# PIVOT POINT?

We are only half way through July. But already much has changed.

On the economy, there is now more clarity. Rate cuts are coming in the US, most likely in September. Data on inflation and jobs over the last week have confirmed that the balance of risks has shifted, clearing the way for the Federal Reserve to begin to ease. The Fed is unlikely to make its move when it meets later this month. It is still cautious about inflation. But markets are already celebrating. Global equities finished the week higher, rising more than 1%. US Small Cap equities were the standout performers, however, with the Russell 2000 finishing the week 6% higher.

Politically, the world is also at a pivot point. But here, recent events have just deepened uncertainty. Investors looking for clarity on US—and European—policy prospects will have to wait.

Most importantly, in the US it is still not clear whether President Joe Biden will stay in the race for the presidency. If he insists on staying, questions about his capacity will likely continue. And if he does step down, there will be a scramble to replace him, with uncertainty likely to continue until the Democratic convention in August.

Across the Atlantic in France, President Macron is struggling to form a government that he can work with and that will not push for policies that rock the boat in Europe, whether more deficit spending or less aid for Ukraine. Snap national elections in France kept the far right out of government, but failed to deliver an outright winner—and strengthened the hand of the far left. The UK bucked the trend toward confusion when voting on July 4. There, too, voters showed their dislike for current leaders. The election, held with admirable speed, led to a clear victory for Sir Keir Starmer's Labour Party. The new Prime Minister was in place the next day and his Cabinet has begun work. Labour's victory is good news for the energy transition as the new PM has indicated he would like to see the UK as a clean energy superpower.

## EASING AHEAD

The global cycle of monetary policy will start in earnest when the Fed cuts US interest rates. Although Europe and Canada began to ease last month, they will not go much further without the US. The Bank of England did not move on the eve of the UK election, but is likely to do so at its next meeting on August 1. But the UK too would prefer to be in the company of the Fed. Differing outlooks for rates have been a factor in currency moves. The dollar reacted immediately to Thursday's better-than-expected inflation data, while the GBP rose against the dollar and the Euro.

The economic news in July suggests that the data-dependent Fed will soon decide that the time has come to ease. Chair Jerome Powell signaled as much in testimony to Congress this week, when he noted that high inflation was no longer the only risk for the US economy.

Powell has long used comments about the balance of risks to indicate his views on monetary policy. The risk of doing too little to quash inflation was clearly upper most during the sharp run-up in rates in 2021-22. Since then, the Fed has been concerned that easing too soon, against the backdrop of an unusually tight labor market, could allow a flare up in inflation. Already in 2023, Powell began to signal the possibility of easing as he talked about the risks becoming more balanced between inflation and overly tight money that could tip the economy into recession.

But during the first half of 2024, the prospects for US rate cuts dimmed. The downward trend for inflation, which had been reliant on sharp declines in goods prices that had surged earlier, seemed to have stopped. Underlying inflation in services, and housing, stayed well above the 2% Fed target for price stability.

The June release this week put the cap on a string of better reports for the second quarter. A lower than expected increase in June in the core CPI—which rose at an annual rate of less than 1%—was particularly welcome. It reflected much smaller increases in the costs of services as well as a long-awaited fall in housing-related costs.

In the past three months, the underlying rise in consumer prices has averaged 17bp a month, compared to 37bp in the first quarter and a little over 25bp in the second half of last year.

Consumer price moves have been volatile, in part reflecting the difficulty of seasonal adjustment at a time of large changes in underlying data. The Fed will have its preferred inflation measure—core PCE—before its next meeting. But it does not need to rely only on price data to judge the effectiveness of what is now two years of tight money. Unemployment is still low by historical standards. But at 4.1% in June it was significantly above the low of 3.4% reached in January 2023. Other recent measures of labor market pressures also indicate a softening jobs picture. Vacancies have come down sharply from their peak. Workers have become less willing to quit their jobs.

