



2024 Economic & Market Outlook

# Half-Time Report

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## Has The Inverted Yield Curve Lost Its Touch?

Heading into the second half of 2024, it appears the markets are no longer focusing on the odds for a recession. Given the prior track record of an inverted Treasury (UST) yield curve and the fact the UST 2-Year/10-Year differential has been in negative territory since mid-2022, it was not unreasonable to anticipate that a negative quarter or two of real gross domestic product (GDP) could be in the offing.

Nevertheless, the economy has proven to be far more resilient than anyone had expected, with an integral factor being the relatively solid labor market setting. The June jobs report did produce some mixed results, perhaps indicating some slowing in activity is now occurring. However, the underlying tenor of the data did not point towards any signs of apparent weakness.

Looking ahead, perhaps the best way to diagnose the economy's prospects is to break real GDP into five cylinders of an engine. As long as the labor market doesn't fall off a cliff, consumer spending is expected to remain a positive contributor. Gross private domestic investment could also be on the plus side but could be held back by residential outlays. Trade and inventories are typically wild cards in quarterly GDP calculations and we don't see that changing anytime soon. Finally, baseline government outlays will more than likely be neutral at worst, with continued infrastructure spending possibly providing support.

Against this backdrop, we continue to expect the U.S. economy to produce modest growth and avoid an outright recession during the second half of this year.

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## Are We Back To Disinflation?

Another surprising macroeconomic occurrence to begin 2024 was the hotter-than-anticipated reads on inflation. While some further improvement in overall price pressures was a reasonable base case scenario, various inflation measures were revealing that the last mile toward the Federal Reserve's (Fed's) 2% inflation goal might be a bit more difficult.

However, as we were finishing up the first half of the year, inflation reports did begin to come in a bit cooler than expected. The natural question now becomes, which trend will continue in the months ahead?

Interestingly, Fed Chair Powell had mentioned that "seasonal problems" may have been behind the unexpected inflation readings to begin the year. If that was the case, the markets may now be witnessing some reversal in those earlier price pressure trends. We anticipate that disinflation will continue to be prevalent moving forward, but either way, it appears that reaching the Fed's 2% goal has become a bit more of a grind than previously anticipated.

## Fed Policy Impact

Interestingly, the June Federal Open Market Committee (FOMC) meeting came around after the money and bond markets and the Fed had finally come into a somewhat better alignment on the potential for future rate cuts. Specifically, the policy makers revised their dot plots (Fed Fund Rate projections) to show only one rate cut for this year as compared to the three easing moves that were previously in place. Following the aforementioned cooler inflation reports, the markets now seem to be operating under the assumption that the Fed's latest Fed Funds Rate projection has become obsolete.

That being said, the schism between the official Fed forecast and the money and bond markets' new rate expectations is not as wide as when we began 2024. Indeed, implied probabilities for Fed Funds Futures are pointing toward two rate cuts for this year, a scenario that was penciled in by eight Fed members in the June dot plots.

The debate surrounding how the potential rate-cutting episode will play out will remain a fluid one through the summer months and into the fall. Chair Powell has continued to emphasize that future policy decisions are highly data dependent, and while inflation is no doubt a primary influence, the “totality of the data” (employment) is extremely important as well. Unless the data surprises to the upside, the Fed does seem intent on reducing the Fed Funds Rate at some point later this year. In our opinion, two rate cuts seems like a reasonable case scenario.

Although we are just entering the second half of the year, we anticipate the markets shifting to rate-cutting prospects for 2025 in the months ahead. For the record, the Fed's latest median estimate is for four rate cuts, but, as history has shown us, we should take that projection with a grain of salt for now.

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## The Election And Policy

With November rapidly approaching, policy implications are beginning to come into focus. Differences between respective policies are abundant, but there are areas of agreement and continuity—regardless of which party wins the Presidential race—that should be kept in mind. Tariffs and other harsh trade rhetoric (particularly toward China) will be rampant between now and November 5th as both candidates have used them. After the debate and the surge in campaign speeches, there is little chance of this bipartisan talking point fading from focus.

