



Q4 2024 OUTLOOK

PGIM Quantitative Solutions Multi-Asset Team

Executive Summary

Economic Outlook

- Uncertainty about when the US Federal Reserve (Fed) would begin its rate-cutting cycle – and the pace at which it would likely proceed – kept the fixed income markets on edge throughout the summer.
- Fears that the Fed had waited too long to cut rates, potentially triggering an imminent recession, weighed on investors.
- The Fed ultimately followed a more aggressive path, initiating its rate-cut cycle with a 50bps cut.
- However, it's unlikely that this is the start of a new pace of rate cuts. The Summary of Economic Projections (SEP) is consistent with a downshift back to 25bps cuts at the November and December meetings.
- Leaving rates unchanged for most of 2024 as inflation fell effectively tightened monetary policy, contributing to rising downside risks.
- Nevertheless, a recession does not seem imminent. Robust domestic demand has continued to support the growth in US economic activity.
- In Europe, GDP growth remains anemic. Falling inflation provided the European Central Bank (ECB) cover to start its rate-cut cycle in June, earlier than the Fed. After the initial 25bps cut, the ECB waited until September for the next rate decrease. More rate cuts are anticipated, but remain data dependent.
- In Japan, the economy is still feeling the aftershocks following the unwinding of the yen carry trade. The stronger yen is likely to keep inflationary pressures in check, but there are lingering concerns that the Bank of Japan will revert to its old habits of tightening monetary policy too aggressively and too soon.
- The People's Bank of China has cut rates several times this year, but that has yet to turn around slowing economic growth in China.

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All investments involve risk, including the possible loss of capital.

Market Outlook

- As we approach the final stretch of 2024 and start the run-up to the US presidential election, global financial markets continue to evolve.
- The third quarter saw a continuation of the risk-on theme evident in markets for much of this year, marked by a spike in volatility driven by US recession fears and the yen carry trade unwind.
- Still, as much as the first half of 2024 was marked by low volatility and strong gains in risk assets, the sudden flare-up in risk aversion in July and August set the stage for continued market volatility in the near term, until at least the US election is over.
- Historically, equity markets have turned in muted performance in the run-up to elections, followed by a post-election relief rally. With stocks already booking strong year-to-date gains, fundamentals might be a bigger market driver, together with election-related policy uncertainty.
- The stocks-bonds yield gap is well below its 30-year historical average of 2.6%, suggesting an unfavorable risk-return profile for stocks relative to bonds.
- Strong stock returns going forward depend on significant earnings growth improvement and valuation multiple expansion, which are less likely in the near term.
- For fixed income, the steady moderation in economic growth along with rising confidence that core inflation is easing has resulted in a sharp drop in the 10-year Treasury yield over Q3.
- Rates volatility is likely to persist as markets continue to evaluate the extent of rate cuts, especially given the sustained strength of the economy.
- The environment of moderate growth and inflation along with expected rate cuts will likely be supportive of credit spreads remaining around their current tighter-than-average levels.

Economic Outlook

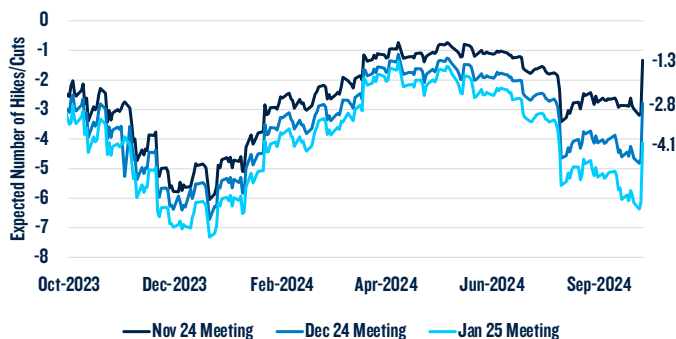
Sluggish into Fall but Still Resilient

Uncertainty about when the US Federal Reserve (Fed) would begin its rate-cutting cycle – and the pace at which it would likely proceed – kept the fixed income markets on edge throughout the summer. Fears that the Fed had waited too long to cut rates, potentially triggering an imminent recession, weighed on investors. But as the autumn leaves start changing color, there is still time before a winter of discontent.

