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VANTAGE POINT Q4 2024

Sailing Close to the Wind

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INTRODUCTION

Welcome to another edition of Vantage Point, the quarterly economic and markets outlook from the BNY Advisors Investment Institute.

Navigation is often art and science. For sailors, it is literally charting a course through currents, weather and wind – an endeavor that is more complicated when moving upwind. For the bold, skilled sailors can "sail close to the wind," steering the boat as closely as possible into the wind while still maintaining forward momentum, rather than the more conservative (albeit longer) zig zag path. We think this analogy applies to the current investing environment. Policymakers need to navigate the complex crosscurrents of employment, inflation and growth – without stalling out.

Central bankers are in a difficult position as they navigate the risks of the global economy, and there are many. First, the key fear gripping policymakers for the past couple of years – inflation – has meaningfully receded but not disappeared entirely. This allowed developed market central banks to begin cutting rates over the summer, with the European Central Bank, Bank of England and Bank of Canada leading. Second, labor markets materially loosened. In the US, the Sahm rule, a signal often interpreted as a recessionary warning when the 3-month moving average of the unemployment rate rises by half a percentage point or more relative to its previous 12-month low, was triggered. This data point pushed the Federal Reserve (Fed) to initiate its plan to a longer, more gradual decline in US policy rates.

As investors welcome the early stages of central bank easing, they too face challenges. While bonds and risk assets seem to be aggressively priced, they reflect opposing perspectives on the trajectory of the US economy – it's impossible for both views to be correct. Bonds have had strong recent performance, pricing in an ambitious view of Fed policy. Bond prices currently suggest the Fed may already be behind the curve in starting the easing process and it would be more prudent for the Fed to move quickly and aggressively, potentially front-loading rate hikes, to stave off recessionary pressures. Risk assets, for their part, have demonstrated confidence in the soft-landing narrative. Despite an increase in volatility over the summer, US stock prices continued to challenge market highs and credit spreads remain historically tight; both trends seem to shirk off any potential concern in labor markets.

We have a more optimistic view of global economy and confidence in the plan set forth by policymakers, but we also keep our sails tight as recessionary pressures continue to grow. Our central scenario (Soft Landing, 45%) is that US economy continues to slow to a rate below trend but avoids entering recessionary territory. Softening growth and a loosening labor market allows inflation to continue its downward path towards its 2% target. Any bouts of economic volatility would be transitory, as lower levels of household leverage, steady gains in productivity and a Fed with plenty of dry powder should keep growth in positive territory.

For our more optimistic view, a releveraging of the economy and artificial intelligence (AI) drive global growth surprises to the upside (New Economy, 30%). In this scenario, productivity gains in sectors that are early to deploy AI and easing of financial conditions release pent-up demand. We are seeing early signs of this scenario as US unemployment statistics were revised downwards for the first part of the year; however, domestic growth numbers were not. US unit labor costs would ease further, which would support profit margins in the corporate sector particularly in tech-oriented sectors, re-accelerating the economy. In this scenario, we would also see more policy support in China to re-balance its economy, lowering the risk of domestic deflation in the region. Ultimately, this would lead to a more gradual, or even pause, in the Fed's easing.

The first two scenarios are likely bullish ones for investors; the last scenario is where policymakers are too late to react to worsening labor data and job layoffs pick up into 2025, leading the US to slip into a shallow recession (Shallow Recession, 25%). In this scenario, it is difficult to determine the likely reaction function, as 2008 was the last time a material decrease in asset prices accompanied a decrease in wages.

Ultimately, we believe a recession would be contained and short-lived as private sector balance sheets are much stronger today than they have been and the Fed has ample scope to cut rates to limit downside risks.

As usual, we create detailed forecasts for each scenario, assign probability weights and present our perspectives on the possible paths ahead. In our most likely scenario, we expect slowing global growth and an increasing, but still low probability of recession. Inflation continues its path to target, and the Fed initiates its plan for a gradual policy normalization, which is slower than current market expectations. It is challenging to sail into the wind for investors and policy makers alike—let's dive in.

ERIC HUNDAHL, CFA
Head of Investment Institute,
BNY Advisors

BNY Advisors' Investment Institute consists of our macroeconomic research, asset allocation, manager research and operational due diligence teams.

VANTAGE POINT SUMMARY

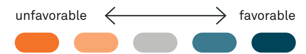
We summarize the outlook based on the idea that a significant share of moves in financial markets can be explained by the three macro factors considered – growth, inflation and monetary policy – and that macro-driven tactical investment opportunities arise when there is a substantial discrepancy between our own views and what is priced in by the market.

Table 1: Our global outlook vs market expectations

		Takeaway
Growth		US growth is below expectations over the next 12 months, growth elsewhere is in line with expectations.
Inflation		Inflation is broadly in line with market expectations over the next 12 months.
Policy		Policy is loosened but not by as much as the market is expecting, particularly in the US.

How to read the heatmap. **Blue** indicates much better than expected (relative to the market) growth, much lower than expected inflation and significantly greater than expected policy accommodation. **Light blue** indicates better than expected growth, lower than expected inflation and greater than expected policy accommodation. **Grey** indicates that expectations for economic growth, inflation and policy are broadly in line with the market. **Light orange** indicates worse than expected growth, greater than expected inflation and a tighter than expected monetary policy. **Orange** indicates significantly worse than expected growth, much greater than expected inflation and a much tighter than expected monetary policy.

Table 2: 12m investment conclusions

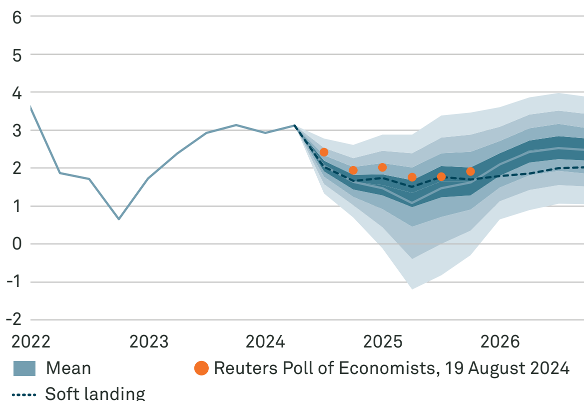


Asset class	Q4 '24	Δ	Rationale
Equities			Slower growth is expected to be a drag on equity returns in the near term.
Sovereigns		↑	Safe fixed income is seen as benefiting from slower growth.
Credit			Given compressed spreads a better risk-reward is found in other assets.
Real Assets			We favor assets that benefit from lower growth and geopolitical uncertainty.
Cash			Monetary policy is being loosened. Better returns or protection are found elsewhere.

The outlook in two charts

Takeaway: The US economy is slowing down. Recession is a risk, but it remains unlikely.

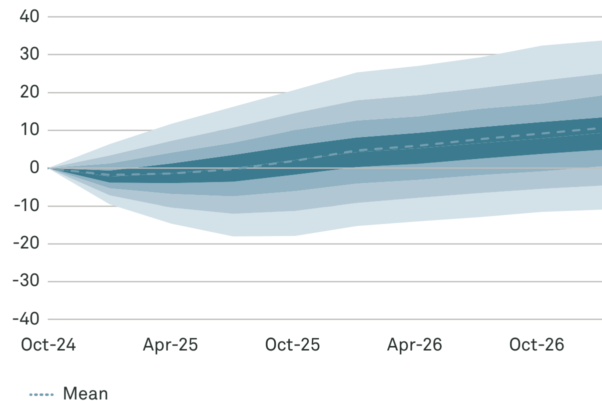
CHART 1: US GDP
FOUR-QUARTER PERCENTAGE CHANGES



Source: LSEG Datastream/Fathom Consulting.

