IDB BANK™
GLOBAL WEALTH MANAGEMENT

VIEWPOINTS

NOVEMBER 2024

Climbing The Wall of Worries

Equities in the third quarter continued to climb the wall of worries from potentially market negative events on the horizon. U.S. elections are less than a month away and geopolitical tensions in the Middle East are elevated along with risks from the Russia/Ukraine war. Yet, equity investors have shrugged off the potential impact from these events and global equities were up 6.7%. Fixed income portfolios also fared well returning 5.2% for the benchmark Bloomberg Aggregate Index. A simple balanced portfolio of 60% global equities and 40% investment grade fixed income was up 6.1% as markets climbed a wall of worries.

There were notable developments in the quarter which confirmed our expectations that market breadth would improve. The S&P equal weighted index was up 9.6% for the quarter while the market cap weighted index was up 5.9%. Broadening of stock performance occurred as earnings contribution broadened. A similar broadening occurred internationally with both emerging market equities (up 8.4%) and developed ex-U.S. equities (up 8.2%) outperforming U.S. large cap stocks. U.S. small and mid-cap stocks fared better than large caps. The tech heavy NASDAQ Composite Index lagged and was up only 2.8%.

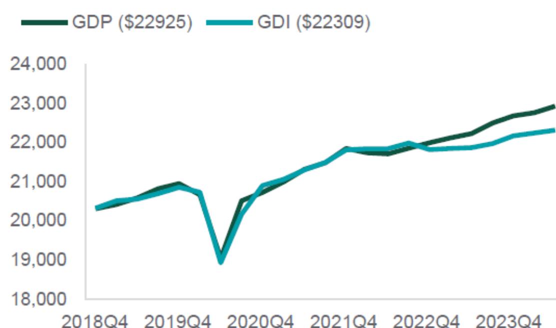
The macro picture in September was broadly unchanged. If anything it appears to have improved on the growth front. There were a couple of weak employment reports but positive revisions in September showed continued strength in the labor markets. One change that caught our attention was the revisions to GDP/GDI data which, prior to the revisions, were painting different pictures of the economy. Market participants were worried that GDP was overstating the strength of the U.S. economy while the weaker GDI was the truth. Instead, the GDI data was revised up to match the strength in the GDP data. The U.S. economy remains strong, with solid labor markets and inflation normalizing.

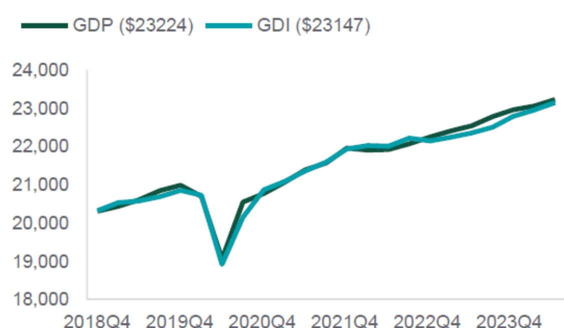
China equities rallied in September as the Chinese authorities announced several measures to boost real estate prices, consumer sentiment and asset prices. At first glance, the monetary measures appear substantial but the magnitude and details of their fiscal plans are not yet clear. Structural adjustments are needed to have a lasting impact on the economy but for the moment the markets are hopeful. We remain slightly overweight emerging market equities in the global portfolios.

Risk of an equity drawdown due to fundamental drivers remains low, but U.S. elections, geopolitical tensions and potential growth shocks in Europe keep us from taking maximum risk in the portfolios. However, the combination of ongoing U.S. growth and easing monetary policy underpins our modest overweight in equities over bonds.

Stronger Growth Post-Revisions

The wedge between GDP and GDI barely exists after the annual update of the National Economic Accounts.





Source: Northern Trust Asset Management, BEA. GDP = Gross Domestic Product; GDI = Gross Domestic Income. Data as of 6/30/2024.

