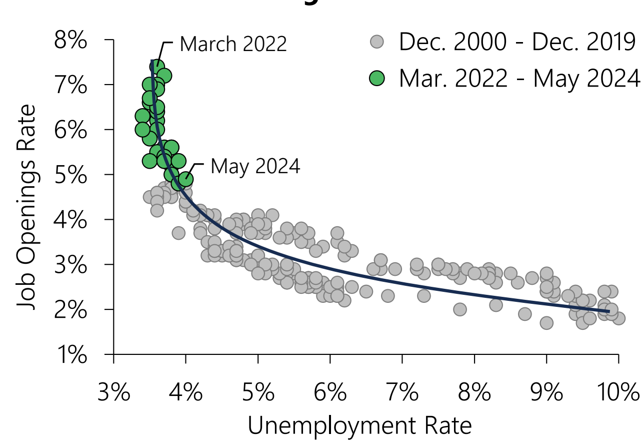
The bifurcation of the economy extends to the business world. Smaller companies have found it much more difficult vis-à-vis larger businesses to hire employees, secure inventory, adjust to

**Exhibit 1: Willingness to Lend vs. Credit Growth**




Source: Federal Reserve, 7/8/24

**Exhibit 2: U.S. Beveridge Curve**

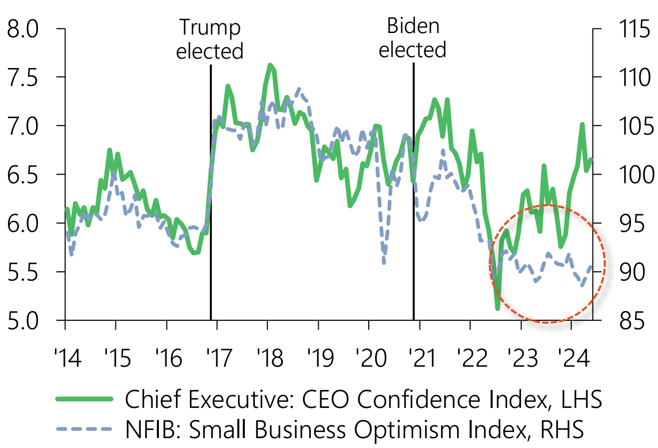



Source: Bureau of Labor Statistics, 7/2/24 higher prices, and tackle increased regulation in the post-pandemic economic environment. As a result, small business optimism has dipped to levels not seen since the aftermath of the 2007-2009 recession (Exhibit 3). In contrast, CEO confidence has steadily improved since mid-2022 and is above its historical average. Some economists speculate that the NFIB's small business report has a Republican bias that currently skews the results downward, as partisanship seems to have bled into several surveys (or "soft data") more than typical in recent years. However, the "hard data," be it gross value added, net operating surplus, or output per hour, affirms that smaller businesses are struggling (Exhibit 4). So, it is unsurprising that hiring plans continue to soften and, like the Beveridge Curve, signal a rise in joblessness (Exhibit 5). Small business troubles broadly affect the economy, as firms with fewer than 50 employees comprise about 45 percent of private payrolls (<250 employees ≈ 73 percent). A Trump presidential election win could boost small business optimism based on the prospects for fewer regulations, lower taxes, and less competition from imports. Still, many small firms could again find themselves on the losing end of possible trade war-related supply constraints and inflationary pressures.

### Euro Area's Sticky Inflation May Postpone Much-Needed Monetary Support

The Euro Area economy entered the second quarter on an improved footing but stumbled again in June (Exhibit 6). The improving momentum in the composite PMI since last fall slipped to a three-month low of 50.9 last month, as manufacturing output dropped to a six-month low of 46.1 (readings below 50 indicate contraction). The region's largest economy, Germany, cannot seem to sustain upward economic momentum, and its second-largest, France, was stuck in the doldrums well before a snap legislative election plunged the nation (and the entire Euro Area)

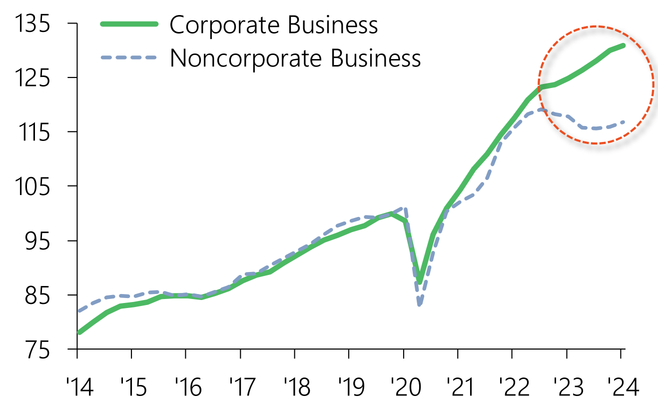
**Exhibit 3: U.S. Business Confidence**




Source: Chief Executive Magazine, NFIB, 6/30/24

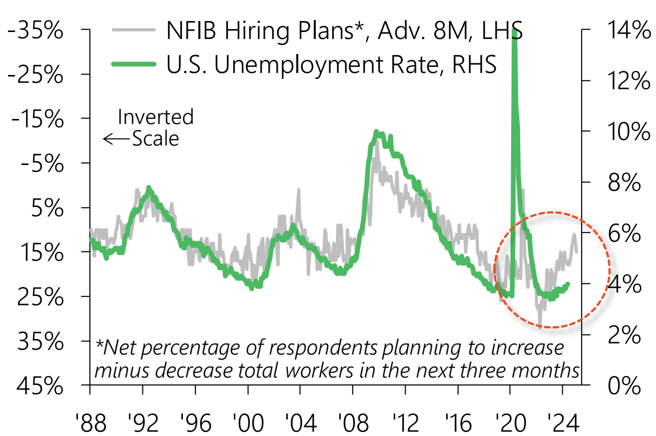
**Exhibit 4: U.S. Nonfinancial Gross Value Added**

Indexed, 12/31/2019 = 100



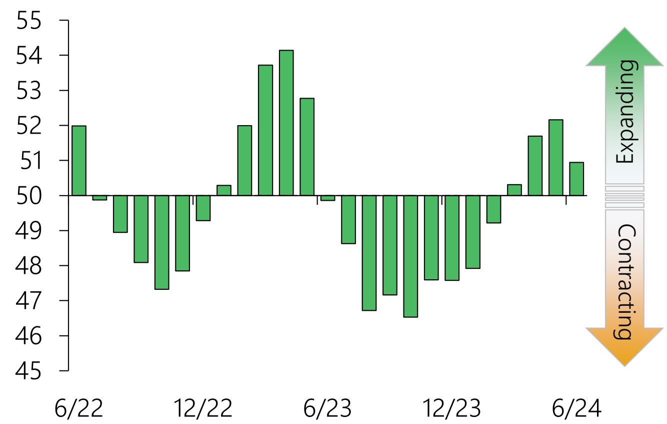

Source: Federal Reserve, 6/7/24

**Exhibit 5: Hiring Plans vs. Unemployment Rate**




Source: National Federation of Independent Business, BLS, 7/5/24

**Exhibit 6: Euro Area Composite PMI**




Source: S&P Global, 7/3/24

into uncertainty. Renewed economic softness will pressure the European Central Bank (ECB) to ease further after delivering on its promise to reduce interest rates by 25 basis points in early June. However, recent signs of sticky inflation may oblige the ECB to pause until there is more evidence to the contrary. Although core consumer inflation declined to +2.8 percent year over year in June (peaked at +7.5 percent in March 2023), the six-month annualized rate ticked up to +4.7 percent. We think the Euro Area will keep its head above water and that real GDP will grow sub-one percent in 2024, but another Trump presidency is a moderate downside risk for 2025 and beyond. Oxford Economics estimates that protectionist U.S. policies could shave up to 40 basis points off its baseline real GDP forecast.

