Citi Wealth Releases Mid-Year Outlook 2024: Renewed Growth, New Challenges

June 06, 2024

NEW YORK – Today, Citi Wealth released its mid-year Wealth Outlook for 2024 – Renewed Growth, New Challenges. The report offers an updated analysis of the global economy, markets and geopolitical landscape for the remainder of 2024 and beyond.

At the beginning of 2024, Citi Wealth outlined a year of recovering corporate profits and slowing U.S. employment. While the global economic expansion is broadening across regions and industries, the report notes that the Fed will begin to ease monetary policy and shift its focus to sustaining the expansion. Citi Wealth expects U.S. inflation to ease to 2.5% by the end of 2024.

Although investors are likely looking ahead to the U.S. election in November, the report states that it is unlikely to change the direction of the world economy and markets. The risks outlined include potential supply chain shocks, tariffs and unpredictable geopolitical flareups.

“We are focused on building resilient core portfolios with global diversification across asset classes,” said Steven Wieting, Chief Economist, Chief Investment Strategist and interim Chief Investment Officer for Citi Wealth. “We are encouraging our clients to stay fully invested and to complement their portfolios with high-conviction opportunistic investments.”

With markets having priced in continued near-term expansion, Citi Wealth anticipates potential investment opportunities in areas such as U.S. small-and mid-cap growth equities, some developed and emerging markets and defensive growth in healthcare. Citi Wealth believes clients can seek income from intermediate, high-quality U.S. dollar bonds and sees potential in private equity, real estate and hedge funds for qualified and suitable investors.

Opportunistic Investments

1. Semiconductor equipment makers
2. Medical technology and life science tools firms
3. Defense contractors
4. Western energy producers
5. The Japanese yen and yen-denominated tech and financials
6. Yield curve normalization
7. Structured credit for qualified and suitable investors

Citi Wealth also outlines its unstoppable trends in the report, which are long-term forces that are transforming how we live and work.

Unstoppable Trends

- **AI-propelled digitization:** The AI revolution is still only in its early stages. Citi Wealth likes AI infrastructure and select AI users such as robotics and automation, drug discovery, cyber security, grid constructors and power generators near data centers.
- **Energy transition:** The clean energy transition is vital to prosperity and wellbeing. Citi Wealth favors renewable energy technology specialists, those with energy efficiency enabling AI strategies, and their beneficiaries, publicly traded and private.
- **Healthcare:** Aging populations, growing wealth and

technological advances could drive healthcare returns over the long term. Short-term valuations are attractive; Citi Wealth favors exposure via specialist actively managed strategies.

- **G2 polarization:** The U.S.-China (G2) strategic rivalry is set to intensify, reshaping global trade, geopolitics and many investments. Citi Wealth favors the likes of tech supply chain diversification beneficiaries in the U.S. and China.

About Citi

Citi is a preeminent banking partner for institutions with cross-border needs, a global leader in wealth management and a valued personal bank in its home market of the United States. Citi does business in nearly 160 countries and jurisdictions, providing corporations, governments, investors, institutions and individuals with a broad range of financial products and services.

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Aging Gracefully

By: Liz Young Thomas · June 13, 2024 · Reading Time: 11 minutes

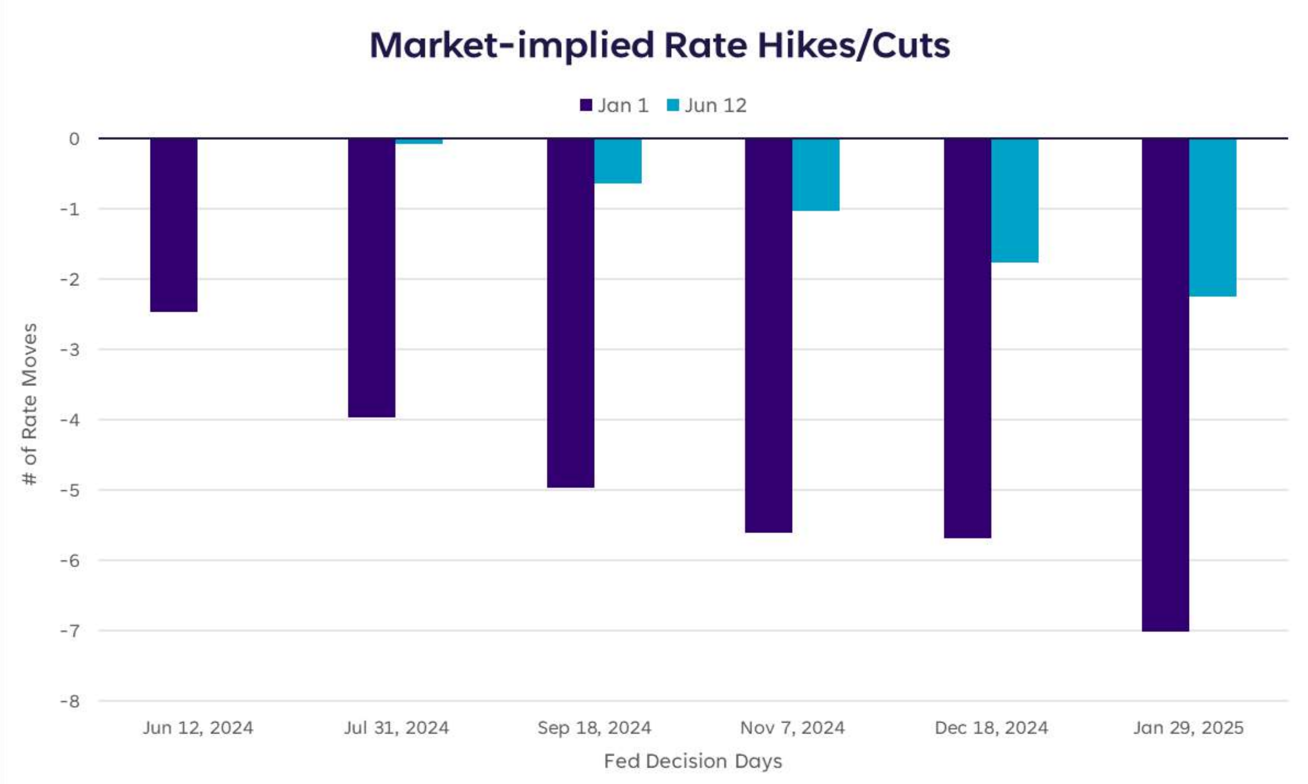
The mid-year outlook is always an interesting combination of a report card and a progress report. It’s a time to review our annual outlook and see what has materialized as expected and what hasn’t. It’s also a time to check in on year-to-date market activity, economic developments, and to recalibrate an outlook for the second half of the year.
Our 2024 outlook was titled “A Cycle for the Ages” and still feels very appropriate. One thing that has gone as expected in the first half of 2024 is that we’ve seen more surprises, including the sheer amount of new records we’ve set in markets and economic variables. This is undoubtedly still a cycle for the ages — and one that, so

far, is aging gracefully.

Of Jumbo Proportions

If I had to pick one word to characterize 2024 thus far it would be ‘big.’ I’m not just talking about stock market performance, although an S&P 500 up 14% and semiconductors up 50% through early June is quite strong. I’m talking about the unexpected and large moves we’ve seen in Fed rate expectations, Treasury yields, and commodity performance. And that list doesn’t even include the various new records we’ve already set this year, but more on that in the next section.

Perhaps the biggest move was in Fed rate expectations. Markets came into the year expecting six cuts in 2024 starting in March — as it stands now, futures pricing suggest one or two before the end of the year. Not only was this a large and quick repricing, but it resulted in surprisingly unbothered equity markets that, before this change, were seemingly *begging* for cuts.



Source: SoFi, Bloomberg. Data as of June 12, 2024.

A combination of strong economic data, sticky inflation readings, and hawkish Fed speak brought cut expectations down, and caused big moves in Treasury yields. The 10-year Treasury yield started the year at 3.88% and rose to a high of 4.70% on April 25 as investors tried to digest a much longer Fed pause than previously thought.

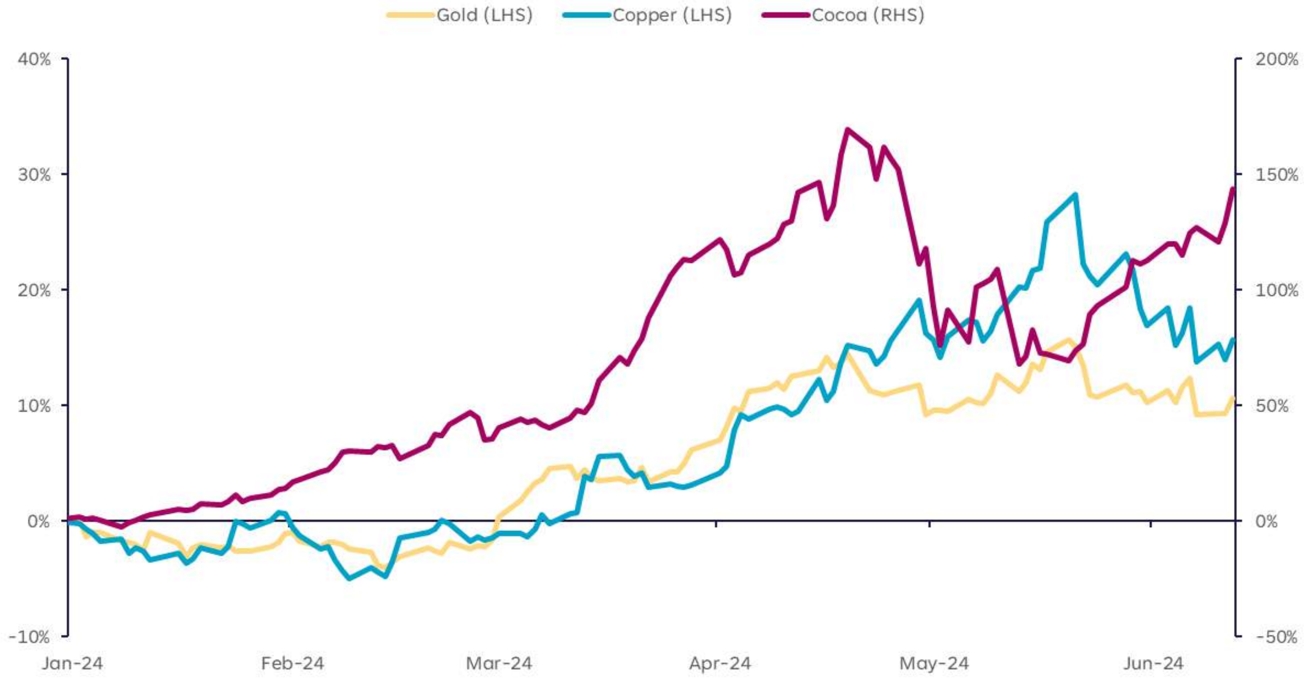
Despite a brief 5% correction in April, equity markets have continued upward. All of this has caused most, if not all, bears to turn at least slightly bullish in the short-term, and led many Wall Street strategists to raise their year-end price targets. The chase is on.

Strategist 2024 Year-End S&P 500 Price Targets				
Company	**Start of Year**	**Latest**	**Net Revision**	**Latest vs. Current S&P 500 Level**
BMO	5,100	5,600	500	3.3%
Wells Fargo	4,625	5,535	910	2.1%
Oppenheimer	5,200	5,500	300	1.5%
Societe Generale	4,750	5,500	750	1.5%
Bank of America	5,000	5,400	400	-0.4%
UBS	4,850	5,400	550	-0.4%
Barclays	4,800	5,300	500	-2.2%
RBC Capital Markets	5,000	5,300	300	-2.2%
Ned Davis Research	4,900	5,250	350	-3.2%
Fundstrat	5,200	5,200	0	-4.1%
Goldman Sachs	5,100	5,200	100	-4.1%
Citigroup	5,100	5,100	0	-5.9%
Deutsche Bank	5,100	5,100	0	-5.9%
Evercore ISI	4,750	4,750	0	-12.4%
Stifel Nicolaus	4,650	4,750	100	-12.4%
Morgan Stanley	4,500	4,500	0	-17.0%
Cantor Fitzgerald	4,400	4,400	0	-18.8%
JPMorgan	4,200	4,200	0	-22.5%
Median	**4,875**	**5,225**	**200**	**-3.6%**

Source: SoFi, Bloomberg. Data as of June 12, 2024.

The other big set of moves I want to highlight is the performance of certain commodities YTD. Although headlines are still dominated by AI and related stock performance, a smattering of commodities have seen eye-popping returns in 2024 that most investors were likely not positioned for. New year, new surprises.

Cumulative YTD Returns



Source: SoFi, Bloomberg. Data as of June 12, 2024.

The drivers of these moves were all different, which is perhaps the most interesting takeaway. The move in gold was more of a defensive/global currency volatility play, while copper prices were a result of supply shortages and the expectation that AI-driven data center build outs would keep demand elevated. Cocoa marched to the beat of its own drum (and y-axis) as the already limited crop saw severe shortages, while humans around the world binged on chocolate. Ok, I made that last part up.

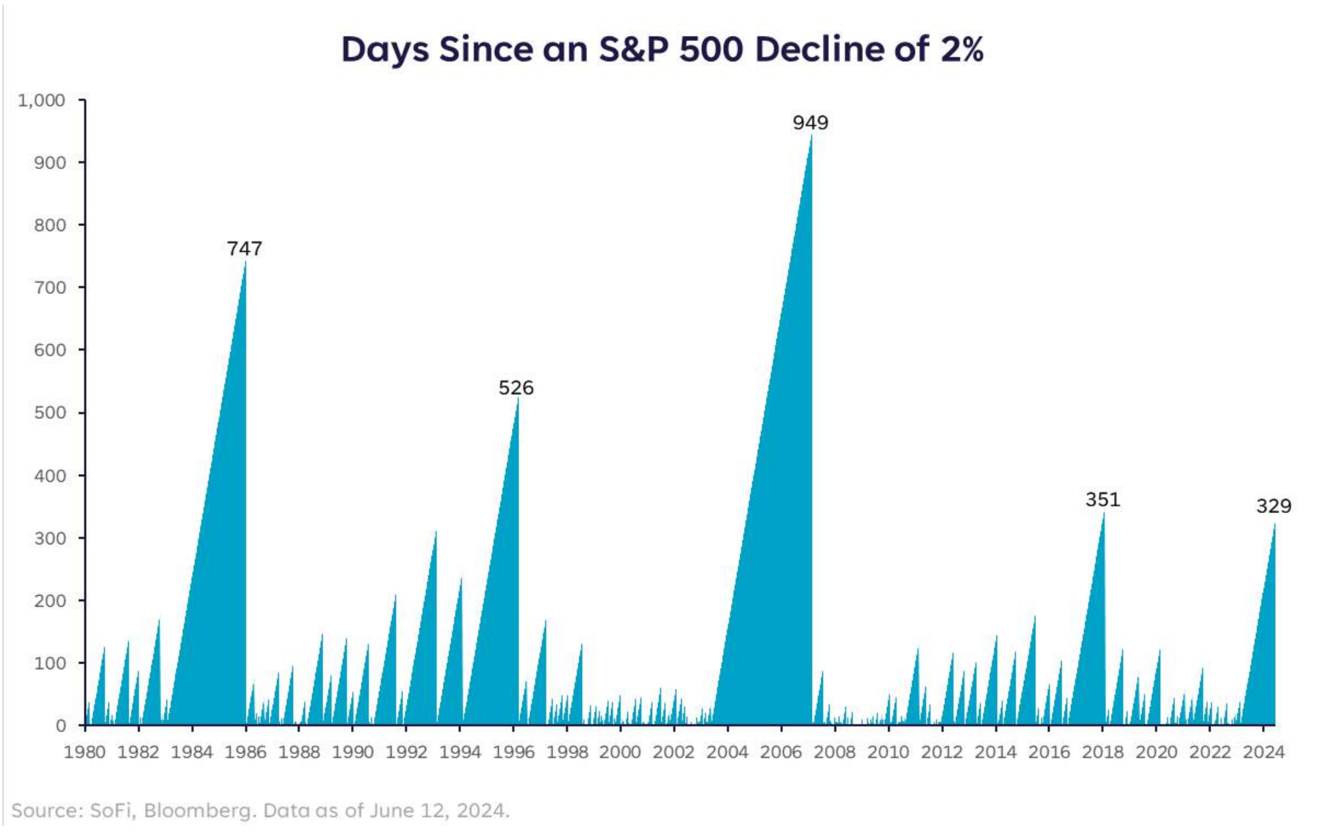
In any event, these pockets of parabolic charts were surprising and an indication that inflationary forces are not dead.

Broken Records

To put a cherry on top of the big market moves sundae, the first half of the year also saw a number of new records, a statement that's starting to sound like a broken record.

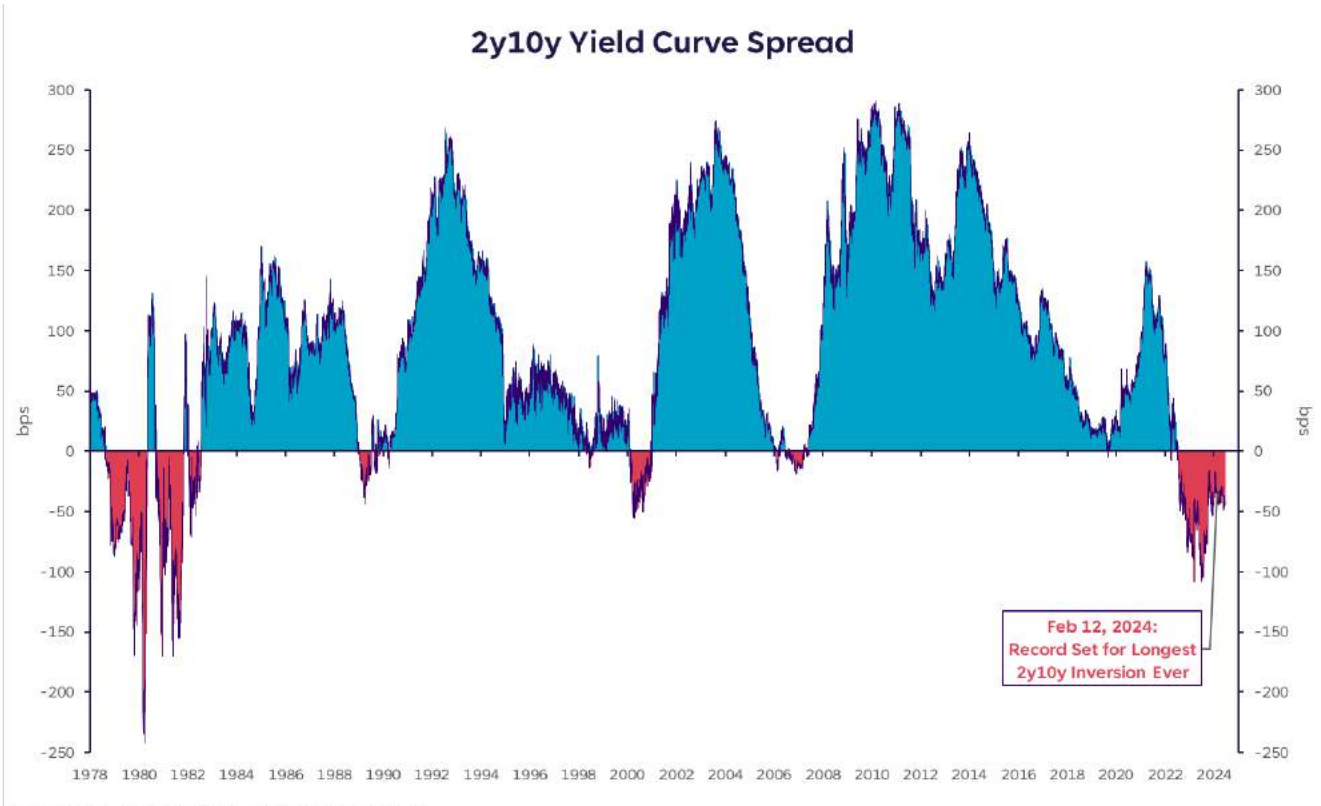
The S&P 500, Dow Jones Industrial Average, Nasdaq Composite, and Nasdaq 100 hit new all-time highs. Much of the recent run in the S&P and Nasdaq has been driven by semiconductor and AI enthusiasm, which is seemingly served in endless quantities. That enthusiasm has even lifted adjacent-story assets such as copper (above), and utilities which are needed to power the new data centers.

This AI frenzy of buying has pushed markets toward a couple other records. Namely, the number of trading days we've now gone without a 2% decline in the S&P. This is the longest stretch since February 2018. It's not a new historical record, but it stands out as one of the longest in history — though still a far cry from the 949 day stretch that ended in February 2007.



It’s easy to see why bullish sentiment has taken over and fewer bears remain. Everything appears to be going well and risk appetite looks healthy.

But some concerning records have also been broken. In February, we crossed the threshold into the longest yield curve inversion of all time. That fact in-and-of-itself doesn’t foretell a particular outcome, but at some point the inversion has to re-steepen and become an upward sloping curve. The reason this matters is because an inverted curve is typically seen as a precursor to a recession, and some believe the longer and deeper the inversion, the more painful the result on the other side.



Source: SoFi, Bloomberg. Data as of June 12, 2024.

The expected painful result hasn’t happened yet, but neither has the re-steepening. History has shown us that equity markets tend to do well during yield curve inversions, but struggle as a re-steepening occurs, which

I'll cover later in this piece.

But wait, there's more. We're also nearing the longest Fed pause ever, and if rates stay on hold past October, we'll break that record, too. The consensus school of thought seems to be that Fed cuts will be supportive of equities – but since cuts are very likely to cause a curve steepening, I'm not so confident that will be the case.

Last Hike Date	First Cut Date	Days from Last Hike to First Cut	Last Hike to First Cut Return
May 1, 1974	Jul 1, 1974	44	-6.1%
Mar 3, 1980	Apr 1, 1980	22	-8.7%
May 8, 1981	Jun 1, 1981	17	1.0%
Aug 21, 1984	Oct 2, 1984	31	-1.8%
Feb 24, 1989	Jun 5, 1989	72	13.3%
Feb 1, 1995	Jul 6, 1995	112	19.2%
May 16, 2000	Jan 3, 2001	167	-7.4%
Jun 29, 2006	Sep 18, 2007	319	22.1%
Dec 19, 2018	Aug 1, 2019	162	19.2%
Jul 26, 2023	**?**	**231***	**20.3%***
	Average	**118**	**7.1%**

Source: SoFi, Bloomberg. *Data as of June 12, 2024.

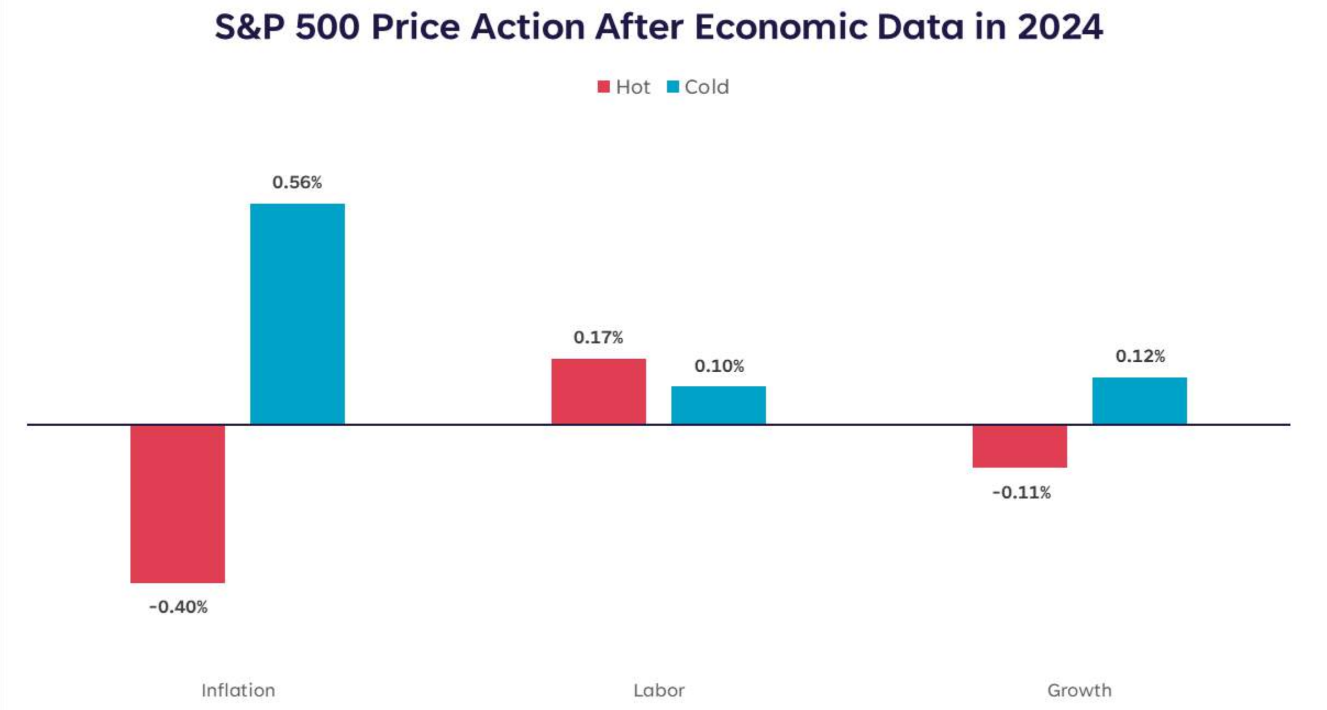
Again, this alone does not signal anything of certainty, but in prior cycles it hasn't been the hikes or the pauses that the market struggles with, it has been the cuts. Market bottoms typically occur *after* the cuts begin, because they typically occur in response to a weakening environment. In fact, only one time in history did a cutting cycle (albeit a gentle cutting cycle) occur without a subsequent market bottom. That period was in the mid-90s, and some believe we may be able to repeat the same scenario this time.

One of the big differences between then and now was that the unemployment rate was at 5.6% and on its way down when the Fed cut rates in July of 1995. I'd call that uncomfortably high, but not alarmingly high. As such, a little stimulation and loosening in conditions may have been warranted.

On the contrary, we only *just* ended a streak of sub-4% unemployment in May, which had gone on for 28 consecutive months. The labor market has been tight for a long time, and the focus is slowly shifting to labor as the next most important gauge of when the Fed will start cutting. But here's the rub: If the Fed won't start cutting until labor weakens further, they'll be cutting into a *rising* unemployment picture. That would be consistent with a *weakening* environment during cuts, rather than a strengthening environment like we saw in the 90s. Thus, consistent with expectations of market turbulence rather than market exuberance.

Thirsty for Something Cold

Despite these historical truths, markets have welcomed cooling data. And despite various Fed speakers continuing to warn that rates will be higher for longer, or that further hikes are not entirely off the table, any indication from economic data that puts a tally in the cooling column has been rewarded.

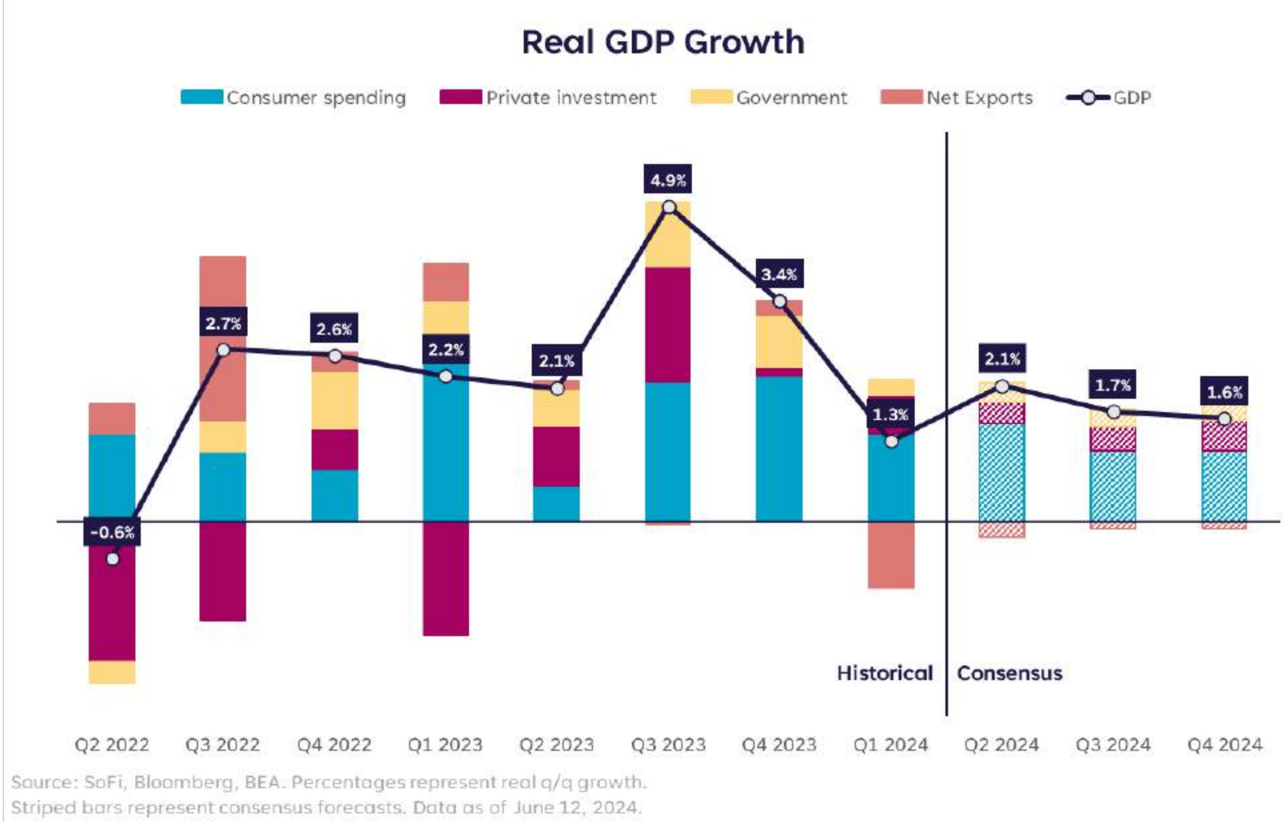


Source: SoFi, Bloomberg. Categories are defined as the following: Inflation includes CPI and PPI; Labor includes NFP jobs added and job openings; and Growth includes retail sales, ISM Manufacturing and Services PMI's. Data as of June 12, 2024.

So far, that's been a safe stance to take. Indicators for inflation, jobs, and GDP have come down off of hot levels, but none have approached nor entered concerning territory. That would be the most likely definition of a soft landing if it can persist as monetary policy normalizes.

But when does cooler data become too cool? And if the data is cooling, doesn't that mean we're late in the economic cycle?

Growth data has already started to cool and is expected to remain around or below trend (trend being 1.8% according to the FOMC) for the remainder of the year. I view this as a welcome sign in the fight against inflation, but an unwelcome sign for those betting on ever-expanding profit margins and revenue growth; especially because the consumption component is what seems to be taking a hit.



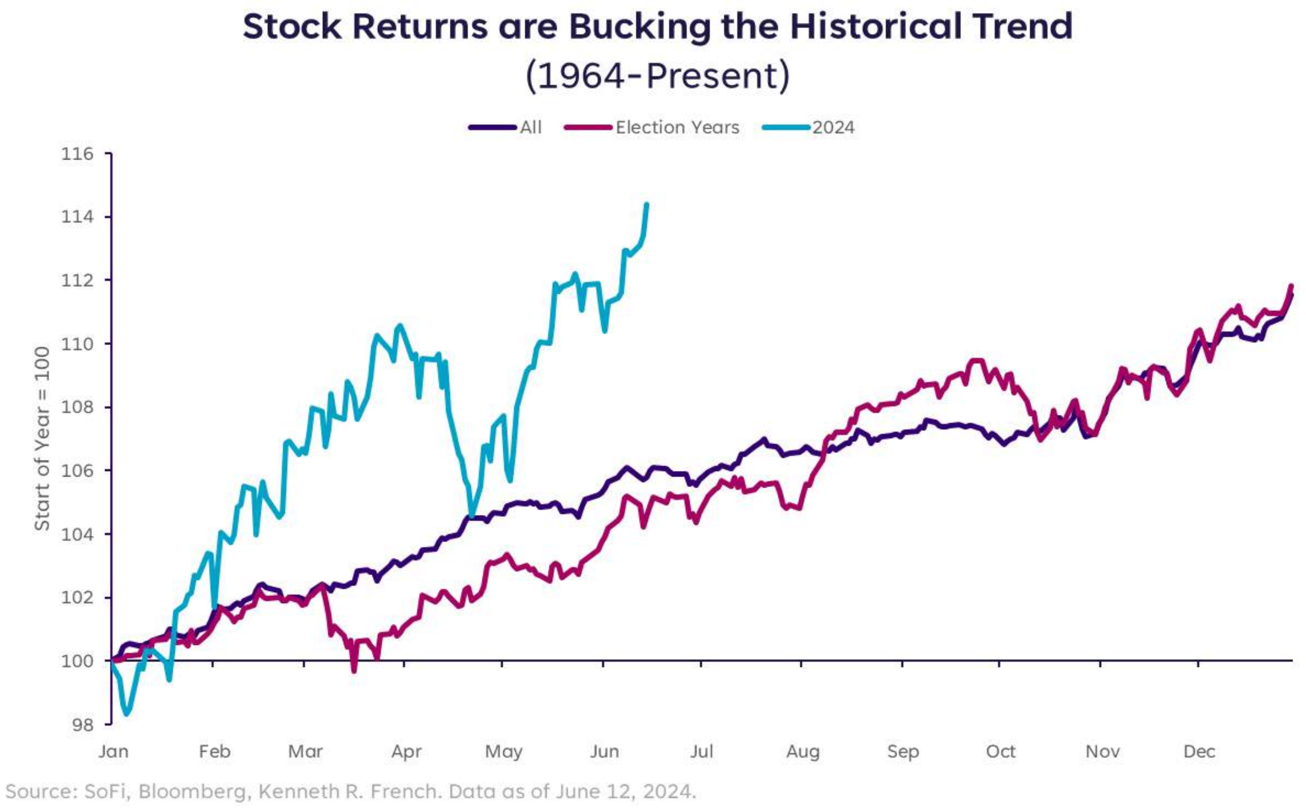
As for the question that seems to be at the crux of everything – where are we in the business cycle – I still firmly believe that lower GDP, cooling labor markets, falling inflation, large-cap stock dominance, and a Fed that's about to start cutting rates, are clear indications of a late cycle environment. I've said it before and I'll say it again, just because it's longer than expected, doesn't mean it's over. But it may not end in the second half of 2024 either.

The Other Side of June

As we begin the second half of 2024, I expect more records to be broken that will solidify this cycle as one for the ages. I also expect the debate over whether or not we've already achieved a soft landing to continue, and for pockets of the market to become more extended than they already are because investors have proven that it takes more than a wobble to threaten their optimism.

