Market analysis | August 26, 2024

At a glance

Investor attention remains concentrated on the path of Federal Reserve interest rate policy. Rising hopes for cuts in the wake of Fed Chair Jerome Powell's keynote address at the annual Jackson Hole Symposium lifted both bond and stock prices last week.

Number of the week

10.6%

The increase in new home sales, the highest annualized sales pace since May 2023.

Term of the week

Defensive stocks – Stocks that tend to provide consistent dividends and stable earnings regardless of the state of the overall stock market and economy. A constant demand for their products exists, so their stock prices tend to be more stable during the various phases of the business cycle.

Bond yields reflect a somewhat aggressive cutting cycle, assigning a roughly one-third chance the Fed delivers a 0.50% cut in September and a cumulative 1.00% in cuts before year-end followed by another 1.25% in cuts in 2025. Fed Chairman Jerome Powell refrained from commenting on the magnitude of cuts, emphasizing policy will adjust as economic conditions change.

Bill Merz, CFA, *Senior Vice President, Head of Capital Markets Research, U.S. Bank*

Global economy

Quick take: The U.S. housing market improved in July along with service business activity, though manufacturing remains a challenge. Outside the U.S., business activity appears to be recovering, with European manufacturing the exception.

Our view: The global economy continues to see moderating growth, especially across manufacturing activity, and inflation continues to decelerate. Despite higher interest rates, the U.S. Bank Economic team sees conditions consistent with a soft landing in the U.S.

- **S&P Global's purchasing manager surveys indicate still-strong U.S. business activity**, particularly for the service sector. The August flash (preliminary) number improved to 55.2 for service businesses, up from 55.0 in July and just below the 26-month high reached in June. Manufacturing activity remains stagnant, with the index dropping to 48.0 from 49.5 in July, the second successive month of contraction after exhibiting expanding activity for the first six months of the year. Employment growth remains a challenge in both surveys.
- **Home sales improved in July** as mortgage rates fell below 7%. Existing home sales rose by 1.3% over June, the first monthly increase since February. New home sales jumped 10.6% to the highest annualized sales pace since May 2023, with lower mortgage rates and improved supplies lifting activity.
- **Globally, flash purchasing manager indexes improved in August** with services providing much of the strength in activity. Services surveys showed improving expansion in India, Australia, the Eurozone, the United Kingdom and Japan. Australia and the Eurozone continue to experience a manufacturing contraction, while the United Kingdom and Japan are expanding and India's business activity remains robust.

Equity markets

Quick take: U.S. equities continue to inch higher following last week's dovish Federal Reserve (Fed) comments, despite seasonal headwinds, as the slightly better-than-expected second quarter earnings season draws to a close.

Our view: Inflation is falling, interest rate cuts loom and earnings are trending higher, all of which help provide valuation support. Recent price action shows strength among both growth- and defensive-oriented sectors.

- **Performance "breadth" is constructive.** The S&P 500 continues to trend above its historical annual average of 12.2%, dating back to 1926. As of Friday's close, the index is up 18.1% for the year, with all 11 sectors in positive territory and seven up 13% or more. This broad-based strength is typically indicative of favorable underlying business conditions.
- **Second quarter results are trending modestly above expectations**. As of Friday's close, with 95% of S&P 500 companies having released results, sales and earnings are advancing 4.7% and 9.3%, respectively, above projections of 4.4% and 8.6%. Another 3% of S&P 500 companies are slated to release results this week, highlighted by artificial intelligence bellwether NVIDIA on Wednesday.
- **Consumer spending remains resilient but with signs of slowing** among lower-income groups. Banks and credit card companies say credit remains positive with no meaningful uptick in loan or credit card defaults. Airlines, lodging companies and big box retailers said spending appears to have plateaued on "experiences" but is increasing on discretionary goods, excluding furnishings that typically require financing.
- **Business spending remains robust**, particularly around artificial intelligence-related products, with no sign of slowing in capital expenditures spending. Cloud and security remain priorities, driven by the need to modernized infrastructure. The pace of growth among enterprise software and hardware companies is showing isolated pockets of slowing as companies prioritize investments elsewhere.
- **Consensus earnings projections for 2024 and 2025 remain stable; valuation is elevated.** Analysts forecast earnings of roughly $242 per share for 2024 and $277 in 2025 for S&P 500 companies, according to Bloomberg, FactSet and S&P Cap IQ, reflecting robust 9.5% and 14.5% year-over-year growth, respectively. At present, the S&P 500 trades at 23.3 times the 2024 estimate and 20.3 times 2025 projections, at the high side of fair. Second quarter results indicate expense control remains a priority, helping support profit margins and earnings growth.

