CIO Strategy Bulletin

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More Growth, Less Easing

Key Takeaways

- A strong employment report for September doesn't erase a trend of slowing employment gains in the US. But it is consistent with solid output data, tracking above 3% for real GDP in the third quarter. Corporate earnings are rising broadly. A US recession simply isn't in sight.
- Quite similarly, the US CPI was slightly stronger than expected in September, but we still believe the Fed can dial back from restrictive monetary policy at a "measured pace." We doubt the Fed will ease below a 3.5% policy rate next year.
- As fears of a harder landing have been erased, US Treasury yields have rebounded to an average near 4%, in line with our estimates of long-term fair value. Macroeconomic easing steps will continue across the world in 2025, including in China. However, their extent depends in part on US polices as we described in our CIO Bulletin two weeks ago.

Potential Portfolio Implications

- US bond yields are slightly more appealing after jumping nearly 50 basis points across the yield curve since mid-September. The US dollar recovered slightly on signs that the Fed will not need to ease as aggressively as feared.
- Investors should remember that forecasts for Fed rate cuts have been highly erratic and of limited value. The extent of US rate cuts in 2025 is uncertain, but we believe markets have erased some of the risk of excessively strong easing expectations. More importantly for equity markets, there's no sign of an overheating economy.
- Returns in the US equity market have been negative on average in the Octobers prior to US presidential elections over the past century. The last election year with a positive October return was 2004. This was followed by gains in all but the 2008 financial crisis. Investors shouldn't allow near-term volatility to mislead them.
- This does not mean US policy won't matter. We continue to focus on quality income growth for portfolios ahead of US election uncertainty (see our September 7th CIO Bulletin). We expect US governance to significantly drive certain market outcomes and perhaps alter our asset allocation once election results are clear.

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Faint Signal Through So Much Noise

After a "big cycle" in 2020-2022, global markets have continued to feel aftershocks, arguably "mini cycles." Arguments over where the Fed would stop tightening (some said at 6-7% for cash rates) are over. In August, some argued that an economic collapse had finally begun and the Fed would need to quickly act with "emergency" easing steps.

After hinting for much of the year that restrictive US monetary policy could someday relax a bit, Fed Chair Powell delivered a 50 basis point rate cut in September. The move sparked much debate within the Federal Open Market Committee, just as it did in markets. Action was a bit later than we suspected coming into 2024, but also a bit larger to "reward our patience." The extent of the easing this year may be similar to our initial expectations or just a bit more aggressive (please see Wealth Outlook 2024).

As we've long noted, the US Treasury yield curve has steepened in every Fed easing cycle, meaning longer-term Treasury yields have drifted up compared to short-term yields. What the Fed does over the short-term may be surprising, even shocking at times, but it all "averages out" over 10 years or longer. We took that message to heart when we eliminated an overweight in long-term US Treasuries in favor of US large cap equities on August 7 (please see August GIC Asset Allocation). Today, long-term Treasuries appear attractive compared to other developed market sovereign bonds, but only appropriately valued as a low-risk component of a portfolio.

Unusual situation: rate cuts and corporate profit gains at the same time

Knowing what the Fed will eventually do doesn't matter much for short-term market performance. Expectations for US monetary policy are highly erratic compared to the central bank's actual rate cutting path (see **FIGURE 1-2**). The important question across asset classes is *how the economy will perform. Why* the Fed is setting policy rates as it does is easily more important than the particular rate level. Certain months have deviated, but the US economy this year has seen inflation slow while output and profits accelerate. This unusual circumstance has helped the S&P 500 rise in excess of 20% for a second year (see **FIGURE 3**).