Takeaway: As the economy goes through a soft growth patch in the months ahead, we think that portfolios more heavily invested in equities will offer a worse risk-return than portfolios heavily invested in fixed income.

CHART 2: 80:20 PORTFOLIO OUTPERFORMANCE INDEX[1]



Source: Fathom Consulting.

1 The chart shows the performance of a 80% equity-20% sovereign fixed income portfolio vs a 20% equity-80% sovereign fixed income portfolio.

EXECUTIVE SUMMARY

Our new scenarios in brief

PROBABILITY

45%

SCENARIO 1

Soft Landing

- The US economy slows to below trend but avoids outright recession.
- Inflation eases to target on rising slack in labor markets.
- Lower private leverage and gradual productivity improvements provide key buffers.
- They backstop earnings and wages and forestall job losses.
- Chinese over-manufacturing dampens tradable goods prices.
- Fed cuts steadily and ceases balance sheet reduction.
- These stabilize the USD and overall global financial conditions.
- Europe struggles with slowing US activity and stiffer Chinese manufacturing, but sees some improvement in activity on faster consumption growth.
- Japan's reflation and policy normalization also face headwinds.
- Emerging Markets (EMs) benefit from USD stabilization.
- But they're pressured by Chinese export competition amid weaker US growth.
- Global bonds do well with slowdown concerns and rate cuts lowering real yields.
- Equity price multiples soften, and credit spreads widen toward long-term averages.

PROBABILITY

30%

SCENARIO 2

New Cycle

- As interest rates come down, corporates and households start re-leveraging.
- Macro uncertainty also falls, leading to a fall in saving rates outside of the US and a pick up in consumption growth.
- Eventually, AI leads to higher business investment and quicker productivity gains.
- US unit labor costs (ULCs) ease further and prop up corporate margins.
- The US economy and other tech-oriented economies re-accelerate.
- China moves more decisively to re-balance its economy, lowering deflation risk.
- A strong pick up in private sector activity leads to a reemergence of inflationary pressures, pausing the Fed's easing.
- Europe and Japan benefit from the US-led upturn and Chinese re-balancing.
- On net, the emergence of a 'New Cycle' benefits the rest of the world as well.
- The sharp fall in interest rates leads to a near-term weakening in the US dollar.
- Most positive scenario for risk assets – pushing equity multiples higher, risk spreads lower near-term.
- But bonds do less well, and the UST yield curve bear-steepens.

PROBABILITY

25%

SCENARIO 3

Shallow Recession

- Lagged impacts of policy tightening and political uncertainty weigh on activity.
- US households rebuild savings, corporate capex stalls, Fed remains too worried about inflation and is (initially) slow to respond.
- Pace of job layoffs picks-up into 2025, economic sentiment takes a hit.
- Oil prices decline sharply, China fails to rebalance, global inflation plummets.
- US economy slips into a shallow recession but avoids a full-blown crisis, as overall healthy private sector balance sheets, and the Fed's ample scope to cut rates limit downside risks.
- But recession concern and a narrower US current account deficit strengthens the USD.
- Stronger USD and weaker US growth pressures vulnerable EMs.
- Worst plausible outcome for equities, cyclical sectors particularly exposed to a pull-back.
- Credit spreads also widen past their long-term averages, but still bonds outperform on lower rates.

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01
WHAT WE THINK

01 WHAT WE THINK: FORECAST SUMMARY

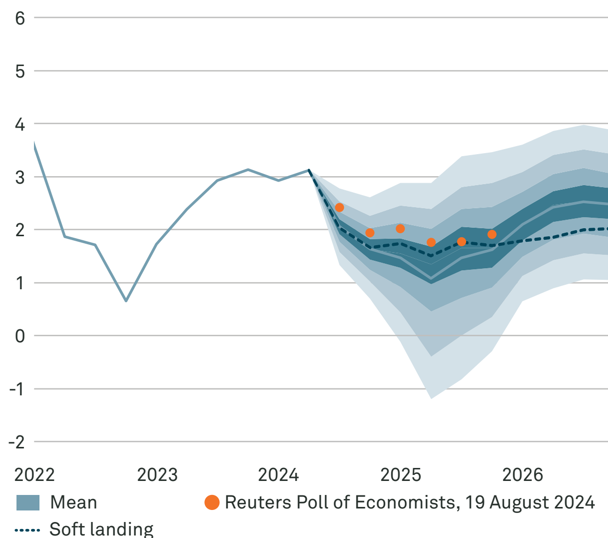
The triggering of the ‘Sahm rule’,[1] a commonly cited predictor of an impending US recession, has generated a number of headlines since the last edition of Vantage Point was published. However, the US labor market has continued to add jobs over the past quarter and other high-frequency data do not show a clear steer towards recession. Indeed, last quarter’s US GDP print came in marginally above the central expectation presented in the previous edition of this publication. That said, optimists and pessimists alike could easily find data points to support their preferred narratives.

This quarter, we present three scenarios:

- **Soft Landing** (45%) — A fairly benign scenario where GDP growth remains solid (but not spectacular) and inflation continues to drift back towards target, enabling the Fed to adjust the policy rate smoothly back towards 3%.
- **New Cycle** (30%) — An upside scenario where demand holds up better than expected in the near term and inflationary pressures are relatively contained due to a rebound in aggregate supply (which is boosted by the emerging benefits of artificial intelligence).
- **Shallow Recession** (25%) — A scenario where the monetary tightening seen to date has put in place the conditions needed to tip the US into recession with

1. The Sahm rule is a historical observation that a US recession has always occurred around the time that the 3-month moving average of the unemployment rate has risen at least 0.5 percentage points above its 12-month low. Importantly, the “rule” has not always held in other economies outside the US.

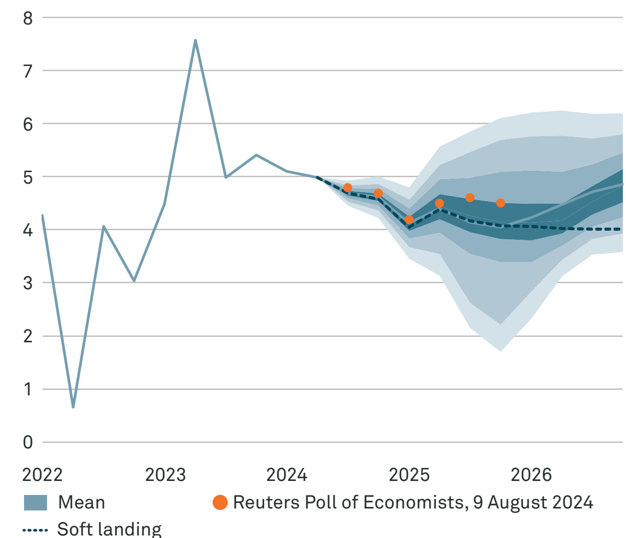
CHART 3: US GDP
FOUR-QUARTER PERCENTAGE CHANGES



Source: LSEG Datastream/Fathom Consulting.