But the path matters. I do not expect market strength to broaden out anew, and I do not expect economic data to surprise to the upside any longer. Here are some specific variables to watch:

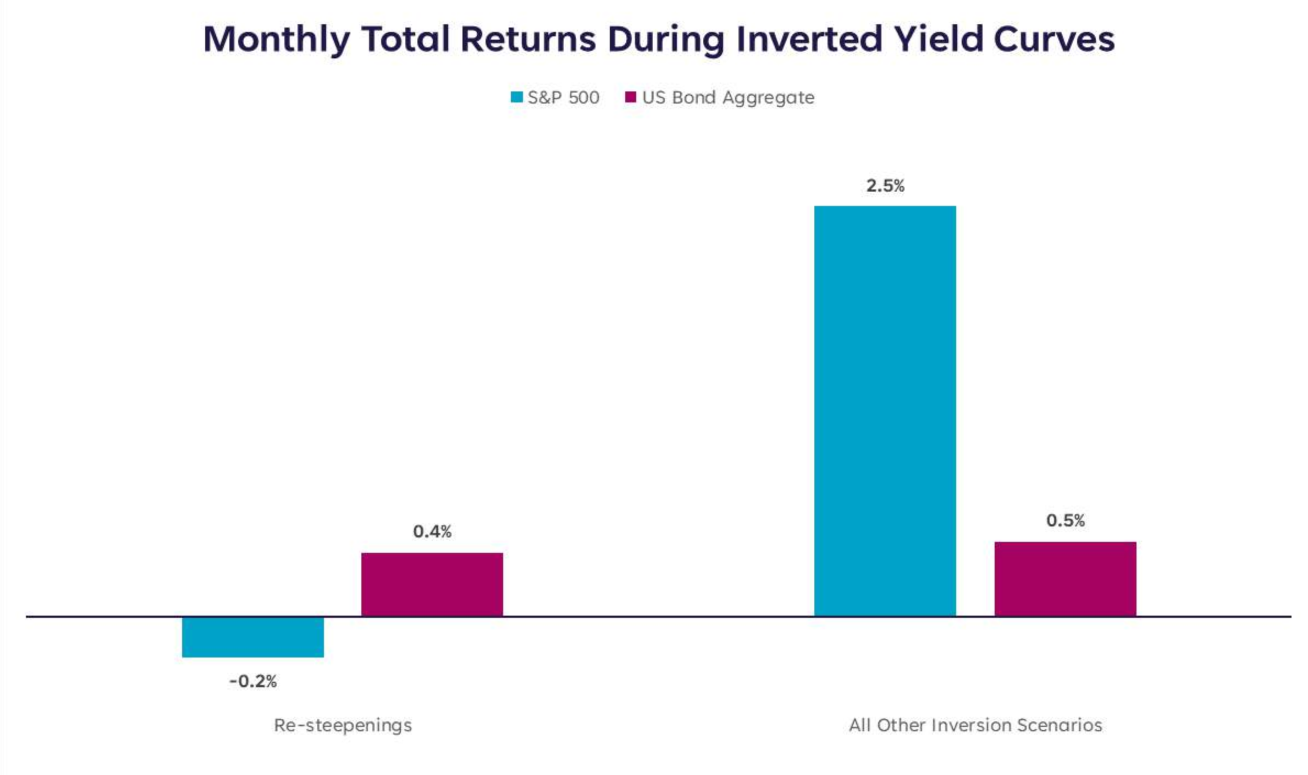
1. **The U.S. Presidential Election.** This goes without saying. There are seasonal patterns to how markets typically behave during election years and so far, we're off track. Given the uncharacteristically positive returns we've had already this year, I'd expect some volatility through summer as debates begin, uncertainty mounts, and economic data cools. But I also expect that post-election relief will be in order, as usual. During that possibly volatile pre-election period, the severity of a market decline will matter. I expect political narratives to center more around economic weakness if a pullback of 10% or more materializes, but for the relief on the other side to be stronger.



2. **The unemployment rate rising above 4%.** As attention shifts more and more to the labor market, investors will be watching payrolls data and the unemployment rate. Given that we only just emerged from sub-4% unemployment, I don't think markets are prepared for a rate between 4-4.5%, which is where I believe we will finish the year (the FOMC forecast is for 4.0% unemployment, I expect it to be higher). It's important to note that even 4.5% is not *high*, but under 4% is abnormally *low*. Investors have grown accustomed to a tight labor market as a buoy; therefore, the digestion of rising unemployment could bring jitters.

3. **Yield curve steepening.** Last, but certainly not least on this list. We've seemingly forgotten about the yield curve inversion, or perhaps started to think it doesn't matter. I believe it does matter, and the lack of concern over it is a form of complacency. As the first Fed rate cut

nears, short-term rates are likely to fall, which could reduce the inversion, if not erase it entirely. The chart below shows average stock and bond performance during yield curve inversions – and compares the periods when the curve is re-steepening to all other inversion scenarios. During re-steepenings, stock performance is negative on average and the possibility of a steep decline is higher. The threat of a steepening curve is real in the second half and investors should take notice.



Source: SoFi, Bloomberg. Data is from Jan 1977 - June 2024.

So which parts of the market look poised to do well? The answer to this is purely my opinion, and is based on my belief that we are late-cycle, headed toward rate cuts, a steepening yield curve, and a period of a weaker U.S. dollar. And remember, the path matters. All asset classes will not move in a straight line between now and the end of the year, but if I had to put a point-to-point prediction on what I think can perform well, I'd choose as follows:

- Large-cap stocks, especially those with solid dividend payouts and strong profit margin growth. Some AI-related stocks may fall into those categories and could continue to rise, but rather than multiple expansion helping to power the upside, I believe the decisions companies make around capital stewardship will matter more.

- Utilities, Staples, Healthcare, and Energy. That list encompasses the classic defensive sectors, but is not a call for pure defense. It's simply how markets tend to respond in steepening yield curve environments. Many companies in these sectors pay hefty dividends, which is part of the attraction. Another effect of lower short-term rates and a cutting cycle is likely to be weakness in the U.S. dollar, which supports Energy.

- 2-year Treasuries. This now feels like a tale as old as time, but investors have been reaping the benefits of yields hovering around 5% for a while. It's time for them to start reaping the benefits of capital appreciation. Markets react before the action takes place, and as we enter autumn with rate cuts on the menu, I expect to see 2-year yields fall.

That's a Wrap

Another couple quarters have come and gone, and one thing's for sure: Markets can be a most humbling, rewarding, and exhilarating sport. I've never been a professional athlete, but I imagine the dedication and mental toughness it takes to consistently put yourself in a position to win or lose, sometimes through no control of your own, is unparalleled. Except, perhaps, by market participants trying to choose the right spots to make money every year. We continue to take our chances, using the best information we have, and walk out onto the field. Here’s to another six months worthy of prime-time viewership.

Want more insights from SoFi’s Investment Strategy team? [The Important Part: Investing with Liz Thomas](), a new podcast from SoFi, takes listeners through today’s top-of-mind themes in investing and breaks them down into digestible and actionable pieces.

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Q3 2024 Investment Outlook – Broadening opportunities to put cash to work

HSBC Global Private Banking is advising high net worth and ultra high net worth clients that there is likely to be a richer set of opportunities to put their cash to work in the second half of 2024, despite uncertainties around global elections and central bank rate decisions.

HSBC Global Private Banking's Q3 2024 investment outlook, Power Up with Income and Growth, sets out how clients should take advantage of attractive yields in bond and private credit markets to build a solid income stream in portfolios, and to power returns in the equity markets.

With the wide range of choices, the outlook suggests that holding large cash balances is likely to be sub-optimal.

Our four investment priorities are:

- **Broadening our equity exposure:** The improvement in economic data should support companies' earnings growth across more geographies and sectors. By broadening the exposure, equity investors capture more opportunities and diversify, while addressing concerns about the rich valuations in the tech sector.
- **Putting cash to work:** Bond yields are currently near decade-high levels, and an allocation to bonds and multi-asset strategies can help generate a stable income stream, while providing portfolio diversification to mitigate against tail risk events.
- **Tapping into private assets and infrastructure:** As more companies are staying private for longer, the depth, diversity, liquidity and ways to access the market continue to grow, while infrastructure returns are often linked to inflation.
- **Unlocking the best opportunities in Asia:** Asia's economic and earnings growth continue to far exceed the global average, with the best opportunities to tap into Asia's structural growth themes in Japan, India and South Korea.

Willem Sels, Global Chief Investment Officer at HSBC Global Private Banking and Wealth, said: "Investors have been facing many uncertainties this year, but we take the view that it is better to stay invested in resilient portfolios with a broad set of high-quality sources of returns, rather than staying in cash or trying to time and second-guess geopolitical events."

Cheuk Wan Fan, Chief Investment Officer for Asia at HSBC Global Private Banking and Wealth, said: "Asia remains the most important growth engine of the global economy, and we find promising and diverse opportunities from Asia's corporate governance reforms and supply chain revamp, the rise of India and ASEAN region, and high-quality bonds."

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Notes to Editors

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HSBC Holdings plc, the parent company of HSBC, is headquartered in London. HSBC serves customers worldwide from offices in 62 countries and territories. With assets of USD3,001 billion at 31 March 2024, HSBC is one of the world's largest banking and financial services organisations.

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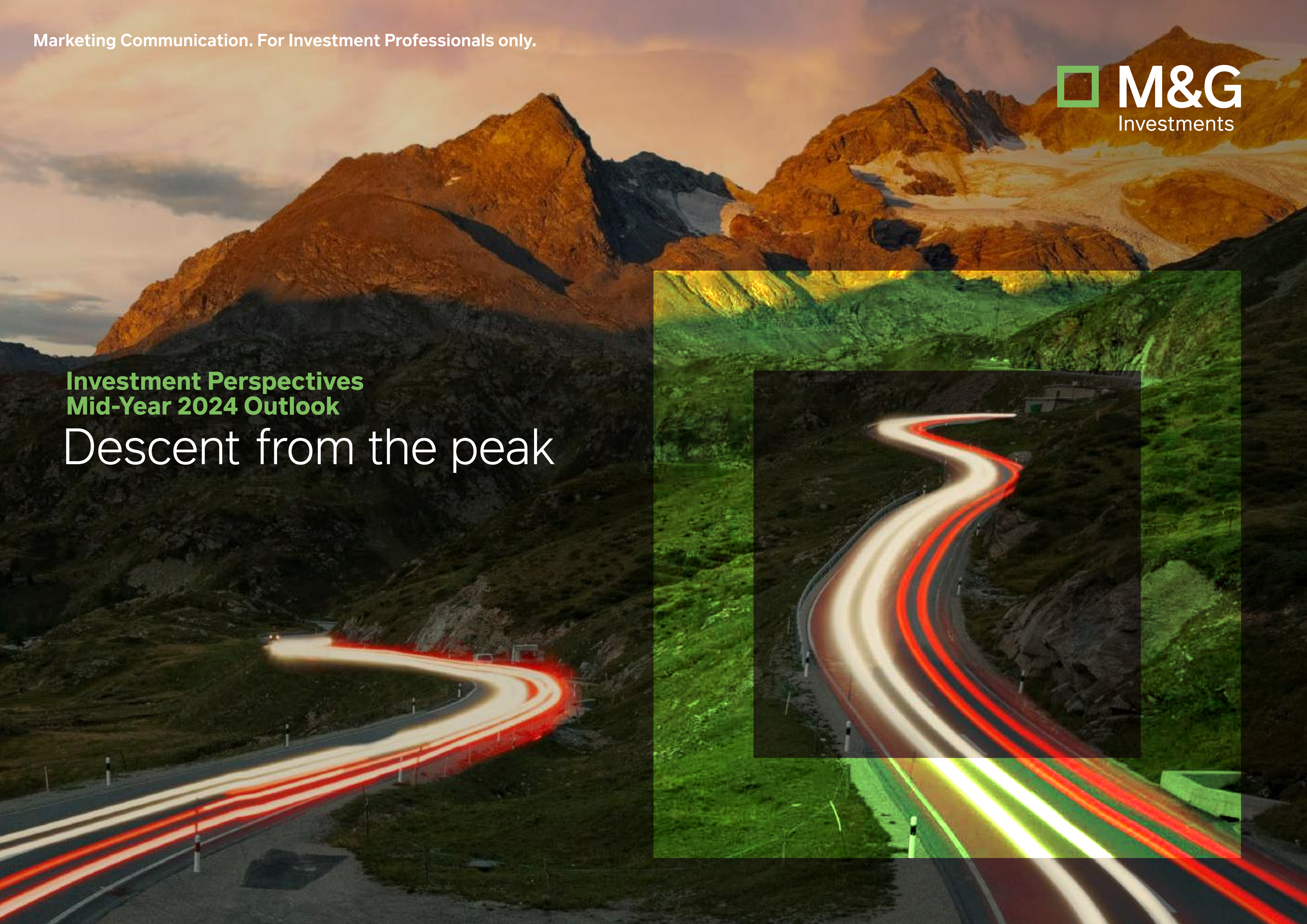
M&G Investments



Investment Perspectives
Mid-Year 2024 Outlook

Descent from the peak

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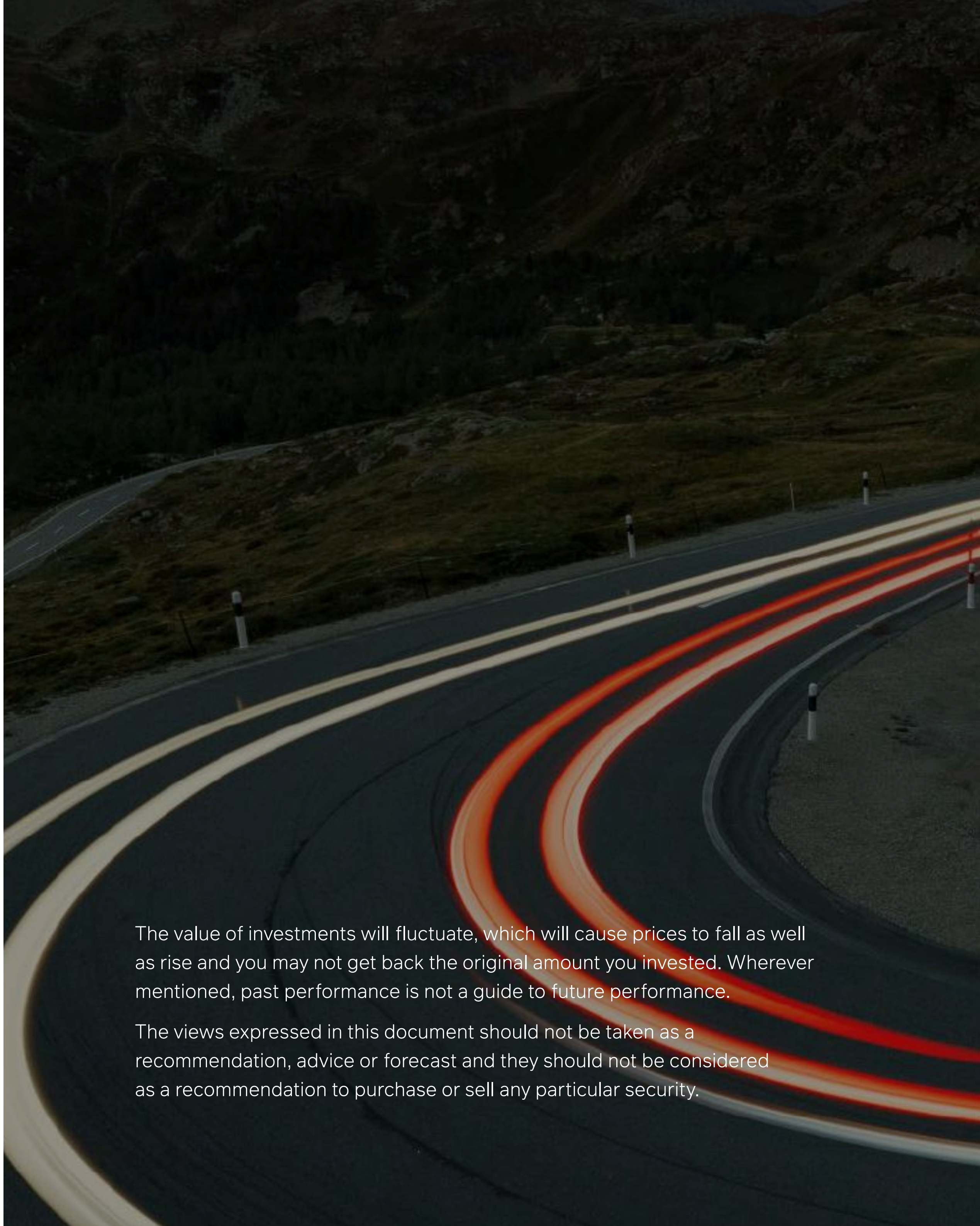


The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever mentioned, past performance is not a guide to future performance.

The views expressed in this document should not be taken as a recommendation, advice or forecast and they should not be considered as a recommendation to purchase or sell any particular security.

Shifting narratives and diverging policies

Welcome to the Investment Perspectives Mid-Year 2024 Outlook. With major central banks moving closer to, or in some cases already implementing, interest rate cuts, M&G Investments' Chief Investment Officers (CIOs), fund managers and investment experts explore what this new policy direction might mean for financial markets.

Amid a complex macroeconomic backdrop and political and geopolitical uncertainty, the descent from the peak could be bumpy, but we believe there is currently a wide array of promising opportunities for disciplined selective investors, across public and private markets.

Bringing together expert views from different asset classes, we seek to illuminate for our clients the investment landscape and map out potential opportunities.

The outlook for monetary policy has continued to dominate financial market commentary this year. At the start of 2024, markets were implying multiple interest rate cuts, but since then the narrative has shifted dramatically as investors have pushed out their expectations for when those cuts will take place.

However, in contrast to much of the previous two years, changing rate expectations have resulted in different outcomes for fixed income and equity markets. So far this year most bonds have been weak, but because this has been the result of resilient growth and stubborn – not rising – inflation, equities have moved higher.

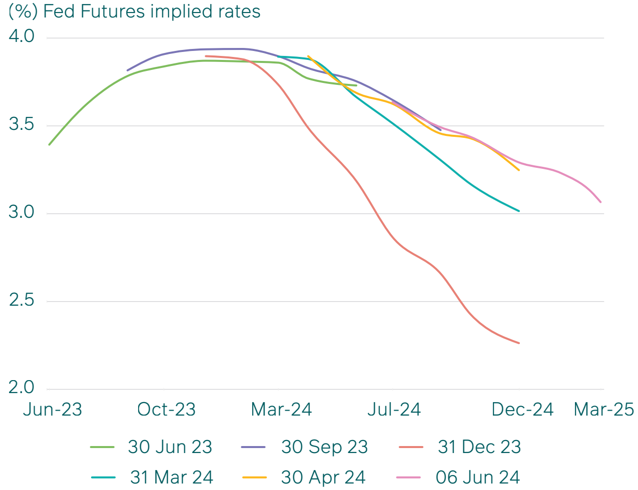
Global stock markets have reached record highs, initially driven by continued excitement about the potential of artificial intelligence (AI) but ultimately broadening out beyond the US and technology. Investors have even returned to formerly unloved stock markets in the UK and China.

In her **'Hidden gems of innovation'** section, **Fabiana Fedeli**, CIO Equities, Multi Asset & Sustainability, discusses this trend, observing that the market is broadening and stock-specific drivers are coming to the fore. In her view, share price performance has been driven by companies beating earnings expectations and successfully delivering innovation.

The combination of undemanding expectations and the power to innovate will be among the best hunting grounds for the creation of alpha in future, according to Fabiana.

As the valuations of many innovative companies have risen spectacularly, in order to harness the potential of innovation and new technologies, Fabiana believes investors need to dig deeper and broaden their search to discover the hidden gems of innovation that are delivering differentiated products and solutions across the globe.

Expectations of US rate cuts have been pushed out



Source: Bloomberg, 6 June 2024.

Focus on central bank policies

As we look ahead to the second half of the year, the main focus for investors may well continue to be central bank policies and the path of interest rates. With the experience of the last couple of years and policymakers' "data dependent" approach, it is perhaps not surprising to see significant market myopia: investors obsess over every relevant data release to try and anticipate the Federal Reserve's (Fed) policy moves. This 'guessing game' has arguably contributed to short-term volatility, such as the wild swings in bond markets seen in the second half of 2023, and could continue to be a source of opportunity for longer term investors.

CIO Jim Leaviss and the Fixed Income team believe that inflation will continue to ease, providing hope for the prospect of rate cuts by the Fed this year. However, they caution in **'Approaching the descent'** that we could be entering a new era of structurally higher inflation, which might mean interest rates settle at a higher level than they were before this rate-hiking cycle.

The team also notes that we are beginning to see central bank policy diverge. Some central banks, notably the European Central Bank (ECB), have begun easing monetary policy ahead of the Fed. In their view, this divergence offers potential opportunities for fixed income investors to diversify across geographies and sectors.

Significantly, the prospect of rate cuts provides a potential opportunity for fixed income investors to capture attractive gains, according to the team. In particular, they believe the current macroeconomic environment is relatively supportive for investment grade (IG) credit, as many IG companies remain in a strong position, having locked in low financing costs for an extended period.

The rise in real (inflation-adjusted) interest rates has had a significant impact on many private markets, says **Emmanuel Deblanc**, M&G Investments' new CIO of Private Markets. On a long-term view, Emmanuel suggests this has actually been a positive for private markets: it avoids the misallocation of capital, fundamental in correctly pricing assets.

Despite a challenging environment, Emmanuel believes opportunities persist in the 'value-add' and opportunistic areas of private markets, including real estate and infrastructure. Structured credit also looks attractive, in his view, with growth driven by the ongoing retrenchment of banks.

For Emmanuel, there are grounds for optimism but investors need to have a clear focus and be selective in their approach to private markets

Politics and markets

So far, "the year of elections" has not proved to be especially dramatic, with few surprise results. However, this could change with the US presidential election in November. While the possible re-match between Joe Biden and Donald Trump is inevitably attracting plenty of media attention and speculation, the impact of the vote on markets is near impossible to forecast. It is worth remembering that the Trump victory in 2016 resulted in market moves that were almost the total opposite of those predicted by pundits.

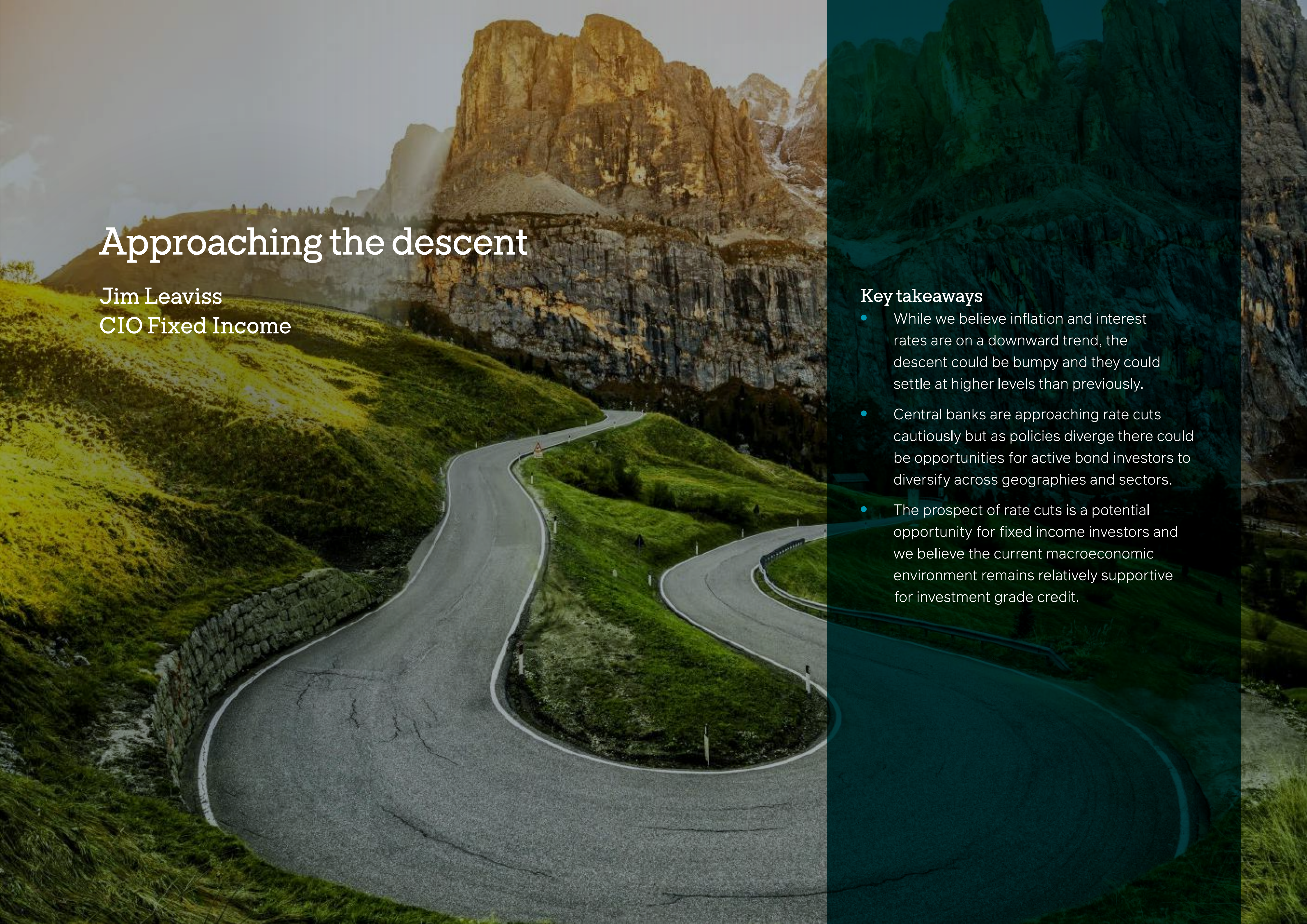
As the election approaches, we will inevitably learn more about the candidates' policies. Although it will be hard to ignore the political clamour, it is worth bearing in mind that, from a long-term investment perspective, what really matters is meaningful policy changes that could have a significant impact on the economy. The rest is just 'noise' that could create tactical opportunities for long-term active investors to exploit.

Embracing the long-term

After a positive start to the year, the investment landscape remains challenging, with major macroeconomic and political events looming in the coming months, as well as the broader backdrop of geopolitical tensions.

By looking beyond the day-to-day noise and adopting a longer-term investment horizon, we believe active selective investors can position themselves for future success and even reap rewards when volatility is elevated.

Patience is a valuable aspect of investing. In the current environment of heightened unpredictability and as the world continues to adapt to a higher interest rate regime, staying focused on long-term goals is arguably more important than ever.



Approaching the descent

Jim Leaviss
CIO Fixed Income

Key takeaways

- While we believe inflation and interest rates are on a downward trend, the descent could be bumpy and they could settle at higher levels than previously.
- Central banks are approaching rate cuts cautiously but as policies diverge there could be opportunities for active bond investors to diversify across geographies and sectors.
- The prospect of rate cuts is a potential opportunity for fixed income investors and we believe the current macroeconomic environment remains relatively supportive for investment grade credit.

Since the beginning of the year, investors' hopes of significant rate cuts in 2024 have been dented by data points showing that inflation was proving stickier than expected, as well as resilient growth and a strong jobs market in the US.

As we enter the second half of the year, markets are now pricing in two cuts of 25 basis points each by the Fed for this year. The Fixed Income team explores how long might rates stay elevated for and what the final landing point might be.

Where do we think inflation will go from here?

After ticking up for three consecutive months, April's US Consumer Price Index (CPI) numbers landed in line with expectations, with year-on-year core inflation registering at 3.6%, the smallest number in three years, while headline inflation decreased to 3.4% year-on-year[1].

This number offered a relief for markets, indicating that inflation is continuing to ease and restoring hopes that rate cuts are once more on the horizon.

We believe that inflation is on a downwards trajectory. We view stubbornly high rents as one key contributor to the recent higher than expected US inflation numbers. Rents are typically 'stickier', in part due to the calculation methodology used by the Bureau of Labor Statistics and the nature of the rental market. Historically, housing market trends have been a leading indicator for rent inflation with house prices typically leading rent inflation by about 18 months. House prices have stabilised following a recent surge, suggesting that rent inflation is likely to continue moderating throughout 2024. Therefore, we believe that one of the stickiest categories in the CPI basket is trending in the right direction.

Furthermore, one of the key drivers of inflation is money supply, with periods of significant inflation characterised by excessive money printing. The Fed undertook significant quantitative easing (QE) in response to the COVID-19 pandemic.

However, since June 2022, the central bank began the process of quantitative tightening (QT). As a result, its balance sheet has been reduced by about $1.6 trillion from a peak of near $9 trillion in early 2022. Money supply tends to lead inflation by approximately 18 months and therefore we believe this reduction supports the assumption that inflation will continue to ease throughout the year.

Bumpy path to inflation target

However, while we believe inflation is moving in the right direction, there may yet be some bumps along the road.

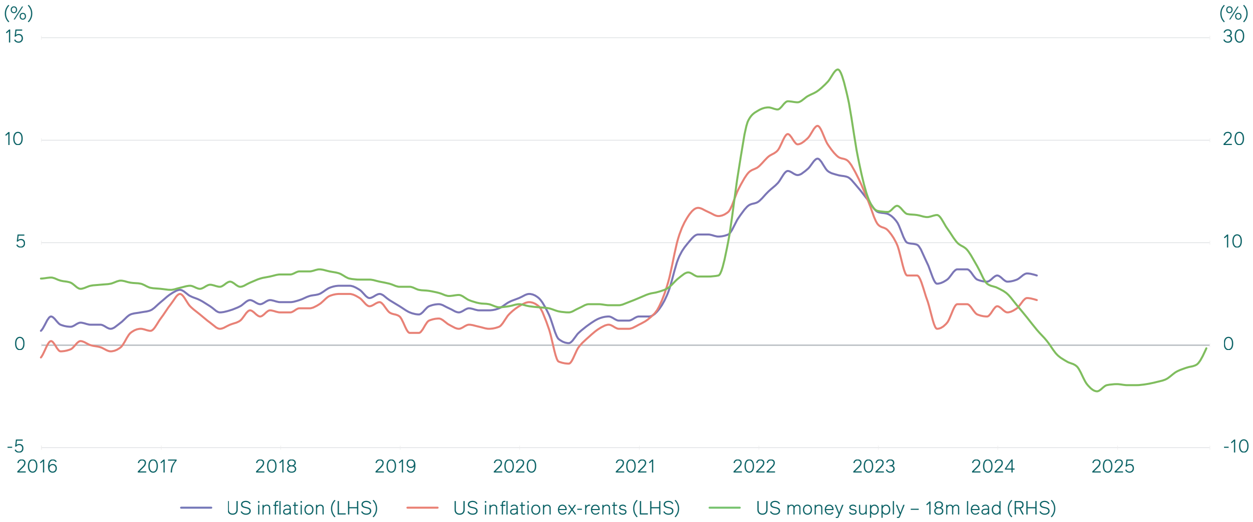
While April's inflation data offered markets a slight reprieve, 3.6% is still well above the Fed's 2% target and several Fed policymakers have adopted 'higher for longer' rhetoric following the release. For example, Atlanta Fed President Raphael Bostic commented that the new "steady state" for interest rates is likely to be higher than experienced over the last decade.

The road to lower rates is littered with obstacles with potential impacts from a still resilient economy and jobs market, as well as the US presidential election in November.

Both geopolitics and the US election raise the potential risk of a resurgence of inflation. With US Treasury interest payments on a 12-month cumulative basis hitting $1 trillion in March and both presidential candidates campaigning on potentially inflationary policies, such as increased tariffs, there are some concerns about US fiscal sustainability.

[1] Source: US Bureau of Labor Statistics, May 2024.

Inflation trending downward as money supply has fallen



Source: M&G, Bloomberg, 30 April 2024.

Furthermore, there is an argument that inflation, and interest rates, have entered a new era and will remain higher. Factors such as the green transition, prolonged periods of heightened geopolitical tension and demographic trends could see the so-called 'neutral rate' – the level at which interest rates neither stimulate nor hold back the economy – settle at a higher level.

While we believe interest rates and inflation are heading downwards, questions linger over the speed at which they will ease.

[2] https://www.reuters.com/world/uk/with-inflation-falling-fast-will-boe-quickly-cut-rates-2024-05-21/

Policy divergence

Since the beginning of the current rate hiking cycle in 2022, most developed market central banks have moved in step with one another. However, with the path of inflation and growth moving at different rates globally, we are beginning to see central bank policy diverge, with developed market (DM) central banks now beginning to act independently of the Fed.

Following the Swiss National Bank, Sweden's Riksbank and the Bank of Canada, the European Central Bank (ECB) has become the latest central bank to start easing monetary policy. The ECB has cut interest rates from record highs, in response to inflation falling close to the bank's 2% target. Markets are pricing in another rate cut this year.

These early moves are in contrast to the scaled back expectations for Fed cuts. ECB president Christine Lagarde has emphasised that the ECB was "data dependent", not "Fed dependent". She added that the two inflations (eurozone and US) are not the same. Eurozone annual inflation fell to 2.4% in April, close to the ECB's target, while economic growth in the bloc was stagnant in the fourth quarter of 2023 before recovering slightly to grow 0.3% in Q1 2024.

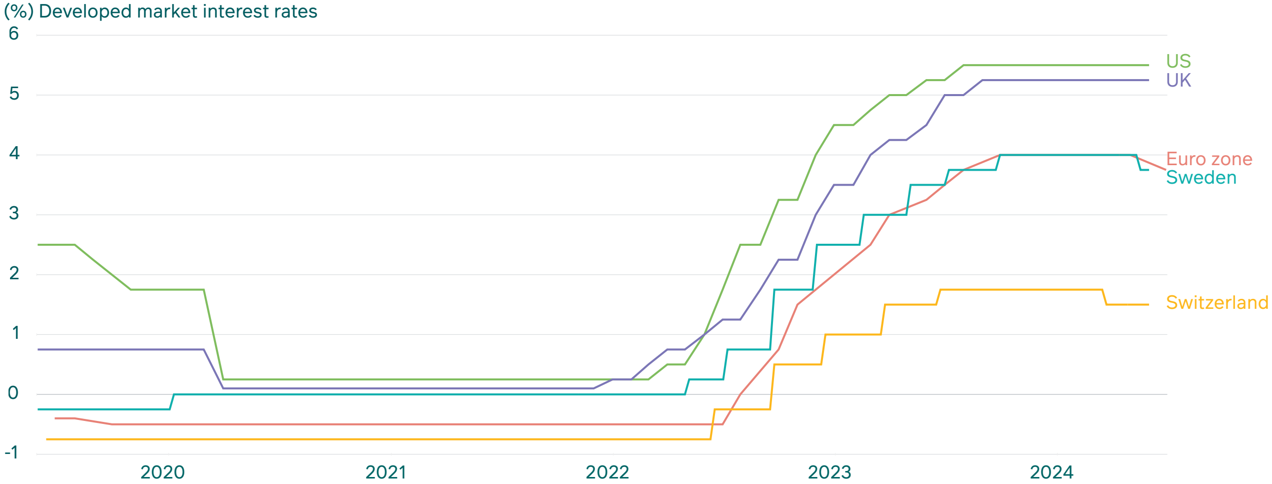
However, central banks are proceeding cautiously as cutting rates ahead of the US risks currency depreciation, which in turn could spark an upswing in inflation from more expensive imports.

The Bank of England is also largely expected to reduce interest rates with futures pricing in an almost 100% chance of a cut at its August meeting[2]. This comes following a sharp fall in the UK's inflation rate to 2.3% in April.

Emerging market central banks led the cycle by hiking faster and further than developed market central banks in an initial response to the uptick in inflation. As a result, these banks subsequently began their cutting cycle earlier, with Brazil making its first cut in August 2023.

As central banks diverge on the path down from the peak, we see potential opportunities for investors to diversify across geographies and sectors. Diverging paths could also make the descent from peak rates more perilous, making active management especially important, particularly within fixed income.

Central bank policy divergence



Source: LSEG Datastream, 7 June 2024.

What does the current environment mean for bonds and where are the opportunities?

Fixed income markets saw a strong and rapid rally in the fourth quarter of 2023, leading many investors to fear that they had missed out.

However, as it became clear that the 7 interest rate cuts originally priced in for the US for 2024 were unlikely to materialise, DM sovereign markets gave back some of their gains in the first few months of the year.

[3] Source: Deutsche Bank, December 2023.

As such, for those who missed out on the bond rush in Q4 2023, the prospect of rate cuts on the horizon provides another potential opportunity to capture attractive gains. As we highlighted in the previous edition of Investment Perspectives, the beginning of the easing cycle can be highly supportive of fixed income markets.

Historically the 10-year US government bond (Treasury) tends to rally after the end of the Fed's hiking cycle. For example, on average, if you bought a 10-year Treasury 63 days before the first Fed cut, you would see a 7% capital gain from a 1% fall in yield, plus the carry, according to research by Deutsche Bank[3]. As such, investing in Treasuries at the peak of the cycle has the potential to deliver a healthy capital gain from a credit risk-free asset.

Supportive environment for credit

While we are looking to position more defensively, we believe the current macroeconomic environment remains relatively supportive for investment grade (IG) credit, with inflationary pressures slowly easing, while growth remains supported by a healthy labour market.

Many IG companies remain in a strong position, having locked in low financing costs for an extended period and thereby insulating themselves from interest rate increases. Additionally, their large cash balances are earning attractive interest rates, allowing them to benefit from higher rates and providing them with a liquidity cushion. As a result, despite higher rates, most IG corporates' balance sheets remain healthy with cash balances and profit margins remaining high.

