

Investment Strategy Outlook

OCTOBER 2024

THE ECONOMY

The Wait Isn't Over, At Least Not For Us

In last month's edition, we noted that it would take some time to know whether the pace of economic activity is finally normalizing after the significant disruptions/distortions brought about by the pandemic and the policy response to it, as we believe to be the case, or whether something less benign is underway and will end in recession. The body of economic data released since then seems to suggest that the wait for the answer to that question wasn't so long after all, with generally stronger than expected data pointing to further normalization, if not reacceleration, in the pace of economic activity. We do not, however, think the recent run of seemingly solid data settles anything. To be sure, our premise remains the same, i.e., that the economy is normalizing back toward the trend rate of growth that prevailed over the decade prior to the onset of the pandemic. We simply think it far too soon to have a definitive answer.

The third estimate from the Bureau of Economic Analysis (BEA) shows real GDP grew at an annual rate of 3.0 percent during Q2, but the bigger news here is that the BEA's third estimate of Q2 GDP incorporated the results of their annual revisions to the recent historical data. The revised data show faster growth in both real GDP and real Gross Domestic Income (GDI) over the period from Q1 2019 through Q2 2024 than had previously been reported. For instance, real GDP is now reported to have grown by 2.5 percent in 2022 and by 2.9 percent in 2023, compared to prior estimates of 1.9 percent and 2.5 percent growth, respectively. The upward revision to real GDI was even larger, with growth in both personal income and corporate profits revised meaningfully higher.

At first glance, the September employment report would seem to allay concerns over the state of the labor market and the broader economy. Total nonfarm payrolls rose by 254,000 jobs in September, while prior estimates of job growth in July and August were revised up by a net 72,000 jobs for the two-month period, and September job growth was broadly based across private sector industry groups. At the same time, the unemployment rate fell to 4.1 percent. Indeed, in the wake of the release of the September employment report, some analysts went so far as to argue that the FOMC had made a mistake by cutting the Fed funds rate by fifty basis points at their September meeting and, as such, should keep the funds rate unchanged at their November meeting. And to think, it was only two months ago that, in the wake of a surprisingly weak July employment, many took to the airwaves to call for "emergency" Fed funds rate cuts on the order of fifty or seventy-five basis points.

As for us, we reacted to the September employment report as we react to each and every data release, which is to go to the details of the data to try and put the headline numbers into proper context. For openers, continuing a pattern that has plagued the employment reports since the onset of the pandemic, the initial collection to the BLS's September establishment survey was 62.2 percent, the lowest rate for the month of September since 2002. As we have been noting for far too long, these low collection rates lay a path for sizable revisions, either in subsequent months or in the annual benchmark revision process. Additionally, the upward revisions to prior estimates of job growth in July and August mainly

reflect upward revisions in the education segments of state and local governments, reflecting the difficulty in adjusting the data to account for changes in the timing of the school year from one calendar year to the next.

To us, however, the much bigger issue is that the September data are riddled with seasonal adjustment noise, which flattered the headline job growth number. In our preview of the September employment report, we noted that we thought there would be strong seasonal adjustment effects stemming from what we expected would be a smaller than normal September decline in private sector payrolls. We pointed to construction, retail trade, and leisure and hospitality services as potential sources of seasonal adjustment noise. That proved to be the case, with leisure and hospitality services the most obvious instance. The unadjusted data show payrolls in leisure and hospitality services fell by 471,000 jobs, a hefty decline to be sure but in percentage change terms this was smaller than the typical September decline. As such, the seasonally adjusted data show payrolls in this industry group rose by 78,000 jobs. We can point to similar, albeit smaller, effects in both construction and retail trade.

The reported decline in the unemployment rate is also a gift from seasonal adjustment. The entire increase in the labor force and nearly all of the increase in household employment in September are accounted for by those in the 16-to-24 year-old age cohort. This reflects nothing more than the not seasonally adjusted data showing much smaller than normal September outflows, which in turn are the flip side of much larger than normal August outflows, amongst this age cohort. This is merely another illustration of how changes in the timing of the school year from one year to the next can confound the seasonal adjustment process.

