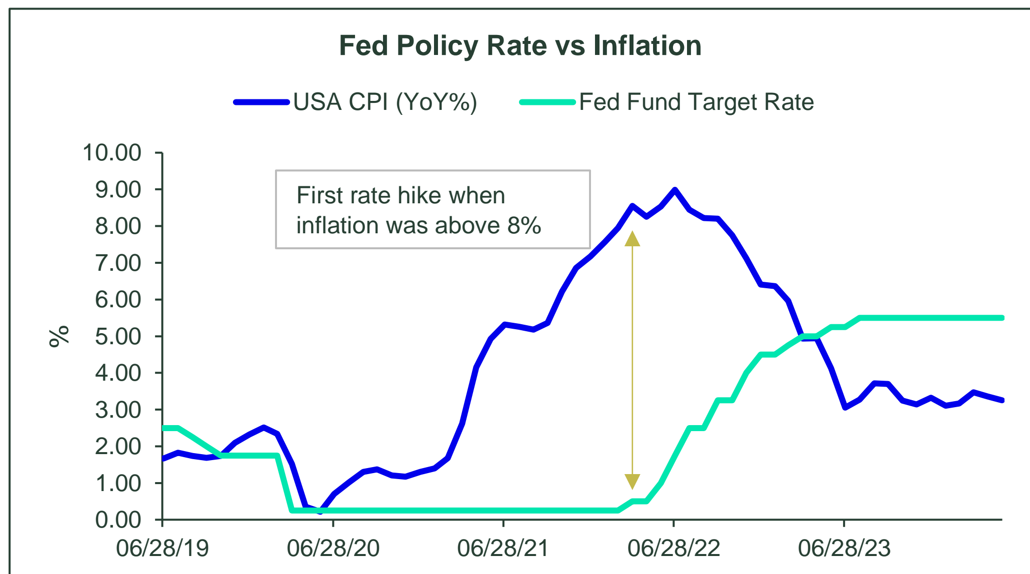
June 20, 2024
Commentary

Weekly Market Update

Insight of the Week

Late on the Way up, Late on the Way Down?

Let's remember the path that led us to where we are today. The market's overall attention is on the Federal Reserve's reaction to the path of inflation and its attempt to orchestrate a scenario where it arrives around 2%. In that process they are attempting to not truly damage economic growth.



Source: FactSet. As of 5/31/2024.

There is general acknowledgment that economic policy acts on a lag, often thought to be around 12-18 months. This means the Fed needs to have an eye on the future economic backdrop, all while they make the policy decisions of today. Looking into the future is certainly difficult. Case in point is the Fed's transitory inflation narrative that kicked off a few years ago. Based on these expectations, they expected inflation to essentially soothe itself, which ultimately didn't happen and made them extremely late to the inflation battle. As you can see in the chart above, the Fed didn't raise policy rates until CPI was already above 8%! Currently, the Fed communicates its reliance on incoming data. Had they put the same amount of weight on incoming data back in 2021, perhaps they may have begun raising policy earlier, and perhaps we'd be having a different discussion today. The current policy rate remains very high and restrictive. The concern remains that in a world of a data dependent Fed, if we see cracks to employment and economic growth, does that mean it's already too late?

Source: State Street Global Advisors, FactSet.

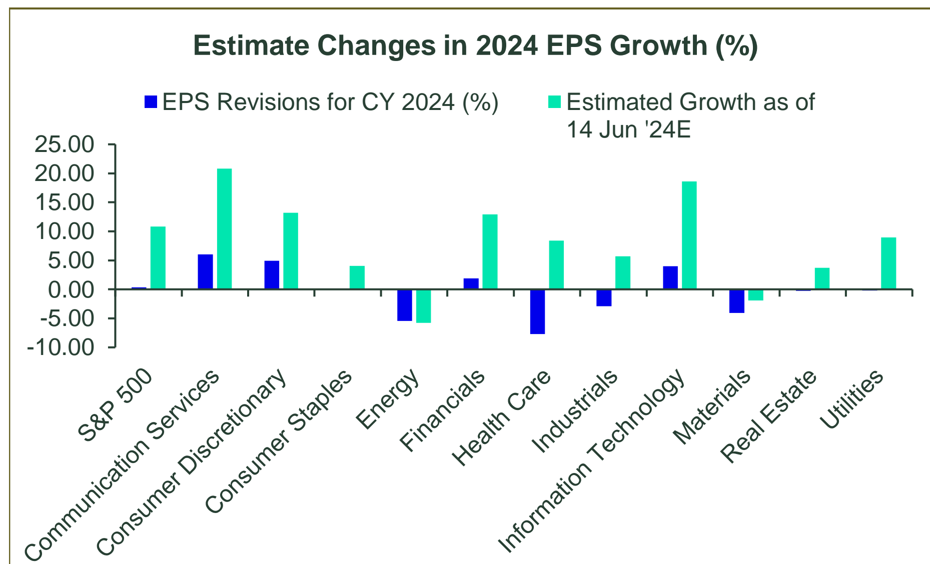
Equities

What Does Retail Sales Mean for Discretionary?

