Sahm Rules Are Meant to Be Broken

Despite warning signs, the US economy has remained strong, but the US election and geopolitical risks remain top-of-mind.

Key Points

- **We think the Federal Reserve's (Fed) rate cut validates a risk-on tilt amid decent growth and decelerating inflation.** That said, we opted for a moderate rather than full overweight view on global equities given that markets anticipated the Fed's move, growth is slower, and geopolitical risks loom.
- **We continue to expect the equity rally to broaden beyond the mega-cap tech names**, helped along by the Fed's "commitment" to preserving growth. We prefer Japanese equities over Europe and China. We've turned neutral on the US.
- **Defensive fixed income priced in the Fed's rate cut well in advance.** Thus, we've moved to a neutral view on duration[1] from a moderately overweight view. We continue to like high yield now that peak defaults appear to be behind us, demand for income is still strong, and net supply is minimal.
- **We think gold's meteoric rise could continue** amid lower US real rates, continued central-bank and retail buying, and geopolitical risk. We also see upside for oil with recession risks waning and prices at the low end of the recent range.
- **Downside risks** to our views include US election-related volatility, broader turmoil in the Middle East, and a spike in inflation that would dim hopes of Fed easing. **Upside risks** include a strong upward turn in the global cycle and a weaker dollar. Meaningful fiscal stimulus from China could also translate to upside risk for emerging markets (EM).

Insight from sub-adviser Wellington Management

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Just as it seemed everyone had studied up on the Sahm rule,[2] which indicated the US economy was in recession based on a half percentage point rise in unemployment, the Fed cut rates by 50 basis points (bps)[3] and left a recession looking much less likely. Fed Chair Jerome Powell assured markets that the size of the cut didn't suggest concern about the US labor market but, instead, represented a risk-management measure to ensure the Fed doesn't fall behind in its full employment mandate and a "strong start" toward pushing policy rates back to neutral.

Rather than rules of thumb, we're focused on prospects for growth, inflation, policy, and valuations. We're also well aware of the risks related to the US election, but ultimately, we think monetary policy and prospects for a soft landing will be more important to markets than politics, so we've retained our moderately overweight view on global equities. As of early October, the US presidential race remained very close, raising the specter of lawsuits, allegations, and social unrest. But our base case is a peaceful transfer of power and divided government, which will avoid the most extreme policies espoused by the candidates. If we're correct, election-induced volatility could be an opportunity to add risk. If we're wrong, we'll need to reassess the economic implications.

With an additional 150 bps of rate cuts projected by the Fed by year-end 2025, we expect equities to outperform fixed income. After the Fed's first rate cut in past easing cycles, global equities have performed well when there was no recession (left chart in **FIGURE 1**). On the other hand, fixed income has performed slightly better in a recessionary environment (right chart). Within equities, we expect to see continued gains broadening out beyond the mega caps. Our top equity pick is Japan, followed by the US—although we have turned neutral on the US given pricey valuations. After August's mini crisis, precipitated in part by the Bank of Japan's (BOJ's) interest-rate hike, yen carry trades[4] have been flushed out and the BOJ may be set to pursue a measured pace of tightening.

We're less sanguine about Europe, which has an uninspiring earnings outlook and is exposed to China, which still faces problems in the property market and other challenges. China's recent stimulus announcements are a positive development, but it'll take time to determine whether they go far enough to change the market's longer-term trajectory. Beyond China, we maintain a neutral view on EM equities, where valuations are relatively inexpensive but a clear inflection in global growth is still needed.