The enthusiasm for IG credit is demonstrated by the record volumes of new issuance in the first quarter of 2024, as companies seek to take advantage of strong investor demand. Corporate borrowers issued $606 billion worth of dollar bonds in the first quarter of 2024, the highest total since at least 1990[4] as investors sought to secure high yields before the Fed begins loosening policy.

[4] https://www.ft.com/content/2b16f721-007d-4148-b4b7-bca15d054bed

Actively seeking value in short-dated credit

Matthew Russell
Fixed Income Fund Manager

The US Treasury yield curve has been inverted since July 2022, the longest continuous inversion ever[5]. Yield curve inversion is when short-term bonds yield more than longer-dated bonds. This occurs as investors expect the Federal Reserve (Fed) to hold short-term interest rates higher before cutting in the longer term. An inverted yield curve is widely considered as an indicator of an impending recession.

However, an environment where the yield curve is highly inverted also means bond investors could benefit from higher yields at the front end of the curve, without taking as much interest rate, or duration, risk. (Longer dated bonds are more sensitive to changes in interest rates).

The Fed and other central banks have raised borrowing costs aggressively in the past couple of years, in response to soaring inflation. This has been a challenging environment for bonds. However, at the end of last year fixed income markets rallied on expectations that the rate hiking cycle was at an end. There was a substantial opportunity for returns. However, for investors to profit from this was highly dependent on making the correct duration call.

In such an uncertain environment, investing in short-dated bonds can reduce duration risks, decrease downside risks and bring down volatility. By reducing duration, there is less pressure to make a correct call on the timing of the Fed's interest rate decisions. The current curve inversion shows that the market is still expecting rate cuts ahead, in our view. If these were to be adjusted and yields rise, it could result in losses for long duration assets. (Yields move in opposite directions to prices).

As a result, we believe active bond management is as important as ever. As we move through the cycle, spreads will likely tighten on different sectors and bonds, which can provide a rich source of alpha-generating opportunities for active managers; credit selection capabilities are crucial as a volatile market environment can increase dispersion between individual credit valuations.

Furthermore, M&G's credit research capabilities help to ensure that credits we invest in look robust, especially when spreads are tight. This can help avoid credits which are likely to lose value.

Adding value

Our investment universe is not restricted to euro-denominated debt, giving us a wider opportunity set to look for excess returns. For example, a company may issue bonds in sterling, euros and dollars and have the same maturity, duration and credit risk; we have the potential to capture the widest spread and highest yield after hedging back to euros. These plays incrementally add to performance which is how an active manager can add alpha.

We are also able to add value by investing in floating rate notes (FRNs), debt instruments with coupons that fluctuate with interest rates, and asset-backed securities (ABS).

Investing in FRNs enables us to take credit risk with a low level of interest rate risk. Meanwhile, AAA-rated ABS can offer a similar risk premium to BBB unsecured credit. Our approach is to take risk when we believe we are being paid for doing so. With one of the biggest teams of ABS analysts in Europe, we believe we can effectively conduct due diligence and hunt for relative value.

[5] https://www.reuters.com/markets/rates-bonds/us-treasury-key-yield-curve-inversion-becomes-longest-record-2024-03-21/#:~:text=The%20part%20of%20the%20Treasury,ones%20%2D%20since%20early%20July%202022.

A proactive, disciplined approach to credit

Wolfgang Bauer
Fixed Income Fund Manager

While we avoid taking an overall macroeconomic view, we cannot ignore the overall picture; we take an assessment of perceived risks and opportunities.

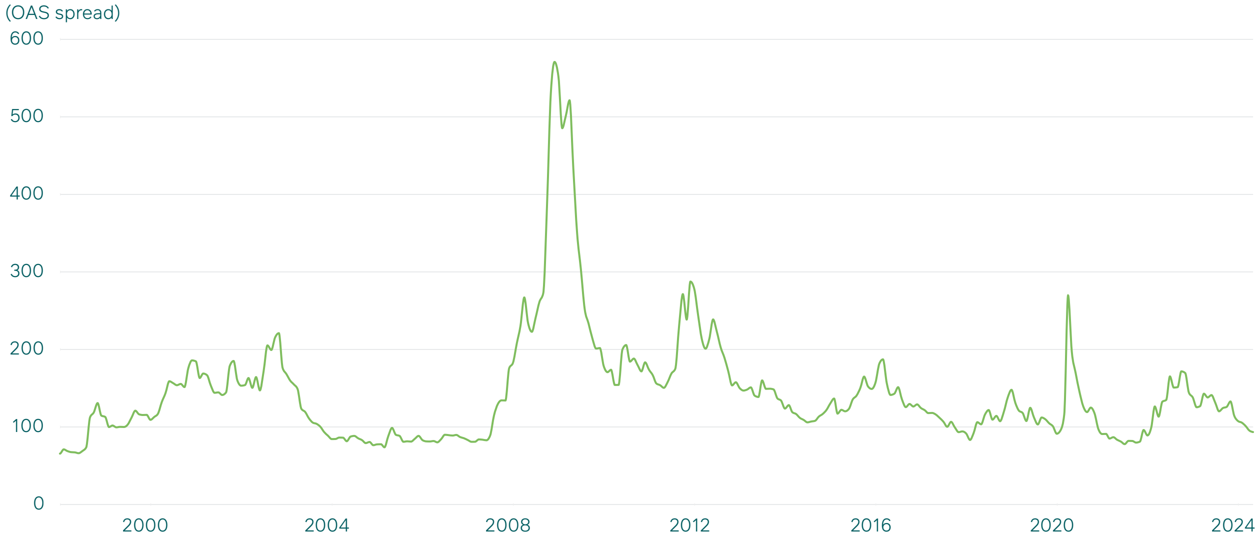
Currently, we believe there is a mismatch between the risks and what is priced in many parts of the credit world; in our view, there are many areas where there is not adequate compensation for these risks and therefore, we believe it is important to derisk in certain areas, ready to deploy capital once there is sufficient compensation.

Lingering inflation

One of the risks facing markets at the moment is lingering inflation; while the inflation picture has improved over the last 12 months, core inflation has proven to be a lot stickier than hoped by both central banks and markets. We believe we have probably seen peak rates and we are unlikely to see a meaningful reacceleration in inflation or higher rates. However, the main risk is that core inflation lingers significantly above target, which in turn could slow down the pace of central bank rate cuts.

This brings its own risks; interest rate markets have already experienced a reality check since December 2023, as it became apparent the scale of rate cuts priced in was unlikely to occur. Yet, this was largely ignored by credit markets.

Global IG credit spreads have narrowed



Note: Spread is adjusted for rating and maturity changes over time.
Source: Bloomberg, ICE Bank of America indices, 30 April 2024.

Pressure of higher refinancing costs

However, higher rates mean higher refinancing costs for companies. While many companies are in a strong position to tolerate higher refinancing costs, the riskier parts of the market may experience pressure should the "higher for longer" scenario play out. This is a risk which we don't see as fully priced in.

Default rates have slowly started to rise, especially in the US. While still at reasonably low levels, they are trending higher as would be expected given higher refinancing rates. The longer higher rates persist, the more likely we will see an acceleration in default rates as some companies may be merely playing for time.

As such, it is important to take a selective, active approach by looking at individual companies and understanding which are suited to survive and thrive in this environment, and which might be challenged with too much debt.

Tight spreads

In Europe, while there has been some tentatively good news in the latest data points for the purchasing managers indices (PMI), the manufacturing component remains in contractionary territory. Therefore, there remains a risk that Europe will continue to flirt with recession for longer than anticipated, which might pose a challenge for some companies' profitability.

Despite these risks, credit spreads have done very well, not least due to the relentless inflows into the asset class. Many institutional investors re-entered the asset class as yields increased sharply throughout 2022 and 2023.

These inflows into the asset class have put strong downward forces on credit spreads, leading to the current spread compression. While this trend may continue for some time as yields remain reasonably high compared to where they have been historically over the last five years, flows into the asset class may ultimately start to stutter due to diminishing risk premiums.

Proactive approach

Currently we have been taking a measured derisking where we feel that valuations no longer justified the risks. In turn, we have built up defensive assets that fulfil three conditions; they should be short-dated, default remote (highly rated) and highly liquid. If the market begins to sell off, we would want to be in a position to swiftly liquidate these positions and buy riskier credit at better valuations. However, we still believe there are pockets of value, particularly within financials and real estate.

We will never be able to perfectly time the market; instead, we have to steer cautiously and be proactive, rather than reactive. We need to be disciplined and sell risk when it is getting expensive. We prefer to derisk into strength and build up liquid "war chests" so if markets sell off and valuations become more attractive, we can deploy capital quickly. The beauty of this approach is that we are not dependent on market timings.

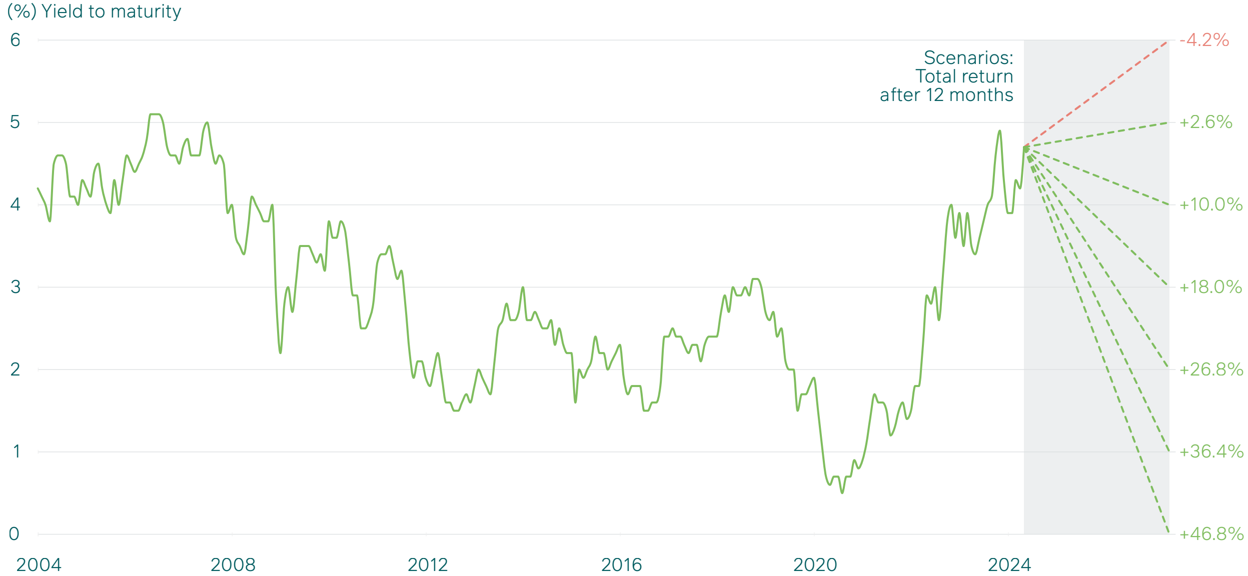
Prospects for optimal income

Richard Woolnough
Fixed Income Fund Manager

The opportunity to deploy cash and increase duration in investment portfolios has re-emerged for the second time in the space of just under a year, in our view. In October 2023, yields on US 10-year Treasuries surged to 5% as higher-than-expected inflation drove investors to rethink their interest rate predictions (smaller-sized cuts – and fewer). Currently, yields are once again approaching the highs seen in this cycle.

But back then, the surge in yields – and subsequent decline – occurred rapidly, leaving many investors behind. Since then, many of these investors have held onto cash with the intent to deploy it when valuations become attractive again. While the market doesn't often offer second chances, it seems that investors may have another opportunity this time around – and we argue it really is time to be active, flexible and well-informed in your bond selection, because of this unique rates-inflation dynamic.

Risk-reward in 10-year US treasuries



Note: The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.
Source: Bloomberg, 30 April 2024.

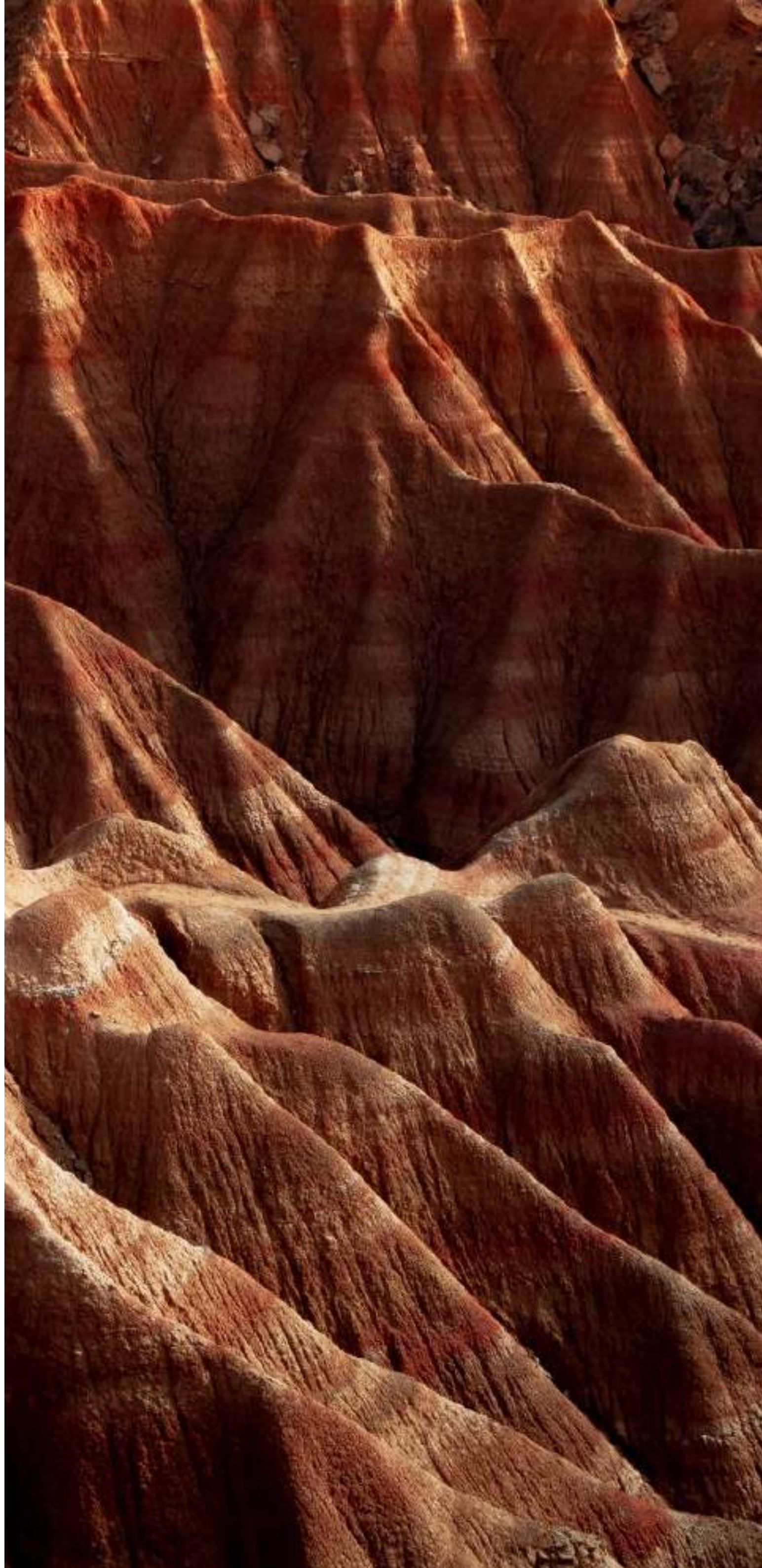
We think there are three key reasons why duration should be added in the coming months:

1. Rate cuts have almost been priced out: Market movements often fluctuate between extremes rather than following a smooth path. While the Fed has maintained a consistent message, market participants have been mainly erratic, shifting from expectations of 'higher for longer' rates to forecasts of multiple rate cuts in 2024-25. Presently, investors have mainly returned to the higher for longer mindset, with almost no cuts, or very few, priced in for this year. Consequently, while this can change in the coming months, we still believe most of the negative news has already been factored into the market.

2. The recent upside surprises in US inflation have spooked some investors to believe that pricing pressures are making a comeback. We have argued against this view for a while now: As long as money supply remains constrained, it is difficult to achieve a sustained and significant inflation 'reacceleration'. At present, money supply is still contracting and it would seem that we are now moving into an environment of "too little money chasing too many goods". This scenario is disinflationary and therefore typically a positive for duration. While some level of 'sticky inflation' may persist, we suggest that there is no need to be overly concerned about inflationary pressures.

3. We believe the risk-reward proposition for owning duration (eg, US government bonds) remains strong. In our view, the downside risk associated with holding government bonds appears limited, while the potential upside offers the possibility of double-digit returns. The chart above – which is based on M&G's internal scenarios of expectations for total returns of 10-year US government bonds – illustrates our belief that risk-reward for duration-bearing assets has improved.

In summary, we believe the opportunity to deploy cash and increase duration in investment portfolios has re-emerged as a result of a unique rates-inflation dynamic, one that has largely come from the central bank response to the COVID pandemic of 2020-21. This may be the final chance for investors to take advantage of the situation, however. In our view, the Optimal Income strategy remains well positioned in this environment with a historically high duration position of 7 years within a high credit quality portfolio (average rating of A).



Hidden gems of innovation

Fabiana Fedeli
CIO, Equities, Multi Asset and Sustainability

Key takeaways

- We do not believe the backdrop lends itself to either trying to time the market with short-term trading or taking broad index exposure.
- Equity performance is broadening and stock-specific drivers are coming to the fore – this year, stocks that have beaten expectations and successfully delivered innovation have outperformed.
- We believe investors need to dig deeper and broaden their search to discover those hidden gems of innovation that are delivering differentiated products and solutions across the globe.

With rates most likely having reached a peak and a resilient growth backdrop, we think equity markets are still a good place for investors to put capital to work, particularly if you consider the approximate $6 trillion[6] parked in money market funds globally[7], part of which we expect to see flowing back into risk assets once interest rates eventually start to decline. That said, with potential volatility coming from macroeconomic and geopolitical news, and some areas of equity markets having performed strongly over the past year, we do not believe the backdrop lends itself to either trying to time the market with short-term trading or taking broad index exposure.

Timing of rate cuts

Firstly, while it is likely that we are at peak rates (with the ECB having just cut by 25 bps), the timing of cuts is uncertain and difficult to gauge. The US Federal Reserve (Fed) itself is data dependent and even it doesn't seem to know when the next cut will come. Looking ahead, it will be important to see how the labour market, consumption and core inflation data develop. While core inflation remains stubbornly sticky, we are close enough to that 2% target that the Fed could consider cutting rates should the economy take a turn for the worse.

That said, for now, there are no signs that a rate cut is either imminent or necessary. With real rates as high as they are now, we should expect some further slowdown in the US economy – although a recession in the US doesn't appear in the cards for this year at least – hence, we could see one or two cuts before year end. Importantly, one rate cut will not necessarily mean a sequence of cuts will immediately follow as central banks, particularly the Fed, may decide to pause after the first one to assess the impact.

It's also worth keeping an eye on US state-level job data, which may offer more clues than the country-wide data. One thing that we know, as does the Fed, is that – once unemployment starts to tick up – the job market can unravel at pace. Two states (California and Nevada) and the district of Washington DC are currently sitting with over 5% unemployment[8]. Again, no reason for panic, but reason enough to keep a watchful eye.

Stock-specific markets

Secondly, on equity index investing: after a strong overall performance, the market is broadening and becoming more stock specific. We continued to see this in the recent earnings season where, even within the same sectors, there were companies able to stand out and differentiate themselves, while others were left behind – observable with companies that, for example, have not invested in product innovation.

Importantly, consumers are becoming increasingly discerning with their purchases, sometimes trading down, but certainly being more selective about what they are willing to spend their money on. For instance, during the recent earnings season we learned that high-spec trucks were all the rage in the US, beauty products... not so much.

The Magnificent Seven (Mag 7)[9] were credited with lifting S&P 500 gains in 2023, given their outsized weight in the index – despite only two of the seven making it into the Top 10 performers in the MSCI AC World Index in 2023. By the same token even a small underperformance can have the opposite effect, dragging the US indices down. We witnessed the impact of these drawdowns in January and April this year, leaving the S&P 500 and Nasdaq trailing other market indices year-to-date.

Interestingly, of the Mag 7 only Nvidia is among, not only the top 10 but also the top 40, best performing stocks in the world year to date:

[6] US dollars.
[7] Source: Bloomberg Intelligence, 28 May 2024.
[8] Source: US Bureau of Labour Statistics, Unemployment Rates for States (bls.gov), 17 May 2024. Data for April 2024.
[9] The so-called Magnificent 7 are large US stocks, Apple, Microsoft, Alphabet, Amazon.com, Nvidia, Tesla and Meta Platforms.

Table 1: Top 10 performers in the MSCI AC World Index year to date

Past performance is not a guide to future performance

Security	Country	Sector	Market Cap. (US$ bn)	% Return
Super Micro Computer	US	IT	45.6	173.7
Nvidia	US	IT	2976.6	144.3
Hanmi Semiconductor	South Korea	IT	11.1	138.1
Vistra	US	Utilities	30.0	127.7
China Hongqiao Group	China	Materials	15.6	106.5
Yutong Bus Co	China	Industrials	7.7	94.0
Pop Mart International	China	Cons. Disc	6.6	93.3
Siemens Energy	Germany	Industrials	20.0	90.3
COSTCO Shipping	China	Industrials	36.4	89.5
Brilliance China Automotive	Hong Kong	Cons. Disc	4.5	89.0

Source: Bloomberg, 6 June 2024, MSCI AC World Index, USD Currency terms.

Selectivity in technology

And speaking about technology, this is one area where selectivity has proven crucial to investment returns this year. We are witnessing a changing-of-the-guard moment. During the last earnings season, overall we saw softer results from tech companies exposed to legacy products. With tighter money supply and worries about the economy, spending on older products has been challenging and corporates are making choices (just as consumers are), and preferring to spend on Artificial Intelligence (AI).

For some companies that benefit from AI-related sales, however, the increased spending on AI is not able to offset the decline in their legacy business. We are at a juncture here where, despite the upside potential for some companies that are able to access significant AI-related growth opportunities, the same companies' legacy businesses have the potential to drag on some of the benefits of that exposure. Hence, it is important to understand all of the drivers of a company's business, no matter how innovative they are on the AI front. This is a typical dilemma when we have a disruptive change in the market.

Innovation driving price performance

For many market participants, the biggest surprise of the first half of 2024 has been the outperformance of equities versus fixed income markets. This is similar to what we experienced in 2023. In H1 2024, equity markets have defied the higher-for-longer fears and delivered solid returns, with the MSCI AC World Index up 8.5% as of 3 June 2024[10]. The reasons are clear and, more importantly, the most recent earnings season has charted the path for what could come in the remainder of 2024.

In our view, there were two key drivers of positive price performance: a beat of expectations and the successful delivery of innovation. The outperformance of European and Chinese stocks was one example of expectations having become too pessimistic, while the dispersion in results from companies in the same sector, even within US technology, has been driven by companies on the right side of innovation trends and their ability to deliver.

In cases where undemanding expectations met with the power to innovate, this created some of the strongest outperformance. Going forward, this will continue to be among the best hunting grounds for the creation of alpha, in our view, with opportunities deriving from investors' tendency to converge around a narrower set of brand names.

Broadening the search for innovative companies

We firmly believe in the power of innovation as a driver of business and investment returns. However, the valuations of many companies at the forefront of innovation have seen a spectacular rise over the past year. Some may still warrant further upside, but others may be due a pause for business fundamentals to catch up with investors' excitement.

This, however, does not mean that the equity market has exhausted its opportunities. To harness the transformative potential of innovation and new technologies from here, we believe investors need to look beyond the 'headliners', and seek opportunities across the wider market; across sectors and geographies. In a nutshell, we need to dig deeper and broaden our search.

While, in the US, Nvidia has been the poster child for tech innovation, and an eye-catching success story, there are many less visible pioneers and innovative companies globally that are offering differentiated products and solutions, and creating a competitive edge for themselves.

In truth, some of the most innovative companies are hiding in plain sight. These may be large multinational conglomerates, where the complexity of their operations means that it can often be a challenge to identify the key business drivers. **Siemens**, for example, which has traditionally been considered a large industrial manufacturing company, has quietly transformed its factory automation business into an industrial software and productivity colossus.

Japan is a rich, if underappreciated, source of innovative companies that are dominating in their respective fields. The country's largest telecommunications firm **NTT** is also the world's third largest data centre owner, and at the forefront of cutting-edge 'photonics' technology, based on light waves. As data creation and transmission increases exponentially, particularly as the use of AI becomes more ubiquitous, the processing of information using the company's optical technologies has the potential to increase energy efficiency by a factor of 100 (as well as increasing transmission capacity by a factor of 125 and reducing latency by a factor of 200)[11].

When we think about the wider physical infrastructure required to power this digital revolution, we will also require greater renewable energy capacity to meet our power generation needs. Top of mind are companies with a dominant market share developing large wind and solar farms, but less frequently mentioned are the material sciences companies like Japan's **Toray**, providing advanced composite materials and components to support the roll-out of these projects. The Japanese company provides approximately 50% of the global composite material used to manufacture wind blades, along with the cutting edge carbon fibre used in aircraft – creating lighter, more fuel-efficient vehicles[12].

And while all eyes are on the technology rift between the US and China, some Chinese companies are quietly innovating in less newsworthy areas of the market. In the

[10] Source: LSEG Refinitiv, price returns in US dollars, 4 June 2024.
[11] Source: NTT website, Innovating a Sustainable Future for People and Planet NTT R&D Initiatives | NTT Technical Review (ntt-review.jp)
[12] Source: M&G Investments, Toray, 2023 (communicated in meetings with company management).

consumer sector, we are seeing apparel retailers seeking to strengthen ties with innovative original equipment manufacturers (OEMs). For example, as sporting goods companies seek to compete on the strengths of their more technical product offering, they are increasingly turning to, and valuing, the OEMs with the strongest offer in terms of fabric and product development.

Hong Kong-based **Crystal**, for instance, provides technical materials to the likes of Uniqlo and Lululemon. The OEMs are increasingly focusing on sustainable materials, production techniques and supply-chain traceability to improve market share, with the likes of Crystal increasingly leveraging large language models (LLMs) and Generative AI (GenAI) to improve efficiencies throughout the value chain.

We can even still find hidden gems among technology stocks, where many of the headline AI names have seen staggering price rises. For example, software solutions company **SAP**, headquartered in Germany, is embedding AI in its software product and using AI to enhance its research and development (R&D) efforts. And, as demand for cloud services continues to grow, SAP's transition of its core enterprise solutions business to the cloud is moving in lock-step with this trend. In our view, the company's prominent position in enterprise software, value-enhancing AI initiatives, steady core business (with more than 70% recurring revenues in most of its software end segments), and ongoing commitment to innovation and improved client experience, could set SAP on course to drive solid growth over the coming years.

There are more hidden gems across industries, including many that are starting to emerge in the financial and healthcare sectors. If we go by recent earnings season results, with consumers and corporates making increasingly deliberate choices about where to spend, companies that are not only meeting their customers' current needs but also improving their products and services to meet their future needs, have been able to beat market expectations and grow – even with the backdrop of higher-for-longer rates. To find them, we just need to dig deeper and broaden our search.

An inflection point for emerging market equities?

Michael Bourke
Emerging Market Equities Fund Manager

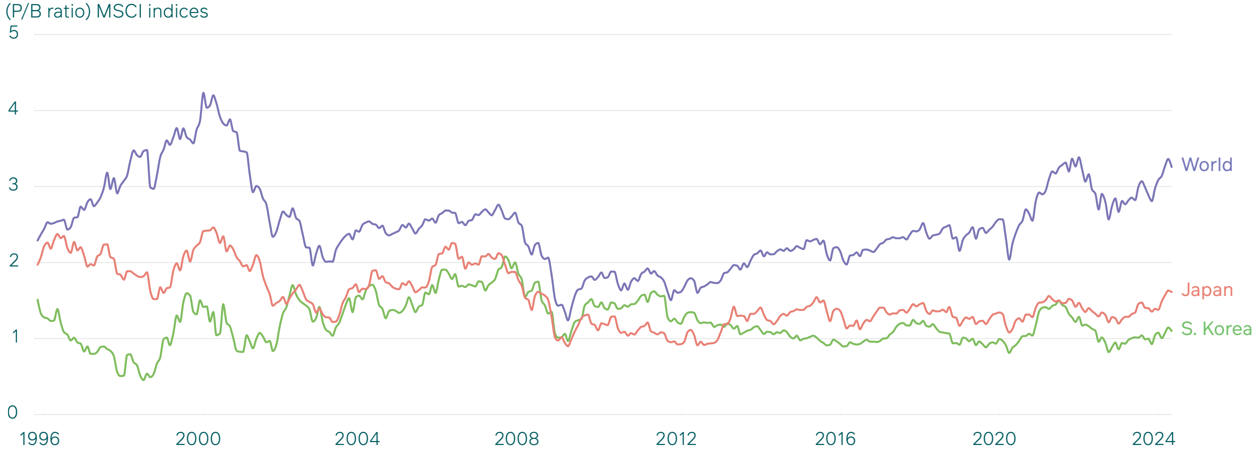
Emerging markets (EM) have faced their fair share of challenges this year (and for the last decade), with the strength of the US dollar, for one, posing a significant hurdle. However, amid this backdrop, EM has witnessed encouraging developments which could capture investors' attention and offer compelling opportunities.

China

Chinese equities have rebounded from their lows in January after valuations became extremely depressed. This recovery can be attributed to a combination of factors, including the introduction of government stimulus measures and stock market reforms, improving economic indicators, as well as growing consumer demand.

As China continues to chart its course towards economic stability, we see investors cautiously embracing the move by Chinese corporates to increasingly focus on returns on capital over growth at all costs. As bottom-up stock pickers, we are excited about the opportunities, but will remain vigilant in a market that is volatile and often trades on sentiment rather than fundamentals. If we witness a recovery in earnings over the upcoming quarters, we hope a fundamental-driven approach will take hold in China once more.

'Japanification' of the Korean discount?



Source: Refinitiv, MSCI, May 2024.

South Korea

The South Korean stock market has traded up strongly this year, driven by corporate reform expectations that followed the announcement of the 'Value-up' programme which launched in June. South Korean companies often trade at lower valuations than their global peers due to a weak corporate governance record, poor returns on capital, and geopolitical challenges with its northern neighbour.

To address the so-called 'Korea discount', regulators are taking cues from their Japanese counterparts and urging companies to establish plans and targets aimed at enhancing shareholder value. We believe these measures have the potential to reshape the investment landscape and unlock new opportunities in the market. The early signs have been promising, in our opinion, and we anticipate a more comprehensive understanding of the programme's impact to emerge over the rest of the year.

Promising signs ahead?

Emerging markets still offer enticing growth prospects, in our view; however, the search for value creation amid these growth engines is what we look for. There are encouraging signs as corporates in large economies like China and Korea are increasingly beginning to understand this dynamic. We believe the next cycle could be dominated by Asian and broader EM companies delivering higher returns on capital.

2024 potentially represents an exciting inflection point because the asset class is still attractively valued, the end of the dollar rate cycle appears to be looming large and we believe geopolitical concerns are already reflected in share prices, particularly in China.

Value investing is still alive in Europe

Richard Halle
European Value Equities Fund Manager

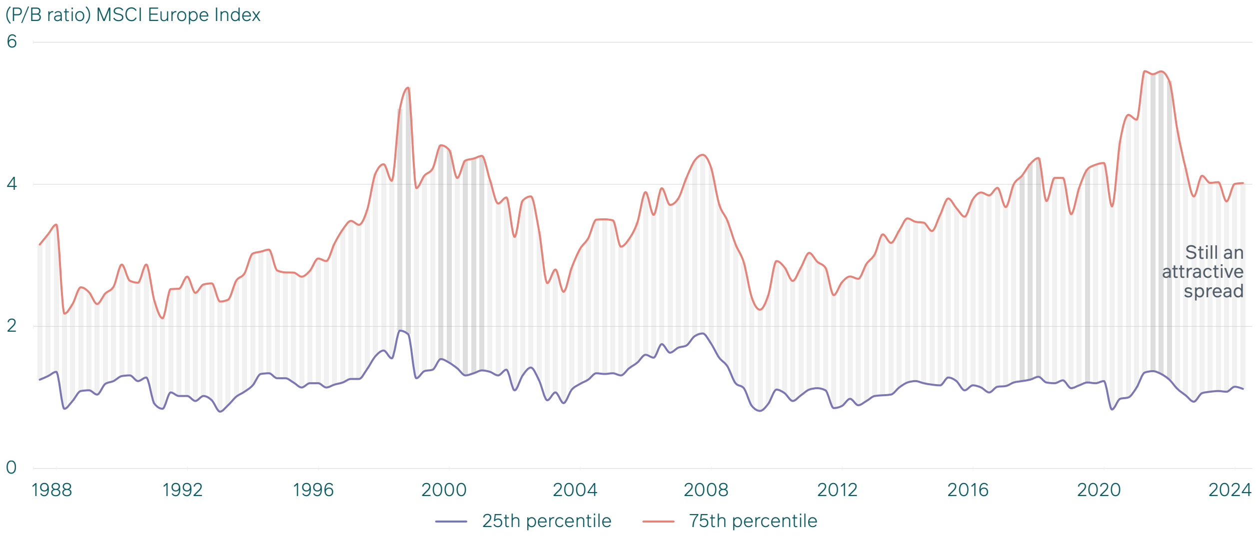
Value investing appears to have fallen out of favour in recent years, most notably in the US, where investors have shifted towards growth stocks. However, the style headwinds in the US have overshadowed the resilience of value in other regions such as Europe.

As dedicated European value investors, we believe the prospects for this long-unloved asset class are extremely promising. For a start, we see a market backdrop that has changed considerably since the pre-COVID era. Instead of a world defined by long-running trends of stability and predictability, where investors could thrive without caring about fundamental valuations, we are now in a world subject to increased volatility, disruption and surprises.

Recent examples of instability include the banking crisis in the US (and its subsequent contagion to Europe); macroeconomic worries; and the impact of rising bond yields on equity 'bond proxies'. All of these have created opportunities for us as contrarian value investors. We believe this world of unpredictability will persist, and being in a position to take advantage of mispriced stocks could lead to good alpha opportunities.

Valuation dispersion in Europe

Past performance is not a guide to future performance



Highlighted bars indicate periods where price-to-book spread is greater than the current price-to-book spread.
Source: LSEG Datastream, 30 April 2024.

Another positive aspect, in our view, is that the European equity market is two-tiered. Valuations of quality growth stocks reached elevated levels during the zero-interest rate environment. The big-name growth stocks have also benefited from passive investors and global investor interest. In contrast, the cheaper part of the market has been overlooked and remains attractively valued, in our view. As a result, the valuation dispersion in Europe is among its widest ever levels.

In a world where valuations of out-of-favour value stocks look attractive and different trends have emerged within the investment regime, we believe different stocks could do well compared to what has led markets previously. Today's value stock may be tomorrow's growth stock, for example. We are seeing cases where this is already happening. Over time, we remain optimistic that investors will look more favourably on value stocks and pay more for companies that were better than they originally thought.

Capturing the power of global dividend growth

Stuart Rhodes
Global Dividend Fund Manager

Dividend investors have experienced headwinds over the past couple of years. The emergence of AI as a major theme has led to a very narrow market, driven mainly by US technology and 'new economy' mega-cap stocks, many of which do not pay dividends.

This has been compounded by the underperformance of traditional defensive areas like consumer staples, utilities and healthcare in a higher interest rate environment. However, the prospect of rate cuts in the coming months could be helpful for dividend-paying stocks and create a powerful tailwind for the strategy.

Encouragingly, today, we are potentially seeing better value in the out-of-favour consumer staples and healthcare sectors than we've been used to in recent years. The severity of the declines in some areas is creating attractive entry points, in our view, for some companies with decades-long track records of paying a growing dividend. This is very important because we believe most of the long-term successful track records within dividend investing have a focus on growth.

Not only does a growing dividend provide a defence against the corrosive effects of inflation, it can put pressure on the share price to move up alongside the dividend.

Dividend investing is not simply restricted to defensive companies. It is possible, albeit harder, to find companies that are growing quickly and pay rising dividends at the same time. We would highlight the surprise decision by Facebook owner Meta Platforms to start paying a dividend this year as a great example of the broad range of dividend opportunities.

