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CIO Alert: Market scenarios from here

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Equity markets have fallen sharply from recent highs, bond markets have rallied, and investors are anticipating faster central bank interest rate cuts. Volatility is likely to remain high in the near term, and the Fed is now more likely to cut interest rates more quickly, but we believe that recession fears are overdone. We believe investors should focus on deploying cash in quality fixed income, tilting equity allocations toward "quality" stocks, and diversifying portfolios across asset classes, including with gold and the Swiss franc.

What happened?
Global equities continued to sell off on Monday.

In the United States, the S&P 500 traded as much as 4.25% lower on Monday, before closing 3% weaker at 5,186. The sell-off was broad-based, affecting all sectors. The Russell 2000 index, representing small caps, fell by 3.3% to around 2,039, and the tech-heavy Nasdaq Composite also fell 3.4%, bringing it to 16,200.

The US moves followed weak trading sessions in Asia and Europe. Japanese markets endured their worst day in history (Nikkei 225 –12.4%), while both the Korean and Taiwanese markets dropped by more than 8%, as fears of a US economic slowdown reverberated across the globe.

The VIX implied volatility index hit a post-pandemic peak of more than 50, indicating heightened uncertainty about the future path for equity markets.

While market moves in recent days have been dramatic, it is important to keep them in the context of recent exceptional performance for global equities. While the S&P 500 is down 8.5% from its mid-July all-time high, it is still up 10% for the year. Performance for investors who are diversified across asset classes should also be somewhat cushioned by the recent strong performance by high-quality bonds.

What's the context?

The narrative driving global equity markets has pivoted dramatically in recent weeks. Optimism about artificial intelligence, robust growth, and a potential "roaring 20s" for economies and markets has given way to fears of a US recession, concerns about AI monetization, and rising risk of conflict in the Middle East.

While US economic data has been softer than expected for several months, Friday's employment data appears to have triggered a mood change in the market. The 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.

Notably, the speed of the rise in unemployment gained particular attention, as it triggered the Sahm rule, by which since 1960 a recession has begun every time the three-month average unemployment rate rose over 50bps from its low in the prior 12 months.

Our base case

In our view, despite the weaker payroll data, recession risks remain low. Our base case is for a soft landing for the US economy, with growth bottoming slightly below the 2% trend, and further moderation in inflation.
We believe investor concerns about a recession are overdone for several reasons:

- 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 owing to the weather was 436,000, compared to an average of 33,000 for July since 2000.
- The Sahm rule, which suggests that the rate of increase in unemployment is a harbinger of recession, looks questionable under current circumstances, in our view. With total nonfarm employment increasing by 2.5mn over the past year, we believe the higher unemployment rate is mainly due to a larger labor supply, rather than job shedding. Initial jobless claims—an indicator of labor demand—are still low by historical levels.
- While earnings commentary suggested some slowdown in advertising, auto, industrials, and software, profit margins remain solid, suggesting that companies have little reason to commence job cuts. S&P 500 companies are on pace to grow earnings per share 11% in 2024.
- Consumers and consumer spending are still in decent shape. June retail sales and personal consumption expenditure data suggest spending is normalizing from an elevated level, not deteriorating. Moreover, households are in good financial shape overall, with positive real income growth and average debt servicing costs that remain low relative to historical averages.
- Services sentiment is positive. The Institute for Supply Management (ISM) reported that its nonmanufacturing purchasing managers' index (PMI) rebounded in July to 51.4, with a jump in new orders and an increase in employment for the first time in six months.
- The Federal Reserve has plenty of scope to support the economy and markets. Recent data has improved confidence that inflation is headed sustainably back toward the 2% target, freeing the Fed to focus more attention on supporting growth and employment. At last week's policy meeting, Powell repeated that the Fed would be "watching very carefully" for signs of a sharp downturn in the labor market. We now believe the Fed will likely start the easing cycle with a 50-basis point cut at the September meeting, with a further 50 basis points of easing in the remainder of 2024, and more to follow in 2025.
- The promise of AI remains intact. Investors appear to have swung from rewarding companies for fast-rising capital spending, to becoming impatient with the pace of monetization. Yet the second quarter earnings season has continued to suggest top tech companies are confident that spending on AI infrastructure will deliver a high return. We have also been encouraged by anecdotal evidence that AI monetization is picking up.
- A further escalation of the Middle East conflict can still be avoided. Risks in the region have increased in recent weeks, and an attack on Israel from Iran and Hezbollah now looks imminent, according to US Secretary of State Antony Blinken. However, recent history suggests Israel will opt for a measured response, as it did following an Iranian drone and missile launch in April.
- The US election campaign could be a further source of volatility. Vice President Kamala Harris has continued to build momentum in her race for the White House. An average of national polls on Friday indicated that Harris has support of 45% of Americans versus 43.5% for Trump, according to 538, the opinion analysis website—within the 1.5-percentage-point band of uncertainty. This suggests that Harris has closed the lead that former President Trump had

