Cetera® Investment Management

Third Quarter 2024

Mid-Year Outlook

The Fed's Pivotal Quarter Overview

The U.S. Federal Reserve started lifting interest rates over two years ago and, we believe, finally stopped nearly a year ago. Investors, who tend to be forward-looking, went from anticipating rate hikes to anticipating rate cuts very quickly. The Fed acknowledges the Fed Funds rate is currently restrictive but wants to gain more comfort that inflation is easing toward their 2% target before cutting rates. It is a balancing act because inflation data is backward-looking, and restrictive Fed policy can increase unemployment and cause a recession.

The good news is the Fed finally got what they wanted in June. The May inflation data was promising, and we think these sorts of reports could continue as the economy cools and the labor market weakens, putting downward pressure on both wage and price inflation.

We are optimistic the Fed will end up cutting rates more than expected this year. While bond markets may not have fully priced this in, equity markets have been flying high on artificial intelligence enthusiasm. Valuations in technology and growth stocks are high and concentration in large cap indexes is also high. Few stocks with large weights in indexes have driven the whole market higher.

This could spell volatility for equity markets at some point, but currently the momentum is strong. A pullback could also create opportunities as a lot of cash is piled into money markets which could find its way into equities if investors find themselves with better entry points.

The bond market seems attractive now with good risk-and-reward dynamics, especially shorter-term bonds if the Fed does end up cutting rates more than expected. Bonds can also mitigate potential equity volatility.

Your Cetera financial professional can keep you focused on your personal goals and objectives. There will be added distractions thanks to it being an election year, but focusing on your own goals and objectives will help take the emotion out of investing. Election years tend to be good years for stocks regardless of who wins. There are larger macro-economic forces at play and the President's ability to enact change is limited, especially with a divided Congress. Both Biden and Trump have been president before, limiting the uncertainty of a new president.

At-A-Glance

Economic growth as measured by Gross Domestic Product (GDP) is cooling as expected from the strong second half of 2023. Economists and the Fed continue to think GDP in 2024 will be close to 2%, which is the goldilocks scenario investors are hoping for.

Through mid-June the S&P 500 is up nearly 15%, continuing to hit all-time highs as anticipation for Fed rate cuts and artificial intelligence fuels investor optimism.

Small cap and value stocks have lagged, similarly to much of 2023, as many stock indexes were pushed higher by large technology companies with big index weights.

The strength of the U.S. dollar continued to drag international equities down. Developed and emerging international market returns are positive this year but lagging U.S. large cap gains.

Bonds had a rough start to the year but have made up a lot of ground recently and major broad market indexes are flat heading into quarter end.