Or, downside risks may have increased, but the economy is still chugging along.

In early summer, Fed Funds futures markets were pricing in a good chance of a rate cut in September, with expectations of two more cuts by year end. However, July's weaker-than-expected labor market report fueled recession concerns, leading calls for emergency inter-meeting rate cuts by the Fed. Markets briefly priced in two rate cuts for the Fed's September meeting before expectations reverted to one cut as equity markets recovered, economic data failed to corroborate recession fears, and the Fed clarified its rate-cut stance. The summer's monetary policy highlight was Chair Powell's Jackson Hole speech that noted increasing downside risks to employment and diminished upside risks to inflation, giving the green light "for policy to adjust." As the September meeting neared, media reports suggested that a 25bps cut wasn't a foregone conclusion. The Fed ultimately followed the more aggressive path, initiating its rate cut cycle with a 50bps cut on September 18th, setting the target range at 4.75%-5.00%.

Figure 1: Expected Number of Cuts Priced from Futures



Source: Bloomberg as of 18-Sept-2024

At the press conference that followed the meeting, Chair Powell characterized the action as an "appropriate calibration of policy" and emphasized that the Fed's decision was based on the data: Inflation has fallen and payroll growth is slowing, moving risks closer into balance. However, it's less likely that this is the start of a new pace of rate cuts. The Summary of Economic Projections (SEP) is consistent with a downshift back to 25bps cuts at the November and December meetings. Going forward, the Fed will continue to follow the data and remain measured, or as Chair Powell remarked, "there's nothing in the SEP that suggests the committee is in a rush to get this done."

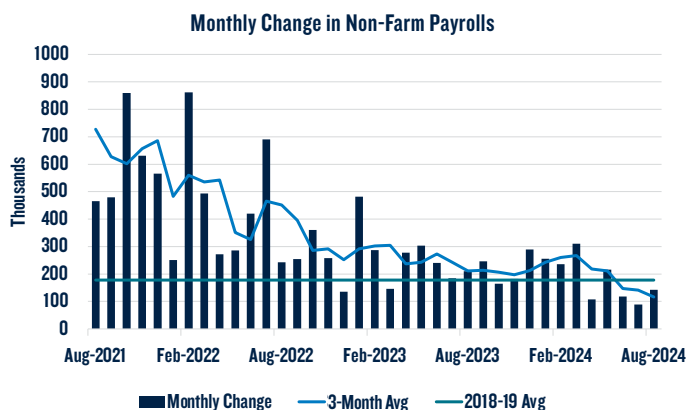
When questioned whether the 50bps cut meant that the Fed was behind the curve, Powell pushed back, underscoring the Fed's commitment not to get behind the curve. Powell is right to focus on the future, but arguably, the Fed has been behind the curve.

With price pressures easing and inflation expectations returning to historical levels, leaving rates unchanged over the course of 2024 effectively tightened the Fed's monetary policy. Short-term real interest rates (as measured by 1-year TIPS) had increased roughly 80bps this year in the lead-up to the September Fed meeting. And while rising real interest rates aren't necessarily indicative of a tighter monetary policy, other measures support that view. For instance, the Atlanta Fed's Taylor Rule Utility provides three alternative monetary policy rules that suggest the appropriate level of rates should have been, on average, 50bps-150bps lower in Q3.

While downside risks have increased, a recession does not seem imminent. Robust domestic demand has continued to support the growth in US economic activity. The Atlanta GDPNow forecast for Q3 GDP growth has been hovering around 2-3% recently, supported by robust household spending. Overall, financial conditions have been supportive, particularly as banks have loosened credit deployment.