Key Takeaway: Our central scenario is close to consensus expectations, but we see downside risk with a one-in-four chance of a year-on-year decline in output by mid-2025.

CHART 4: CHINA GDP
FOUR-QUARTER PERCENTAGE CHANGES



Source: LSEG Datastream/Fathom Consulting.

Key takeaway: We see little chance that official growth targets for this year are achieved and expect Chinese growth to disappoint consensus expectations next year.

Forecasts begin in Q4 2024 and were calculated as of 10 September 2024. Source: BNY Advisors and Fathom Consulting. The “central path” (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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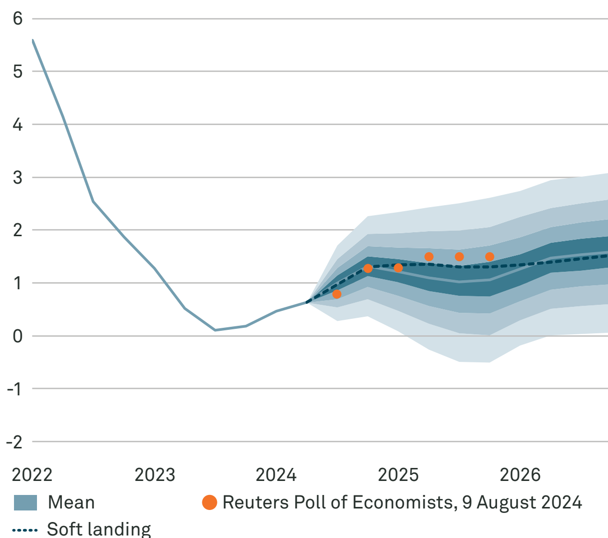
four-quarter growth briefly turning negative next year (post-COVID tailwinds have delayed its onset but not prevented it altogether).

As a result of the mixed signals in the data, in this quarter's Vantage Point we have reduced the weight on the central scenario and increased the weights on the two risk scenarios.

Continuing the tradition set by previous Vantage Point publications, we present our expectations both in the form of point forecasts and in terms of fan charts reflecting the distribution of likely outcomes. As with last quarter, both our central scenario and the mean of our forecast distribution suggest that the US economy will avoid recession and that inflation is likely to drift back to target. However, there is a significant degree of uncertainty around this in both directions. The likely result: market volatility.

Chart 3 shows the distribution of likely outcomes for US GDP growth out to 2026. Although 'Soft Landing', our single most-likely scenario sees US four-quarter growth hover in the 1.5–2.0% range, our mean expectation (which weights together our three scenarios and which is depicted by the solid line) lies to the south of that. Instead, it shows the US economy continuing to slow through 2025, reflecting the delayed effect of monetary tightening (in our central 'Soft Landing' scenario this is not sufficient to tip the US into recession, but in the 'Shallow Recession' scenario it is). That said, while growth is likely to remain weaker in 2025, the outlook for the following year looks a little brighter — at the very least, growth should rebound as monetary policy normalizes. Moreover, the risks to growth in 2026 are further skewed to the upside due to the potential for emerging technologies, such as artificial intelligence, to start yielding material economic benefits (something captured in our upside 'New Cycle' scenario).

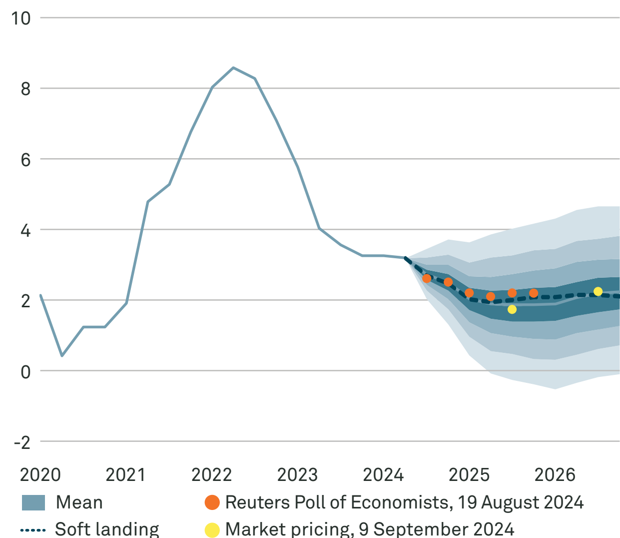
CHART 5: EURO AREA GDP
FOUR-QUARTER PERCENTAGE CHANGES



Source: LSEG Datastream/Fathom Consulting.

Key Takeaway: Euro area growth is likely to remain low next year, with a material risk of recession.

CHART 6: US CPI
FOUR-QUARTER PERCENTAGE CHANGES



Source: LSEG Datastream/Fathom Consulting.

Key Takeaway: Our mean expectation is that inflation converges to target and remains there, but there are significant risks in both directions.

Forecasts begin in Q4 2024 and were calculated as of 10 September 2024. Source: BNY Advisors and Fathom Consulting. The "central path" (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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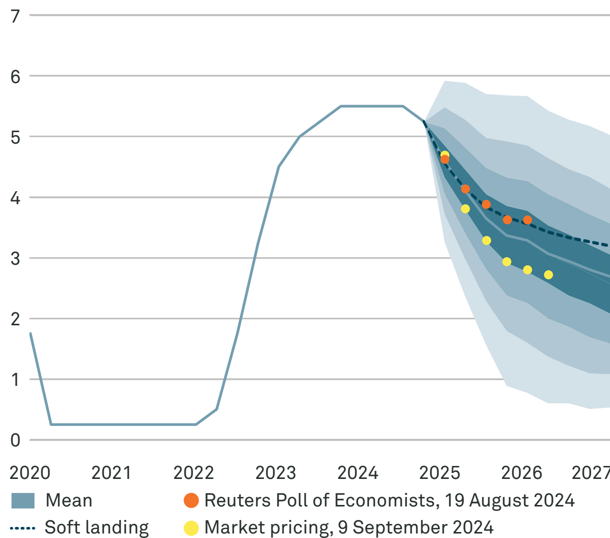
With domestic demand in the China still weak and with policymakers showing limited appetite for stimulus to offset this, our central scenario sees growth average around 4% (Chart 4). We do see some upside risk to this forecast at longer horizons, especially if Chinese companies can successfully harness the opportunities presented by emerging technologies and stronger overseas demand in the upside 'New Cycle' scenario. That said, even this scenario would only see growth of around 6%, well below its pre-pandemic norm.

Both our central scenario and our mean euro area growth forecasts are close to consensus expectations (Chart 5). Trend growth is weaker than in the US and we expect growth to remain in the 1.0–1.5% range. Given a weaker starting point, we expect the US-led 'Shallow Recession' scenario to also see the single currency bloc flirting with recession. Overall, there is less variation in the euro area fan chart, which also reflects our view that the currency bloc is positioned less well to take advantage of the 'New Cycle' scenario (partly due to the world's leading tech companies mostly being based in the US or China).

