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# Resilience Under Pressure

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## What Happens After the Soft Landing?

A funny thing happened while investors foolishly obsessed about both the timing and number of Federal Reserve (Fed) rate cuts this year — the long anticipated US economic soft landing transpired over the past 12 months or so. Distracted investors likely missed it. But for only the fourth time since World War II and the first time in 30 years, the US economy, guided by the Fed, stuck the rare soft landing. The economy slowed, but never entered recession. US GDP (gross domestic product) expanded at an annual rate of 4.9% in the third quarter of 2023, moderating to 1.6% for the first quarter of 2024.<sup>1</sup>

Despite slower economic growth, the labor market remains remarkably resilient. The US has added about 2.8 million jobs over the past 12 months, averaging monthly job gains of 234,000.<sup>2</sup> Initial jobless claims data continue to suggest that businesses are reluctant to let go of qualified skilled workers. And, at 3.9%, the unemployment rate hovers near an all-time low.<sup>3</sup> Gainfully employed consumers will go on spending, repelling recession for at least a little while longer.

Meanwhile, considerable progress has been made over the past couple of years to tame inflation. According to the Bureau of Labor Statistics, the Consumer Price Index (CPI) peaked at an annual rate of 9.1% in June 2022, cooled to 3% a year later, and sat at a still-too-hot 3.4% in April 2024.<sup>4</sup> The Fed is likely pleased, but not satisfied, with inflation's deceleration.

Yet, the first quarter earnings season reveals that businesses are in exceptionally good shape. Seventy-eight percent of S&P 500<sup>®</sup> companies reported a positive earnings surprise for the first quarter. Year-over-year earnings grew by 5.7%. S&P 500 companies' net profit margin of 11.7% is above the previous quarter, year ago, and 5-year average. Analysts are predicting that S&P 500 companies will grow their earnings by 11.1% this year and an even better 14.1% next year.<sup>5</sup>

At the same time, several major economies including the United Kingdom, Europe, Japan, and China are now emerging from past bouts of economic malaise.

Investors have enthusiastically celebrated the soft landing by pushing global stock markets to all-time highs. Credit spreads are extraordinarily tight, and most measures of capital market volatility are restrained.

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## Must All Good Things Come to an End?

Although the environment for risk assets remains largely attractive, early gains from achieving the soft landing are likely in the rearview mirror for investors. It's going to get tougher from here. The soft landing, resilient labor market, falling inflation, spendthrift consumers, strong businesses, and potential Fed rate cuts are already reflected in stretched valuations and record-high asset prices. Risks are decidedly skewed to the downside for the remainder of the year.

The increasing likelihood of a Fed monetary policy mistake, stubborn inflation, disappointing earnings results, toppling over the US fiscal cliff, rising geopolitical tensions, and contentious elections all pose serious risks to the rally.

But, after such strong first half performance, it's likely that capital markets will deliver solid results for investors this year, especially if the typical post-US election rally unfolds. Investors should consider these three strategies when constructing investment portfolios for the second half of 2024:

- 1 Diversify Beyond Mega-cap Stocks
- 2 Optimize Income with Short-term Core and Credit
- 3 Position for Macro Volatility With Real Assets

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### Theme 1: Diversify Beyond Mega-cap Stocks

Resilient earnings and solid economic data continue to support the global equities rally that began last November. But the manufacturing recovery and continued strength in consumer spending have put upward pressure on inflation, reducing the number of expected rate cuts by the Fed. At the May Federal Open Market Committee (FOMC) press conference, Chairman Powell all but eliminated the probability of additional rate hikes but didn't signal when the Fed would begin cutting.

So, despite solid economic growth and encouraging corporate fundamentals, sticky inflation and the Fed's data-dependent approach mean continued uncertainty on the rate path will impact rate sensitive equities. And, the longer the Fed delays rate cuts, the more relevant downside risks become.

In a higher-for-longer interest rate environment, for example, we remain cautious about the downside risks to US large-cap earnings growth beyond big tech — even though S&P 500 companies have exceeded earnings expectations by a large margin in Q1 and positive revisions are at a year-to-date high.<sup>6</sup>

On the other hand, if cooling inflation allows the Fed to cut rates aggressively in the second half of 2024 without a looming recession, small caps' low single-digit growth projection looks achievable given significant downgrades in their 2024 earnings over the past six months. And small caps' near decade-low valuations relative to large caps certainly provide a better risk/reward trade-off.

Despite this monetary policy uncertainty, the US is still expected to lead growth in developed countries. But the eurozone economy has shown positive development, with faster-than-expected Q1 GDP growth and continued disinflation. Additionally, the European Central Bank (ECB) has clearly signaled rate cuts will begin in June with more coming by year end. Along with positive earnings sentiment and attractive valuations, this supports our constructive view of eurozone equities.

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To prepare for the wide range of economic outcomes from the Fed's inflation battle and divergence between the US and eurozone monetary policy, consider diversifying portfolios with:

- Equal-weighted exposure to Tech leaders for resilient growth without concentration
- US small caps at attractive valuations to position for rate cuts
- Eurozone equities that may benefit from rate cuts and potential economic revival

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## Tech Leaders: High Quality to Sustain Resilient Growth

Today's extreme market concentration — driven by a few mega-cap, AI-related stocks — rivals levels seen during the Dotcom era. And it's caused investors to question whether the AI hype over the past 18 months has created a valuation bubble.

Magnificent Seven (Mag 7) stocks' price-to-earnings multiple (P/E), based on the next 12 months' earnings, has expanded 44% since the end of 2022 compared to 14% for the rest of the S&P 500. Yet, Mag 7 valuations are 35% below their pandemic peak and 9% below where they were before the Fed signaled the start of the rate hike cycle.<sup>7</sup> More importantly, the Mag 7's rally has been driven more by stronger growth than by multiple expansions. Changes to their forward P/E accounted for 29% of their total return since 2022 compared to nearly 60% for the rest of the S&P 500.<sup>8</sup>