FIGURE 1

Rate Cuts Supportive for Risk Assets Given Growth Backdrop

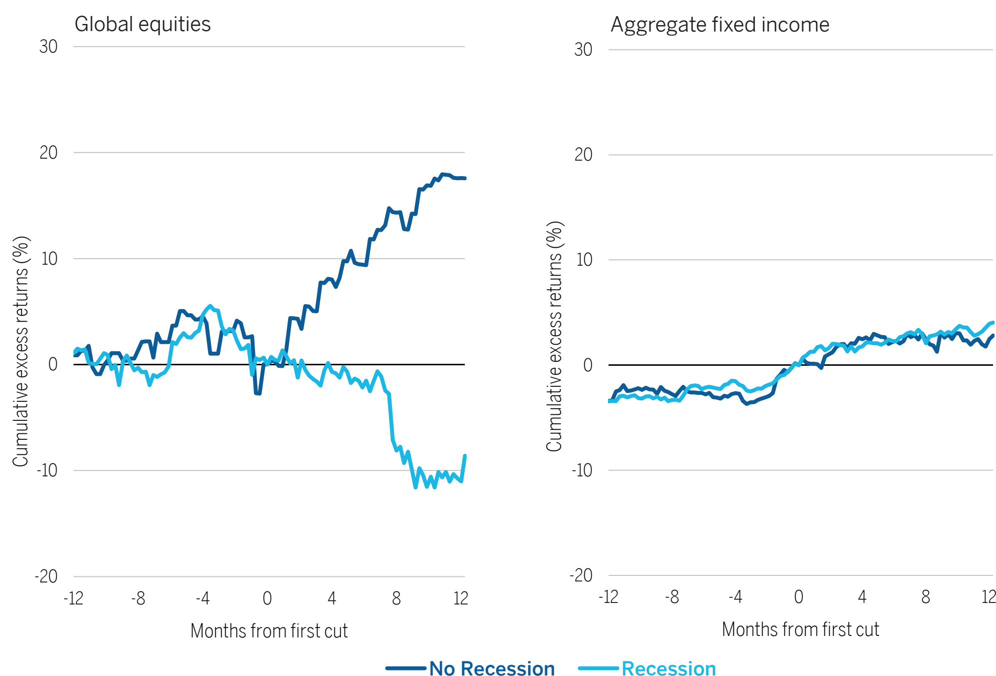


Chart data: 8/83-9/24. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Excess of cash returns. Average returns before and after first rate cut, rebased to 0, with or without a recession in the following 18 months as defined by the National Bureau of Economic Research. Global equities is represented by the MSCI ACWI Index and aggregate fixed income by the Bloomberg Global Aggregate Bond Index. See page 8 for representative index definitions. Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies. For illustrative purposes only. Data Sources: Wellington Management and Refinitiv.

Given the rally of nearly 80 bps in 10-year US Treasuries leading up to the Fed's rate cut, we see limited upside for duration in defensive assets and have moved to a neutral view. We've retained our moderately overweight view on high yield. We see extreme bifurcation between the spreads[5] of higher- and lower-quality spreads, reflecting distress in CCC bonds. While Fed easing will provide some relief, it won't change distressed situations overnight. Thus, we think high-yield spreads could be rangebound, and returns may be driven by coupon income.

Within commodities, where we have a moderately overweight view, we've increased our stance on gold given continued demand from central banks and lower US real rates, among other factors. We take a contrarian view on oil where we see upside to the current low price amid fading recession risks, overstated worries about oversupply, and the potential to earn carry.

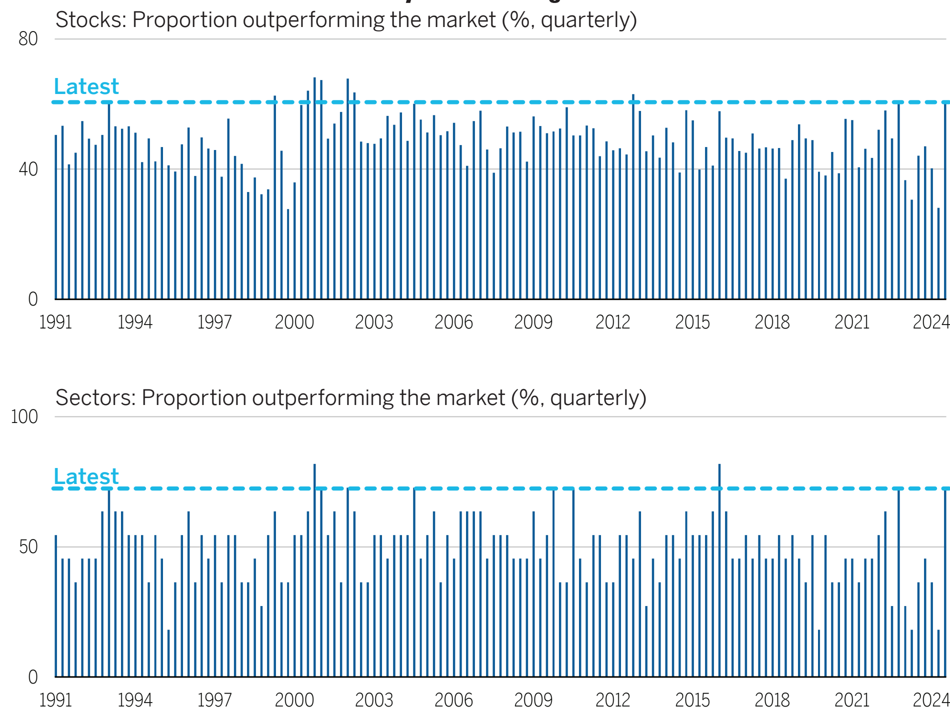
Equities: With Fundamentals Still Favorable, Keep an Eye Out for Entry Points