Our two risk scenarios are both demand-driven — one sees demand firm through next year, while the other sees it weaken. We consequently see the risks to inflation as being finely balanced, although there is a material chance that inflation could move away from target next year, in either direction. We see a one-in-three chance that inflation breeches 4% between now and the end of 2026, but equally a one-in-three chance that it drops below 0%.

With inflation likely to be close to target by the end of the year, our central scenario is that the Fed loosens policy roughly in line with consensus expectations, ending 2026 close to 3% (Chart 7). However, we think a more pronounced slowdown, such as the one incorporated in our 'Shallow Recession' scenario would be sufficient

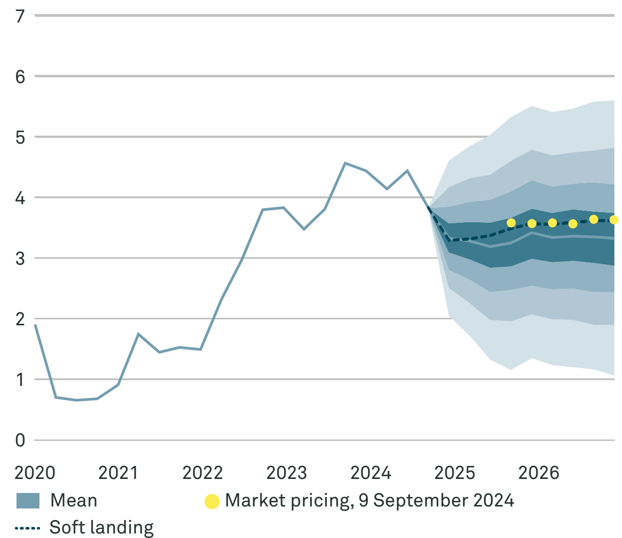
CHART 7: US FEDERAL FUNDS RATE
PER CENT



Source: LSEG Datastream/Fathom Consulting.

Key takeaway: Our mean path for the Fed Funds rate lies between consensus forecasts and market pricing, but the uncertainty in the outlook for growth and inflation is reflected in policy uncertainty.

CHART 8: US TEN-YEAR GOVERNMENT BOND YIELDS
PER CENT



Source: LSEG Datastream/Fathom Consulting.

Key takeaway: Our central scenario sees ten-year yields hover around 3.5%, but there is significant uncertainty around this view.

Forecasts begin in Q4 2024 and were calculated as of 10 September 2024. Source: BNY Advisors and Fathom Consulting. The "central path" (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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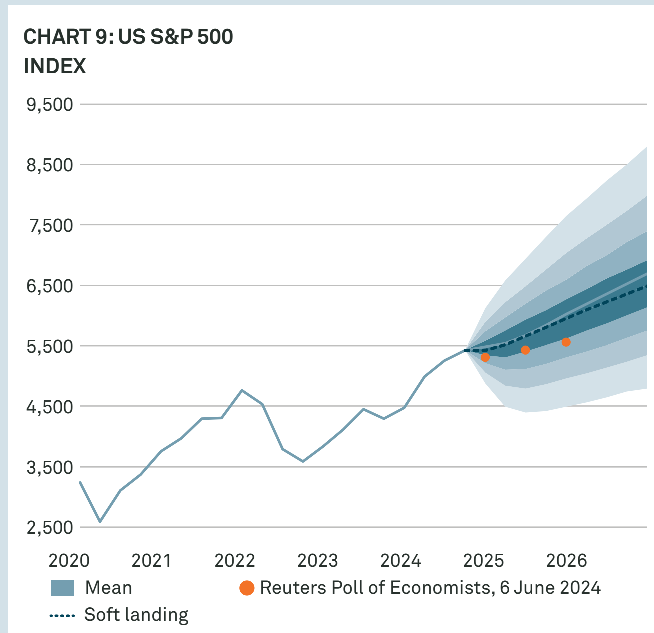
justification for the Federal Open Market Committee to cut rates below 2% next year. Similarly, if demand and inflation both hold up better than expected (as we think might happen in an upside 'New Cycle' scenario) then we see the Fed pausing at around 4% (and would not preclude the possibility of them reversing course).

Our central scenario sees the yield curve 'un-invert' without a recession. This is brought about more by the Fed normalizing policy than by an adjustment in bond yields. Our central scenario's bond yield forecast is a little lower than market pricing (which is closer to the mean of our scenarios).

There is a lot of uncertainty surrounding the path for equities in the near term (Chart 9). If the 'Shallow Recession' scenario materializes then we expect a drawdown of around 15%. Equally, if investors see signs that we are in our 'New Cycle' scenario and foresee an improvement in the supply side of the economy, then we see a good chance of solid equity market momentum. As a result, we expect equity markets — and financial markets more generally — to remain volatile over the coming quarters. In this regard, recent market jitters (such as those related to the end of the Yen carry trade) may persist for some time.

The final fan chart shows our outlook for the trade-weighted US dollar. As with last quarter, both in our mean scenario and in our single most likely scenario, the dollar drifts sideways, as rate differentials ensure that the dollar remains attractive. The uncertainty around this outcome is wide, but roughly evenly distributed.

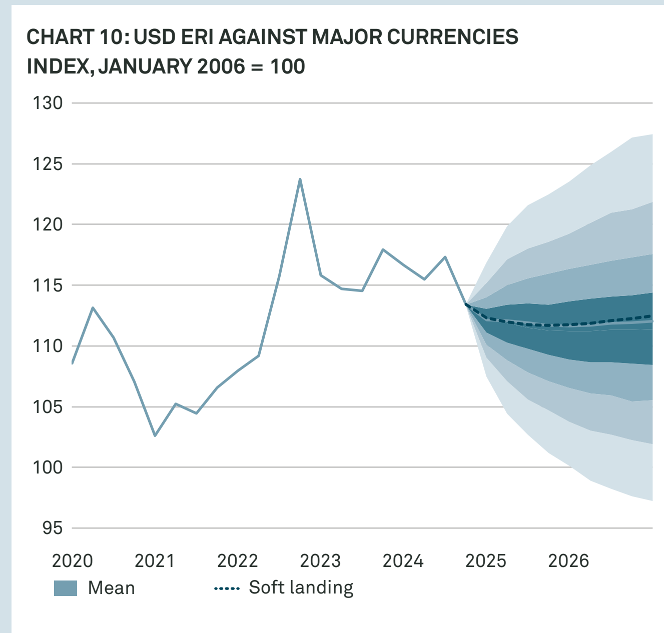
CHART 9: US S&P 500
INDEX



Source: LSEG Datastream/Fathom Consulting.

Key Takeaway: As with last quarter, there is potential for AI to drive returns significantly higher towards the end of the forecast horizon.

CHART 10: USD ERI AGAINST MAJOR CURRENCIES
INDEX, JANUARY 2006 = 100



Source: Fathom Consulting.

Key Takeaway: Our central scenario sees the dollar drift sideways through the forecast horizon.