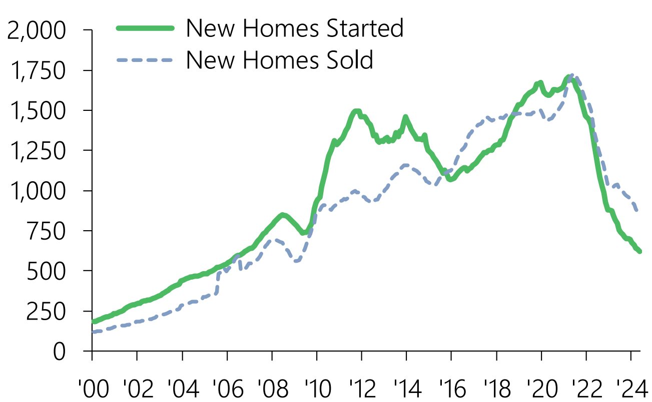
**Bank of Japan's Job Tougher as Unbalanced Growth Poses Policy Trade-Offs**

The Bank of Japan's bid to sustain demand-driven inflation after three decades of deflationary stagnation is getting much more challenging. Still-accommodative monetary policy underpins a favorable backdrop for most businesses and significantly weakened the yen. Large firms have enjoyed a surge in profits due to newfound pricing power, exporters have seen a lift in margins, and the services sector has benefited from a revival in tourism. Yet, a depreciating currency for the import-dependent nation threatens to intensify cost pressures. Households have struggled as rising prices squeeze real incomes, leading to four consecutive quarters of lower consumer spending. Likewise, higher input and funding costs, plus a tight labor market, are weighing on small businesses, contributing to a spike in bankruptcies. Given the crosscurrents, economic growth remains uneven, with real GDP contracting in two of the last three quarters. A much-awaited pickup in wage growth promises to lift consumption. However, recent data, such as a contraction in services activity in June, highlights potential cracks in areas of current strength. The Bank of Japan faces the tricky task of bolstering the consumer by stabilizing the yen while preserving gains made elsewhere. The job has become increasingly difficult, so we now expect negligible growth in Japan's 2024 real GDP versus our prior +0.5 to +1.0 percent expectation.

**Chinese Policymakers Ramping Property Support, But No Bazooka Expected**

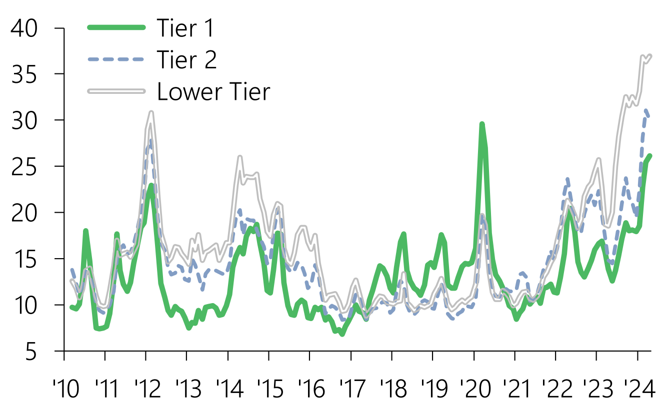
China's property crisis continues to deepen as the government's incremental countermeasures have failed to stabilize the sector (Exhibit 7). New home sales volumes and values for the first five months of 2024 dropped -24 percent and -30 percent year over year, respectively. In May, policymakers responded to the sector's freefall with their boldest initiatives thus far, including relaxed mortgage rules and a 300-billion-yuan central bank lending program to buy completed unsold homes for use as subsidized housing. Still, with a record 31 months of new home supply across 80 cities, the government will likely need to intervene more aggressively to clear the vast excess housing inventory (Exhibit 8). Goldman Sachs economists surmise that over 1.0 trillion yuan is required to backfill the 2024 demand shortfall (and stabilize prices) and that returning the outstanding housing inventory to pre-pandemic levels would require 7.7 trillion yuan (1.1 trillion U.S. dollars). The consensus is that the next round of policy support will come after the Politburo meeting in late July. However, lest we forget, Chinese policymakers' attempts to rein

**Exhibit 7: China New Home Starts and Sales**
Rolling 12-Month Sum, Millions of Square Meters




Source: National Bureau of Statistics,6/18/24

**Exhibit 8: China New Home Months of Sales**
80 Major Cities

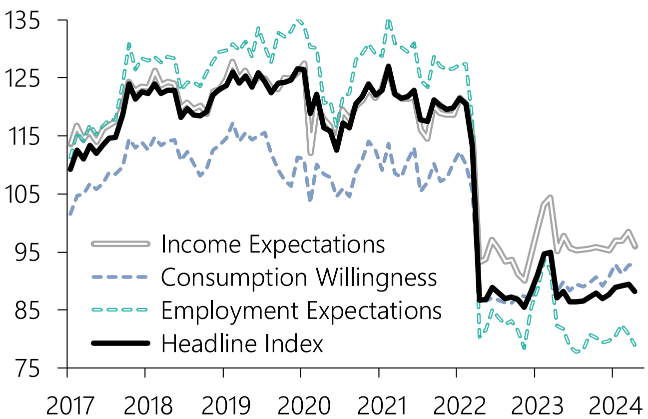



Source: China Real Estate Information Corporation, 6/30/24 in property prices and developer leverage ("three red lines") contributed to, if not triggered, the current property downturn. As a result, we believe their focus will remain on trying to contain the fallout via incremental policy adjustments rather than some grand bailout scheme.

**China on Track to Achieve Growth Target Due to Strong Exports and Investment**

Real estate construction has long been an essential engine for China's growth and consistently accounted for about one-quarter of the economy, directly and indirectly, in the years preceding the current property slump, according to Rogoff and Wang. Including infrastructure, the figure is closer to one-third. Chinese policymakers' efforts to rebalance the economy toward domestic consumption have had limited success so far, as the lingering effects of the pandemic, the real estate downturn, elevated economic uncertainty, and a weak employment outlook have slashed confidence and willingness to consume (Exhibit 9). As property represents the vast majority of household net worth, a negative wealth effect has likely also depressed spending. Similarly, the percentage of urban depositors who prefer more savings is at record levels, and household deposits are well above the historical trend (Exhibit 10). However, growth in manufacturing fixed asset investment and exports have helped fill the gap left by property and consumption, keeping the economy on track to achieve the government's 2024 GDP growth target of "around 5 percent." Exports will likely remain a key growth driver in the second half, buoyed by China's export diversification efforts and improving global PMIs (Exhibit 11). Also, as evidenced by the surge in container rates, buyers are likely building stocks on worries of prolonged Red Sea disruptions and potential tariff hikes if Trump wins the U.S. presidential election (Exhibit 12).