The latest macroeconomic print provided some insight into the retail sector, hinting to a wary consumer. The print was soft, showing May retail sales which rose by 0.1%, below consensus of 0.3%. This was also accompanied by a net revision of -0.4% to the prior month. Rates fell in reaction to this print as markets grappled with how this might factor into monetary policy decisions. We take a look at what this might mean for the equity retail sector, specifically consumer discretionary.

The S&P 500 Consumer Discretionary sector has generated positive performance year-to-date, but interestingly, is the second worst performing sector this year behind Real Estate. The sector is +3%, while the S&P 500 as a whole is +15%. Within Consumer Discretionary, industries include automobile and auto components, broadline retail, distributors, hotels restaurants and leisure, household durables, leisure products, specialty retail, and textiles apparel and luxury. Of the names within these industries, the largest contributors year to date to overall performance have been Amazon +20%, Chipotle +49%, and TJX +12%. The largest detractors from the sector year to date have been Tesla -25%, McDonalds -12% and Lululemon -38%.

Earnings for the sector in Q1 of this year surprised to the upside, reporting YoY earnings growth of 24%, much of which came from the impressive earnings of Amazon. Sales growth was less impressive with YoY growth in sales of just 5%. For the calendar year, earnings growth expectations are good although a bit more tempered than Q1 with estimated growth of 13%. There have also been positive earnings revisions to this number indicating an improving outlook for the year. Interestingly, earnings seem to contradict performance and macroeconomic data which is painting a picture of slowing retail sales among consumers with dwindling excess savings and larger interest payments as a proportion of income. We do see lower sales growth figures, although companies seem continually capable of generating strong earnings. The S&P 500 in general, is expected to generate earnings growth of 10% for calendar year 2024. A snippet of estimated EPS growth among sectors is below along with revisions for the year.



Source: FactSet, S&P. Data as of 6/14/2024.

Relative to other sectors, Consumer Discretionary seems to be poised for a good year, and is among the few sectors with upward EPS revisions. As more retail data comes in, it will be interesting to see how this translates to company sales within the Consumer Discretionary sector which should ultimately influence earnings.

Source: FactSet, S&P. Data as of 6/18/2024 in USD unless otherwise stated.

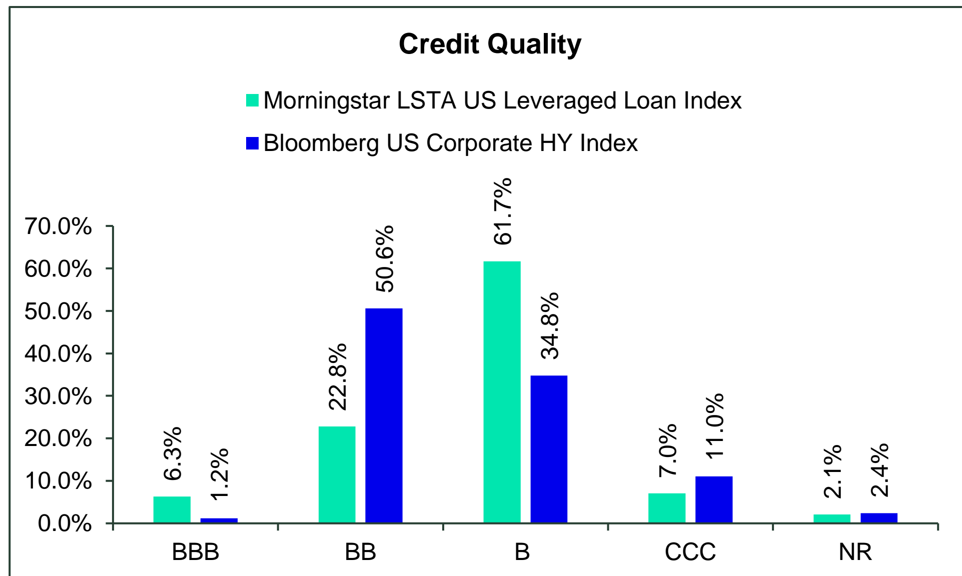
Fixed Income

Favor High Yield Over Senior Loans, With Expectation of Rate Cuts

Carry, due to higher elevated base rates, continues to provide attractive returns for both high yield and bank loans. But based on our expectations of future rate cuts, right now we see more value in broad high yield relative to loans.

