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A New Phase for Rates, Earnings, Politics, and Innovation

Key Catalysts for the second half of 2024

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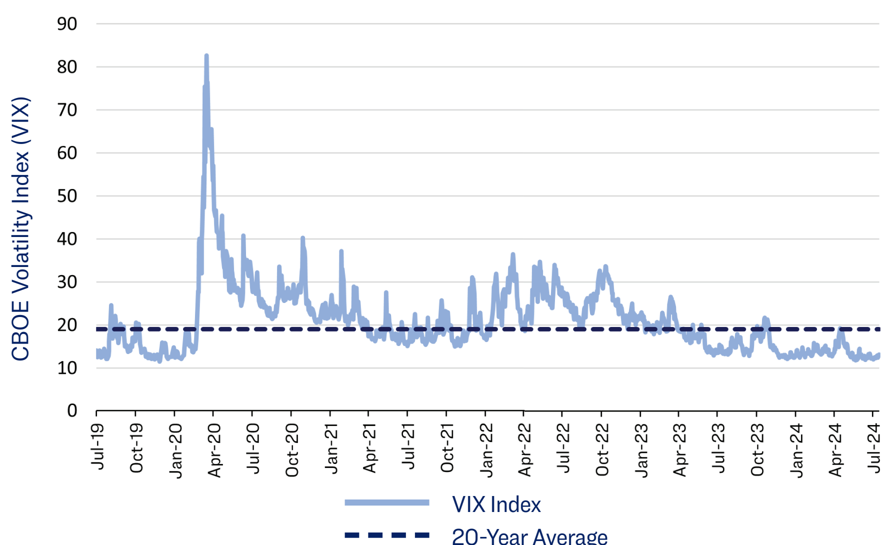
One of 2024's surprises has been the muted volatility of stock prices. Despite higher interest rates, unexpected upticks in inflation, and elevated geopolitical risks, the equity Volatility Index (VIX) now stands at a post-Covid low (Figure 1). Wall Street's favorite fear gauge, the VIX, has averaged just 14 this year, versus its long-term average of 20. Investors have maintained faith in the Federal Reserve's (Fed's) ability to bring down inflation. That has kept sentiment bullish, leading investors to take risk rather than avoid it. Below we highlight four catalysts that could either continue or alter this narrative.

FIGURE 1

The VIX Index has trended below its historical average in recent months.



Source: Bloomberg, TIAA Wealth Chief Investment Office.

Runup to the Elections and Outcome

Headlines around the elections will drive markets for the rest of 2024, and the outcomes will help shape our outlook for next year. Market volatility typically rises in the months leading up to the elections, and this time frame also coincides with historically weak seasonal returns for equities. In recent weeks, political pundits have increased the probability of Donald Trump winning the White House. In a Trump 2.0 scenario, the markets will likely anticipate higher trade tariffs, curbs on immigration, and an extension of the Tax Cuts and Jobs Act (TCJA) provisions. (The TCJA's income-tax cuts are set to expire at the end of 2025). The potential for a faster-growing economy could cause bond yields to stick at higher levels, or even rise further, and that would cause equity volatility to increase, at least initially. This scenario could complicate the Fed's path to cutting rates this year.

Runup to the Elections and Outcome continued...

If a Trump presidency were to reignite inflation and force the Fed to revert to rate-raising mode in 2025, it would be an about-face in monetary policy. Moreover, the bond market may push back on unfunded tax cuts, further muddling the path of rates in the coming year.

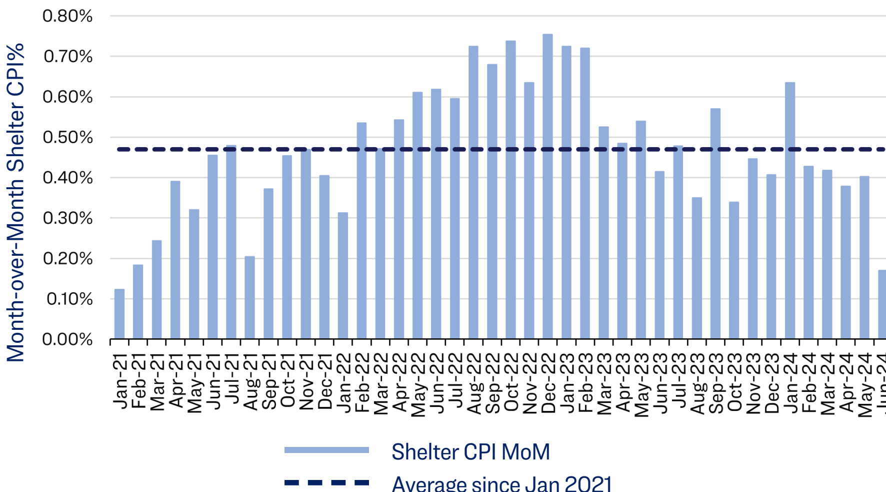
In the scenario of a Democratic presidency, new legislation leading to deficit expansion or to meaningful changes to trade and immigration policies becomes less likely. Therefore, bond market volatility and yields could decline as the risk of an inflationary shock from a Republican sweep recedes and as Fed rate cuts come through. A gridlock scenario may be the most favorable outcome for the markets, as it would limit the implementation of any new, and possibly polarizing legislation.