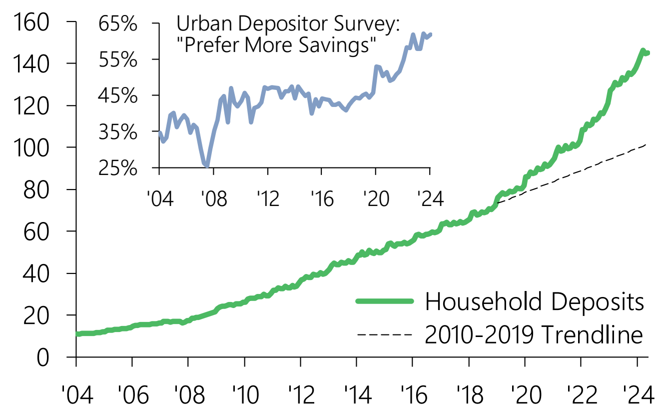
**Exhibit 9: China Consumer Confidence**




Source: National Bureau of Statistics, 6/30/24

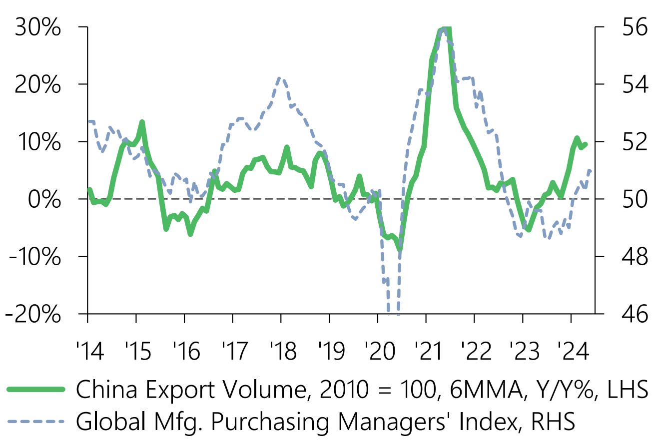
**Exhibit 10: China Household Deposits**

Trillions of Yuan




Source: People's Bank of China, 6/30/24

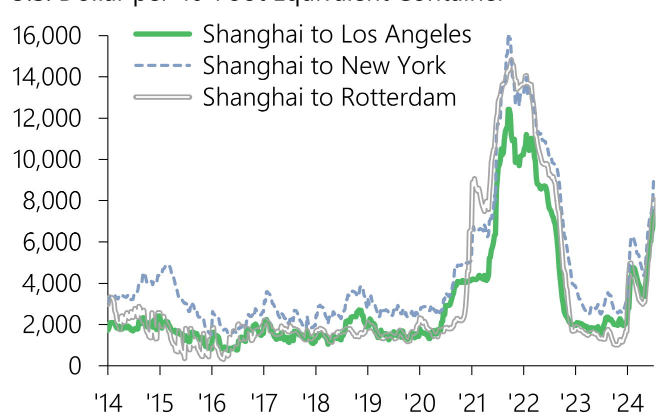
**Exhibit 11: China Exports vs. Global Mfg. PMI**




Source: : CPB, S&P Global, 7/3/24

**Exhibit 12: Drewry World Container Index**

U.S. Dollar per 40-Foot Equivalent Container

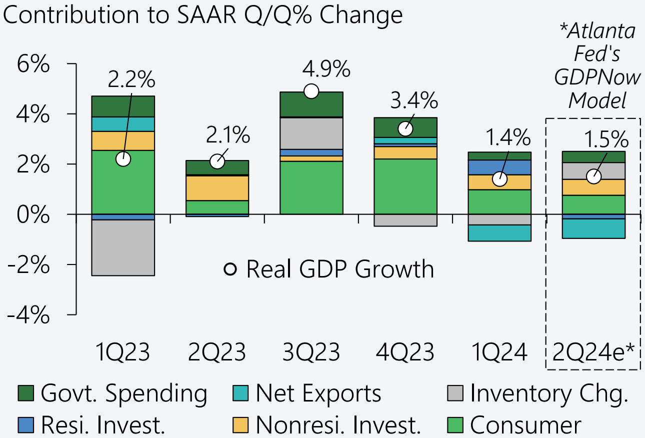



Source: Drewry Shipping Consultants, 7/4/24

## Global Macro: Other Notable Data Points

### U.S. Economic Growth Continues to Moderate

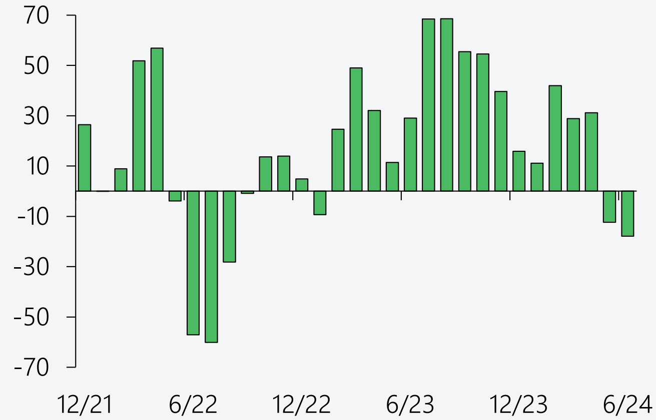
U.S. Real GDP
Contribution to SAAR Q/Q% Change




Bureau of Economic Analysis, Atlanta Fed, 7/3/24

### U.S. Economic Data Surprising to Downside

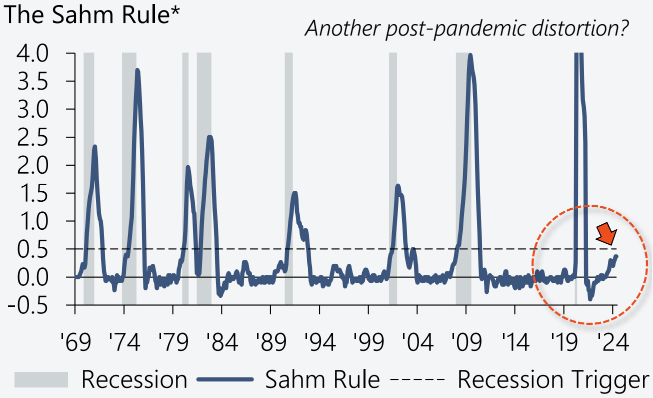
U.S. Economic Surprise Index




Source: Citi Research, 6/30/24

### Sahm Rule Close to Signaling U.S. Contraction

The Sahm Rule*

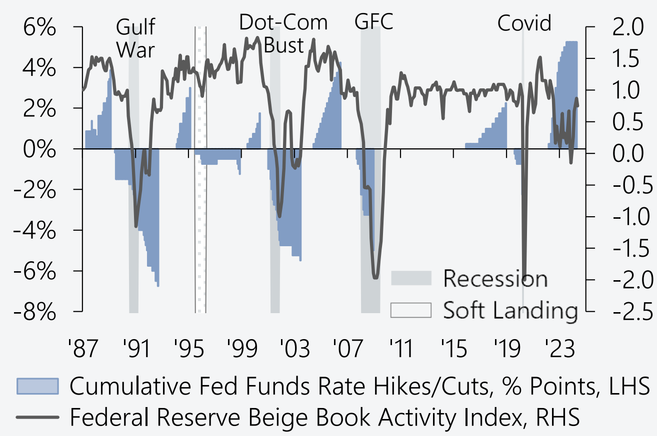



**Signals the start of a recession when the three-month moving average of the unemployment rate rises by ≥0.50pp or more relative to the minimum of the three-month averages from the previous 12 months*

Source: Bureau of Labor Statistics, St. Louis Fed, NBER, 7/5/24

### High Rates Leave Economy Vulnerable to Shock

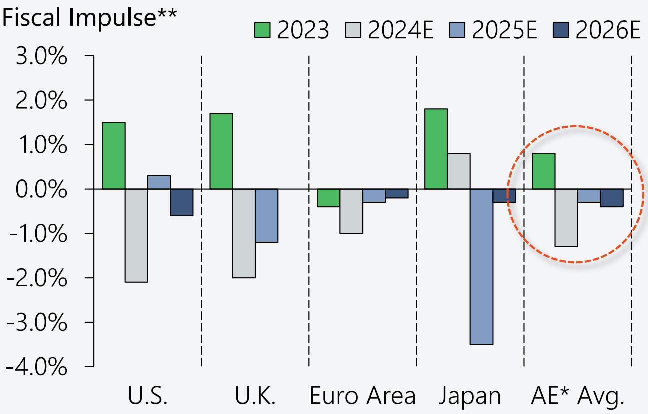
Fed Funds Cycles & Beige Book Activity Index