The one-month hiring diffusion index, a gauge of the breadth of hiring across private sector industry groups, rose to 57.6 percent in September, the highest reading since January. The diffusion index, however, measures the breadth, not the intensity, of hiring. In other words, though most industry groups continue to add jobs, they are doing so at a slower rate, and job growth remains highly concentrated amongst three industry groups – leisure and hospitality services, government, and health care. Through September, these three industry groups accounted for just over seventy percent of all nonfarm job growth in 2024. At some point, the pace of hiring in these industry groups will slow, which will have an outsized impact on overall job growth.

To the extent there is such a thing, we see the "truth" about labor market conditions as being somewhere between the July and September employment reports. More specifically, we think it is clear that the trend rate of job growth is slowing, but the weekly data on initial claims for unemployment insurance and the data from the Job Openings and Labor Turnover Survey (JOLTS) tell us that this remains a function of a slowing pace of hiring as opposed to a rising pace of layoffs. While the slowing pace of hiring has put some upward pressure on the unemployment rate, the bigger driver of the increase in the unemployment rate over the past several months has been notably rapid growth in the labor force, growth which at some

point we expect to slow.

Further cooling in the labor market is consistent with what we expect will be a pronounced slowdown in real GDP growth over the back half of 2024 extending into 2025. Growth in consumer spending is clearly slowing; while overall financial conditions in the household sector remain solid, lower-to-middle income households continue to feel financial stress from the cumulative effects of elevated inflation over the past few years. Moreover, the Conference Board's monthly survey of consumer confidence shows consumers taking an increasingly less favorable view of labor market conditions, which is likely weighing on discretionary spending amongst a broader range of households.

While the Institute for Supply Management's (ISM) Non-Manufacturing Index rose to 54.9 percent in September, the highest reading since February 2023 and suggesting continued expansion in the broad services sector, the ISM Manufacturing Index remains mired below the 50.0 percent break between contraction and expansion. Uncertainty over the outlook for fiscal, trade, and regulatory policy is contributing to malaise in the manufacturing sector, with many businesses having put capital spending plans on hold until there is some clarity on the policy front. This will limit the contribution from business fixed

investment to real GDP growth over the next few quarters.

Even with real GDP growth slowing and the labor market cooling, inflation is not going away quietly. The prices paid index from the ISM Non-Manufacturing Index continues to show steady, and broadly based, increases in prices for non-labor inputs across the services sector. At the same time, should the recent increases in crude oil prices in response to ongoing tensions in the Middle East stick, let alone intensify, the recent run of falling retail gasoline prices will likely reverse, meaning energy would contribute to headline inflation after having been a net drag over recent months.

In short, the paths of economic growth, the labor market, and inflation are far from clear, further complicating the FOMC's efforts to properly calibrate monetary policy. As we noted last month, it seems that each and every economic data release is being interpreted as though it provides definitive evidence of where the economy is heading. Given the mixed signals being sent by the various data releases, this is contributing to volatility in the equity and fixed income markets as well as rapidly shifting expectations around the path of monetary policy. This is something that may not change any time soon.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Institute for Supply Management; The Conference Board

STOCKS

September Better Than Feared, But Headwinds Remain

With the S&P 500 already higher by 19.5% year-to-date and this being a presidential election year, September kicked off many prognosticators, us included, voicing concerns that the month could live up to its historical billing as a challenging one for U.S. stocks. With the benefit of perfect hindsight, however, there was nothing to fear but fear itself, as the S&P 500 turned out a 2% gain during the month, while the S&P Mid Cap 400 and S&P Small Cap 600 eked out 0.9% and 0.6% returns, respectively. At month-end, over 75% of S&P 500 constituents were trading above their 50- and 200-day moving averages, a sign of broad market participation and a bullish market 'condition' leaving us relatively constructive on U.S. large cap stocks as October begins. That said, many hurdles remain between now and year-end.

The resiliency of the broader U.S. equity market and its ability so far to buck the trend of poor historical performance in September and October in presidential election years is most welcome. While we expect a customary year-end lift, as the November through January time frame has historically proven to be the best consecutive three-month stretch for U.S. stocks, we aren't out of the woods just yet. Negative seasonality in election years often persists into the back-half of October and is one reason to be on guard for a pullback in the lead-up to the election in November. But U.S. stocks have historically performed best amid divided government, which we see as the most likely election outcome.

