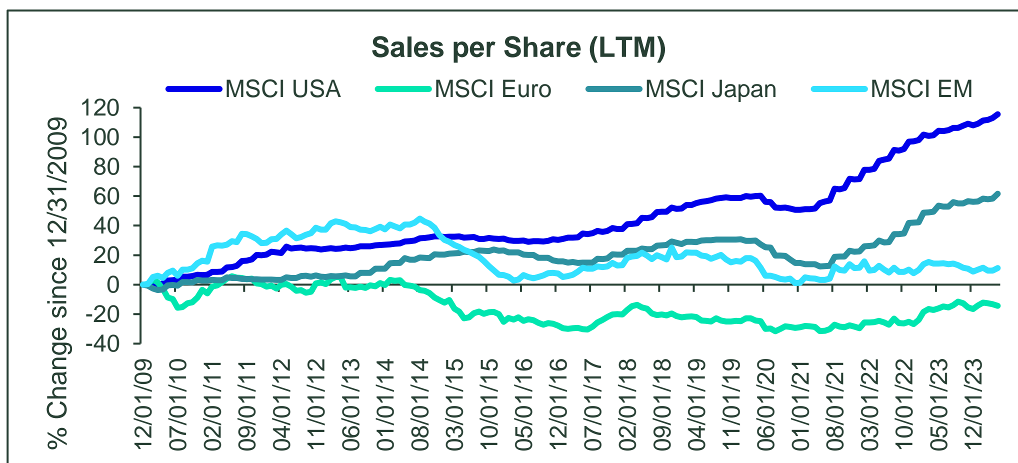
June 6, 2024
Commentary

Weekly Market Update

Insight of the Week

Regional Revenues

Earnings per share (EPS) is often the preferred way of assessing company performance. The simplified equation of EPS is revenues minus costs. Revenues are rather straightforward and measure the incoming sales of product. However, costs are an area where company management can choreograph effects on overall earnings. For instance, a company may have similar year-over-year sales, yet earnings may improve if they went through cost cutting measures. While this may look good for their bottom line, the fact remains they haven't grown their business.



Source: MSCI, FactSet. Data as of 5/31/2024.

In the chart above, we isolate the sales per share of regional equity indices since the beginning of 2010. What becomes clear is the dominance of the US along with an impressive showing from Japan, both of which are at highs. On the flip side, both Europe and Emerging Markets remain below their highs set back in the early 2010's which highlights their structural inability for sustained outperformance.

Higher revenues ultimately give management more bandwidth and flexibility to decide where to invest. We've received questions from clients regarding where in the markets is there the most amount of excitement. Looking at the chart above, and realizing it's not a new story, it's tough to say the US's secular dominance is slowing down. Yes, the US is expensive, but you can expect to pay a premium for higher earnings. The question remains the path of earnings going forward and if investors are willing to pay the price. In our recently released mid-year global market update, we remain cautious on risk assets overall and favor quality stocks, many of which are based in the US.

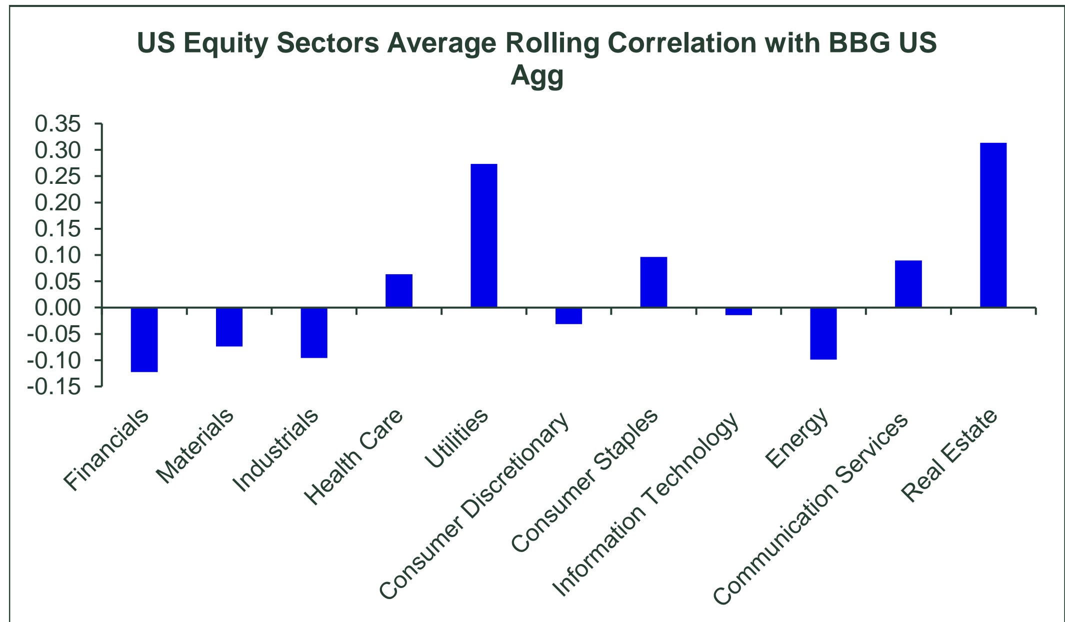
Source: State Street Global Advisors, MSCI, FactSet.

