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LAZARD

Executive Summary

In the 2024 outlook published in November, I made several predictions about the state of the global economy. These included rate hikes shifting to cuts in the United States, where the Federal Reserve would successfully engineer a "soft landing"; the Eurozone and United Kingdom teetering on the brink of recession before seeing growth improve; and Japan exiting yield curve control and negative interest rates. As for the geopolitical environment, I anticipated that the Ukraine war would drag on while Western tensions with China remains elevated, and that the US election would become a focal point for investors given its potential effects on the geopolitical trajectory.

Through the second half of the year, I expect:

- US growth and inflation to decelerate, allowing the Fed to cut rates in the second half of 2024;
- A razor's-edge US election with significant economic and market implications;
- China's housing challenges to persist, but with the cumulative effects of stimulus lifting growth;
- Eurozone disinflation to allow the European Central Bank (ECB) to ease policy materially in 2024, adding additional momentum to already-accelerating growth;
- Japan's inflation normalization to persist, leading households to reassess asset allocation; and
- Western resolve to defend industry against Chinese competition to stiffen, adding to elevated tensions over China's support for Russian aggression in Ukraine.

The global outlook has brightened in 2024 despite some disappointing news along the way. Real GDP growth expectations for the United States have doubled to 2.4% for 2024, but at the cost of somewhat stickier inflation than previously expected. China has taken additional, albeit still insufficient, steps to attack the residential real estate crisis that has sapped consumer confidence. The Eurozone economy appears to have turned the corner with improving service sector prospects and manufacturing stabilization. Japan surprised on the upside, with higher-than-expected wage increases potentially signaling the beginning of a virtuous domestic wage-price feedback loop. This positive economic trajectory has been sustained despite ongoing humanitarian crises in Ukraine and the Middle East and simmering tensions between the West and China.

Interest rate markets have endured significant volatility since the fourth quarter of 2023 with expectations for central bank policy easing ranging from as little as 25 basis points (bps) of Fed rate cuts by year-end to as much as 200 bps of ECB rate cuts. Non-US equity markets have delivered broad-based gains, while the US advance has been narrowly led by a short list of artificial intelligence (AI) and tech beneficiaries. In fact, while the S&P 500 Index has rallied 15% as of late June, the median stock is up just under 4%, and a single stock, Nvidia, accounts for just over 30% of the year-to-date S&P 500 Index rise.

Looking to 2025, I think we have seen peak hawkishness in the short-term rates market. Expectations for rate cuts are likely to increase, with investors settling on a terminal rate in the easing cycle at ~2%–2.5% in the Eurozone and ~3.5%–4.0% in the United States. These expectations translate to little or no downside for US 10-year Treasury yields, which means that US equity market valuations likely have limited upside from current historically elevated levels. Outside of the United States, there is still room for upside both in terms of valuation multiples and earnings recovery given less-resilient economic conditions since the pandemic.

In my view, the tech-AI juggernaut can only be sustained if the customers buying these goods and services realize a return on investment. Put simply, CEOs and CFOs of large companies will not just continue to pour money into AI investments if there is no evidence that the capital deployment is paying off. I believe 2024 is too early to see these returns in earnings or profit margins, but 2025 is not. As investors look ahead, I expect to see a broadening of the equity market rally driven by better earnings growth outside of the technology sector. Importantly, this broadening does not mean that tech and AI stocks stop working. If their customers realize strong returns on investment from their purchases of tech and AI goods and services, I believe we could see continued solid performance from some of the tech leaders. However, the gap between the tech leaders and the rest of the market would likely narrow, if not reverse, as investors realize that the rest of the market has largely stagnated for over two years and now offers more attractive return potential.

United States

Key view: The US economic outlook is positive, but the capitalization-weighted S&P 500 Index appears fully valued. Upside from current levels will need to be driven by earnings growth and a broadening of the equity market rally beyond a small number of technology-related companies.

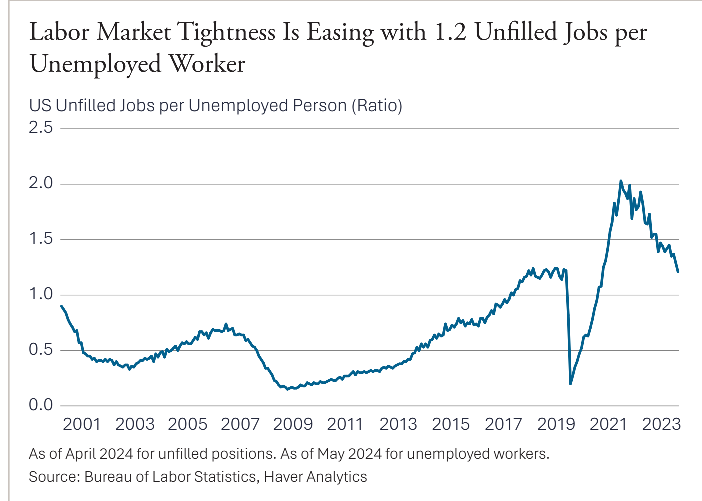
What to watch:

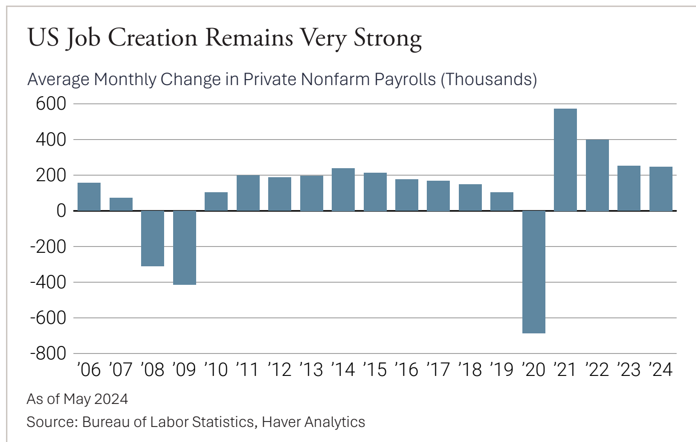
1. **Disinflation:** I expect inflation on a month-on-month (m-o-m) basis to decelerate as we move through 2024 with the core m-o-m Personal Consumption Expenditure (PCE) run-rate falling below 2.5% late in 2024.
2. **Employment:** Tightness in the US labor market is likely to ease causing wage growth to decelerate and unemployment to increase marginally.