We retain a moderately overweight view on global equities. While markets were more volatile in the last quarter, we remain confident in the fundamental resilience of companies and the global economy. With the low risk of an economic hard landing and inflation largely in control, developed-market companies may be well positioned to achieve robust earnings growth. Following the recent rate cuts by the Fed and the People's Bank of China, we expect most central banks to loosen monetary policy over the next 12 months.

All of these factors should support equity valuations, though there are potential headwinds to consider. In particular, while we think markets can deliver on earnings expectations, negative earnings surprises from the Magnificent Seven[6] are a top risk to equity markets in the near term. That said, we continue to expect an improvement in earnings growth outside of the large-cap tech sector, which we think will be reflected in price action. We've seen early signs of broadening at a stock and sector level, as shown in **FIGURE 2**.

FIGURE 2

Extreme Narrowness Followed by Broadening



Quarterly data: 3/31/91-9/30/24. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Based on MSCI USA Index which is a free float-adjusted market capitalization index that's designed to measure the performance of the large- and mid-cap segments of the US market. The top chart displays the percentage of individual stocks within the MSCI USA Index that have outperformed the Index. The bottom chart displays the percentage of the 11 sectors within the MSCI USA Index that have outperformed the entire Index. Both charts are designed to quantify how broad or concentrated market performance has been. For illustrative purposes only. Data Sources: Wellington Management and FactSet.

The potential for volatility driven by the US election over the next few months keeps us from moving to a stronger overweight view on global equities. We don't have a high-conviction view on the election outcome and prefer to allow ourselves some room to lean further into equities at more favorable entry points.

We're neutral on US equities, mostly out of prudence as the market made new highs following the Fed's September rate cut and appears expensive based on traditional valuation metrics. However, when adjusted for declining interest rates and long-term earnings growth potential, the MSCI USA Index appears closer to fair value. Earnings are supported by an expansion in margins, with the growth in productivity well outpacing that in unit labor costs and pointing to improving competitiveness.

With valuations of Japanese equities looking more favorable following the August volatility, we're leaning into Japanese equities after a hiatus earlier in the year. We believe much of the volatility was driven by technical dynamics linked to positioning and the carry trade, rather than fundamental weakness. We also believe the structural case for Japanese equities, including an improving macro backdrop, corporate reforms, and increased cash return through buybacks, remains largely intact. We think there's room for further re-rating here, with our expected returns evenly balanced between valuation expansion and earnings growth components.

In China, recent stimulus is a step in the right direction for liquidity and sentiment. However, we await more policy detail to determine whether this marks a long-lasting turning point in sentiment and valuations. In the meantime, weak private-sector confidence, worsening property-market dynamics, and intensifying deflationary risks make us cautious about the outlook.

We've also turned more negative on European equities relative to other markets. The outlook for earnings is lackluster: With the exception of more domestically oriented sectors such as banks and utilities, the region's equities remain quite dependent on an inflection in the global cycle.

Within sectors, we're most positive on financials, followed by consumer discretionary, utilities, and IT. We have an underweight view on materials, staples, and communication services. These relative sector preferences add up to a balanced cyclical view, and our long IT vs. short communication services view neutralizes an outright Magnificent Seven bet.

Government Bonds: Easing Cycle Underway

Central banks around the world are in easing mode, and China's recent cut in the reserve-requirement ratio[7] adds to the list. Of course, there are exceptions. The BOJ is normalizing rates higher and variations in growth and inflation are causing some central banks, such as the Bank of England (BOE) and European Central Bank (ECB), to move at a more measured pace. However, we think the Fed's strong 50 bps cut signals a commitment to sustaining US growth that will support the global economy as well.

That said, we moved our long-duration view to neutral and have no regional relative value views. As in past easing cycles, markets anticipated the first Fed rate cut, with the US 10-year yield declining almost 80 bps prior to the September Federal Open Market Committee meeting. From here, we think the 10-year yield will remain rangebound around 3.25%–4.25%, with the front end of the yield curve[8] likely to experience more downward pressure than the long end. In fact, the 10-year yield actually rose after the Fed's announcement. In addition, markets have priced in substantial additional easing (**FIGURE 3**). This includes cumulative cuts of around 180 bps by the Fed, 135 bps by the BOE, and 170 bps by the ECB over the next 12 months—all of which are more than the central banks' own projections.

