S&P 500 EARNINGS BREADTH BROADENS

After a few volatile weeks, global equities ended up about 2.6% in August. Following a 15% plus decline in the first three days of August, Japanese equities ended the month up 1.8%. In the U.S., defensive equities performed better than the more cyclical areas and mega cap stocks. Fixed income returns have benefited from recent declines in interest rates. The 2s10s curve (yield curve) has un-inverted. The 2-year Treasury yield declined as the market began anticipating interest rate cuts over the next 12 months. Credit spreads widened somewhat, but it mostly reflected heightened volatility in the rates market and less about the health of the corporate sector.

U.S. economic activity is likely to cool from its brisk pace in the first half, but we don't expect a contraction in the near term. The recent payrolls report and revisions released last month show that the job market is cooling from its earlier hot pace with no evidence of a downturn. Recent data has been broadly consistent with our soft landing base case and if anything, probabilities have coalesced even more around the base case.

Inflation is decelerating to more normal levels. With a cooling labor market, we would expect more progress on services inflation. The Fed has communicated that the "time has come" to begin cutting interest rates in response to falling inflation and slowing growth. The June [1]SEP had the Fed Funds rate at 4.1% by the end of 2025, while the market expects an additional 125 basis points (bps) of cuts. Potential unwinding of rate cut expectations could be a source of volatility. Despite recent moderation, the U.S. growth outlook is much more constructive relative to Europe and China where slowing continues.

The S&P 500 saw 11% year-over-year earnings growth in the second quarter, of which nearly half came from stocks outside of the Magnificent 7. This is a change from the prior 2-3 quarters when their contribution was negative. We see a similar picture in the bond market where credit spreads have remained contained. The High Yield (HY) picture remains constructive with low default rates.

Our recommended 6-12 months tactical asset allocation broadly favors global equities over bonds. There are some valuation concerns around U.S. equities but strong earnings expectations and the broadening of equity markets keep us invested in them. Bonds may remain volatile if the market begins to price out rate cuts. This led us to go further underweight bonds. We do expect a bounce back in global equities but we removed our developed ex-U.S. equities overweight where the growth picture is a little muddy. The reductions in bonds and equities funded additions to Global Real Estate and Global Listed Infrastructure. Both asset classes should continue to benefit from the reduction in the rates environment. Investor sentiment was quite negative on Real Estate and we expect an improvement here as the asset class is highly leveraged to lower and declining rates. Further, Global Listed Infrastructure is particularly well positioned from an earnings and fundamentals perspective.

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S&P 500 ex-Magnificent 7 contributed 5.4% to 2Q S&P 500 earnings growth, the highest level since early 2023.

Source: Northern Trust Asset Management, Bloomberg, FactSet. Data as of 8/31/2024. Magnificent 7 = Mag 7. [1]SEP = Summary of Economic Projections.

BASE CASE EXPECTATIONS

Sticking the Landing

Global growth will move below trend but remain positive, supported by ongoing U.S. economic strength and labor market/consumer resilience. Inflation will remain above target but continue to proceed toward 2%.

Central Bank Transitions

Major central banks have started to cut policy rates and we expect more to follow suit as the year progresses. Economic growth may afford policymakers more time to confirm that inflation progress is sustainable.

RISK CASE SCENARIOS

Stubborn Inflation

Inflation does not move lower due to economic resurgence, tight labor markets, U.S. election induced pressures related to tariff or immigration policies, and/or disruptions from conflict in the Middle East.

Lagged Impacts

A soft landing is taken off the table as easing economic growth evolves into a traditional demand-led recession. In this scenario, a shallow recession is more likely than a deep contraction.

Indexes used and definitions:

MSCI ACWI: A free-float weighted equity index that includes both emerging and developed world markets.

S&P 500 Index: Widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

S&P Global Infrastructure Index: The S&P Global Infrastructure Index includes exposure to 75 companies from around the world that represent the listed infrastructure universe.