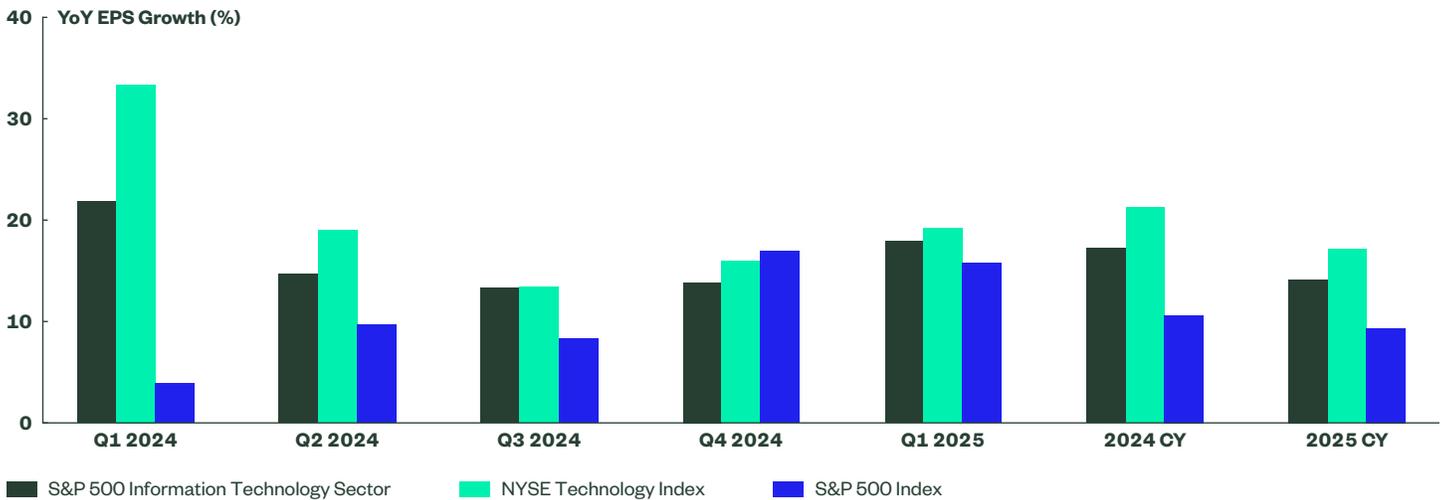
There's no question that growth momentum in AI applications and infrastructure remains strong, despite the current economic uncertainty. Q1 earnings results from Microsoft, Amazon, Alphabet, and Meta show both higher AI spending through 2024 and gains in AI-aided revenue.<sup>9</sup> As organizations transition from early experimentation to aggressive data infrastructure-building to broadening adoption, worldwide spending on traditional and generative AI is projected to grow by 31% and 86%, respectively, on an annualized basis — surpassing a total of \$300 billion in 2027.<sup>10</sup>

The resulting industry and geographic concentration of the Mag 7 will further reduce the diversification in investors' equity portfolios. That's why we favor an equal-weighted exposure to Tech leaders across multiple sectors and countries (the NYSE Technology Index) to capture companies most likely to benefit from the broadening of AI applications and monetization. This includes software development, online consumer platforms, social media, and AI infrastructure (e.g., advanced chip makers and cloud computing) companies.

Due to their high quality characteristics and strong earnings growth, these Tech leaders offer quality growth exposure. In fact, their aggregated earnings grew by 22% in 2023, compared to 1% for the S&P 500.<sup>11</sup> Based on consensus earnings estimates, this less concentrated Tech leader exposure is expected to outpace the broad market again this year with above 20% growth.<sup>12</sup>

While this growth advantage will likely narrow in the next few quarters as the broad market plays catch up, the near-term earnings growth visibility of these Tech leaders is better, given the increases in AI-related monetization and capital expenditure spending revealed in Q1 earnings releases. As a result, their earnings growth estimates for the next three quarters were raised by large margins since the start of the year, compared to negative revisions for the rest of the market (Figure 1).<sup>13</sup>

Figure 1 **Tech Leaders' Earnings Growth Estimates Set to Outpace the Broad Market and Tech Sector**



Source: FactSet, as of May 8, 2024. **Past performance is not a reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Tech leaders' strong profitability and healthy balance sheets are also attractive, particularly in a higher-for-longer interest rate environment. After having focused on growth efficiency and cost cutting over the past two years, Tech leaders' profitability has improved significantly. Their return on equity is at record highs on an absolute and relative basis.<sup>14</sup>

Strong balance sheets, where long-term debt to capital ratio is near its lowest since 2018, should help Tech leaders continue to invest for future growth, even with high financing costs.

### US Small Caps: Fed Cuts Support Growth and Valuations

Though recent inflation trends posed some risks to the soft landing, progress on goods inflation and cooling wage inflation warrant less restrictive monetary policy in the coming months if the Fed is to achieve its dual mandate of maximum employment and stable prices. Solid economic growth, coupled with potential rate cuts not driven by a looming recession, provide a positive backdrop for US small caps, especially given their attractive valuations.

Thanks to a solid labor market and continued strength in consumer spending, the US economy remains resilient, despite expanding at a much slower pace than it did the second half of 2023 due to the drag from trade and inventories. Positive real income growth, alongside a \$37 trillion increase in household wealth since the pandemic, should support consumption in the coming months.<sup>15</sup>

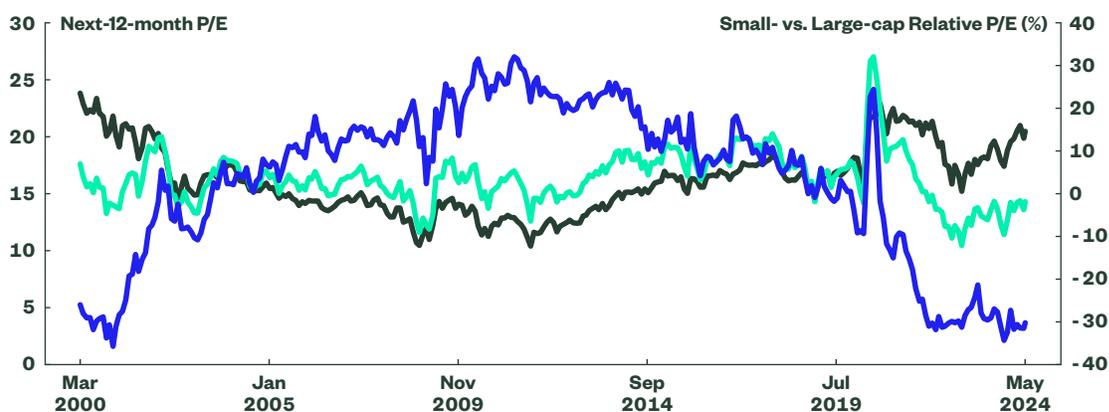
Weaker-than-expected April payrolls and a 0.1% increase in the unemployment rate drove negative headlines. But given how payrolls surprised to the upside in Q1, we view the recent slowdown in payroll gains plus moderating wage inflation as a positive step toward a better supply-demand balance in the labor market, not a threat to consumer demand.