Our Multi-Asset Views

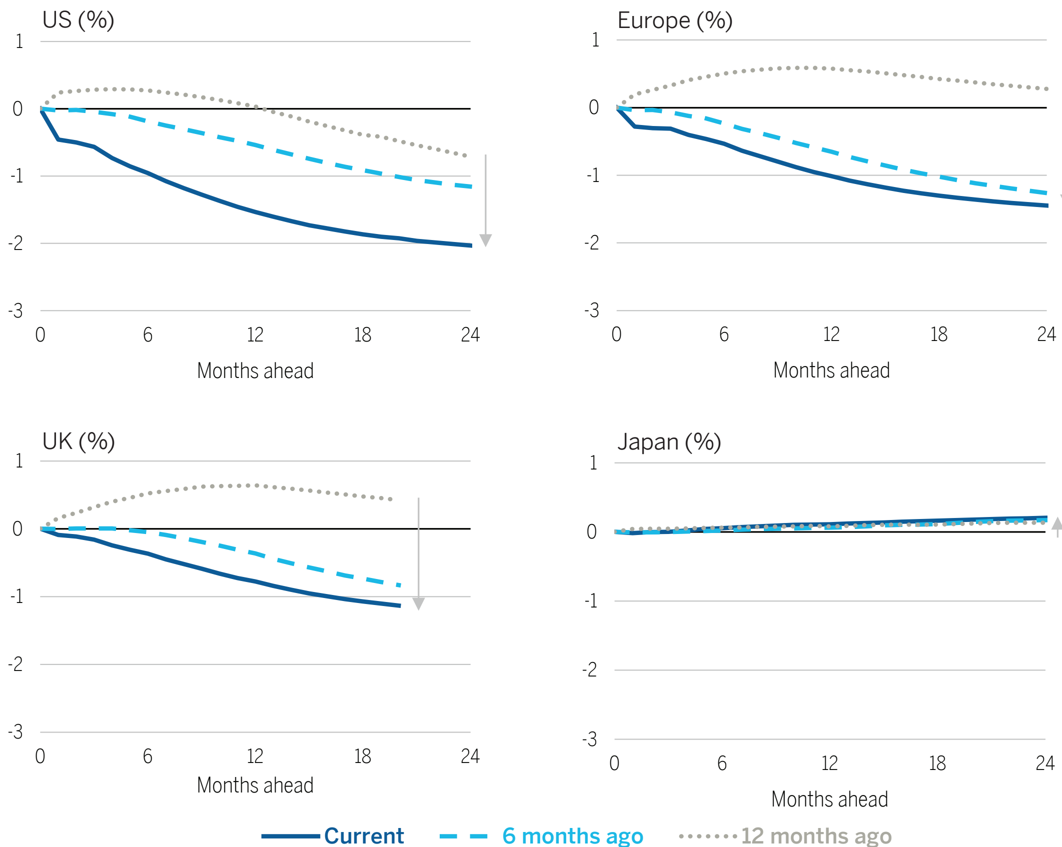
Asset Class	View	Change
Global equities	Moderately OW	—
DM govt. bonds	Neutral	↓
Credit spreads	Moderately OW	—
Commodities	Moderately OW	—
Cash	Underweight	—
Within asset classes		
Global equities		
US	Neutral	—
Europe	Moderately UW	↓
Japan	Moderately OW	↑
China	Moderately UW	↓
EM ex China	Neutral	—
DM govt. bonds		
US government	Neutral	—
Europe government	Neutral	—
Japan government	Neutral	—
Credit spreads		
US high yield	Neutral	—
Europe high yield	Neutral	↓
Global IG	Neutral	—
EMD	Neutral	↑
Bank loans	Neutral	—
Securitized assets	Moderately OW	—

OW = overweight, UW = underweight

Views have a 12 month horizon and are those of the authors and Wellington's Investment Strategy Team. Views are as of 9/30/24, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

FIGURE 3

In the US, A Lot of Policy Rate Cuts Priced In



As of 9/16/24. Overnight Index Swap rate is used to measure rate expectations, subtracting current policy rate. Data Sources: Wellington Management and Refinitiv.

