PMI INSIGHTS

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PMI is an independent, privately held financial services firm specializing in the provision of financial solutions in the areas of:

- Investment Management
- Pensions
- Private Wealth Management

3rd Floor, Suite 1, Omar Hodge Building,
325 Waterfront Drive, Road Town,
Tortola VG1110, British Virgin Islands

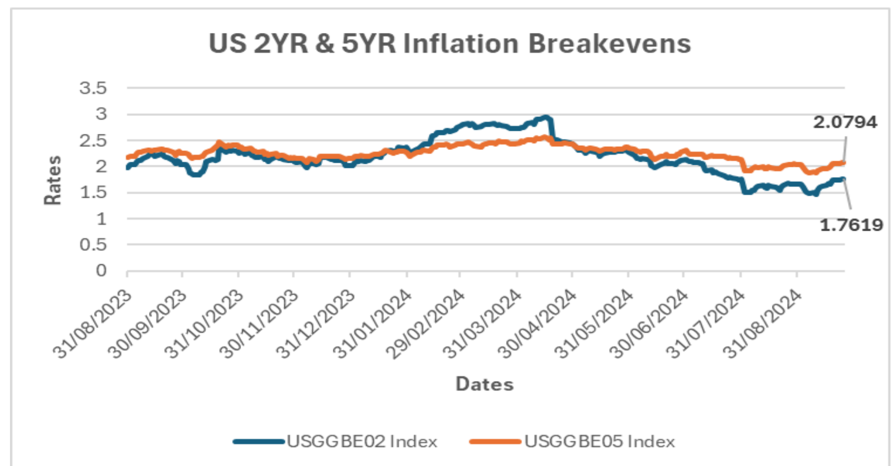
Tel.: +1 (284) 494-4484/5
Email: corpcomm@pmipensions.com

PREPARE FOR LANDING.

by Ryan Seale, BBA, CIM – Chief Investment Officer with PMI

In what could be described as the Super Bowl event of financial markets, on September 18, 2024, the Federal Open Market Committee (FOMC) gave the market a much anticipated rate cut taking the overnight rate to 5.0%. This marked the end of peak interest rates and the start of a new cutting cycle. Underscoring the move on one hand was the Fed's assessment that the economy was in good shape and inflation (currently at 2.5%) was on target towards meeting the 2% longer run goal. The bond market appears to be in agreement with both the 2 yr and 5 yr inflation breakeven pricing inflation at 1.76% and 2.08%, respectively.

Figure 1



Source: *Bloomberg/ PMI*
Data as at 09/25/24

However, on the other side in its fulfilment of its dual mandate (i.e. maximum employment and inflation), while unemployment at 4.2% is still considered not alarming, conditions in the labour market are cooling and any further slowdown in labour demand would have great importance in driving future policy decisions. To surmise, while the upside risks to inflation have diminished, the downside risks to employment have increased.

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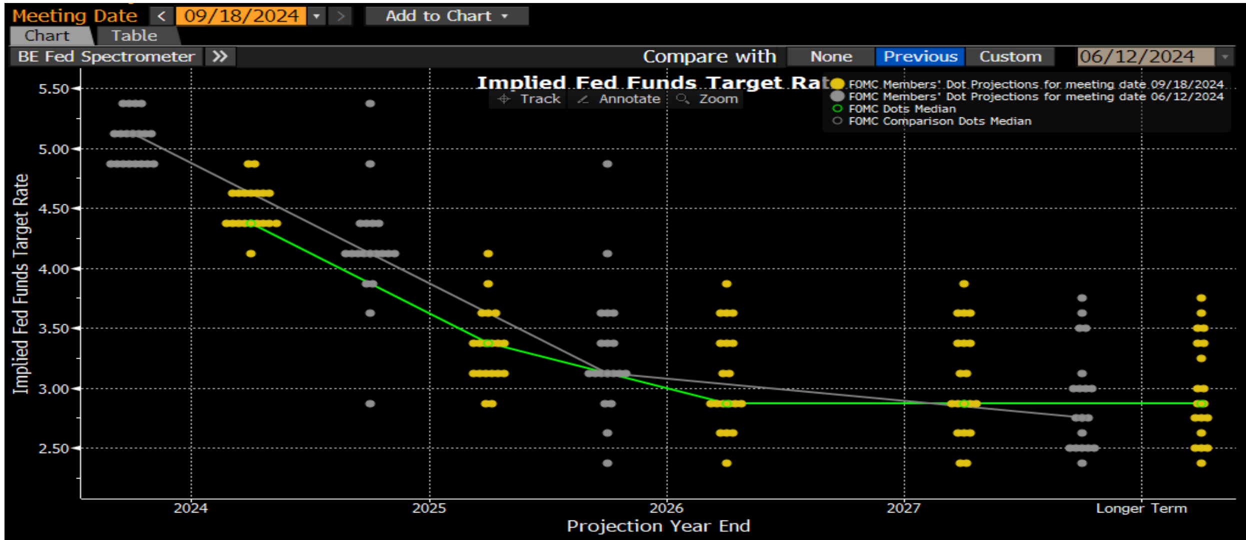
What do the indicators say?