Since the beginning of the year, the consensus US GDP forecast for 2024 has been upgraded to 2.4% from 1.3%.<sup>16</sup> The Atlanta Fed GDPNow estimate for Q2 real GDP growth has been above 3% since late April, signaling solid growth in the first half of 2024. But even against this solid economic backdrop, earnings sentiment in small caps has been gloomy this year as Treasury yields rose to above 4%. Small caps' earnings per share (EPS) estimates have been slashed by more than 5% since the start of the year, with growth expectations falling to low single digits, compared to their 12% estimate from six months ago and the 11% estimate for their large-cap peers.<sup>17</sup>

Rising Treasury yields definitely burden small caps more than they do large caps, mainly because small caps issue more short-term debt and are more sensitive to the current high interest rates. Indeed, small-cap current valuations are pricing in a significant level of financial stress for companies, with small caps' forward P/E 13% below the long-term average and at a 30% discount to US large caps (Figure 2).

Figure 2  
**Small Caps' Forward P/E at a Record Discount to US Large Caps**

■ S&P 500 Index  
 ■ S&P SmallCap 600 Index  
 ■ Relative Valuations



Source: FactSet, as of May 13, 2024. **Past performance is not a reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

But we believe peak interest rates are behind us.

And rate cuts in the second half of this year amid a solid economic environment would ease pressure on small-cap valuations. Given their bearish earnings sentiment so far this year, a resilient US economy may support small caps to deliver upside surprises in the second half, potentially outperforming large caps as US earnings growth broadens out.

Eurozone Equities:  
 Strengthened by  
 a Dovish ECB and  
 Economic Momentum

Green shoots of an economic rebound in the eurozone have appeared in macroeconomic surveys and earnings fundamentals after the region's annual growth decelerated sharply last year to 0.4%.

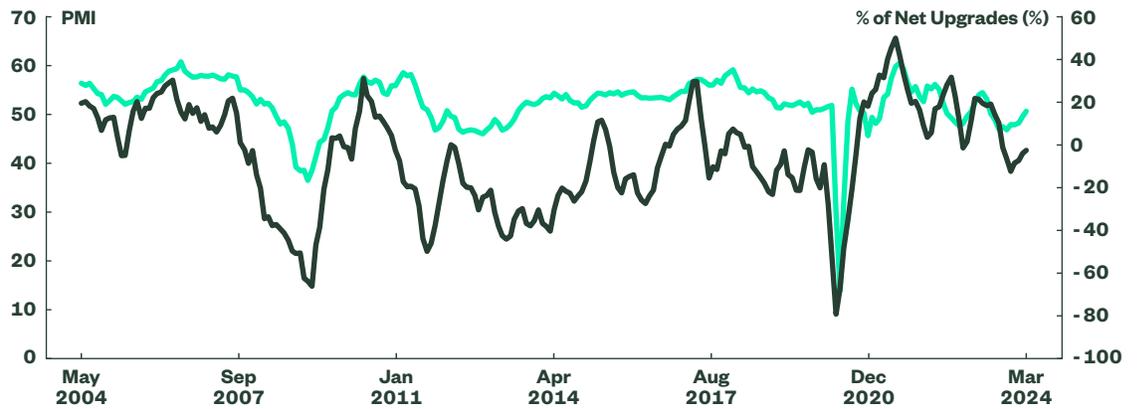
In April, the Eurozone Composite PMI (Purchasing Managers Index) indicated overall business activity had expanded at the fastest pace over the past 11 months, driven by above-trend growth in the service sector.<sup>18</sup> Although manufacturing PMI took a breather from its recent rebound, a shallower decline in output and a two-year high in business confidence support positive development.

Record low unemployment, strong nominal wage growth, and steep disinflation provide a powerful boost to consumer income, potentially supporting domestic consumption and continued expansion in the service sector. A stabilizing Chinese economy may help pull Germany, the largest economy in the eurozone, out of the manufacturing downturn.

Historically, increasing Composite PMI bodes well for positive earnings sentiment (Figure 3). At the beginning of May, earnings upgrades outpaced downgrades for the first time in 10 months as the region's economic recovery progressed.<sup>19</sup> Despite lower growth estimates compared to the beginning of the year, Q1 earnings beats came in stronger than Q4 and above the historical average thanks to resilient profit margins. This suggests room for greater upside surprises in the coming quarters if positive economic momentum continues.<sup>20</sup>

Figure 3  
**Increasing Eurozone Composite PMI Bodes Well for Earnings Upgrades**

■ Eurozone Composite PMI  
 ■ Net Upgrades as % of Total Estimates (3-month Avg.)



Source: FactSet, Bloomberg Finance, L.P., as of May 7, 2024. **Past performance is not reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Meanwhile, steep disinflation and weak economic growth have opened the door for the ECB to dial back policy restrictions. While eurozone inflation peaked at a higher level and later than in the US, it's made greater progress toward the ECB's target. Core inflation has fallen from its peak of 7.5% in March 2023 to 2.8% in April. The replacement of Russian gas suppliers with American ones, warm weather, and prudent energy consumption all resulted in eurozone headline inflation declining even more steeply to 2.4% in April.

As a result, the central bank has strongly signaled rate cuts would begin in June. Our economists project a total of 100 basis points (bps) of cuts this year as their baseline view. With a dovish ECB and steady global demand, a meaningful economic rebound is achievable for the second half of the year, supporting an earnings recovery.

Eurozone equity valuations have become more expensive compared to last year due to the equity market having reached all-time-highs, even outperforming the S&P 500 year to date. But the market's forward P/E ratio (13.8x) is still below its 10-year average (14.8x).<sup>21</sup>

Relative to US equities, eurozone equities are trading at a 15% greater discount than the historical average — around the bottom decile of the past 10 years.<sup>22</sup> Given the prospect of monetary easing and continued positive economic momentum, these valuations may have room for further expansion.

### Implementation Ideas

To position for uncertain monetary policy, diversify by balancing quality growth with cyclical value and consider:

Leading Tech companies for resilience and high quality growth	<b>XNTK</b>	SPDR® NYSE Technology ETF
US small caps for growth and attractive valuations during rate cuts	<b>SPSM</b>	SPDR® Portfolio S&P 600™ Small Cap ETF
European stocks supported by a dovish ECB and economic momentum	<b>FEZ</b>	SPDR® EURO STOXX 50® ETF

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## Theme 2: Optimize Income With Short-term Core and Credit

Uncertainty over Fed policy has led to record-breaking rate volatility for core aggregate bonds. And, the resulting losses have added to core bonds' double-digit two-year drawdown.<sup>23</sup> Given the Fed's reliance on data, and with key economic data coming in with more variability relative to expectations, it's likely that increased market volatility will continue.