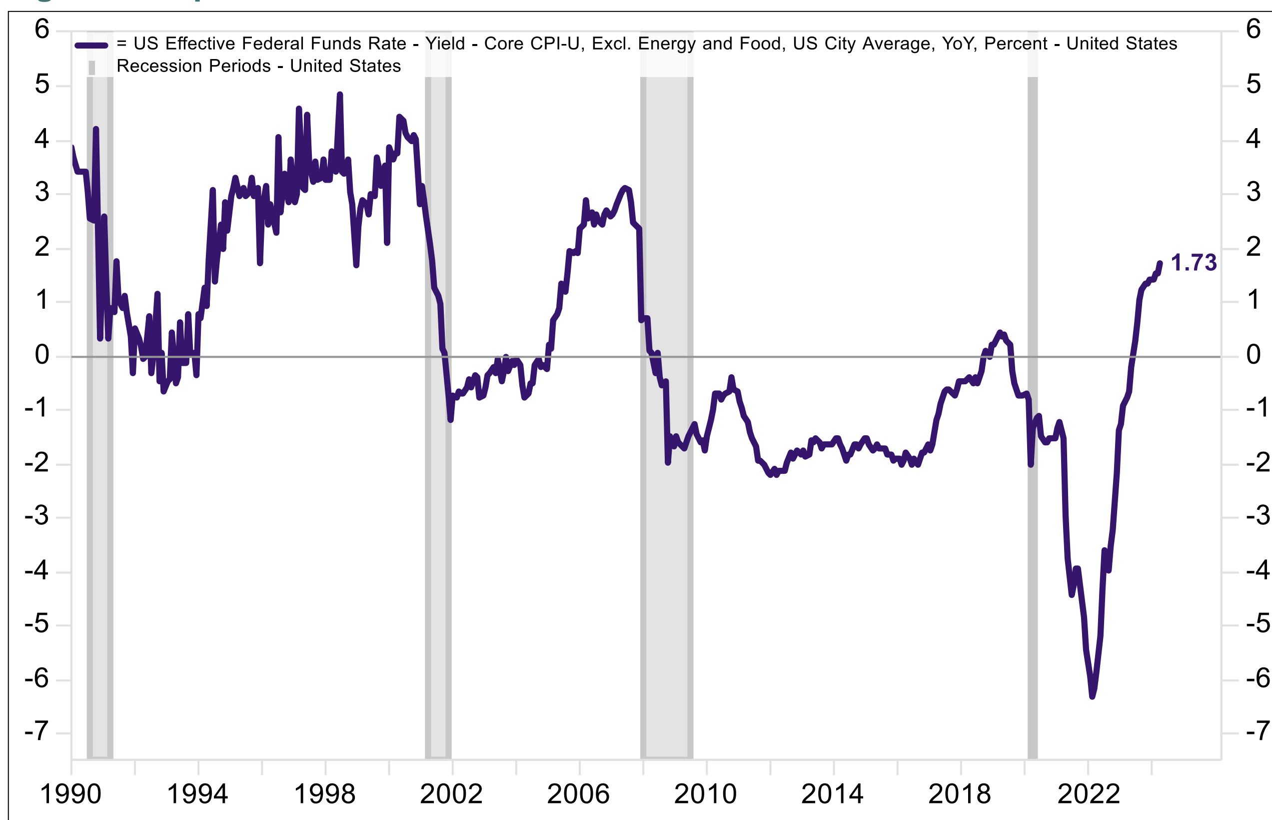
The possibility of increased volatility seems high with stretched valuations and a narrowly driven market. Bonds offer diversification and relatively high yields. We think any volatility might be short-lived and could provide opportunities.

Global Economy

As expected, U.S. economic data has moderated since the end of last year. U.S. GDP growth went from 4.9% and 3.4% in the third and fourth quarters, respectively, to 1.3% in the first quarter of this year. Looking at the Atlanta Fed's forecast for the second quarter, their GDPNow estimate is a healthy 3.1% as of mid-June, but economists' consensus is closer to 2%. Capital Economics, a UK-based economic research firm, estimates U.S. GDP to be 2.3% for all of 2024. This would indicate a soft-landing scenario where the U.S. economy slows but avoids a broad-based recession.

So much of the attention this year has been on the Fed, which stopped raising rates in July 2023. It took little time for investors to go from anticipating rate hikes to anticipating rate cuts. This is because the Fed Funds Rate has been restrictive and exceeded Core CPI since June 2023, with inflation continuing to ease, making it more restrictive. Currently, the Fed Funds rate is 1.76% higher than Core CPI and climbing as seen in **Figure 1**.