Source: Federal Reserve, Oxford Economics, 6/30/24

### Fiscal Impulse Turning to Economic Headwind

Fiscal Impulse**

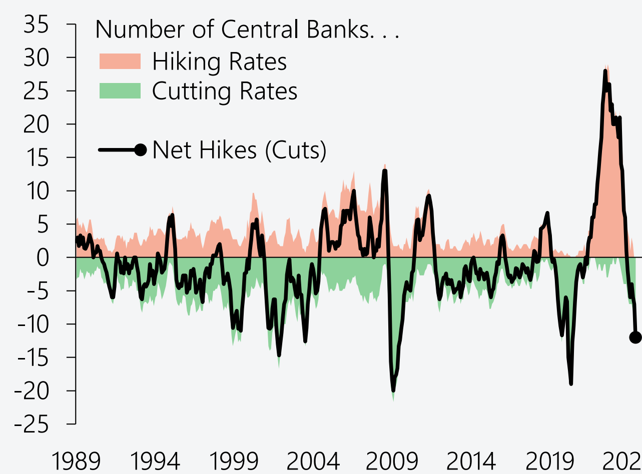



** Advanced Economies*

***Chg. in cyclically-adjusted primary balance as % of potential GDP*

Source: International Monetary Fund, 4/17/24

### Global Monetary Easing Gathering Momentum




Source: World Bank, Bank for International Settlements, 6/30/24

## Fixed Income: Environment and Strategy

### Fewer Fed Funds Rate Cuts Forecasted for 2024

U.S. Treasury yields ended the second quarter of 2024 slightly higher by 10 to 20 basis points, with larger increases concentrated in longer maturities. Early in the quarter, yields surged due to elevated inflation and robust economic growth but later reversed due to downward revisions and new data pointing to a declining trend that we expect to persist. During the June meeting, Chair Powell noted that the Federal Reserve (Fed) now expects only one or two 25-basis point fed funds rate cuts in 2024, effectively shifting easing to 2025, with no significant change to longer-run rate projections (Exhibit 13). This outlook is largely shared by market participants. We foresee the most probable scenario as a 50-basis point cut in the fourth quarter, strategically timed to avoid any perception of political influence, particularly in the context of an election year. This delay may cause the Fed to start the easing cycle later than ideal, necessitating more aggressive rate cuts in 2025. We expect at least a 200-basis point reduction in the fed funds rate during this easing cycle, which will normalize the yield curve to its upward slope. Modest rate adjustments and positive real rates will enable the Fed to remain restrictive in its monetary stance while projecting political neutrality and facilitating a smooth economic transition.

### Corporate Spreads Stable but Expected to Widen

We continue to expect corporate bond spreads to widen, which is in line with our expectation for a slowdown in economic activity over the next several months. Our allocation to corporate bonds was slightly more than half that of the Bloomberg U.S. Aggregate Bond Index at the start of the second quarter of 2024, and we reduced exposure by a small amount during the quarter. Despite a slight widening in credit spreads and a modest shift higher in the U.S. Treasury curve, attractive yields and strong credit fundamentals continue to drive demand for corporate bonds. Mutual fund and ETF flows into investment-grade bonds remain robust, continuing the trend since mid-2023. In addition, the bond market has, without hesitation, absorbed year-to-date new investment-grade issuance, which has exceeded expectations and the three-year average. Valuations in other sectors remain attractive relative to corporate bonds, leading us to increase positions in asset-backed securities, mortgage-related securities, and taxable municipal bonds.

### Taxable Fixed Income Strategy

We prioritize generating a substantial income advantage relative to respective benchmarks to drive consistent outperformance over time. Our strategy involves reducing exposure to credit sectors where appropriate and favoring higher-quality mortgage-related sectors to capitalize on anticipated improvements in the housing market (a slowing economy should bring down mortgage rates and improve affordability). Portfolios are strategically positioned to emphasize the middle of the yield curve, as we expect four-to-eight-year maturity securities to outperform as the yield curve reverts to a more normal upward slope. Moreover, as general election apathy is reflected in upcoming confidence readings, we intend to trade around the volatility inherent in an election year tactically. While we believe the Fed is unlikely to cut rates before the election, there will be substantial room to lower the Fed funds rate target post-election, given elevated real rates, while maintaining a hawkish stance. In the interim, although sustained economic growth may prevent the Fed from cutting rates before winter, we believe bonds will rally as the mere passage of time shifts investor focus towards impending rate cuts.

**Exhibit 13: Summary of Federal Reserve's Economic Projections**

| Percent | Median | | | | Range | | | |
|---|---|---|---|---|---|---|---|---|
| | 2024 | 2025 | 2026 | Longer-Run | 2024 | 2025 | 2026 | Longer-Run |
| Change in Real GDP | 2.1 | 2.0 | 2.0 | 1.8 | 1.9–2.3 | 1.8–2.2 | 1.8–2.1 | 1.7–2.0 |
| March 2024 Projection | 2.1 | 2.0 | 2.0 | 1.8 | 2.0–2.4 | 1.9–2.3 | 1.8–2.1 | 1.7–2.0 |
| PCE Inflation | 2.6 | 2.3 | 2.0 | 2.0 | 2.5–2.9 | 2.2–2.4 | 2.0–2.1 | 2.0 |
| March 2024 Projection | 2.4 | 2.2 | 2.0 | 2.0 | 2.3–2.7 | 2.1–2.2 | 2.0–2.1 | 2.0 |
| **Federal Funds Rate** | **5.1** | **4.1** | **3.1** | **2.8** | **4.9–5.4** | **3.9–4.4** | **2.9–3.6** | **2.5–3.5** |
| March 2024 Projection | 4.6 | 3.9 | 3.1 | 2.6 | 4.6–5.1 | 3.4–4.1 | 2.6–3.4 | 2.5–3.1 |

Source: Federal Reserve, 6/12/24

## High-Grade Tax-Exempt Yields Increase and Credit Spreads Tighten

Yields on high-grade tax-exempt bonds generally increased during the second quarter of 2024, with intermediate-term bond yields rising the most. Specifically, Municipal Market Data AAA General Obligation (GO) bond yields in the belly of the curve rose by about 30-35 basis points. Longer maturities rose by 5-10 basis points, while shorter maturities increased by 15-20 basis points. Credit spreads, particularly those on high-yield municipal bonds, continued to tighten.

## Credit Quality Was the Primary Driver of Performance

Tax-exempt municipal bond performance was mixed during the quarter but spread tightening continued to impact performance positively (Exhibit 14). Overall, the Bloomberg Municipal Bond Index was relatively unchanged. The short- and long-term bond segments had positive performance, while the intermediate segment had negative performance. Performance in the revenue bond sectors was also mixed, with industries such as hospital and housing bonds having positive performance and others such as resource recovery and lease bonds having negative performance. Lower credit quality bonds outperformed higher-quality bonds, with bonds rated "A" or lower generally having positive performance.

## Record New Issue Volume for the First Six Months of the Year

Municipal bond issuance totaled nearly $239 billion in the first half of 2024. Although this is only slightly higher than the total for the first six months of 2021, it is a marked recovery from the depressed volume over the last two years. Flows into mutual funds continued to be mixed but positive overall, and demand remained strong during the second quarter, while secondary trading volume during the quarter was average.

## Outlook for Tax-Exempt Fixed Income in 2024

We may have reached a point where the election cycle will be a more significant driver of short-term performance than the U.S. Federal Reserve. While market participants continue to have varied expectations regarding Fed policy, we have coalesced around an expected outcome of one or two rate cuts this year. We are gaining confidence that the Fed will wait until after the election to change policy unless we see a marked weakening in the economy. However, we are encouraged by what seems to be a further reduction in inflation and are hopeful that the most recent data points will continue to form a trend over the next few months. We believe the Treasury and Municipal bond yield curves are moving toward a positive slope. Still, we don't think that objective will be achieved until the Fed begins to tighten its policy rate. On balance, investor demand for tax-exempt income should remain strong, but we may see continued short-term volatility throughout 2024.