The focus from here will be on real growth. Higher jobless claims could signal a weaker employment and growth picture. On the other hand, lower inflation and looser financial conditions amid buoyant markets are helping sentiment, leading to tentative signs of improved activity. Ultimately, the Fed will need to guide policy to the unobservable neutral rate (the rate that neither restricts nor accelerates growth) and estimates there are in a wide range. The Fed's long-term terminal rate[9] gives us a clue: It's at 2.9%, around 200 bps from the current policy rate. That's quite a bit higher than what was considered neutral in the past and might be lower if the cycle weakens more than expected or even higher if inflation turns out to be structurally higher amid deglobalization, a shrinking labor force, increased government spending, and mounting costs related to the energy transition.

Credit: Still Checking Enough Boxes for a Moderately Overweight View

With central banks cutting rates, inflation receding, and growth on a good trajectory, the macro backdrop continues to be favorable for credit. Company balance sheets have stabilized and remain healthy, supported by a positive earnings season. We're past the peak in high-yield credit default rates, and more accommodative capital markets have made it easier for companies to refinance and term out liabilities, decreasing the impact of the maturity wall. This supply has been well absorbed by strong demand, as investors lock in an attractive all-in yield.

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We anticipate that spreads will remain rangebound in this environment. As a result, we believe income will primarily drive returns over the next year, with limited opportunity for spread tightening. We prefer high-yield credit over investment-grade credit; carry is more attractive in the former and likely to remain well supported by the healthy macro and fundamental backdrop.

We continue to see some risks for credit, which leaves us with only a moderately overweight view. The recent decrease in yields is beneficial for some companies looking to refinance, but low-quality companies need to see additional interest-rate cuts to avoid costly refinancing rates. This means some distress remains in the riskiest part of the high-yield market, but we expect it will dissipate as rate cuts materialize, which could provide spread tightening potential in a positive macro environment (**FIGURE 4**).

Some distress remains in the riskiest part of the high-yield market.

Regionally, we now have a neutral view, closing our preference for European high yield over EM high yield. We see a smaller return differential between the markets, with elevated risks around French fiscal policy and more Fed cuts providing a potential tailwind for EM assets.

FIGURE 4

Credit Spreads Are Tight but Distress Remains in CCC

Credit Spread Percentiles

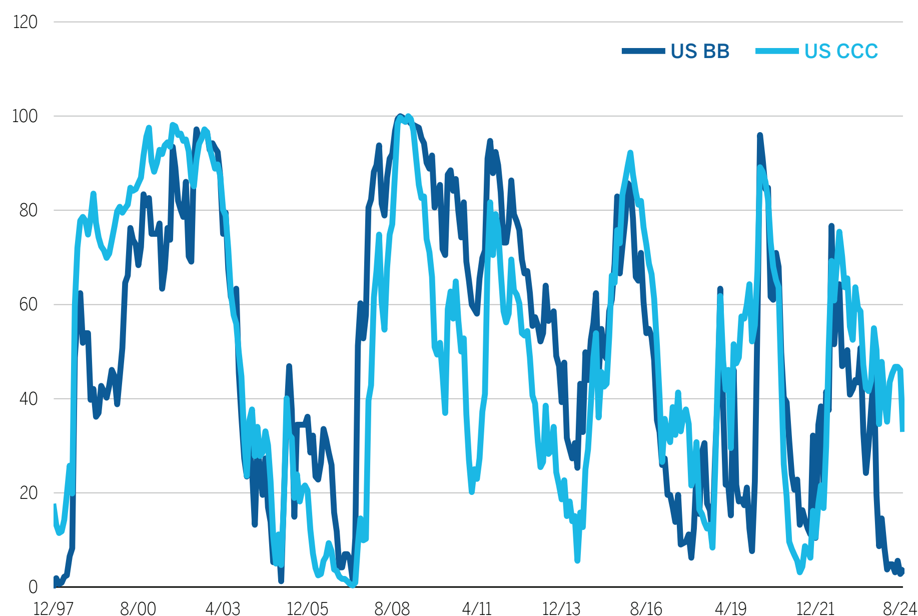

Chart data: 12/31/97-9/30/24. Data Sources: Wellington Management, Refinitiv, and ICE.

Commodities: Focused on Gold and Oil in a Volatile World

We maintain our moderately overweight view on commodities, driven by positive views on gold and oil—both of which may be effective diversifiers amid elevated geopolitical risk.

We believe gold prices can continue to be supported in 2025 as central banks cut policy rates, which is typically associated with more demand for gold. Central bank buying of gold remains strong, and we're now seeing increased retail demand in China and India, spurred by tax incentives.