The most likely path for US rates is an orderly decline over a year or more, in small steps of 25bp. The Fed hopes that this will be enough to avoid a hard landing. If earnings disappoint or the jobless rate suddenly jumps, rather than creeping up, the central bank will hope that it can ease more rapidly without upsetting the balance with inflation.

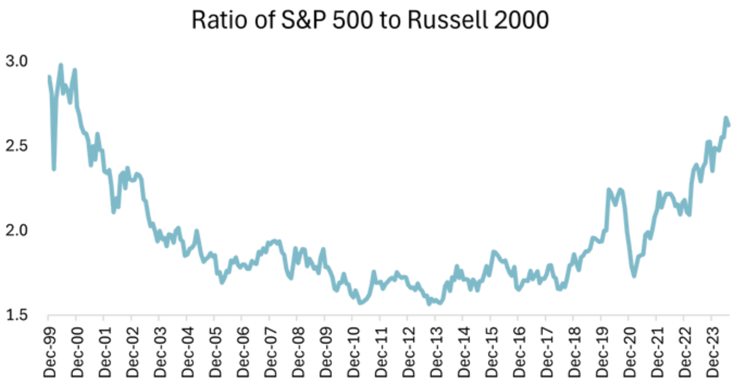
## POLITICS GETTING HARDER

Two weeks after he stumbled in debate with former President Trump, President Biden has called for an end to the discussion about whether he should stand down from running in the November election. So far he has not silenced the critics in his own party. These were muted somewhat this week by the gathering in Washington of America's most important allies for the NATO summit. Uneasy Democrats did not want to undermine the show of US leadership and strength. Next week, when former President Trump will become the official nominee for president at the Republican convention, may be make or break for President Biden.

In any event, many polls show the likelihood of a victory for Republicans in November has risen. A sweep of the House and Senate is also possible. This may matter as much for the rest of the world as for America. Business and political leaders in Europe and Asia are sharply focused on US developments and the implications for trade and geopolitical relationships.

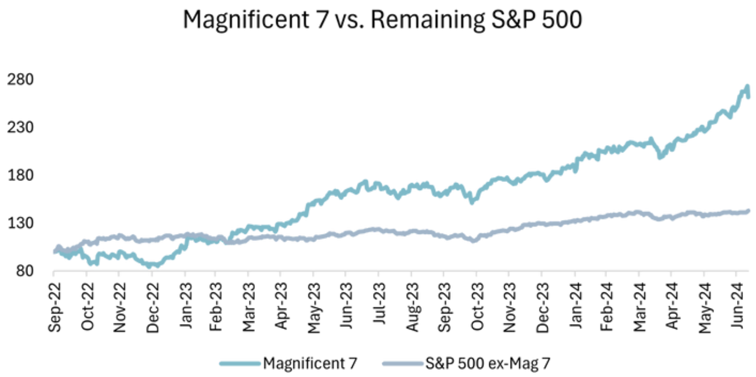
## EQUITIES

Equity markets closed the week in dramatic fashion following the latest CPI print (detailed above). Following the repricing of interest rates (discussed below), US small caps, as measured by the Russell 2000, posted their biggest one-day move of relative performance vs. the S&P 500 since March of 2020, with the Russell rising 3.3% and the S&P 500 falling nearly 1% on the day of the release. This is perhaps not surprising given the underperformance of the Russell compared to the S&P was at its most stretched since the dotcom bubble era going into release. Moreover, markets saw similar price action at the end of 2023 after US 10-year rates peaked in late October at 5% and rallied into year end. All equities did well over that period, but small-cap equities did particularly well.