FIGURE 1: Fed's forecast of its policy rate vs actual

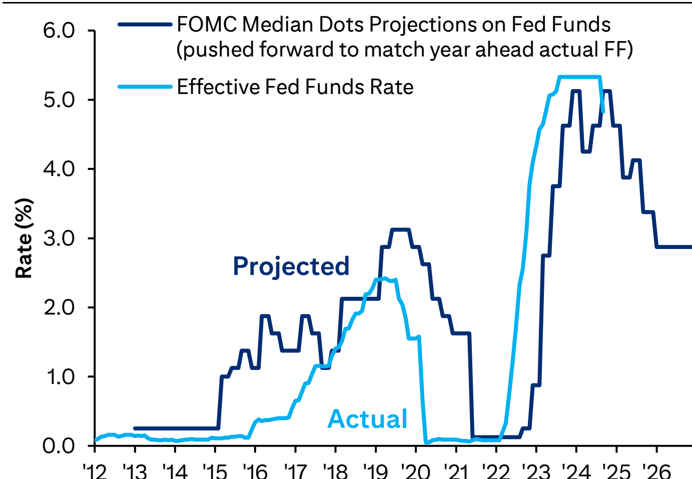
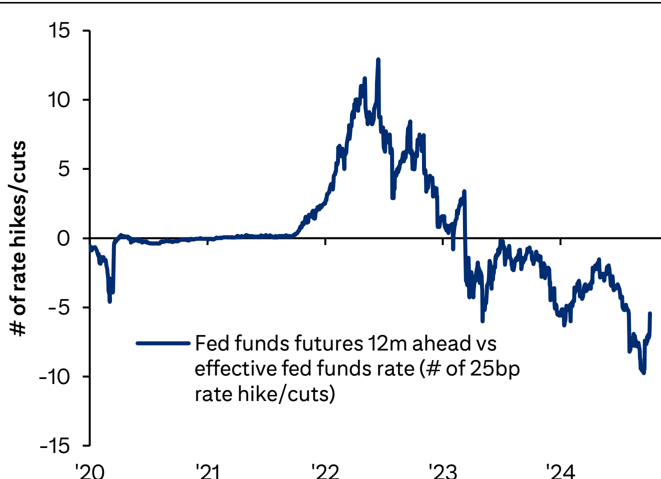


FIGURE 2: Bond market expectation of Fed rate cuts in 12 months ahead



Source: Bloomberg as of October 7, 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

FIGURE 3: Change in Fed policy rate vs corporate profits Y/Y%

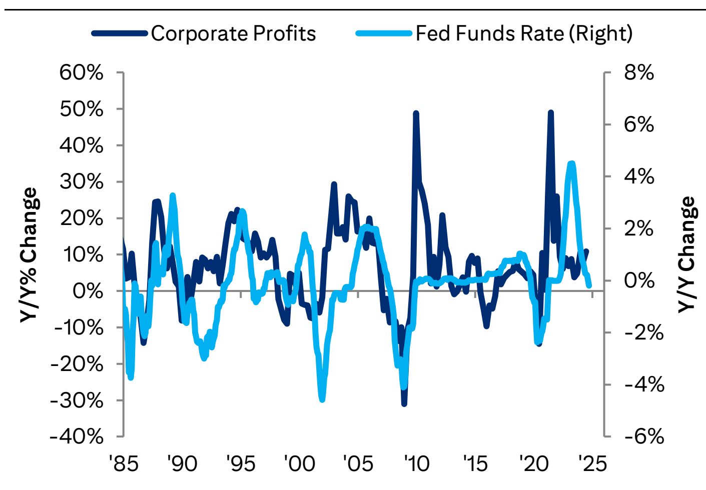


FIGURE 4: How has a 60/40 blend of US equities and bonds performed two years after a decline in both assets over 12 months?

	1-yr subsequent returns 60/40	2-yr subsequent returns 60/40
# Instances of Negative Y/Y Stock and Bond Returns	53	47
% Instance Positive Subsequent Returns	84.9%	100.0%
% Instance Negative Subsequent Returns	15.1%	0.0%
Average Return	**13.4%**	**32.2%**
Median Return	**8.7%**	**28.0%**

Source: Haver Analytics and Bloomberg as of October 8, 2024. Note: 60/40 returns show the combination of the annual total return of the S&P 500 and the 10-Year US Treasury (UST) with 60% allocated to the S&P 500, and 40% allocated to UST. All performance information shown above is hypothetical not the actual performance of any client account. Hypothetical information reflects the application of a model methodology and selection of securities in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. The returns shown above are for indexes and do not represent the result of actual trading of investable assets/securities. The average return is the arithmetic average while the median represents the midpoint of distributed returns. The asset classes used to populate the allocation model may underperform their respective indexes and lead to lower performance than the model anticipates. Index returns do not include any expenses, fees or sales charges, which would lower performance. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Have markets gone too far?

The starting point for evaluating the risks to a market rally matters. The returns following the joint stock and bond market declines of 2022 have not been truly extraordinary. The 36% gain for a 60/40 mix of US equites and bonds is just above the average performance following the 47 cases of joint stock bond market declines over any 12-month window of time in the past century (see **FIGURE 4**). It does exceed the 26% return in the two years following 1931 and 1969, the only other calendar years besides 2022 in which the US experienced joint declines in both asset classes.

The strong performance of US markets – and our own tactical overweight for the US in both equities and bonds – is a risk we need to manage (see **FIGURE 5**). As we discussed two weeks ago, how US fiscal and monetary policy evolve post the November 5th election creates two-sided risks for the US dollar, domestic, and international asset prices.