The current DOT plot (which is the official view of how the FOMC views the path for the Fed Fund's target rate) now signals another 50 basis point of cuts for the remainder of 2024 (target range of 4.25 to 4.50%) and a further 100 basis points of cuts for 2025 (target range 3.25 to 3.50%). This was a positive for the market as it laid out the Fed's commitment to lowering rates.

Figure 2



Source: *Bloomberg*

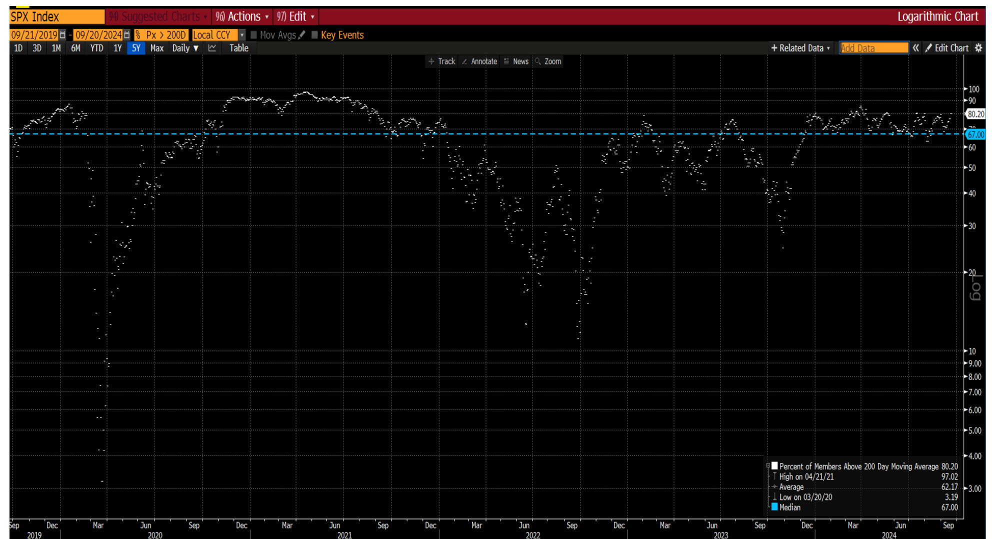
Figure 3

Source: *Bloomberg*

The Bloomberg Financial Conditions Index (BFCIUS Index) as a gauge for financial conditions highlights that while financial conditions indeed had become more restrictive, they are still at accommodative levels at 0.648 (See **Figure 3**).

The broadening out across sectors that occurred over the last quarter remains intact. Market breadth as determined by the percentage number of stocks that are trading above their 200-day moving average (currently at 80%) is quite healthy and stands above the intermediate median of 67% (See **Figure 4**).