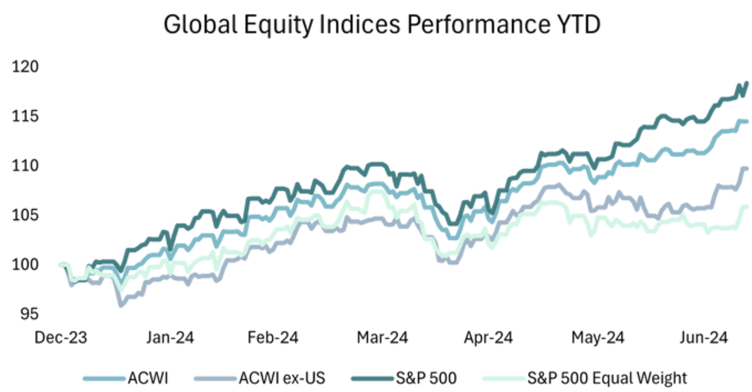



Other interest rate sensitive industries and geographies also outperformed significantly following the good news on inflation. Emerging markets outperformed the S&P by more than one percentage point, while non-profitable tech, renewables, and biotech all outperformed by four percentage points or more. It is likely that in the coming days some of this relative performance will reverse as any forced selling or short covering normalizes, but these initial moves would suggest some of the biggest beneficiaries of easing monetary policy may be outside of mega-cap tech.

It may seem curious that mega-cap tech should underperform now, as throughout the COVID era low interest rates powered the valuations of these companies higher. Despite a brief wobble in 2022, during the most aggressive policy response from the Fed, these mega-cap tech stocks have significantly outperformed US equity markets. This phenomenon is likely attributable to two dynamics. To begin with, the fundamentals for the Mag 7 have been much better than the remaining S&P 500. Since Q4 2022 earnings for these companies have grown 60%, the remaining companies have experienced earnings growth of -1%. In addition, due to the superior earnings power, these names likely became favored as a “safe haven” in the event of an economic hard landing (something many investors spent 2023 worrying about). These two dynamics seemingly divorced these stocks from their general interest rate sensitivity and enabled them to power global equity markets higher.

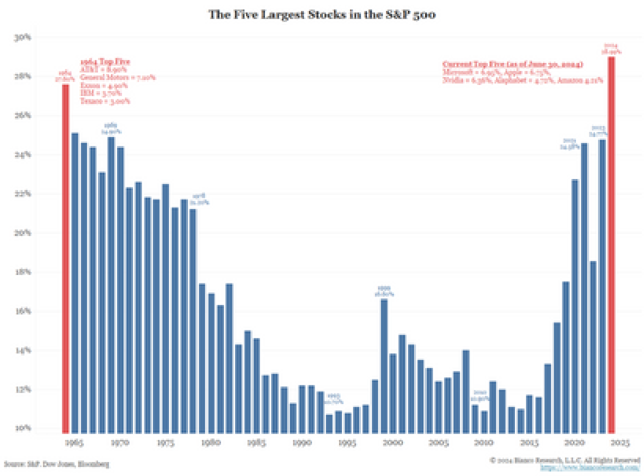



The impact that this cohort of US companies has had on global indices is pronounced. As one can see from the chart below, the MSCI ACWI has far outpaced ACWI ex-US. Indeed, there have been standout markets alongside the US including Japan, which despite some recent bumps remains up 13% YTD in dollar terms—keeping pace with the broader global equity market. Two large emerging markets, specifically India and Taiwan have outpaced US and global markets rising 19% and 40% respectively. Still, it is clear the US equity market has played a major role in driving the overall equity market higher.



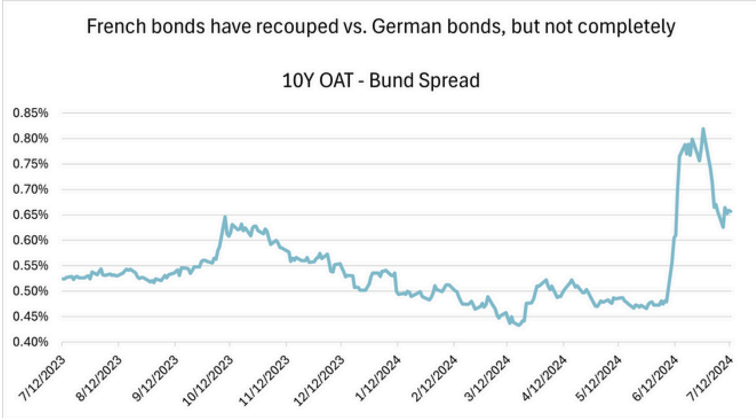

This concentrated outperformance has led to extreme levels of position concentration in global indices—the top-five stocks in the S&P 500 account for nearly 29% of the S&P 500. The index has not been that concentrated since 1964 when AT&T,