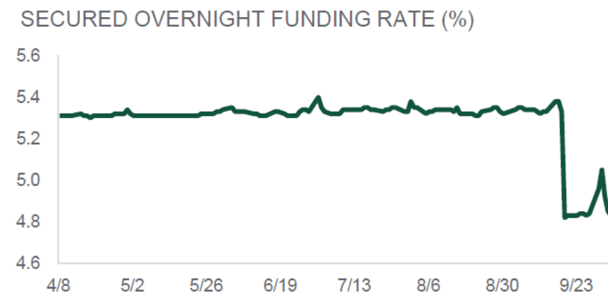
Interest Rates

The Secured Overnight Funding Rate (SOFR) is a closely watched gauge of conditions in the market for overnight repurchase (repo) agreements, where trillions of dollars of funding transactions take place daily. Because of this important role in U.S. Treasury market functioning, stress in the repo markets can potentially spill over into other asset classes. A spike occurred in September of 2019, and the echoes of that September remained on the minds of market participants and regulators last month.

SOFR has exhibited more normal levels of volatility this year, often rising around important dates like month-ends when there are large swings in supply, only to retrace in the following days. We saw that same pattern in recent weeks, but the magnitude of the move was larger than we or markets expected. SOFR topped out at 5.05% on October 1st, notably 0.05% above the top of the of fed funds target range set by the FOMC before normalizing. While the Fed officially targets fed funds rather than SOFR, trading outside of the target range could call into question the orderly functioning of markets. The Fed seems keen to avoid a repeat of 2019, and may further adjust the pace of balance sheet runoff in the coming months.

A SEPTEMBER TO REMEMBER IN SOFR?

After trading outside of the fed funds target, SOFR normalized just a few days into October.



Source: Northern Trust Asset Management, Bloomberg. Data from 4/8/2024 through 10/4/2024.

- SOFR spiked above the top of the fed funds target range around quarter end.
- The spike was short lived – we don't view this as an immediate sign of reserve scarcity.
- Nonetheless, out of an abundance of caution, the Fed may adjust or end quantitative tightening in the coming months.

Credit Markets

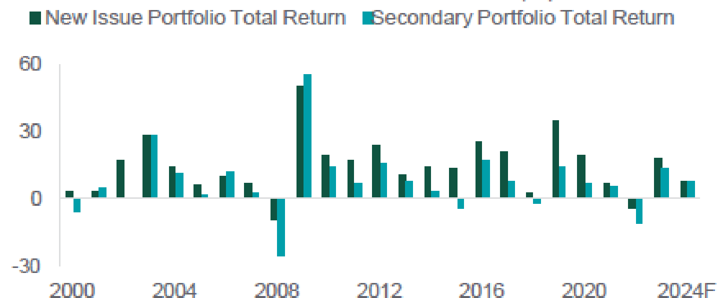
High yield posted another strong month of performance for the month of September despite heavy supply headwinds, as the Fed rate cut helped boost investor sentiment. Capital markets activity in September was at a 3-year high with roughly $34B of gross supply for the month. The pace of supply is expected to slow as we get closer to the U.S. presidential election. High yield new issue volume is almost more than double last year's volume. However, it is only marginally higher when looking at non-refinancing activity of $53B versus $49B last year. We believe an investor can enhance portfolio performance by increasing participation in new issues.

The average annual return for a rolling 35-day new-issue portfolio is +14.6% since 2000, which compares to an average gain of +7.5% for the secondary portfolio. The new-issue portfolio has outperformed in every single calendar year since 2010 (see chart). The outperformance is less acute for leveraged loans. While more supply can often be seen as a headwind, active management allows for it to also be a source of alpha for the high yield asset class. New issue supply also typically coincides with positive investor sentiment.

NEW ISSUE, NEW OPPORTUNITY

High yield new issue has historically outperformed the secondary market.

HY NEW ISSUE VS. SEC. PERFORMANCE (%)



Source: Northern Trust Asset Management, JPMorgan. Annual data from 12/31/1999 through 9/20/2024. Sec. = Secondary. Note: The "new-issue" portfolio consists of bonds issued within the last 35 days. After 35 days are complete, the new-issue then transfers to the "secondary" portfolio. Past performance is not indicative or a guarantee of future results.

- Capital markets activity in September was at a 3-year high with roughly $34B of gross supply for the month.
- We believe an investor can enhance portfolio performance by increasing participation in new-issues.
- While more supply can often be seen as a headwind, active management allows for it to also be a source of alpha for the high yield asset class.