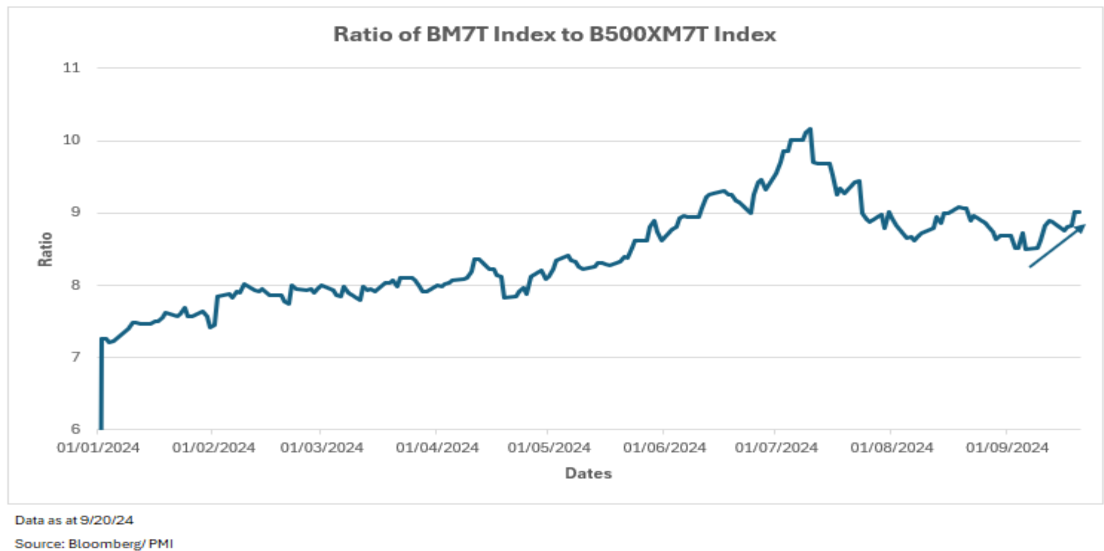
Figure 4



Source: *Bloomberg*

The Magnificent 7 stocks are staging a turnaround which is suggestive that the de-rating which recently occurred may be over for now. **Figure 5** shows the BM7T Index representing the Mag 7 stocks out-performing relative to the market as represented by the Bloomberg S&P 500 ex Mag 7).

Figure 5



Data as at 9/20/24
Source: Bloomberg/ PMI

Risk On Versus Risk Off

In short, the soft-landing narrative appears very much in play as the main consensus (the Bloomberg US Recession Probability Forecast is currently at 30%) while the economy remains resilient with 2Q GDP (final estimate) at 3% (which was higher than the consensus estimate of 2.9%). However, the Fed still has a fine needle to thread where any pick-up in inflation or unemployment could rapidly shift current views.

In our view, this means an all clear cannot be given as there remain signs suggestive of even slower economic growth ahead. **Figure 6** highlights a consumer that still remains tapped out with consumer debt at all-time highs while personal savings as a percentage of disposable income is approaching the June 30, 2022, lows.

Figure 6

Source: *Bloomberg/PMI*

To compound this, wage growth has resumed its downward trajectory (**Figure 7**) and consumer confidence (**Figure 8**) fell sharply for September to 98.7 against the consensus which was looking for a 104.0 reading.

Figure 7

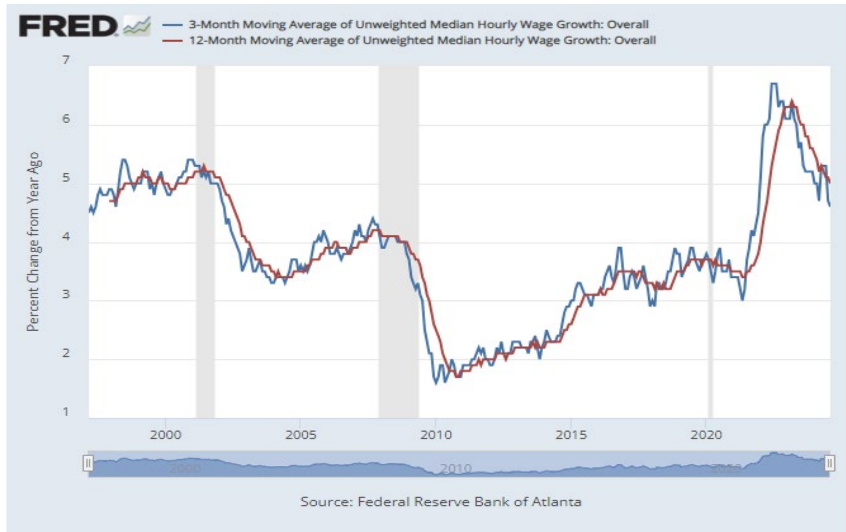
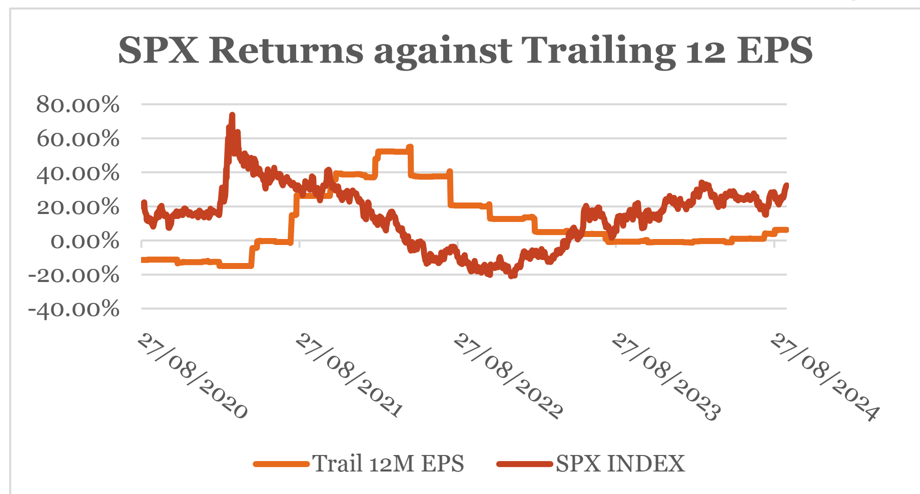


