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CIO Alert: Risk-off mood takes hold

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Equities and bond yields fell in tandem on Friday, due to weak jobs data, raising concerns that the Fed may have delayed rate cuts too long, risking a recession. We now anticipate a 100 basis point rate cut this year, up from our previous forecast of 50 basis points.

What happened?

Equities and bond yields fell in tandem on Friday, as weak jobs data fueled investor anxiety that the Federal Reserve has waited too long before cutting rates and that the US economy could be headed for a recession.

The July employment report contained significant downside surprises, with nonfarm payrolls increasing by only 114,000 and the unemployment rate rising to 4.3%, up from 4.1% in the prior month and from a low of 3.4% as recently as May 2023. Average hourly earnings grew 0.2% month over month, and weekly hours worked declined, indicating negative implications for household income.

While the unemployment rate is still relatively low by historical standards, such a rapid rise in unemployment in the past has often been associated with an abrupt slowing of economic growth. This weak data caused investors to price in a faster pace of monetary easing, with markets now implying close to 120 basis points of cuts this year, up from 66 basis points as recently as two weeks ago and 36 basis points at the start of July.

Markets also appear to have become impatient for evidence that heavy investments in AI are starting to pay off for top tech firms.

The risk-off mood pushed the S&P 500 1.8% lower. The selling was fairly broad-based; every sector was lower with the exception of consumer staples and utilities, which are more defensive. The riskiest segments of the market such as small-

caps fared the worst, with the Russell 2000 small-cap index down 3.5%. There was not much distinction in performance between large-cap growth and value stocks, although the NASDAQ did fall 2.4%. The yield on 10-year US Treasuries fell 19 basis points to 3.8%.

What do we think?

It can be a mistake to read too much into a single data release. It is possible that the weakness of the July jobs report was accentuated by Hurricane Beryl. The number of people who reported being unable to work due to the weather was 436,000; this compares to an average of 33,000 for July since 2000. In addition, the rise in unemployment partly reflected an increase in the number of Americans seeking jobs. We will be looking for clarification from next month's jobs data.

But the report was undeniably disappointing and will heighten concern that the Fed has kept rates too high for too long. Given recent evidence that inflation is moving sustainably back to the Fed's target, we think the central bank has an incentive and justification to move more swiftly than previously expected to bring rates lower. Earlier this week, Fed chair Jerome Powell signaled that the Fed would be "watching really carefully" for signs of a sharp downturn in the labor market.

Against this backdrop, we now expect the Fed to cut rates by 100 basis points this year—up from our prior forecast of 50 basis points. Barring a stronger jobs report for August, we think the Fed will begin the easing cycle with a 50-basis-point cut at its September meeting.

However, our base case remains that the US economy will avoid a recession with growth remaining close to the 2% trend rate. With rates at a 23-year high, the Fed has plenty of flexibility to support the economy and markets. Most important, households are in good financial shape overall, with positive real income growth, average debt servicing costs that remain low relative to historical averages, and aggregate net wealth that has increased 37% since the start of the pandemic. All of this should underpin continued increases in positive real consumption, the biggest driver of economic growth. In addition, financial conditions have already eased markedly as bond yields have come down across the curve. This should help revive the housing market and encourage investment.

Meanwhile, we believe conditions are still broadly supportive for the equity market. Despite some signs that the pace of earnings revisions is moderating, we believe S&P 500 earnings per share are still on track to grow 11% in 2024. The swift change in market mood regarding AI also looks premature, in our view. It will likely take some time for companies to demonstrate that they can earn a return on their AI investments, but there are no indications that companies are backing away from these investment plans given the technology's promise. More broadly, in prior non-recessionary episodes, the S&P 500 has risen 17% on average in the 12 months after the first Fed rate cut.

How do we invest?

Equities are likely to remain volatile in the near term, but the pullback in recent weeks has improved their risk reward, especially for tech stocks. The S&P 500 is down about 6% from its all-time high on 16 July, while the FANG+ index has fallen 14% from its peak. There could be more downside if investor concerns about slowing growth and a Fed that is behind the curve continue to rise, and AI developments fall short of expectations. But similar to last fall when the S&P 500 fell 10% because of overheating concerns and the risk of more restrictive Fed policy, we expect the growth concerns fueling the current sell-off will be unfounded.

Thus, we maintain our year-end price target of 5900 for the S&P 500. Earnings fundamentals remain positive. Profits for S&P 500 companies remain on track to grow 10-12% for the second quarter. Companies accounting for more than 75% of the S&P 500 market cap have now reported, and the results have been generally positive overall as 60% of companies beat sales estimates and 75% beat earnings estimates, both in line with historical averages. Guidance by US companies for the third quarter has also been in line with normal seasonal patterns.

Against this backdrop, we advise investors to consider several strategies:

Position for lower rates. The global momentum toward lower rates has continued to build this week, with the first cut of the cycle from the Bank of England. The Fed also gave its clearest signal yet this week that cuts are on the way. With economic growth and inflation slowing, and central banks starting to cut interest rates, we see significant opportunities in the fixed income market. We believe investors should invest cash and money market holdings into high-quality corporate and government bonds, where we expect price appreciation as markets start to anticipate a deeper rate-cutting cycle. We expect quality bonds to perform well in our base case for a soft economic landing in the US, and even better in the risk case scenario of a recession—helping to cushion weakness in other parts of a portfolio.

Seize the AI opportunity. With a high bar set by the market, the 2Q reporting season hasn't been a smooth ride for the global tech sector. However, fundamentals remain solid, and global tech is on track to report earnings growth of 24% y/y for the quarter. We see 43% y/y growth in big tech's overall capex for 2024 after they guided for another USD 9bn increase. As we outlined in our CIO AI report (10 June), AI applications such as personal assistants and content generation will have to justify the AI infrastructure spend in data centers and GPUs. Thus far, earnings reports continue to suggest high conviction in ROI of AI infrastructure spend by tech executives as well as anecdotal evidence that AI monetization is picking up. We maintain our positive view on the AI growth story and think that the recent share price correction offers a good opportunity to add exposure to leading AI beneficiaries in the semiconductor, software, and internet space at more reasonable valuations. Investors can also consider structured strategies for more defensive exposure to navigate future volatility ahead of the US election.

Seek quality growth. We believe seeking quality growth should apply broadly to investors' equity holdings. Recent earnings growth has been largely driven by firms with competitive advantages and exposure to structural drivers that have enabled them to grow and reinvest earnings consistently. We think that trend will continue, and investors should tilt toward quality growth to benefit.

Diversify with alternatives. Amid economic uncertainty, we view alternatives as a strategic source of diversification and risk-adjusted returns. Hedge funds not only have the potential to help stabilize portfolios during times of stress but also take advantage of dislocations and generate attractive returns when other asset classes may struggle. Investing in alternatives does come with risks, including around illiquidity and a lack of transparency.

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