3. **Fed policy:** The Fed is likely to begin easing at the September Federal Open Market Committee (FOMC) meeting and could deliver two or three rate cuts of 25 bps by year-end.
4. **US election**: It's too early to call the US election, but if Donald Trump wins a second term, the policies he has promised vis-à-vis tariffs, taxes, and deregulation could meaningfully affect the economy and markets. Trump's geopolitical policies could also transform the landscape by raising questions about the United States' commitment to defending allies in Europe and Asia.

Since the pandemic, GDP has grown meaningfully faster in the United States than in other developed economies. Strong demand growth combined with supply chain challenges spurred the initial inflationary surge in goods prices that then transmitted into the service sector. US headline Consumer Price Index (CPI) inflation peaked at 9.1% in June of 2022 before falling to 3.3% in May of 2024 as supply chains normalized and demand decelerated due to the sharpest monetary policy tightening in four decades as well as depletion of households' excess savings.

US growth and inflation are likely to slow through year-end. The consensus among economists for real GDP growth is 2.4% in 2024 and 1.8% in 2025, according to Bloomberg. I expect 2024 growth to be closer to 2% as consumer spending growth decelerates and labor markets cool with lower job creation, fewer unfilled jobs, and slower quit rates. Nonfarm job creation has remained well above historical levels with approximately 250k new jobs per month from the beginning of 2023 to May of 2024. However, other metrics are signaling easing of labor market tightness. The number of unfilled jobs per unemployed worker declined from 2.0 to 1.2 since March 2022, and the voluntary quit rate fell from 3.0% of workers per month to 2.2%. These data suggest easing of tightness in the labor market that should result in decreased upward wage pressure and hence lower price pressures in general.





Weaker consumption growth is also likely a result of increasing stress on household finances. The New York Fed's Quarterly Report on Household Debt and Credit reported a new record of $17.7 trillion of household debt in the first quarter of 2024. More importantly, the serious delinquency rate, reflecting loans that are past due for 90 days are more, rose 36% year-on-year (y-o-y) for mortgages, 30% for credit cards, and 13% for auto loans. While mortgage delinquencies remain near historic lows,

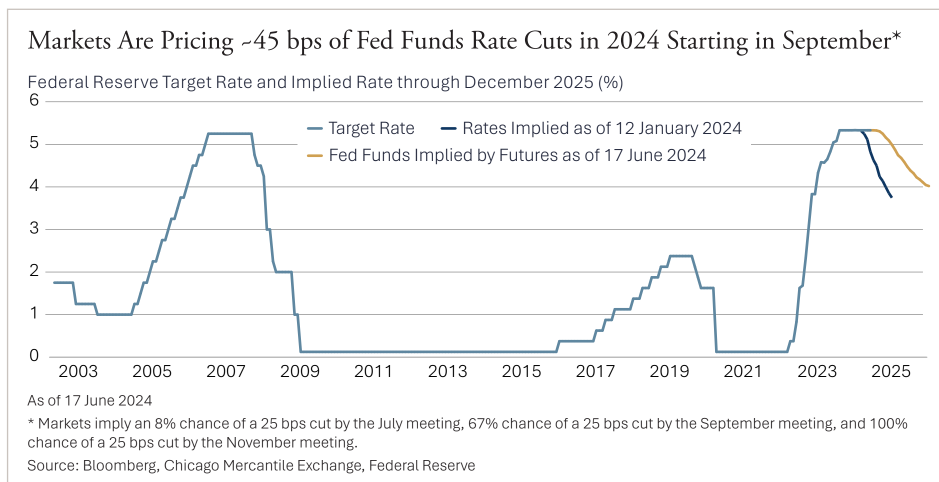
"The serious delinquency rates for American credit cards and auto loans are now above the average levels of the last decade."

in large part due to the significant regulatory tightening that followed the Global Financial Crisis (GFC), the serious delinquency rates for credit cards and auto loans are now above the average levels of the last decade. Through May, consumer stress also became more apparent through disappointing retail sales.

With supply chain issues resolved, labor market tightness easing, and consumer demand weakening, inflation is likely to continue decelerating into 2025. Shelter inflation reported in CPI and PCE metrics should gradually reflect private sector data, and services inflation excluding shelter will likely decelerate as wage pressures subside. The y-o-y figures might not slow rapidly given base effects, but the m-o-m trajectory should improve.

Alongside weakening consumer conditions, US commercial real estate (CRE) challenges remain. The Mortgage Bankers Association (MBA) estimated $929 billion of CRE debt will mature this year. Of this amount, just over $200 billion is expected to be backed by office space, the focal point of likely losses. One recent example of office stress that helps frame the severity of the challenges is 1740 Broadway in New York. When the $308 million single-asset securitization loan was originated in 2014, the building was appraised at $605 million. A single corporate tenant occupied 77% of the floor space until early 2022 when the tenant departed. In 2023, the building was appraised again at only $175 million, a markdown of 71%. Even though the original loan was equal to only 51% of the appraised value, implying 49% equity in the building, the lenders ended up incurring a loss of 62% net of all costs. Given how the loan was packaged, the loss wiped out all tranches below the AAA-rated level with even the AAA holders losing 26% of their principal. This was the first loss on an AAA-rated securitization in developed markets since the GFC. While I cannot speak to the features of this specific building, it highlights the stress likely to be incurred by CRE lenders—primarily regional and local commercial banks—in 2024, which will add to a tightening of credit conditions beyond the constraints already imposed by lenders.

