INVESTMENT PERSPECTIVES

MAY 2024

Key Takeaways —

- A pickup in Europe's growth should reduce the pessimism toward European equities.
- Real yields suggest longer-term returns are likely to be appealing from here.
- Is a high for the S&P 500 still ahead?

EUROPE IS POISED FOR A CATCH UP (REDO)

Mark Luschini, Chief Investment Strategist

While we wrote about the improvement in Europe's economy in last month's publication, citing mostly soft factors such as rebounding investor and business sentiment and prospects of a mid-year rate cut, more recent developments further support a more positive outlook for the Old World.

To be sure, economic activity in the United States and Europe has been diverging for the better part of the last two years. This, in turn, has fed expectations that the growth gap between the two continents will remain wide. However, recent data suggests the difference in anticipated growth rates should narrow rather than expand. Therefore, in our judgment, there is a widening window for European equities to outperform.

Fiscal policy differences were the most visible headwind to European growth last year. The International Monetary Fund (IMF) estimates that the fiscal thrust subtracted 0.4% from Europe's GDP while contributing 1.6% to that of the United States, which translates to a 2% swing. For 2024, the IMF projects fiscal policy will again subtract 1% from European growth, but the expected drag in the United States will be far greater at 2.1% of GDP. Therefore, we are likely to see a convergence in growth rates, all else equal. That alone could help close the gap. However, there are other fundamental factors at work that should also contribute to boosting the European economy. Global industrial activity was a major headwind to European growth last year. Europe is more exposed than the United States to the gyrations of the global manufacturing cycle. Exports account for about 19% of GDP in the Euro area compared to just 10% in the United States, and similarly, Europe's industrial sector represents a larger portion of output and employment. As a result, the manufacturing contraction experienced in 2022 and 2023 weighed on the European economy much more than it did on the United States. Looking through the balance of this year, improving industrial activity is expected to continue. Financial conditions have stabilized and should loosen as inflation continues to subside, allowing the European Central Bank to cut rates (as policymakers have hinted) at their upcoming meeting in June.

Real wage dynamics also contributed to the weakness in Europe's growth relative to the United States. In October 2022, Europe's inflation-adjusted wages were plunging, but those in the United States began to stabilize, eventually turning positive long before the same was true for European workers. That weighed much heavier on European consumer spending than that on United States households. Today, real wage growth in Europe is finally approaching parity with that of the United States. Regarding household spending, United States consumers have largely depleted excess savings accrued during the pandemic, while European consumers still hold an estimated $1+ trillion in excess savings. This suggests that European consumption can "catch up" relative to the United States due to pent-up demand, as witnessed by the well-below-trend pace of durable goods purchases. Finally, surveys of industries have also begun to reflect converging paths. For instance, April's composite of manufacturing and services activity overtook that of the United States, while employment trends flatter those of European labor markets.

For investors, the persistent but uncommonly deep valuation gap between the European equity market and that of the United States should narrow. Indeed, a delta will persist since the United States stock market proxy—the S&P 500 index—overweights high-growth sectors such as Technology, Communication Services, and Consumer Discretionary, which have a disproportionate representation of tech-related companies and warrant an elevated multiple. However, on an equal weight sector basis, Europe's broad equity bourse trades at more than a 20% discount to its United States counterpart, which is more consistent with periods of extreme economic tumult across the Euro area. Hence, a pickup in Europe's growth should reduce the pessimism toward European equities currently evident in their valuations, allowing multiples to expand while earnings grow, and propelling share prices to advance for potentially handsome gains. ■

GETTING REAL

Guy LeBas, Chief Fixed Income Strategist

We typically talk about nominal yields as the biggest source of returns in the fixed-income markets. However, nominal yields exclude the potential impacts of expected inflation. By contrast, real yields represent a concept that estimates forward-looking returns relative to inflation. Real yields emerged as a key focus area for fixed-income investors following the historic 2022-2023 Federal Reserve (Fed) rate hike cycle.