## Tax-Exempt Fixed Income Strategy

Most portfolios have a longer duration and a significant yield advantage over their benchmark. Although we believe municipal bond yield trends will broadly follow the movement of Treasury bonds, it is worth noting that tax-exempt yields have gotten somewhat rich relative to Treasury bond yields. We continue to opportunistically add to select taxable municipal bonds for cross-over accounts subject to the corporate tax rate, longer-term single-family housing bonds, and other revenue bond issues where appropriate, and short-call bonds when we can source them at attractive yields. We think portfolios are appropriately positioned for the current backdrop.

### Exhibit 14: Bloomberg Municipal Bond Index Percent Returns

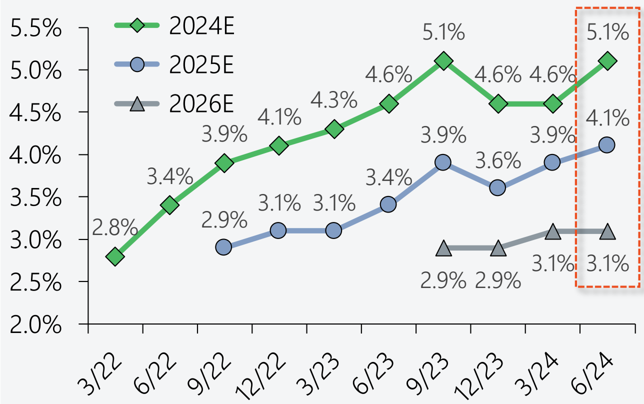
| | QTD | YTD | | QTD | YTD | | QTD | YTD | | QTD | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Muni Bond Index | -0.02 | -0.40 | AAA | -0.28 | -1.09 | GO Bond Index | -0.30 | -0.99 | | | |
| 3-Year | 0.36 | 0.08 | AA | -0.11 | -0.68 | Revenue Bond Index | 0.07 | -0.20 | Education | 0.02 | -0.57 |
| 5-Year | -0.42 | -0.79 | A | 0.22 | 0.33 | Electric | -0.14 | -0.48 | Water & Sewer | -0.17 | -0.69 |
| 7-Year | -0.85 | -1.33 | BBB | 0.68 | 1.29 | Hospital | 0.56 | 0.61 | Resource Recovery | -0.99 | -1.80 |
| 10-Year | -1.04 | -1.57 | | | | Housing | 0.71 | 0.12 | Leasing | -0.36 | -0.78 |
| Long | 0.83 | 0.08 | | | | IDR/PCR | 0.49 | 1.21 | Special Tax | 0.05 | -0.75 |
| | | | | | | Transportation | -0.07 | -0.11 | Tobacco Index | 0.42 | 0.95 |

Source: Bloomberg, 6/30/24

## Fixed Income: Other Notable Data Points

### Data-Dependent Fed Postpones Rate Cuts

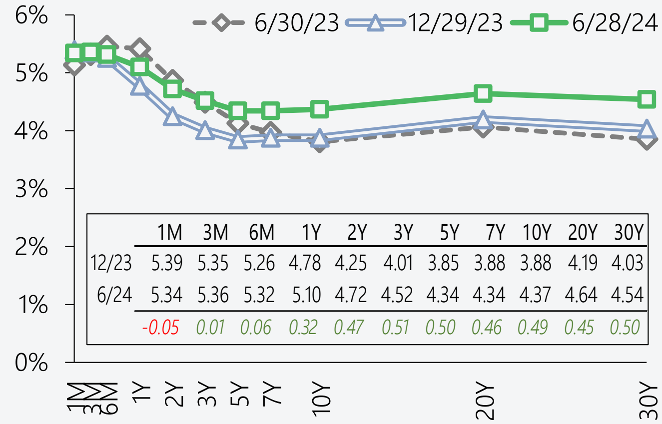
FOMC Median Fed Funds Rate Projections
Year End, Percent




Source: Federal Reserve, 6/12/24

### Yield Curve Now Modestly Higher but Flatter

U.S. Treasury Yield Curve

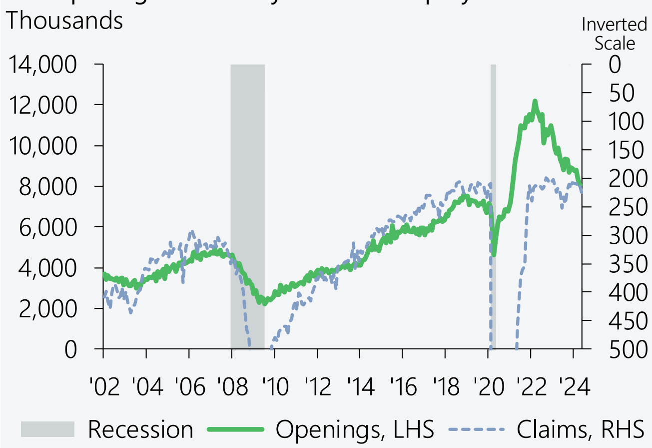



| | 1M | 3M | 6M | 1Y | 2Y | 3Y | 5Y | 7Y | 10Y | 20Y | 30Y |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 12/23 | 5.39 | 5.35 | 5.26 | 4.78 | 4.25 | 4.01 | 3.85 | 3.88 | 3.88 | 4.19 | 4.03 |
| 6/24 | 5.34 | 5.36 | 5.32 | 5.10 | 4.72 | 4.52 | 4.34 | 4.34 | 4.37 | 4.64 | 4.54 |
| | -0.05 | 0.01 | 0.06 | 0.32 | 0.47 | 0.51 | 0.50 | 0.46 | 0.49 | 0.45 | 0.50 |

Source: FactSet, 6/30/24

### U.S. Labor Market Tightness Continues to Ease

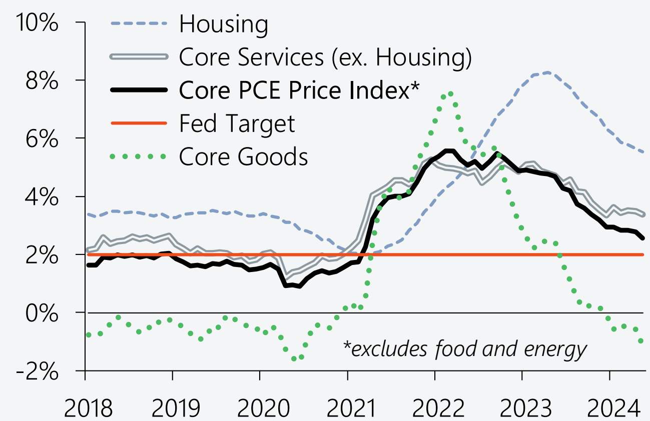
Job Openings vs. Weekly Initial Unemployment Claims
Thousands