Figure 1: Gap Between Federal Funds Rate and Core CPI



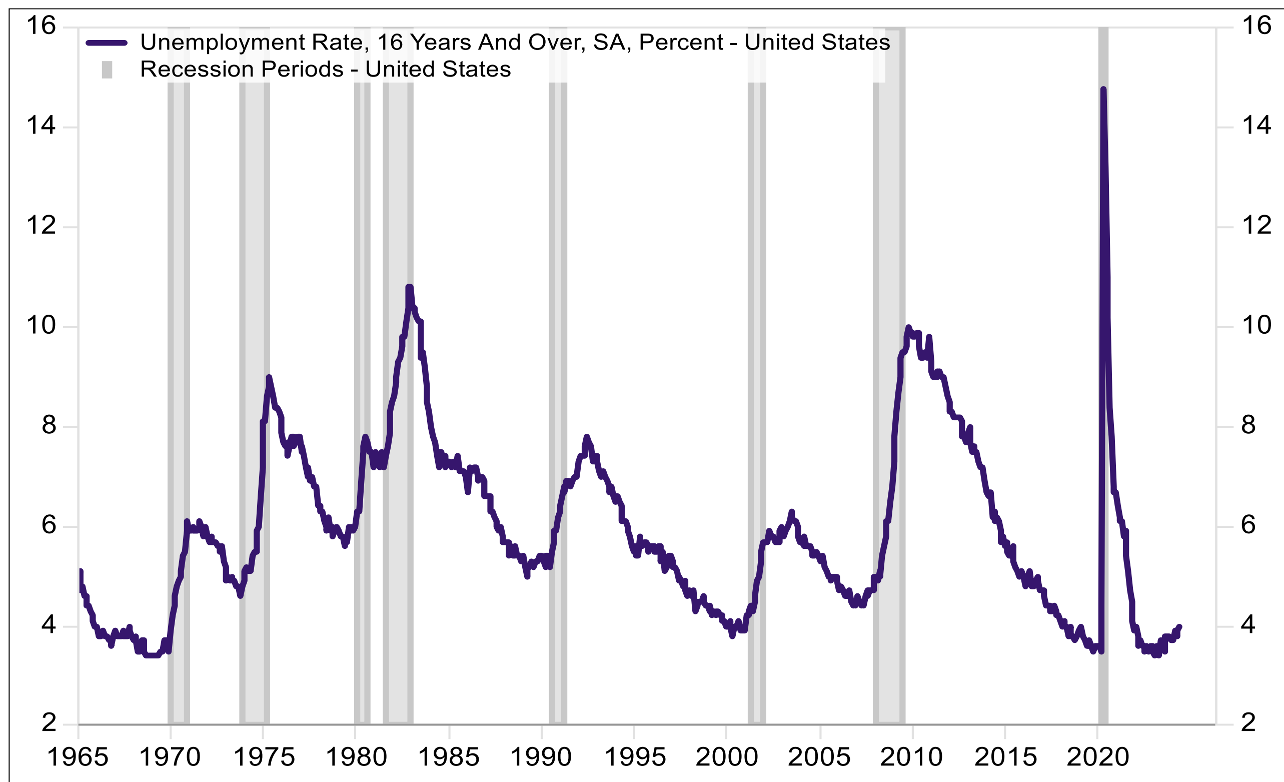
Source: Cetera Investment Management, FactSet, Federal Reserve, U.S. Bureau of Labor Statistics. Data as of 5/31/2024.

We received higher-than-expected inflation data early in the year, which helped justify the Fed's decision not to lower interest rates too quickly. The Fed is aware of the risk of lowering interest rates too soon and repeating the mistake it made in the early 1980s when it was forced to raise rates again as inflation reignited. They are willing to maintain higher rates for longer, despite the risk of causing unnecessary harm to the economy and especially the labor market.

However, Fed policy and inflation do not impact everyone equally. For example, currently the unemployment rate is 4%, rising from a cyclical low of 3.4% in April 2023, but for workers aged 20-24 years old, the unemployment rate spiked to a seasonally adjusted 7.9%. Meanwhile, for 25–54-year-olds, the prime-age workforce, unemployment is still low at 3.3%. In another example, while cruise ships are reporting record bookings, fast food retailers and food makers are reporting resistance to price increases. Credit card and auto loan delinquency rates remain relatively low, but they are starting to trend higher. We could see cracks in the economy emerging from low to middle-income households, which is currently being masked by strength in spending by wealthier households. While inflation appears to be easing, causing undo harm on the labor market would be a double whammy for those hit the hardest by inflation.

In Jerome Powell's June 12 press conference after the Federal Open Market Committee (FOMC) meeting, the labor market was mentioned several times, but he declined to indicate which labor market data points would concern him as examples of broader signs of weakness. He did say the committee would lower interest rates more quickly if the labor market showed signs of deterioration and understands how inflation and Fed policy can impact individuals differently. There is reason to be concerned as the unemployment rate usually inches down gradually and then spikes higher in a recession. As outlined in **Figure 2** below the unemployment rate has started to tick higher already. The grey bands in the chart indicate recessions. We will be watching the labor market closely over the next quarter as we are sure the Fed will be too. While investors want lower interest rates to help stimulate the economy, a spike in unemployment would not be the reason for celebration.

Figure 2: Unemployment Rate



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics. Data as of 5/31/2024.