Although Meta's prospective dividend yield is less than 0.5%[13], we see a long runway for that dividend to get a lot bigger in the future, and it could represent the start of an interesting trend among technology and new economy companies to incorporate dividends as part of their cash returns to shareholders.

After a challenging time for dividend investing, we are encouraged by the wide range of opportunities we are finding and the developments unfolding in the market. We think the headwinds we currently face with a narrow US equity market are likely to dissipate in time and, therefore, from a longer term perspective we feel optimistic about the future.

We remain resolutely focused on dividend growth as a compelling strategy over the long term, without losing sight of the reality that the global economy faces challenging times ahead. Dividend cuts will be inevitable for companies not equipped with the financial armoury to withstand a cyclical downturn. Balance sheet strength is a key consideration in our company research to ensure that dividends can be sustained in the current climate.

[13] Source: Morningstar, Meta's First Dividend Explained, Feb 2024.

Spotlight on listed infrastructure

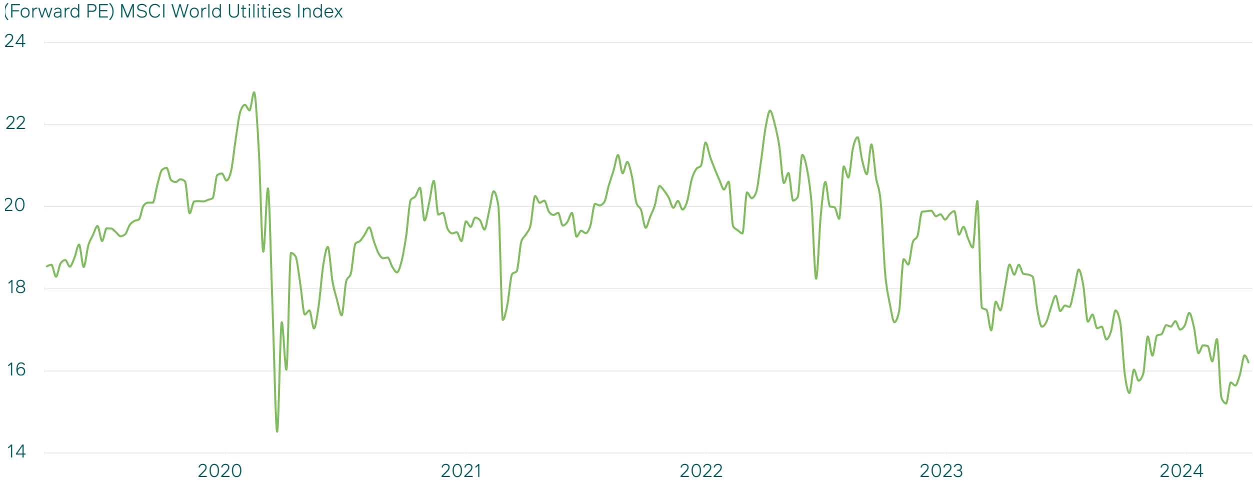
Alex Araujo
Global Listed Infrastructure Fund Manager

There is no question that the recent macroeconomic backdrop has been unfavourable for listed infrastructure. In a world where investors have chased more “exciting” technology stocks and penalised dividend-paying stocks, the asset class has encountered headwinds.

Listed infrastructure tends to have a large allocation to the utilities and real estate sectors, both of which are perceived to be interest sensitive. The market narrative around ‘higher for longer’ interest rates has been challenging but with inflation moving in the right direction, and recent rate cuts in Europe (and potentially more on the horizon in the US), we are optimistic about the outlook for infrastructure investing.

We see attractive valuations across the asset class currently. One area that is compelling, in our view, is utilities where valuations remain at near record low absolute and relative levels. Simply by virtue of being dividend-paying stocks they have been punished by the market, despite the sector continuing to deliver consistent earnings growth and higher dividends.

Valuations of utilities have fallen significantly



Source: Bloomberg, 31 March 2024.

Another sector that has been caught up in this trend is companies structured as real estate investment trusts (REITs). These companies have real assets at their core and those with robust and growing earnings are very attractive, in our view. The REITs we hold are not in structurally-challenged areas such as offices or retail. We have invested in data towers, data centres and logistics warehouse operators, which continue to demonstrate strong growth fuelled by the inexorable demand for digital communications and the evolution of artificial intelligence (AI).

Infrastructure could play a critical role in supporting our digital future in other ways too, for instance by providing the power sources and grid networks needed to meet increased demand for data and power.

While we wait patiently for the macroeconomic backdrop to shift, we see companies continuing to grow their dividends, offering an income that helps offset and protect against inflation. With attractive valuations, the potential for compounding income growth and access to powerful structural trends, we believe the outlook for listed infrastructure is promising.

Addressing the income challenge

Stefano Amato
Multi-Asset Fund Manager

Income is king, especially in an environment of persistently higher prices. But how to address the income challenge without sacrificing growth, the irreplaceable ingredient for satisfactory investment outcomes over the long run?

We believe that the answer lies in a combination of disciplined adherence to evergreen investment principles and an active approach to tactical asset allocation.

On one hand, in our multi asset income funds we purposefully aim to diversify sources of returns and income generation across a broad range of asset classes. This can allow us to build robust portfolios that can benefit from medium-term asset appreciation but are also able to withstand unforeseen economic shocks.

In the current environment, this translates into a well-diversified approach to income generation across asset classes which – as per the chart on the right – also features dynamic shifts as we react to new investment opportunities that arise over time.

Additionally, we actively monitor global markets with the aim of harvesting tactical investment opportunities when we can spot attractive fundamentals, unusual price action and extremes in investor beliefs as per our ‘patient opportunism’ philosophy.

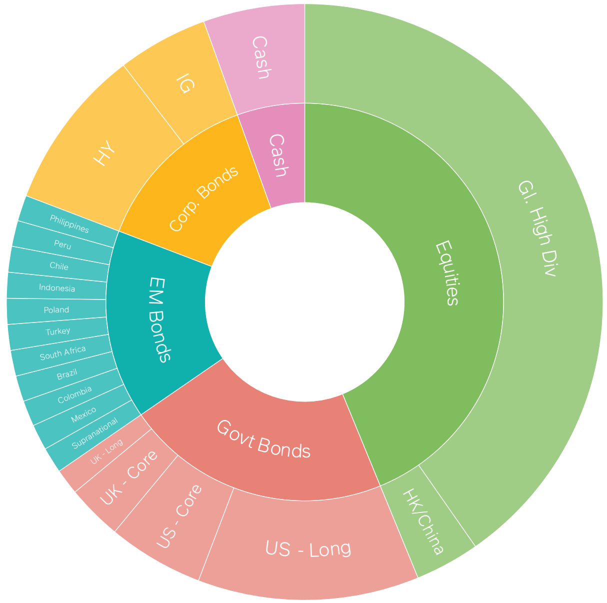
A recent example of this would be our choice to buy Chinese equities in January, when they were lowly valued and we could observe many signs of antipathy among investors.

Presently, our confidence in the potential to deliver both income and growth is partially restored as we observe tentative signs of decoupling between equities and bonds.

At prevailing yields, bonds already provide a meaningful contribution to the strategy’s income. If their ability to provide portfolio insurance is even only partially restored – as policymakers now have a lot of ‘dry powder’ to counteract any growth shocks – we can then have more (guarded) confidence in pursuing opportunities in the equities space, therefore retaining exposure to potential growth appreciation over time.

A combination of robust diversification plus ‘patient opportunism’ should therefore serve investors well, potentially enabling the generation of meaningful levels of income without sacrificing prospects for capital growth.

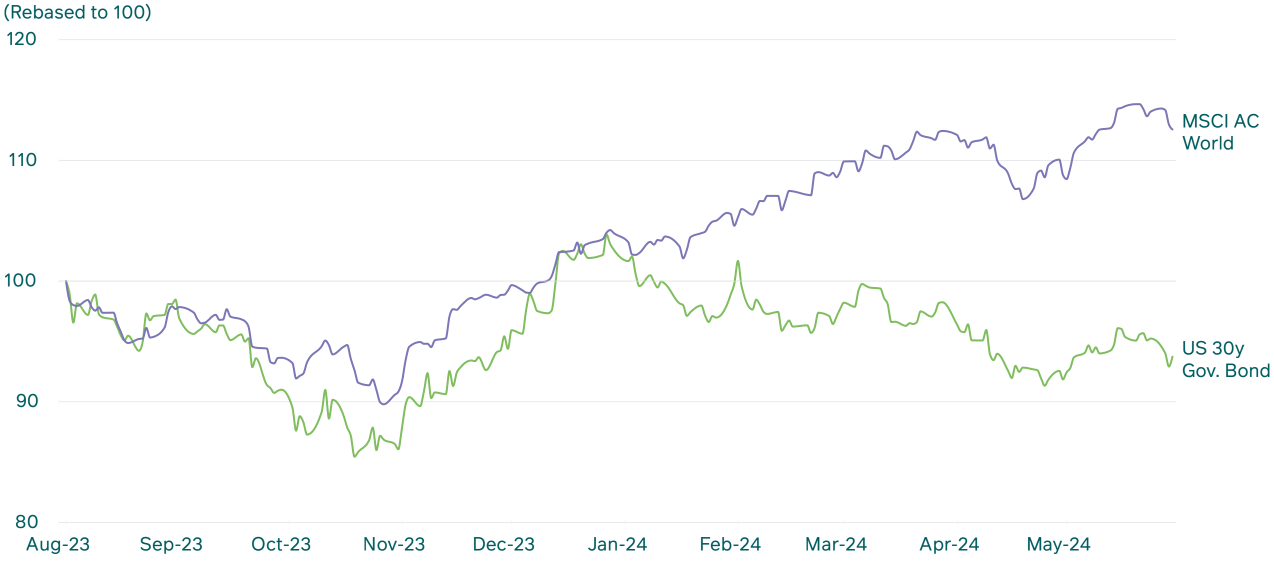
A diversified approach to income generation



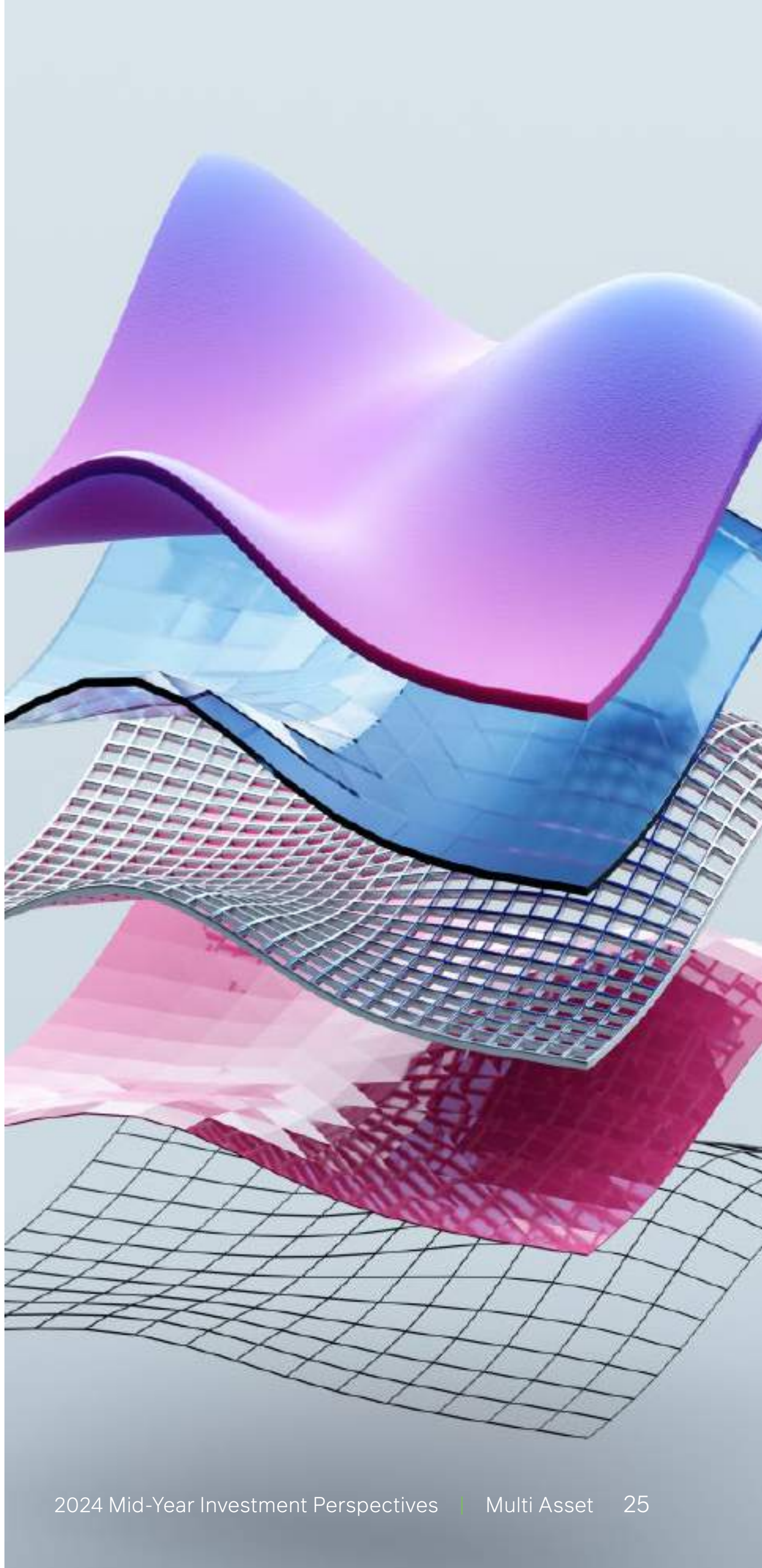
Source: M&G, 15 May 2024. For illustrative purposes only, chart shows the portfolio breakdown of the M&G Multi Asset Episode Income Strategy.

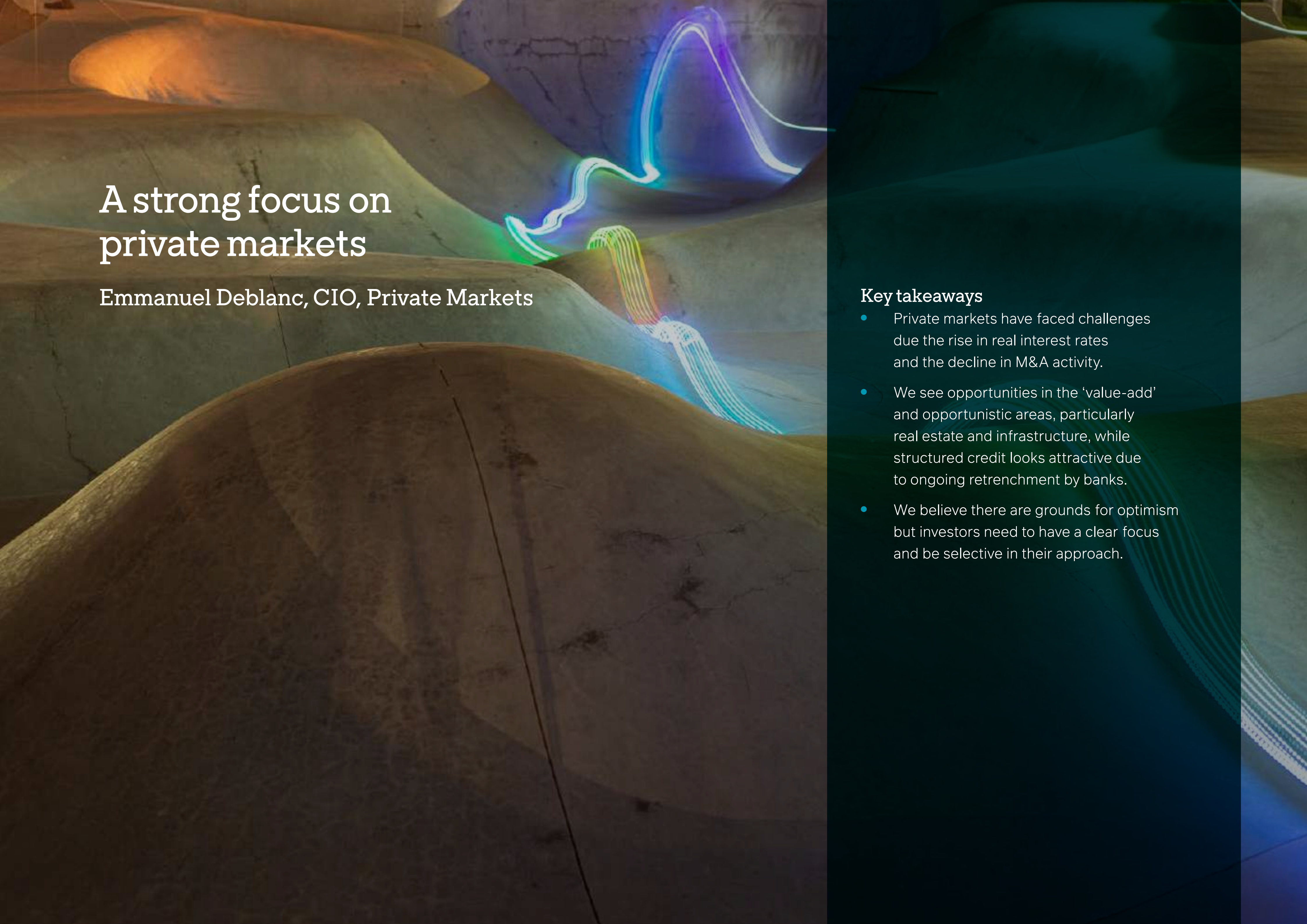
Divergent equity and bond performance in 2024

Past performance is not a guide to future performance



Source: Bloomberg, as at 31 May 2024. Returns in US dollars.





A strong focus on private markets

Emmanuel Deblanc, CIO, Private Markets

Key takeaways

- Private markets have faced challenges due the rise in real interest rates and the decline in M&A activity.
- We see opportunities in the 'value-add' and opportunistic areas, particularly real estate and infrastructure, while structured credit looks attractive due to ongoing retrenchment by banks.
- We believe there are grounds for optimism but investors need to have a clear focus and be selective in their approach.

Private markets have remained a strong focus for investors over recent years. However, the current macro-led backdrop for private markets has certainly proven challenging. Of course private markets are not a singular investment area, rather a collective of strategies, and the impact of these macro factors has not been uniform.

The most significant issue impacting many private markets has been the rise in real (inflation-adjusted) interest rates. These have risen considerably in Europe, the UK and the US and now sit around 200 basis points. This matters within most private markets as higher rates reduce distributions to investors and put pressure on valuations. However, the reality is a bit more nuanced and I believe, long term, this has actually been a positive for private markets. It avoids the misallocation of capital, fundamental in correctly pricing assets.

It is also worth noting the decline in merger and acquisition (M&A) activity within private markets over the last couple of years. This is important for private equity investors who are looking for exits as well as new opportunities to re-deploy their capital. The number of infrastructure fund closes has also halved over the last 5 years with a commensurate fall in total capital raised.

We believe opportunities persist however within the value-add and opportunistic areas of private markets. Over the very short term, I would flag real estate, infrastructure and opportunities with a clear climate theme. It is also apparent that both renewables and climate-tech remain buoyant and could offer an array of opportunities.

Looking to other private market areas, within the corporate area, loan issuance is beginning to recover, whilst on the equity side, the worst fears have not materialised. Private equity has been saved with a less deep economic downturn than many predicted.

Lastly I would highlight the attraction of structured credit. Several themes are driving growth in this area, not least retrenchment of banks from certain areas of lending due to regulatory and capital requirements. This has opened up more space for structured credit, particularly in Europe.

To conclude, while private markets have faced their challenges recently, we believe there are definitely grounds to remain optimistic – opportunities clearly exist. The key take-away I would make is that investors need a clear focus and adopt a highly selective approach to where within private markets they chose to focus.

Significant momentum in structured credit

James King
Head of Structured Credit

The prevailing market consensus is that both interest rates and inflation in developed economies are on an eventual downward trajectory. However, the actual outcome remains uncertain. Amid this lack of clarity, investors are understandably asking where they should be deploying their capital. Structured credit is an area that M&G Investments believes offers rich and diverse opportunities in a variety of market and macroeconomic environments, providing many options for investors depending on their risk/return and liquidity preferences. The market and macro background is important, but the case for structured credit is not dependent on any particular environment and indeed has demonstrated robust through-the-cycle performance.

The structured credit market has seen significant momentum in recent years, driven by both demand and supply-side factors. Notable of these supply drivers has been the pullback by banks from certain lending activities due to stricter regulatory capital requirements which have been brought in following the global financial crisis (GFC). This regulatory pressure has been coupled with episodes of disruption within the global banking sector, led by and large by higher interest rates, which has shone the light once again on bank balance sheets and the critical need to deleverage.

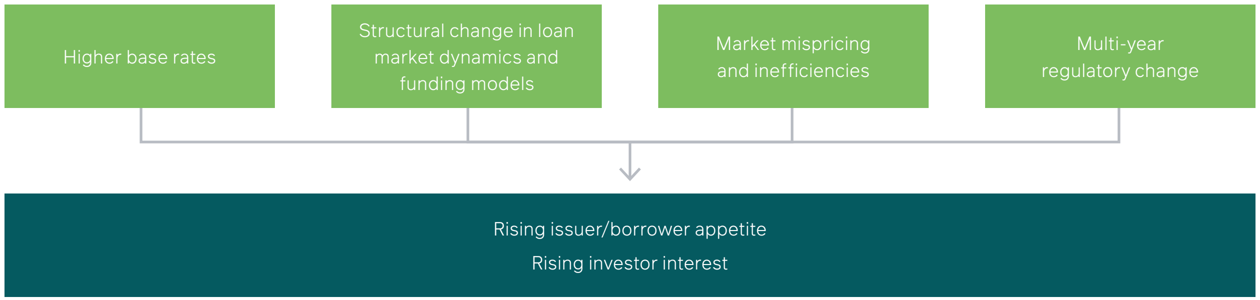
Private, non-bank finance has consistently stepped in to fill this funding void to the real economy, either as providers of debt capital, or as buyers of loan portfolio assets.

The array of available investment opportunities across the asset class has grown exponentially but we believe this growth is set to continue. Offering investors the ability to access high quality performing loan pools originated by core banks and non-bank lenders alike, structured credit has the potential to target different parts of the capital structure and source investments from both public and private markets depending on risk-reward. The asset class has consistently offered excess returns and reduced return volatility relative to traditional fixed income investments, together with the strong structural protections inherent within the asset class, which we believe should prove particularly attractive to investors in the face of an ever-changing investment landscape.

The ability to access such compelling opportunities requires a very specific skillset and suite of capabilities. In particular a manager needs to demonstrate deep structured credit experience in order to access unique and differentiated deal flow. Within this investment arena, a vast network of relationships matter, with well-established managers best placed to secure a robust pipeline of deals across a unique and evolving opportunity set.

Active in private and alternative debt markets for over 40 years, M&G Investments is an originator and investor spanning the entire asset universe and referencing a range of diverse collateral types. We have a large structured credit team comprising over 40 professionals managing €7.5bn[14] of dedicated structured credit assets. We believe this provides M&G Investments with both the resources and expertise to successfully leverage this exciting area of the wider fixed income complex now and going forward.

Investment conditions could benefit from a confluence of factors



Source: M&G Investments.

[14] Source: M&G, as at 31 December 2023.

A well-timed entry for real estate debt?

Dan Riches
Head of Real Estate Finance

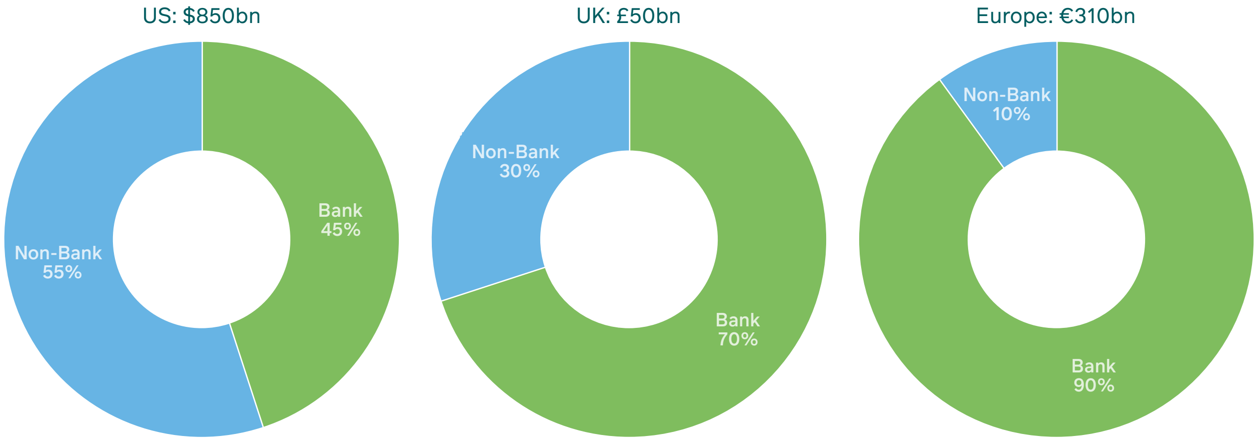
With equity-like returns for credit investing, real estate debt is attracting increasing attention from investors globally, as well as new market entrants.

In our view, the benefits of the asset class stand out in the current economic environment, given that debt benefits from a significant equity cushion, in addition to typically predictable cash flows. The ability to lend at lower debt bases, based on a reduction in property values, can further improve risk dynamics. Loan margins also appear attractive on an absolute and relative value basis. We believe investing in real estate debt today therefore looks well-timed.

Traditional bank lenders continue to retrench from the asset class as a result of increasingly onerous regulatory capital requirements, while falling values and higher interest rates mean banks' focus is likely to turn towards performance and existing loan books. However, we are cautiously optimistic that systemic risk remains an unlikely scenario given generally lower leverage and higher underwriting standards throughout the last lending cycle, and a more diverse lender base.

For non-bank lenders, the opportunity to continue to grow market share remains significant. The UK will likely remain a key focus as one of Europe's largest property markets, with a favourable loan enforcement regime. Further reduction of bank lending in markets such as Germany and France, where bank lenders represent a large share of the market, could also offer a pronounced deployment opportunity for non-bank capital. A granular understanding of country-specific issues is necessary, however, given the complexities involved in navigating nuanced property market dynamics and legal regimes.

Annual loan origination volumes and sources of capital



Source: Bayes Business School Commercial Real Estate European Lending Report – H1 2023, Macfarlanes: The growth of real estate debt, November 2023.

Banks' retreat coupled with downward property valuations is likely to create a sizable debt funding gap over the coming years – estimated at €93 billion by 2026[15] though it is an evolving picture, with changing rates and capital values starting to stabilise.

In our view, refurbishments and new developments represent a compelling opportunity for non-bank lenders to provide moderate leverage at potentially attractive returns. Regulation has made this type of lending unviable for some banks, while others are pulling back over concerns about the impacts of cost inflation and increased insolvency risk in the construction supply chain. Another consideration is the fact that projects can often take longer and be more costly than anticipated to complete. However, these risks can be factored into loan metrics through rigorous due diligence.

In particular, we are seeing an increasing requirement for 'brown to green' property transitions, with the potential to create assets that meet modern occupier requirements and help to regenerate city centres. A solid understanding of sustainability costings is necessary as part of these financings, since the capex required to complete heavy refurbishment of this kind can be challenging to quantify.

[15] AEW Capital Management, August 2023.

An ongoing recovery for global real estate?

Richard Gwilliam
Head of Global Real Estate Research

Following a challenging couple of years, we expect global real estate markets to continue to recover throughout the rest of 2024, with stabilising capital values and largely positive rental growth prospects. Nevertheless, we believe a focus on income and asset quality will be important in the new cycle, as investors and lenders become more selective, and investment performance differentials become apparent between assets of higher and lower quality. New investments made in the next 6-12 months are likely to be recognised as a robust vintage in the long term, benefiting from high entry yields and strong occupational profiles.

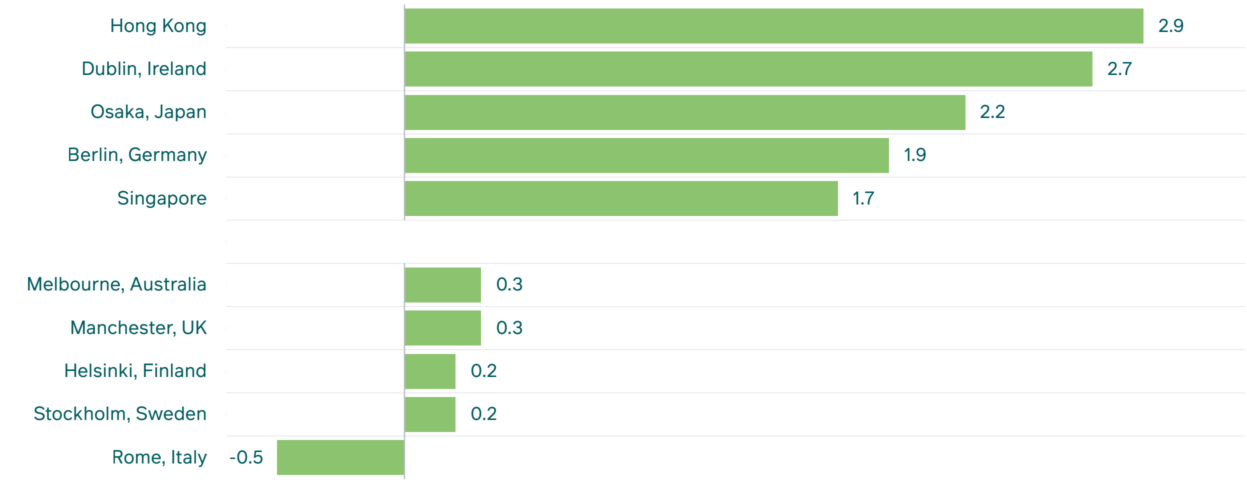
Nominal rental increases are expected to be driven by a stronger economy – particularly in Asia – or at least an uptick in economic growth, which will spur occupier demand. Challenged development viabilities have limited the supply pipeline in most geographies – though there are some examples of the converse – which should help to stimulate rental growth over the next few years, in light of acute supply-demand imbalances.

Though refinancing challenges remain, the risks within banks are largely well understood and appear modest. The risk of wider systemic stress is unlikely, in our view, but lender behaviour and financing availability will be a key determinant of asset bifurcation and performance moving forward.

Despite some challenges and risks on the downside, with investment market stabilisation in sight and the global economy appearing set to recover, the outlook for property is looking increasingly optimistic, in our view. As such, 2024 may present the most attractive buying opportunity for real estate that has been seen for some time.

New supply looks set to be restrained in most markets... but not everywhere

Office net additions as a % of stock (2024–25 pa average)



Source: PMA, Spring 2024.

Digital infrastructure – an energising opportunity

Toby Rutterford, Associate Director
M&G Real Assets, Impact and Private Equity

The world is becoming increasingly digitalised and data has been called the lifeblood of the knowledge-based economy. This shift is made possible by digital infrastructure, the physical infrastructure required to support the delivery of digital technologies in the everyday lives of global communities.

The M&G Real Assets team believes that digital adoption represents a multi-billion-dollar investable opportunity. Significant capital expenditure (capex) will be required to keep pace with technological change, and evolving business and consumer practices globally.

However, the digital infrastructure market is at an intersection. Demand for digital services is increasing at a pace beyond the market's ability to build the critical infrastructure required to promote their delivery. For private market investors, this creates a nuanced and, in our view, compelling investment opportunity with long-term, persistent and systemic tailwinds.

Rising demand for data centres

The digital infrastructure market has evolved over the past decade. From mobile network towers to the evolution of 5G technology and fibre internet networks, we have seen a new wave of investment opportunities that offer stable cashflows, often with escalating rates during the contract life, and defensive characteristics, making them attractive to infrastructure buyers.

As the demand for data has increased, data centres, a collection of servers in a dedicated structure, has become an increasingly investable asset class, key to the delivery of digital services. This demand, driven by growing use of outsourced IT capabilities (the Cloud) and widespread adoption of artificial intelligence (AI), is expected to grow rapidly in the coming years.

Like towers, data centres offer hard-to-replace, contractual cashflows which, given their critical nature, are highly attractive to infrastructure investors.

A key challenge of digital adoption and greater demand for data centres, is the accompanying increase in power consumption. Generative AI, in particular, is seen as a "game-changer" when it comes to demand for electricity. According to the International Energy Agency, on average, a single ChatGPT request is nearly 10 times more power intensive than a simple Google search[16].

In our view, the data centre market is at an inflection point where demand has accelerated beyond the market's ability to absorb new capacity. We observe near record low vacancy rates across the US and Europe. We believe this makes it an attractive time to deploy capital.

However, we would argue that practical challenges and market nuance mean that not everyone deploying capital into this theme today will be successful.

Practical considerations

The International Energy Agency estimates that 460 terawatt-hours (TWh) of electricity was consumed by data centres in 2022. Growth in consumption is projected to reach more than 1,000 TWh in 2026 due to the aforementioned growth drivers.[17] That increase is greater than the annual electricity demands of Germany[18].

This level of demand, at a time when supply is constrained in key markets, creates several practical execution considerations which we believe will shape the investment opportunity.

There are several key diligence items we believe investors should be focused on, namely: grid capacity constraints which are a limiting factor in many markets; competition for skilled labour and availability of key components which continues to be a challenge; sustainability considerations associated with the delivery of power (water and energy use as well as carbon intensity); location and counterparty creditworthiness.

As we stand today, there is a risk that the rising tide lifts all boats; however, locational specific factors and strength of contract underpinning the assets are key to delivering long-term value and minimising stranded asset risk, in our view.

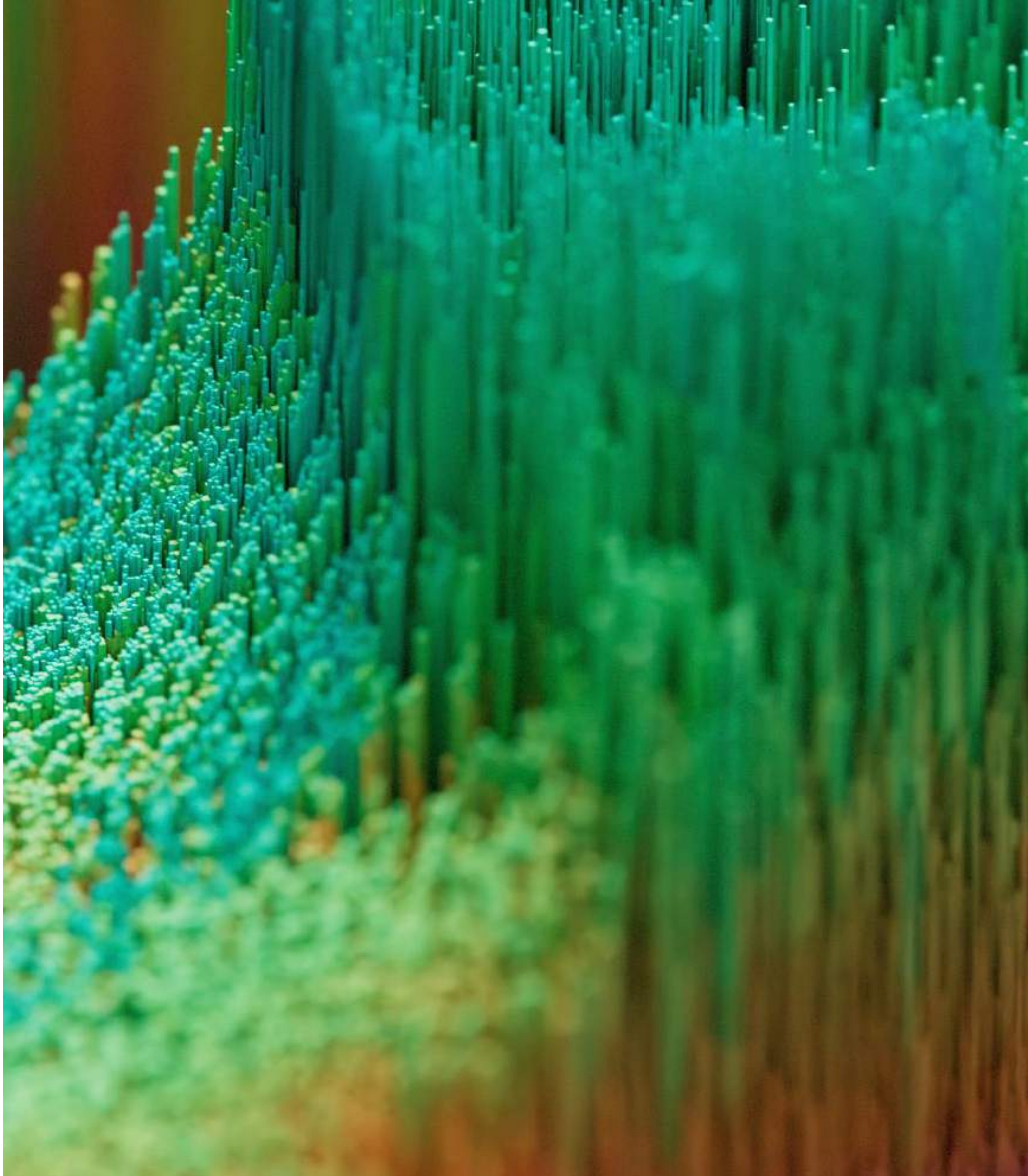
[16, 17] Source: International Energy Agency (IEA), "Electricity 2024: Analysis and Forecast to 2026", January 2024.
[18] Source: Statista, April 2024.