We are not willing to take big risks on the election outcome amid close polling data. However, until there is clarity, one potential opportunity that seems somewhat underpriced is higher quality firms with a history of strong dividend growth. These are the “turtles” that over the longer-term have “beaten the hares” in terms of volatility-adjusted returns (see **FIGURE 6**).

FIGURE 5: US share of global equity market cap and real trade-weighted US dollar index

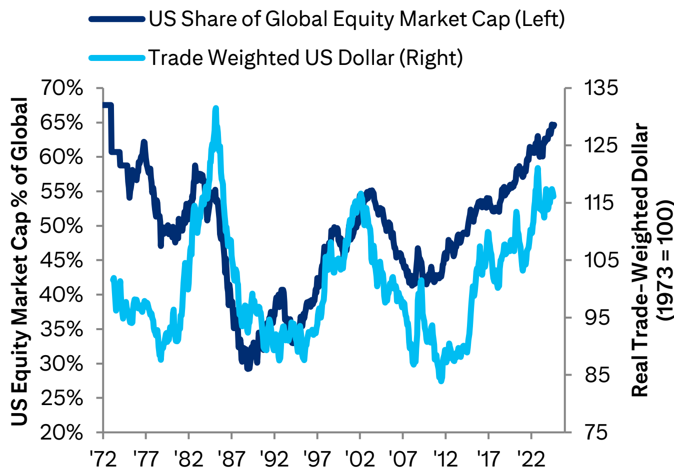
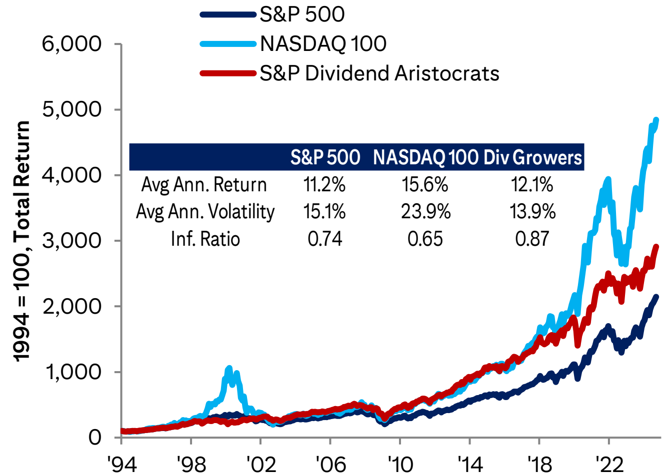


FIGURE 6: US Dividend Aristocrats, S&P 500, and Nasdaq 100 total return and volatility



	S&P 500	NASDAQ 100	Div Growers
Avg Ann. Return	11.2%	15.6%	12.1%
Avg Ann. Volatility	15.1%	23.9%	13.9%
Inf. Ratio	0.74	0.65	0.87

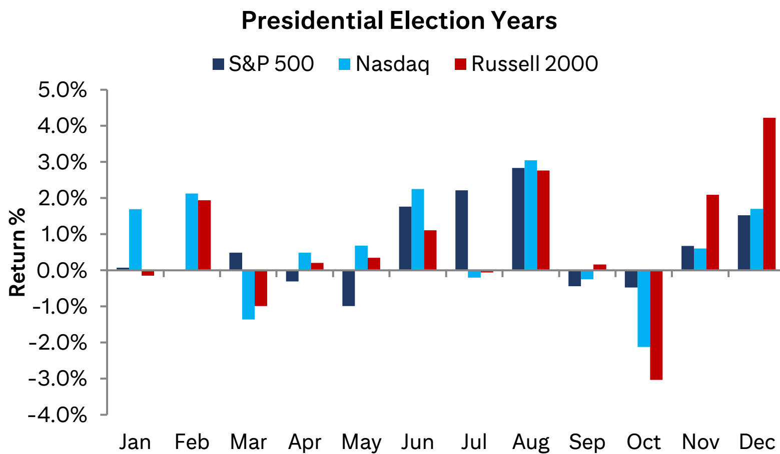
Source: Haver Analytics and Bloomberg as of October 9, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

A pre-election health check on the US economy

The post-US election environment can create a sharp movement in asset prices. History shows that pre-election periods – most acutely the month before – tend to be biased toward negative returns on uncertainty and apprehension (see **FIGURE 7**).