Forecasts begin in Q4 2024 and were calculated as of 10 September 2024. Source: BNY Advisors and Fathom Consulting. The "central path" (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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02
WHAT THE
MARKET THINKS

02A WHAT'S PRICED IN

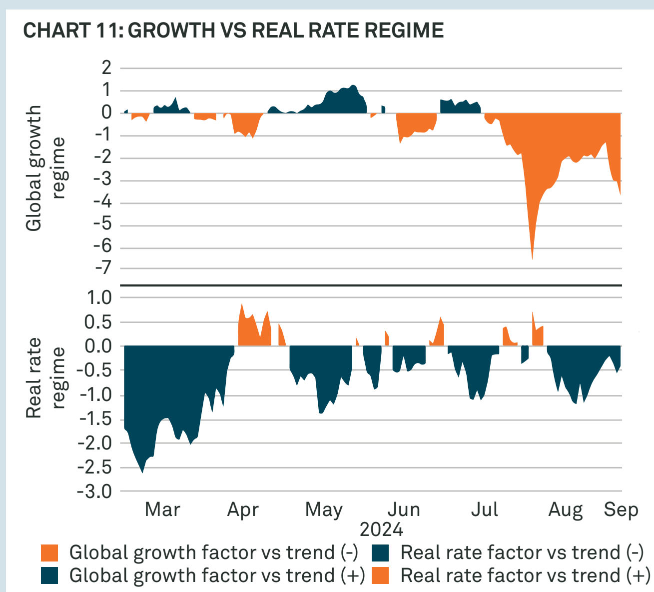
Summary

Market performance over the summer was overall positive but very volatile, with equity sell-offs in both August and September triggered by US growth concerns and the unwind of popular trades. Sovereign fixed income performed strongly and better than equities on a risk-adjusted basis, particularly in the US, as the market priced in a sharp loosening in monetary policy from major central banks. Broad commodity prices were weak, in line with the downward revision to global growth expectations. Cross-asset returns continue to broadly align to a soft-landing scenario of temporarily below trend growth and softer inflation, but the probability of recession priced in by the market has risen. This is especially evident in the US interest rate market, where the anticipated policy cuts over the next 12 months mirror those seen during past shallow recessions. Such an aggressive loosening cycle is sustaining elevated equity market expectations, which continue reflecting a benign macro environment characterised by robust earnings growth. The combination of recessionary-like rate cuts expected, and strong equity earnings is an unusual phenomenon which makes both the equity and interest rate markets vulnerable to a revision in expectations. Considering the non-linear nature of growth declines seen historically after increases in the unemployment rate of a similar magnitude to today's, the equity market is likely to be particularly attuned to negative data surprises, and more so than to positive data. Given the growth slowdown we expect over the months ahead, we think risk-adjusted returns for equities are likely to be lower than for sovereign fixed income into year-end, as discussed in the Investment Conclusions section.

Market-based growth expectations

- Global market-implied growth expectations fell over the period, as shown by the underperformance of asset classes and strategies most sensitive to the economic cycle: e.g. copper vs gold, and cyclical vs defensive equities.
- The level of growth expectations remains above long-term averages, and more optimistic than survey indicators of growth such as the global composite PMI.
- Leading growth indicators that tend to anticipate changes in the global PMI show some moderation of growth but to healthy, soft-landing like, levels. The market appears to be pricing in little recessionary risks. The balance between risk and reward in US equities, as derived from option

Summary: Market returns over the quarter are consistent with a weaker growth, and lower rates regime.



Source: Macrobond, BNY Advisors.
Data as of 13 September 2024.

Growth: Market view of growth is worsening but remains more optimistic than economic survey data.

Source: Macrobond, BNY Investments.
Data as of 11 September 2024.

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prices, appears to be excessively optimistic given our assessment of risks, even after accounting for AI-driven expectations of high returns in tech stocks.

Market-based inflation expectations

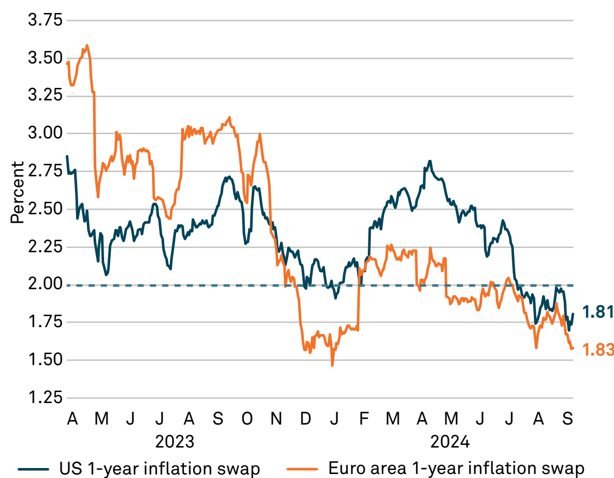
- Market implied inflation expectations fell significantly over the quarter, and at short horizons they're suggesting that inflation will undershoot the 2% target in both the US and the euro area. Real short-term interest rates instead remain above neutral, implying that policy is seen as remaining restrictive over the next 1-2 years. This combination of restrictive policy and below-target inflation suggests the market is pricing in some policy mistake from central banks in the near term. In the UK, instead, short term inflation expectations remain somewhat above target.
- Long term, inflation is seen as remaining at around 2% in the US and the Euro area, but to stabilise above target in the UK. In other words, the market is questioning the Bank of England's (BoE) commitment to price stability, a conclusion we disagree with.
- For Japan, the market had been pricing inflation to return below but not too far from the 2% target, but over the past few months some of these expectations have unwound, leaving medium and long-term inflation expectations below 1.5%.

Market-based monetary policy expectations

- Global interest rates repriced significantly lower over the quarter, driven by a worsening in growth expectations and the anticipated support coming from central banks.
- The market is pricing in a sharp policy loosening cycle. As a general rule, central banks tend to adjust interest rates in a series of small steps in the same direction. But in the case that risks to the (inflation and employment) policy objectives rise, and such risks are non-linear (such as in the case of higher unemployment) or particularly worrying (such as in the case of a threat to inflation expectations), a more pre-emptive approach is desirable, and sharper changes in rates may take place.
- The market is pricing in a very rapid shift in US monetary policy, and one that looks even more aggressive than what is implied by a 'front-loaded' policy strategy. In the US, investors anticipate the Fed to deliver a similar number of rate cuts over the next 12 months as seen historically in the context of shallow recessions.
- Expectations for other major central banks (e.g. the ECB and the BoE) are more muted, and what is priced in appears to be more reasonable given the range of outcomes for the global economy.

Inflation: The market expects inflation to be weak in the near term.

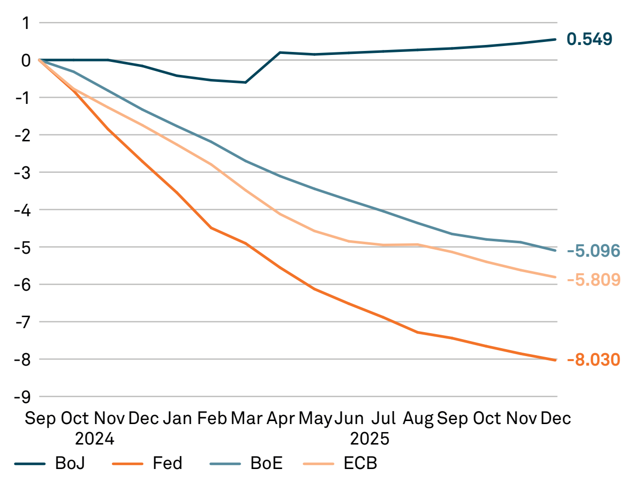
CHART 13: US AND EURO AREA NEAR-TERM INFLATION EXPECTATIONS



Source: Macrobond, BNY Advisors.
Data as of 11 September 2024.