Bullish or Bearish Rate Cuts

The Fed has remained in the dovish camp all year, transmitting to market participants that monetary policy is at restrictive levels and therefore inflation is likely to gradually decline. The Fed may be finally getting to the other side of the inflation whack-a-mole, with the U.S. stringing together three consecutive encouraging Consumer Price Index (CPI) reports, and with the stickier shelter inflation (i.e. housing costs) decelerating (Figure 2).

FIGURE 2

Shelter CPI % data shows that housing cost inflation is declining.



Source: U.S. Bureau of Labor Statistics (BLS), TIAA Wealth Chief Investment Office.

Throughout its hiking campaign, the Fed was solely focused on the inflation side of its dual mandate. It could ignore the growth side, due to strong economic activity and labor market resilience. However, there is increasing evidence that the red-hot labor market is cooling[1], with the unemployment rate rising to 4.1% in June, with the pace of job creation slowing, and with demand for labor moderating (Figure 3).

FIGURE 3

Job openings have been on a steady decline.

Source: U.S. Bureau of Labor Statistics (BLS), TIAA Wealth Chief Investment Office.

Bullish or Bearish Rate Cuts continued...

While inflation will still be central to Fed policies, it can no longer ignore the slowing growth picture, which makes it likely that the Fed will initiate rate cuts during its September 18th meeting. Investors, meanwhile, will try to get a grip on whether the Fed has truly achieved a "soft landing" (taming inflation without tipping the economy into recession) or whether it kept interest rates too high for too long, causing a slowing economy to morph into a weak economy, leading to a further rise in the unemployment rate and a pullback in consumer spending. If the upcoming Fed cuts are in the category of mid-cycle normalization, similar to 1995, then cash is likely to come off the sidelines and into stocks. However, if there is growing evidence of a growth downturn, then volatility will rise, despite Fed easing.

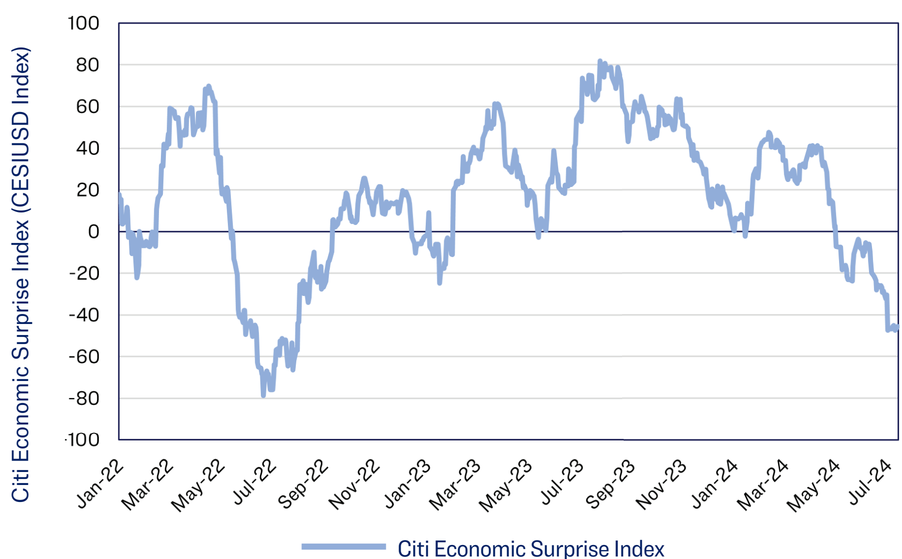
The Churn within Corporate Profits

Corporate profits for the S&P 500 grew ~6% in the first quarter and are expected to grow another 9% year-over-year in Q2. This inflection in profits has been key to keeping equities charging to new all-time highs, despite significant bond volatility and fading expectations for Fed rate cuts. However, technology and tech-related stocks in general, and mega-cap stocks in particular, have almost entirely driven this earnings improvement, with the top 10 companies now contributing 23% of the earnings, while making up 35% of the S&P 500 index's market capitalization.