Source: Bureau of Labor Statistics, NBER, 6/30/24

### PCE Prices Inching Closer to Fed's 2% Target

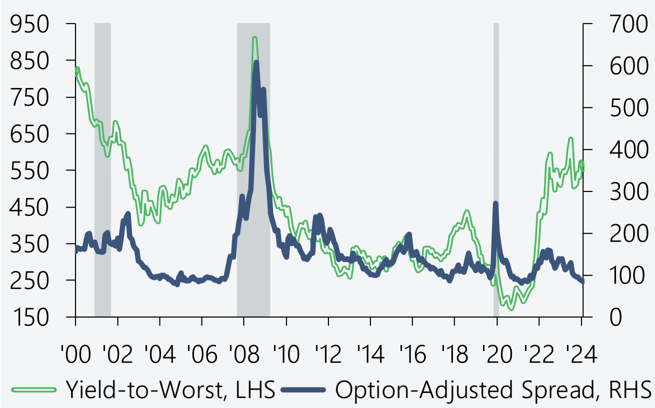
Y/Y Percent




Source: Bureau of Economic Analysis, 6/28/24

### Corporate Spreads Will Widen as Yields Drop

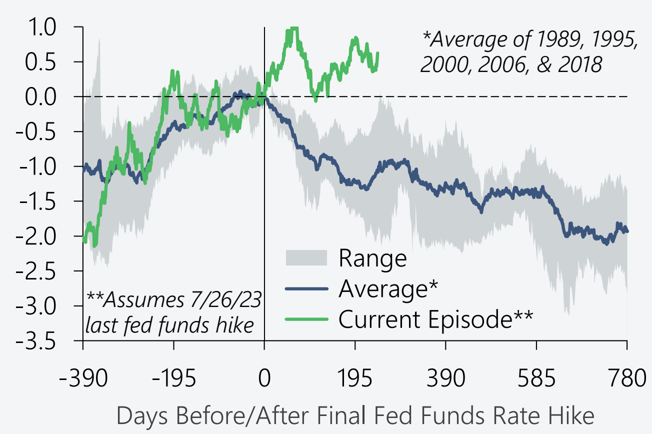
Bloomberg U.S. Aggregate Corporate IG
Basis Points




Source: Bloomberg, 6/30/24

### 10-Yr. Treasury Yield Remains Stubbornly High

10-Year Treasury Yield Minus Yield on Day of Final Hike




Source: FactSet, 6/30/24

### Historic S&P 500 Index Concentration Distorting Market Metrics

S&P 500 Index returns, which had begun to broaden beyond a handful of tech-oriented stocks late in the first quarter of 2024, became incrementally more concentrated as the second quarter progressed. By June, only 20 percent of S&P 500 constituents had a one-month return higher than the overall benchmark – the lowest percentage since at least 1986 (Exhibit 15). And just one stock, Nvidia, represented a whopping 44 percent of the S&P 500's second-quarter return of +4.3 percent. By comparison, the S&P 500 Equal Weight Index declined -2.6 percent during the second quarter, representing the largest calendar quarter performance differential since the first quarter of 2020 and the fourth quarter of 1999 before that. Equities de-rated in the second quarter to discount higher-for-longer rates, something Treasuries had started to do the quarter prior. While long-duration and other rate-sensitive stocks would usually underperform in such a situation, fear-of-missing-out investors crowded into high-momentum artificial intelligence stocks and their derivative plays (e.g., utilities). As a result, the market-cap-weighted S&P 500 Index looks overbought based on the relative strength index (RSI). Here, as well, a few mega-cap stocks are distorting the picture. At the end of the June quarter, only 5 percent of S&P 500 stocks were overbought (14-week RSI above 70), with another 8 percent in the "caution zone."

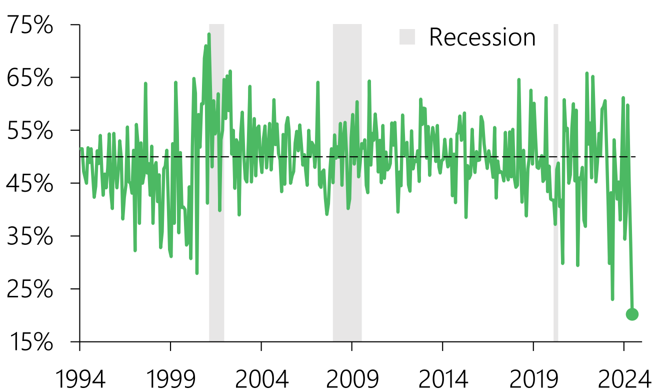
### Stock Market Volatility Poised to Rise (Normalize) Into U.S. Elections and Beyond

There is no consistent pattern to stock market performance in U.S. presidential election years as economic factors have far outweighed political considerations historically. Yet, on average, the S&P 500 Index moved sideways in the first half of the year but rallied in the second to post a +6.9 percent price return (+9.4 percent, ex. 2008). This year, the opposite may hold true as equity investors discount weakening growth prospects (especially as immigration tightens and fiscal support fades) and the risks of another Biden or Trump term. Aside from the geopolitical implications, the policies of both presidential contenders may prove inflationary and cast doubt on the downward path of the fed funds rates, contributing to greater financial market volatility. As impending monetary easing, growing investor confidence in a soft landing, abundant legacy liquidity, and the fear of missing out propelled the equity market upward, the CBOE Volatility Index (or VIX), the market's so-called "fear gauge," has trended downward since late 2022 and remains exceptionally low. On average, the VIX has traditionally climbed in the year's second half, with an even more pronounced rise in presidential election years (Exhibit 16). However, the vast legacy liquidity still sloshing around could continue to buoy equities.

### Legacy Liquidity Continues to Provide a Strong Underlying Bid for Equities

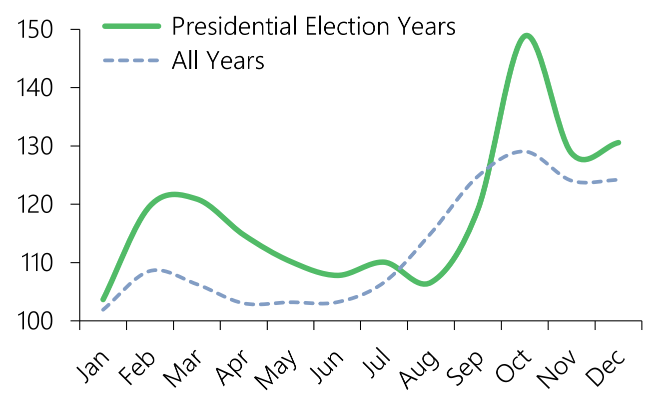
In the second quarter, nearly $60 billion flowed into U.S. equity mutual funds and ETFs, taking the twelve-month cumulative total to about $275 billion (Exhibit 17). Over the last four years, nearly $1.8 trillion has flowed into equity mutual funds and ETFs worldwide, with roughly 75

**Exhibit 15: % of Constituents Beating S&P 500**
Based on Rolling One-Month Returns




Source: BofA Research, FactSet, 6/30/24

**Exhibit 16: Average Progression of VIX Index**
1990-2023




Source: Piper Sandler, 6/30/24

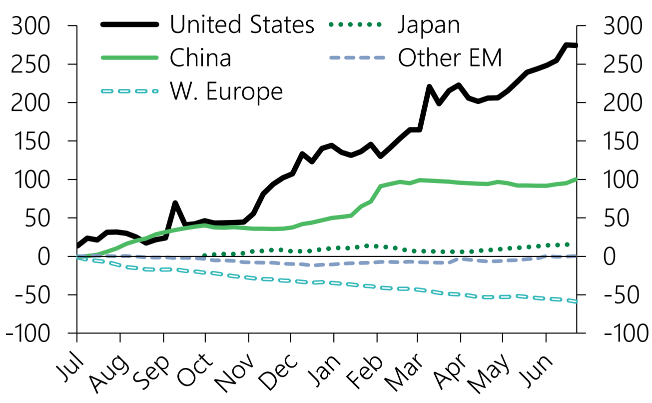
percent of that going into U.S. equity funds or global funds with U.S. exposure. At the end of the first quarter of 2024, U.S. households had a record 42 percent of financial assets in equities. The elevated exposure represents a risk to incremental equity demand and the wealth effect on consumer spending should stocks pull back (Exhibit 18). Also, even though the Sentix survey shows that institutional investor sentiment is unexceptional, active portfolio managers are fully invested as per the NAAIM Exposure Index, with the fear of missing out and abundant liquidity likely playing a considerable role. The aggregate assets of the world's top five central banks are down 13 percent from the early 2022 peak but are still about 40 percent (or $7.5 trillion) above where they were at the end of 2019 (Exhibit 19). At the end of June 2024, there was over $6.1 trillion in U.S. money market mutual funds compared to $3.6 trillion at year-end 2019. And according to S&P Global, private equity firms worldwide have about $2.6 trillion in dry powder.