Policy: All major central banks (except the BoJ) are expected to cut rates in the coming quarters, but the Fed is expected to loosen by more.

CHART 14: MAJOR CENTRAL BANKS – RATE HIKES (+) AND CUTS (-) PRICED IN



Source: Macrobond, BNY Investments.
Data as of 11 September 2024.

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02B MARKET SENTIMENT

Sentiment whipsawed during the quarter as the macro risk focus shifted away from inflation to growth and the labor market. Bullish sentiment peaked in mid-July, but swiftly collapsed in August as a US "growth scare" embroiled markets and spiked volatility. But the scare proved brief, and a relief rally swiftly ensued as incoming data (i.e., lower initial jobless claims and retail sales) allayed fears of imminent recession. Sentiment correspondingly jumped back to near July's bullish levels, only to stumble as September began and growth concerns resurfaced, questioning the consensus soft landing narrative. Overall, sentiment has moved closer to neutral during the quarter but is still leaning bullish on many metrics.

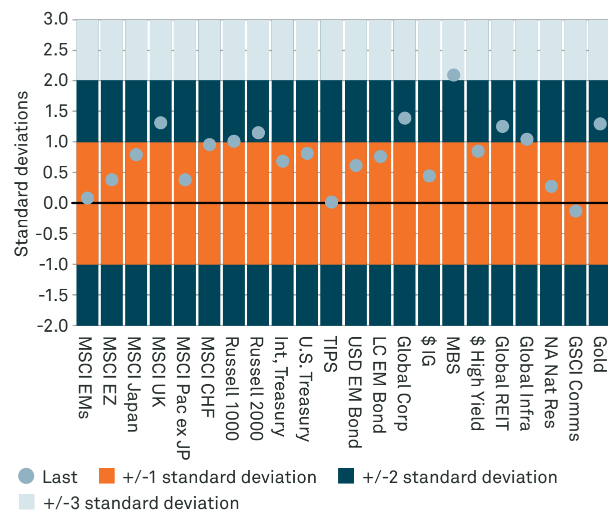
The takeaway from the quarter's swinging sentiment/ positioning and general volatility is that the market is grappling with macro inflection point uncertainty. We expected a pickup in volatility as incoming data pulled the market narrative in opposing directions, although admittedly, the realized volatility was greater than we anticipated. Technical, rather than fundamental, reasons exaggerated the volatility (e.g., low liquidity in early August and unwinding of Yen carry trades).

The likelihood of ongoing volatility and swings in sentiment remains high in the coming months. The market focus on growth rather than inflation raises the likelihood of sharper equity moves because equity as an asset class is more sensitive to the growth outlook. Moreover, mixed signals coming from macro data impacting the growth outlook and political uncertainty are unlikely to quickly deliver clarity that markets and investor's desire.

Based on our macro factors work (i.e., comparing asset prices to macro variables, see table), we see more assets moving above our estimates of macro factor fair value (FV) compared

Most assets are trading above levels implied by our macro factors, due to decelerating growth.

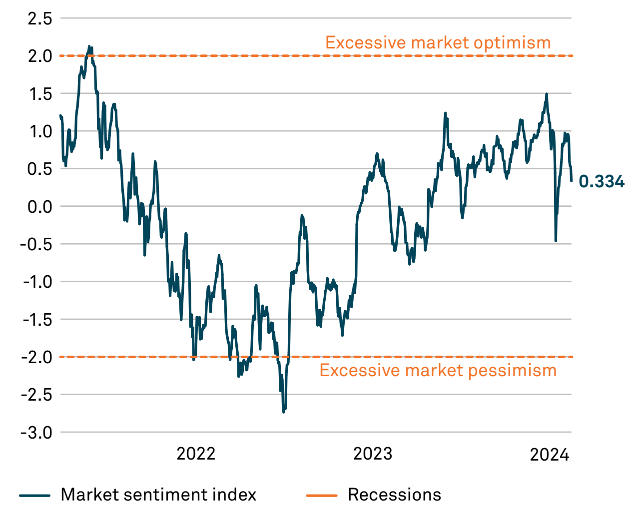
CHART 15: DEVIATION FROM MACRO FACTOR FAIR VALUE



Source: Macrobond, BNY Investments.
Data as of 9 September 2024.

Sentiment whipsawed during the quarter, but moved closer to neutral overall.

CHART 16: MARKET SENTIMENT INDEX



Source: Macrobond, BNY Advisors. Data as of 11 September 2024.

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to the previous quarter. Why? The growth macro factor has softened, but asset prices have moved higher or remained roughly flat for most assets we track. This makes assets appear relatively more expensive. We see only a few assets now trading below the implied macro factor FV estimates, notably commodities, which declined during the quarter.

For the US market broadly, positioning and sentiment continue to tilt bullish, despite moving closer to neutral amid the market swings during the quarter. Our market sentiment indicator peaked for the year in mid-July (+1.5 standard deviation) but crashed and flipped briefly negative in early August. The subsequent rebound was strong, and sentiment appeared to be tracking quickly back to peak levels. Large cap equity valuations remain above what our macro factors would imply for fair value but have remained fairly stable compared to the previous quarter given limited market gains. Overall, the set up for the fourth quarter is somewhat more constructive from a sentiment standpoint, although positioning appears to have remained fairly bullish.

Our cross-asset momentum signals show that equity momentum faded broadly for equities during the quarter. Momentum ebbed more acutely for international equity markets that failed to bounce back as strongly after August's sell-off, such as Europe and Japan equity. By contrast, fixed income has turned positive across the board and now looks attractive relative to equities on a momentum basis. Last quarter, despite the start of cutting cycles, sovereign bonds still lacked momentum as inflation concerns lingered. However, it appears that as inflation uncertainty is replaced by growth uncertainty, rates have rallied and now have further momentum tailwind (i.e. lower rates).

Fixed income momentum flipped positive across the board, while equity momentum faded.

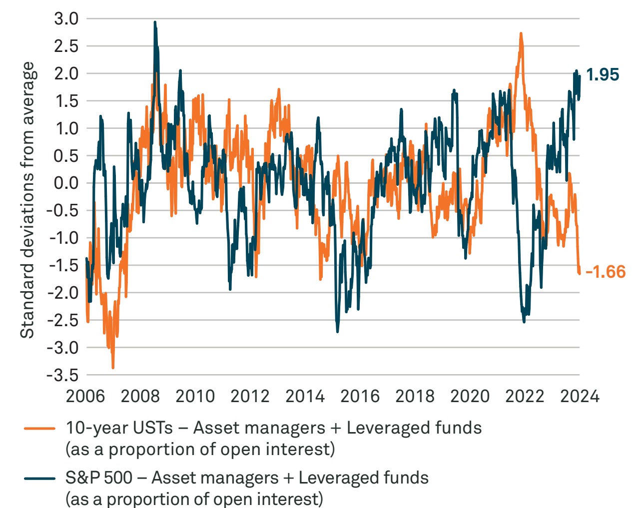
TABLE 3: CROSS ASSET MOMENTUM SIGNAL

Cross asset momentum signal (-1 to +1)	Last	Current
Equities	**0.9**	**0.3**
S&P 500	1.0	0.8
Nasdaq 100	1.0	0.2
FTSE 100	1.0	0.9
Eurostoxx 50	1.0	0.0
Topix (Japan)	1.0	-0.1
Hang Seng (China)	0.7	-0.3
Emerging Markets	0.9	0.3
Sovereign fixed income	**-0.7**	**0.7**
US 10-year	-0.9	0.9
Canada 10-year	-0.5	1.0
Germany 10-year	-0.8	0.7
UK 10-year	-0.2	0.7
Japan	-1.0	0.3
Credit	**0.4**	**1.0**
$ Investment grade	0.0	0.9
$ High Yield	0.8	1.0
Alternatives	**0.5**	**0.4**
Gold	1.0	1.0
Oil	0.1	-0.2

Source: BNY Advisors using Bloomberg data.
Data as of 9 September 2024.