built up over President Biden, who dropped out of the race last month. A blue wave, in which the Democratic Party claims control of both the White House and Congress, is not our base case. But such an outcome might lead to an increase in capital gains and corporate taxes, which could lead some investors to harvest capital gains before such a move.

What would happen to markets in such a scenario?

- *Equities*: While markets are likely to remain volatile in the near term, we expect concerns about growth to ultimately prove unfounded. And investors should remember that Fed rate cuts in prior episodes that did not result in recession have typically been followed by strong equity market returns, with the S&P 500 rising by 17% on average after the first Fed rate cut. More than 75% of the S&P 500 market cap has now reported 2Q earnings. We have seen some softening in earnings data, but not so much as to change our profit growth outlook. Corporate profits are likely to grow by 11-12% in 2Q on a year-over-year basis, at the higher end of with our initial estimate. While the breadth of earnings beats is in line with historical averages, the magnitude of the beats are a bit below normal.Our base case year-end and June 2025 S&P 500 price targets remain 5,900 and 6,200, respectively. We expect 11% S&P 500 earnings growth in 2024 (USD 250) and 8% growth in 2025 (USD 270).
- *Bonds*: Fixed income markets are also likely to remain volatile, and a further rally in high-quality bonds (and declines in US 10-year yields) is possible in the near term should recession concerns persist, and the unwinding of carry trade positions continues. That said, if future data demonstrates the US remains on course for a soft landing, as we expect in our base case, then we would expect yields to settle in the 3.5-4.0% range by the end of the year. From a portfolio perspective, we continue to believe investors should deploy excess cash into high-quality fixed income, which can help cushion overall portfolios against heightened fears of recession.

What could trigger a downside scenario?

Of course, we do also need to consider the possibility that things could turn out worse than in our base case. This could happen by a variety of mechanisms:

- Future data demonstrates that jobs are being shed, adding to evidence that Fed policy has been too tight for too long. As more Americans become fearful about losing their job, they could cut back spending to build up precautionary savings.
- AI investment slows. AI investment has been driving both the fortunes of chipmakers, notably Nvidia, and the cloud operations of the likes of Microsoft, Amazon, and Alphabet. If top tech companies start announcing that they are scaling back capital spending plans, we would be concerned about earnings sustainability. We would also be discouraged by a slowing in the growth of cloud revenues. Finally, disappointments on expected advances in chip technology could also trigger downside for tech stocks.
- A miscalculation by either Israel or Iran leads to a significant escalation in the Middle East, leading to higher global risk premia, as investors fear potential disruptions to oil supplies.

In such a scenario, we would expect global growth to fall sharply owing to weakness in consumer spending and labor markets, as well as a fall in AI-related investments. In response, we would expect central banks to cut rates swiftly, bringing monetary policy back into accommodative territory. The Fed would likely reduce rates well below the neutral policy rate, which we currently estimate to be around 3%.

What would happen to equity and bond markets in such a scenario?

- *Equities*: We see the S&P 500 falling to around 4,200 in our hard landing scenario driven by cuts to profit growth expectations and a reduction in valuation multiples.
- *Bonds*: A hard landing would prompt an aggressive Fed cutting cycle, in our view. In this scenario we would expect the 10-year US Treasury yield to finish 2024 at 2.5%. In addition to gains for high-quality bonds, we would expect appreciation in other relatively safe-haven assets such as gold, the Swiss franc, and the Japanese yen.