The good news is that the labor market is currently very strong. There are around 1.25 job openings for every unemployed individual and the overall unemployment rate is still very low at 4%. Furthermore, the labor market is growing by at relatively robust pace of 248,000 jobs per month this year.

Attention on the Fed is justified as a Fed policy mistake could cause a recession. However, perhaps some of the hyperattention is just noise. A 0.25% cut to the Fed funds rate will not have impact to the economy much. Investors are forward-looking though and would like to see rate cuts before restrictive policy negatively impacts the labor market and the broader economy. This is essential to engineering the soft landing everyone is hoping for. We still think that the Fed will cut rates two to three times this year and do not put too much weight into the Fed's newest Summary of Economy Projections (aka dot plot), which only calls for one rate cut by year-end based on the median forecast. Fed officials did not get the May CPI data until the final day of the June FOMC meeting and likely did not revise their forecasts for the new report which showed inflation easing. They also are erring on the safe side in their inflation and rate forecasts, likely because they do not want to telegraph a rate cut too early. That might function as a rate cut as markets would price it in before the actual rate cut.

Unfortunately, inflation data has a problem called base effects over the next three months. CPI data is usually examined over a 12-month period. For example, in July, last June's data will drop off and this month's June data will be added to that 12-month period. The problem is inflation data from June to August of 2023 wasn't too bad, so relatively good inflation data will drop out of the calculations. Jerome Powell alluded to this in his June press conference and will probably look more closely at the month-over-month data and forward-looking inflation metrics rather than the past 12 months. Investors, however, may react to the common 12-month average CPI metrics, which will likely not move dramatically lower over the next couple of months due to these base effects.

One final point regarding inflation data is something we wrote about last quarter. Shelter costs make up nearly 36% of the CPI index, and 45% of Core CPI, with much of the category in a component called homeowners' equivalent rent. This measures how much one could rent their home for if they decided to rent it out. It tries to capture living expenses, but most homeowners refinanced at very low rates and saw deflation during the pandemic, not inflation. Additionally, if we look at the rental market, landlords have been reducing their prices in recent months, so we are seeing deflation for new rental listings, not inflation. Not all countries use this metric in their inflation calculations, and it can skew inflation data because it tends to lag the rental market. We anticipate this number will eventually slow further, but it will take time. When it does, it will be a significant disinflationary tailwind for inflation figures. If we take shelter costs out of the calculation, core CPI was negative in May, and less than 2% on a year-over-year basis. Even with shelter costs included, May was the lowest monthly core CPI reading since August 2021.

Looking abroad, other central banks have already begun easing. China has been adding stimulus and the European Central Bank (ECB) cut interest rates in June even though recent inflation data wasn't as good as hoped for, and inflation remains above their target.

To summarize, we think the Fed could end up cutting rates more than expected in 2024. Fed policy is currently restrictive and could hurt those already most impacted by inflation. The Fed is being conservative in their inflation and Fed Funds forecasts, and a large component of the inflation calculation (homeowners equivalent rent) may skew inflation readings higher. The ECB already cut rates without getting to their 2% target and the Fed could be next. The Fed has changed the Fed Funds rates prior to a presidential election before and we currently anticipate a Fed rate cut in September.