Nevertheless, forecasters have turned more pessimistic in recent months. The Philadelphia Fed's Q3 Survey of Professional Forecasters suggests a more modest 1.5%-2% GDP growth in the next several quarters and into early 2025 (although admittedly, economic forecasters rarely see recessions coming). This expected moderation in growth is being driven by a decline in payrolls (Figure 2), averaging just over 100,000/month over the past three months, less than the pace of population growth and well below the 2023 average of roughly 250,000.

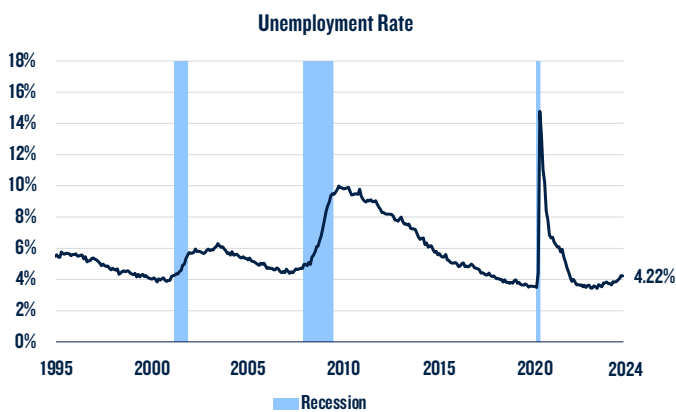
Figure 2: Slowing Growth in US Non-Farm Payrolls



Source: Bloomberg as of 13-Sept-2024

The slight rise in unemployment also raised alarm bells in August when it triggered the Sahm rule threshold (Figure 3). However, the rule's author has warned that the increase doesn't guarantee that a recession will occur. Rising unemployment combined with high interest rates make for a more difficult environment for consumer lending. Delinquency rates on loans and credit cards, particularly for low-income borrowers, are rising compared to their post-COVID lows. Even so, falling interest rates, absent a further deterioration in the labor market, should help keep delinquencies contained.

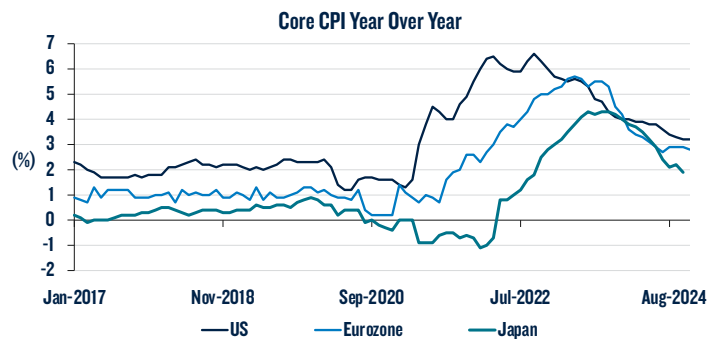
Figure 3: Rising US Unemployment Triggers Sahm Rule



Source: Bloomberg, NBER as of 13-Sept-2024

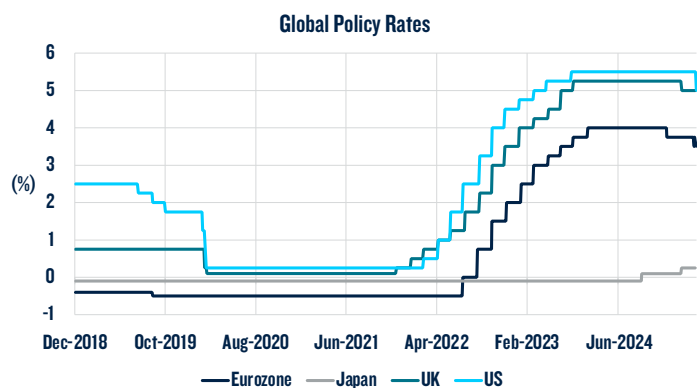
Despite rising downside risks, the US continues to outpace other developed market economies. While 2024 Eurozone economic activity has expanded at a faster pace than in 2023, GDP growth remains anemic. Meanwhile, falling inflation provided the European Central Bank (ECB) cover to start its rate-cut cycle earlier than the Fed. But core inflation remaining above the ECB's 2% target (despite a significant drop from the 2023 peak of 5.7%) has justified a more conservative path of cuts. Following an initial 25bps cut in June, the ECB waited until September for the next rate decrease. At the September press conference, President Lagarde indicated that more rate cuts are anticipated, but emphasized they would remain data dependent. This suggests a pause in October, with a potential cut in December if conditions warrant.