Figure 8

Source: *Bloomberg/PMI*

Figure 9

The SPX Index trading at all-time highs has benefited from improved corporate fundamentals (along with multiple expansion) with trailing earnings in the SPX Index registering improvement on a rolling comparable 12-month basis (See **Figure 9**). It should be noted that from a valuation perspective the SPX Index is trading around a 29% premium relative to its intermediate median forward P/E multiple.



Source: *Bloomberg/ PMI*
Data as at 09/24/24

Therefore, with the market at all-time highs and trading at a hefty premium, focus resides on those sectors which are offering the most favourable return/risk metrics (incorporating defensive/cyclical attributes) towards sustaining this rally into year end and beyond. Rolling forward, earnings (See **Figures 10** through **20**) on a comparable basis paint a somewhat mixed picture wherein some sectors are recording expanding forward earnings growth, while others have plateaued or are in decline (all data as at 09/24/24, Source: Bloomberg/PMI).

Figure 10

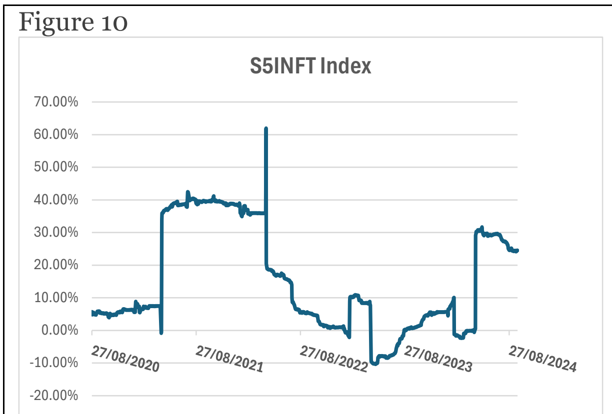


Figure 11

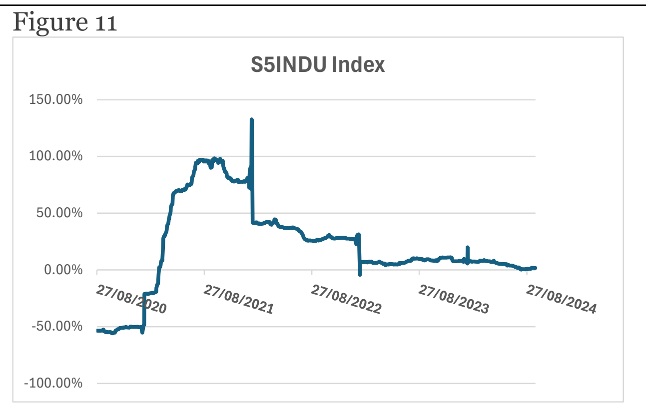


Figure 12

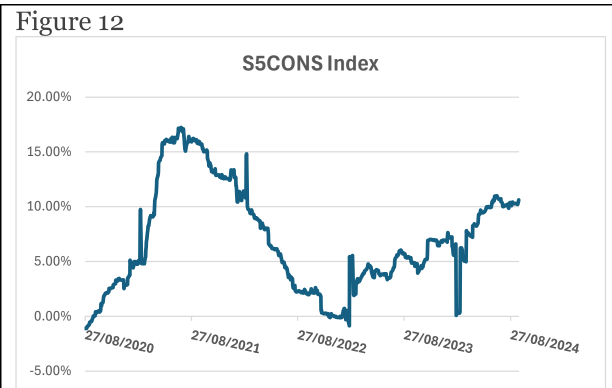


Figure 13

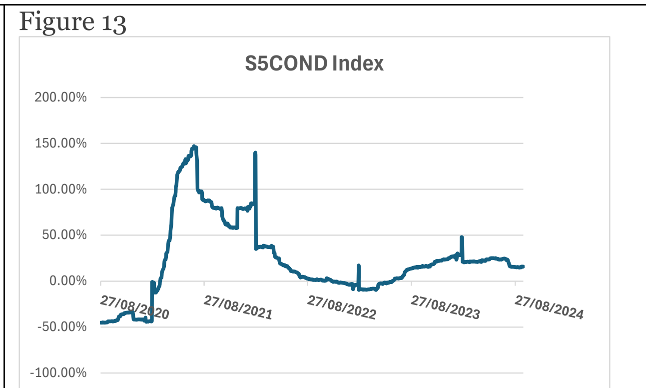


Figure 14

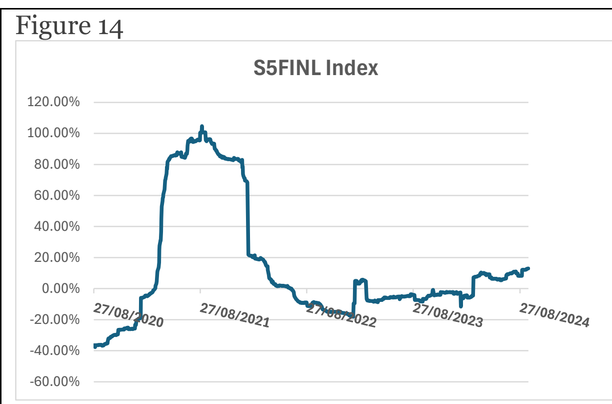


Figure 15

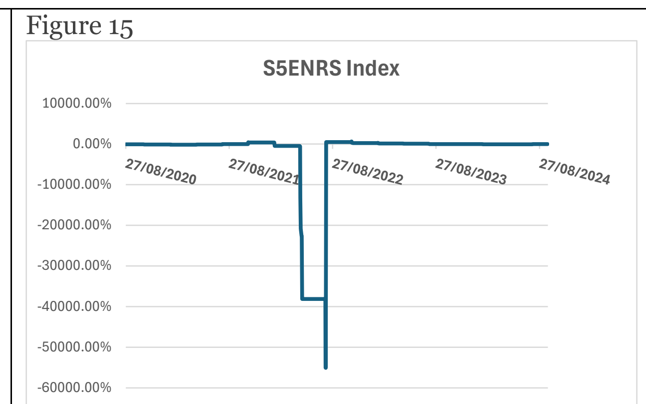


Figure 16

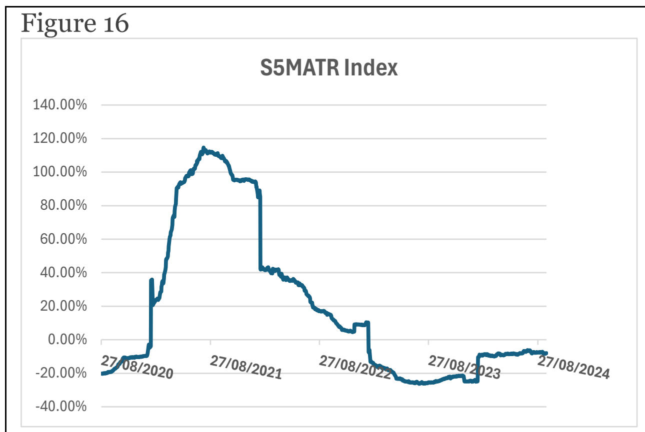


Figure 17

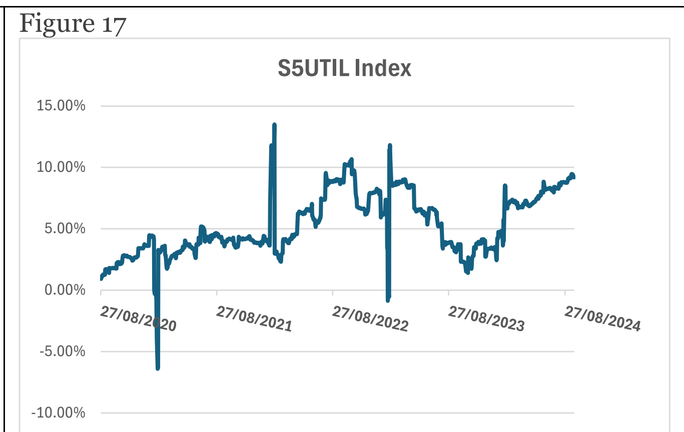


Figure 18

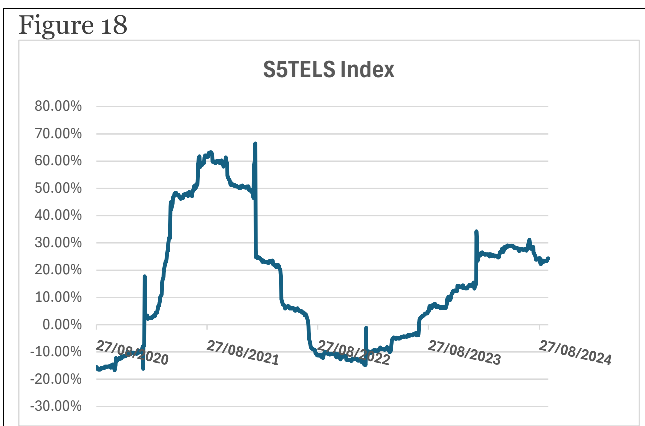


Figure 19

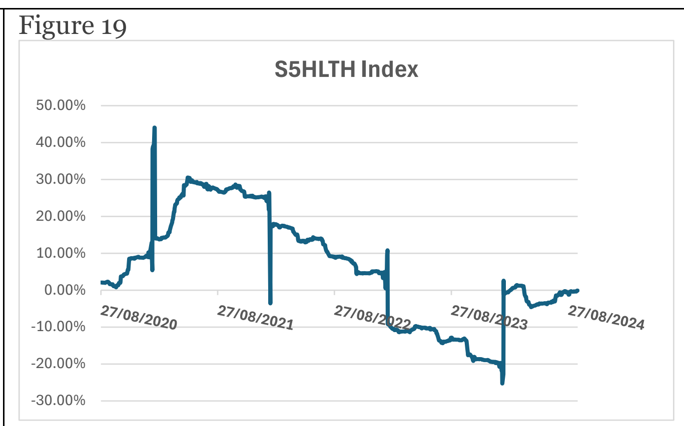
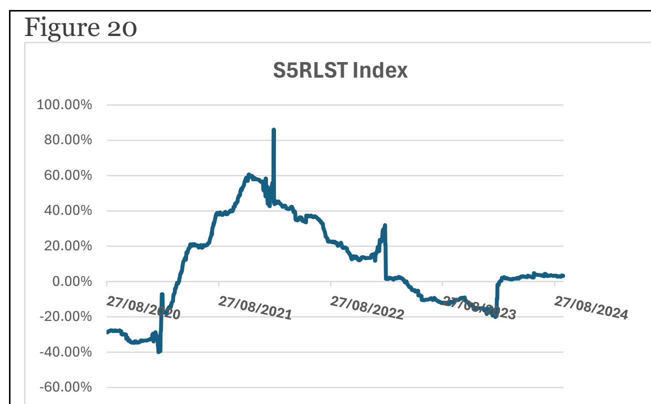


Figure 20



From a valuation perspective, while most valuations are stretched, staples, energy, real estate and utilities are still somewhat favourable.

With growth in earnings expectations appearing challenged and valuations stretched, the market will be heavily dependent on the Fed making good on its promise of rate cuts toward sticking a soft landing. We favour a diversified sector approach with an emphasis on financials, staples, healthcare, real estate (on a selective basis), energy, utilities and AI related tech at this time. In addition, from a diversification point of view, gold remains attractive as well as Emerging Markets (iShares MSCI Emerging Markets ETF) for the following: It trades at (forward P/E multiple valuation discount relative to SPX Index) and should continue to benefit from expected USD weakness. Lastly with its largest exposure to China (24.06%) it can indirectly benefit from that country's latest round of monetary stimulus.