While the Presidential race garners much of the focus, the House and Senate are as important for the economic and policy outlook. Currently, there is no clear indication of which party will take a majority in either house. With numerous toss-ups and the ever-present risk of surprise polling swings, the House and Senate are worth watching more than the Presidential election. If you cannot pass bills and enact legislation, the policy implications of either party winning the executive branch fade dramatically.

We are watching developments closely, but do not see significant market shocks emanating from November. Markets are not oblivious to the political cycle and are constantly pricing in incremental information. Dramatic swings in either direction could alter this sanguine attitude, but that is more likely to come from the House and Senate races—not the Presidential election.

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## Trends In Equity Markets

### **Equity Outlook: Be Careful Wishing for An Easing Cycle**

Though this cycle has surprised in its economic resilience, our concern with regard to equities is the historic record of rate cuts, which tend to come once something in the system has broken. To wit, we saw the VIX Volatility Index rise materially in the months (and sometimes years) after the Fed's first cycle cut in 1995, 2001, 2007 and 2019, though the 1998 rate cut witnessed volatility subside the following year. Additionally, not all is lost; no one associates the post-1995 episode as troublesome for risk assets. Nevertheless, we know in retrospect that rate cuts were unable to fend off trouble at the turn of the century and on the eve of the Global Financial Crisis. As for 2019, that easing cycle's effect is anyone's guess; COVID-19 rolled into town a few months later.

### **U.S. Equity Market**

We continue to point to stocks that rank highly on profitability measures, along with indications of proper balance sheet maintenance in the form of lower debt metrics. Screens for high return on equity (ROE) and return on assets (ROA) often have satisfactory downside capture profiles that may come in handy as the summer's dog days roll in.

Meantime, it is no secret that the market has become top-heavy, with a few eye-watering valuations popping up across various sectors. We count 23 members of the S&P 100 that trade for more than 50 times reported earnings per share. These include such disparate businesses as semiconductors, injectable weight-loss drug plays, warehouse clubs, general media, tax preparation, rideshare and beyond. For context, value players will not find much that jumps off the page in mega caps, as just two S&P 100 companies trade for under 10 times earnings.

The better values are often lurking in a land far away from large caps. If an investor is willing to toss out the legions of negative earnings plays inside an index such as the Russell 2000, what is left in small caps is a basket that trades at a satisfactory discount to this Magnificent Seven-dominated market.

### **Opportunities beyond the U.S.**

Internationally, we maintain our constructive view on Japan and India, both of which are benefitting from the reflexive alternative-to-China rotation.

**Japan:** We are heartened by the country's follow-through on not only corporate governance reform promises but also on last year's promised retirement investment incentives. On the former, the so-called "Name and Shame" list of companies with poor governance has been published and appears to have lit a fire under the market's lumbering laggards, which have begun to draw up gameplans to get their acts together. Additionally, the much-awaited tripling in the annual household maximum contribution to the country's defined contribution retirement system has served as a catalyst for domestic equity investment.

**India:** Though Prime Minister Narendra Modi's Bharatiya Janata Party (BJP) disappointed in this summer's elections, the market has already looked past that negative development. Most seers on the Street continue to anticipate India setting the record among all major economies for GDP growth in both 2024 and 2025. From an asset allocation perspective, most American portfolios only hold India inside broad emerging markets baskets. To perpetuate the bull market, investors will need to start performing the same level of due diligence on India as they do on comparables, namely China.

### **Adapting to Currency and Global Market Dynamics**

As we saw in the action surrounding this summer's European elections, owning foreign equities in an unhedged manner often entails taking on a risk that is highly correlated to the stock market. In short, when European equities fall, the euro tends to fall with them.

Japan's situation is a little different, in that the yen spent most of the last few years declining while stocks advanced. Still, with the Bank of Japan now trying to defend the currency, the yen is also serving as a source of unnecessary volatility for those who own equities in an unhedged manner.

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## New Rate Regime

While the money and bond markets wonder what higher for longer will actually mean, the more accurate way of looking at fixed income is that it has entered into a new rate regime, where interest rates are now at levels a generation of investors has not witnessed before. We continue to suggest investors use laddered and/or barbell strategies for their fixed income portfolios.