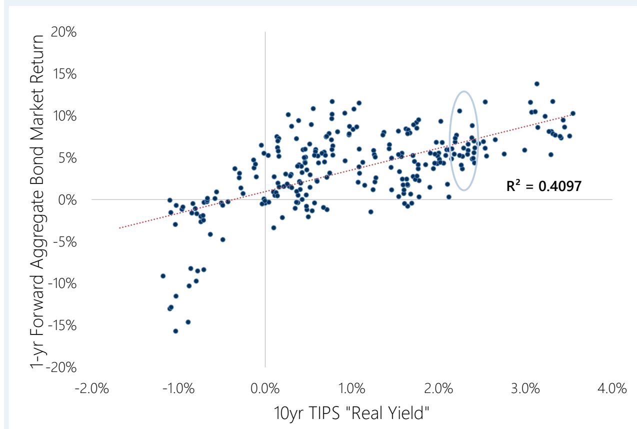
Real yields reflect the return investors can expect after stripping away inflation expectations, making them an essential benchmark for gauging true long-term returns. The calculation defines real yields as the difference between nominal Treasury yields and yields on inflation-linked Treasury Inflation-Protected Securities (TIPS) of the same maturity. TIPS yields represent expected real returns since the securities' principal adjusts for changes in consumer prices.

Real yields climbed significantly from the 0%-1% range that persisted through much of the 2010s. As of April 30, the 10-year Treasury note yielded 4.68%, while the 10-year TIPS yielded 2.28%, with the 2.40% difference representing market inflation expectations over the next decade. Today's real yields are well above the 1.05% average since 2000, vastly higher than the prior decade, and are more in line with the period before the 2008 Global Financial Crisis than of any period since.

Current elevated real yields are a function of:

- Monetary policy tightening: When central banks, such as the Federal Reserve, raise interest rates faster than inflation expectations rise, it can lead to higher real yields. Through the current cycle, the Fed has hiked rates by roughly 5%, while inflation expectations have risen by a much smaller margin.
- Upside potential for growth: Stronger economic growth can lead to higher real yields, as investors may expect higher real returns to compensate for the increased opportunity cost of investing in bonds rather than other investments. There's a chance that higher economic productivity in today's environment could boost long-term growth.
- Supply and demand dynamics: A decrease in the supply of TIPS or an increase in demand for these securities can drive prices up and real yields down. With increases of (mostly) United States government bond issuance, real interest rates have risen to "clear" the additional supply.

Chart 1: Buying Aggregate Bond Markets When 10yr Real Yields >2% Resulted in Avg 6.9% 1yr Forward Return



Source: Janney ISG; Bloomberg

For fixed-income investors, real yields are yet another piece of evidence that longer-term returns are likely to be appealing from here. When 10-year real yields are above 2%, the 1-year forward return on the Aggregate Bond Market Index has averaged 6.9%. By contrast, when 10-year real yields are below 1%, the 1-year forward return has averaged a more meager 1.7%. While the starting point of real yields is not the only thing that matters for forward returns, variability in TIPS yields explains about 40% of the variability in returns. Clearly, the starting point of real yields holds a strong correlation. And with real yields where they are today, the forward return potential looks very appealing.

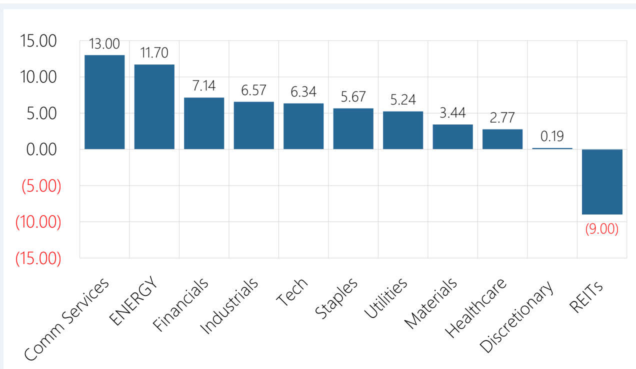
THE BEST IS ENDING — OR NOT

Gregory M. Drahuschak, Market Strategist

Last month's Investment Perspectives pointed out that April generally has been favorable for stocks. April 2024, however, failed to abide by its typical history as the S&P 500 ended the month with its fifth-worst result since 1950.

On a year-to-date basis, however, the cap-weighted S&P 500 posted a solid gain, but how it got there contrasted with how 2023 ended. The Technology, Communication Services, and Discretionary sectors topped the 2023 sector ranks. Communication Services maintained its ranking, but through this April, the Energy Sector leaped from tenth to the second spot while the Discretionary Sector dropped to 10 in the performance list of the 11 sectors.

Chart 2: Year-to-date 2024 Sector Percentage Changes



Source: Janney ISG

Every year, as May begins, the phrase "sell in May and go away" finds its way into the financial press. Statistically, data confirms that the market in the November through April period, on average, outperforms the May through October period. As the accompanying table illustrates, however, in the 24 years from 2000 through 2023, the S&P 500, on average, has ended the May through October period with a loss only five times. Two of these periods coincided with recessions. The 5.55% loss in 2008 resulted from the economy grappling with the onset of the Great Recession. Seasonal patterns make for interesting conversation, but they do not provide sufficient consistency for altering the structure of portfolios or equity exposure overall.