Figure 21

	Forward P/E	10 yr Median P/E	Premium/ Discount
S5INFT Index	34.39	21.72	58.31%
S5INDU Index	24.75	18.78	31.75%
S5CONS Index	21.55	20.65	4.32%
S5COND Index	26.93	22.56	19.36%
S5ENRS Index	14.07	19.49	-27.82%
S5FINL Index	16.90	14.12	19.74%
S5HLTH Index	22.17	17.32	27.98%
S5MATR Index	23.63	18.06	30.83%
S5RLST Index*	41.88	38.74	8.09%
S5TELS Index	20.37	16.23	25.54%
S5UTIL Index	19.83	18.03	9.98%
SPX INDEX	24.09	18.67	29.03%

Source: *Bloomberg/ PMI*
**Data from 19/09/16*
Data as at 09/24/24

The case for Gold remains intact

Figure 22

	YTD Returns (%)
GOLD	28.8
SPX Index (Tot Return)	21.43%

Source: *Bloomberg/ PMI*
Data as at 09/25/24

Gold has been an out-performing investment on a YTD basis. **Figure 22** highlights that on a YTD basis Gold's return has been 28.8% while the SPX Index returned 21.43% on a total return basis.

This rally still has room to run as the secular bull market which began in late 2015 remains very much intact (See **Figure 23**). Gold, the safe haven asset is poised to benefit from lower interest rates, dollar weakness, uncertainty surrounding the US Fiscal path, increased geopolitical risks as well as its role as a hedge against financial uncertainty or market tail risk activity.

Figure 23

Source: *Bloomberg*

It is this role in which it can oft provide portfolio insurance during times of financial distress that makes it quite unique and an advantageous addition to any portfolio.

Figure 24

Figure 24 highlights that by adding a 10% allocation to a stock portfolio during the tech market crash it improved the portfolio's return from -44.17% to -39.10% with portfolio volatility at 19.35%. Therefore, it improved portfolio performance on a risk adjusted basis

Two Asset Portfolio during Tech Market Crash (2000-2002)					
	Weight	Return	Volatility	Asset Class Return Contribution (%)	Asset Class Volatility Contribution (%)
SPX Index	90%	-44.17%	21.49%	-39.75%	19.34%
Gold	10%	6.58%	13.83%	0.66%	1.38%
				-39.10%	20.72%
				Portfolio Volatility (Corr<1)	19.35%

Source: *Bloomberg/ PMI*
Data from 24/03/00 to 26/07/02

Figure 25

Two Asset Portfolio during Financial Crisis (2007 to 2009)					
Ticker	Weight	Return	Volatility	Asset Class Return Contribution (%)	Asset Class Volatility Contribution (%)
SPX Index	90%	-50.13%	20.04%	-45.12%	18.04%
Gold	10%	39.96%	26.48%	4.00%	2.65%
				-41.12%	**20.69%**
				Portfolio Volatility (Corr <1)	18.68%

Source: *Bloomberg/ PMI*
Data from 31/08/07 to 27/02/09

Figure 25 highlights that by adding a 10% allocation to a stock portfolio during the financial crisis market crash it improved the portfolio's return from -50.13% to -41.12% with portfolio volatility at 18.68. Therefore, it improved portfolio performance on a risk adjusted basis.

As it stands, volatility as measured by the VIX Index at current levels remain elevated post the Fed rate cut, however still below what would be considered worrying. However, this may change going into the next Fed meeting and the upcoming US elections in November.

Figure 26

Source: *Bloomberg*

Fixed Income

The bond market (post Fed 50bps rate cut on Sept 18th) rallied at the shorter end of the curve (2 yrs or less) which is controlled by Fed policy, while the longer-term maturities sold off (See **Figure 27**). Even with the shorter end coming down, rates are still attractive at 4.60% (around the 1yr mark) to around 4.52% (at the 5yr mark) within the investment grade universe. We recommend keeping duration relatively short (1 to 5 years) at this time.

Figure 27

Source: *Bloomberg*

In Conclusion

All the ingredients are there wherein the soft-landing scenario remains intact. This is supported by on target inflation and the Fed front loading its rate cutting cycle with a 50 bps cut into somewhat still loose financial conditions. GDP growth is holding up and labour market conditions are still registering as non-alarming. Many of the 11 sectors have been delivering strong earnings growth, however the outlook while still positive is now somewhat muted. The SPX Index is trading at a hefty premium at 29.03% amid signs that we could see slower economic growth ahead. Therefore, a diversified sector approach with an emphasis on those areas of the market where stocks continue to look attractive e.g. Financials, staples, healthcare, real estate (on a selective basis), energy, utilities and AI related tech is recommended. Attractive opportunities exist outside US equities within emerging markets and Gold. Fixed Income at the shorter end of the curve (1 to 5 yrs) remains favourable PMI.