GM, Exxon, IBM, and Texaco comprised 28% of the index. In the past few years, this level of concentration has benefitted passive index investing as the top performers become an increasingly important part of the index, and that momentum builds on itself to the benefit of all index holders. The downside of this became apparent at the end of this week as the broad-based index fell amid good economic data. If these moves are any indication of the dispersion set to occur during any future easing cycle, the value of active management cannot be understated.

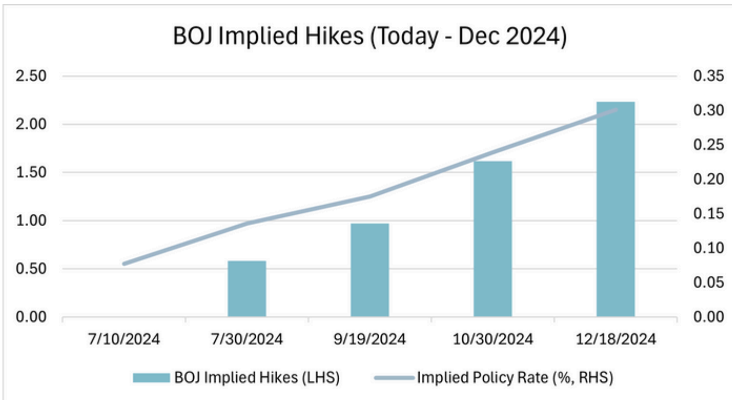



## FIXED INCOME

The last two weeks in global rates markets have been choppy to say the least. Amidst a slew of consequential elections, domestic political developments and a softer-than-expected inflation print, short and long-dated interest rates across the globe have swung meaningfully. The most notable of these came in the wake of Thursday's surprise CPI print. US yields plunged and the curve bull steepened as front-end rates fell faster than longer-dated tenors as traders increased their expectations for interest rate cuts from the Fed. Currently, market participants expect two rate cuts from the Fed in 2024 with a ~48% probability of a third by year-end, up from 1.7 cuts this time last week. Prior to Thursday's inflation data release, the 10-year sold off to nearly 4.5% following an exceptionally strong University of Michigan Sentiment release. Only two days later, a notably weak ISM Services number spurred a week-long rally back to 4.3% before ending the week at 4.2% after CPI spurred a bout of bond buying.




Despite much fanfare in domestic rate markets, the last two weeks have not exactly been smooth sailing in international waters. Not wanting to be outdone by the other dovish central banks, the Swiss National Bank cut rates again to 1.3% on June 20th, the lowest in the developed world excluding Japan, while both the Swedish Riksbank and Royal Bank of New Zealand left rates unchanged. After a violent sell-off following President Macron's snap election decision, French bonds rallied as Marine le Pen's National Rally party came third in the legislative elections, trailing the left-wing New Popular Front and Macron's own Ensemble party. While investors still demand a healthy premium for owning French OATs over German bunds, the spread between the two has retraced in recent days.



Thursday's dovish CPI release also had a profound effect on the Japanese yen. As markets priced in a more aggressive Fed-cutting cycle, the yen strengthened against the greenback, slightly immediately following the release, then rallied significantly 10 minutes later. It remains to be seen whether this was driven solely by market participants or yet another intervention by the Bank of Japan, as Masato Kanda—Japan's top currency official—declined to comment whether the central bank had indeed intervened. Nevertheless, Japan remains an outlier compared to other central banks lowering rates, with OIS markets pricing in two further rate hikes between now and year-end, with the potential for a third still on the table.