But credit isn't witnessing the same volatility. Foundations for its year-to-date gains are underpinned by sturdy economic growth, improving earnings fundamentals, and positive ratings momentum. Spreads, however, are noticeably tight. And while that can be cause for concern, historically, at these current levels, returns have still been positive over the following 12 months.<sup>24</sup>

Given that the outlook for credit is favorable while broad core bond exposures are challenged by policy-related rate volatility, investors should consider:

- **Actively managed floating rate loan strategies** that seek to limit rate volatility without sacrificing income potential by focusing on high-yielding below investment-grade markets
- **Short-term active core strategies** to pursue more yield with less volatility than core bonds, by balancing exposure to rate- and credit-sensitive sectors
- **Balanced high-quality intermediate investment grade bonds** to take on more fairly-compensated credit and rate risks, given their yield, duration, and spread profiles relative to core bonds

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## Fed's Policy Patience Delays Rate Cuts

After significant declines in 2023, CPI has since made limited progress toward the Fed's 2% target. As a result, the Fed anticipates keeping rates elevated for longer than previously expected, until more progress is made to temper stubborn inflation.<sup>25</sup> This should keep short-term rates, like the US 2-year yield, close to the fed funds rate, limiting the slope of the curve. In fact, consensus economic forecasts have the differential between the US 2- and 10-year remaining inverted until Q1 2025, with the 3-month and 10-year differential not having an upward slope until at least Q3 2025.<sup>26</sup>

Futures implied forecasts show the market slowly warming to the idea of higher for a little bit longer. At the start of the year, implied futures pricing projected the lower bound of fed funds rate to be 4.35% by July whereas current projections expect it to be 5.25% (indicating no cuts by July).<sup>27</sup> The same trend exists for the year-end rate level. To start the year, futures markets had the fed funds rate at 3.75% while current projections have the average rate at 4.8%.<sup>28</sup>

Big picture? The curve will likely remain inverted for a bit longer, as long as short-term rates remain high. But *some* rate cuts may occur in the second half of this year — just not as many as previously expected. There's also a slight risk of no rate cuts this year, as some Fed officials have warned against not finishing the job on cooling inflation.<sup>29</sup>

Analysis from Strategas Research Partners reinforces this risk. They found that multiple waves of inflation are common — with a second wave of US inflation starting on average 30 months after the first peak. The US is now almost 24 months past the June 2022 peak in CPI.<sup>30</sup>

The data-dependent Fed is challenged by the increased variability of key economic data releases. This variability likely stems from changes in consumption, employment, and social behaviors during the pandemic that have made accurate economic data forecasts more difficult.

For example, CPI prints this year have deviated from consensus expectations by an average of 10 bps. It's the fourth consecutive year where prints have deviated by more than the pre-pandemic 10-year average of 7 bps.<sup>31</sup> The same trend exists with labor reports; data this year is coming in over/under estimates by a wider range than normal (~50% deviation from expected versus pre-pandemic average of 31%).<sup>32</sup>

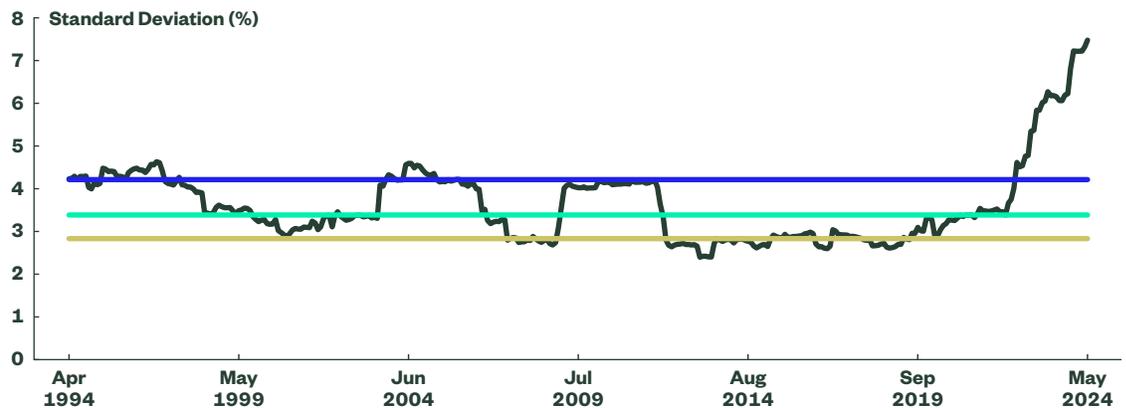
The calendar also will challenge the Fed's ability to remain patient. The window to implement policy decisions prior to a systemic macro event like the US election closes a little more each day. And as data continues to exhibit higher variability than normal, rate volatility will have more reason to remain elevated — challenging rate-sensitive bond allocations.

These challenges are underscored by the fact that long-term US Treasury bonds' rolling 90-day standard deviations of returns (13%) are greater than US equities' (12%).<sup>33</sup> Typically, perceived safe-haven long-term US Treasuries have a realized volatility that is four percentage points less than stocks.<sup>34</sup> Not so in this new rate risk regime.

Core bonds are experiencing a similar trend. While not greater than stocks, their own standard deviation of returns over the past 90 days plots in the historical 89th percentile over the past 30 years.<sup>35</sup> In fact, this latest bout of realized rate risks has exacerbated the longer trend, as the Bloomberg U.S. Aggregate Bond Index's (Agg) trailing 3-year standard deviation of returns is at all-time highs (Figure 4).

Figure 4  
**Realized Rate Risks  
Are at Record Highs,  
and Rising**

- Rolling 36-month Standard Deviation of US Agg Returns
- Median
- 80th Percentile
- 20th Percentile

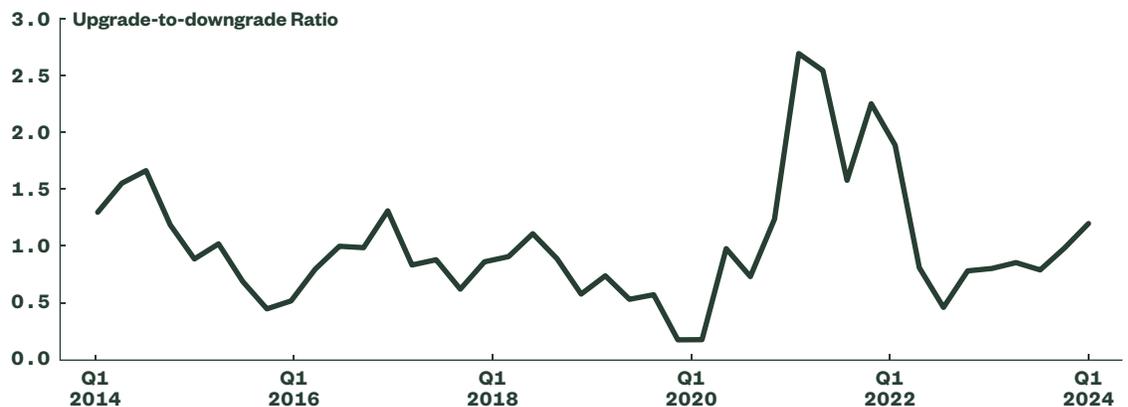


Source: Bloomberg Finance, L.P., as of May 14, 2024, based on monthly returns for the Bloomberg U.S. Aggregate Bond Index. **Past performance is not reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The same healthy economic signs that led to rate cut repricing have helped support credit exposures. In fact, five tailwinds underpin the case for credit:

- 1 A growing economy:** A healthy labor market, resilient household demand, and business investment fueled a 3.1% real rise in final sales to private domestic purchasers. This key gauge of underlying demand has expanded for three consecutive quarters.<sup>36</sup>
- 2 Positive earnings growth:** After a string of negative quarters, earnings for US equities are poised to record their third consecutive quarter of growth.<sup>37</sup> Earnings growth is projected for the two remaining quarters of 2024 and for all of 2025.<sup>38</sup> For below investment-grade issuers, the same trends exist as positive Q1 earnings surprised to the upside.<sup>39</sup>
- 3 Improving ratings momentum:** After downgrades outpaced upgrades for seven consecutive quarters, the upgrade-to-downgrade ratio finally moved above 1 (indicating more upgrades than downgrades) in Q2. Positive ratings momentum indicates improving overall credit fundamentals, a trend also reflected in improving debt coverage ratios for below investment-grade issuers (Figure 5).<sup>40</sup>
- 4 A healthy coupon (i.e., carry):** High yield bonds yield around 8%, while senior loans have a yield above 9%<sup>41</sup> — greater than their own historical averages and the yields of today’s core bonds.<sup>42</sup>
- 5 Supportive technicals:** High-yield issuers have brought \$113 billion of new issuance to the market, almost twice the pace of this time last year.<sup>43</sup> And in April, more than 40 US investment-grade firms sold \$53 billion of bonds over a three-day stretch, the most crowded three-day calendar since 2021, while high-yield issuers priced nearly \$11 billion — seizing on strong investor demand for the carry associated with credit.<sup>44</sup>

Figure 5  
**Positive Credit Rating Trends Help Support the Case for Credit**



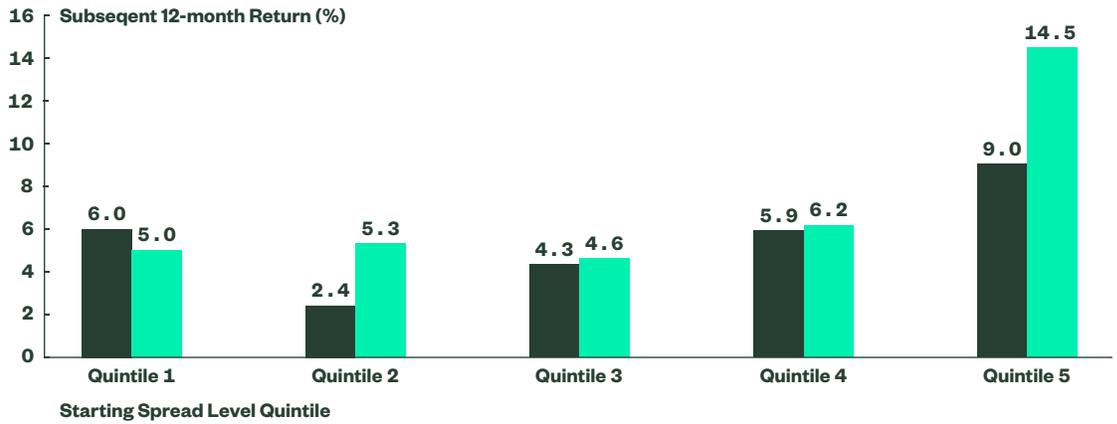
Source: Bloomberg Finance, L.P., as of May 14, 2024, based on S&P ratings for North American corporate issuers for investment-grade and below-investment-grade debt. **Past performance is not reliable indicator of future performance.**

Tight credit spreads are cause for concern. For both high-yield and investment-grade corporate bonds, spreads are approximately 40% below their historical averages and plotting in the lowest quintile over the past 20 years.<sup>45</sup> Yet, our research shows that the relationship between the starting spread level and the subsequent 12-month returns is mixed.

Rather than a linear relationship, where the lowest returns occur when spreads are in the bottom quintile and the best returns when spreads are in the top quintile, returns show more of a “smile” pattern (Figure 6). In fact, quintile one’s (today’s) starting spread level returns are higher than quintiles two or three for investment-grade corporates and high yield.

Figure 6  
**Starting Spread Levels Have Historically Shown an Uneven Relationship**

IG Corporates  
 High Yield



Source: Bloomberg Finance, L.P., as of April 30, 2024, based on the Bloomberg U.S. Corporate Bond Index and the Bloomberg U.S. High Yield Corporate Bond Index spread and subsequent 12-month returns from 1994 to 2024. **Past performance is not reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

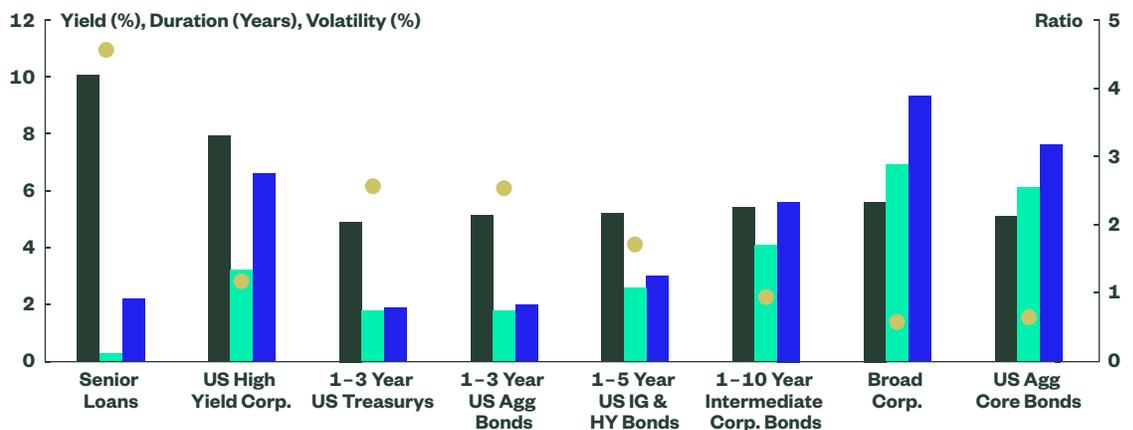
Optimizing Income Opportunities While Managing Rate Risks

Elevated rate risks and conducive credit trends support using credit-related strategies that have the potential to limit rate-induced price swings. Expressing a bias to credit can take many forms, however.

