STATE STREET GLOBAL ADVISORS

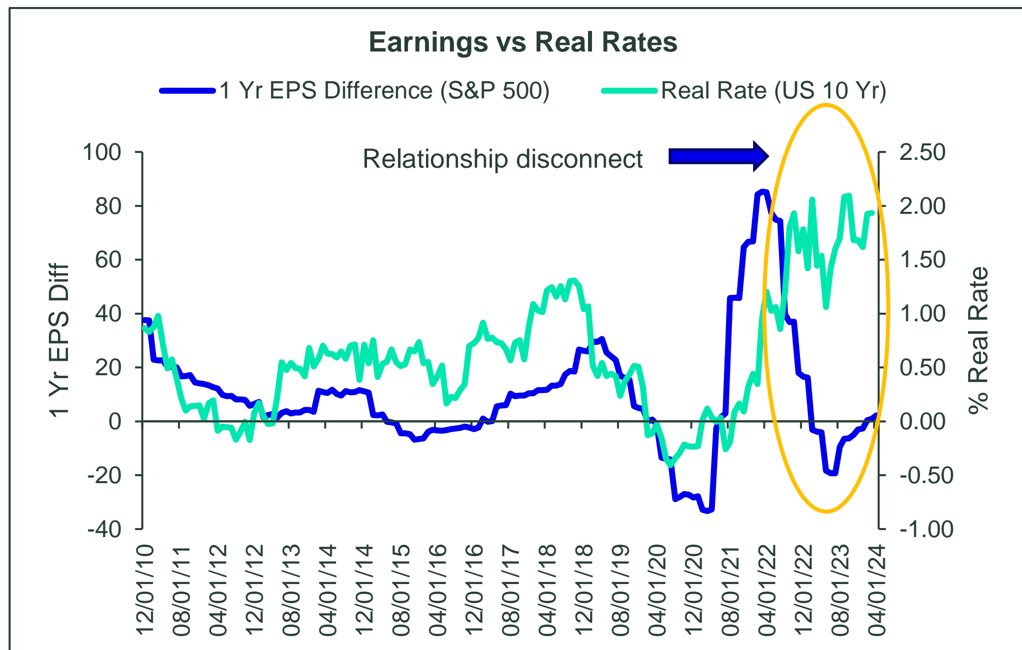
May 2, 2024
Commentary

Weekly Market Update

Insight of the Week

Real Rates and Earnings

Real rates are the portion of nominal rates that remain after removing inflation expectations. At times, higher real rates can have different meanings. From a negative angle, higher real rates add pressure on the economy as borrowing costs are restrictive. Conversely, a Federal Reserve that's willing to raise policy rates can signal that economic growth is healthy and can absorb a higher cost of capital.



Source: S&P, FactSet, Federal Reserve Bank of St. Louis. As of 4/30/2024 in USD.

In the above chart, we show the relationship of US 10Yr real rates versus the 1 year change in EPS for the S&P 500. Prior to the past few years, there was a decent positive relationship between the two. The interpretations is that as corporate profits were increasing and healthy, they could handle higher real rates, symbolic of a growing environment. Enter hot inflation in 2022 and this relationship has now broken down as the Fed uses high real rates as a weapon to purposely slow down the economy, pulling inflation down.

Currently, real rates remain close to highs and are a step function higher than anything seen over the past 10+ years. We believe inflation will continue to normalize, so our concern turns to the economic growth. Real rates, at this level, is restrictive and will be a headwind on earnings. Policy rate decisions act on a lag so waiting to cut until the first sign of trouble could be a mistake. Currently, the market

is pricing in a first rate cut in November. However, we continue to prefer a first rate cut sometime this summer.

Source: State Street Global Advisors, FactSet, S&P, Federal Reserve Bank of St. Louis.

Equities

More than Halfway Through Q1 Earnings

During the fourth week of April, the S&P 500 clinched its best week (2.68%) since last November, as companies reported stronger-than-expected earnings. However, the S&P 500 index had fallen by 5.4% during the first three weeks of April, as the release of hotter than expected March inflation data dimmed the hopes of a rate cut in June. This lead to the volatility spike in US equities with VIX reaching 19.23 (highest level this year) during April. As the earnings season kicked off, the S&P 500 has recovered some losses during the later part of the month and ended April with a loss of 4.08%.