My base case expectation is for the FOMC to begin easing rates at the September meeting and to cut two additional times before year-end. The April and May inflation and labor reports began to reestablish a clear disinflationary trend. By September, the FOMC will have three additional inflation and labor market reports to determine whether price pressures have been capped. Other than potential data disappointments, another constraint on the FOMC is the risk of being seen as politically motivated, as cutting rates at the last meeting before the election could be perceived as an attempt to lift President Biden's reelection prospects. My assumption is that the FOMC will make the decision warranted by the data and market expectations and will ignore political considerations. After May CPI surprised on the downside, markets moved from implying just over one 25 bps rate cut to two by year-end.



As of 17 June 2024

* Markets imply an 8% chance of a 25 bps cut by the July meeting, 67% chance of a 25 bps cut by the September meeting, and 100% chance of a 25 bps cut by the November meeting.

Source: Bloomberg, Chicago Mercantile Exchange, Federal Reserve

"Of the **$929 billion** of US commercial real estate maturing this year, just over **$200 billion** is expected to be backed by office space, the focal point of likely losses."

Perhaps more important than when the FOMC reduces rates first is the degree to which they cut rates through the easing cycle. I expect the US economy to continue growing at or above potential (1.75%–2.25% in 2024 and 2025); if I'm correct, the Fed will ease due to disinflation rather than economic weakness, in which case the rate-cutting cycle could be relatively moderate. I expect the Fed Funds rate to trough at or above 3.5%, which would imply that long-term interest rates are unlikely to decrease materially and that fair value for the US 10-year is between 4% and 5%. If this is the case, the primary benefit of rate cuts will be at the short end of the yield curve for floating-rate borrowers.

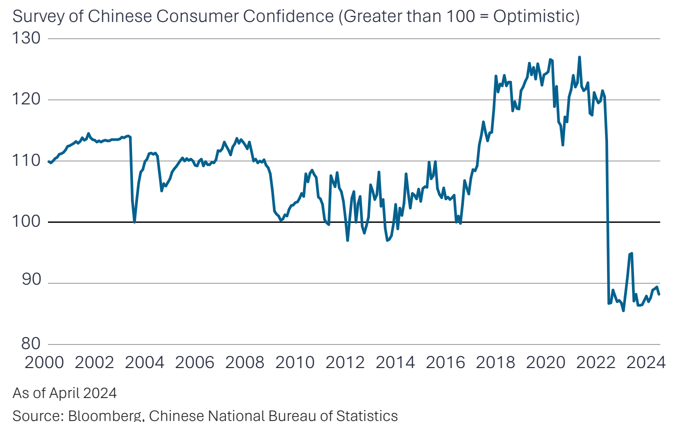
China

Key view: There is no quick fix for China's housing woes, but the broader economy is likely to improve through year-end as real estate investment bottoms. Chinese equities have rallied strongly year-to-date and could offer more upside, but the easiest gains are likely behind investors.

What to watch:

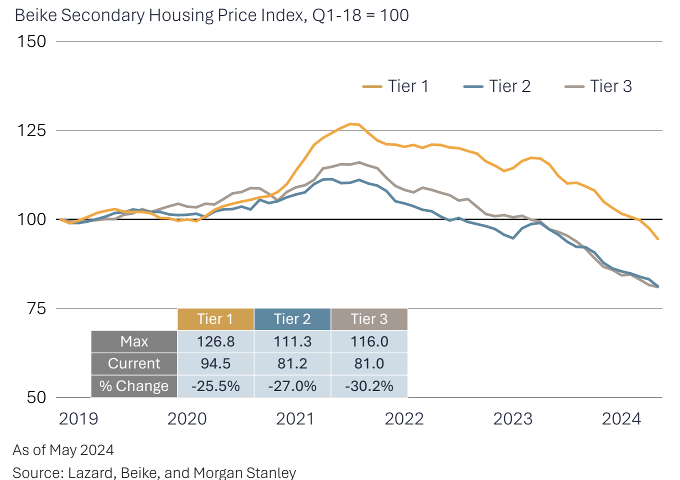
1. **Home prices:** I expect home prices to bottom over the next 12 months as consumers realize that new supplies of housing in the future will be sharply lower than in the past. I do not expect home price increases, but I do expect consumer confidence to improve once prices bottom.
2. **Government stimulus:** Government intervention to date has been a good start but remains insufficient to accelerate growth. I remain skeptical that we will see major announcements of demand stimulus, but any surprise would be received positively by markets.
3. **Trade friction:** In the absence of meaningful domestic demand stimulus, China's economy will become more dependent on exports to drive growth, increasing trade friction with the West.

Chinese Consumer Confidence Remains Near Record Low Levels



As of April 2024
Source: Bloomberg, Chinese National Bureau of Statistics

Home Prices in China Have Fallen Materially in the Secondary Market



	Tier 1	Tier 2	Tier 3
Max	126.8	111.3	116.0
Current	94.5	81.2	81.0
% Change	-25.5%	-27.0%	-30.2%

As of May 2024
Source: Lazard, Beike, and Morgan Stanley

China's economic malaise persisted through the first half of the year with the residential real estate crisis worsening and home prices accelerating on the downside. Prices for previously-occupied homes in Tier 1 cities have fallen 25%–30% from the peak while prices in Tier 3 cities are down over 30%. Given that Chinese households have approximately 60% of their assets in residential real estate, such large declines are very damaging to consumer confidence, which remains near record lows. As real estate developers struggle to avoid default, land sales by local governments to developers have fallen sharply, curtailing revenue to fund municipal operations.