Figure 4: Core Inflation Trending Lower but Still Elevated in US & Eurozone



Source: Bloomberg as of 13-Sept-2024

Figure 5: Rate-Cutting Cycle Begins in US & Europe, BoJ Hiking Rates



Source: Bloomberg as of 19-Sept-2024

In Japan, the economy is still feeling the aftershocks following the unwinding of the yen carry trade. Throughout the first half of 2024, the yen steadily depreciated as capital flowed to markets with more attractive interest rates despite government interventions to prop up its value. However, when the Bank of Japan (BoJ) hiked interest rates to 0.25% in late July and adopted a hawkish stance, the yen surged dramatically. This forced carry traders who had borrowed in yen to cover their positions, triggering a brief global market sell-off in early August. The stronger yen is likely to keep inflationary pressures in check, but there are lingering concerns that the BoJ will revert to its old habits of tightening monetary policy too aggressively and too soon. Nevertheless, the Japanese economy grew solidly in Q2, and current consensus forecasts are for continued expansion in H2. Meanwhile, the Liberal Democratic Party (LDP) has appointed former defense minister Shigeru Ishiba to be the next Prime Minister.

Monetary policy easing hasn't been reserved only for developed markets. The People's Bank of China has cut rates several times this year, but that has yet to turn around slowing economic growth in China. The real estate sector continues to be a drag, and while CPI is back in positive territory it remains historically weak. The government promised additional fiscal stimulus at the third plenum but has held off from the expansive stimulus programs of the past in favor of more balanced growth.

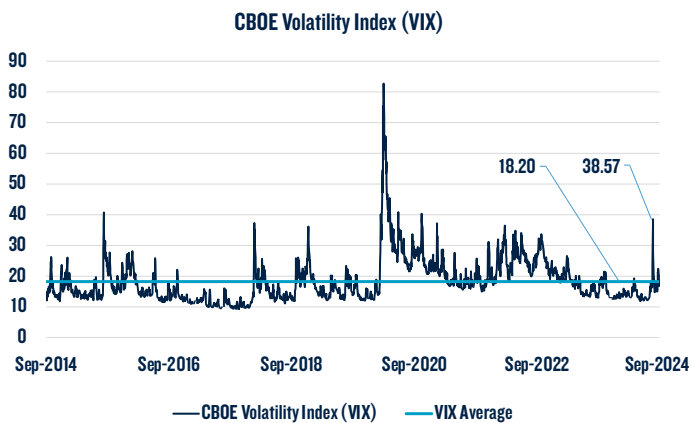
Market Outlook

Markets Remain Guardedly Risk-On in Election Run-Up

As we approach the final stretch of 2024 and start the run-up to the US presidential election, global financial markets continue to evolve. With the Fed embarking on its much-awaited easing cycle, markets are overcoming fears of an economic hard landing and adjusting expectations about the extent of future rate cuts as inflation continues to moderate.

The third quarter saw a continuation of the risk-on theme evident in markets for much of this year. In the first half of July, the S&P 500 Index hit a succession of record highs, while bonds rallied on increased speculation that the Fed would cut rates in September. But risk assets fell sharply in mid July, and the Magnificent-7 posted significant losses that left the index down over -10% from peak to trough. Commodity prices also saw notable declines, particularly among energy and industrial metals. Intense volatility continued in early August, with the VIX briefly spiking to levels last seen in March 2020 (Figure 6). The heightened volatility was triggered by a weak US jobs report, which raised fears that the US might be heading into a recession. Outside of the US, the BoJ's rate normalization and hawkishness led to a sharp unwinding of the yen carry trade and a massive slump in Japanese markets, with the TOPIX falling by more than -12% in a single day on August 5th. However, markets stabilized later in the quarter, supported by reassuring macro data and Fed Chair Powell's dovish message at Jackson Hole.