As of May 1,2024, 67% of the S&P 500 companies have reported actual results. Among these, 78% have reported actual EPS above estimates and 61% have reported a positive revenue surprise. Both the percentage of S&P 500 companies reporting positive earnings surprises and the magnitude of earnings surprises (8.35%) are above their 10-year averages. So far, for Q1 2024, the blended (y/y) earnings growth rate for the S&P 500 is 4.42%.

	Q1 2024			Q2 2024	CY 2024	Net Profit Margin	
Name	Growth Blended (%)	Surprise (%)	% Pos Surprise	Growth 1 May '24E	Growth 1 May '24E	Q1 2024	Q1 2023
S&P 500	4.42	8.35	77.88	9.58	10.73	11.59	11.56
Communication Services	35.53	14.07	91.67	19.78	21.73	13.60	10.85
Consumer Discretionary	22.96	13.05	71.43	7.02	12.64	7.87	6.75
Consumer Staples	2.79	7.66	86.96	0.05	3.79	6.11	6.07
Energy	-25.71	0.67	56.25	14.48	-3.96	9.59	12.50
Financials	5.71	5.62	68.85	5.86	12.41	17.60	17.60
Health Care	-26.24	11.40	91.43	17.90	8.30	6.44	9.28
Industrials	5.92	10.18	84.21	-1.43	6.88	9.37	9.13
Information Technology	22.12	7.13	88.10	14.65	17.22	25.46	22.36
Materials	-21.84	7.66	72.73	-7.70	-1.48	9.19	11.16
Real Estate	7.80	4.35	61.90	2.95	3.17	35.76	35.49
Utilities	22.98	4.55	73.33	13.40	8.98	13.09	10.29

Source: FactSet. Data as of May 1, 2024. Blended combines actual results for companies that have reported and estimated results for companies that have yet to report.

The above table shows that out of 11 sectors 8 reported positive y/y earnings growth, led by the Communication Services, Utilities, Consumer Discretionary and IT sectors. Whereas, sectors like Health Care, Energy, and Materials have reported a y/y decline in earnings.

The blended net profit margin for the S&P 500 for Q1 2024 (11.6%) is similar to Q1 2023 but slightly higher than Q4 2023 (11.2%). Looking at the sectors, compared to Q1 2023, 8 sectors have reported a y/y increase in net profit margin. IT (25.5% vs.

22.4%) reported the highest increase in magnitude of net margin followed by Utilities (13% vs. 10.3%) and Communication Services (13.6% vs. 10.9%).

Analysts continue to increase their earnings expectations for the S&P 500, as there are no signs of a slowdown. Looking ahead, analysts expect (y/y) earnings growth rates of 9.58% for Q2 2024 and 10.73% for CY 2024. However, a strong economy could be an upside risk to inflation over the coming months. This could further push out rate cuts and increase uncertainty over the short term.

Source: State Street Global Advisors, S&P, FactSet.