We think recent price declines and a positive roll yield,[10] which reflects the lower cost of longer-dated futures, warrant a constructive stance on oil. However, our optimism is tempered somewhat by the possibility that additional supply could come into the market and weigh on prices.

Risks to Our Views

Downside risks to our views include a reacceleration in core inflation, leading central banks to push back against the current implied path for interest rates, and downside surprises in the earnings of mega-cap stocks. We're also keeping a close eye on the Middle East conflict. If it continues to escalate, it risks pushing oil prices up, leading to supply-chain frictions and increasing macro uncertainty.

Upside risks to our views include an upward inflection in the global-growth cycle together with a weaker US dollar. This scenario would lead to a catch-up for global laggards and stronger gains for risk assets. Another upside risk would be a scenario in which central banks cut rates faster than currently priced in if inflation declines more than expected. A final upside risk worth mentioning is a stronger-than-expected third-quarter earnings season, with expanding margins demonstrating productivity improvements.

Investment Implications

- **Consider sticking with global equity exposure** — With the Fed having launched the easing cycle with a strong start, we're more confident in a soft landing characterized by moderating growth and lower inflation. We think allocators may want to consider a risk-on tilt despite expensive valuations and political noise as we expect positive fundamentals and monetary policy to support earnings.
- **Expect further broadening in the equity rally** — We see upside potential in Japanese equities given that improved corporate governance should benefit earnings and that strong earnings expectations are already priced into the US market. US equities could see improved earnings prospects for areas outside of the US mega-cap tech stocks, which could benefit value, small cap, and some cyclicals. Among sectors, we favor financials, IT, utilities, and consumer discretionary over materials, staples, and communications.
- **Consider favoring credit over duration in fixed income** — Despite tight spreads, we continue to like credit for the carry, strong supply/demand technicals, and declining default rate, and we favor an overweight to high yield. We think 10-year US government bond yields will be rangebound around 3.25%–4.25%.
- **Consider a small allocation to commodities** — We see upside to gold and oil prices over the coming year. Geopolitics, retail demand in China and India, central-bank buying, and lower real rates could support further appreciation in gold. Oil could benefit from receding recession fears and low inventories.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

[1] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[2] According to the Sahm Rule, the early stages of a recession is signaled when the three-month moving average of the U.S. unemployment rate is half a percentage point or more above the lowest three-month moving average unemployment rate over the previous 12 months.

[3] A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

[4] A carry trade is any strategy where an investor borrows capital at a lower interest rate to invest in assets with potentially higher returns.

[5] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

[6] The Magnificent Seven stocks are a group of high-performing and influential companies in the US stock market: Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla.

[7] Reserve requirements are the amount of funds that a bank holds in reserve to ensure that it is able to meet liabilities in case of sudden withdrawals. It is a tool used by the central bank to increase or decrease the money supply in the economy and influence interest rates.

[8] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[9] The terminal federal funds rate is the ultimate interest rate level that the Federal Reserve sets as its target for a cycle of rate hikes or cuts. It is the longer-term target rate at which prices are stable and full employment is achieved.

10 Roll yield is the amount of return generated in the futures market after an investor rolls a short-term contract into a longer-term contract and profits from the convergence of the futures price toward a higher spot or cash price.

Bloomberg Global Aggregate Bond Index provides a broad-based measure of the global investment-grade fixed-rate debt markets.

MSCI ACWI Index is a free float-adjusted market capitalization index that measures equity market performance in the global developed and emerging markets, consisting of developed and emerging market country indices. MSCI index performance is shown net of dividend withholding tax.

Important Risks: Investing involves risk, including the possible loss of principal. Security prices fluctuate in value depending on general market and economic conditions and the prospects of individual companies. • Foreign investments may be more volatile and less liquid than U.S. investments and are subject to the risk of currency fluctuations and adverse political, economic, and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets such as China. • Investments in the commodities market may increase liquidity risk, volatility and risk of loss if adverse developments occur. • Investments linked to prices of commodities may be considered speculative. Significant exposure to commodities may subject the investors to greater volatility than traditional investments. The value of such instruments may be volatile and fluctuate widely based on a variety of factors. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • Investments in high-yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. • Small-cap securities can have greater risks, including liquidity risk, and volatility than large-cap securities. • Different investment styles may go in and out of favor, which may cause underperformance to the broader stock market. • Diversification does not ensure a profit or protect against a loss in a declining market.

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