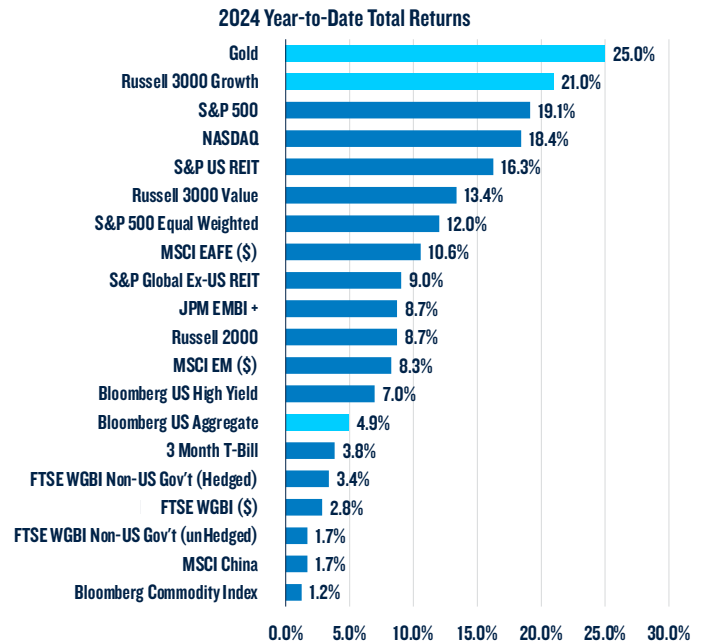
Figure 6: Volatility Lingers Following Risk Aversion Spike



Source: FactSet as of 16-Sept-2024

Year to date, many asset classes and segments have posted solid gains (Figure 7). Risk assets continue their strong advance, driven by US large-cap growth stocks that are benefiting from robust demand. Interestingly, gold – which typically performs well during periods of high risk aversion and inflation worries – has also posted strong gains. Meanwhile, the US Aggregate Bond Index had a terrible first half as inflation worries resurfaced but has since stabilized and notched modest gains as inflation began to moderate and rate cuts came into focus.

Figure 7: Fear & Greed Drive Gold & Large-Cap Growth Returns



Source: FactSet as of 11-Sept-2024

As much as the first half of 2024 was marked by low volatility and strong gains in risk assets, the sudden flare-up in risk aversion in July and August set the stage for continued market volatility in the near term, until at least the US election is over. With summer coming to an end, investor attention has refocused on the US presidential election. We explored historical election year financial market dynamics in a [recent paper](#). It seems likely that the current election will be closely contested, with a very tight race predicted in a number of battleground states. Highlights from former President Trump's policy agenda include corporate tax cuts and tariff increases. While tax cuts were positive for stocks during Trump's first administration, his proposed tariff increases could have negative implications for foreign exporters to the US. Meanwhile, key aspects of Vice President Harris' policy point to the possibility of corporate tax hikes and more fiscal expansion, which have mixed implications for stocks.