Figure 7 illustrates the yield, duration, volatility, and yield-per-unit-of-volatility ratio profiles of short-term bond sectors to help you decide how to pursue today’s credit opportunities in an evolving rate risk regime.

Figure 7  
**Short-term Core and Credit Strategies Help Balance Income and Risk**

Yield (%)  
 Duration (Years)  
 1-year Standard Deviation of Returns (%)  
 Yield-per-unit-of-volatility Ratio



Source: Bloomberg Finance, L.P., as of May 15, 2024. US High Yield Corp = Bloomberg U.S. High Yield Corporate Bond Index, 1-3 Year US Treasurys = Bloomberg U.S. 1-3 Year Treasury Index, 1-3 Year US Agg Bonds = Bloomberg 1-3 Year U.S. Aggregate Bond Index, Broad Corporates = Bloomberg U.S. Corporate Bond Index, US Agg Core Bonds = Bloomberg U.S. Aggregate Bond Index, Senior Loans = Morningstar LSTA Leveraged Loan Index, 1-5 Year US IG & HY Bonds = Bloomberg U.S. Universal 1-5 Year Index. **Past performance is not reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The flexibility of active strategies to manage rate risks, while pursuing opportunities amid a broader universe, may be the most beneficial approach in the core. More so, duration-controlled active strategies that combine both traditional bond sectors (e.g., investment-grade corporates and US Treasurys) and non-traditional ones (e.g., CLOs, securitized credits) can support tactical positioning along the yield and credit curve.

An actively managed senior loan strategy can also help limit rate risks, without sacrificing income. Due to their floating rate coupons, senior loans have minimal interest rate risk — resulting in realized volatility of just 2.2%, versus the Agg’s 7.6% over the past year.<sup>46</sup>

Since senior loans are below investment-grade rated securities, this reduction in rate risk doesn’t constrain their potential for income generation. Yields are above 9%, leading to a yield-per-unit-of-duration more than four times that of core bonds and three times that of fixed-rate high yield (Figure 7). And active strategies’ prudent risk management and sector and security selection may help navigate a credit market with healthy fundamentals and supportive technicals, but rich valuations.

Balanced credit strategies can also be found within investment-grade markets. High-quality investment-grade corporate bonds with maturities between 1 and 10 years, leading to a weighted duration of four years, allow investors to take on *some* duration risk, but with a better balance toward income. The segment’s 5.41% is greater than core bonds’ 5.07% and on par with broad corporates’ 5.60%.<sup>47</sup>

Sitting in the short-plus belly of the curve cuts out the long-term tail of corporate bond exposures that offer little yield pickup (30 bps) while adding eight years of duration relative to the 1–10 year space.<sup>48</sup> As a result, the 1–10 year part of the corporate curve helps strike a better balance between yield, duration, and potential rate volatility relative to other broad corporate bond and Treasury sectors.

## Implementation Ideas

To protect against rate volatility and also take on credit risk in response to positive economic trends, consider:

Actively managed floating rate loan strategy	<b>SRLN</b>	SPDR® Blackstone Senior Loan ETF
Short-term active core strategy	<b>STOT</b>	SPDR® DoubleLine® Short Duration Total Return Tactical ETF
Balanced high-quality intermediate investment-grade bonds	<b>SPIB</b>	SPDR® Portfolio Intermediate Term Corporate Bond ETF

## Theme 3: Position for Macro Volatility With Real Assets

For nearly 40 years, a global peacetime dividend between the world’s economic superpowers, combined with increasing globalization, created a powerful one-two punch to stabilize interest rates and inflation at benign levels. As a result, long duration investments such as stocks and bonds performed well. The traditional 60/40 investment portfolio thrived in this environment.

Today, rising geopolitical tensions and deglobalization in the aftermath of the pandemic threaten to destabilize the global economy through higher rates and inflation. Investors may need a different set of investments in a diversified portfolio to achieve their long-term goals and objectives.

Investors should consider:

- Gold for its low correlations to both stocks and bonds and historical trend of preserving purchasing power during periods of above-average inflation.<sup>49</sup>
- Inflation-sensitive assets like inflation-linked bonds, infrastructure, real estate, and natural resource equities.
- Agriculture, energy, and metals and mining industries, all likely to benefit from stubborn inflation and potentially higher commodity prices.

## US Economy Beating Expectations

The US economy, aided by massive amounts of fiscal stimulus, continues to defy consensus expectations for a meaningful slowdown. Instead, the mid-May Federal Reserve Bank of Atlanta GDPNow estimate for annualized real GDP growth for the second quarter is a robust 3.6%.<sup>50</sup> At the same time, several major economies including the United Kingdom, Europe, Japan, and China are emerging from recent bouts of weakness.

Should something go unexpectedly wrong, global central banks such as the Fed, Bank of England, ECB, Bank of Japan, and People's Bank of China stand ready to lend support to their respective economies through monetary policy accommodation. In addition, considerable progress has been made in taming inflation since it peaked two years ago in the summer of 2022. As a result, several central banks, including the Fed, are expected to begin cutting interest rates later this year.

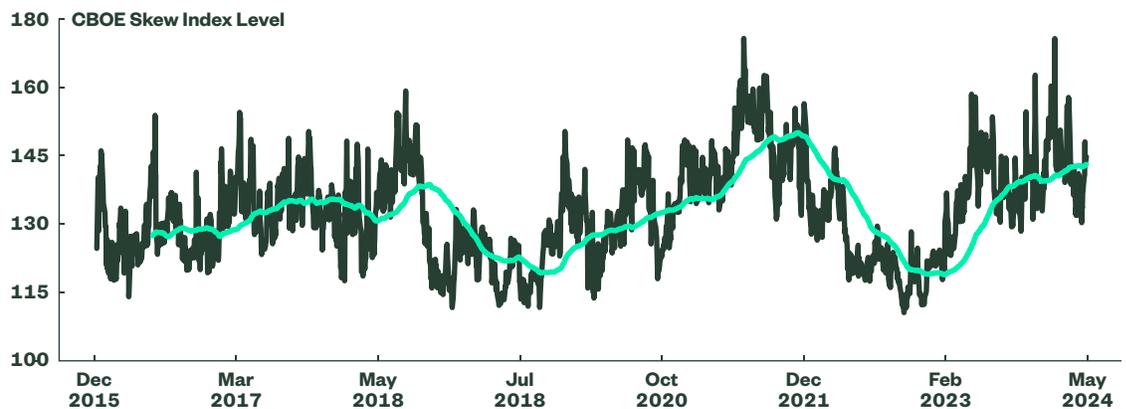
Supported by determined fiscal and monetary policies, steady economic growth has combined with strong labor markets, growing corporate profits, and healthy consumer spending to create an attractive backdrop for risk assets. But much of this favorable environment for risk taking is already reflected in stretched valuations and high asset prices. Many stock markets around the world are at or near all-time highs, credit spreads are historically tight, and most measures of capital market volatility are remarkably subdued.