Equities

Correlation Between US Equity Sectors and Bonds

The correlation between equities and fixed income instruments is a fundamental aspect of portfolio construction influencing diversification strategies, asset allocation decisions, and risk-adjusted return profiles. In recent years, stock bond correlation has garnered attention for turning positive from its negative tendency since the beginning of the 2000s. As of the end of May 2024, the 36 month rolling stock bond correlation is still positive at 0.71.

We take a closer look at the varied relationship between different US equity sectors and US fixed income returns below. The chart shows the average of the 36 month rolling correlation between S&P 500 sectors against the Bloomberg US Aggregate Index. Macro-economic factors such as business cycles and interest rates impact the correlations of these sectors.



Source: FactSet. Monthly data from February,1997 till May 31,2024. S&P 500 Real Estate sector data from November 30,2001. Average rolling correlation is calculated as mean of 36 months rolling correlation between S&P 500 sector returns and BBG US Agg index returns.

Viewing the results more closely, we can make sense of the positive and negative correlations we are seeing today. Defensive sectors such as Utilities, Consumer Staples and Health Care offer stable earnings and dividend yields. These sectors tend to perform relatively well during periods of market stress or economic downturns similar to bonds, hence the positive correlation. On the other hand, Industrials, Materials and Energy which are considered cyclical, benefit from economic expansion, increased capital expenditures and rising demand for raw materials and commodities. However, interest rates rise during economic expansion to prevent overheating of stronger economy, which affect bond prices negatively hence producing a negative correlation.

The Real Estate sector though considered cyclical usually benefits from lower interest rates, which reduce borrowing costs for mortgages and financing, making properties more affordable and attractive investments. Hence, higher positive correlation (0.31)

with US bonds. Another interest rate sensitive sector, Financials, displays a negative correlation with bond returns as when interest rates are rising, Financials typically benefit from widening net interest margins as bonds lose in value. Low interest rates are also a tailwind for the Communication Services sector as it includes companies in media, telecommunications and internet services which often have significant capex. Similar to bonds, these companies would benefit from lower interest rates, which reduces their borrowing costs and hence produce a positive correlation.

For the Information Technology and Consumer Discretionary sectors, we see a mixed correlation (closer to zero) with bond returns. These sectors are sensitive to economic cycles and exhibit higher betas relative to the broader market. The Technology sector is usually driven by innovation and growth, while Consumer Discretionary is driven by macroeconomic variables like consumer confidence and disposable income. Similar to bonds these sectors benefit from falling yields, however during economic expansion this relationship changes as bonds become unattractive and these sectors perform well.

Understanding the correlation of various equity sectors with bond returns is crucial as it aids in constructing resilient portfolios that can deliver optimized risk adjusted returns across different market conditions. Although different equity sectors have varying relationships to bond prices, we expect the overall stock bond correlation to normalize. Should this normalization occur, we should see bonds providing the diversification benefit that is intended.

Source: FactSet, Bloomberg, S&P. Considering S&P 500 as proxy for stocks and Bloomberg US Aggregate for bonds. Average correlation is calculated as simple average of 36 months rolling correlation between S&P 500 index returns and BBG US Agg index returns.