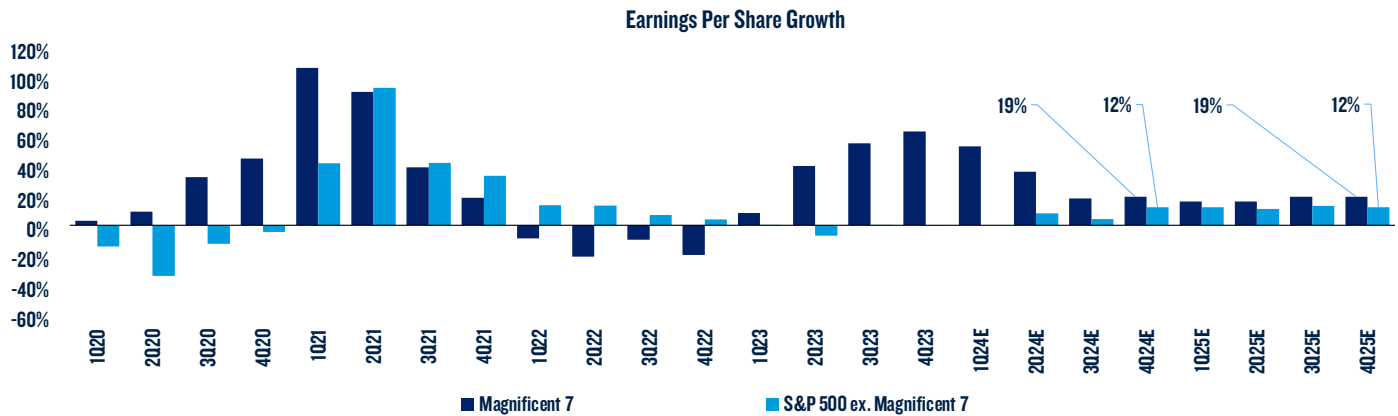
Stock valuations improved following the July-August selloff, but have since retraced, pricing in continued economic and earnings growth. The S&P 500 forward multiple is now at around 21x, still comfortably above the historical average of 15.7x. The stock-bond yield gap, currently at approximately 0.8%, recently widened as bond yields fell. However, the current yield gap remains well below its 30-year historical average of 2.6%, suggesting an unfavorable risk-return profile for stocks relative to bonds. In addition, strong stock returns going forward depend on significant earnings growth improvement and valuation multiple expansion, which are less likely in the near term. We explore this further in the sidebar based on our latest [Capital Market Assumptions](#).

For fixed income, the steady moderation in economic growth along with rising confidence that core inflation is easing has resulted in a sharp drop in the 10-year Treasury yield over Q3, to around 3.6%. As markets continue to evaluate the extent of rate cuts, it's possible that markets have priced in more rate cuts than are likely, especially given the sustained strength of the economy. The outcome of the US election could also be bearish for bonds given prospects of tariff hikes or additional fiscal spending. However, the current environment of moderate growth and inflation along with expected further rate cuts will likely be supportive of credit spreads remaining around their current tighter-than-average levels.

Historically, equity markets have turned in muted performance in the run-up to elections, followed by a post-election relief rally. With stocks already booking strong year-to-date gains, fundamentals may

play a leading role as market drivers, together with election-related policy uncertainty. The current environment of slower but still solid economic growth, declining but still elevated inflation, and prospects of additional central bank rate cuts have benefited stocks. Earnings growth (Figure 8) in the US is also expected to improve over the next four quarters, with slower large-cap tech earnings offset by an improvement in earnings growth for the rest of the market. However, lower-risk assets and fixed income securities are likely to benefit if growth falls faster. On the other hand, if falling inflation and solid growth drive lower interest rates, both risky and more conservative assets stand to benefit. Commodities have recently lagged as risk aversion increased amid prospects of slower global growth. This dynamic is likely to persist in Q4 with growth continuing to slow, particularly in China.