To date, the Chinese government has resisted delivering a "bazooka"-style stimulus package to resolve the housing crisis and accelerate economic growth, delivering instead measures that in aggregate should improve the outlook. Most recently, the People's Bank of China (PBoC) announced a re-lending facility of RMB 300 billion to be allocated to 21 banks to use for funding RMB 500 billion of loans to local governments to buy

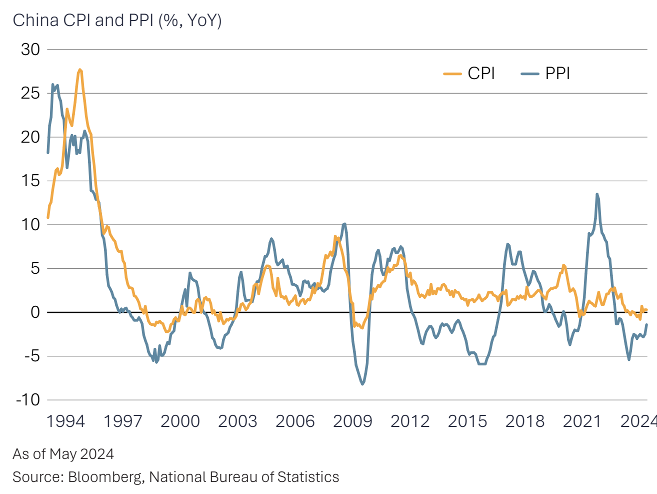
"Prices for previously-occupied homes have fallen **25–30%** in China, where households have approximately **60%** of their assets in residential real estate."

finished-but-unsold homes to be turned into public housing. At the same time, downpayment requirements for purchase of a primary residence were reduced to 15% from 20% and for homes other than a primary residence to 25% from 30% while benchmark borrowing rates were also eased in some situations. The new housing measures sound reassuring, but they effectively replicated an existing RMB 100 billion facility introduced months earlier by the PBoC that has only seen RMB 2 billion of actual utilization. It is not clear why local governments would avail themselves of the new facility given that they have shown little appetite for the original facility intended to serve the same purpose.

China is not relying on housing intervention alone, however. The Ministry of Finance announced in May that it would auction RMB 1 trillion of ultra-long central government special bonds to provide funding for local governments and infrastructure investments to enhance environmental resilience. The bonds are a positive step as the funding is desperately needed by local governments, but the bonds will be issued over a six-month period versus only two months in 2020 when this tool was last used, suggesting a lack of urgency.

Despite the lack of compelling policy intervention, there are positive economic signs from China, including strengthening exports and industrial data in recent months. China has successfully ramped up its production and exports of electric vehicles (EVs) globally, capitalizing on domestic scale and technological and cost advantages while overcoming increasing trade barriers from some developed market trading partners. EVs and other new energy products such as solar and wind products are likely to further drive export growth, but a surge in exports could trigger increased tension with the importing countries seeking to protect domestic producers from unfair competition driven by subsidization of Chinese producers.

In China, Persistent Low Inflation Could Become Problematic



As of May 2024
Source: Bloomberg, National Bureau of Statistics

Ultimately, the policies that investors want to see from China would focus on increasing domestic demand rather than adding to excess supply. China's Producer Price Index (PPI) has been negative on a y-o-y basis for 20 consecutive months as insufficient demand, combined with excess supply and some degree of lower input costs, pushed prices down. China has suffered from an imbalance of excess savings and insufficient consumption for decades due to the absence of a resilient social safety net, lack of *hukou* reform, and the effects of other social policies. Thus far, there is no sign of a change in tack by the authorities, but it is sorely needed.

Eurozone

Key view: Eurozone growth is likely to accelerate from the sequential stagnation of 2023 as inflation subsides, the ECB eases monetary policy, and real wages increase.

What to watch:

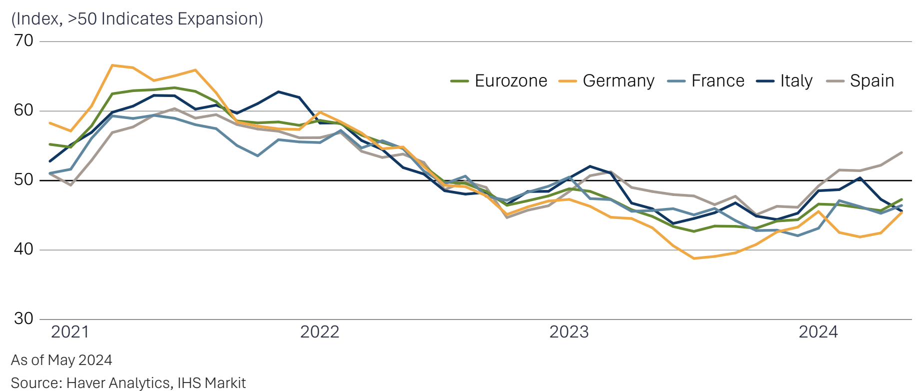
1. Disinflation: Inflation will likely continue decelerating but services will be the focal point to ensure this stickier price pressure does not become entrenched.
2. Monetary policy: The ECB could deliver up to 100 bps of total rate cuts by year-end with an additional 100 bps in 2025, assuming my expectations are met for wages and inflation.
3. Wage gains: Real wage gains should persist but will likely need to moderate to allow the ECB to continue easing policy.

The Eurozone outlook has improved year-to-date with economic green shoots appearing even before the ECB began easing in June. The Purchasing Managers' Index (PMI) for manufacturing has improved from depressed levels, with Spain being the positive outlier compared to the rest of the major Eurozone economies that have been recovering within contractionary territory. Services PMIs have improved significantly to expansionary levels across each major economy other than France, which dipped back to contractionary levels in May. The Eurozone outlook is not rosy, but the improvement should accelerate on the back of ECB rate cuts given the preponderance of floating-rate debt for households and companies in the Eurozone. Monetary policy changes should have a more immediate and sizable effect, boosting Eurozone growth and corporate earnings in 2024.

The ECB was able to begin cutting rates in June because inflation decelerated more

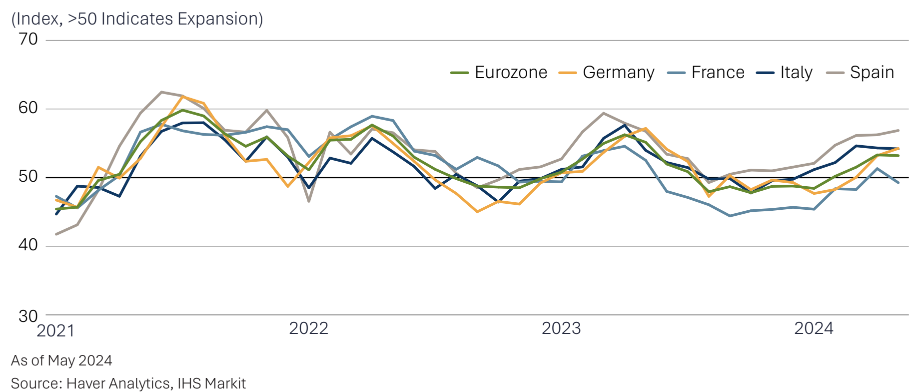
> "If the Fed deems inflation too high to cut rates in 2024, **the ECB might have to rein in its rate cuts** to avoid excessively weakening the euro and importing inflation through the exchange rate."