Fixed Income

Credit Factors Can Provide Crucial Insights During Late-Cycle Market Resilience

Credit markets have been relatively stable since the banking turbulence in March 2023. Looking closely at credit style factor data, alongside market structure and market participant behavior, are important for understanding why the market remains resilient despite being late in the credit cycle.

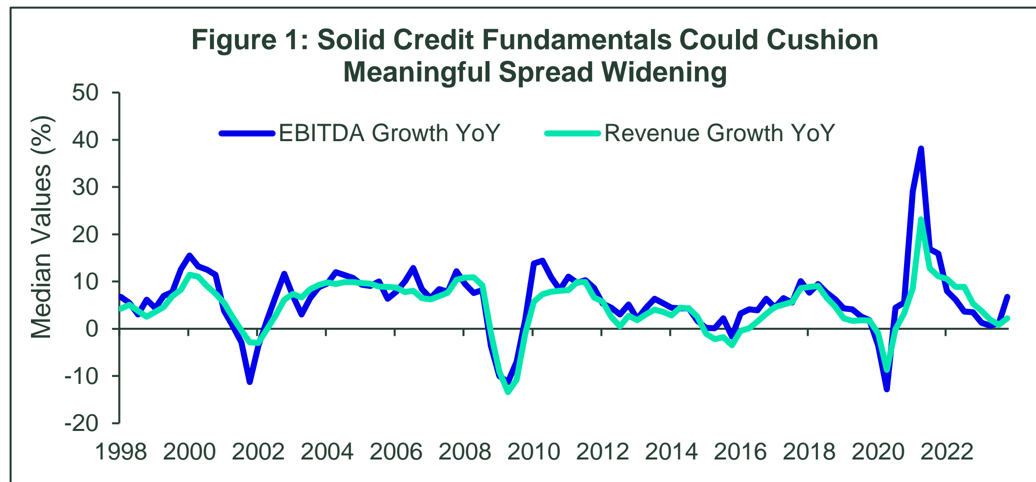
Investment Grade

Spreads on the US investment grade (IG) and high yield (HY) corporate bond indices have tightened to historically rich levels of around 90bps and 300bps, respectively. Meanwhile, fundamentals and market technicals remain supportive with Treasury yields near their highs over the past 15 years. Continued resilience has been the dominant theme in US markets over the past year. The following helps explain the steadiness in IG corporates:

1. Strong Macro Backdrop. Propped up by strong consumption, the economy has managed to avoid the more significant downturn that was anticipated in prior quarters, and rate cut expectations have shifted dramatically from six at the beginning of 2024, to two today. The market’s prevailing base case is a soft landing.

2. Attractive Yields. Despite tight spreads, investors continue to view 5.5% and 8% yields in IG and HY as attractive. IG bond funds have seen strong inflows of $138.5 billion year to date per JP Morgan, with robust gross supply (+30% YoY based on Barclays new issue US IG supply, as of April 30, 2024) following strong demand from retail investors, overseas buyers, buy-and-hold insurance companies, and de-risking pension funds.

3. Solid Credit Metrics. IG credit fundamentals have managed to avoid the cyclical downturns reminiscent in previous cycles. Higher interest expense and debt overall and lower interest coverage, could dampen fundamentals moving forward, but thus far, credit metrics remain supportive of rich valuations (Figure 1).



Source: Bank of America. As of December 31, 2024. Data represent median values for US investment grade non-financial corporate issuers excluding Utilities.

<u>High Yield</u>

The high yield market has been similarly boring and well supported. Default activity is muted, and issuance activity is normalizing. We saw $73 billion in new issuance in Q1 2024 per Barclays, which is on pace to be in line with the average annual issuance from 2010-2021.

We believe that changes in market structure can help explain market resilience late in the credit cycle. In particular, a significant slice of speculative transactions have moved from public to private markets, increasing the seeming resilience of the former, and potential vulnerabilities in the latter. Visibility into these more speculative deals is less apparent now in public markets. Private credit at approximately $1.6 trillion in market value is now roughly the size of the $1.6 trillion public HY corporate bond market, per Pitchbook.