### U.S. Treasuries

Within the U.S. Treasury market, investors have seen a rather sizeable turnaround in yield levels from the end of last year. The rally that followed the peak yield levels around mid-October was predicated on a weakening economy, cooling inflation and an aggressive rate-cutting response from the Fed. In order for UST yields to remain at or below the levels that were being registered, validation needed to occur, and as we witnessed during the first half of this year, the cornerstones of that rally were not validated.

As a result, UST yields have retraced a measurable portion of their Q4 decline and appear to have possibly established fair value trading ranges. However, if the Fed is in heightened data dependence mode, that means the UST market is as well, elevating the volatility quotient, accordingly. Unless there is a negative economic or inflation surprise on the immediate horizon, we believe upcoming data and Fed policy should keep the UST 10-Year yield anchored around a 4.50% equilibrium level, give or take 25–30 basis points on either side of this reading.

### Fixed Income Asset Allocation

The resiliency in the economic landscape provides a supportive landscape for U.S. credit, but the market has already moved to price this into valuations, limiting the potential for further spread tightening and making investing in corporate bonds largely an income trade. Yield spreads over Treasuries remain at tight levels relative to history for both high-yield and investment-grade corporates. This doesn't preclude spreads from either drifting lower or staying firm in what we expect to be a range-bound (higher) for longer-term backdrop in Treasury rates. Corporate bond market behavior after hikes ended in 2006 provides some precedent for near-term stability, but it also highlights the need to stay vigilant as spreads turned higher as the economy began to buckle in 2008. We continue to see corporate bonds as a source of good income, and we remain focused on higher-quality issuers.

Corporate bond market behavior highlights the need to stay vigilant.










Securitized assets offer better valuation prospects and a complementary source of income to corporate bonds. We suggest a small over-weight allocation to the sector, using a core of agency MBS pass-throughs and collateralized mortgage obligations supplemented by a plus component of non-agency mortgage-backed positions and other securitized credit positions.

Thus, we think investors should allocate across diversified sources of income taking small, calculated positions across investment-grade credit, U.S. high-yield credit and securitized assets (relative to Treasuries). Keeping some allocation to short-term fixed income also makes sense with the continued inversion of the yield curve and to take advantage of opportunities as they evolve.

## Asset Allocation Summary

### Equities

- + We remain neutral on stocks relative to bonds.
- + In U.S. equities we are predisposed to higher quality firms that exhibit value investing characteristics. We have reason to believe that companies that emphasize dividends and buybacks may be opportune if market conditions deteriorate. Companies that are unable to earn a profit in a world of full employment, high stock prices and reasonable inflation will be hard-pressed to get their act together if any part of that trifecta falls apart.
- + While the S&P 500 Index trades at a steep premium to international equities, relative valuations outside of the top-heavy market gauges are near long-term averages.
- + Outside the U.S., we have under-weight allocations to Europe and China, and over-weight allocations to Japan and India.










Equities	Negative 	Neutral 	Positive 
Equities vs. Bonds			
U.S. Large-Cap Growth			
U.S. Large-Cap Value			
U.S. Mid-/Small-Cap			
Developed International			
Emerging Markets			

Source: WisdomTree, as of 6/30/24. Evaluations are subject to change as market conditions change. This is for illustration purposes only and does not represent investment advice. All evaluations are on a relative and not absolute basis. Red = a negative relative evaluation; gray = a neutral relative evaluation; green = a positive relative evaluation. You cannot invest in an index, and past performance does not guarantee future results.



## Fixed Income

- + We added duration in a deliberate manner last year and are now closer to a neutral stance relative to benchmarks.
- + However, given the inverted nature of the yield curve and our expectation for ongoing interest rate volatility, we remain allocated to short-duration bonds, including Treasury floating rate notes.
- + We remain constructive on quality-screened credit and have an over-weight allocation to mortgage-backed securities.

Fixed Income	Negative 	Neutral 	Positive 
Duration			
U.S. Treasuries			
Investment Grade Credit			
High Yield Credit			
Securitized Credit			
Non-U.S.			