Eurozone Manufacturing PMIs Remain in Contractionary Territory Except in Spain



As of May 2024
Source: Haver Analytics, IHS Markit

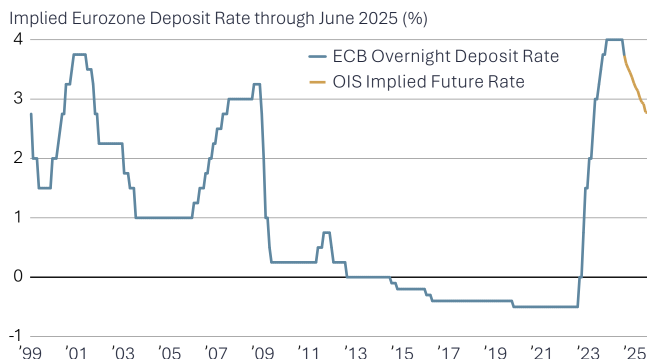
Eurozone Service PMIs Have Improved Considerably



As of May 2024
Source: Haver Analytics, IHS Markit

Markets Suggest ~43 bps of Additional ECB Rate Cuts in 2024*

Implied Eurozone Deposit Rate through June 2025 (%)



As of 17 June 2024

* Markets imply an 11% chance of a 25 bps cut at the July meeting, 70% chance of a 25 bps cut at the September meeting, and a 98% chance of a 25 bps cut by the October meeting.

Source: Bloomberg

smoothly than in the United States. While the ECB was the first major central bank to ease rates, its latitude to cut aggressively might be limited by several factors. First, although headline inflation has decelerated from a peak of 10.6% in October 2022 to only 2.6% in May 2024, core inflation remains well above the ECB's target at 2.9% and services inflation (45% of the Eurozone CPI basket) remains at 4.1%. Second, Eurozone wage growth surprised on the upside in the first quarter of 2024 at 4.7% versus 4.5% in the fourth quarter of 2023. An ECB blog post explained that the upside surprise was based on delayed wage adjustments in Germany, pushing the metric higher while other Eurozone wage increases subsided; nonetheless, wage gains of over 4.5% do not correspond to getting inflation down to 2% in the near term. Finally, the ECB might also be constrained by FOMC decisions. If the Fed deems inflation too high to cut rates in 2024, the ECB might have to rein in its rate cuts to avoid excessively weakening the euro and importing inflation through the exchange rate.

Fortunately, the Eurozone growth outlook is not entirely contingent on rate cuts. Real wages are improving as inflation decelerates and as wages catch up to prior price-level increases. While the pace of wage growth in the first quarter of 2024 is slightly worrying relative to the ECB's 2% inflation target, it does suggest real wages are rising meaningfully enough to propel increased consumption, which should lift economic growth through 2025. As China's growth improves, the combined domestic and export drivers should take Eurozone GDP to levels equal to or greater than its relatively muted potential.

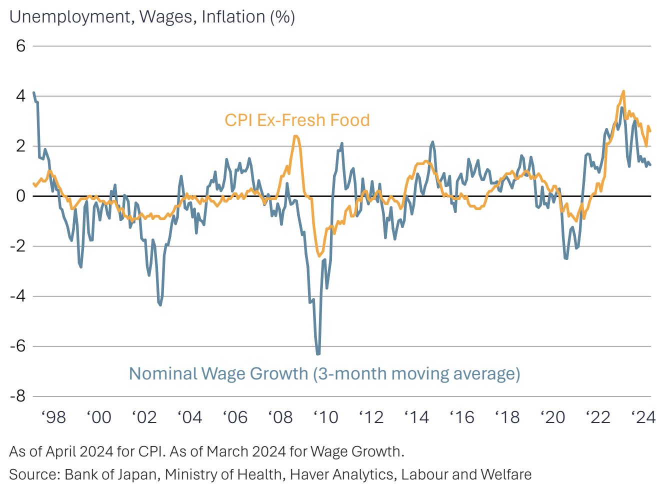
Unlike in 2023, economic growth should be sustained through 2024 on a sequential and y-o-y basis. In 2023, sequential GDP was largely unchanged through much of the year, which still translated to y-o-y growth given the weaker results in 2022 as the economy was still recovering from COVID. Hence, 2024 and 2025 are likely to be more gratifying, for both the economy and corporate earnings, than 2023.

Japan

Key view: Japan appears to be in the early stages of an inflation normalization process that should lead to changes in consumer purchasing behavior and household asset allocation decisions. Companies are managing their balance sheets more effectively, which should lead to higher returns and increased growth as capital is put to more productive uses.

What to watch:

1. **Wage gains:** I expect wage gains to persist in 2025 with real wages turning positive. Higher wages should increase pressure on companies to invest to raise productivity, accelerating economic growth.