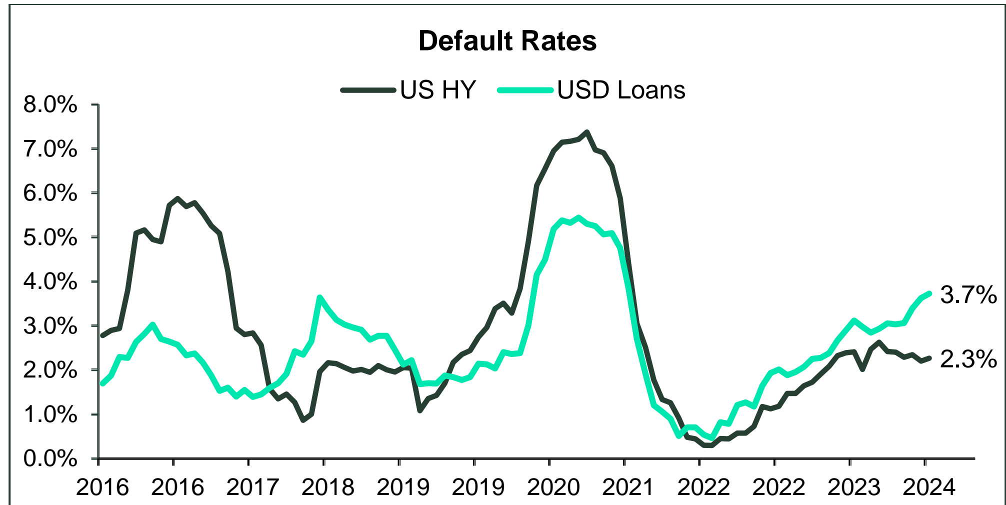
Floating rate securities such as bank loans provide increasing returns during periods of rising interest rates, which we saw from March 2022 to October 2023. With an average coupon reset period of roughly 45 days, investors are able to sidestep duration risk while earning higher yields as rates increase, which is ideal for investing in spread product with rising rates. High yield bonds are dually tied to interest rates (through duration) and spread. When rates rise or fall, typically that duration component would impact the returns of high yield bonds.

Broadly, loans currently have higher carry due to the lower quality of issuers in most indices. The Morningstar LSTA US Leveraged Loan Index includes 62% of B rated issuers, while the Bloomberg US Corporate HY Index has 51% in BB issuers. In the event that base rates and spreads remain steady, bank loans would outperform given that quality-driven yield advantage.



Source: Bloomberg LLP, Bloomberg US Corporate HY Index; Morningstar, Morningstar LSTA Leverage Loan Index. Data as of May 31, 2023.

Corporate fundamentals for both high yield bonds and bank loans remain strong and default rates remain low, and we see no large divergence in spread between the two asset classes going forward.



Source: Bank of America. Data as of April 30, 2024.

At SSGA were have revised our rate cut projections to two cuts in 2024 and additional cuts front loaded in 2025. Given our dovish rate cut expectations over the next 12 months, we see better opportunity in the duration component of high yield augmenting returns relative to the additional carry in loans .

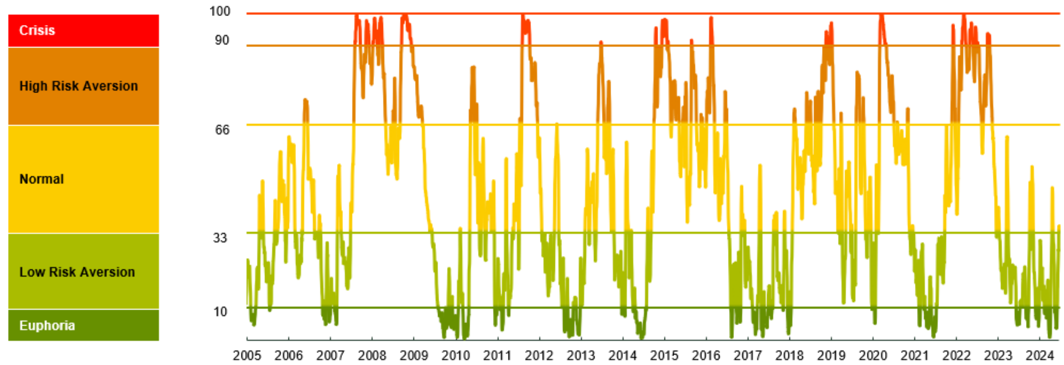
As of May 31, 2024 yield to maturity of the Morningstar LSTA US Leveraged Loan TR USD was 9.93% and 8.01% on the Bloomberg Corporate High Yield Index.

Source: State Street Global Advisors, Bloomberg, Morningstar, Bank of America.

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 Normal Regime (since June 14): 4 days



As of June 19, 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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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.

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