<u>Credit Style Factors Can Add Value When Spreads Are Tight</u>

We can look to credit style factor data to help guide decision making at all parts of the cycle, including late cycle when valuations are becoming more stretched. Where purely value-oriented investors may have begun selling credit months ago when spreads were already well on the rich side of long run fair value, momentum could be the differentiator that, used in conjunction with value, keeps you invested through the turn in the cycle. Below we show the performance of "exposure-matched" portfolios that tilt toward high credit style factor exposure for value,

momentum, and sentiment individually, while accounting for risk factor exposures (Figure 2). Doing so properly isolates the impact of the style factors. In 2023, momentum shined in a year when spreads continually tightened to historically rich levels.

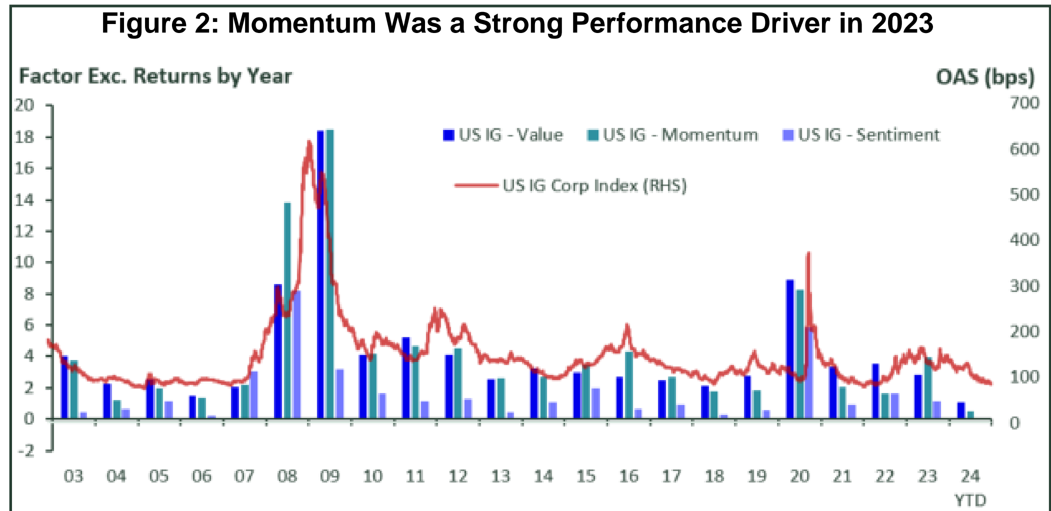


Figure 2: Momentum Was a Strong Performance Driver in 2023

Sources: Barclays QPS, Bloomberg Finance, L.P. As of April 30, 2024.

The Bottom Line

Understanding market structure and the institutional constraints that drive investors is key to our active investment philosophy, on both the fundamental and systematic sides. Our experience in credit markets and recognition of the structural changes therein helps us to make better investment decisions, even when spreads are tight and markets are showing the type of resiliency that we are seeing today.

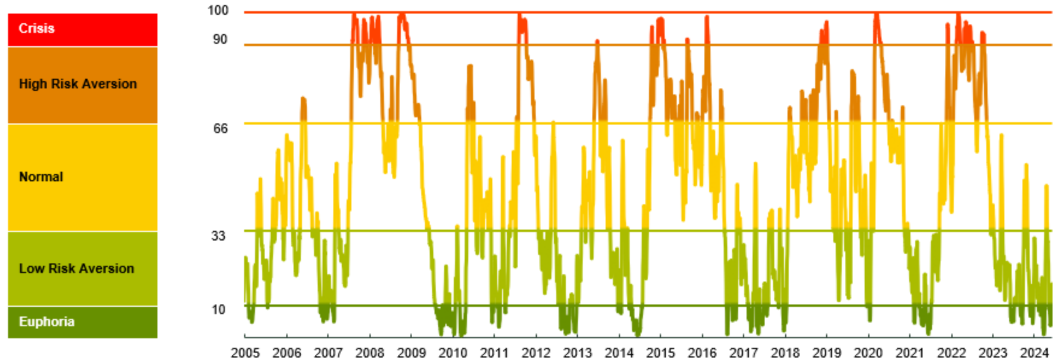
We can look to credit style factors to help guide decision making at all parts of the cycle, including late cycle when valuations are becoming more stretched. Understanding market structure, participants in the market and what’s driving their behavior, and what the style factor data can tell us – utilizing the full, comprehensive toolkit – can help add value to the investment process and create better outcomes for investors in the long run.

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 June 3): 2 days



As of June 5, 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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