The last October before a US election that posted a positive equity market return was 2004. No President delivers magical cures, but as uncertainty fades, post-election returns have been biased positive in all but the most extreme negative economic environments (November/December 2008 is the last example). Of course, in a world of AI data mining, it would not surprise us if investors attempt to act on this historical pattern, confounding a repeat (past performance is no guarantee of future results!)

FIGURE 7: US equity returns by month during presidential election years of the past century



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Policies matter

As discussed two weeks ago, the power of the US President and policy differences of the two candidates are significant enough to generate different outcomes in markets favoring either domestic or international assets. Continued Fed easing and declines in the US dollar might be clearer if Harris continued the Biden administration's policy course. A return of Trump to the White House with a "Red Sweep" of Congress would deliver tariffs and perhaps new domestic tax cuts, boosting the dollar and limiting the extent of Fed easing. In either case, however, markets may quickly adjust to these conclusions. China's incredibly swift repricing of macro policies over just two weeks might be a good indication of how markets can swiftly adjust to public information.

Beyond such an initial lurch in US/non-US assets, what will matter is how the economy performs and how investors evaluate the future beyond. Here, our "initial conditions" look reasonably positive. As **FIGURE 8** shows, US inflation has slowed sharply as unemployment moved just gradually higher. Even with an upward surprise in September, headline US inflation has fallen to 2.4% over the past year. This is below the 2.5% pace we expected for year-end 2024 in our 2024 Wealth Outlook. Following a period of intense upheaval in the pandemic and initial recovery, productivity growth is picking up, allowing output to flourish as profits grow and labor demand slows (see **FIGURE 9**).

A powerful round of hurricanes has hit the US late in the season, delivering pains for many Southeast residents in a world of multiple, man-made crises (please see last week's CIO Bulletin for a discussion of the Middle East). In this case, the historic data are quite clear. Beyond the sad loss of life and property, natural disasters have had limited impact on macroeconomic performance. Only when productive capital is significantly impaired – as was the case in 2005 and 2017 when the costliest hurricanes (Katrina and Harvey respectively) wrecked much of Louisiana and Texas – could we discern lasting employment losses on a macro scale.

In much of the Emerging World, the balance sheet capacity to "build back" following disasters isn't secure. It's crucial to think about how investments can support innovation and improvements to safeguard communities and enhance their resilience. Investors can approach this through two primary strategies: climate adaptation and climate mitigation. One key area to explore is the alternative energy space – see our Sustainable Investing Spotlight: The new energy horizon.

FIGURE 8: US CPI Y/Y% vs unemployment rate

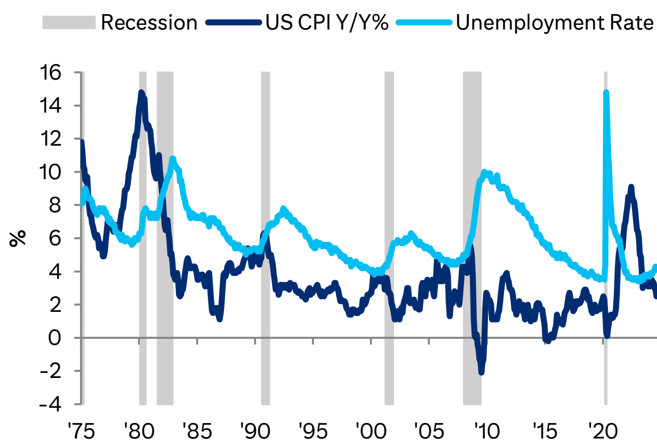
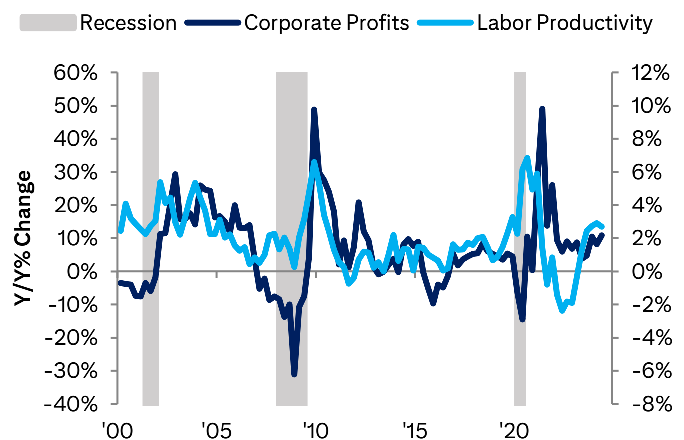


FIGURE 9: Corporate profits and labor productivity Y/Y%



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Medium grade	Baa	BBB	BBB
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Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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