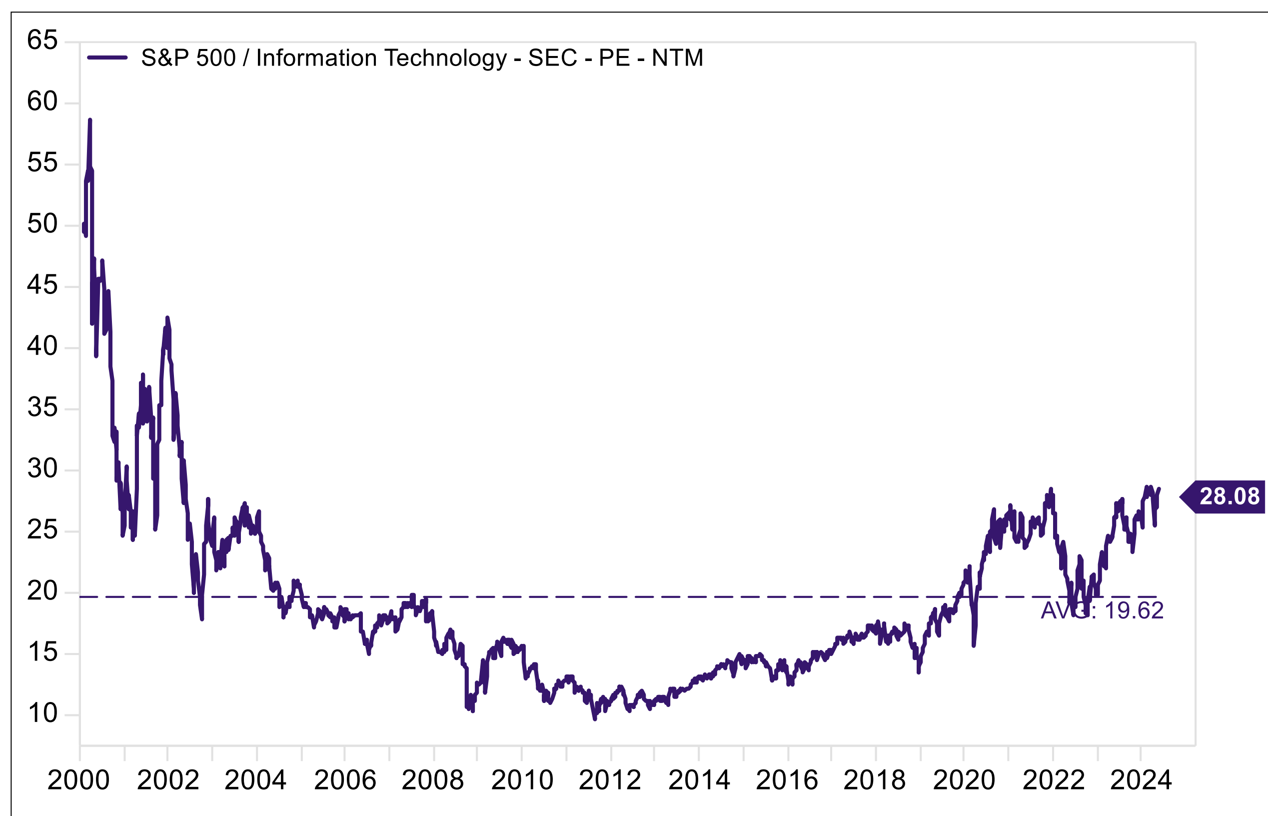
Equity Markets

In April, the S&P 500 finally saw its first negative month since October 2023, but that was short-lived as May more than made up for April's loss and, in June, the index continued its climb higher into record territory. As we near the quarter end, the S&P 500 is up nearly 15% year-to-date. This was led mostly by large cap stocks which are up more than 20%. Value stocks developed international and emerging markets are up around 6%, while small cap stocks are up only 1%.

Along with optimism around Fed rate cuts and weaker inflation expectations, artificial intelligence continued to be the theme for stock investors as technology stocks were up more than 20%. The S&P 500's largest 10 companies make up roughly 35% of the index, so when these mega cap technology stocks do well, so does the S&P 500.

Investors are also bullish about future earnings growth. S&P 500 earnings growth is expected to be 11.7% this year and 14.2% next year, much improved from last year's measly 1.9% growth. While earnings growth can justify some stock appreciation, much of it continues to be multiple expansions. Stock prices relative to earnings continue to rise. In **Figure 3** the Technology Sector P/E ratio is near its recent post pandemic highs, but still well under the dot-com bubble levels. However, tech valuations are above the long-term average. Keep in mind the average is also pushed up by the dot-com bubble.

Figure 3: Stretched Tech P/E's?
S&P 500 Technology Sector: Next 12-Months P/E Ratio



Source: Cetera Investment Management, FactSet, Standard & Poor's Data as of 5/31/2024.

So, the bull market narrative is that inflation is cooling, and the Fed will finally cut rates. Additionally, earnings are projected to be much better in the future and profit margins are healthy. Artificial intelligence optimism and momentum are also positives.

The bear market narrative is that valuations are getting stretched, the economy and labor markets are cooling, and the Fed could be late to cut interest rates. Earnings could also come under pressure if profit margins get squeezed. Producer prices are easing faster than consumer prices, while the consumers are hitting their limits with how much inflation they can absorb. Corporations may have to start absorbing more of the future inflation.