Accessing themes through private markets

We believe there are two significant investment themes emanating from the current paradigm: providing digital capacity through selective investment in data centres and adjacent infrastructure; and providing energy solutions which unlock capacity constraints and, in the process, decarbonise the energy mix.

In our view, private markets are the optimal way to access this significant growth opportunity today. Public markets tend not to reward capex heavy strategies in infrastructure where the focus can be on delivery of quarterly earnings and yield.

In contrast, we believe the long-term patient nature of private markets offers investors an attractive route to participate in this once in a generation opportunity. We do not believe the heightened take-private activity in the data centre market over the past few years to be co-incidental, and likely where a significant proportion of the growth will be observed.



A spectrum of possibilities within private credit

Catherine Ross
Head of Private Credit

While the global economy may be experiencing a downturn, we believe investment opportunities exist that could allow investors to both mitigate risk and secure attractive long-term returns. Private credit is a strategy which potentially has these characteristics. Indeed, one of the largest areas of private credit, direct lending, can be capable of delivering reliable income stream potential together with high risk-adjusted returns.

With balance sheet restraints restricting lending by public banks, direct lending has stepped in to fill the void. Together with a trend by both small and larger corporates to remain private for longer, the direct lending market has expanded significantly. However, we believe its attractions have enduring appeal. As direct loans typically are floating rate, they naturally provide a hedge when interest rates rise. Coupled to this, the asset class may provide portfolio diversification benefits due to the contractual nature of returns offered and mitigate equity market volatility given limited mark-to-market price risk.

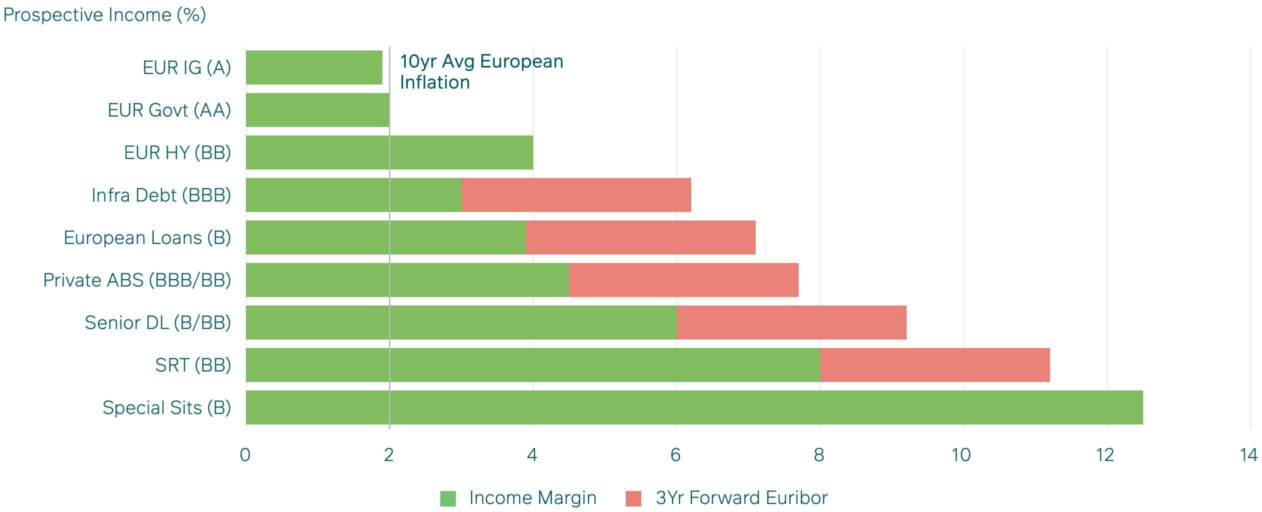
With global economies unsettled, direct lending is not risk free. It is not immune to weaker overall business conditions and any serious recession would lead to higher default rates. However, tighter documentation of direct lending deals via maintenance covenants, together with the advantage of a greater depth of access to both company management and financial information, give the asset class a clear advantage. In our experience, this deeper due diligence can limit the risk of borrower default.

A final compelling characteristic of the wider private credit universe, in our view, is its ability to typically generate real income returns over long term inflation (c.2%). More traditional credit classes, such as investment grade corporate debt and government bonds, struggle to achieve this.

Success within private credit, and direct lending specifically, depends on the expertise and experience of the private corporate lender. M&G Investments has been investing in direct lending since the emergence of the asset class in 2009 with a large and highly experienced investment team with over 50 professionals.

For investors prepared to broaden their investment horizons, we believe private credit offers deep attractions given its ability to deliver both real income and high risk-adjusted long-term returns.

Prospective annual income over 3 years



Note: The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.
Source: M&G, Bloomberg, Credit Suisse and ICE BofA as of May 2023.

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Ideas for navigating a new era

2024 is nearly half over, and from a macroeconomic standpoint, things haven't unfolded the way many market watchers and policymakers expected. Growth has surprised to the upside. Inflation has remained stubbornly above target. Job growth is stronger than anticipated. And investors are bouncing between interest-rate pessimism and corporate-profit optimism. All of this is set against a complex macro backdrop of heightened geopolitical risk and critical elections in the US and around the world. This Mid-year Investment Outlook collection offers ideas from multiple Wellington investors, strategists, and other professionals on risks and active opportunities amid continued macro regime change.

T.RowePrice

2024 Global Market Outlook
Midyear Update

How central bank policy could impact your portfolio

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2024
Global Market Outlook
Midyear Update

Nikolaj Schmidt
Chief Global Economist

Ken Orchard
Head of International Fixed Income

Peter Bates, CFA
Portfolio Manager, Global Equities

Tim Murray, CFA
Capital Markets Strategist, Multi-Asset Division

All eyes on central banks

We are pleased to share our outlook for global economies and markets for the second half of 2024.

In the six months since we published our 2024 Global Market Outlook, the market environment has changed in many ways. Consensus expectations for central bank policy, in particular, are markedly different. Prices of interest rate futures reflect expectations for far fewer interest rate cuts from global central banks than seemed likely in December 2023. Equity and fixed income markets are readjusting accordingly.

The European Central Bank (ECB) kicked off the cycle of lowering rates by the major developed market central banks at its June policy meeting. But the path and magnitude of easing by the world's rate setters for the rest of the year is far from certain. This outlook details the factors shaping that path for the Federal Reserve (Fed) and other key central banks.

For the global economy, we anticipate broadening growth. While the U.S. remains strong, leading indicators elsewhere suggest that the narrative of U.S. economic exceptionalism may abate.

What does this backdrop mean for markets and asset classes? We expect a broadening in U.S. equity market performance and see attractive value in some international stock markets. Investors seeking to move out of cash may find attractive opportunities in shorter-term bonds, as well as equities.

Most importantly, we believe the ongoing transition from the low rates that prevailed after the 2008–2009 financial crisis to an environment characterized by structurally higher interest rates will present favorable conditions for active managers to outperform.

Broadening global growth, resurgent inflation define outlook

Six months ago, the consensus outlook for the global economy in late 2024 featured steadily falling inflation amid a slide toward recession that would trigger aggressive central bank rate cuts. The best outcome would be a "soft landing" slowdown that dodged a recession thanks to central bank action. Investor hopes for this scenario led to simultaneous rallies in equities, high-quality government bonds, and bonds with credit risk.

What a difference a few months make: Consensus now expects continued expansion, resurgent inflation pressures, and limited easing from central banks. We're not quite as sanguine on growth as this "no landing" scenario, but it looks like recession is off the table for at least the next six months.

Broadening of global growth

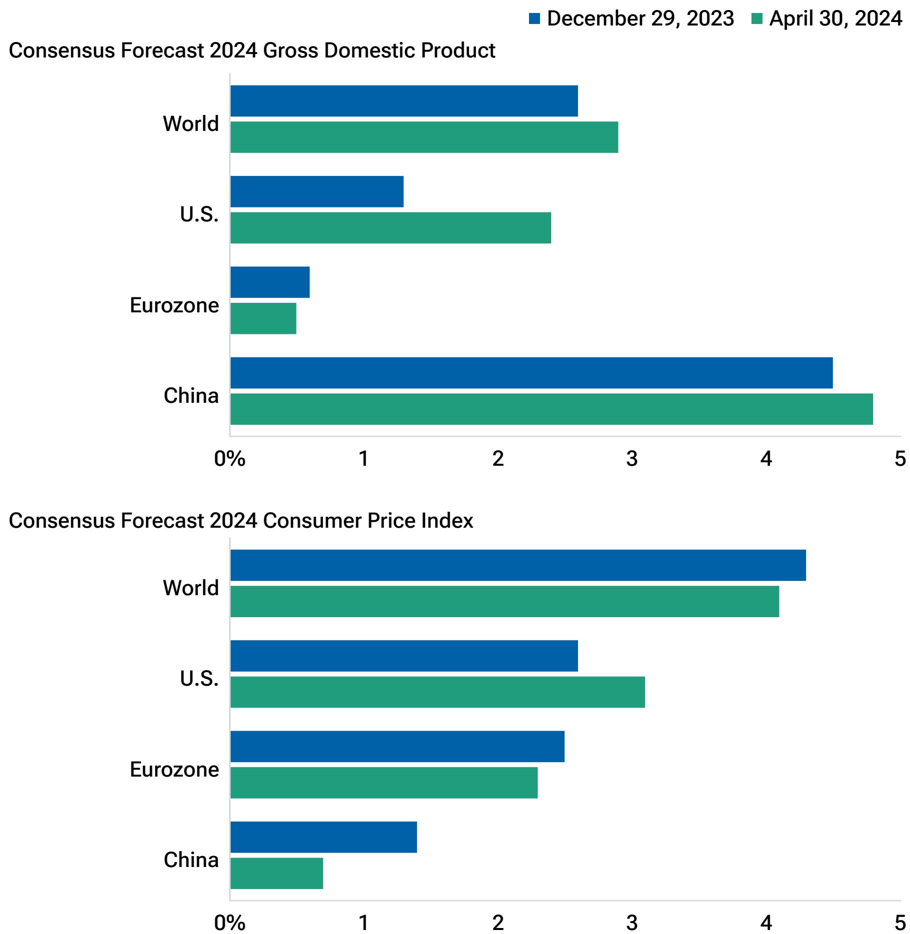
The consensus also still involves U.S. exceptionalism, with U.S. expansion easily outpacing anemic growth in other developed markets. But U.S. first-quarter growth disappointed. With leading indicators in the eurozone moving smartly higher, we could easily see an overall broadening of global growth, undercutting the U.S. exceptionalism narrative.

> "...recession is off the table for at least the next six months."

Nikolaj Schmidt
Chief Global Economist

More growth, more U.S. inflation

(Fig. 1) How consensus forecasts have shifted since the end of last year



As of April 30, 2024.
Source: Bloomberg Finance L.P.
There is no guarantee that any forecasts made will come to pass.
The consensus forecasts are for full-year 2024 GDP and CPI figures, taken at the end of December and the end of April, respectively.

The European Central Bank at its June meeting became the first major developed market central bank to cut interest rates. The Bank of England (BoE) looks poised to be the next to ease ahead of the UK general election on July 4, followed by the Federal Reserve. Because of the weaker starting point for the eurozone economy, we think the ECB will cut the most in 2024, with sticky inflation keeping the Fed to only one or possibly two rate reductions of 25 basis points each.

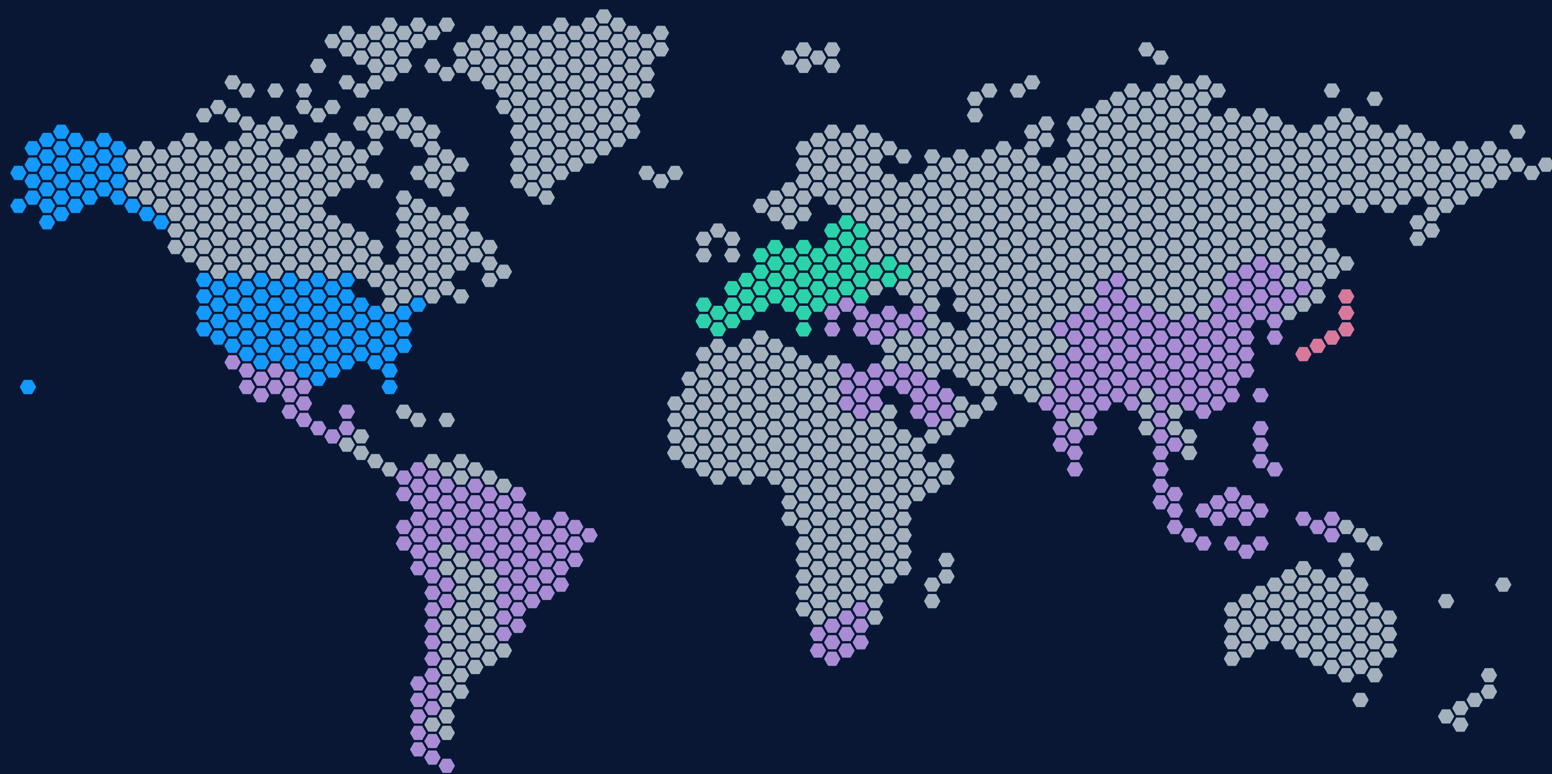
Which way for monetary policy in 2025?

The overarching question is: Where will this bring monetary policy in 2025? Even modest rate cuts this year could easily lead to reaccelerating growth—and inflation that would force the Fed to raise rates next year, with other major central banks following close behind. This could mean that central banks will be tightening policy as the labor market weakens going into the next recession.

In this unusual scenario, we would expect more divergence in returns as investors sort through the implications for sectors and individual securities. Active portfolio management, with a focus on fundamental analysis and relative value, would be vital in this environment.

Global macro and monetary policy guide 2024

As of May 31, 2024.



	U.S.	Eurozone	Emerging Markets	China	Japan
Growth	Outperformance of the U.S. economy versus developed markets to taper.	Economy faces medium-term challenges from tighter fiscal impulse.	Improving global picture is expected to support emerging markets (EM) economic growth.	Policy is modestly supportive, constrained by subdued credit impulse.	Growth expected to pick up, driven by increases in real (inflation-adjusted) incomes.
Inflation	Inflation unlikely to fall to target, with services proving sticky.	Inflation should gradually come down to target, with the risk being services.	After a rapid fall, the disinflation trend is starting to meet some resistance in EM.	Difficult to see much upward inflationary pressure without a credit cycle.	Core inflation expected to remain well below target, with yen posing upside risks.
Monetary policy	Maximum two cuts this year; resilient data to keep rates higher for longer.	ECB became first major developed market central bank to start cutting rates in June.	EM central banks to slow cuts due to currency weakness concerns.	Incremental easing to continue through balance sheet instead of rate cutting.	Window to deliver further hikes is narrowing amid weakening inflation momentum.

For illustrative purposes only. Actual future occurrences may differ, perhaps significantly, from expectations.

Murky environment to challenge Fed policymakers

Investors have steadily ratcheted back their expectations for Federal Reserve rate cuts in 2024. In most previous economic cycles, the Fed has been the first to ease, but the ECB was the first mover this time. We still see a slight possibility of a Fed cut this summer followed by the central bank cutting 25 basis points at its December policy meeting, after the November elections are out of the way.

Fed policymakers seem eager to implement an "insurance cut" or two in 2024 to preempt a slowdown—assuming that inflation moderates. The Fed believes that monetary policy is tight, so it would only take modest softening in the labor market to convince the central bank to cut.

The Fed wants to avoid any sign that it is influenced or motivated by politics, so will not act at the September or November Federal Open Market Committee (FOMC) meetings. In fact, a July rate reduction might be earlier than the Fed would act if it were not an election year.

Elevated potential for Fed surprises

The potential for surprises from the Fed is much greater than in a typical late-business-cycle environment. There's an increasing chance that a lack of progress on getting annual core inflation to 2% will prompt the Fed to keep rates steady for an extended period. Stepping back for a broader view, we are more likely to see the Fed surprise with fewer cuts than with more. Preempting the question on whether it is possible that resurgent inflation could prompt the Fed to raise rates later this year, we place less than 20% odds on that outcome.

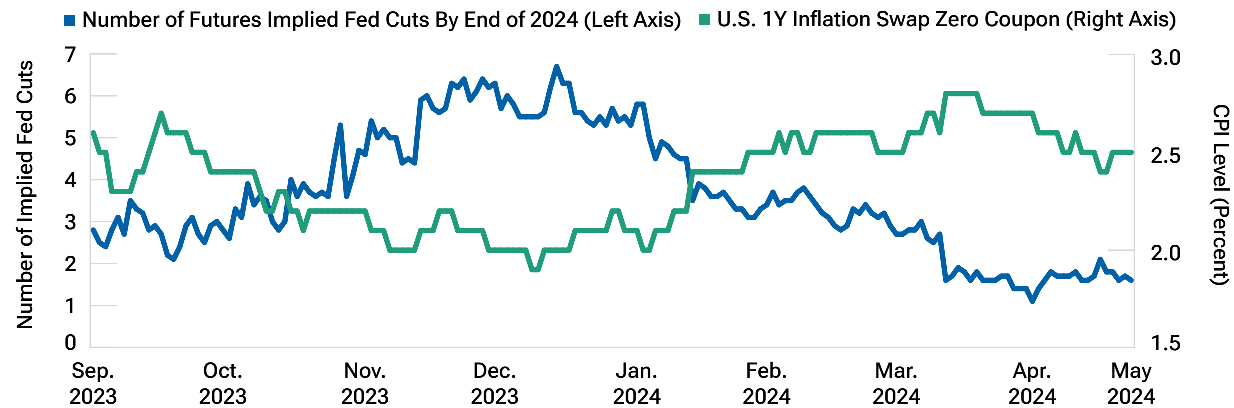
The outlook for Fed easing in 2025 is even murkier. Two to three cuts in 2025 are priced in now, which appears too dovish. One or two rate reductions next year seems more realistic. And there is a risk that "insurance cuts" by the Fed could allow inflation to fester and raise the chances of the Fed moving back to a hiking bias in 2025.

Key takeaway

The Fed is more likely to surprise with fewer cuts than with more.

Rate cut expectations have fallen steadily in 2024

(Fig. 2) Rising inflation concerns have dampened anticipation of significant easing



As of May 22, 2024.
Source: Bloomberg Finance L.P.
Actual outcomes may differ materially from any expectations made.

ECB and BoE to cut as BoJ remains an outlier

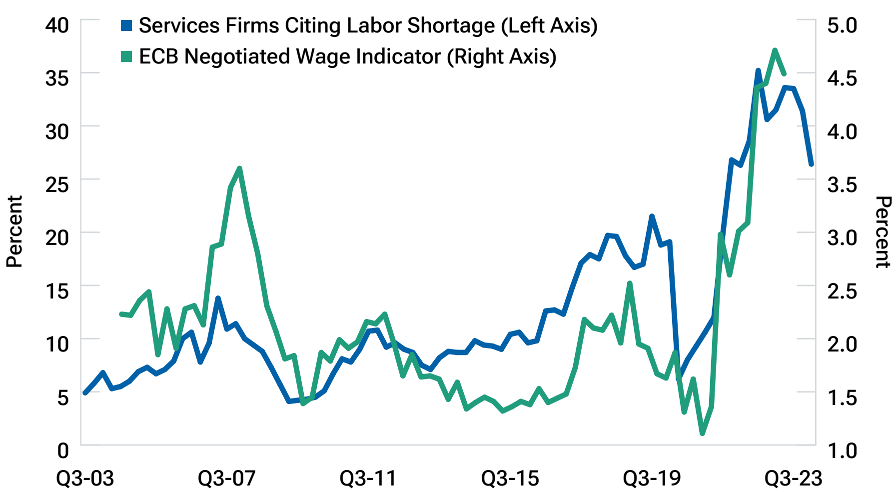
For all developed market central banks (excluding the Bank of Japan (BoJ), which is an outlier), monetary policy is quite tight. They will want to avoid tipping their economies into recession. Consequently, these central banks can cut while preserving a tight monetary policy stance. In fact, they will probably ease proactively if inflation allows—if they wait until economic activity craters before cutting, they will be far behind the curve because it will be a long way back to neutral.[1]

[1] The neutral rate neither stimulates nor restrains economic growth.

Persistent wage growth will make ECB cautious over easing

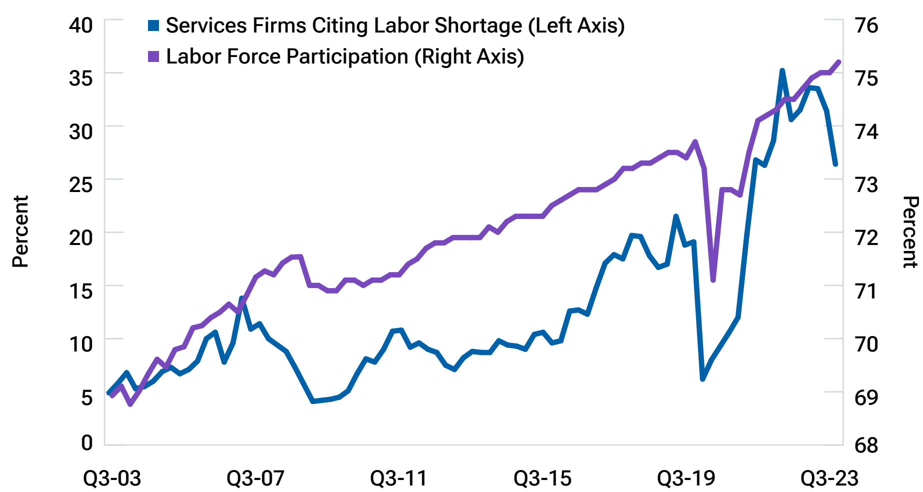
(Fig. 3) The eurozone economy could be susceptible to an abrupt labor market slowdown

Labor Shortage vs. Eurozone Wages



As of May 24, 2024.
Sources: ECB, European Commission.

Eurozone Labor Demand vs. Labor Supply



As of May 24, 2024.
Sources: European Commission, Eurostat.

Fears of labor market cracks lead ECB to act

Eurozone inflation has fallen to the extent that the ECB was able to cut rates in June. ECB policymakers think that eurozone employers have been hoarding labor over the past 12 months. This makes the region's economy susceptible to an abrupt labor market downturn if corporate profit margins come under pressure amid softer final demand.

The big questions are: When will the ECB ease after June, and how large will the cuts be? The number of expected cuts has been steadily dropping, but we believe the ECB will likely cut twice before the end of 2024—however, it could be as few as once or as many as three times.

BoE likely to follow in the third quarter

There have been hopes that the BoE would follow fast on the heels of the ECB by cutting rates later in June, but we believe it may be a little later than that. With tentative signs that the UK economy is recovering, the BoE may not feel it needs to rush in cutting rates and is likely to wait until the autumn before doing so.

Gradual tightening from the BoJ

Japan has also struggled with inflation—but the lack of it rather than prices rising too quickly. After finally moving away from its subzero rates policy earlier in 2024, we expect the BoJ to continue gradually tightening while sounding dovish enough that the market doesn't undo its work in boosting inflation. By tightening policy, the BoJ would also support the yen, which has plumbed multi-decade lows against other major currencies in 2024.

> "The BoE may not feel it needs to rush in cutting rates...."

Ken Orchard
Head of International Fixed Income

Central bank decisions to watch

June 6
ECB became the first major developed market central bank to cut rates

June 12
Fed likely to stay put at FOMC meeting

June 14
BoJ could continue to tighten policy

July 31
Fed could make its first rate cut

September 18
With the U.S. presidential election on the horizon, Fed policymakers likely hesitant to cut

September 19
Possible first cut from the BoE

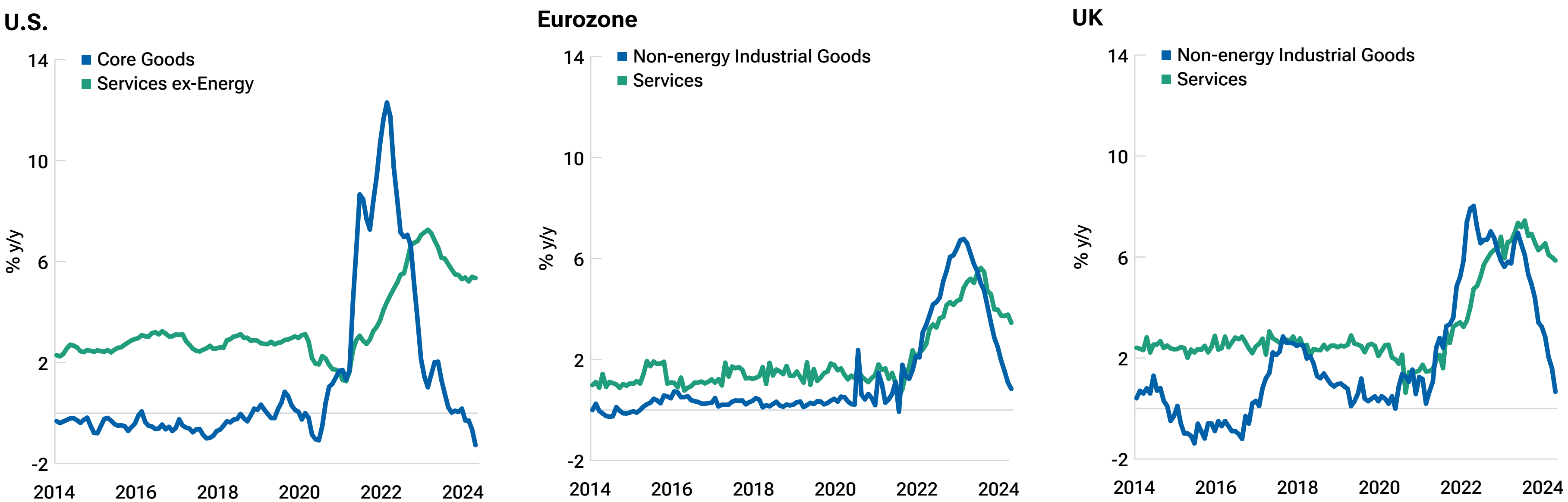
November 7
Two days after presidential election, Fed likely to hold rates steady

December 18
Look for the Fed to lower rates

Reaccelerating inflation to make central banks walk tightrope

Developed market services inflation is proving sticky

(Fig. 4) Goods inflation is falling much faster



As of April 30, 2024.
y/y=year-over-year.
Source: U.S. Bureau of Labor Statistics, EU Statistical Office of European Communities, UK Office for National Statistics/Haver Analytics.

Inflation is notoriously difficult to predict, and it has continued to baffle most forecasters since the onset of the pandemic in 2020. However, it's becoming clear that inflation isn't going away, and we see a meaningful risk that it will reaccelerate as U.S. exceptionalism moderates and global growth broadens.

Several factors drive risk of reaccelerating inflation

The big decrease in global inflation from 2022 to 2023 was due to goods disinflation, which is the easy part of taming inflation. Now services inflation, which is sticky, needs to fall. But for this to happen, the labor market must have space to adjust—wage pressures drive services inflation, and higher unemployment is required to control wage pressures. Artificial intelligence (AI) is one countervailing force that could help tame services sector wage growth, but AI will take time (and expense) to implement, making it a longer-term factor.

Fiscal spending in an election year will also put upward pressure on inflation, and energy prices—which have been a headline inflation tailwind since surging in 2022 following Russia's invasion of Ukraine—are a wild card that could easily spike again if conflict in the Middle East escalates or other geopolitical hot spots erupt.

These factors would, of course, make central banks' difficult balancing act between supporting growth and restraining inflation that much harder.

Because we see renewed upward pressure on inflation, investors may benefit from exposure to real assets such as commodities—including gold and silver—and real estate or to inflation protected government bonds. Real assets tend to hold up well in inflationary environments, while inflation-protected government debt has principal and interest payments that adjust based on inflation data.

Key takeaway

The big decrease in global inflation from 2022 to 2023 was due to goods disinflation, which is the easy part of taming inflation. Now services inflation, which is sticky, needs to fall.

U.S. stocks face a broadening, not a rotation

In recent years, the U.S. stock market has been dominated by the "Magnificent Seven" technology stocks, but there are signs this once-monolithic group of large-cap growth firms is beginning to fragment. The outperformance of the Magnificent Seven propelled the S&P 500 to new highs earlier this year and resulted in the index becoming concentrated to an unprecedented degree.

Performance within the group is now diverging, however— as of late May, NVIDIA, Meta, Microsoft, and Amazon have continued to outpace the market, while Apple, Alphabet, and Tesla have begun to lag. As the benefits of AI technology are unlikely to be evenly spread among the members of the Magnificent Seven, further dispersion within the group can be expected.

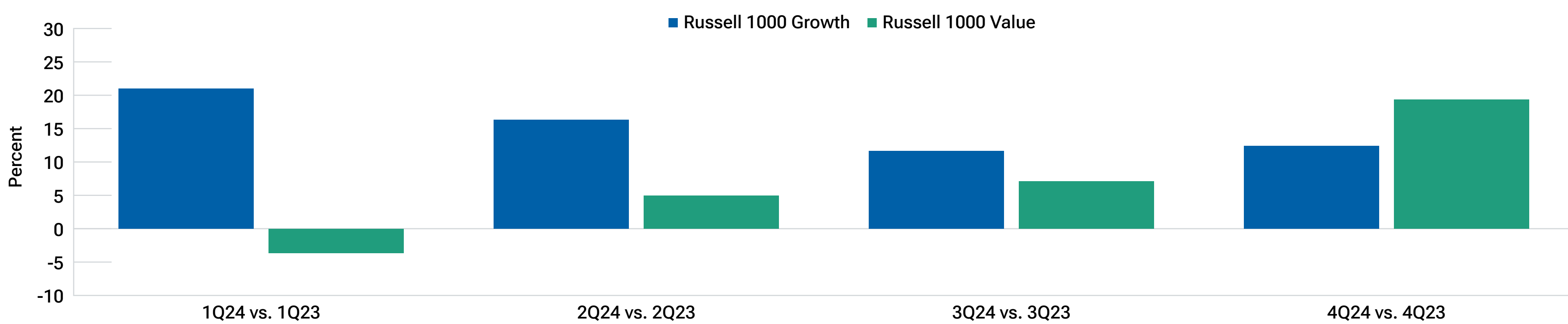
Fewer cuts should favor value stocks

Meanwhile, value stocks could be primed for a comeback as investors seek to diversify their exposure beyond the Magnificent Seven, particularly given growing expectations that the higher rate environment will persist. If the Fed only makes a few cuts or does not cut at all, value companies should benefit as they have tended to be more rate-sensitive and have typically fared better in a world where interest rates

Past performance is not a reliable indicator of future performance and is subject to change.

Value stocks look poised for earnings resurgence

(Fig. 5) Estimated earnings per share of value stocks set to outstrip growth stocks later this year



As of May 13, 2024.
Source: FTSE Russell (see Additional Disclosures).
Actual outcomes may differ materially from estimates.
Each time period shows the estimated year-over-year change in quarterly earnings for growth and value stocks for each quarter this year.

remained higher for longer. And while value stocks have begun to perform better in recent months, they continue to trade at a significant discount to growth stocks. If conditions continue to favor value stocks—as we believe they will—the dominance of growth stocks may start to fade.

Small-cap stocks are trading at a major discount to larger companies after struggling for several years against high inflation and a steep rise in borrowing costs. While the persistence of a higher rate environment could limit the upside of small-cap stocks, the earnings of smaller firms should improve if rates come down.

A widening opportunity set

Although we believe that value—and possibly small-cap—stocks may begin to challenge the dominance of large-cap growth stocks, it is important to stress the difference between a broadening of the market's opportunity set and a rotation between market styles, sectors, or capitalization. We are not predicting the imminent demise of the Magnificent Seven—rather, we anticipate a continued broadening of opportunities to include more companies and sectors across the market that may have lagged in recent years.

"...we anticipate a continued broadening of opportunities to include more companies and sectors across the market that may have lagged in recent years."

Peter Bates, CFA
Portfolio Manager,
Global Equities

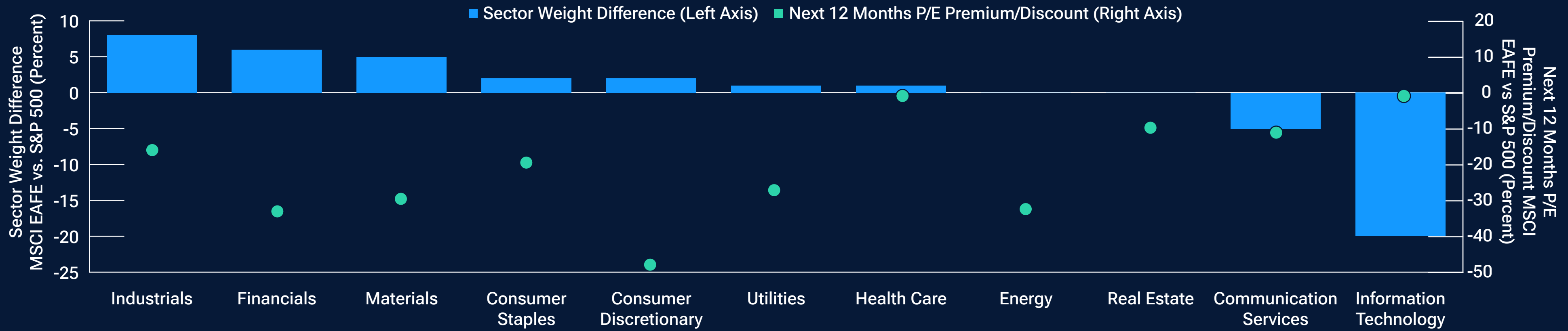
International stocks still appear to be good value

Fueled by the outperformance of growth technology stocks, U.S. equities reached all-time highs earlier this year, pushing their premium versus international (i.e., non-U.S.) stocks to 20-year wide levels. International stocks remain favorably valued but are fundamentally more attractive in the post-COVID environment, as demonstrated by improved earnings growth in recent years. This is because, in contrast to the U.S. market's heavy exposure to growth stocks, the international market is more exposed to value-oriented sectors such as financials, materials, industrials, and energy, where we see secular support in the years ahead. The S&P 500 Index, for example, has a very different sector composition from the MSCI EAFE Index.