Key scenarios

	Bull case: Roaring 20s	Base case: Soft landing	Bear case: Hard landing	*Things to watch*
Probability	20%	60%	20%	
Market path	**Bonds down slightly, equities up** Equity markets rally amid strong US growth, moderating inflation, and optimism about the impact of AI on earnings. Bond yields are volatile but rebound to slightly above current levels by year-end.	**Bonds up, equities slightly up** Bonds yields and equities may drop further in the near term on recession fears. But as these fears prove unfounded, equities rally and bond yields finish the year close to current levels	**Bonds up, equities sharply down** Global equities post double-digit losses and credit spreads widen. Valuations in AI stocks drop substantially. Safe-haven assets such as high-quality bonds, gold, the Swiss franc, and the Japanese yen, appreciate.	
Economic growth	The US grows above the trend rate of about 2% as labor markets, household balance sheets, and corporate earnings prove resilient. Improving European growth and fiscal stimulus in China contribute to strong global growth.	US economic growth remains around trend over the next 12 months. Other Western economies experience sub-trend growth, in line with market expectations. China announces targeted measures to support economic activity.	Global growth falls sharply over the next 12 months owing to further weakness in consumer spending and labor markets, as well as a fall in AI related investments. GDP contracts for at least two consecutive quarters in both the US and the Eurozone. Chinese economy disappoints.	*US, China: PMI data* *US, Europe: Industrial prod.* *Global: Consumer spending* *US: Housing starts* *US: Savings rates, depletion* *US, Europe: Delinquency ratios* *Europe: gas prices*
Inflation	Resumes decline in the US and continues to fall in Europe, reaching central bank targets earlier than expected.	Continues to fall gradually in the US and continues to fall in Europe, normalizing in 2H24.	Falls quickly as demand for goods and services collapses.	*Global: Oil price* *US: CPI and PCE inflation* *US: ISM prices-paid subindex* *US: Average hourly earnings* *US: Chg in nonfarm payrolls* *US: JOLTS openings and hires* *Eurozone: HICP inflation* *Global financial conditions* *Bank lending surveys*
Central banks	Continue cutting policy rates in mid-2024 as inflation normalizes. The Fed cuts rates by 50bps in 2024, with cuts in September and December. Strong growth may limit expectations for cuts thereafter.	Continue cutting policy rates in Q3-2024 as inflation normalizes. The Fed cuts rates by 100bps in 2024, with cuts in September and December. Markets expect deeper cuts in 2025 and 2026 amid slowing growth and inflation.	Major central banks cut rates swiftly, bringing monetary policy back into accommodative territory. The Fed lowers its policy rate by at least 250bps over the next 12 months.	
Geopolitics	A de-escalation in the Middle East crisis and in the Russia-Ukraine war, and/or an improvement in bilateral relations between the US and China.	The Middle East crisis remains geographically contained. The Russia-Ukraine war continues. The US election contributes to volatility, particularly at a sector level, but the net effect on broader markets is limited.	Tensions in the Middle East escalate to a regional war with potential for significant disruption to oil supply. The war in Ukraine escalates, and US-China tensions intensify.	*Middle East crisis and oil supply* *Russia-Ukraine war signposts* *US sanctions on Chinese companies* *US election season*

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Recommendations

Throughout 2024 we have reiterated the theme of "quality," in both bonds and equities. With recession fears rising, quality remains a key theme.

In fixed income, we would expect quality bonds to deliver positive total returns in our base case, and they could rally even further if recessionary fears continue to mount. With cash interest rates likely to fall more quickly than we had previously expected, it remains important in our view for investors to deploy excess cash into medium-duration quality fixed income.

In equities, quality is an investment style that has historically outperformed as whole, but with the highest relative returns during recessions. Since 1992, quality stocks have delivered 9% annualized outperformance over global indices during recessions. (MSCI ACWI quality index versus MSCI ACWI). Companies with strong balance sheets and a track record of earnings growth, as well as those that are exposed to structural growth drivers, should be relatively well positioned if cyclical fears mount.

Elsewhere, we continue to like gold and the Swiss franc. The cost of direct hedging on equity markets has risen in recent days. As such, diversification with quality bonds, gold, and the Swiss franc is an important way for investors to insulate portfolios against further equity market volatility. Switzerland looks closer to the end of its policy easing cycle than most other central banks, and we would expect gold to benefit from central bank reserve diversification, investors seeking relative "safe havens'" and anticipation of faster interest rate cuts.

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