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## Alternatives

- + With the expectation that stock-bond correlations could remain in positive territory, we believe trend-following and other liquid alternative strategies can play an important role in multi-asset class portfolios.
- + We continue to favor strategies that seek to generate uncorrelated returns in periods of heightened volatility.
- + While rising correlations with equities have called into question the hedging capabilities of fixed income, the dollar has acted as a better portfolio diversifier.

Alternatives	Negative 	Neutral 	Positive 
Liquid Alternatives			
Real Assets			

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## Glossary

**Barbell strategy:** An investment strategy that aims to balance risk and reward by investing in high-risk and low-risk assets, while avoiding middle-risk options.

**Buyback:** When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

**CBOE Volatility Index® (VIX®):** A key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. It is the premier benchmark for U.S. stock market volatility.

**Collateralized mortgage obligation (CMO):** A type of mortgage-backed security that bundles similar mortgage loans together and sells them as a single investment to investors.

**Disinflation:** Term used to describe instances of slowing inflation; different from deflation in that price levels are still increasing overall, just at a slower rate.

**Dot plot:** A chart based on the economic projections of the Federal Reserve board members that illustrates their views on the appropriate pace of policy firming and provides a target range or target level for the Federal Funds Rate.

**Downside capture:** A measurement of an investment's relative performance in down markets.

**Duration:** A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

**Earnings per share (EPS):** Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

**Fed Funds Futures:** Financial contracts that represent the market opinion of where the daily official Federal Funds Rate will be at the time of the contract expiry. The futures contracts are traded on the Chicago Mercantile Exchange (CME) and are cash settled on the last business day of every month. Fed Funds Futures can be traded every month as far out as 36 months.

**Fed Funds Rate:** The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

**Federal Open Market Committee (FOMC):** The branch of the Federal Reserve Board that determines the direction of monetary policy.

**Federal Reserve (Fed):** The Federal Reserve System is the central banking system of the U.S.

**Gross domestic product (GDP):** The sum total of all goods and services produced across an economy. Real GDP is adjusted for price changes.

**High yield (HY):** Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securities.

**Inflation:** Characterized by rising price levels.

**Inverted yield curve:** An interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality.

**Investment grade (IG):** A rating that signifies a municipal or corporate bond presents a relatively low risk of default.

**Liquid alternative:** An alternative investment, one that is not one of the three traditional asset types (stocks, bonds and cash), that can be bought and sold on a daily basis.

**Magnificent Seven:** Refers to a group of high-performing U.S. stocks including Microsoft (MSFT), Amazon (AMZN), Meta (META), Apple (AAPL), Google parent Alphabet (GOOGL), Nvidia (NVDA) and Tesla (TSLA).

**Pass-through:** A payment mechanism whereby all amounts received on the assets held by the issuing vehicle are immediately passed through (paid) to the investors.

**Quality:** Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets and operating profitability. This term is also related to the quality factor, which associates these stock characteristics with excess returns relative to the market over time.

**Recession:** Two consecutive quarters of negative GDP growth, generally characterized by a slowing economy and higher unemployment.

**Return on assets (ROA):** Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets use to generate them.

**Return on equity (ROE):** Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

**Russell 2000 Index:** Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

**S&P 100:** Measures the performance of large-cap companies in the U.S. and comprises 100 major blue-chip companies across multiple industry groups.

**S&P 500 Index:** Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the U.S. economy.

**Securitized:** A debt security whose value is backed by an asset or pool of assets such as a mortgage.

**Size capitalization:** A measure by which a company's size is classified. Large caps are usually classified as companies that have a market cap of more than \$10 billion. Mid-caps range from \$2 billion to \$10 billion. Small caps are typically new or relatively young companies and have a market cap between \$200 million and \$2 billion.

**Spread:** Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

**Treasury (UST):** Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

**Treasury floating rate note:** A debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

**U.S. agency mortgage-backed securities:** Pools of securitized residential mortgage loans that are issued and guaranteed by U.S. government agencies.

**Valuations:** Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

**Value:** Style of investing characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the value factor, which associates these stock characteristics with excess returns relative to the market over time.

**Yield curve:** Graphical depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

**Yield:** The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. High-yield or “junk” bonds have lower credit ratings and involve a greater risk to principal. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer’s ability to make such payments will cause the price of that bond to decline.

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