### Corporate Earnings Growth Should Broaden Into 2025

The U.S. economy may have skirted a contraction in 2023 due to resilient consumer spending, pro-cyclical fiscal stimulus, and a surge in immigration. Yet, earnings for several GICS sectors within the S&P 500 Index were less fortunate (Exhibit 20). An -18 percent drop in the average price of oil after 2022's +38 percent war-driven spike weighed on the energy sector's earnings in 2023. However, still-healthy prices due to steady demand and managed supply paired with an industry consolidation tailwind support the sector's positive earnings growth outlook. Also, following one-off M&A- and pandemic-related earnings distortions, the healthcare sector is set to post sustainable high-single to low-double-digit earnings growth driven by an aging global population, innovation, and durable procedure/product demand. Materials sector earnings fell

**Exhibit 17: Equity Mutual Fund and ETF Flows**

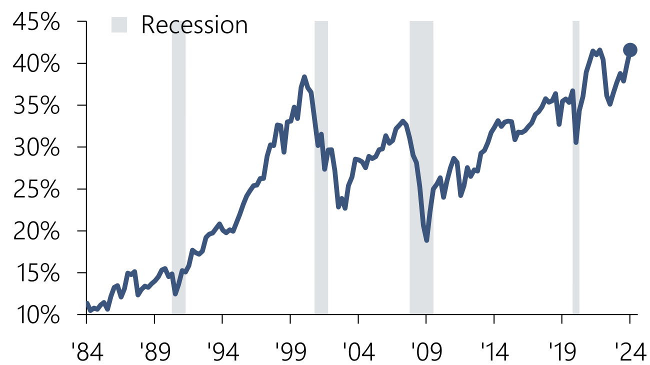
$ Billions, Cumulative




Source: EPFR, 6/26/24

**Exhibit 18: U.S. Household Equity Exposure**

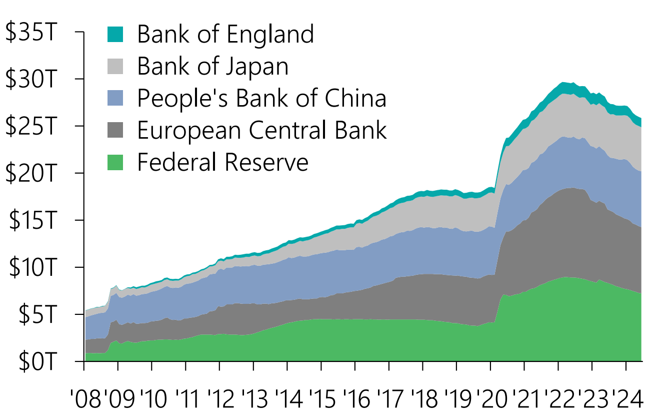
U.S. Households, Equities as % of Total Financial Assets
As of March 31, 2024




Source: Federal Reserve, 6/7/24

**Exhibit 19: Assets of Five Largest Central Banks**

Trillions of Constant U.S. Dollars




Source: Fed, ECB, BoE, BoJ, PBoC, 6/30/24

**Exhibit 20: S&P 500 Earnings Growth by Sector**

| Y/Y Percent | 2023 | 1Q24 | 2Q24E | 3Q24E | 4Q24E | 2024E | 2025E |
|---|---|---|---|---|---|---|---|
| Comm. Svcs. | 29.3% | 41.8% | 22.1% | 12.9% | 17.3% | 22.0% | 13.2% |
| Cons. Disc. | 47.9% | 25.2% | 7.2% | 3.3% | 18.5% | 14.0% | 15.3% |
| Energy | -26.5% | -23.1% | 9.0% | -3.3% | 0.5% | -4.9% | 11.7% |
| Financials | 1.8% | 9.1% | 5.1% | 1.0% | 40.9% | 13.1% | 11.6% |
| Health Care | -20.9% | -25.2% | 17.4% | 16.9% | 23.8% | 8.5% | 18.2% |
| Industrials | 20.5% | 4.0% | -3.5% | 11.1% | 7.7% | 6.2% | 15.8% |
| Materials | -23.3% | -20.8% | -10.7% | 7.8% | 23.3% | -1.6% | 16.3% |
| Staples | 2.7% | 5.6% | -0.8% | 3.4% | 6.0% | 3.9% | 7.6% |
| Tech | 6.5% | 26.0% | 16.2% | 14.7% | 15.3% | 19.4% | 19.0% |
| Real Estate | 1.0% | 4.9% | -1.9% | 4.2% | 4.6% | 1.4% | 5.8% |
| Utilities | 5.0% | 27.7% | 8.5% | 5.3% | 0.0% | 8.2% | 9.0% |
| **S&P 500** | **1.9%** | **7.0%** | **8.9%** | **8.2%** | **17.4%** | **11.4%** | **14.5%** |

Source: FactSet, 6/30/24

in 2023 from pandemic-inflated comparisons, and as customers cut inventories, global growth slowed, and the adoption of electric vehicles/renewables fell short of expectations. However, earnings growth will resume against easier year-over-year comparisons. The broader earnings growth should lead to much less concentrated stock returns and a healthier overall market.

### Global Equity Strategy

Relatively full valuations for stock indices after another solid quarter of equity returns, signs of decelerating economic growth, and the upcoming presidential election signify a high likelihood for considerable market volatility in the near term. As such, stock selection remains imperative, with the plummet in stock correlations providing an excellent opportunity for stock pickers.

Despite technology's dominant role in driving stock indices higher, we continue to maintain an overweight position across our equity strategies. In many cases, artificial intelligence (AI) and the "Magnificent Six" stocks have diverted investors' attention away from other growing areas within technology. For instance, software and IT services stocks have underperformed in 2024 due to concerns that corporate budgets have focused on AI-related projects at the expense of software and services. In our view, this concern is largely unwarranted, and valuations in many groups are compelling in diverse areas with secular growth prospects, including cybersecurity, cloud adoption, digital transformation, IT consulting, and data analytics. While there are some concerns about elevated valuations in some "AI beneficiary" semiconductor and tech hardware subsectors, increases in revenue and earnings estimates have provided fundamental support. Given such, we remain focused on areas with strong secular tailwinds, including chip design, power management, memory, semiconductor capital equipment, and edge AI devices.

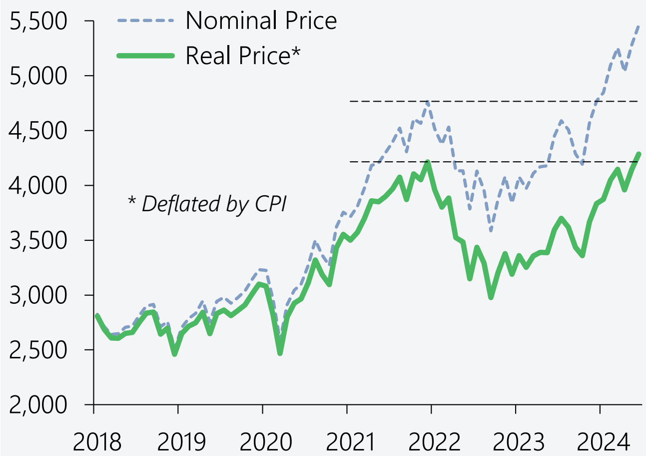
Second-half 2024 corporate earnings will likely reflect the recent softening in economic growth, particularly in the United States. While portfolios are already underweight in many consumer cyclical groups, we have reduced capital goods exposure as weakness spreads to the industrial economy. Banks also remain underweighted in portfolios, but we are closely watching for signs of deteriorating credit trends to determine if we should pare back exposure further. To be sure, Federal Reserve rate cuts might eventually spark animal spirits in these groups, but we suspect near-term earnings concerns will carry more weight.

