



## 2Q24 Market Overview: Choose Your Own Adventure

**The behavior of financial assets in the second quarter—highlighted by narrowing credit spreads and expanding equity multiples—continued to reflect an environment in which investor risk perception generally is low despite the many potential hazards on the road ahead.**

The S&P 500 Index returned 4.3% in the period, while the MSCI World Index gained 2.6%.<sup>1</sup> Growth continued to outpace value handily, as the “narrative economics”—as economist Robert Shiller would term it—surrounding such developments as artificial intelligence and GLP-1 agonists fueled investor enthusiasm in certain companies and segments of the stock market. In contrast, more mature, economically sensitive industries were generally soft.

The second half of 2024 appears likely to be a period of choices: on political leadership in the US and the handful of other countries yet to go to the polls in this bumper year for elections; on the direction of monetary and fiscal policy in developed nations where both inflation and economic momentum generally are slowing while debt burdens continue to grow; on the trajectory of geopolitical relations in a world of seemingly intractable conflict. It’s quite possible the investment landscape six months from now may be markedly different from today’s.

### KEY TAKEAWAYS

- Equities—and growth names in particular—continued to advance during the second quarter even as the Federal Reserve’s cautious stance on rate cuts fell short of market expectations.
- Though signs of economic fade are mounting in the US, both employment conditions and business sentiment remain at relatively healthy levels. Stimulating an economy with no obvious slack in it, however, risks triggering an unwelcome asymmetric inflationary response.
- The run of success in Japanese equity markets abated in the second quarter. Having arguably achieved its goal of sustainable inflation after decades of fighting deflation, the Bank of Japan faces an incredibly complex policy path moving forward.
- Latin American currencies and equity markets like Mexico and Brazil have been battered by a series of local political developments and persistent interest rate differentials.

1. Source: FactSet; data as of June 30, 2024.

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## Cleared for Landing?

Despite what election-cycle polls of the American electorate might suggest, financial market participants appear to have found comfort in a macro environment marked by easing inflation (especially for goods), positive if slowing economic growth and the potential for rate cuts in the not-too-distant future.

Following its June policy meeting, the Federal Reserve's "dot plot" of federal funds rate projections now calls for one 25 basis point cut by year end—down from three cuts in its March report—and the central bank continued to offer a cautious outlook for loosening despite "modest further progress" toward its inflation goals.<sup>2</sup> While markets have appeared to view rate cuts as the answer to their collective prayers for nearly a year now, they may want to be careful what they wish for. Both employment conditions and business sentiment remain at relatively healthy levels for now, and goosing an economy with no obvious slack risks triggering an unwelcome asymmetric inflationary response. The risks seem particularly high given the country's troubling fiscal dynamics; in fact, the Congressional Budget Office recently updated its estimate of the fiscal 2024 budget deficit to \$2.0 trillion, or 7% of GDP.<sup>3</sup> Fiscal discipline is not a term associated with either major political party today, and the prospects for improvement in the foreseeable future are dim regardless of the result of November's elections.

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On the other hand, there exists the possibility that we are closer to entering an economic stall zone than the beginning of a durable re-expansion. For example, the latest PMI reading for the services sector—which comprises more than 70% of the economy<sup>4</sup>—slipped into contraction, suggesting some lost momentum in June.<sup>5</sup> It's worth noting that while the US federal deficit remains elevated, it's down year over year, depriving the economy of the same fiscal boost it was benefitting from in 2023.

We've also seen signs of a slowly weakening unemployment picture. While still near multidecade lows, the unemployment rate increased from 3.7% to 4.1% year to date, while the number of full-time employees declined.<sup>6</sup> Reviewing most US recessions since World War II, we've noticed that the unemployment rate has tended to inch higher early into the slowdown before accelerating sharply.

Other metrics contribute to the hypothesis of economic fade. Yields on 10-year Treasuries, often considered a barometer of economic optimism, have drifted lower from their April highs (and are well off the cyclical peaks established in October 2023), and the Treasury curve remains inverted. Credit spreads have shown signs of bottoming in the past few months, and bank lending standards remain challenging for commercial and industrial borrowers.<sup>7</sup> Consumers who have increasingly been relying on their credit cards—the personal savings rate has declined steadily from its Covid-era highs and now sits at around 4%, a level not seen since the global financial crisis<sup>8</sup>—likely find their balance sheets withering under the weight of mounting debt, as interest rates exceed wage growth.