## Global Macroeconomic Landscape Grows More Fragile

Market volatility likely will be exacerbated by the fact that more than 40% of the world's population is eligible to vote in an election this year.<sup>51</sup> November's US presidential election promises to be one of the closest and most divisive races in US history. Investors should brace themselves for greater election headline risks.

Figure 8  
**Increased Implied Tail Risks Reflect a Wider Range of Outcomes**

■ SKEW Index  
■ 200-day Moving Average



Source: Bloomberg Finance, L.P., as of May 16, 2024. **Past performance is not a reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Meanwhile, the probability of a monetary policy mistake is rising. Central banks are desperately trying to find the right balance between inflation and economic growth.

If central bankers cut interest rates prematurely, they risk repeating the stop and go monetary policy mistakes of the 1970s that enabled inflation to come roaring back. If they wait too long, central bankers risk producing an unwanted recession, capital market catastrophe, or possibly both — the more typical monetary policy mistake. Regrettably, central bankers find themselves in an unwelcome Catch-22 situation.

Ballooning fiscal deficits resulting from extraordinary government spending to combat the negative consequences of the pandemic likely brought future economic growth forward. Governments must now issue an increasing amount of sovereign debt to fund those deficits. This is especially true in the US and it's happening at a time when central banks, including the Fed, and other natural purchasers of sovereign debt are buying fewer bonds.

As a result, the supply of sovereign debt is rising while demand is falling. This likely has contributed to higher and more volatile interest rates than many market participants had anticipated. This could destabilize the global economy and result in a correction in lofty asset prices.

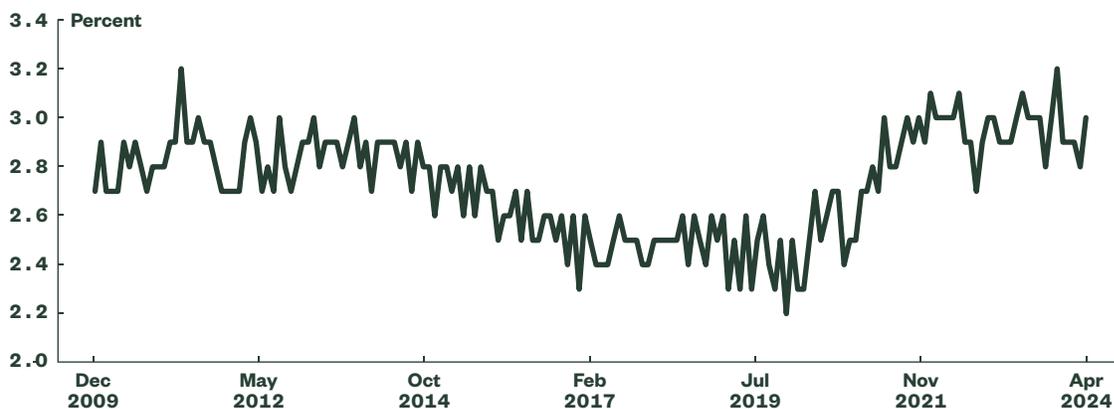
Stubborn inflation is possibly the greatest risk to macro stability.

Supply-demand imbalances in the housing and labor markets remain. For example, the supply of affordable housing remains too low while demand remains high. Similarly, in the labor market, the supply of qualified skilled workers is constrained but businesses' demand remains high. These imbalances could put upward pressure on housing prices and wages, ultimately further fueling inflationary pressures.

The multi-decade transition from fossil fuels to alternative sources of cleaner energy has been far more inflationary than many policymakers expected. The transition has increased the demand for commodities and natural resources required to leave fossil fuels behind while supply remains constrained, pushing prices higher.

Geopolitical tensions in the Russia-Ukraine war, Middle East conflict, and friction between the US and China over Taiwan could damage the global economy and bolster inflation. Rising trade protectionism — like the recent increased tariffs on Chinese imports from semiconductors to solar cells and medical products — likely will hurt the global economy and result in higher prices.

Figure 9  
**Expectations for Future Price Increases Are Rising**



Source: Bloomberg Finance, L.P., as of April 30, 2024, based on the University of Michigan Expected Change in Prices During the Next 5–10 Years: Median Response. **Past performance is not a reliable indicator of future performance.**

## Diversify Portfolios Given Shifts in the Macro Environment

In a more volatile macro environment with higher interest rates and sticky inflation, a different mix of investments may be needed in a diversified portfolio to enable investors to reach their long-term goals and objectives.

Long duration Treasuries, for example, haven't provided the expected diversification benefits or added protection that many investors anticipated this year. In fact, for the first time ever, long duration Treasuries have delivered negative performance in the 10-months following the last Fed rate hike in July 2023. Long duration Treasuries have experienced a notable drawdown since August 2020 and have delivered virtually no return since 2012.<sup>52</sup>

Long duration bonds may not be investors' best option for income and stability. Instead, including more real assets in a diversified investment portfolio could be an increasingly attractive option for investors.

Building a 5–10% real assets allocation, drawing equally from stocks and bonds and/or funding it using elevated cash balances, could help further diversify portfolios and better prepare them for today's macro volatility, higher interest rates, and inflationary environment.

## Implementation Ideas

To position for increasing macro volatility with real assets, consider:

Gold offers low correlations to both stocks and bonds along with a historical trend of preserving purchasing power during periods of above-average inflation. <sup>53</sup>	<b>GLD</b> <sup>®</sup>	SPDR <sup>®</sup> Gold Shares
	<b>GLDM</b> <sup>®</sup>	SPDR <sup>®</sup> Gold MiniShares <sup>®</sup> Trust
This tactical real assets ETF allocates to multiple inflation-sensitive markets beyond commodities, including gold, inflation-linked bonds, infrastructure, real estate, and natural resource equities. Its prudent risk management approach has the potential to generate higher risk-adjusted returns.	<b>RLY</b>	SPDR <sup>®</sup> SSGA Multi-Asset Real Return ETF
A global portfolio of natural resource producers focused on agriculture, energy, and metals and mining industries will likely benefit from stubborn inflation and the potential for higher commodity prices.	<b>GNR</b>	SPDR <sup>®</sup> S&P <sup>®</sup> Global Natural Resources ETF

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**60/40** Shorthand for an asset allocation approach that combines equities and fixed income, with 60 percent in stocks and the remaining 40 percent in bonds. The combination is meant to balance potential to generate capital gains (and losses) associated with stocks with the capacity to protect principal inherent in income-generating bonds.

**Bank of Japan** Japan's central bank. The BoJ is responsible for implementing monetary policy, managing the currency, and controlling money supply for the world's third-biggest economy.