As of April 2024 for CPI. As of March 2024 for Wage Growth.
Source: Bank of Japan, Ministry of Health, Haver Analytics, Labour and Welfare

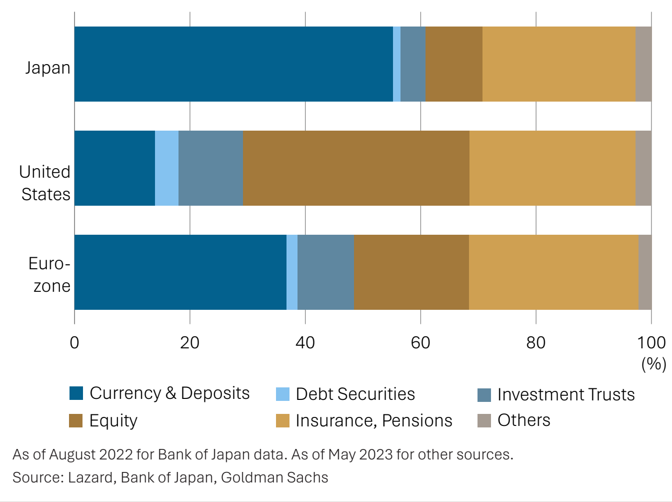
2. **BoJ policy:** The BoJ is likely to raise rates minimally by year-end, risking an even weaker yen to avoid snatching defeat from the jaws of victory in the fight against deflation and lowflation.
3. **Capital allocation:** Companies are likely to recognize the benefits of optimizing their capital allocation to drive share price gains. Households should begin to shift their asset allocation away from bank deposits and currency toward riskier assets.

It is too early to say with a high degree of confidence that Japan has definitively escaped deflation and lowflation, but the evidence is accumulating. The preliminary results of the ***shunto*** wage negotiations offered the most compelling substantiation to date, with total compensation increasing 5.58% at large companies reported by the business lobby Keidanren and 5.17% across all companies, according to Japan's largest union group Rengo. These wage increases are the largest since 1991. The seventh, and final, tabulation of wage gains will be released in July and should be consistent with preliminary results.

Wage gains are important as they should drive domestic price increases. Core inflation (defined in Japan as all prices including energy but excluding fresh food) has exceeded 2% y-o-y for the last two years, exceeding wage growth through much of that time. Given relatively severe labor shortages in Japan due to demographic challenges, it would be reasonable to expect ongoing upward pressure on wages, which should translate into sustained domestically driven inflation.

The Bank of Japan (BoJ) responded to higher inflation by ending its negative interest rate policy (NIRP) and terminating yield curve control (YCC). In response, the Japanese yield curve has steepened with the 10-year Japanese Government Bond (JGB) trading at a 1.0% yield for the first time in 12 years in May. Rate markets imply additional rate hikes by the BoJ through year-end, but I am skeptical that it can deliver much additional tightening without risking undermining the nascent exit from lowflation. The BoJ will be challenged to balance the need for higher rates to support the yen in foreign exchange markets versus the need to stimulate domestic demand and inflation.

Japan's story is not entirely about interest rates and inflation. The Tokyo Stock Exchange (TSE) has played a critical role in changing the narrative around corporate governance. While corporate governance often makes people's eyes glaze over (and for some induces a deep sleep), the topic is very important to the future of Japanese equities and the economy. In January 2023, the TSE announced new guidelines under its "Action to Implement Management that is Conscious of Cost of Capital and Stock Price." While the name is anything but snappy, it has placed significant pressure on companies to increase their price-to-book valuation multiples by better managing capital. To date, over 1,100 of 1,650 TSE prime-listed companies have committed to reducing cross-shareholdings, and the return of capital through dividends and buybacks has reached record highs. While returning capital will not necessarily lead to higher profits in an absolute sense, it should lower shareholder equity,



As of August 2022 for Bank of Japan data. As of May 2023 for other sources.
Source: Lazard, Bank of Japan, Goldman Sachs

"Inflows into Japan's Nippon Individual Savings Accounts (NISAs) have increased by approximately **300%** since January 2024 guideline changes."

which mechanistically raises the return on equity and results in a higher price-to-book ratio. Funds returned to shareholders can be reallocated to companies that need capital to expand which should accelerate earnings and GDP growth.

Improved governance and better capital management, combined with a weaker yen, have propelled Japanese equities to new record highs, finally topping the 1989 market peak. At the same time, the Japanese government overhauled the guidelines for Nippon Individual Savings Accounts (NISAs) in January 2024 to triple the amount that can be invested and significantly extend the tax deferral period for the accounts. Inflows into NISAs have since increased by approximately 300%. Historically, about 80% of inflows into NISAs were allocated to non-Japanese assets, but thus far in 2024, the overseas allocation has fallen to 50%, perhaps signaling the resurgence of a culture in which investors would rather take on risk than deposit funds into bank accounts with 0% interest rates.

In mid-2022, Japanese households had 55.2% of their financial assets allocated to bank deposits and currency but only 9.9% to equities. To the extent we see a sustained reallocation away from negative real yielding assets such as deposits and currency into riskier assets, there could be material additional upside in equities.

Geopolitics

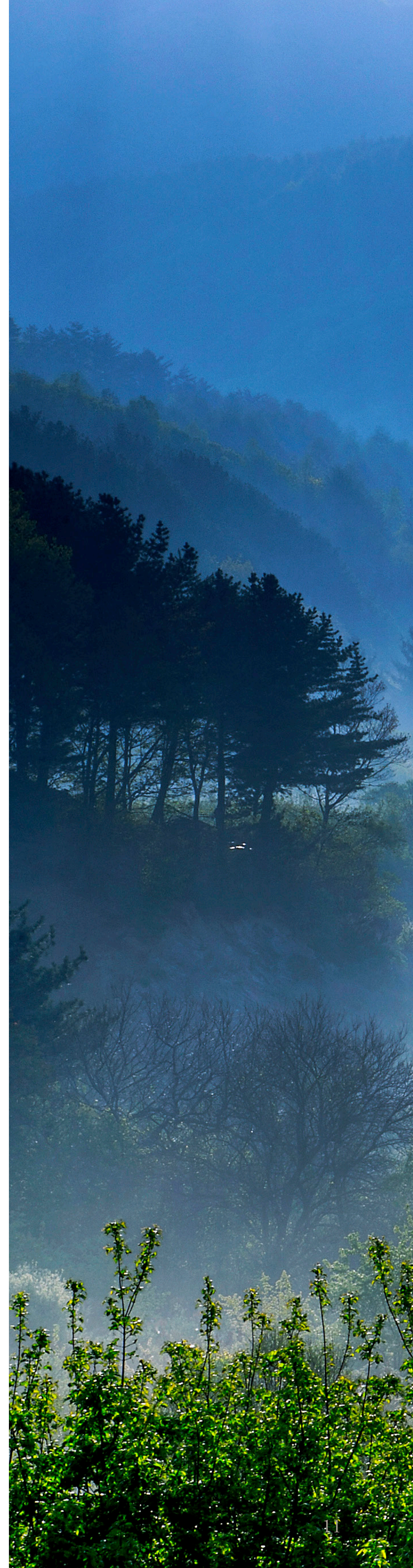
Key view: Geopolitical risk is unlikely to subside. The war in Ukraine looks nowhere near resolution and there is a growing US bipartisan consensus on increasing economic and geopolitical pressure on China. Meanwhile, a Trump presidency may inject even more volatility into the geopolitical landscape given uncertainty over his support for European and Asian allies and his plan to broadly raise US tariffs.