2. Source: Board of Governors of the Federal Reserve System; June 12, 2024.

3. Source: Congressional Budget Office; data as of June 18, 2024.

4. Source: Bureau of Economic Analysis; data as of June 27, 2024.

5. Source: Institute for Supply Management; data as of July 3, 2024.

6. Source: US Bureau of Labor Statistics, Federal Reserve Bank of St. Louis; data as of July 5, 2024.

7. Source: Federal Reserve Bank of St. Louis; data as of July 2, 2024.

8. Source: Bureau of Economic Analysis, Federal Reserve Board of St. Louis; data as of July 2, 2024.

## New and Old Challenges Abroad

The mid-July meeting of the Chinese Communist Party's Central Committee—the third plenum—is expected to offer clues about the country's economic policy priorities as it seeks to address a broad range of challenges, including fiscal ties between the country's central and local governments. It's been speculated that Beijing may use this meeting to assume greater responsibility for funding the various growth drivers that currently falls to heavily-indebted provincial authorities while also providing them with more sustainable tax receipts. While this could help abate deflationary pressures in China, it would weigh on its balance sheet. It could also bleed into how the country conducts its foreign policy, perhaps exacerbating instability in Asia. On a more hopeful note, there has also been some chatter that the third plenum may result in the introduction of corporate governance reforms to countries listed in China; such measures could help promote a re-rating of China's equity market, as they have in Japan.

Speaking of Japan, equity markets there have cooled after a very strong run of performance that was supported at least in part by governance measures enacted by the Tokyo Stock Exchange to enhance shareholder returns. Japan faces an incredibly complex policy path moving forward. Having arguably achieved its goal of sustainable inflation after decades fighting deflation, the Bank of Japan is faced with the prospect of raising policy rates, which would be a fraught maneuver even before accounting for the impact of potentially higher interest expense given the country's high debt to GDP ratio and very large budget deficits. The sequence of policy tightening may be key here, and while the BOJ has a range of options—hiking rates, shrinking its balance sheet, enacting fiscal discipline, or some combination thereof—there are no easy answers. The BOJ is walking a tightrope any way you look at it, and the yen has plummeted amid the uncertainty.

Europe, meanwhile, faces fiscal and political uncertainty of its own, perhaps best exemplified by France's snap election in early July. The fractured result left no single alliance close to holding the 289 needed to govern Parliament with a stable majority. With none of the left, center and right political blocs demonstrating the propensity to compromise as of yet, President Macron has been reluctant to exercise his constitutional responsibility of appointing a new prime minister. The most palatable option—to markets, at least—may be assigning a technocrat to the job to keep the government running until a fresh batch of elections can be held, no sooner than 12 months from now.<sup>9</sup> But large fiscal deficits and political stalemate are not a good cocktail when you can't print your own money, and French government bond spreads have widened relative to its euro zone peers.<sup>10</sup>

The fractured result of France's snap election highlights the fiscal and political uncertainty on the Continent.

9. Source: *The Economist*; data as of July 8, 2024.

10. Source: Bloomberg; data as of July 9, 2024.

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## Down, but Not Out

Looking at equity markets from the bottom-up, it appears that a bit more cyclical risk is being appreciated, as we have seen softness in more mature, economically sensitive areas like agricultural equipment, truck engine manufacturing, timber/lumber, oil and oil services, and durable equipment manufacturing. This has been especially true for businesses failing to deliver strong upside earnings surprises. Outside the US, there has been broad weakness in emerging markets like Mexico and Brazil, where even good businesses have been trading off due to weakness in local currencies.

For a while now we've been banging the drum about the many risks facing investors in the current environment, from massive sovereign debt loads to geopolitical strife. While this may suggest we are downbeat on the equity investment environment broadly, recent meetings with the managements of our portfolio companies all over the world left us feeling quite constructive about our individual exposures. Rather than constantly obsessing over the macroeconomic and political variables that could impact short-term performance, time may be better spent seeking opportunities to invest in quality businesses that can demonstrate resilience across multiple states of the world. Such companies, in our view, tend to have strong market positions and/or control scarce assets, with track records of durable cash flow generation and astute management.

Top-down risks underscore the importance of bottom-up rigor.

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