Putting these cases together, we think there could be some near-term volatility, but we remain optimistic for 2024 overall. We believe the Fed will cut rates and the economy and labor market will soften but at this point the economy seems on solid footing. Furthermore, wages are rising faster than inflation while inflation is slowing. While artificial intelligence optimism and tech valuations could fade, other parts of the market offer better values, particularly small cap and international stocks.

While the ECB cut rates first, the Fed may end up cutting rates more. This would put downward pressure on the U.S. dollar and make international investing more profitable. A strong dollar has been a headwind for international stocks for many years now.

Valuations can also remain elevated for long periods. If there is a pullback in equities, investors are holding a lot of cash on the sidelines which could be supportive if they buy the dips and use the cash opportunistically to buy stocks.

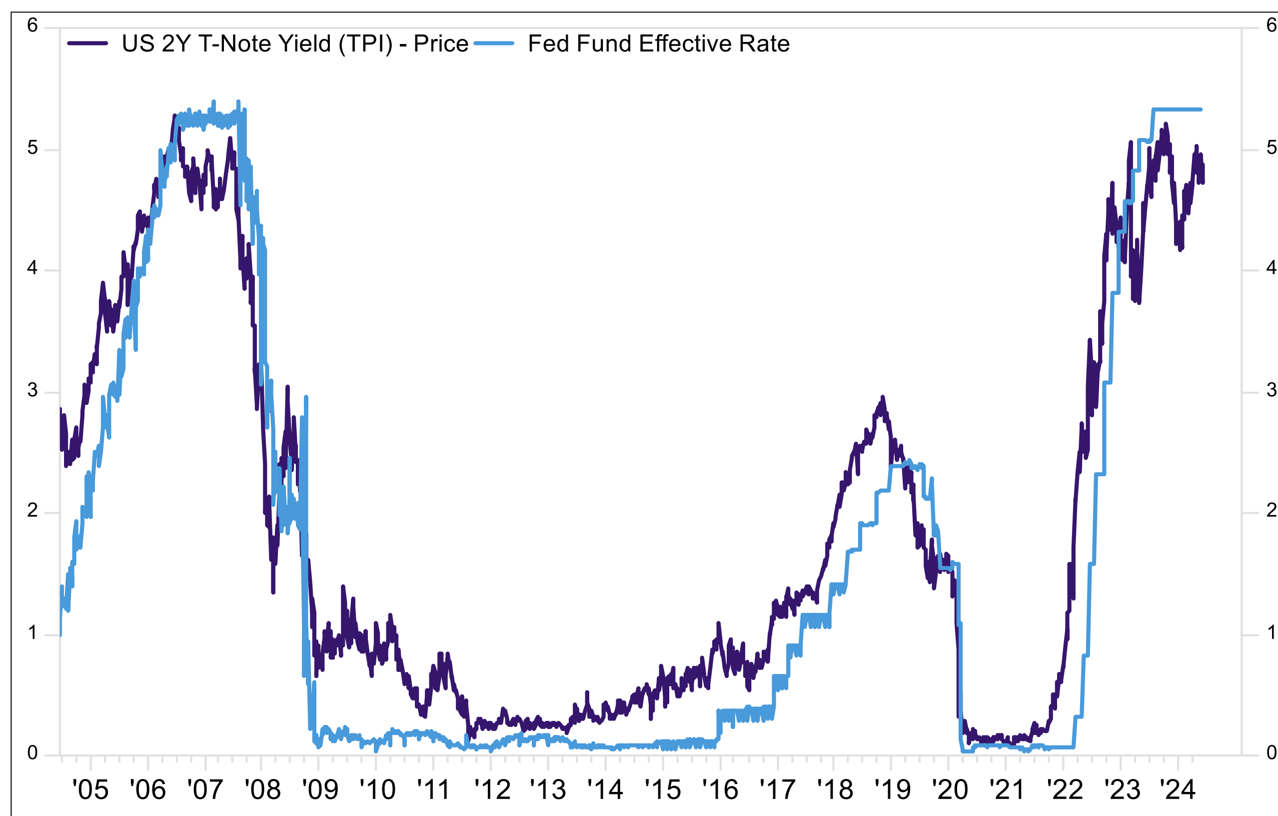
Fixed Income

Within bonds, the yield of 10-year Treasury notes started the quarter at 4.2% and made its way up to 4.7% on April 25 before its rocky road back down to close to where it began the quarter. When yields rise, prices fall, so at the high point in April, the Bloomberg U.S. Aggregate Bond index was down around 3.5% on a year-to-date basis before climbing its way up to around even by mid-June. The index currently has a yield of around 4.5% with a duration of close to 6 years. The risk-return relationship is a lot better than in recent history.