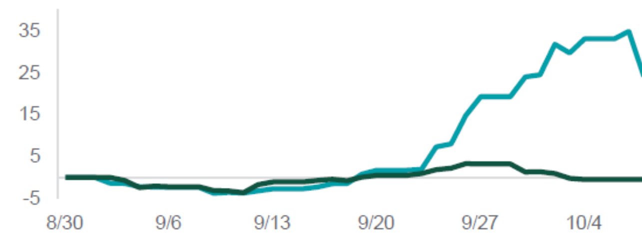
Equities

U.S. large caps finished the month 2.1% higher, laying September seasonality fears to rest. The month began on a sour note with information technology – notably semi-conductors – and other cyclicals leading the way down with defensives providing some shelter. After recovering by mid-month, markets rallied broadly following the Fed's 50-basis point rate cut on September 18. Historically speaking, equity markets have performed well in the 12 months following the start of a rate cut cycle, especially in non-recessionary scenarios. Outside the U.S., China launched a broad array of stimulative measures – monetary, fiscal, and more – aimed at reviving the economy. Following these announcements, China equities posted their biggest rally since 2008, jumping over 30% before giving some back thereafter.

Recent U.S. economic data remained constructive, including the much stronger than expected jobs report on October 4. Further, third quarter earnings recently kicked off with aggregate earnings expected to grow 4.2% year-over-year. The next-12-month earnings outlook is also strong with the expected gains coming across the majority of sectors. Against this backdrop, we reaffirmed our overweight equity positioning in the U.S. and emerging markets.

CHINA GIVES EMERGING MARKETS A BOOST

China rallied the most since 2008.



Source: Northern Trust Asset Management, Bloomberg. Total return data from 8/31/2024 through 10/9/2024. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

- September looked like a miniature version of August, with a tech-led sell-off to start the month followed by a rally leading into and following the Fed rate cut.
- Stimulative measures in China gave Chinese equities a short-term charge following a multi-year period of lackluster performance.
- We reaffirm our constructive view on equities, maintaining overweights to the U.S. and emerging markets. We remain neutral on developed ex-U.S. equities.

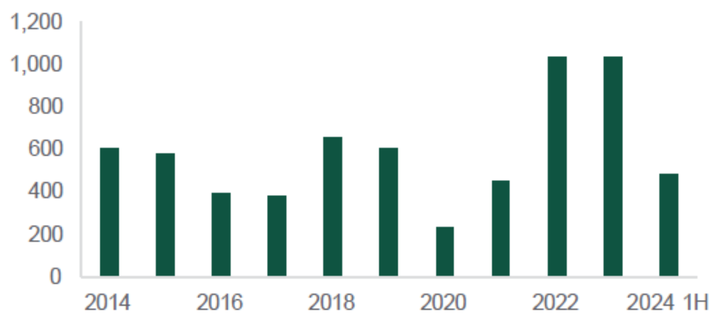
Real Assets

Gold continued its rally in September, increasing 5.2% during the month. This puts its year-to-date gain at 27.7%, outpacing the broader global equity market. Historically, economic and geopolitical uncertainty drive the demand for gold as does the often coinciding decline in interest rates.

During this cycle, evidence shows that emerging market central bank purchases have been the primary driver of gold performance. Other drivers of gold demand (jewelry and investment) have demonstrated de minimis growth. Over the past 24 months, and especially since the beginning of the Russia/Ukraine conflict, emerging market (EM) central banks have accelerated their gold purchases. The 2022 freezing of Russia's Central Bank's assets prompted many EM central banks to reconsider what they deem to be "risk-free" and to diversify away from USD- denominated assets and into gold. We have seen this before where sanctions and the freezing of EM central bank assets coincides with gold price spikes, such as with Iran in 1979, Libya in 2011, and Russia in 2014.

GOOD AS GOLD

Central bank gold demand has been historically strong.



Source: Northern Trust Asset Management, World Gold Council. Data from 12/31/2013 through 6/30/2024. Measured in Tons.

- Gold has rallied this year, outpacing global equities so far.
- Central bank purchases have been a key driver of this performance as emerging market central banks have replaced some USD-denominated assets for gold.

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 this to continue 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 re-surgence, 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 tha represent the listed infrastructure universe.

INVESTMENT PROCESS

The asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic returns are developed using five-year risk, return and correlation projections to generate the highest expected return for a given level of risk. The objective of the tactical recommendations is to highlight investment opportunities during the next 12 months where the Investment Policy Committee sees either increased opportunity or risk.

The asset allocation recommendations are developed through the Tactical Asset Allocation, Capital Markets Assumptions and Investment Policy Committees.

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ViewPoints reflects data as of 10/17/24.

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