The market could not escape the grip of the Federal Reserve credit policy. As 2024 began, there was thinking that the Open Market Committee might cut interest rates as many as six times. As April ended, the market started considering the possibility that the Fed might not lower the Fed fund target range at all. This thinking was a primary reason the S&P 500 on April 30 posted its worst one-day loss since January 31, 2024. However, concern that the Fed might not lower interest rates as much as desired pressured the S&P 500 throughout April, as half of all the trading sessions ended with losses.

Chart 3: Estimated % 2024 Year-Over-Year Earnings Change

	May	June	July	August	September	October	Average
2000	-2.19%	2.39%	-1.63%	6.07%	-5.35%	-0.50%	-0.20%
2001	0.51%	-2.50%	-1.08%	-6.41%	-8.17%	1.81%	-2.64%
2002	-0.91%	-7.25%	-7.90%	0.49%	-11.00%	8.64%	-2.99%
2003	5.09%	1.13%	1.62%	1.79%	-1.19%	5.50%	2.32%
2004	1.21%	1.80%	-3.43%	0.23%	0.94%	1.40%	0.36%
2005	3.00%	-0.01%	3.60%	-1.12%	0.69%	-1.77%	0.73%
2006	-3.09%	0.01%	0.51%	2.31%	2.46%	3.15%	0.89%
2007	3.26%	-1.78%	-3.20%	1.29%	3.58%	1.48%	0.77%
2008	1.07%	-8.60%	-0.99%	1.22%	-9.08%	-16.94%	-5.55%
2009	5.31%	0.02%	7.41%	3.36%	3.57%	-1.98%	2.95%
2010	-8.20%	-5.39%	6.88%	-4.75%	8.76%	3.69%	0.17%
2011	-1.35%	-1.83%	-2.15%	-5.68%	-7.18%	10.77%	-1.24%
2012	-6.27%	3.96%	1.26%	1.98%	2.42%	-1.98%	0.23%
2013	2.08%	-1.50%	4.95%	-2.90%	4.69%	4.27%	1.93%
2014	2.10%	1.91%	-1.50%	3.77%	-1.55%	2.32%	1.18%
2015	1.04%	-2.05%	1.97%	-6.26%	-2.64%	8.30%	0.06%
2016	1.53%	0.09%	3.56%	-0.12%	-0.12%	-1.94%	0.50%
2017	1.16%	0.48%	1.93%	0.05%	1.93%	2.22%	1.30%
2018	2.16%	0.48%	3.60%	3.03%	0.43%	-6.94%	0.46%
2019	-6.58%	6.89%	1.31%	-1.81%	1.72%	2.04%	0.60%
2020	4.53%	1.84%	5.51%	7.01%	-3.92%	-2.77%	2.03%
2021	0.55%	2.22%	2.27%	2.90%	-4.76%	6.91%	1.68%
2022	0.01%	-8.39%	9.11%	-4.34%	-9.34%	7.99%	-0.83%
2023	0.25%	6.47%	3.11%	-1.77%	-4.87%	-2.20%	0.17%

Source: Thomson Financial; Janney ISG

The April consumer confidence index provided the evidence some traders needed to argue for lower interest rates, as the Conference Board's widely followed Consumer Confidence Index deteriorated for the third consecutive month. The headline measure at 97.0 was seven points lower than the previous month. The Present Situations Index declined 3.9 points to 142.9, while the Expectations Index fell 7.6 points to 66.4. The labor market differential also worsened as 40.2% of consumers said jobs were "plentiful" versus 41.7% in March. Concern expressed by survey respondents about the job market, business conditions, and income stood out as key elements in the report.

The same day the market got the Consumer Confidence report, the Chicago PMI had its worst reading since November 2022 when it came in at 37.9 versus the 45 consensus.

On the other hand, the Atlanta Federal Reserve's GDPNow tracker suggested that second quarter GDP appears to be on track for 3.9% growth.

We suspect that this summer, "on the other hand," might be one of the most common phrases in the financial press as we continue to get conflicting evidence about the state of the economy. However, we are not conflicted in the belief that aside from the potential for a typical mid-cycle correction, the high for the S&P 500 is still ahead.

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