What to watch:

1. **US election:** A second Biden term would likely imply foreign policy continuity while a second Trump term could increase geopolitical uncertainty.
2. **Israel-Hamas negotiations:** Pressure on Israel and Hamas to agree to a ceasefire has increased significantly and will continue to rise as casualty figures grow. However, the risk of expansion of the current hostilities to include an expanded confrontation with Hezbollah has increased meaningfully.
3. **Ukrainian military position:** To the extent Ukraine is able to stabilize the front line and thwart Russia's advances as it receives additional US and European assistance, Russia could become more aggressive.

By the end of July, elections for over half the world's adult population will largely be completed. While many elections were relatively uneventful, some have surprised prognosticators including India where the Bharatiya Janata Party (BJP) led by Narendra Modi won only 240 seats versus pre-election expectations for as many as 400. Conversely, Mexico elected its first female president with a record number of votes and a super-majority in the Chamber of Deputies and a near super-majority in the Senate of the Republic. UK voters are expected to deliver a landslide to the Labour Party on 4 July while France will vote in a two-round snap election on 30 June and 7 July in a risky gambit by President Macron to try to force voters to reject the National Rally party led by Marine Le Pen. The most consequential remaining election will be in the United States with significant global implications both economically and geopolitically.

Looking beyond elections, two major geopolitical crises continue unabated. The Russian assault on Ukraine grinds on with incremental gains for Russia. Israel has degraded Hamas' capabilities but has failed thus far to "destroy" it, while global pressure to wind down the fighting is increasing as casualties mount on both sides.



From an economic perspective, the likelihood of a significant expansion and escalation of the Israeli-Hamas conflict engulfing Iran in formal hostilities remains elevated. Fortunately, Israel did not respond proportionately to the Iranian missile and drone attack in mid-April, which allowed both sides to de-escalate. However, tensions between Israel and Hezbollah have subsequently increased materially keeping the risk of escalation and expansion high.

Ukraine remains a risk factor as well. Western allies are increasingly allowing Ukraine to use contributed weapons against targets in Russia, a practice not allowed until the end of May. To the extent Ukraine stabilizes the front lines, Russia may escalate pressure on Ukraine to change the dynamics of the war. Other factors such as the degree of direct NATO engagement could also trigger a step change in the conflict.

Finally, the most consequential geopolitical risk is a confrontation between China and the United States. Ongoing skirmishes in the South China Sea between China and the Philippines appear to be the most likely source of potential near-term conflict: China's persistent antagonization of Philippines forces attempting to resupply troops on a grounded ship near the Second Thomas Shoal could accidentally lead to a clash in which the United States has a treaty obligation to defend the Philippines. Fortunately, Taiwan's election and inauguration passed uneventfully, and we see the probability of a near-term conflict over Taiwan as being low, but we should remain watchful and aware that the level of tension is high.

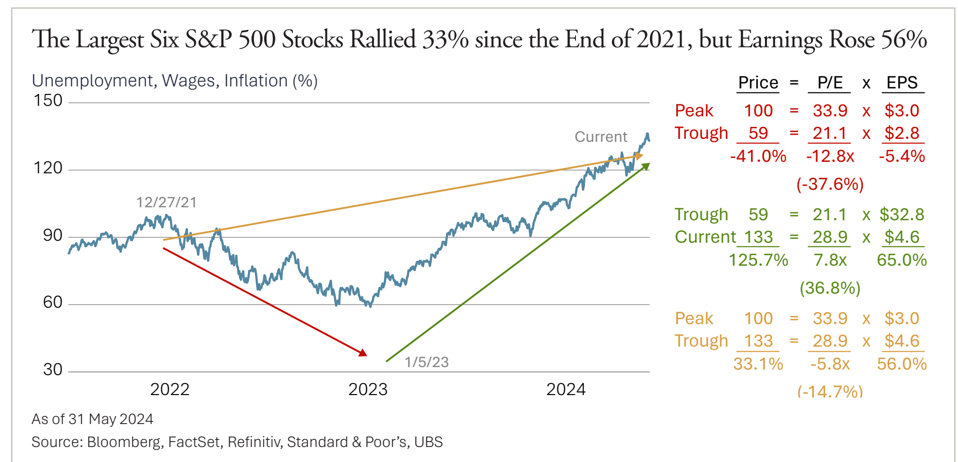
Market Implications

The market response to macro data has been inconsistent over the course of the year. Markets have proven quite good at being wrong when it comes to pricing in interest rates. Through most of the current cycle, markets underestimated how high rates would go and for how long they would stay there. At the end of 2021, futures markets implied the fed funds rate would end 2022 at 0.75%; it ended the year at over 4%. By October 2023, markets were forecasting rate cuts with 60 bps of easing by the end of 2024, taking the Fed Funds rate to ~4.70%; three months later, markets were pricing 168 bps of easing taking rates to ~3.65% by year-end. By the beginning of May 2024, markets were expecting less than 30 bps of easing and Fed Funds at ~5% at year-end. While the numbers differ, the direction and magnitude of such errors have been paralleled outside of the United States as well.

I believe market expectations are too hawkish in 2024. The ECB began cutting rates in June, and I expect 100 bps of easing by year-end. My base case is that the Fed will initiate the easing cycle at the September FOMC meeting, cutting rates 50–75 bps in 2024. Markets are pricing 30 bps of tightening from the BoJ through year-end, but I expect additional hikes are likely to be limited to 10–20 bps.