Figure 8: Earnings Broadening Beyond Large-Cap Tech



Source: PGIM Quant, Bank of America as of 11-Sept-2024

Election Outlook

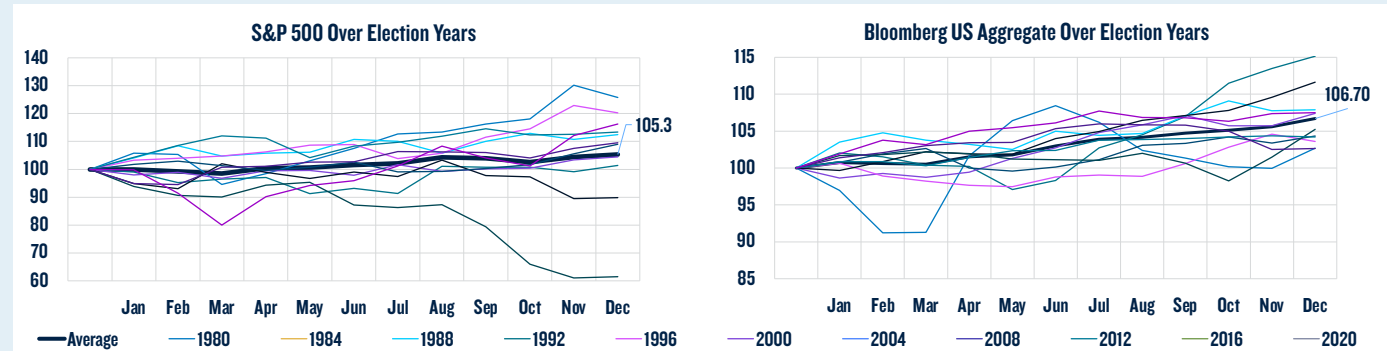
Like a broken clock chiming every fourth year, the US presidential election season is upon us. The state of the economy, and in particular the labor market, has historically been a key factor in swaying election outcomes. Economic growth has been strong in the past year or so, partly boosted by leftover pandemic savings and Biden administration initiatives, including those boosting investments in green technology and semiconductors. While the economy and the labor market are solid, inflation has turned out to be sticky and has put a wrinkle in the incumbent party's prospects for re-election.

On average, equity markets have posted moderate gains during election years (Figure 9), although lower than historical annual averages. It can be difficult to isolate the effect of elections on equity market performance due to diverse macro and policy environments over the many election years. The increased volatility

during election years has made stocks move up gradually for most of the year, usually followed by a relief rally in the final two months as the uncertainty lifts. Among equity factors, quality and low-risk factors perform relatively better. While value has done well during election years, its best performance is usually during the initial part of the presidential cycle. Growth factors typically do well later in the cycle. Momentum factors, such as those based on price and earnings, also perform well mid- to late-cycle.

Meanwhile, fixed income assets (Bloomberg US Aggregate Index) outperform stocks on average during election years. Historically, the Fed tends to set policy a little looser during election years, putting downward pressure on interest rates. Combined with increased volatility in risk assets, the environment for fixed income is relatively more favorable.

Figure 9: Election Years Historically Favor Bonds



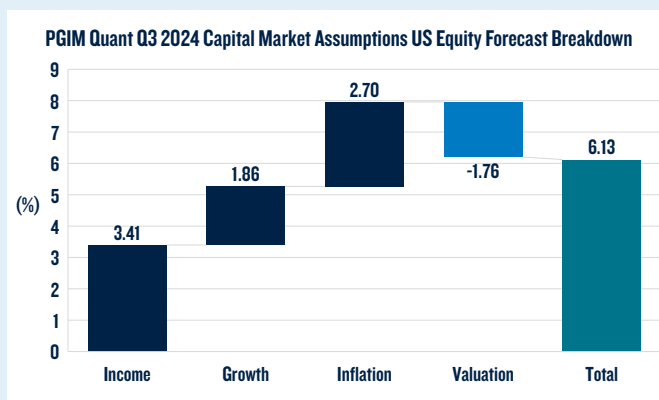
Source: FactSet as of 11-Sept-2024

Long-Term Equity Outlook

[PGIM Quantitative Solutions' Capital Market Assumptions](#) (CMAs) underpin the long-run outlook for strategic allocations in our individual strategies and multi-asset portfolios. The CMAs provide 10-year expectations for the major asset classes by decomposing return expectations into three broad categories: income, growth, and valuation adjustment.

In the Q3 2024 CMAs, expected total returns for US equities over the next 10 years remain around 6% (Figure 10), compared with 11% realized returns over the past 20 years. A repeat of such high returns is less likely. Assuming no changes to the current income forecast, for stocks to deliver similar returns would require valuations to expand by ~40%, rising to roughly the same levels as during the peak of the dot com bubble. Alternatively, nominal earnings would need to grow by ~10%, compared to the currently expected 4.5% growth rate.

Figure 10: Long-Term Equity Returns are Muted Relative to History



Source: PGIM Quant as of 30-Jun-2024

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