The fluctuation in longer-term bonds was primarily due to long-run economic growth and inflation expectations. The 10-year Treasury yield is important because long-term borrowing costs are correlated with it. Thus, the national average for 30-year fixed mortgage rates peaked in late April at 7.29% before falling back to around 7%.

Shorter-term bonds like 2-year Treasury bills are influenced more by expectations around the Fed Funds rate. The yield of 2-year Treasury bills is often seen as where the market thinks the Fed Funds rate will be one year from now. With the high inflation reports earlier in the year, it was feared the Fed would keep rates higher for longer, so the 2-year Treasury yield made its way up to 5%, as seen in **Figure 4**, before falling to around 4.75% at the time of this writing. With the Fed Fund rate currently in a range between 5.25% – 5.5%, that would imply the market thinks we could get two to three 0.25% rate cuts by next summer. We think the market and the Fed could be underestimating the amount of rate cuts at this point for the reasons we discussed in the economy section. If we are right, this would be good for shorter term bonds.

Figure 4: 2-Year Treasury Yield and Fed Funds Rate



Source: Cetera Investment Management, FactSet, U.S. Treasury Department, U.S. Federal Reserve. Data as of 6/14/2024.

Moving down in credit quality, many investment-grade corporate bond indexes have yields over 5% and below investment grade indexes have yields above 7.5%. With more yield, comes more risk, though. Looking at risk, high-yield bond spreads are relatively tight. The good news is that tight spreads could mean low risk of recession in the near-term, but these spreads can also change quickly. We are cautious on high yield at spreads at these levels. While still owning high-yield bonds could make sense in a diversified portfolio, we currently favor investment- grade corporate bonds.

Overall, we think the risk-return relationship within high-quality bonds is good. Shorter term bonds could do well if market expectations around the Fed Funds rate changes. We still recommend around a benchmark duration to mitigate equity volatility. It could be a good opportunity for those overallocated in money market or cash positions to increase duration to shorter-term bonds before rate expectations change, where suitable.

The Bottom Line

After some high inflation readings early in the year, it appears that inflation is easing toward the Fed's target. While it may reach that target this year, if inflation continues this path, the Fed could start scaling back its restrictive monetary policy and lowering interest rates. It appears this could happen as soon as September, and while cutting rates by 0.25% won't make that much of a difference in the grand scheme of things, it is a signal to investors that the Fed has gone from being a foe to being a friend.

Equity markets have been riding the AI optimism tailwind though, so it isn't obvious how much more of a tailwind lowering rates could provide. Stock market indexes have been largely driven higher by only a few large technology stocks that make up a growing percentage of the S&P 500. Lowering rates could provide a tailwind for the rest of the stock market that hasn't gone up as much, such as value and small cap stocks. We do think there will be volatility along the way as the economy cools and the labor market moderates. Overall, the economy is still on solid footing, and investors have a lot of cash in money markets and bank accounts that could provide support in the event of any market pullbacks. Bonds seem relatively attractive and could offer diversification benefits to help mitigate stock market volatility.

While 2024 is an election year and there will be a lot of noise attached to politics, our analysis of past election years shows that stock markets were up over 10% on average in post-World War II era election years. Elections matter, but they tend not to influence stock returns. Both Joe Biden and Donald Trump have been president before, so that also takes out a lot of the uncertainty around this election.

Diversification is prudent and your Cetera financial professional can help you through any uncertainty to keep you focused on your personal goals and objectives.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg US Aggregate Bond Index is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. Eligible bonds must have at least one year until final maturity, but the index holdings have a fluctuating average life or around 8.25 years. This total return index is unhedged and rebalances monthly.