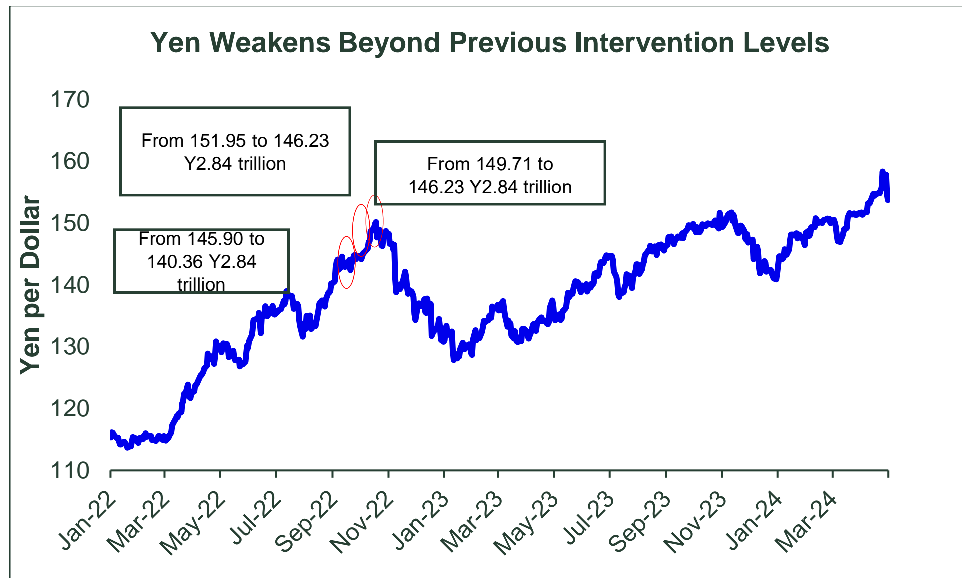
Fixed Income

Potential Implications for US Bond Yields From Recent Japanese Bond and Currency Volatility

The Japanese yen has been both weak and highly volatile in recent weeks, with the currency trading at a thirty year low of 160.245 last week. The volatility spiked as it breached the 160 level to then quickly rally by 3% to 155.5, indicative of potential BoJ intervention. While Japanese officials declined to comment, it would appear that the break above the 160 mark, signals a level at which the Ministry of Finance is willing to step in, and Japanese banks were also observed to have been selling USD for JPY subsequently. Further intervention was suspected as the currency strengthened again in this holiday shortened and liquidity challenged week in Japan.

For local investors, with Japanese rates still very low and Japanese government bond yields also low but rising materially, domestic investors continue to seek higher potential returns overseas, by investing in U.S. Treasuries and other developed market government bonds. This as well as the BoJ's decision not to adjust asset purchase volumes continues to keep Japanese bond yields under upward pressure. Yen outflows and the central bank's policy of maintaining asset purchases also continue to keep the currency under pressure.

Despite the unconfirmed intervention, we do not believe that MoF will need to sell its vast reserves of US Treasuries, that could assert upward pressure on US bond yields. Of Japan's $1.3tr foreign reserves, $327bn are estimated to be parked in deposits ($155bn official number) and $172bn in short-dated bills below 12mth maturity, giving MoF enough liquidity to potentially intervene* to support the Yen, before having to dip into their longer-dated US treasury holdings.

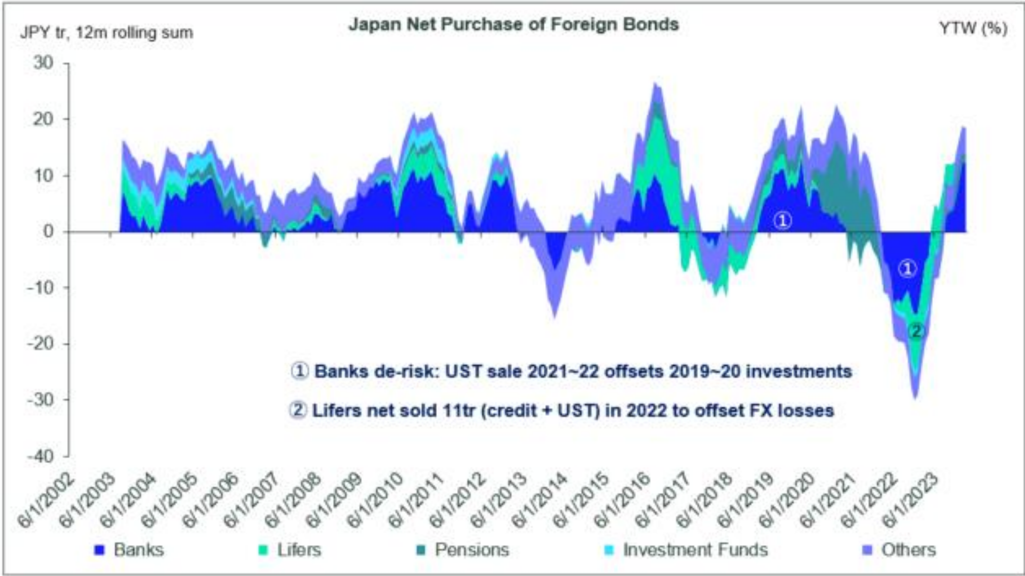


Source: Bloomberg, Ministry of Finance. Data as of 5/2/2024.