Equities to a large degree have ignored discount rate volatility for the last 18 months. The S&P 500 Index and the MSCI EAFE Index, which focuses on developed markets excluding the United States, both delivered a total return of approximately 55% from the mid-October 2022 low through mid-June 2024. Perhaps as importantly, the drivers of performance for US and non-US indexes were very different. Eight of the ten biggest contributors to the S&P 500 gains were technology and communication services stocks while the non-US markets were driven by a much broader base of industries ranging from healthcare to technology to financial and industrial companies.

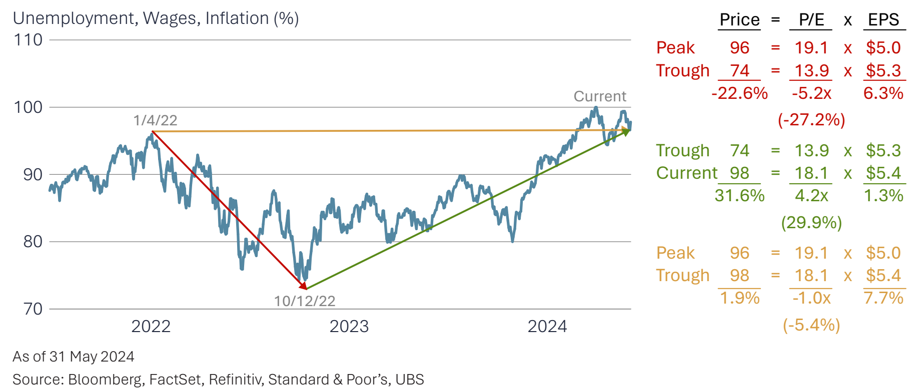
With the S&P 500 Index trading at over 21x forward earnings, further upside is likely to be driven by earnings growth rather than increased price-to-earnings metrics. The S&P 500 Index can continue to be led by tech stocks, but not to the



The Largest Six S&P 500 Stocks Rallied 33% since the End of 2021, but Earnings Rose 56%

As of 31 May 2024
Source: Bloomberg, FactSet, Refinitiv, Standard & Poor's, UBS

> “The **S&P 500** Index has generated a total return of **55%** from the lows of 13 October 2022 to 13 June 2024, with **60%** of that return being generated by **10 stocks**.”



The Remaining 494 Stocks in the S&P 500 Rose ~2% since 2021 with Earnings Growth of ~8%

As of 31 May 2024

Source: Bloomberg, FactSet, Refinitiv, Standard & Poor's, UBS

degree it has been in recent years. From the lows of 13 October 2022 to 13 June 2024, the S&P 500 Index has generated a total return of 55% with 60% of that return being generated by 10 stocks. By comparison, the MSCI EAFE Index has returned 53% with only 30% of the return being generated by the top 10 stocks and 35% from the top 20. The narrowness of the US market advance has been at or near record levels, while non-US markets have delivered a healthier broad-based advance.

From my perspective, the only way the mega-cap tech companies can continue to deliver market-beating earnings growth is if their customers realize a return on investment from buying their goods and services. To date, we have seen strong growth in earnings from the top six stocks but no meaningful earnings growth from the rest of the S&P 500 stocks in aggregate since the end of 2021 when the market hit its previous peak.

Non-US markets are trading on much less demanding valuation multiples and are likely to benefit from accelerating growth while US growth decelerates. Moreover, non-US companies typically are more exposed to floating-rate debt, which should benefit them disproportionately as the ECB and other non-US central banks ease before the Fed. Finally, non-US companies also could enjoy a more significant recovery in revenue and earnings from current levels as their economies were less resilient after the pandemic than the US economy, which benefited from much larger fiscal and monetary stimulus.

While equity markets have delivered strong returns from the late 2022 lows, it is important to note that markets have not advanced materially from late-2021 highs. In fact, one common theme I have heard repeated globally this year is that asset owners are over-allocated to cash. Through 2023, many global investors expected recession in response to the sharpest monetary policy tightening in four decades. Not only did recession not occur, but equity markets moved higher through the year. The opportunity cost of missing the equity rally was regrettable, but the pain was mitigated by the highest returns on cash in many years. Now, with the outlook shifting to lower short-term interest rates and reduced earnings on cash, many investors are eager to allocate capital to riskier assets, but they are reluctant to do so at or near record-high market levels.

My view is that the best approach is to allocate capital away from cash to riskier assets while identifying those “risky” assets that are less correlated to the most expensive parts of the global equity market (e.g., tech and AI leaders) and instead invest in areas of the market that have more unrecognized upside going forward. These include emerging markets, Japan, small cap, and infrastructure-related equities. Another option for gaining equity exposure with less downside risk is to consider convertible bonds, which offer a bond floor (assuming you have done the proper credit analysis) while also offering equity upside participation through the embedded call option.

Overall, the lesson of history is that owning equities over time is among the best investment options, but it is important to be fully invested through the cycle and to not try to time the markets. In fact, one recent analysis indicated that over the 20 years from 2003 to 2022, investors who missed the 10 strongest up-days in the US equity market forfeited over half of the total return from the entire investment period.[1] This anecdote applies similarly, though to different degrees, to global equity markets, where trying to time entry and exit points is a very risky proposition. While no one likes to buy at the peak, it's also important to recognize that five years from now, such a purchase, if targeted based on the quality of the investment and the valuation thereof, will often be seen as a wise decision.

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Ronald Temple is the Chief Market Strategist for Lazard's Financial Advisory and Asset Management businesses. In this role, Ron provides macroeconomic and market perspectives to Lazard's investment teams on a firmwide basis and works closely with Lazard's Geopolitical Advisory group to assess economic and market implications of key geopolitical issues globally. Ron also advises clients of Lazard's Asset Management businesses regarding macroeconomic and market considerations that are important to achieving their objectives.

Notes

1 Timing the Market: Why It's So Hard, in One Chart (Visual Capitalist, 2024)

Important Information

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