Supply chain diversification, infrastructure rebuild, defense spending, and the likelihood of higher energy prices should favor traditional value sectors as capital spending accelerates. As these sectors are currently cheaper and, in some cases, have a lower earnings bar than their U.S. counterparts, investors seeking diversification from large-cap tech growth stocks may seek to increase their exposure to select international markets.

The MSCI EAFE Index is not an ex-U.S. S&P 500 Index

(Fig. 6) Sector weightings and valuations contrast sharply between the two indices



As of April 30, 2024.
Source: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved. Please see Additional Disclosures page for more information about this Standard & Poor's information.
These statistics are not a projection of future results. Actual results may vary.
P/E= price-to-earnings.

Improving corporate governance is driving Japanese stock performance

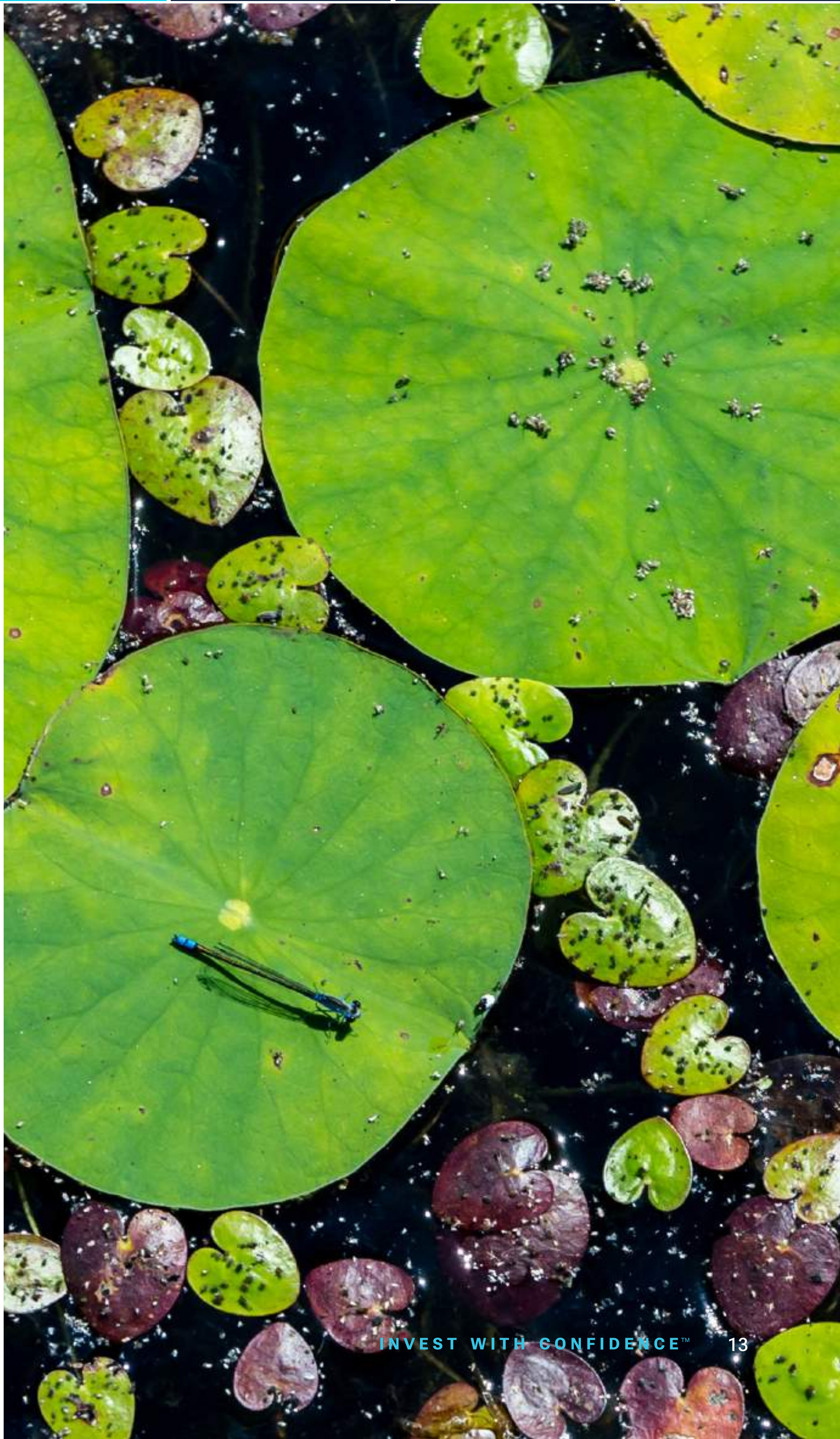
Of the international markets, we continue to favor Japan. Improved corporate governance standards continue to have a tangible—and considerable—impact on company performance. Shareholders are now a much higher priority in Japan than they were in the past. While the BoJ recently ended its negative interest rate policy, it is not expected to embark on a hiking cycle that brings Japanese rates in line with those of other developed markets. This should keep the yen relatively weak and Japanese exports competitive. Valuations are reasonably attractive, too—although the Nikkei 225 has climbed to within reach of its record high, Japanese stocks continue to trade at a low price-to-book value. However, investors outside of Japan will need to consider how yen weakness relative to other currencies will impact the value of their returns.

South Korea and Vietnam the pick of emerging economies

South Korea has sought to emulate Japan's success in boosting stock valuations with a corporate governance drive. Tax incentives have been offered to businesses that prioritize shareholder returns, while the new "Korea Value-up Index" will list firms that have improved capital efficiency. Vietnamese stocks also appear cheap despite a cyclical recovery, an expanding consumer economy, and a looming upgrade to emerging market status. With corporations seeking to diversify their supply chains beyond China, Vietnam appears well placed to attract manufacturing capacity.

Key takeaway

Of the international equity markets, we continue to favor Japan, South Korea, and Vietnam.



Investors moving out of cash may favor equities and short duration bonds

A vast amount of money is hanging over U.S. financial markets in money market funds and other short-term liquid instruments. Evidence from past economic cycles suggests that this strong liquidity preference will ease at some point, especially if the U.S. avoids a deep recession.

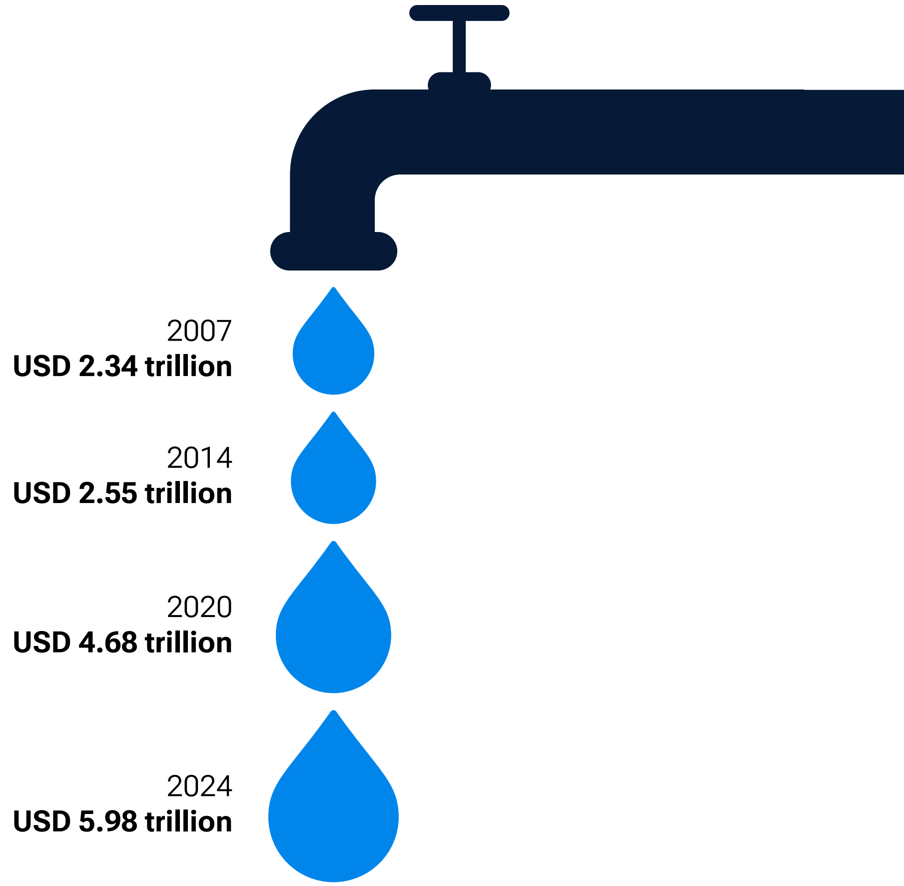
As concerns over a hard landing for the U.S. economy have receded, focus has shifted from recession risk to inflation risk. This will impact where investors seek to allocate their money. Historically, bonds—particularly longer-dated bonds—have been an excellent hedge against recession but a poor hedge against inflation. During rare periods when inflation has turned negative due to sharp economic downturns, bonds have outperformed stocks.

“Evidence from past economic cycles suggests that this strong liquidity preference will ease at some point, especially if the U.S. avoids a deep recession.”

Tim Murray, CFA
Capital Markets Strategist,
Multi-Asset Division

U.S. investors are flush with liquidity

(Fig. 7) Money market fund assets are highly elevated

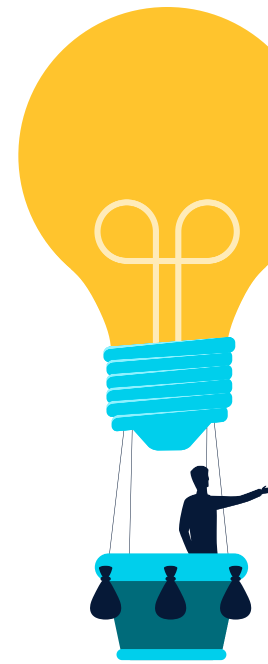


As of April 1, 2024.
Source: Investment Company Institute.

Energy stocks may offer best hedge against inflation

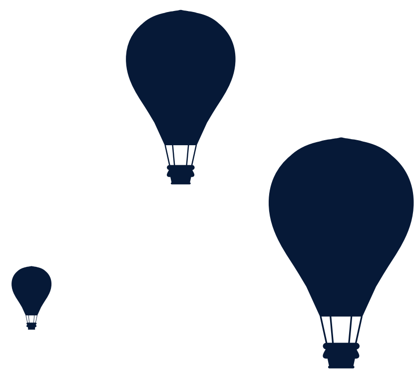
Stocks have tended to perform best during periods of low, moderate, or even slightly elevated inflation. But they have typically dipped sharply during recessions and have also weakened when inflation has moved to very high levels. However, energy sector stocks have historically performed quite well during periods of very high inflation. These patterns suggest that one way to hedge against inflation risk would be to tilt portfolios to stocks, with an emphasis on the energy sector and other commodity-oriented equities.

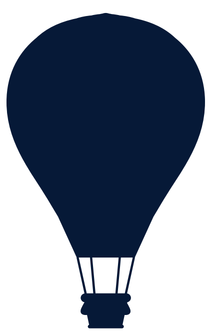
Investors are also likely to turn to shorter-term bonds given attractive yield levels available and the potential for price appreciation if yields move lower. Short-term bonds are highly valued during uncertain periods—such as the present—as they are less exposed to interest rate changes than longer-dated bonds. They also provide the potential for higher returns than cash while being almost as flexible. This flexibility may be useful given uncertain economic and market conditions.



Key takeaway

Commodity-oriented equities may offer an effective hedge against inflation risk.





Shifting market conditions will favor active management

The investment environment is changing. The post-GFC era of low rates and abundant liquidity is being replaced by one of higher rates, greater divergence of returns, and more volatile markets. We believe this period of transition will continue in the second half of 2024 and underpin conditions for active managers to outperform.

Challenging market conditions will require investors to be more valuation-sensitive than in recent times, when a rising tide lifted all boats. Traditional skills, such as identifying stock drivers and idiosyncratic risk, will continue to be essential, but investors will need to take into account wider macroeconomic, social, and geopolitical factors along with company fundamentals.

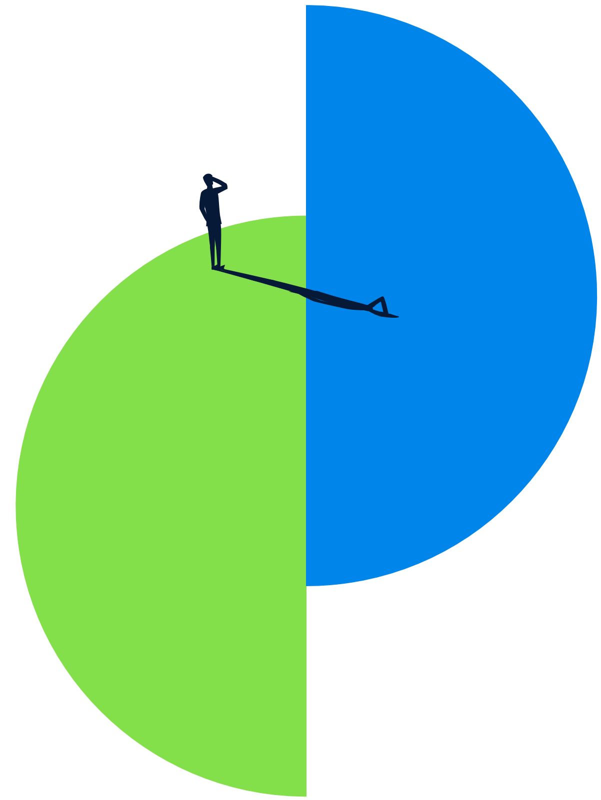
Active managers have performed well following periods of index concentration

Active managers tend to go beyond benchmarks and into factors that can be cyclical, such as small-cap and value stocks—both of which we believe may perform well in the period ahead. Top performing active managers have also historically performed well following periods of heavy index concentration—and markets recently have been concentrated to an unprecedented degree.[2] Although it is difficult to predict when the current period of index concentration will recede meaningfully, there are already signs that the dominance of the Magnificent Seven is beginning to fade.

The end of the period of very low rates will also, we believe, lead to greater dispersion and heightened volatility in bond markets. Active investing can help with duration management, as well as managing country selection, curve positioning, and security selection.

These developments do not mean we expect passive investing to undergo a major retreat. However, we believe that active management will be the better option for the period ahead, as it can offer better outcomes during periods of greater volatility and dispersion.

[2] Based on eVestment U.S. large-cap manager performance and S&P 500 Index concentration analyzed from September 30, 1989 to December 31, 2023. **Past performance is not a reliable indicator of future performance.** As of April 30, 2024, the S&P 500 Index and Russell 1000 Growth Index both registered their highest levels of concentration in 20 years, as measured by the combined weighting of the 10 largest stocks in each index.



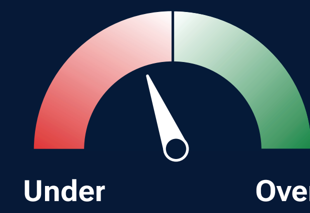
Key takeaway

We believe the likelihood of continued asset price dispersion and heightened volatility will suit active management strategies.

2024 tactical allocation views

As of May 31, 2024.

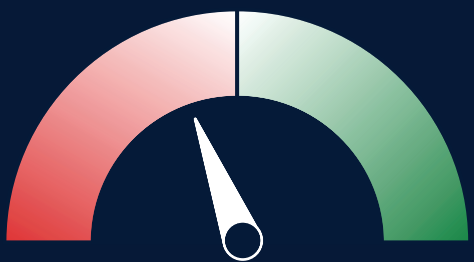
Weighting Guide



T. Rowe Price multi-asset positioning—asset class

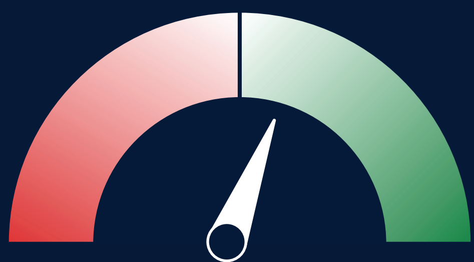
Equities

Earnings continue to strengthen, but face elevated expectations. Potential for broader market participation as economic growth improves, commodity prices increase, and consumer spending remains resilient.



Bonds

Yields remain attractive but volatility could persist due to global divergence in growth, inflation, and central bank expectations. Credit fundamentals remain supportive; however, spreads remain tight.



Cash

Continues to offer attractive yields as the yield curve remains inverted, and continues to offer liquidity should market opportunities arise.

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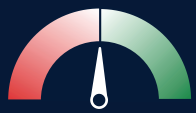
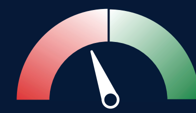
T. Rowe Price multi-asset positioning—equities



U.S.

Earnings expectations improving. Economic activity resilient. Valuations may limit upside.

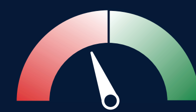


U.S. Growth vs. Value[1]

Improving economic outlook and broadening of equity market performance could be supportive for value.

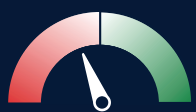
Global ex-U.S.

Valuations attractive on a relative basis. European equity outlook improving. Chinese growth appears to have stabilized.



Global ex-U.S. Growth vs. Value[1]

Value stocks cheap and could benefit if recession concerns fade. Growth stocks challenged by consumer weakness in China and Europe.

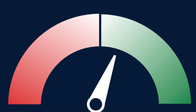


Europe

Inflation had been steadily declining but is showing signs of bottoming. Economic growth remains weak.

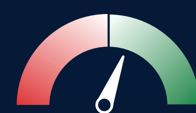
U.S. Small- vs. Large-Cap[1]

Small-caps offer attractive relative valuations but are challenged by higher-for-longer interest rates.



Japan

Economy welcomes inflation after decades fighting deflation. Corporate governance continues to gradually improve.

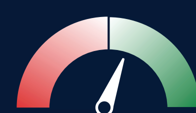


Global ex-U.S. Small- vs. Large-Cap[1]

Small-caps offer very reasonable valuations against a muted global growth profile. Could benefit from improvement in economic growth.

Emerging Markets

Valuations attractive. Monetary policy easing could provide support. Chinese equities finding some footing, but structurally challenged.

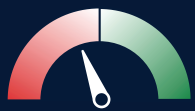


Real Assets Equities

Commodity-related equities are cheap and offer an attractive hedge to stickier inflation.

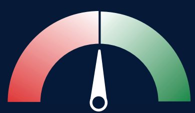
[1] For pairwise decisions in style & market capitalization, positioning pointed represents positioning in the first mentioned asset class relative to the second asset class.
This material is not intended to be investment advice or a recommendation to take any particular investment action.

T. Rowe Price multi-asset positioning—bonds



U.S. Investment Grade (IG)

Yields broadly attractive. Credit fundamentals and technical backdrop supportive. But yields have upside risk and credit spreads[1] are tight.



Developed ex-U.S.IG (Hedged)

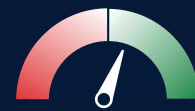
Global central banks cautiously eyeing rate cuts. Yields look attractive on a USD-hedged basis.

U.S. Treasury Long

Longer term yields biased higher due to increased supply, resilient growth, and stickier inflation.

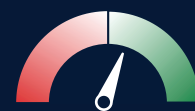
Inflation Linked

Sector offers a hedge should inflation settle at, or move higher, than current levels.



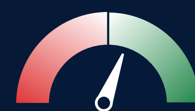
Global High Yield

Attractive absolute yield levels supportive, but tight spreads may reflect a too optimistic backdrop.



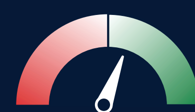
Floating Rate Loans

Yields could remain elevated on less aggressive Fed cut expectations. Spreads attractive, although default rates expected to rise.



EM Dollar Sovereigns

Yields modestly attractive. Central banks easing cycles and moderating inflation may benefit EM bonds.



EM Local Currency

Central bank easing and lower inflation could be tailwinds, but a higher-for-longer Fed could sustain dollar strength.

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The asset classes across the equity and fixed income markets shown are represented in our Multi-Asset portfolios. Certain style & market capitalization asset classes are represented as pairwise decisions as part of our tactical asset allocation framework.
[1] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

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Allspring

JUNE 2024

Macro Matters Special Edition

Midyear Outlook 2024

Stay on track with the Midyear Outlook

As we reach the middle of 2024, where do our experts think you should focus portfolios given shifting rate expectations, sticky inflation, and global uncertainties? Allspring shares our insight on how to focus on quality equities and "ride the curve" in fixed income portfolios to pursue attractive income and the best client outcomes. ***Follow the insight*** to find out more.

Key takeaways for the second half of 2024

01

While U.S. and international growth should slow, the slowdown will be faster internationally. International markets are likely to progress more quickly toward inflation targets.

02

Fixed income investors should expect further progress toward interest rate normalization. We suggest considering front-end focus, multi-sector strategies, and a high-quality bias.

03

We believe equity investors should stay focused on quality with volatility ahead. Learn what this means to our investment teams and how they identify quality companies.

Will interest rate divergence drive asset prices?

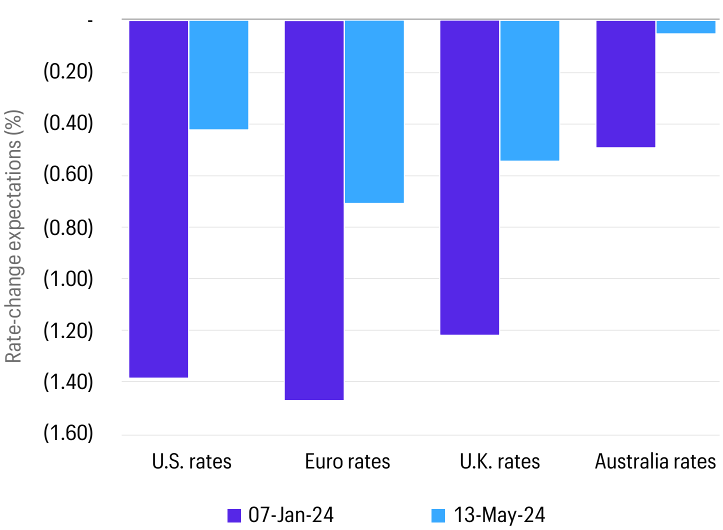
MATTHIAS SCHEIBER, PH.D., CFA

Head of Systematic Multi-Asset,
Systematic Edge

A measured approach by each central bank means cuts in Europe and Asia with the U.S. on hold

When 2024 began, investors expected broad-based rate cuts worldwide given the flurry of weaker global data and central banks' growing comfort with inflation's trajectory. Since then, we've experienced a rather bumpy ride as larger rate cuts became priced out in the U.S. and, to a lesser degree, Europe. Figure 1 shows the overall change in rate-cut expectations since the beginning of 2024.

FIGURE 1: EXPECTATIONS HAVE SHIFTED FOR TOTAL CHANGE IN CENTRAL BANK RATES BY 31-DEC-24



Sources: Allspring and Bloomberg Finance L.P., December 2023 to April 2024

A more cautious Federal Reserve (Fed) approach in 2024's second half seems justified given recent U.S. growth and inflation data, and we anticipate a maximum of two U.S. rate cuts this year. In Europe, we believe the European Central Bank and the Bank of England will begin a series of rate cuts over the summer, as we expect growth will stay low, consumer sentiment will remain weak, and inflation will continue rapidly declining toward the central banks' target levels.

The sticky U.S. inflation rate probably will end 2024 higher than anticipated when the year began. A strong labor market and higher oil prices support higher U.S. inflation, while a stronger U.S. dollar could help offset some of the upward pressure via lower import costs. With the Fed now holding past June, higher interest rates should keep inflation uncertainty low for the rest of 2024.

Internationally, we expect much faster progress toward inflation targets. With headline inflation of about 2.4%, the eurozone is already quite close. The U.K., though, has some work to do with inflation still considerably above the target level of 2%. We expect to see more improvement toward the target soon. China is already undershooting on the prices side, and its consumer price indicators will likely turn negative again this summer. This will lead to monetary policy divergence (differing monetary policies adopted by the world's most systemically important central banks) for 2024's second half.

The first half provided a precursor of what the second half will likely bring. While U.S. and international growth should slow, the speed of adjustment will be much faster in international markets. In the U.S., company earnings, retail sales, and jobs have remained strong, supporting the economy, but tightening financial conditions—partly due to higher real rates and weakening external demand—could lead real U.S. growth to stabilize between 1.5–2.5%. Outside the U.S., weakness will be the trend. Cautious consumers are spending less and saving more. Manufacturing and labor have been weakening. The lack of fiscal and monetary stimuli will keep Europe's real growth rate close to 0%. Regarding China, we've observed that underneath the country's growth data, domestic weakness is being offset by cheap exports.

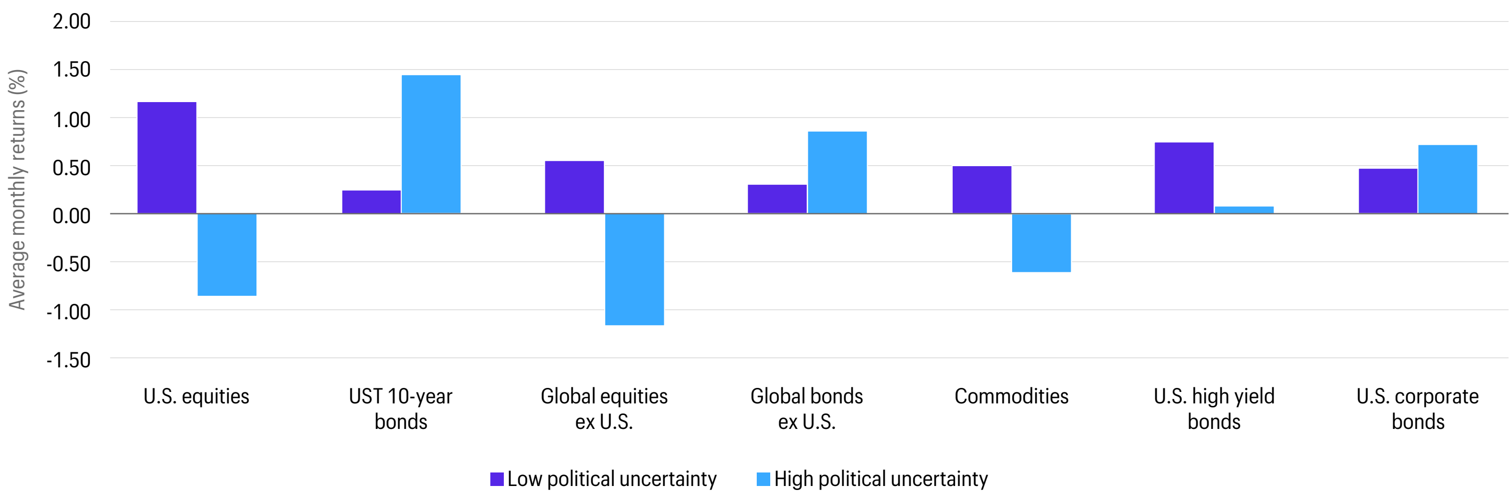
We see two main risks markets face in the second half

While the macro outlook looks conducive for asset prices over the coming months, there's always a risk of uncertainties—unplanned events that might take a meaningful toll on markets. From our perspective, two main concerns in this category are the uncertain impact of November's U.S. elections on markets and the potential for increasing geopolitical risk primarily in the Middle East.

The U.S. presidential election is almost certain to be a pivotal event for markets. Irrespective of the outcome, equities and commodities historically have struggled with higher political uncertainty while higher-quality bonds, like government bonds and corporate bonds, have fared better (Figure 2). This is true for both U.S. and global asset prices as the significance of this U.S. event has the potential to affect global sentiment.

Geopolitical risk in the Middle East rose markedly in the first half of 2024, raising the prospect that Iran could engage militarily with Israel or another country at the same time that Russia continues its war in Ukraine. We expect this risk to remain high throughout 2024—we see no signs that the rising tensions will abate soon. While the potential for any negative impact is highest in commodity markets, it's also possible the Western world could experience higher inflation as a result.

FIGURE 2: WHEN POLITICAL UNCERTAINTY IS HIGH, HIGH-QUALITY BONDS HISTORICALLY HAVE OUTPERFORMED EQUITIES



Sources: Allspring and Bloomberg Finance L.P., December 1989 to March 2024

U.S. equities = Bloomberg U.S. Large Cap Total Return Index
UST 10-year bonds = Bloomberg 10-Year U.S. Treasury Bellwethers Index
Global equities ex U.S. = MSCI World ex USA Index
Global bonds ex U.S. = Bloomberg Global Aggregate Bond ex-U.S. Dollar Total Return Index
Commodities = Bloomberg Commodity Total Return Index
U.S. high yield bonds = Bloomberg U.S. Corporate High Yield Total Return Index
U.S. corporate bonds = Bloomberg U.S. Corporate Bond Total Return Index

In this environment of lower inflation and growth along with political uncertainty, **the outlook for medium-term bonds remains favorable. This environment also should support equities,** especially in markets with lower interest rates and weaker currencies. **However, higher starting valuations warrant an active approach to managing risk**—to move past the U.S.'s "Magnificent 7" into high-quality companies in better-priced areas of the market like small caps, mid caps, and international equities.

Can income *still* drive outcomes?

GEORGE BORY, CFA

Chief Investment Strategist,
Fixed Income

Bond investors can continue managing risk by using the three basic principles we identified at the start of 2024:

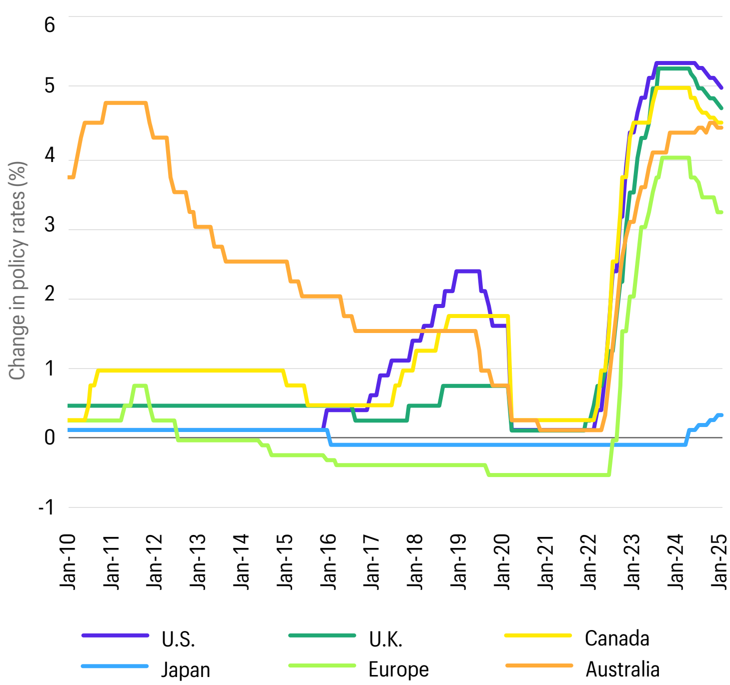
01 Diversify duration. Spread duration across different yield curves in an effort to maximize income and capture return potential.

02 Prioritize flexibility. Diversify across sectors and securities to remain nimble.

03 Be intentional with risk. Use high nominal and real yields to pursue durable, inflation-beating cash flows over multiple years.

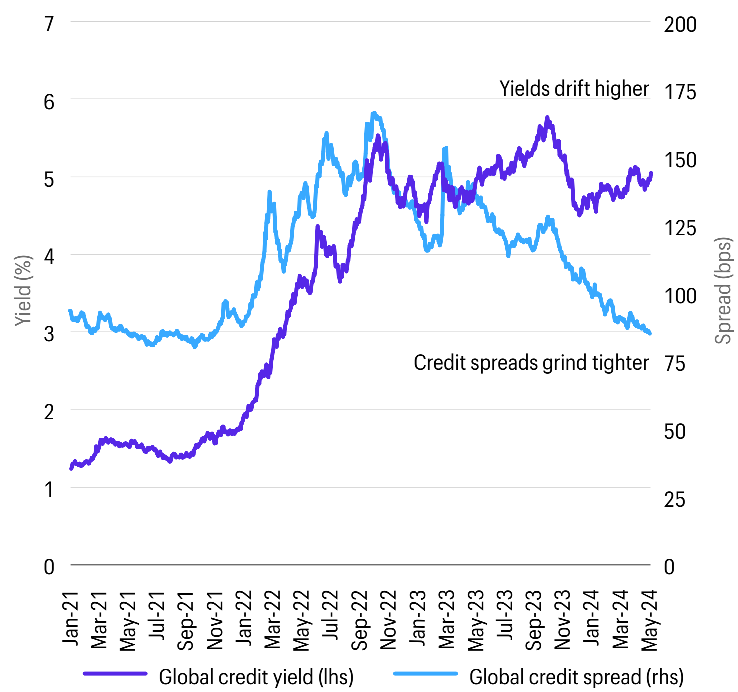
These principles are just as relevant in June as they were six months ago, and they're likely to remain so over the rest of 2024 and into 2025. The global macroeconomic backdrop as of mid-2024 is a mix of diverging front-end interest rates, uneven growth, and sticky inflation across many jurisdictions (Figure 1). Elevated yields and tight credit spreads should persist in these conditions (Figure 2). Big policy shifts in the second half will likely include broader central bank inflation targets and political volatility.

FIGURE 1: CENTRAL BANK POLICY RATES AND FORWARD EXPECTATIONS



Allspring and Bloomberg Finance LP. Each country's policy rate is represented by Bloomberg's pricing. Data is as of 30-May-24.

FIGURE 2: GLOBAL CREDIT: HIGHER YIELDS, TIGHTER SPREADS



Sources: Allspring and Bloomberg Finance L.P. Each sector is part of the Bloomberg Global Aggregate Bond Index. Data is as of 30-May-24.

100 basis points (bps) equal 1.00%.

Fixed income investors should expect further progress in 2024 along the path of interest rate normalization as policymakers worldwide navigate the shifting landscape. Prudently financed public- and private-sector borrowers possess considerable advantages in this environment. Highly indebted entities will face real pressure—or even solvency issues—due to higher borrowing costs and tighter financial conditions. Identifying the winners and losers will be paramount to capture attractive absolute and relative returns in bond portfolios over the coming years.

In this environment, consider the following actions we believe will benefit fixed income portfolios over the coming months:

01 FOCUS ON THE FRONT END

Adding duration at the front end of yield curves will likely steepen and/or "twist" as yield curves normalize in the second half of 2024.

We favor duration in Europe and emerging economies, neutral positioning in the U.S., and underweighting Japan.

Ultrashort and short-duration strategies coupled with a high-income yield advantage should perform for taxable, tax-exempt, and global bond investors.

02 EMPLOY MULTI-SECTOR STRATEGIES

Multi-sector debt strategies that include the *plus* parts of the bond market should allow investors to capture positive *real yield* while also layering in some protection against unexpected bouts of volatility and/or an economic hard landing.

Incremental yield at the front end of yield curves—by going down the rating spectrum, up to and including high yield, coupled with high-quality duration at the long end and structured products and mortgage-backed securities (MBS) in the intermediate part of the curve—provides an attractive blend of *diversified duration*.

03 MAINTAIN A HIGH-QUALITY BIAS

Bond strategies tracking the core of the taxable and tax-exempt bond markets offer a high-quality bias and mid-market duration that should provide stable cash flows and protection against an economic hard landing.

Structured cash flows in asset-backed securities, MBS, and other structured products can help investors diversify cyclical risk that's inherent in single-issuer corporate credit and provide precise risk exposure.

Tax-exempt municipal debt in the U.S. also allows bond investors to move up in quality and de-emphasize cyclical exposure.