Equity positioning remained bullish, while bond bearishness persists despite rates rally.

CHART 17: POSITIONING IN THE S&P 500 AND 10-YEAR US TREASURIES



Source: Macrobond, BNY Invesments.
Data as of 9 September 2024.

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03
INVESTMENT CONCLUSIONS

03 INVESTMENT CONCLUSIONS

Summary

Spiking market volatility inevitably spurs re-questioning of investors' baseline expectations. Is the market sniffing out a recession that's difficult to read in the economic data? Or do brief selloffs and strong rebounds simply characterize a panicky market on edge because the widely expected recession never arrived? These answers are unknowable in real time, but a probabilistic scenario-based approach is (we think) the most accurate, and intellectually honest, way to attempt answering them and identify the key investment implications.

The incoming macro data remains mixed, but on balance suggests that recession risks increased during the quarter. While the market reaction to August's "growth scare" was overdone (in part due to technical factors), it was not entirely unfounded. Uncertainty around a macro inflection point, combined with near-term political uncertainty, is a potent concoction for market volatility, especially as the market was priced heavily (and still is, broadly) for a soft landing. This makes the equity market especially sensitive to downside data surprises that call growth expectations into question.

A key question for markets is whether the upcoming series of policy rate cuts are "growth saving" emergency policy actions, or benign "normalization" cuts. The latter would clearly benefit risk assets more favorably and is how we've modelled the policy response in 'Soft Landing' and 'New Cycle' scenarios. Unfortunately, history tells us that most policy cuts are the former, as we've modelled in 'Shallow Recession'. The market expects numerous cuts through 2025. Using history as a guide, these expectations appear more like a shallow recession scenario than a soft landing. But history also suggests that the market underestimates cutting cycles more than overestimates (more cuts realized than expected). A result that stems from the market usually failing to forecast recessions until they're already happening. Where does this leave us?

We remain in the "slowdown/no recession" camp based on our scenario probabilities, so expect that cuts are more likely of the "normalization" variety than "growth saving". As such, risk assets overall are expected to perform reasonably well over the forecast horizon, but the near-term outlook is more nuanced. Given the growth slowdown we project in the months to come and accompanying equity volatility, our main equity fan chart remains skewed to the downside into year-end. Although odds-against (25%), the magnitude of the equity drawdown in a recession scenario weighs heavily on our mean equity outlook. As a result, we think risk-adjusted returns for sovereign fixed income have a good chance of outperforming equities in the immediate future.

In 2025, the equity path rises with a more balanced risk profile as the upside 'New Cycle' scenario plays a larger role. We expect equity to outperform bonds for the full-year. In both 'Soft Landing' and 'New Cycle', we project a stabilizing US labor market that is cooling, but not collapsing. A normalized labor market will maintain positive economic momentum, even if slowing to below trend temporarily, as modelled in 'Soft Landing'. Near-trend economic growth supports healthy

corporate margins and follow through on earnings growth expectations. Admittedly, earnings expectations are likely too optimistic if our most likely scenario pans out, which could be a 2025 headwind. But at the same time, the monetary policy easing cycle should support parts of the economy and market that have been under pressure, including US small caps. A broadening of market performance in recent months points to this beginning to be priced into the market, but we expect there's more to come as easing cycles gather pace.

The table shows the potential paths for the S&P 500 using estimates of P/E and EPS (price/earnings and earnings per share, respectively).

Soft landing	Year End Values		
	2024	2025	2026
EPS Estimate	245	267	291
Earnings Growth	10%	9%	9%
Price/Earnings	23	22	22
Approximate Level	5,642	5,882	6,408
Annual Return Estimate	18%	4%	9%

New cycle	Year End Values		
	2024	2025	2026
EPS Estimate	252	287	316
Earnings Growth	13%	14%	10%
Price/Earnings	24	24	23
Approximate Level	6,048	6,894	7,268
Annual Return Estimate	27%	14%	5%

Shallow recession	Year End Values		
	2024	2025	2026
EPS Estimate	245	240	276
Earnings Growth	10%	-2%	15%
Price/Earnings	19	21	21
Approximate Level	4,661	5,048	5,806
Annual Return Estimate	-2%	8%	15%

Prob. Weighted S&P 500	5,518	5,977	6,515
Annual Return Estimate	16%	8%	9%

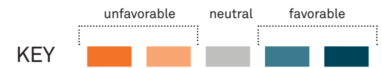
Forecasts were calculated as of 10 September 2024. BNY Advisors.

Valuations remain tricky. While the rate-cutting cycle may support even more elevated valuations, cutting expectations are already quite aggressive. It's difficult to envision much more of a tailwind. In fact, there's a greater risk that rate cuts come more gradually and/or the Fed must pause the easing cycle, particularly in "New Cycle". However, if a hawkish pause in 2025 is accompanied by accelerating growth, then the equity market may shrug off the policy concern after a brief pullback, as it did in 1997 (part of the famous mid-90's soft landing). Lastly, our research into the expected equity market impact of Artificial Intelligence's (AI) suggests that valuations could easily push even higher in the coming years as AI adoption spreads.

Based on our probability weighted scenarios, we derive risk-adjusted return estimates across assets to guide our views. Additionally, the views below benefit from the insights of BNY's Global Macro Advisory Council (GMAC)[1], a group of senior investment personnel from across BNY's investment firms. In the tables that follow, we lay out tactical (near-term) and strategic (multi-year) views. Overall, we remain neutral global equity, on a tactical basis, but see regional opportunities to add value (see table). We're favorable on government bonds (US and international, possibly FX-hedged) given attractive carry and the stage of the cycle, which suggests increasing potential benefits from portfolio hedging.

[1] The Global Markets Advisory Council (GMAC) is part of BNY Investments and leverages BNY's diverse expertise across its investment firms and generates differentiated insights to help deliver high conviction asset allocation models across geographies, regions, styles and asset classes.