Looking ahead, however, investors expect earnings for the Mega cap (specifically Magnificent 7) names to decelerate, while earnings for the rest of the index to accelerate. In fact, the 2Q is expected to be the first earnings per share (EPS) growth quarter for the other 493 companies since 4Q22, according to BofA Global Research[2]. If this plays out, then equity market gains will likely broaden, helped further by Fed easing. For the overall stock market to move higher, not only do the expensive mega cap names need to deliver on lofty expectations, but the others need to participate in the earnings improvement story. With the recent pick up in negative economic surprises[3] (Figure 4) and with companies' pricing power fading, this earnings revival cannot be taken for granted. Depending on its sustainability, it will either keep investors interested in equities, or prompt profit taking.

FIGURE 4

Economic Data has not been living up to the heightened expectations recently.



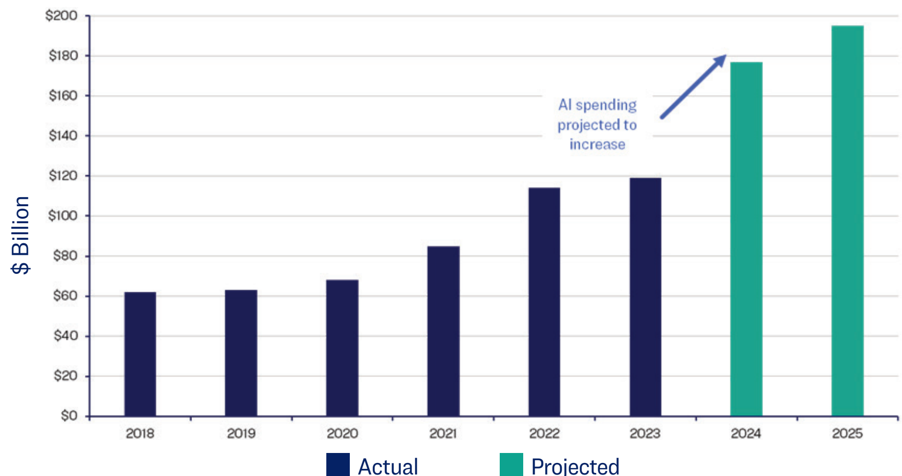
Source: Citi, Bloomberg, TIAA Wealth Chief Investment Office.

Artificial Intelligence Storylines

Artificial intelligence (AI) has been a dominant theme for investors since ChatGPT was launched back in November 2022. AI has fueled demand for computational power and advanced semiconductors and contributed to massive capital spending on AI models and data centers (Figure 5). Since November 2022, the broad technology sector has risen by 92%, trouncing the S&P 500's rise of 40%[4]. More specifically, the semiconductor industry has surged 105%[5], and an equal-weighted index of the Magnificent 7 stocks[6] is up a whopping 161%. We first touted AI as a driver of "the next great bull market" back in September 2023, and we continue to view AI as a transformative technology, with the potential to change how businesses operate, consumers consume, and innovation happens. It should drive productivity improvements across the global economy over the next decade.

FIGURE 5

Corporate spending on AI is surging.[7]



Source: Corporate Filings, Goldman Sachs, TIAA Wealth Chief Investment Office. Data through 1/24/2024.

Nonetheless, we are still in the early innings of this AI-led transformation. Most of the investor focus until now has rightly been on enablers, like semiconductor companies and hyperscalers that operate massive global networks of data centers and cloud computing capabilities. Given the need for large research budgets and investment outlays to succeed in this space, these companies have the competitive advantage and scale to be long term winners. However, it will take time to monetize these AI investments as the industry navigates the fast-changing landscape of emerging products, customer applications, regulations, and new competition. Given elevated expectations, any disappointments on the revenue and earnings front may be punished by investors, creating headwinds for the broader market. These potential pullbacks may well be buying opportunities for long-term, patient investors.

Companies in other areas, such as engineering and construction, electrical equipment, and utilities, also stand to benefit from the need to build out AI economy infrastructure and provide the power needed to run it. Longer term, companies that can use AI to target and better service customers should benefit from reduced costs, expanded margins, or increased sales. Bottom line: The AI innovation storyline will remain a catalyst for the foreseeable future.

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[1] 'Job openings' is a monthly indicator published by the Bureau of Labor Statistics that includes either newly created or unoccupied positions where an employer is taking specific actions to fill these positions.
[2] BofA Global Research; Earnings Tracker: 2Q preview: Other 493 back in the black; 7/9/24.
[3] The Citi Economic Surprise Index measures data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected, while a negative reading means that data releases have been worse than expected.
[4] 11/30/22 to 7/11/24.
[5] Philadelphia Semiconductor Index.
[6] Bloomberg Magnificent 7 Total Return Index – Apple, Amazon, Google, Nvidia, Tesla, Meta, Microsoft.
[7] This chart illustrates the combined capex of Microsoft, Alphabet, Meta, and Amazon Web Services.

CIO PERSPECTIVES

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