Market analysis | September 23, 2024

At a glance

The Federal Reserve started its rate-cutting cycle by trimming its target interest rate by 0.5%. This was widely cheered by equity investors, with the S&P 500 touching another all-time high. In contrast, longer-term interest rates rose on fears inflation could rebound.

Number of the week

9.5%

The increase in housing starts in August, after a 7% decrease in July.

Term of the week

Infrastructure stocks – The term infrastructure refers to the basic physical systems of a business, region or nation. These systems tend to be capital intensive and high-cost investments, and are vital to a country's economic development and prosperity. This can include transportation systems, communication networks, sewage, water and electric systems.

Recent performance reflects a risk-on bias. The S&P 500 ended last week up 19.6% for the year, with all 11 sectors in positive territory, nine of which are up 10% or more. Also noteworthy is the improving performance in September, historically the worst-performing month of the year. For the month as of Friday's close, the index is up 1.0% after being negative prior to last week; seven of 11 sectors are posting month-to-date gains.

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Global economy

Quick take: U.S. consumer spending remains stable, and lower interest rates appear to be helping the housing market recover. However, weaker spending and continuing housing market struggles indicate Chinese economic activity remains soft.
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.

- **Retail sales rose 0.1% in August after a solid 1% gain in July,** suggesting momentum for back-to-school spending. Looking at the past six months to smooth the month-to-month volatility, retail sales rose an annualized 2.9%. This is consistent with positive consumer spending and easing price pressures supporting household purchasing power.
- **Home building recovered from July's hurricane-related declines,** though sales of existing homes remain modest. Housing starts gained 9.25% in August after plunging 7% in July. Compared to August 2023, housing starts are up a respectable 3.9%. Building permits rose 4.9% in August, an indication of some improvement in activity, though this is still 6.5% lower than a year ago. The NAHB/Wells Fargo Housing Market Index rose slightly in September, with lower interest rates supporting home builder sentiment. Still-elevated construction costs are still a challenge, however.
- **China's August economic data indicates still-slow economic activity**, hurt by weak consumer sentiment and lower housing prices. Industrial production grew just 4.5% year-over-year, slowing from 5.1% in July. Retail sales gained just 2.1% year-over-year after a 2.7% gain in July. Fixed asset investments slowed from 3.6% in July to 3.4%; stronger state spending could not offset weaker private investment. Real estate investment declined 10.2% year-over-year, unchanged from July, though housing prices continued to slump, down 5.3% year over year.

Equity markets

Quick take: U.S. equity performance reflects a risk-on (more aggressive) bias following weakness earlier in the month. Valuations, while elevated, are supported by moderating inflation, lower interest rates and rising earnings.
Our view: Inflation is falling, interest rate cuts are in motion and earnings are trending higher, all of which help provide valuation support. Near-term, broad market volatility is likely to remain more the norm versus exception due to elevated valuations, limited company information flow and ongoing election-related nuances.

- **Recent performance reflects a risk-on bias.** The S&P 500 ended last week up 19.6% for the year, with all 11 sectors in positive territory, nine of which are up 10% or more. Also noteworthy is the improving performance in September, historically the worst-performing month of the year. For the month as of Friday's close, the index is up 1.0% after being negative prior to last week; seven of 11 sectors are posting month-to-date gains.
- **S&P 500 performance reflects strength among the largest companies, albeit at a moderating pace.** The 20-largest S&P 500 companies by market capitalization, representing roughly 46% of the S&P 500, are outpacing the index by roughly a two-to-one margin, up 39% versus 19.6% as of Friday's close. While this shows continued performance strength among the largest S&P 500 companies, it is less than the nearly three-to-one margin of outperformance at midyear.
- **S&P 500 earnings growth projections for 2025 seem optimistic; valuations are elevated.** Analysts forecast S&P 500 earnings of $242 per share for full-year 2024 and $277 in 2025, according to Bloomberg, FactSet and S&P Cap IQ, reflecting respective robust 9.6% and 14.5% year-over-year growth. At present, the S&P 500 trades at 23.6 times the 2024 estimate and 20.6 times 2025 projections, at the high side of its historical average. Emphasis will be on company guidance for 2025 following third quarter results beginning in mid-October.
- **Estimated third quarter revenue and earnings growth reflect modest increases.** The third quarter reporting period unofficially begins October 11, with the release from several money center banks. At present, third quarter sales and earnings are projected to increase 4.4% and 4.2%, respectively, over year-ago levels, according to FactSet. This is below the approximate 5.0% sales growth and 11.5% earnings growth posted for the second quarter.

Bond markets

Quick take: Riskier high yield corporate bonds performed well last week, with the Federal Reserve's (Fed) decision to cut interest rates 0.50%, boosting investor sentiment. Short-term Treasury yields fell in response to the larger-than-normal rate cut, but long-term yields rose due to investor concerns that easier monetary policy could rekindle inflation.

Our view: Blends of diversified high-quality bonds offer opportunities to lock in yields above 4% before the Fed cuts interest rates further. Modest supplemental exposures to riskier high yield bonds and unique bond types such as non-agency mortgages and reinsurance can further improve return potential in fixed income portfolios.

- **The Fed cut interest rates by 0.50%, and its projections included a faster rate-cutting campaign than previously indicated**. By cutting rates 0.50% and projecting 0.50% in additional cuts this year, the Fed appears to acknowledge the risks of keeping rates higher for longer outweigh the risk of a reacceleration in inflation due to loosening policy. The projections reinforce our guidance to ensure ample diversification within bond portfolios and to lock in steady income at compelling levels for years, rather than facing reinvestment risk due to falling policy rates when remaining in cash.
- **The Bank of England (BoE) and Bank of Japan (BoJ) held interest rates steady last week**. The BoE cut rates 0.25% in August but decided to delay a second rate cut to ensure inflation settles at its target. The BoE stated it's likely to cut again in coming months, and bond yields reflect investor expectations for that to occur in November. Meanwhile, the BoJ noted the increasingly uncertain global economic outlook merits further assessment before its next rate decision.
- **Risky bond prices pushed higher last week.** High yield corporate and municipal bonds offer less extra yield over Treasuries than historical averages to compensate for credit risk. This implies valuations are somewhat expensive, but defaults are slowing and investor demand remains strong, which can support prices for some time. The Fed backing off its restrictive monetary stance helps maintain stable credit conditions and can act as an additional tailwind for riskier bonds.

Real assets

Quick take: Real assets trailed the broader market last week, with higher long-term interest rates dampening prices despite the Fed cutting its short-term interest rate target. Real Estate was the worst-performing sector. Commodity markets were led higher by the energy industry, but all sub-sectors posted positive as investors sought protection from the risk of rekindled inflation.

Our view: Tangible assets with stable cash flows present relative value opportunities should recession fears increase. Commodities could trade higher if a more dovish Fed leads to greater inflation.

- **Real Estate trailed the S&P 500 by 2.4% last week.** Office and data center companies posted the strongest returns while residential and industrial properties fared the worst. Only the office sector posted positive results. Publicly traded real estate continues to trade at discounts to private markets (individual properties).
- **Infrastructure stocks trailed the broader market by 1.6% last week.** Airports and utilities led gains while toll roads and midstream energy were the worst performers. Utilities are outperforming the S&P 500 by 8% this year.
- **Crude oil prices rose 4.9% last week,** with the Fed's interest rate cut spurring gains across the entire commodity complex. Additionally, domestic inventory of crude oil declined, and inventory is particularly low at the crucial storage hub in Cushing, Oklahoma. Over a longer-term horizon, the crude market appears undersupplied, which should act as a tailwind to prices.

Important disclosures provided on page 4