**Basis Point (bps)** A unit of measure for interest rates, investment performance, pricing of investment services and other percentages in finance. One basis point is equal to one-hundredth of 1 percent, or 0.01%.

**Bloomberg U.S. Aggregate Bond Index (Agg)** A benchmark that provides a measure of the performance of the US dollar denominated investment-grade bond market. The "Agg" includes investment-grade government bonds, investment-grade corporate bonds, mortgage pass through securities, commercial mortgage-backed securities and asset backed securities that are publicly for sale in the US.

**Bloomberg U.S. Corporate Bond Index** A fixed-income benchmark that measures the investment-grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

**Bloomberg U.S. Intermediate Corporate Bond Index** A benchmark designed to measure the performance of US corporate bonds that have a maturity of greater than or equal to one year and less than 10 years.

**Consumer Price Index (CPI)** A widely used measure of inflation at the consumer level that helps to evaluate changes in cost of living. The CPI is composed of a basket of consumer goods and services across the economy and

is calculated by the US Department of Labor by assessing price changes in the basket of goods and services and averaging them. Core CPI is the same series, but excluding food and energy prices, which are considered volatile enough to distort the meaning and usefulness of so-called headline CPI. The absence of food and energy, means the core series reflects long-term inflation trends more accurately.

**Correlation** The historical tendency of two investments to move together. Investors often combine investments with low correlations to diversify portfolios.

**Credit Spreads** The difference in yield between a US Treasury bond and a debt security with the same maturity but of lesser quality.

**Deglobalization** A movement toward a less connected world, characterized by powerful nation states, local solutions, and border controls rather than global institutions, treaties, and free movement.

**Drawdowns** A specific decline in the stock market during a specific time period that is measured in percentage terms as a peak-to-trough move.

**Dotcom Era** The speculative stock-market run-up of the late 1990s that grew out of excitement about the potential of the Internet. While companies such as eBay and Amazon were born in this period, countless other start-ups with vague business plans and no profits were funded by investors dreaming of winning big. The fervor peaked on March 10, 2000, and a nearly three-year bear market followed.

**Earnings Per Share (EPS)** A profitability measure that is calculated by dividing a company's net income by the number of shares outstanding.

**European Central Bank (ECB)** The European Union's central bank, which is responsible for monetary policy within the EU. The ECB was founded in 1998.

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**Eurozone** The eurozone, also sometimes referred to as “euroland,” is the geographic and economic region that consists of all the European Union countries that have incorporated the euro as their national currency since the currency’s launch in 1999. This area comprises 27 countries currently.

**Forward Price-to-earnings (P/E)** The price of a security per share at a given time divided by its projected earnings per share over the coming year. A forward P/E ratio is a way to help determine a security’s stock valuation — that is, the fair value of a stock in a perfect market. It is also a measure of expected, but not realized, growth.

**Gross Domestic Product (GDP)** The monetary value of all the finished goods and services produced within a country’s borders in a specific time period.

**Inflation** An overall increase in the price of an economy’s goods and services during a given period, translating to a loss in purchasing power per unit of currency. Inflation generally occurs when growth of the money supply outpaces growth of the economy. Central banks attempt to limit inflation, and avoid deflation, in order to keep the economy running smoothly.

**Investment-grade Bonds** Bonds that have a relatively low risk of default. Bond-rating firms, such as Standard & Poor’s, use different lettered descriptions to identify a bond’s credit quality. In S&P’s system, investment-grade credits include those with ‘AAA’ or ‘AA’ ratings (high credit quality), as well as ‘A’ and ‘BBB’ (medium credit quality). Anything below this ‘BBB’ rating is considered non-investment grade.

**Magnificent Seven (Mag 7)** The Magnificent Seven refers to the group of 7 stocks that currently dominate most major indexes: Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta Platforms and Tesla. Due to their outsized market capitalizations, Magnificent Seven stocks hold a disproportionate influence on the market-cap weighted Nasdaq composite and S&P 500 indexes.

**NYSE Technology Index** An equal-dollar weighted index designed to objectively represent the technology sector by holding 35 of the leading U.S. technology-related companies.

**People’s Bank of China** The central bank of the People’s Republic of China, which oversees the world’s second-biggest economy.

**Percentile** Percentile ranking is a system of ranking scores that shows the percentage of results that are lower than the benchmark or fund in question for the most recent three-year period. Every year, each score is updated with the most recent year’s percentiles.

**Purchasing Managers Index (PMI)** An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

**Quality Companies** The term refers to companies with a consistent track record of strong earnings and stable balance sheets.

**Recession** A period of temporary economic decline during which trade and industrial activity are reduced.

**Return on Equity** The amount of net income returned as a percentage of common shareholders’ equity. ROE shows how well a company uses investment funds to generate earnings growth.

**S&P 500® Index** A popular benchmark for U.S. large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

**Senior Loans** Floating-rate debt issued by corporations and backed by collateral such as real estate or other assets.

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**Soft Landing** A soft landing is a gradual slowdown in economic growth that avoids a recession. A soft landing is the goal of a central bank when it seeks to raise interest rates just enough to stop an economy from overheating and experiencing high inflation, without causing a severe downturn.

**Valuation** The process of determining the current worth of an asset or a company.

**Volatility** The tendency of a market index or security to jump around in price. Volatility is typically expressed as the annualized standard deviation of returns. In modern portfolio theory, securities with higher volatility are generally seen as riskier due to higher potential losses.

**Yield-per-unit-of-duration** Yield-per-unit of duration is expressed by yield-to-worst being divided by effective duration where duration is a measure of the sensitivity of the price of a bond to a change in interest rates and yield to worst is a measure of the lowest possible yield that can be received on a bond with an early retirement provision.

**Yield-per-unit-of-volatility** Calculated by subtracting the risk-free rate of return from the expected return and dividing the result by the negative portfolio's standard deviation. The higher the ratio, the better the risk-adjusted yield may be.

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Because of their narrow focus, sector funds tend to be more volatile than funds that diversify across many sectors and companies.

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Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise, 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.

Investments in asset backed and mortgage-backed securities are subject to prepayment risk which can limit the potential for gain during a declining interest rate environment and increases the potential for loss in a rising interest rate environment.

Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

Increase in real interest rates can cause the price of inflation-protected debt securities to decrease. Interest payments on inflation-protected debt securities can be unpredictable.

The values of debt securities may decrease as a result of many factors, including, by way of example, general market fluctuations; increases in interest rates; actual or perceived inability or unwillingness of issuers, guarantors or liquidity providers to make scheduled principal or interest payments; illiquidity in debt securities markets; and prepayments of principal, which often must be reinvested in obligations paying interest at lower rates.

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