Bond markets

Quick take: Treasury yields fell last week as Fed Chairman Jerome Powell foreshadowed a September interest rate cut. Bond markets now reflect expectations of approximately 1% of rate cuts this year and 1.25% next year.
Our view: The prospect of upcoming Fed rate cuts paired with a moderating pace of economic growth establishes a favorable backdrop for bond holdings. Bonds may still face price fluctuations, since interest rates already price in high expectations for rapid rate cuts, but bonds continue to offer compelling opportunities to accrue meaningful income.

- **Powell prepared investors for a rate cut at the Fed's September 18 meeting.** Speaking at the annual Jackson Hole Economic Symposium, Powell said, "the time has come for policy to adjust," implying the Fed is ready to cut rates at its next meeting. He said he has gained confidence inflation will settle around the 2% price stability target. His speech focused on the labor market, which has begun decelerating, with moderating job growth and a rising unemployment rate. This marked a strong contrast to the Fed's previous fixation on slowing inflation and set the stage to begin easing off its restrictive policy stance. Powell noted "the cooling in labor market conditions is unmistakable" and the Fed does "not seek or welcome further cooling in labor market conditions." While his speech concretely foreshadowed a September rate cut, the size and pace of cuts are still up for debate. Bond yields reflect a somewhat aggressive cutting cycle, assigning a roughly one-third chance the Fed delivers a 0.50% cut in September and a cumulative 1.00% in cuts before year-end followed by another 1.25% in cuts in 2025. Powell refrained from commenting on the magnitude of cuts, emphasizing policy will adjust as economic conditions change. The Fed's reactive data dependency remains a key source of uncertainty that can cause swings in bond prices.
- **The Fed's attention to downside economic risks bolsters investor confidence in lower-quality bonds.** Riskier high yield corporate and municipal bonds have fully recovered their losses from earlier this month. Valuations on high yield bonds are back to somewhat expensive levels compared to history, but strong demand continues to backstop prices and the extra yield on riskier bonds is still meaningful. Other esoteric bond categories like reinsurance and non-agency mortgages also offer attractive yields. Investors can spread out exposures across a variety of these markets to limit sensitivity to credit stress in isolated pockets of issuers.

Real assets

Quick take: Interest rate-sensitive real assets outperformed the broader market last week, with lower fixed income yields supporting prices. Gains were broad-based across real estate and infrastructure assets, with all sub-sectors posting positive returns. Commodity markets were led higher by industrial metals while crude oil traded lower.
Our view: Diversified publicly traded real estate remains inexpensive compared to private real estate. Tangible assets with stable cash flows present relative value opportunities as recession fears increase. Commodities look to trade lower as growth expectations decline.

- **Real Estate outperformed the S&P 500 by 2.2% last week.** Industrial and office properties posted the strongest returns while data center and residential companies fared the worst. Publicly traded real estate continues to trade at discounts to private markets (individual properties).
- **Infrastructure stocks beat the broader market by 0.2% last week.** Airports and utilities led gains while midstream energy and railroads were the worst performers. All sub-sectors posted positive returns.
- **Crude oil prices fell 0.8% last week despite large declines in domestic inventories of crude and refined products.** Domestic inventories of crude and refined product keep moving lower, and over a longer-term horizon, the crude market appears undersupplied, which should act as a tailwind to prices.

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