Global climate transition strategies could also perform well while pursuing carbon-reduction strategies at the same time.

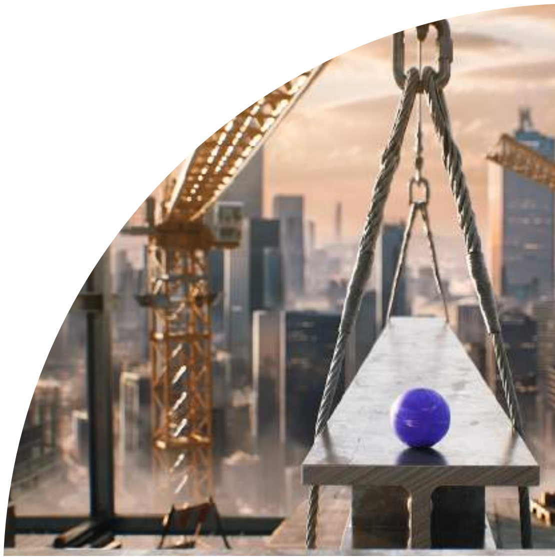
Income can drive desirable outcomes

With nominal yields still close to multidecade highs, bonds have continued to deliver value. Further, breakeven inflation rates imply attractive real yields across several jurisdictions and sectors.

Within sectors, price/yield/spread dispersions across sectors, issuers, and securities remain wide, which we believe should benefit investors who can monetize security selection and reduce dependence on large macro or directional positions.

What are the major risks to this bond-friendly environment? We've identified the following: possible central bank policy errors, U.S. elections in November 2024, and potential military escalations in the Middle East and/or Eastern Europe.

In today's market, most bonds are doing exactly what they're designed to do: generating consistent, predictable cash flows that we believe should beat inflation over time. These cash flows can anchor a well-diversified investment portfolio. Furthermore, the prospect of political upheaval only strengthens the argument. Opportunities to "ride the curve" and capture these investments can be built into a wide array of fixed income portfolios across different maturities, sectors, regions, tax statuses, and currencies.



Are you taking stock of quality and valuations?

ANN MILETTI
Head of Active Equity & Chief Diversity Officer

At the start of 2024, we said investors should consider owning quality stocks given the ongoing paradigm shift of monetary policy and lack of tailwinds supporting lower-quality businesses. So far, the market has largely agreed, and we remain steadfast in supporting this approach for the balance of 2024.

However, let's step outside the shadow of an intangible concept—*quality*—and bring some sunshine in by providing several concrete examples of how quality can be perceived and applied in this industry.

A company's value is based on the cash flow it produces, and the stock market represents investors' expectations for the company's future cash flows. These seem irrefutable, but what an investor *believes* affects these future cash flows has a material impact on how that investor *defines what to look for* in a quality business. The definition may change as investors move through an economic cycle, digest different regional opportunities, or reflect on the characteristics of the specific investable universe(s) in which they've focused their investments.

Importantly, as asset owners, investors should make the effort to learn what different investment teams *specifically mean* when they say they own quality businesses. To illustrate this concept, we've compiled the table below, which shows how three Allspring teams that invest in different equity categories define what a quality business means to their team.

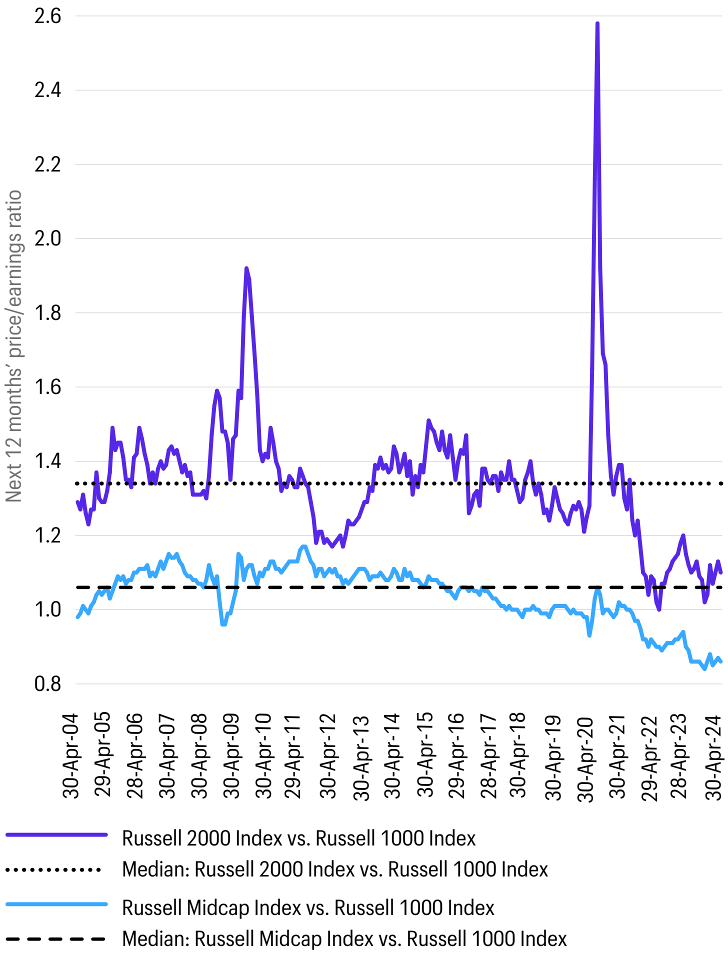
EQUITY TEAM CATEGORY	TEAM'S CRITERIA FOR IDENTIFYING QUALITY	COMPANY EXAMPLES WE BELIEVE ARE HIGH QUALITY*
Global Value	**Company must offer:** • **High visibility of demand** • **Cash flow stability** from limited drawdown risk • **Financial freedom** due to excess balance sheet capacity • **A skilled management team,** especially in capital allocation	Carlisle Companies Inc. AerCap Holdings N.V. Walmart Inc. J&J Snack Foods Corp. Mueller Industries, Inc.
U.S. Growth	**Company must demonstrate:** • **Clear competitive advantages** • **A value proposition** to customers • **A resilient and predictable business model** that's highly cash generative • **A skilled management team** at execution and investing capital	Progressive Corp. Visa, Inc. Chipotle Mexican Grill, Inc. Trade Desk, Inc. Health Equity, Inc.
Emerging Markets	**Company must generate:** • **A *return* on capital that's higher than its *cost* of capital** over an extended period • **Pricing power or scale of production** that drives cost advantages	Taiwan Semiconductor Manufacturing Company Ltd. Li-Ning Company Ltd. Shoprite Holdings Ltd. Fomento Económico Mexicano, S.A.B. de C.V. InPost sp.z o.o

*The securities listed should not be considered a recommendation to purchase or sell any particular security. The securities may or may not be in an Allspring portfolio.

Look for quality and attractive pricing in small and mid caps

Notice that none of the teams' quality criteria mention a business's size, as there's no need to sacrifice quality when moving down in market cap. That's especially beneficial in an environment like today's, where, relative to large caps, small caps and mid caps are undervalued. Their attractive valuations mean investors are being compensated to move down in market cap.

FIGURE 1: U.S. SMALL- & MID-CAP VALUATIONS ARE CURRENTLY ATTRACTIVE RELATIVE TO LARGE CAPS'



Sources: Allspring and Maestro, from April 2004–April 2024. Indexes are unmanaged and cannot be invested in directly. **Past performance is no guarantee of future results.**

While it's challenging to predict when small and mid caps could revert back toward their average longer-term prices, we think the fading exuberance around the large-cap artificial intelligence theme is as good a catalyst as any to point out the current valuation dispersion, as seen in Figure 1.

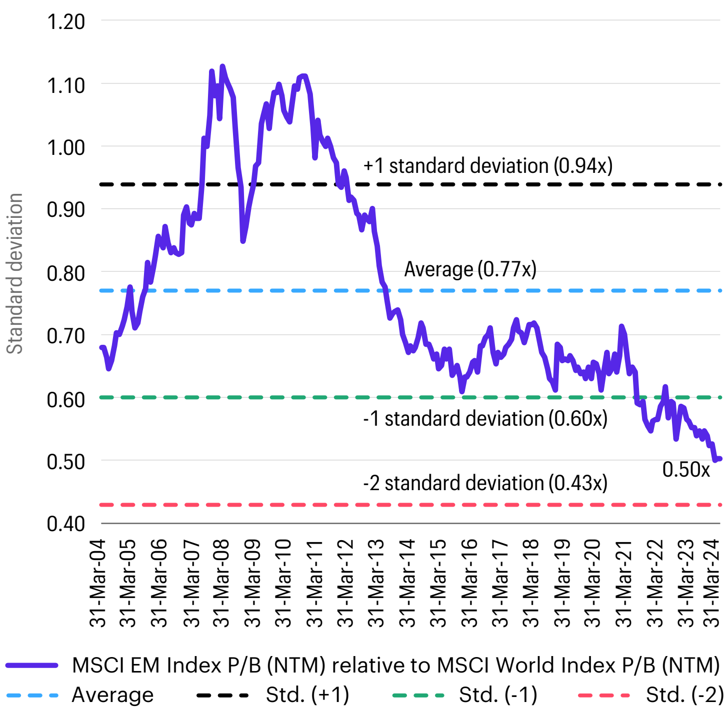
The rewards of deciding to invest more in small- or mid-cap stocks could likely be amplified by choosing active managers who've proven themselves adept at exploiting the inefficiencies of the small-/mid-cap universe. But for over 15 years, many investors have chosen instead to buy broad market exposure through passive indexes. Passive indexes, though, hold the good, the bad, and the ugly—which means significant portions of those purchases were in low-quality stocks.

In a perfect investing world—where all economies regularly fire on all cylinders and central banks consistently pump just the right amount of liquidity into their systems—passive investing could be a winning approach. But we know this isn't the case at all times, and certainly not today.

Emerging markets offer opportunities for discerning investors

Looking outside the U.S., there's an additional level of complexity (and thus opportunity) for investors. The emerging market category has long underperformed developed markets, resulting in some investor fatigue for the category. However, perhaps the tide is beginning to turn—and those who consider investing in emerging markets will see that the category currently is significantly discounted relative to developed markets, as shown in Figure 2. Also, they'll likely find that having to grapple with the geopolitical, economic, currency, and fiscal variables within emerging markets underscores the value a quality investment manager can deliver through constant monitoring and risk management.

FIGURE 2: EMERGING MARKETS ARE CURRENTLY TRADING AT A 50% DISCOUNT TO DEVELOPED MARKETS



Sources: Allspring and FactSet, as of 31-March-24

The P/B ratio (NTM) compares a stock's projected market value with its projected book value 12 months forward from the date of the comparison. It is calculated by dividing the stock's projected closing price by the projected book value per share 12 months forward from the calculation date. Standard deviation is the square root of the sum of squared deviations from the mean. It is often used as a measure of volatility, variability, or risk.

Past performance is no guarantee of future results.

We understand that uncertainty and volatility frequently appear—and critical investment decisions must be made with the goal of maximizing risk-adjusted returns in the face of shifting environments.

This is today's environment. In the U.S., for example, the Federal Reserve has been confronting a lukewarm economy and stubbornly high inflation. Consumers have shown tremendous resilience, but their stamina has been fading. This type of fluctuation is the norm, and it's why active investment managers recognize the need to dig into the fundamentals of each business they're considering. Active managers want to understand where each company resides within their team's definition of quality and how the company may successfully navigate today's environment and the possible shifts ahead.

We believe the back half of 2024 looks ripe for volatility. It's a good idea to stay focused on **quality**—we suggest you ask your investment managers what that word means to them.

Allspring

For further information

We're committed to thoughtful investing, purposeful planning, and the desire to deliver outcomes that expand above and beyond financial gains. Visit our website at www.allspringglobal.com.

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- For retail clients, contact your financial advisor.
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The "Magnificent 7" is a group composed of these seven market-leading, mega-cap stocks in the S&P 500 Index: Nvidia Corp.; Meta Platforms, Inc.; Tesla, Inc.; Amazon.com, Inc.; Alphabet Inc.; Microsoft Corp.; and Apple Inc.

The Bloomberg Global Aggregate Bond Index is a measure of global investment-grade debt performance. This multicurrency benchmark includes Treasury, government-related, corporate, and securitized fixed-rate bonds from both developed and emerging market issuers. You cannot invest directly in an index.

The Bloomberg Commodity Total Return Index is an index that tracks the performance of futures contracts on commodities and adds the returns from investing in U.S. Treasury Bills. You cannot invest directly in an index.

The MSCI World ex USA Index captures large- and mid-cap representation across 22 of 23 developed markets countries—excluding the United States. With 1,022 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. You cannot invest directly in an index.

The Bloomberg U.S. Large Cap Total Return Index is a float market-cap-weighted benchmark of the 500 most highly capitalized U.S. companies. You cannot invest directly in an index.

The Bloomberg Global Aggregate Bond ex-U.S. Dollar Total Return Index is a measure of investment grade debt from 24 local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. You cannot invest directly in an index.

The Bloomberg U.S. Corporate High Yield Total Return Index measures the U.S. dollar-denominated, HY, fixed-rate corporate bond market. You cannot invest directly in an index.

The Bloomberg 10-Year U.S. Treasury Bellwethers Index is a universe of Treasury bonds and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments. You cannot invest directly in an index.

The Bloomberg U.S. Corporate Bond Total Return Index measures the investment grade, fixed-rate, taxable corporate bond market. You cannot invest directly in an index. The MSCI Emerging Markets Investable Market Index (IMI) captures large, mid and small cap representation across 24 Emerging Markets (EM) countries. With 2,669 constituents, the index covers approximately 99% of the free float-adjusted market capitalization in each country. You cannot invest directly in an index.

The MSCI World Index captures large and mid-cap representation across 23 Developed Markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country. You cannot invest directly in an index.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. You cannot invest directly in an index.

The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index. You cannot invest directly in an index.

The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index. You cannot invest directly in an index.

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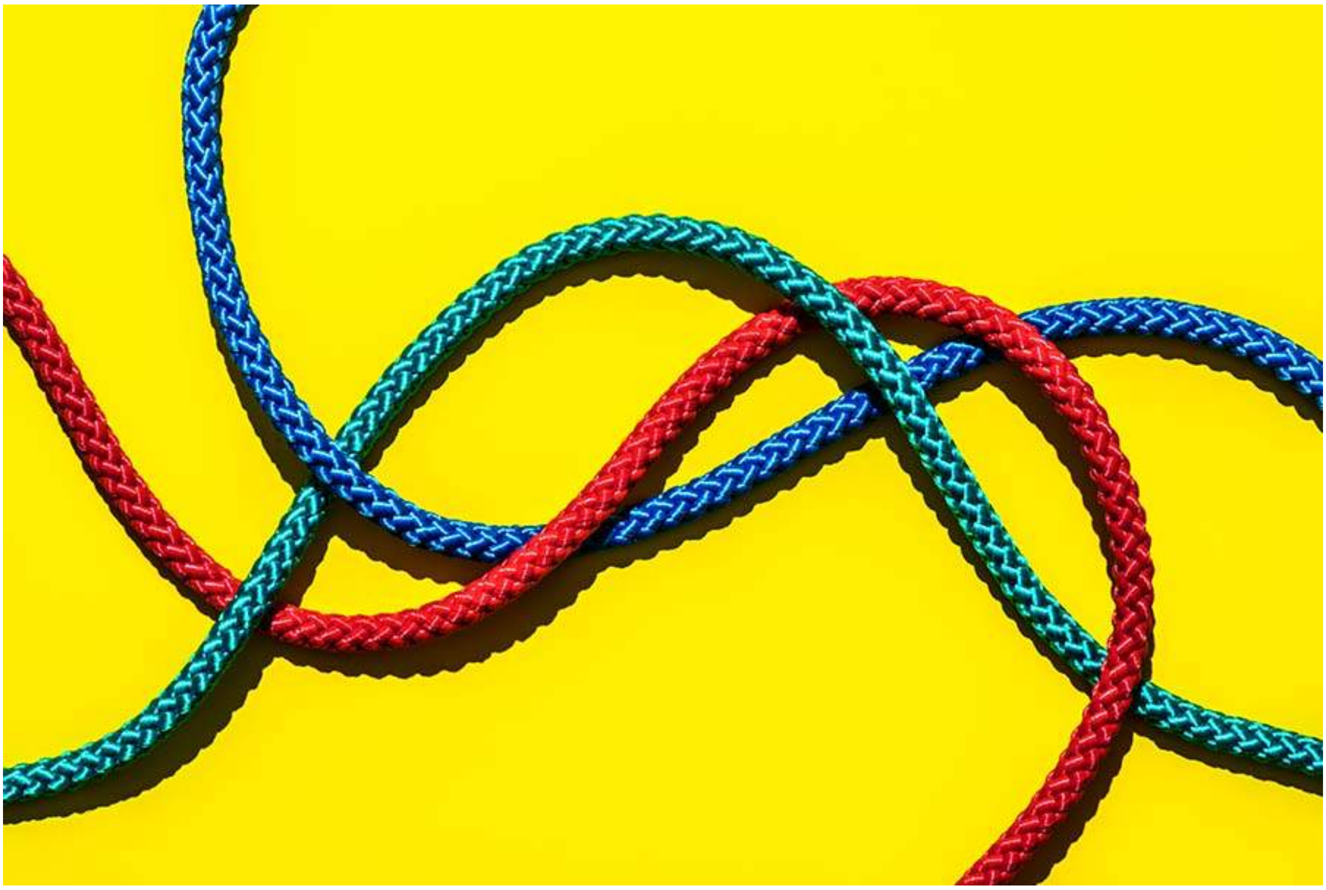
Schwab Market Perspective: Mid-Year Outlook



June 14, 2024 Liz Ann SondersKathy JonesJeffrey KleintopKevin Gordon

As we move into the second half of 2024, economic and market expectations have increasingly diverged. Inflation appears to be moderating, but mixed signals on the strength of the labor market and other economic areas have made it hard for investors to gauge when the Federal Reserve might begin to cut short-term interest rates. Other major central banks are likely to cut their policy rates earlier than the U.S., although we still expect one to two Fed rate cuts this year. We believe inflation will continue to slow, but not in a straight line, potentially driving continued market volatility.

U.S. stocks and economy: Diverging paths

Certain segments of the U.S. economy and stock market have experienced stronger recoveries this year than others, with an increasing number of "bifurcations" developing in the economic data.

For example, after clear decelerations in both services and manufacturing over the past couple of years, services have reaccelerated, as you can see in the chart below. There was hope around manufacturing's recent move back into expansion, but it was short-lived.

Services' reacceleration

Source: Charles Schwab, Bloomberg, ISM (Institute for Supply Management), as of 5/31/2024.

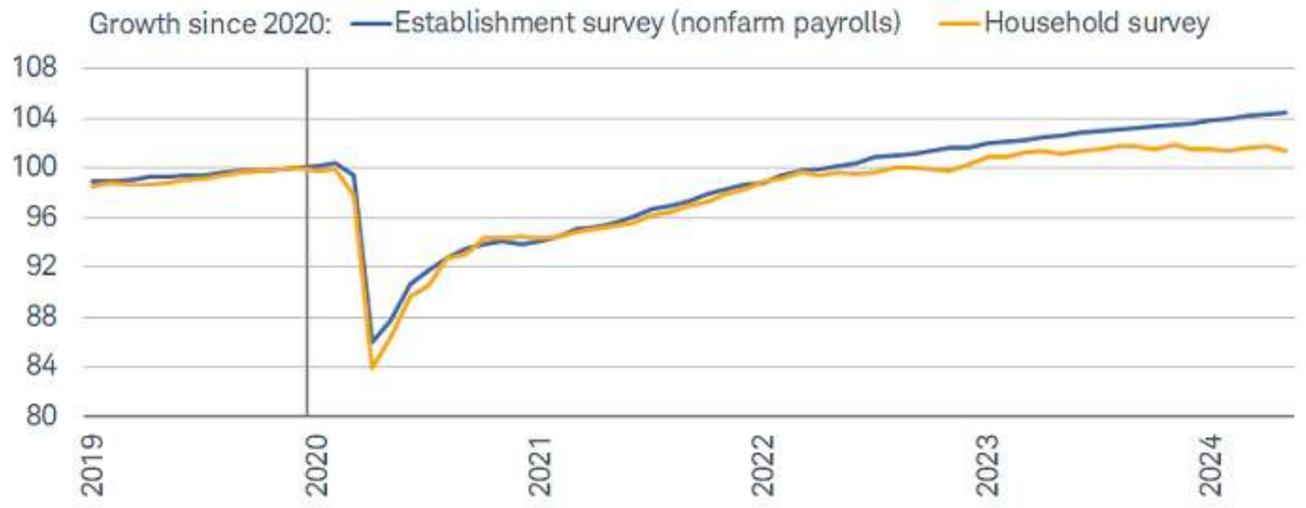
The Manufacturing ISM Report On Business and the Services ISM Report On Business (formerly the Non-

Manufacturing ISM Report On Business) are based on data compiled from purchasing and supply executives nationwide. Readings above 50 indicate expansion in activity and below 50 indicate contractions.

Looking ahead, we expect choppier patterns for both services and manufacturing, with any coming weakness in the labor market showing up more on the services side than on the manufacturing side.

Another example is the widening spread between two monthly surveys published by the Bureau of Labor Statistics (BLS): the establishment and household surveys. The former is derived from the BLS survey of companies’ payrolls—that is, how many jobs have been created or eliminated—and suggests that 6.9 million jobs have been created during the past two years. However, the latter—from which the unemployment rate is calculated—suggests the rate of job growth has been less than half that, at 3.2 million. For what it's worth, the household survey has tended to be more accurate at important turning points in the cycle (in both directions).

Household survey versus payroll survey



Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics, as of 5/31/2024.

Data indexed to 100 (base value = 12/31/2019). An index number is a figure reflecting price or quantity compared with a base value. The base value always has an index number of 100. The index number is then expressed as 100 times the ratio to the base value.

Amid these and other divergences in the data, expectations have fluctuated regarding when the Federal Reserve may begin to cut interest rates. We believe inflation will continue to slow, but with bouts of volatility, leading to jumpy expectations around Fed policy. Absent a swift move down in core inflation (unlikely), the green light for the Fed to begin easing policy likely rests with the labor market (so far only showing minor cracks).

In terms of the stock market, stable Treasury yields should be supportive of the stock market, but a sharper move either higher (driven by an inflation reacceleration) or lower (driven by much weaker economic growth) would likely lead to weaker performance and/or higher volatility. In other words, a "Goldilocks" scenario would continue to be supportive, but the likelihood of that persisting is diminishing.

Given the potential for volatility, we suggest focusing on companies with high-quality attributes, such as strong profit margins, upward revisions to earnings estimates, and high interest coverage ratios. These companies may be better positioned to weather potential ups and downs.

Fixed income: Watching the Fed

We came into 2024 expecting the Federal Reserve to cut its benchmark policy rate, the federal funds rate, three to four times this year, for a cumulative total of 75 to 100 basis points (or 0.75 to 1 percentage point) from its current range of 5.25% to 5.5%. However, given the resilience of the economy, stubbornness of inflation, and guidance from the Fed, we have lowered that to one or two rate cuts of 25 basis points each.

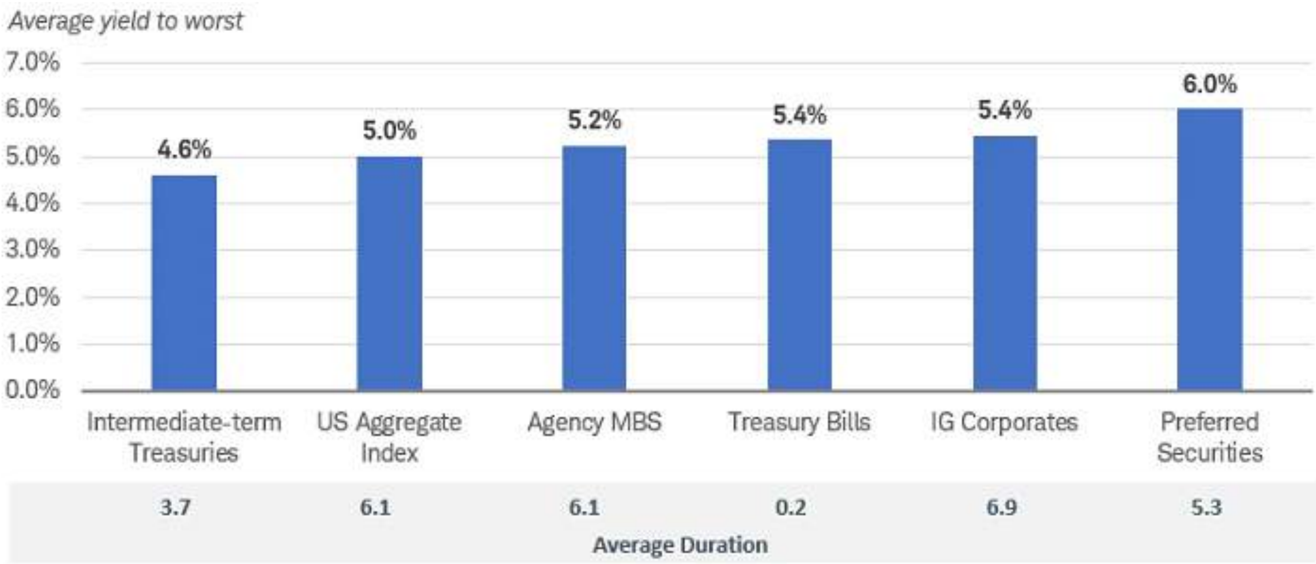
We also expect continued volatility. Even after the Federal Reserve pivots to rate cuts, the reason for the cuts will be important to assessing the magnitude of easing going forward, with inflation and employment data likely to be the key indicators.

For fixed income investors, the prospects of positive returns look good in the second half of 2024. One of the main reasons is that coupon rates—the current income paid on the bond—are at high levels. Higher coupon rates can offset price declines because the total return an investor receives is a combination of the income stream plus or minus the price change. The higher the current income, the less significant the price fluctuation tends to be to the investor's total return.

We also suggest looking beyond Treasuries and considering extending duration. With short-term interest rates higher than long-term rates in the Treasury market, many investors are reluctant to extend duration. However, staying in very short-term investments presents reinvestment risk. If short-term yields fall in the future, which is likely with Fed rate cuts on the horizon, then those 5%-plus yields will not be available when it's time to reinvest the funds.

However, there are areas of the fixed income markets that can provide yields as high as short-term Treasuries at longer maturities. As the chart below illustrates, an investor looking to lock in yields above 5% for a longer time frame could choose investment-grade corporate bonds or government agency mortgage-backed securities. Those willing to take more duration and/or credit risk could consider preferred securities as well. In other words, it's possible to build a portfolio that generates yields over 5% for seven to 10 years, barring default.

Various fixed income investments have yields near or above 5%



Source: Bloomberg, as of 6/3/2024.

Indexes represented: **Treasury bills** = Bloomberg US Treasury Bills TR Index; **Intermediate-term Treasuries** = Bloomberg US Intermediate Treasury TR Index; **U.S. Aggregate Index** = Bloomberg US Aggregate TR Index; **Agency MBS** = Bloomberg US MBS Index; **IG Corporates** = Bloomberg US Corporate Bond Index; **Preferred Securities** = ICE BofA Fixed Rate Preferred Securities Index. Yields shown are the average yield-to-worst. Yield to worst is the lowest possible yield that can be received on a bond with an early-call provision that does not default. Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. **Past performance is no guarantee of future results.**

Extra yield comes with more risk when compared to Treasuries, which are backed by the full faith and credit of the U.S. government. Nonetheless, we believe the risk of a default in investment-grade corporate bonds or government agency mortgage-backed securities is low in a diversified portfolio.

Global stocks and economy: Building on recovery

After a quarter of the world's 45 largest economies fell into recession in 2023, the first half of 2024 brought a global economic recovery, helping to lift the MSCI World Index by nearly 10%. While we expect the second half of the year to build on this recovery, it may be characterized by a divergence in central bank policy—with some poised to cut rates earlier than the U.S. Federal Reserve—and election-related risks that have the potential to increase stock market volatility.

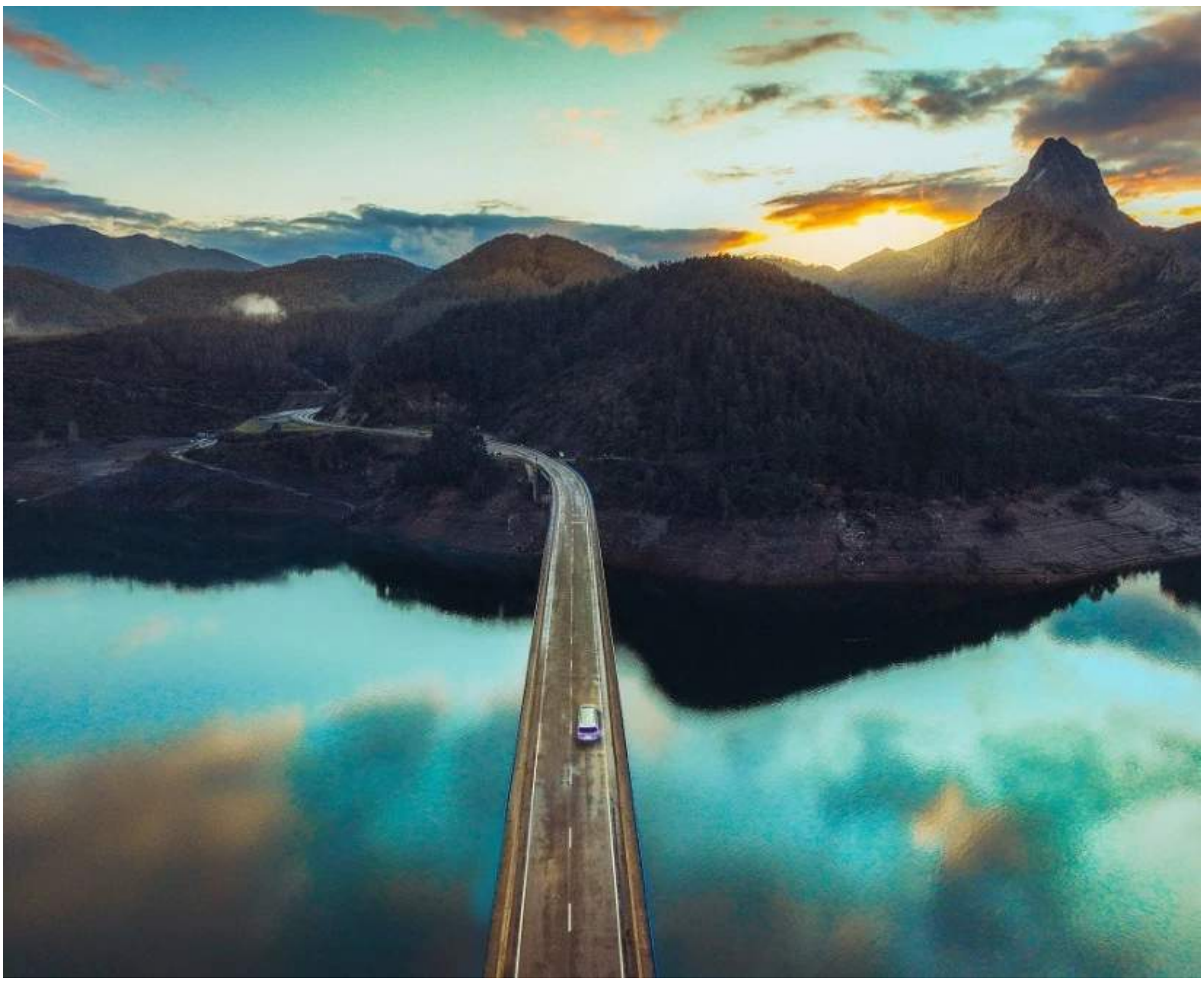
The widening divergence between the outlook for rate cuts by the Fed and those of other major central banks has strengthened the dollar so far this year, because higher interest rates can make holding a currency more attractive. With non-U.S. central banks likely to cut more aggressively, stock valuations have risen, offsetting the drag on performance from a falling currency for U.S.-based investors.

Elections during 2024 may see populists across the globe gain ground and shift policies away from free trade and pro-market reforms, potentially contributing to market volatility. Mexico (the U.S.'s biggest trading partner) and the European Parliament have just held elections. The U.K. will hold an election in July, and—of course—the U.S. holds its election in November. Markets could respond negatively to an outlook of rising tariffs and trade frictions that might potentially boost inflation and weigh on exports.

Yet it is significant that "my country first" trade policies tend to involve more than just tariffs—increasingly, they include incentives to support domestic industries: Subsidies, tax breaks, accelerated depreciation, and research-and-development grants could result in more capital spending and production, potentially fostering more domestic growth and less inflation for domestic goods and acting as an offset to tariffs increasing import costs. While the overall trends may be increasingly clear, the outcomes for investors are not. There will be a lot to monitor in central bank actions and indications of future policies through the election outcomes during the second half of 2024.

Citi Wealth Releases Mid-Year Outlook 2024: Renewed Growth, New Challenges

June 06, 2024



NEW YORK – Today, Citi Wealth released its mid-year Wealth Outlook for 2024 – Renewed Growth, New Challenges. The report offers an updated analysis of the global economy, markets and geopolitical landscape for the remainder of 2024 and beyond.

At the beginning of 2024, Citi Wealth outlined a year of recovering corporate profits and slowing U.S. employment. While the global economic expansion is broadening across regions and industries, the report notes that the Fed will begin to ease monetary policy and shift its focus to sustaining the expansion. Citi Wealth expects U.S. inflation to ease to 2.5% by the end of 2024.

Although investors are likely looking ahead to the U.S. election in November, the report states that it is unlikely to change the direction of the world economy and markets. The risks outlined include potential supply chain shocks, tariffs and unpredictable geopolitical flareups.

"We are focused on building resilient core portfolios with global diversification across asset classes," said Steven Wieting, Chief Economist, Chief Investment Strategist and interim Chief Investment Officer for Citi Wealth. "We are encouraging our clients to stay fully invested and to complement their portfolios with high-conviction opportunistic investments."

With markets having priced in continued near-term expansion, Citi Wealth anticipates potential investment opportunities in areas such as U.S. small-and mid-cap growth equities, some developed and emerging markets and defensive growth in healthcare. Citi Wealth believes clients can seek income from intermediate, high-quality U.S. dollar bonds and sees potential in private equity, real estate and hedge funds for qualified and suitable investors.

Opportunistic Investments

1. Semiconductor equipment makers
2. Medical technology and life science tools firms
3. Defense contractors
4. Western energy producers
5. The Japanese yen and yen-denominated tech and financials
6. Yield curve normalization
7. Structured credit for qualified and suitable investors

Citi Wealth also outlines its unstoppable trends in the report, which are long-term forces that are transforming how we live and work.

Unstoppable Trends

- **AI-propelled digitization:** The AI revolution is still only in its early stages. Citi Wealth likes AI infrastructure and select AI users such as robotics and automation, drug discovery, cyber security, grid constructors and power generators near data centers.
- **Energy transition:** The clean energy transition is vital to prosperity and wellbeing. Citi Wealth favors renewable energy technology specialists, those with energy efficiency enabling AI strategies, and their beneficiaries, publicly traded and private.
- **Healthcare:** Aging populations, growing wealth and

technological advances could drive healthcare returns over the long term. Short-term valuations are attractive; Citi Wealth favors exposure via specialist actively managed strategies.

- **G2 polarization:** The U.S.-China (G2) strategic rivalry is set to intensify, reshaping global trade, geopolitics and many investments. Citi Wealth favors the likes of tech supply chain diversification beneficiaries in the U.S. and China.

About Citi

Citi is a preeminent banking partner for institutions with cross-border needs, a global leader in wealth management and a valued personal bank in its home market of the United States. Citi does business in nearly 160 countries and jurisdictions, providing corporations, governments, investors, institutions and individuals with a broad range of financial products and services.

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Midyear outlook for markets and investments

Fidelity Viewpoints

A panel of Fidelity pros share their top investing ideas.

Key takeaways

With the year nearing its halfway point, *Viewpoints* decided to check in with some of Fidelity's leading strategists and managers to hear their latest views on markets and the economy—plus what may lie on the horizon over the rest of the year.