For our international portfolios, we prefer exposure to stocks in China, South Korea, Singapore, and India. Our positive bias on the Chinese market is due to expected macro resilience amid still-high investor skepticism, which is reflected in current equity valuations. The MSCI China Index is trading at about 10 times forward earnings and is attractively valued relative to its own trading history and global benchmarks. Earnings revisions turned modestly positive following first-quarter 2024 results, although with noticeable disparity across sectors. While we do not expect any significant near-term stimulus announcements following the Politburo meeting and Third Plenum in July, we do expect an acceleration in fiscal funding to provide some downside protection to the economy later this year. We continue to favor industries with positive secular trends, including the internet, healthcare, insurance, consumer, and utilities. We also continue to emphasize companies with strong balance sheets and cash flows that can support growth investments and high dividend payouts.

In India, Prime Minister Narendra Modi won a historic third term, but his Bharatiya Janata Party (BJP) lost its majority. However, the BJP-led National Democratic Alliance has a solid majority and will pursue its agenda, which includes expanding infrastructure, manufacturing, and technology. In addition, new spending will focus on the poor, women, and rural areas. We expect India's economy to grow in excess of +6 percent per annum over the next two years, led by robust domestic demand and capital spending in a variety of sectors. Therefore, we favor procyclical areas, including financials, consumer, information services, industrials, and energy. Overall, we continue to see attractive opportunities in many emerging markets, particularly within our preferred sectors, including financials, e-commerce, consumer staples, industrials, renewable energy, technology, and basic materials.

## Global Equities: Other Notable Data Points

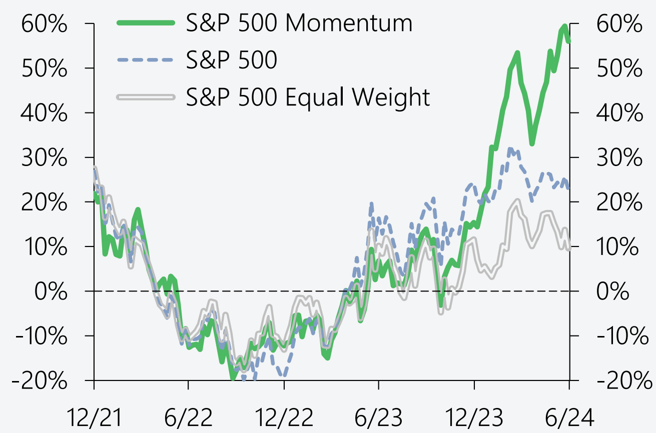
### Real S&P 500 Index Recently Reached New High




Source: FactSet, U.S. Department of Labor, 6/30/24

### S&P 500 Momentum Index Surged in First Half

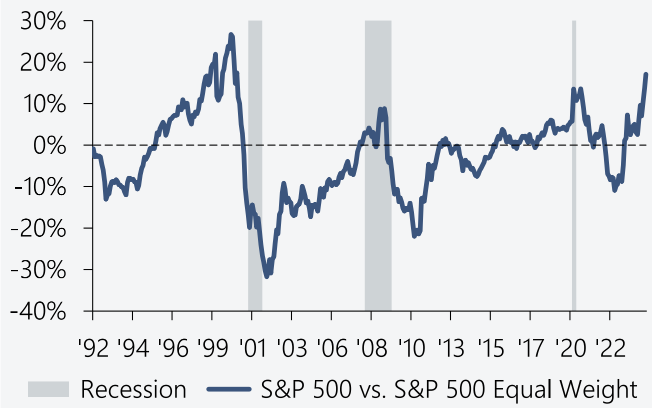
Rolling Twelve-Month Price Returns




Source: FactSet, 6/30/24

### Near-Record S&P 500 Index Return Differential

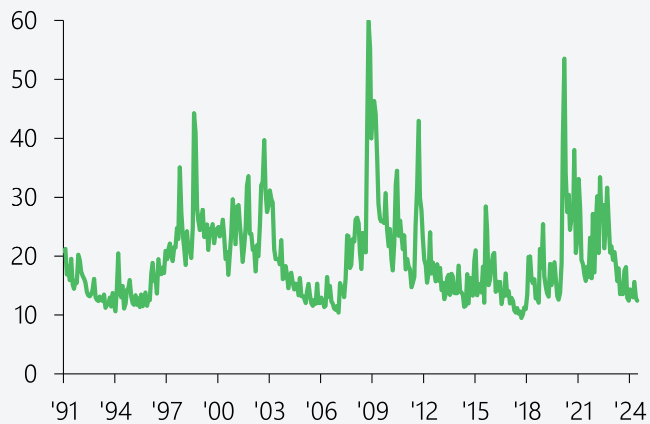
S&P 500 vs. S&P 500 Equal Weight
Rolling Two-Year Relative Price Returns




Source: FactSet, 6/30/24

### Implied Volatility Remains Near Historical Low

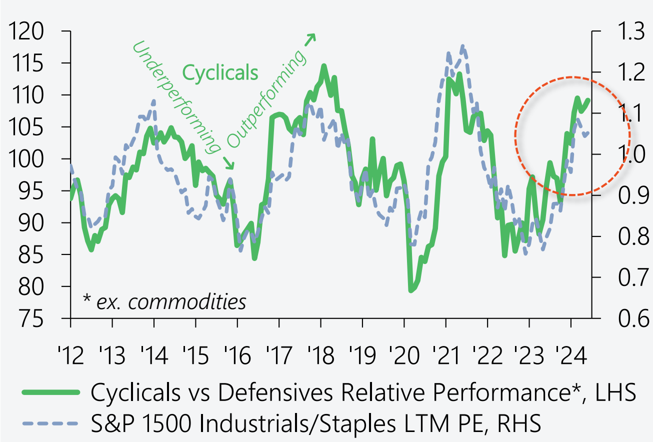
CBOE Volatility Index (VIX)




Source: FactSet, 6/30/24

### Cyclical Trade Appears Increasingly Stretched

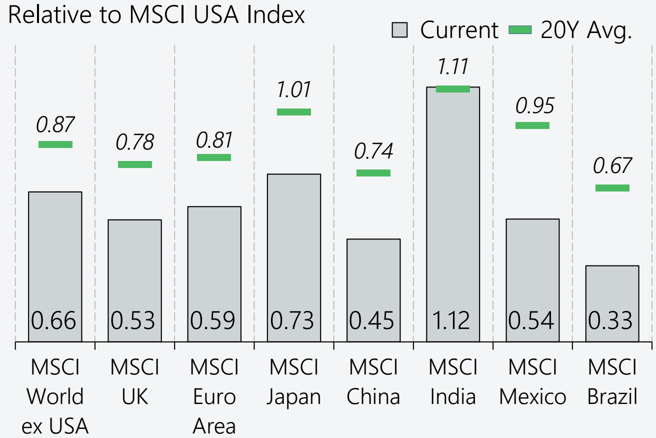
Cyclicals-Defensives Rel. Performance and Valuation




Source: Goldman Sachs, FactSet, 6/30/24

### International Relative PE Valuations Attractive

NTM Relative PE Multiples, by MSCI Region/Country
Relative to MSCI USA Index




Source: FactSet, 6/30/24