ASSET CLASS VIEWS



Major asset class	Tactical view	Strategic view	Comments
Equities			Neutral stance overall due to near-term growth outlook uncertainty around policy inflection points. There are regional opportunities to add value. We prefer Europe and UK equity, as well as EM ex China.
Sovereign Bonds			Sovereign bond yields are expected to fall and income returns remain meaningful. Safe sovereign fixed income is to be preferred to credit, as spreads remain tight.
Credit			Further spread widening on slowing US growth, gradual policy easing and an expected rotation of investment flows toward safer, cheaper, asset classes. Total returns to be constrained despite attractive income. We prefer higher quality credits over HY.
Alts/Real Assets			We prefer infrastructure given equity exposure but stability. Commodity exposure is a diversified hedge to inflationary pressures.
Cash			Cash attractiveness is supported by low volatility, elevated income returns, and rates that are expected to fall more slowly, but better expected return opportunities are appearing elsewhere.

Equity	Tactical view	Strategic view	Comments
Developed Markets Equity			Growth outlook uncertainty overhangs market near-term. But we expect benign growth, albeit moderating, and disinflationary trends, paired with nascent loosening cycles will reduce equity headwinds and support risk appetite into 2025.
US Equity			Given moderating growth expectations and labor market concerns, near-term risks skewed to the downside. Elevated multiples could de-rate if policy easing is perceived as bearish "growth saving". Brighter 2025 as near-term constraints fade and expected positive AI impact dominates.
UK Equity			The macro outlook has been improving, and uncertainty falling. Cheap valuations on both relative and historical average basis remain attractive and imply that minimal less bad news could spur a rally. 12m forward EPS growth expectations remain low compared to peers.
Europe ex UK			The leading indicators we track have been conflicting, but we still expect some improvement ahead. Earnings expectations have recovered somewhat in recent weeks but remain weak. Income returns are significant, with dividend + buyback yields providing more than 4%, or about ~70+% of the total return assumed in our long-term capital market assumptions.

Equity	Tactical view	Strategic view	Comments
Japan Equity			Japan is reflating more durably --underpinned by rising wages, more entrenched inflation expectations and strengthening corporate sector reforms. BOJ policy normalization will be gradual, not unduly restrictive. Corporate earnings to remain buoyed by domestic improvements, however, tailwinds from Yen weakness to wane.
EM Equity			Lower US rates and a stable trend in the USD to ease global financial conditions and help EMs. But weakening G3 demand and a more protracted downturn in China to hurt external demand and commodity producers' terms of trade.
EM ex China Equity			EM equity excluding China remains attractive. Underlying price trends reflect a variety of secular themes: AI-driven semiconductor-led gains in Taiwan; domestic-demand strength in India; and friend-shoring in places like Mexico and Central Europe. Alongside a stabilizing USD, modest rate cuts from an increasing number of EM central banks are tailwinds.
China Equity			Deflation is becoming more entrenched, and the policy response has been reticent, reactive and insufficient. The real growth target (~5%) is likely to be missed. In this backdrop, the prospect of reviving risk sentiment sustainably and rapidly closing output gaps has grown more challenging.

Fixed Income	Tactical view	Strategic view	Comments
US Treasuries			We see less risk of a rapid deterioration in growth that would force an aggressive cutting cycle, as implied by market pricing. However, given attractive carry and the stage of the cycle, we see increasing potential benefits from portfolio hedging.
Intl. Sovereign Debt			FX hedged income returns are attractive in absolute terms and vs Treasuries. Less rate cuts are priced in vs the Fed for most central banks, but several other DM economies appear also at risk of recession. US term premium risk also advocates for increasing diversification.
Global IG			Spreads are rich relative to history and amid a gradual slowdown, especially in the U.S., high grade corporate spreads are expected to widen modestly. We expect fundamentals to hold up, but risk-adjusted-returns are not attractive yet for us to turn more constructive.
High Yield Debt			Spreads have gotten rich, and we expect a re-widening of spreads toward long-term averages on a slide in HY corporates' margins and their rising issuance needs --amid a global slowdown, weakening commodity prices and gradual policy easing.
EM Local Currency Debt			Peak US rates, better EM inflation fundamentals, easing global goods prices, decent real rate buffers and cheap currency valuations keep EM local debt attractive. EM rate cuts to be catalyzed by onset of Fed policy easing.
EM USD Debt			Our 'neutral' recommendation balances slowing G3 and China growth alongside decent policy buffers, cheap currencies, improved economic flexibility and better fiscal fundamentals (relative to DMs). Valuations are less expensive than IG and HY credits.

Source: BNY Advisors, as of September 10, 2024.

Past performance is no guarantee of future results.

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DEFINITIONS

Japan (Nikkei 225): The NIKKEI 225 is an index that tracks the performance of the largest 225 companies traded in the Japanese market. **10Y UK Gilt** – Average yield of a range of UK government bonds all adjusted to the equivalent of a ten-year maturity. **Phillips Curve:** An economic theory that inflation and unemployment have a stable and inverse relationship. US **Consumer Prices (CPI) Index** measure of prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rate represents the inflation rate. The **10Y US Treasuries Average Yield** of a range of Treasury securities all adjusted to the equivalent of a ten-year maturity. The **CBOE VIX Index (VIX)** is an indicator of the implied volatility of S&P 500 Index as calculated by the Chicago Board Options Exchange (CBOE). The **Majors Dollar Index (USD)** measures the value of the US dollar relative to a basket of currencies of the most significant trading partners of the US including the euro, Japanese yen, Canadian dollar, British pound, Swedish krona, and Swiss franc. The **MSCI EM Index (Emerging Markets Equities)** tracks the total return performance of emerging market equities. The **S&P 500 Composite Index (S&P 500)** is designed to track the performance of the largest 500 US companies. **Europe STOXX 600** Index represents the performance of 600 large, mid and small capitalization companies across 18 countries in the European Union. **Bloomberg US Corporate High Yield:** covers the universe of fixed-rate, non-investment grade corporate debt in the US. **Bloomberg US Corporate Investment Grade:** designed to measure the performance of the investment grade corporate sector in the US **1-mth. 1-year forward swap:** the avg. interest rate for 1-mth. in 1-year forward. **GDP:** gross domestic product is the total monetary or market value of all the finished goods and services produced within a country's borders over a given time period. **Fed funds Rate:** the target interest rate for overnight lending and borrowing between banks. **Purchasing Managers Index (PMI):** An economic indicator derived from monthly surveys of private sector companies. A level above 50 indicates expansion compared to the prior month and below 50 contraction. Investors cannot invest directly in any index. **Soft landing:** a gradual and controlled economic slowdown, often aimed at preventing a recession or minimizing its impact. **Global Financial Crisis:** The severe economic downturn that began in 2007-2008, characterized by widespread banking failures, a collapse in housing markets, and subsequent global recession. **Neutral Rate of Interest** (r-star or r*) is the short-term interest rate that would prevail when the economy is at full employment and stable inflation. A rate at which monetary policy is neither contractionary nor expansionary.

STATISTICAL TERMS

Skewness in statistics represents an imbalance and an asymmetry from the mean of a data distribution. In a normal data distribution with a symmetrical bell curve, the mean and median are the same. **Probability-weighted mean** is similar to an ordinary arithmetic mean, except that instead of each of the data points contributing equally to the final average, data points are weighted by the statistical probability for a particular scenario outcome. **Duration** is a measure of a bond's interest-rate sensitivity, expressed in years. The higher the number, the greater the potential for volatility as interest rates change.

OTHER

QE: quantitative easing. **Fed:** US Federal Reserve. **ECB:** European Central Bank. **BOJ:** Bank of Japan. **BOE:** Bank of England.

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