Viewpoints Market Sense anchor Heather Hegedus sat down this week for a conversation with **Cait Dourney, CFA**, who leads business cycle research on Fidelity's Asset Allocation Team; **Jurrien Timmer**, Fidelity's director of global macro; and **Naveen Malwal, CFA**, institutional portfolio manager with Strategic Advisers, LLC, the investment manager for many of Fidelity's managed accounts.

Here are excerpts from their conversation about why the markets might be stronger than investors realize, what surprises could throw a wrench into the outlook, and their top investing ideas for the rest of the year. (Watch their full discussion in the video player below.)

Sign up for *Fidelity Viewpoints* weekly email for our latest insights.

***Viewpoints*: We've been watching and waiting for 2 years for a recession that hasn't happened. Can we finally put those fears to rest?**

Cait Dourney: What we're seeing in the US is a resilient expansion. We're not seeing really any immediate or near-term recession risk.

Now, there are different flavors of expansion. Over the last couple of years, we've been in more of a late-cycle expansion. And typically, in history, late cycles then decelerate into the recessionary phase. But something different has happened this time, and instead in the last year we've seen more mid-cycle dynamics emerge. These are things like corporate profitability stabilizing and even expanding in some sectors. We're seeing earnings start to turn around again and start to grow. So this has been very different from history.

***Viewpoints*: We're in the middle of a bull market right now, but a lot of investors are wondering how much steam it has left. Is there still room to run?**

Jurrien Timmer: I believe there is. By all accounts, the bull market started in October 2022 after about a 28% decline. Since then we're up around 50%. That's been a really good outcome. We also look at what we call "secular trends," or super cycles. Since the 2008 to 2009 financial crisis, we’ve been in a super cycle of above-average returns. My sense is that we’re in the seventh inning of a cyclical bull market and also the seventh inning of a secular bull market. So even though 7 sounds close to 9, I think time is still on our side here.

We’re also in the fourth year of a presidential cycle, which historically has been a strong year for markets. So far, we’re tracking this fourth-year pattern very closely. That would suggest that the rest of this year could actually stay positive as well.

Viewpoints Market Sense: 2024 midyear outlook roundtable

Watch the full conversation as our panel of Fidelity pros weigh in on what's next for markets, the economy, and your money this year.
View full transcript (PDF)

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***Viewpoints*: Let's talk about what this all means for investors. Naveen, how has your team been managing client portfolios through this period?**

Naveen Malwal: As Cait and Jurrien described, the backdrop is pretty positive. In spite of the fact that it's late cycle, or the seventh inning, there's still likely to be growth ahead.

With that in mind, we're managing client accounts in a way where it's close to targeted allocations, but we're leaning a bit more toward stocks and a bit away from bonds. That's because historically, as long as there is an expansion, stocks tend to outperform bonds and short-term investments. Within stocks, we're favoring areas like US stocks and emerging-market stocks. And to add some diversification, we're also investing in high-yield bonds, in commodities, and alternative funds. These are parts of the market that have the potential to add some extra performance or help manage risk.

***Viewpoints*: One of the biggest topics this year has been inflation. Cait, when does your team think inflation might get back down to a more palatable level?**

Cait Dourney: Unfortunately, we do see inflation staying around the 3% level where it's recently been for some time. That's because there are 2 major contributors that are holding up the overall inflation rate. The first is the job market. The strong job market has been keeping a floor under wages and pushing up services prices, which is what most of us spend a lot of our money on. The second is housing. There still isn't enough housing supply in the US, which puts pressure on home prices and rent prices in some areas.

I do have 2 pieces of good news. The first is that while inflation is still with us, wages are now growing faster than inflation. So our buying power is in a better place and is rising. The second is that those days of 9% inflation are behind us. That inflation level was related to the pandemic-related disruptions, which we wouldn't expect to come back.

***Viewpoints*: Hand-in-hand with the inflation discussion is the Fed. Given that inflation outlook, Jurrien, are rates cuts really on the table?**

Jurrien Timmer: I think we can all agree that at the current fed funds rate, the Fed is restrictive. If inflation is coming down on a rate-of-change basis and the economy is still expanding, but maybe at a slower rate, it makes sense that the Fed could give back a few of those rate hikes. We call that an “easing bias.”

Right now, the market’s expecting a couple of rate cuts this year into next year. And the Fed seems to be on board with that, but it is rightfully waiting to give us those rate cuts. I think the Fed is saying, “We’d rather give it to you later than give it to you prematurely, then have to take it back.” So I do believe it will deliver on those rate cuts, but it may do so slowly. I think that’s prudent.

***Viewpoints*: What do higher rates and stickier inflation mean for positioning a portfolio?**

Naveen Malwal: Yields have risen on bonds. If you’re a bond investor, you may get higher income from your existing or new investments in the bond space. And if the Fed is looking at rate cuts it could lead bonds to gain in value. So far, this year has not been happy for bond investors, but the outlook may be getting more optimistic.

Regarding inflation, 3% inflation might sound high compared with the last 20 years. But if you go back longer term—over the last 70 or 100 years—inflation has often been around 3% or more over the long run. And guess what? Over that time stocks have done great, bonds have done well, and the economy has grown. So I don’t believe this environment requires a whole new way of investing.

***Viewpoints*: Another big theme for the rest of this year will be the election. From your point of view, Cait, what's at stake?**

Cait Dourney: We see really 2 main impacts regardless of who wins the election. The first is upward pressure on inflation. Both parties have plans for government spending and investment and are expected to run larger fiscal deficits than what we've experienced in recent decades. All of that spending tends to put upward pressure on inflation. And we're likely to get some form of trade restrictions like tariffs, which raise the cost of imported goods.

The second impact is some upward pressure on interest rates—and that's for a lot of the same reasons. Higher inflation tends to put upward pressure on interest rates, and more borrowing to fund those deficits tends to put upward pressure on interest rates.

***Viewpoints*: Let's shift gears now and talk about potential opportunities. Jurrien, where are you seeing some of the most interesting opportunities?**

Jurrien Timmer: Until this year, when the market finally broadened out to some degree, we had a very bifurcated, narrow bull market. From late 2022 throughout 2023, the market rally was really just in the hands of a handful of very large-cap stocks—called the "Magnificent 7." Part of the reason for that was the Fed. If you're a smaller company and you have more debt or you have a weaker balance sheet, the cost of capital matters. If you're one of these big, big, Mag-7 stocks, you have so much cash you may not need to borrow money.

So there are parts of the market that have been left behind, such as small caps, value stocks, and non-US stocks. Those parts of the market have been a lot cheaper than the headline index. And if the Fed is finally able to lower rates, and if inflation sort of finds a new floor, then maybe the rest of the market can finally breathe again, and might get a chance here.

***Viewpoints*: How about you, Naveen? What does your team consider to be the top opportunities right now?**

Naveen Malwal: We see a lot of opportunities, but I'll focus on international—and emerging markets in particular. They have lagged developed markets and US stocks in recent years. There is an environment right now where the headlines maybe don't feel so good for some of those regions. What we've seen, though, is a lot of governments have taken actions to help overcome some of their challenges. And we've seen the outlook improving for economic growth and earnings growth in some parts of Asia and Latin America, and that might be a good opportunity going ahead.

So even though those stocks have lagged, counterintuitively, there might be an opportunity there for long-term investors.

***Viewpoints*: No discussion would be complete without also talking about risks. What do you each see as risks to your outlook for the rest of the year?**

Cait Dourney: Inflation. It's not our base case, it's not what we expect, but if inflation were to reaccelerate, that's a risk because it might mean the Fed's not done raising rates, and that can be very disruptive for financial markets.

Jurrien Timmer: I would echo what Cait said. If inflation stays high or goes higher, the cost of capital goes up. And that affects the bond market, it affects the stock market, it affects basically everything. I think the risk is not that the market collapses, but that the run rate goes down because the cost of capital goes up.

Naveen Malwal: There's also a risk that—just like last year—we're all going to worry about these things, and the markets might still rise. Last year I heard from a number of folks telling me, "Naveen, I missed it. I missed the rally. I was so worried." I think one of the biggest risks this year is that none of the doomsday scenarios come to pass, earnings are rising, the economy is growing, stocks do well, and a lot of people miss it because they're so worried.

***Viewpoints*: Let's go to our lightning round now. If you**

could pick just one highest-conviction idea, what would it be?

Cait Dourney: Owning stocks in addition to just short-term investments or bonds. Stocks have historically gone up over time, and they tend to be more resilient in the face of things like inflation. So don't jump ship—stay along for the ride.

Jurrien Timmer: Have a plan and stick with the plan. Don't second-guess it the second something goes wrong.

Naveen Malwal: Diversification. Don't just chase the winners.

***Viewpoints*: If you could choose one metaphor to explain what is going on with the economy and markets, what would it be?**

Cait Dourney: The US economy is the foundation of a house that the markets sit on top of, and that foundation is quite strong. There may need to be repairs done every now and then, but the foundation is solid.

Jurrien Timmer: The market has seasons, just like nature. We talk about late cycle, mid cycle, early cycle, down cycle—but it's inherent of nature to grow, and the markets reflect that.

Naveen Malwal: There are a lot of indicators out there. It reminds me of maybe an airline pilot and their dashboard and all those dials and buttons. Just because a couple of those lights maybe aren't where we want them to be, it's not a reason to completely change course. Keep a wide point of view and don't just stick to the negative news.

***Viewpoints*: The next time we gather it will be 2025. What will we be talking about then, and in the back half of this year?**

Cait Dourney: I'll be watching earnings. They've come through for a lot of the big companies, but are we seeing that improvement through the rest of the market and through the world?

Jurrien Timmer: The Fed doesn't often stick the landing, but so far, it is doing that. By next year, we may know whether it did or not.

Naveen Malwal: I agree with both of those, and I'll add—does the market continue to broaden? If the storyline stays positive, I can picture how more stocks in the market, both US and international, could take part in an ensuing rally.

INVESTMENT OUTLOOK 2024

Expert views to help you navigate today's market trends and portfolio opportunities.

Six months into 2024, the global economy continues to show resilience. But with central bank policy still uncertain, geopolitical headwinds, and election outcomes to be decided, many investors are in a holding pattern. As we await the economic landing, now may be the opportune time for investors to judiciously increase risk in preparation for a mid- to late-cycle re-acceleration.

Asset class outlooks exploring the

investment drivers that matter most

Panel discussion

Watch a panel session with our asset class heads providing their views on thesecond half of the year.

Investment insight from our asset class heads

Key Takeaways

Morgan Stanley’s outlook for most equity and fixed-income markets is largely positive heading into the second half of 2024, as global interest rate cuts are finally on the horizon: The European Central Bank is likely to start cutting in June, the Bank of England in August with the U.S. Federal Reserve predicted to follow in September. These interest rate cuts have been much anticipated by investors, who pushed markets up and down in the first half of the year as they adjusted expectations about when and how quickly policy rates would begin their descent, while volatile data kept central bankers from acting.

“Investors priced in and out a soft landing, a hard landing and no landing, reacting to every surprise in the economic data,” says Serena Tang, Morgan Stanley’s Chief Global Cross-Asset Strategist. “The second half should see the paths of disinflation, growth and policy become clearer, setting up a constructive outlook for nearly all markets.”

In particular, European and Japanese equities offer investors attractive valuations, with share prices expected to rise as earnings estimates revise upward. U.S. stocks, meanwhile, are likely to see robust earnings growth but may not see a corresponding lift in share prices, as is typical of a mid-to-late cycle environment. In core fixed income, mortgage-backed securities (MBS), leveraged loans and investment grade corporate bonds are attractive.

“Roughly $6 trillion accumulated in money-market funds as the Federal Reserve raised rates,” says Tang. “As the Fed starts to cut, investors are likely to rotate that money into other assets such as high-quality fixed income and equities—probably in that order.”

Bullish and Cautious

Morgan Stanley Research sees global equities bringing positive returns this year, helped by the macroeconomic environment and the potential for increases in corporate earnings. In standout Japan, returns potentially could reach 17% while European stocks could reach 18%. Investors should be on the lookout for stocks whose performance is inversely correlated to bond yields, such as real estate, construction and materials and utilities, as well as quality growth sectors such as software, aerospace and defense, pharmaceuticals and semiconductors.

“This is the highest our weighted average base case forecast has been, outside of bear market and pandemic recoveries. For Japan's TOPIX benchmark index, the upside forecast is the highest ever," says Tang. She notes, however, that valuations are likely to be high in many markets, prompting caution from investors.

In fixed income, strategists favor "spread" products that offer yield above what investors can generally get from Treasury bonds. These include public and private corporate credit, securitized credit, MBS and emerging-market sovereign credit. Investment-grade corporate bonds, for example, can help hedge broader market uncertainty. If global growth is more robust than expected, credit spreads can potentially tighten, even though they are already narrow. If growth grinds to a halt, total returns can benefit from duration.

Looking back at similar historical periods can offer a perspective on how the current environment might play out in terms of investors' portfolios. In prior years when the Fed has cut rates and bonds and stocks have done well—as Morgan Stanley expects this year—the optimal mix in a multi-asset portfolio has been to increase allocation to bonds. In 2007, for example, an investor with perfect foresight would have wanted a mix of 58% stocks, 26% core fixed income, 8% other, 5% commodities and just 3% cash. (We remind our readers that past performance is not a guarantee of future results.)

Hedging the Unknowns

There are uncertainties in the outlook going into 2025, based on unpredictable events—including the outcome of the U.S. presidential election and changing patterns in immigration, household formation and consumer preferences, to name a few.

With this in mind, investors should consider assets that might offer "convexity," with the potential for positive returns and controlled risk of losses. European stocks are one example: Companies in the MSCI Europe index derive about 25% of their revenue from the U.S. and about 30% from emerging markets. This means investors can potentially benefit from hotter growth in either region while benefiting from cheaper valuations than the S&P 500 and lower volatility compared with emerging market stocks.

One other theme that can help with the uncertainty is carry, which may allow investors to benefit from differences in interest rates between two currencies. As an example, for a U.S. dollar-based investor, the expected dividend yields of European and Japanese equities, when hedged for foreign exchange risk, are above historical averages.

A strong economy in a fragile world

Chart description (1): The chart describes total employee compensation growth. For the Japan line, the first data point came in at 1.35% in Q1 2005; it went flat and dropped to a low point at -6.2% in Q2 2009. Then it came back up and stabilized with the last data point coming in at 2.1% in Q1 2024. For the Euro Area line, the first data point came in at 2.8% in Q1 2005; it went flat and slightly upward until it dropped to -0.99% in Q3 2009. Then it picked up again, but dropped precipitously to -6.99% in Q2 2020. It then came back up, and the last data point came in at 6% in Q4 2023. For the United States line, the first data point came in at 5.9% in Q1 2005; it went flat and bottomed to -4.1% in Q1 2009. Then it went back up and peaked at 6.33% in Q4 2012. Then it went flat and briefly dropped before going to a new peak at 12.1% in Q2 2021. The last data point came in slightly lower at 5.6% in Q1 2024.

Chart description (2): The chart describes S&P 500 performance in different inflation regimes (1950–2024), %. For 0–2%, the bar is at 10.7%. For 2–3%, the bar is at 13.8%. For 3–5%, the bar is at 8.7%. For >5%, the bar is at 2.4%.

Chart description (3): The chart describes years from innovation to productivity growth for innovations, including steam engine, electricity, PCs/internet, and AI. It's displayed in the format of a bar chart. For the steam engine bar, it's showing 61 years from innovation to productivity growth. For electricity, it's 32 years from innovation to productivity growth. For PCs/internet it's 15 years from innovation to productivity growth. For AI, it's estimated to be around seven years from innovation to productivity growth.

Chart description (4): The chart describes highest quintile of free cash flow margins, forward P/E ratio relative to the same cohort in large-cap stocks. The first data point came in at 0.58x in February 1976. Then it went all the way up and peak at 1.72x in November 1983. Then it came back down and bottomed at 0.53x in January 2000. It then spiked to a new peak at 1.62x in April 2009. Then it came down all the way with the last data point coming in at 0.74x in April 2024.

Chart description (5): The chart describes cumulative performance since January 2022, %. For the MSCI Germany Small Cap line, the first data point came in at 0% in January 2022. Then it went down all the way and bottomed at -45.9% in September 2022. Then it bounced back and stabilized at low level and ended the series at -27.8% in April 2024. For MSCI World, the first data point came in at 0% in January 2022. It came down and bottomed at -26.5% in October 2022. Then it went up and the last data point came in at 3.6% in April 2024. For MSCI

Germany, the first data point came in at 0% in January 2022. It then came down and bottomed at -30.4% in September 2022. Then it went up and the last data point came in at 0.7% in April 2024.

Chart description (6): The chart describes trade reliance in % terms. For Europe reliance on Russia for energy (pre-Ukraine invasion), the bar is at 22%. For global reliance on China for lithium batteries, the bar is at 76%. For global reliance on Taiwan for advanced chips, the bar is at 92%.

2024 Midyear Global Market Outlook

Since we published our Global Market Outlook (GMO) in December 2023, risk assets have remained resilient in the face of increased uncertainty, powering ahead despite stickier-than-expected inflation and a deepening Middle East conflict. Meanwhile, bond markets, regarded as the likeliest winner for 2024, have struggled as inflation lingered, spawning “higher for longer” concerns. We continue to see fixed income as a bright spot for investors given current yield levels, slowing growth, and continued disinflation. We remain cautious on risk assets and favor quality stocks in equity markets. We continue to believe emerging markets will remain vulnerable given the global landscape, but do see pockets of opportunity within emerging market debt and select emerging market equities.

Our outlook for 2024 was a year of “Positioning the Pieces” as investors weighed multiple factors within the macroeconomic environment to assess how they converge. This picture has not shifted. We believe many factors remain in flux and investors should focus on right-sizing their positions and getting portfolio implementation right. Most importantly, we stress the need to retain flexibility to respond as clearer signals develop.

Macroeconomic Outlook: Finding Stable Ground for a Soft Landing

Headlines have been dominated of late by uncertainty around the future path of the US Federal Reserve’s rate decisions. Our stance has not changed since the start of the year. We believe disinflation will continue in the US and economic activity will be weaker this year relative to last year. A soft landing is still our base case scenario and we anticipate the Fed will be in the position as early as this summer to lower interest rates.

At the beginning of this year, we highlighted disinflation and slowing growth as being the two core trends, which in turn open the door to the next big trend — monetary policy easing. In the US, none of the three trends above has been fundamentally altered despite a string of hawkish inflation prints at the start of 2024. In fact, while the US did not participate much in the global slowdown in 2023, it looks increasingly poised to join it in 2024. We do not want to make too much out of the softer-than-expected first-quarter GDP report, but we note that our forecast is somewhat below consensus on US growth for the remainder of the year. We see broadening signs of momentum loss in consumer discretionary spending, expanding signs of erosion in labor demand, and widening signs that the big fiscal impulse to growth is beginning to fade.

This is by no means a negative story. In fact, it is a very good story of moderation, normalization, and getting to a soft landing. Moderation in demand facilitates moderation in inflation — both in labor and goods/services markets — and allows for rate cuts that preserve and nurture the soft landing.

Outside of the US, we look for the European Central Bank (ECB) to deliver a first cut in June, Bank of Canada in July, and Bank of England (BoE) in August. In Japan, we look for a 15 basis point hike to 0.25% in the latter part of the year.

Cutting Through the Noise

Noise in the data and idiosyncratic developments should not be mistaken for trend changes or permanent shifts in approach. Dramatic pronouncements about big changes in equilibrium variables, such as the neutral interest rate, should be avoided in a world still finding and defining the "new normal" following the unprecedented Covid-19 shock. Being open-minded makes sense, while rushing to conclusions does not. Naturally, there are risks to the outlook. Indeed, geopolitical risks loom large in one of the most momentous global election years on record. Yet risks to the baseline should not be conflated with the baseline itself. This is why we have reiterated our more dovish view on inflation and rates even as the market swung widely in the other direction.

Geopolitical Outlook: Risks Are Now

Peaking

2024 was always going to be a turbulent year on the geopolitical front. US elections carry their own inherent policy risks that directly affect the world's largest capital market and indirectly impact the majority of global public assets. This year's elections are occurring against a backdrop of deeper rifts in the global order, several armed conflicts, fiscal headwinds, and protectionism.

As a consequence, the coming months will have a higher-than-normal threat of geopolitical shocks that affect markets. This election year comes amid a secular trend of continued global fragmentation, which has weakened traditional crisis stabilization mechanisms (i.e. international institutions and norms) that have managed conflict actors and exercised crisis management in recent decades. In short, the global order has frayed, and malicious actors have more room to maneuver in an election year than they might otherwise have.

The conflict and rising tensions in the Middle East represent a clear example of this trend. Notwithstanding some recent developments, skeptics may claim that a regional war has thus far been averted and make the argument that crisis containment is working. But this view understates the severity of actors breaking precedent and crossing new thresholds as witnessed with the October 7 Hamas attacks, Israel's response, and Iran's various interventions (both direct and via proxies). Crisis averted does not mean crisis resolved, and the escalation risk remains greater today than it did a few months ago.

Aside from the Middle East tensions, several other regions present the potential to reset risk perceptions. Foremost, the centrality of East Asia in the world's global supply chain means that any headline risk could have an outsized market impact. For example, negative developments or events on the Korean Peninsula, in the Taiwan Strait, or in the South China Sea could suddenly upend risk sentiment even in the absence of a material economic event.

Are Markets Underestimating the Risk?

Against this backdrop, one might imagine this current acute phase of elevated risk to be reflected in global risk premia. Instead, standard gauges of risk such as the CBOE Volatility Index (VIX) remain below historical averages (Figure 2), and the cost of hedging against equity drawdowns, currency depreciation, or credit deterioration remains well below post-pandemic averages and close to the multi-cycle lows seen in 2023. The exception of late has been higher volatility in bonds and currencies and a sharp rise in demand for gold, the latter of which is also seeing a surge in demand from both Chinese state-backed bodies and retail buyers. In sum, as a growing trend of global fragmentation further reinforces the uncertain landscape, investors should prepare for volatility until such time as calmer times prevail. Geopolitical unrest is likely to continue impacting the commodity complex, further clouding upside-and-downside risks related to inflation.

Fixed Income Outlook: Phase Transition

While some aspects of fixed income markets have changed since the start of the year, much remains the same. Overall, bonds retain their place on center stage with impressive yields, abating (slowly) inflation, and a strong but slowing economy that has convinced the Fed that the next rate move will be lower. A similar picture is unfolding outside the US (with the exception of Japan), creating ample opportunities for global fixed income investors.

Separating the signal from the noise is critical in assessing fixed income data, and the level of noise can be an indicator of what type of regime we sit in. Increasingly divergent views based on inconsistent economic data can also cause difficulty in evaluating where markets are headed. Coming into 2024 on the back of lower inflation prints, expected cuts to the federal funds rate as early as March, and declining yields and spreads, two-year US Treasury yields fell close to 4% (Figure 3). As inflation metrics remained sticky in the first quarter, those yields retraced as expectations for Fed cuts declined and the timing was pushed back. Despite two very different narratives, and the associated headlines, two-year rates stayed range bound. This all describes a typical phase transition perfectly. Short-term trading and a fast-moving news cycle distract from the crucial question — where do we go from here?

Figure 3: Two-Year US Treasury Yields Remain in Range

The most likely paths that will drive an exit from this range-bound stage of the cycle have the potential to drive meaningful returns for investors given current rate levels. With no shortage of noise in the data, our view focuses on longer-term structural and cyclical factors pointing to moderating inflation and diminished growth. Cracks in the economic and business cycle remain a point of concern. Even with stickiness in the inflation data during the first quarter, the federal funds rate remains firmly in restrictive territory relative to the neutral rate (that we believe is now about 2.75%). This will impact business fundamentals, perhaps compounding an otherwise moderate slowdown. Additionally, the strength of the consumer could subside amid higher mortgage and credit card rates, while small businesses may struggle to borrow.

Our core view is that inflation will continue to moderate, allowing the Fed to implement a series of rate cuts that take short-term rates to more appropriate levels. But getting inflation back to the 2% target may not be necessary given recent signaling by the Fed that unemployment readings also matter. Whether the first rate cut occurs this summer — or how many rate cuts the Fed can squeeze in before the New Year — is ultimately less important than getting the direction right. For that reason, we maintain an extended duration position as our primary risk stance.

Outside of US Treasuries, corporate credit remains less attractive due to extremely rich valuations. We see more opportunities in emerging markets and structured credit such as mortgage-backed securities (MBS) and commercial mortgage-backed securities (CMBS). However, in both sectors investors must wade through real underlying fundamental considerations — for example, corporate real estate or China — warranting a prudent approach. Whether a soft or hard landing comes next, we remain confident that current rate levels offer attractive entry points for investors.

Equity Market Outlook: Challenges to Further Gains

Given our macroeconomic forecast and the current earnings picture, what is our outlook for equities for the remainder of the year? We began the year with a subdued outlook for equities but stock markets have maintained their incredible momentum. Record highs were reached in the US, Europe, and, most notably, Japan amid resilient economic data and robust corporate earnings. However, we believe moderation is still warranted. An ongoing decline in the equity risk premium, lofty valuations (especially in the US), and shifting expectations around interest rates could eventually temper enthusiasm. For the remainder of the year, we see a number of diverse drivers of global equity performance, and these drivers differ across the US, Europe, and Asia. Varied trends across regions suggest that there is a strong case for evaluating the opportunity set along geographic lines.

US Markets: Inflation Uncertainty Continues

The S&P 500 Index hit new highs before partially retreating in April as sticky inflation data prompted the Fed to "recalibrate" its thinking on the likely pace and magnitude of rate cuts. While we have concerns about higher yields and the ramifications of any misstep in earnings, equity markets have generally held up well due to improved economic data and some respite in May from hotter-than-expected inflation data. In fact, corporations are aggressively buying back stock and returning capital to shareholders as a result of higher margins, creating a catalyst for positive momentum. However, fewer rate cuts could spawn volatility along with the following side effects:

Decreasing Equity Risk Premium: As yields back up on higher-than-expected inflation prints, additional compensation is demanded for owning stocks over bonds. This in turn tends to put downward pressure on stock prices.

Weaker Earnings: While we have seen positive full-year EPS revisions, mainly in the technology sector, there are concerns that (1) restrictive monetary policy could dampen corporate earnings, partly because of the impact of high rates on consumer spending, and (2) evidence of margin compression outside the tech sector is emerging. Households are feeling the strain as debt loads have started to climb.

Our bias for growth stocks remains in place despite some strong performances in value-heavy sectors such as energy, financials, and industrials sectors. The best outcome for value would be where the cost of debt falls but without impairment to economic growth. In this scenario, should the equity market rally continue to broaden out beyond growth stocks, we would maintain our preference for higher-quality names and sectors.

European Markets: Still Looking for Sustained Growth

Europe's performance since last October is impressive, but returns have still lagged the US in this period. We maintain a cautious stance due to mixed economic data, modest growth and negative earnings revisions so far this year. Europe's economic and corporate fundamental picture has improved somewhat, with the eurozone composite purchasing managers' index (PMI) back above 50 (indicating growth) in March and April. However, recent declines in retail sales and industrial production signal that growth remains fragile, raising questions over the robustness of fundamentals.

Profit margins continue to show resilience, but sales growth peaked in September and input costs have likely bottomed out, while more cautious consumers will inevitably hit earnings (Figure 4). Although the household savings rate is still relatively strong, and unemployment is hovering near record lows, the threat from a weaker consumer grows as the macroeconomic backdrop deteriorates.

The greater representation of cyclical companies in Europe means the region's markets would also be impacted by slower economic growth should the ECB resist lowering rates ahead of other major central banks for fear of weakening the euro and thereby importing inflation. Stocks that meet the "quality" criteria are also less plentiful in the region with lower earnings growth expectations offsetting the relatively more attractive valuations.

Japanese Markets: The Reform Narrative Underpins Japanese Equities

The resurgent Japanese stock market saw the Nikkei 225 Index finally surpass its 1989 peak this year. A pick-up in Japanese inflation has allowed companies to lift prices, potentially boosting revenue and earnings, while rising wage costs may be offset by greater consumer propensity to spend. Increased government spending and export growth also underpin the case for Japanese equities. There have been some signs of profit-taking, but we note the following:

Investment Boost: The BoJ’s exit from negative interest rate policy in March along with shareholder-friendly policies could spur continued foreign investor interest. Japanese corporations with large cash reserves could reinvest in domestic growth opportunities in order to keep pace with inflation.

Earnings Revisions Uptick: Potential for positive earnings revisions due to higher interest rates and investment income, bolstered by a stronger US economy.

Corporate Governance Reform: The continuing Tokyo Stock Exchange drive to improve companies’ corporate governance and capital efficiency could help create higher-quality, more profitable companies and push the market towards more sustainable growth.

Even after Japan's stock market surge, the tailwinds from governance reforms, share buybacks, and an expansion of tax-exempt retail schemes contribute to an investment backdrop worthy of attention.

Emerging Markets: The Strong Dollar Remains a Headwind

With the strength of the US dollar showing no signs of abating, we remain generally cautious about emerging markets. We noted as 2024 began that a higher-for-longer interest rate environment had been priced into emerging market equities. While we do not see much value in emerging market equities in aggregate, pockets of opportunities remain, particularly in those countries benefiting from the ongoing reorganization of global supply chains.

As a whole, the geographic dispersion we have seen across equity markets suggests that investors should be thoughtful about their regional allocations and the underlying risks. As supply chains continue to adapt and rising trade protectionism affects what consumers buy and from where, investors should focus on how this will play out across different regions.

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Mid-Year Outlook 2024

Welcome to our “Mid-Year Outlook”, the investment strategy update from Barclays Private Bank, which is also available to download as a PDF at the bottom of this page.

In the chapters below, we look at the different paths being followed by leading central banks on the timing for rate cuts in the US, Europe and UK, and assess the implications for bonds and equities.

With around half the world heading to the polls this year, we also examine just how much of an effect election results could have on prospects for financial markets.

And beyond our usual wide-ranging asset class and financial market analysis, we highlight what investors might do to better position their portfolios for climate-change risk.

As always, we hope you enjoy the articles, and we thank you for entrusting us with your investments.

Jean-Damien Marie,

Head of Investments, Private Bank and Wealth Management

Vanguard’s 2024 economic forecasts

Notes: Forecasts are as at 14 November 2023. For the US, GDP growth is defined as the year-over-year change in fourth-quarter GDP. For all other countries/regions, GDP growth is defined as the annual change in GDP in the forecast year compared with the previous year. Unemployment forecasts are the average for the fourth quarter of 2024. NAIRU is the non-accelerating inflation rate of unemployment, a measure of labour market equilibrium. Core inflation excludes volatile food and energy prices. For the US, euro area and UK, core inflation is defined as the year-over-year change in the fourth quarter compared with the previous year. For China, core inflation is defined as the average annual change compared with the previous year. For the US, core inflation is based on the core Personal Consumption Expenditures Index. For all other countries/regions, core inflation is based on the core Consumer Price Index. The neutral rate is the equilibrium policy rate at which no easing or tightening pressures are being placed upon an economy or its financial markets.

Source: Vanguard.

Bond market outlook

Despite the potential for near-term volatility, we believe this rise in interest rates is the single best economic and financial development in 20 years for long-term investors. Our bond return expectations have increased substantially. We now expect UK bonds to return a nominal annualised 4.4%–5.4% over the next decade, compared with the 0.8%–1.8% annualised returns we expected before the rate-hiking cycle began. Similarly, for hedged global ex-UK bonds, we expect annualised returns of 4.5%–5.5% over the next decade, compared with a forecast of 0.8%–1.8% when policy rates were low or, in some cases, negative.

If reinvested, the income component of bond returns at this level of rates will eventually more than offset the capital losses experienced over the last two years. By the end of the decade, bond portfolio values are expected to be higher than if rates had not increased in the first place.

Similarly, the case for the 60/40 portfolio[1] is stronger than in recent memory. Long-term investors in balanced portfolios have seen a dramatic rise in the probability of achieving a 10-year annualised return of at least 7%, from a 9% likelihood in 2021 to 39% today.

Equity market outlook

A higher-rate environment depresses asset price valuations across global markets while squeezing profit margins as corporations find it more expensive to issue and refinance debt. Valuations are most stretched in the US. As a result, we have downgraded our US equity return expectations for British pound investors to an annualised 4.1%–6.1% over the next 10 years from 4.3%–6.3% heading into 2023. Within the US market, value stocks are more attractive than they have been since late 2021, and small-capitalisation stocks also appear attractive for the long term.

US equities have continued to outperform their international peers. The key drivers of this performance gap over the last two years have been valuation expansion and US dollar strength beyond our fair-value estimates, both of which are likely to reverse. Indeed, our Vanguard Capital Markets Model® (VCMM) projections suggest an increasing likelihood of greater opportunities outside the US. We project 10-year annualised returns of 6.8%–8.8% for non-US developed markets, 4.7%-6.7% for UK equities and 6.4%–8.4% for emerging markets, all from a British pound investor’s perspective.

A return to sound money

For households and businesses, higher interest rates will limit borrowing, increase the cost of capital and encourage saving. For governments, higher rates will force a reassessment of fiscal outlooks sooner rather than later.

For well-diversified investors, the permanence of higher real interest rates is a welcome development. It provides a solid foundation for long-term risk-adjusted returns. However, as the transition to higher rates is not yet complete, near-term financial market volatility is likely to remain elevated.

IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model® (VCMM) regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Distribution of return outcomes from VCMM are derived from 10,000 simulations for each modelled asset class. Simulations as of 30 September 2023. Results from the model may vary with each use and over time. For more information, please see the Notes section.

Notes:

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may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based.

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The Vanguard Capital Markets Model® is a proprietary financial simulation tool developed and maintained by Vanguard's primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include US and international equity markets, several maturities of the US Treasury and corporate fixed income markets, international fixed income markets, US money markets, commodities and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte

Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

[1] In our analysis, the 60% equity/40% fixed income portfolio is represented by the following indices: Equity: UK equity (MSCI UK Total Return Index) and global ex-UK equity (MSCI AC World ex UK Total Return Index). Fixed income: UK bonds (Bloomberg Sterling Aggregate Bond Index) and hedged, global ex-UK bonds (Bloomberg Global Aggregate ex Sterling Bond Index Sterling Hedged). UK equity home bias: 25%, UK fixed income home bias: 35%.

2024 Midyear Investment Outlook: Anticipating rate cuts

Important information

NA3630368

Image: pa_YON / Getty

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

Diversification does not guarantee a profit or eliminate the risk of loss.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China’s dependency on the economies of other Asian countries, many of which are developing countries.

Investors whose primary currency is not in US Dollars should be mindful of potential exposure to fluctuations in exchange rates.

Stocks of small- and mid-sized companies tend to be more vulnerable to adverse developments, may be more volatile, and may be illiquid or restricted as to resale.

A value style of investing is subject to the risk that the valuations never improve or that the returns will trail other styles of investing or the overall stock markets.

The health care industry is subject to risks relating to government regulation, obsolescence caused by scientific advances, and technological innovations.

The profitability of businesses in the financial services sector depends on the availability and cost of money and may fluctuate significantly in response to changes in government regulation, interest rates and general economic conditions. These businesses often operate with substantial financial leverage.

Fixed income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Junk bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

Most senior loans are made to corporations with below investment-grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid.

Investments in real estate-related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate.

Real estate companies, including REITs or similar structures, tend to be small and mid-cap companies and their shares may be more volatile and less liquid.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

The Consumer Price Index (CPI) measures change in consumer prices.

The Citi Economic Surprise indexes are quantitative measures of economic news, defined as weighted historical standard deviations of data surprises; a positive reading of the Economic Surprise Index suggests that economic releases have on balance been beating consensus.

Statements in the audio clip about the relative performance of the US economy versus the eurozone, emerging market, and Chinese economies based on these indexes as of June 6, 2024.

Purchasing Managers' Indexes (PMI) are based on monthly surveys of companies worldwide and gauge business conditions within the manufacturing and services sectors.

Credit spread is the difference in yield between bonds of similar maturity but with different credit quality.

Tightening monetary policy includes actions by a central bank to curb inflation.

Monetary easing refers to the lowering of interest rates and deposit ratios by central banks.

The discount rate is the interest rate a central bank charges commercial banks and other financial institutions for short-term loans.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. Duration is expressed as a number of years.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The eurozone (also known as the euro area) is an economic and monetary union of European Union member states that have adopted the euro as their common currency.

The opinions referenced above are those of the author as of **June 6, 2024**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.

Mid-Year Investment Outlook 2024: Finding value, avoiding traps

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