A majority of domestic investors expect another small hike (~0.25%) from the BoJ around Oct 2024, in line with options market pricing, given the relatively dovish stance of governor Ueda following the April 25th BOJ policy meeting. We think with current elevated USDJPY levels, in addition to an increase in inflation pass through (due to a weak JPY and higher wage growth) could translate into an earlier hike by the BoJ potentially by July 2024; followed by more hike(s) into early 2025.

Rate hikes may not be the ultimate driver of JPY strength, as we believe this is more of a Fed story than a BoJ story. With markets pricing out large Fed rate cuts by 2024 year-end, USDJPY has drifted higher. Absent a powerful growth acceleration in the US, the direction of travel of Fed rates policy remains lower in our view. In this scenario, we believe the Yen has the potential to appreciate by up to 10~15% vs USD over the course of next 2 years driven by US-Japan rates compression, with US economy’s resilience posing a downside risk to our expectation.

Moreover, given the expected increase in JGB yields, we do not expect Japanese investors to sell down more USD assets. The majority of short-term carry investors (“tourist flows”) have been sold down (see below ① & ②), while the remaining Japanese capital, invested in foreign bonds are structural long-term investments from Official sectors such as national pensions and official foreign reserves, thus we do not anticipate any significant sale of US Treasury bonds or other foreign bonds back into JGBs.



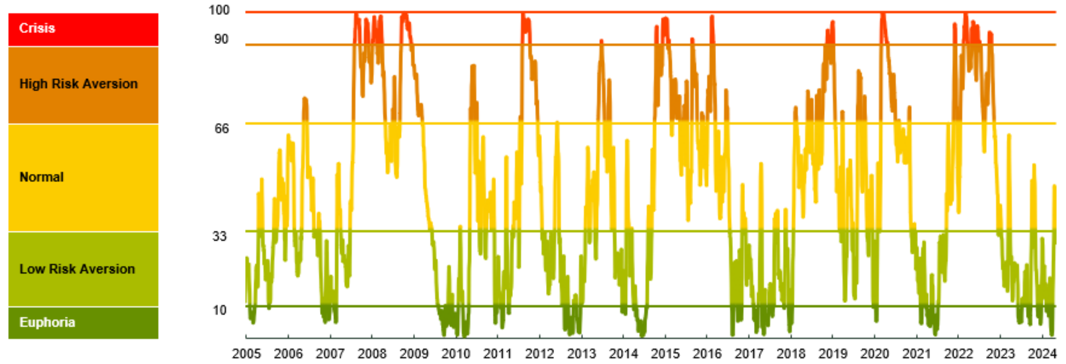
Source: Bloomberg, Ministry of Finance. Data as of 3/29/2024.

Source: State Street Global Advisors, Bloomberg.

Market Regime Indicator

The Market Regime Indicator (MRI) represents a proprietary multi-asset class model designed to characterize risk appetites within the capital markets.

Days in the Low Risk Regime (since April 26): 4 days



As of May 1, 2024. The data displayed is not indicative of the past or future performance of any SSGA product. The portion of results through March 31, 2011 represents a back-test of the MRI model, which means that those results were achieved by means of the retroactive application of the model which was developed with the benefit of hindsight. Data displayed beyond this date is not backtested, but is still generated by the model referenced. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The Market Regime Indicator (MRI) is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used, equity implied volatility, currency pairs implied volatility and bond spreads, are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views of those markets. These factors are combined to create a single measure and used to identify one of five risk regimes: Euphoria, Low Risk, Normal, High Risk, and Crisis. A slight calculation change was made as of June 28, 2019.

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*Pensions & Investments Research Center, as of 12/31/22.
†This figure is presented as of March 31, 2024 and includes ETF AUM of $1,360.89 billion USD of which approximately $65.87 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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Marketing Communication

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The views expressed in this material are the views of Christopher Carpentier, Zanub Raza, Masahiko Loo, and Saketh Reddy Moyilla Sai Shiva through the period ended May 2, 2024 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

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Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Generally, among asset classes, stocks are more volatile than bonds or short-term instruments. Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns. U.S. Treasury Bills maintain a stable value if held to maturity, but returns are generally only slightly above the inflation rate.

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