Aside from seasonality and political uncertainty, rising Treasury yields and the quarterly earnings season could also potentially act as near-term hurdles for stocks. Yields on U.S. Treasuries rose sharply to start October as economic and labor market data forced investors to revisit their expectations of U.S. economic growth, inflation and, in turn, just how aggressively the Federal Open Market Committee (FOMC) may be willing or able to cut the funds rate in the coming months. Yields rising for the 'right' reason, i.e. an improving economic growth outlook, should be supportive of further gains for cyclical stocks/sectors, but valuations come under pressure and Treasury bonds would

become greater competition for capital should yields rise much above current levels with the 10-year yield around 4%.

Lastly, while it's no different than it is at the start of any other quarterly reporting season, it's worth mentioning that over half of S&P 500 constituents report this month and will be barred from repurchasing their own shares until after posting quarterly results. Consequently, corporations, which have been an active market participant and significant buyer of their own shares year-to-date, will be unable to step in and opportunistically prop up prices should volatility ramp up and their own shares drop. Taken together, these potential market headwinds aren't reason enough to reallocate out of stocks and into less risky assets, in our view, but are reason to temper expectations over the coming weeks, albeit with the knowledge that investors will likely be well served to lean into any near-term weakness in U.S. stocks in preparation for a year-end relief rally.

Emerging Markets Making A Strong Case For Investor Capital. Historically, exposure to Chinese stocks has been a source of volatility for equity portfolios with high peaks and deep drawdowns expected, but from our viewpoint, the China rebound theme can be accessed without concentrating exposure to EM behind the Great Wall. Last month, the MSCI Emerging Markets Index advanced by 5.7%, more than doubling the S&P 500 in September, a welcome advance with gains broad-based and not just driven by China, as 20 of the 28 countries represented in the index generated a positive return on the month. Underlying market breadth also improved with 80% of the stocks in the EM Index finishing the month above their 200-day moving average, a three-year high and a marked improvement from 52% at the start of the month. When drawing parallels to China, the MSCI Emerging Markets Index may not present the same rock-bottom valuation but does trade at a relatively attractive 12.1 times forward earnings with earnings growth over the next year projected to be approximately 31%. That earnings growth estimate will likely prove to be too high, in our view, but we still see a path to substantial year-over-year earnings growth in the coming year as central banks make

monetary policy less restrictive. This should help relieve some of the strain on emerging market currencies, allowing EM issuers to pay down debt at a lower cost while improving global liquidity that will need to be deployed, potentially into riskier asset classes with a higher expected return, such as emerging market stocks. A tectonic shift in investor sentiment due to China’s stimulus and the promise of further action to come has generated sizable returns for investors in EM in a short period of time, but a period of consolidation or sideways prices allowing emerging market stocks to digest the gains from recent weeks with breadth remaining at/near current levels should set up a sustainable trend higher.

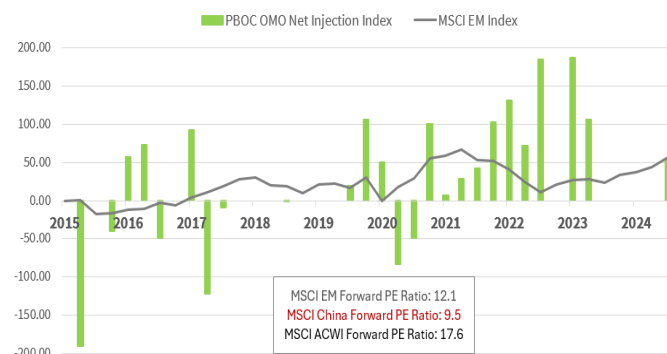
Emerging Market Breadth Improves To 3-Year High



China’s Stimulus Efforts Are A Good Start, But Skepticism Is Still Warranted. Country leadership within the MSCI Emerging Markets (EM) Index made an about-face in September as China announced a long-awaited wave of stimulus measures aimed at rebooting the economy, a series of moves that pushed the nation’s equities to make up for lost time, with the MSCI China Index jumping 20.7% during the month. The September surge in Chinese stocks propelled China into second place in the MSCI EM country rankings year-to-date between first-place India and third-place Taiwan, and the MSCI EM Index has closed what was a wide performance gap versus global stocks in a big way, with a 17.1% year-to-date return, while the MSCI All-Country World

Index returned 19% over the same time frame. The parabolic move in Chinese stocks has investors rightfully asking: “is this another head fake to be sold, or a sign of more upside to come?” While the break above year-to-date highs for Chinese stocks shouldn’t be ignored, the initial surge can be chalked up largely to short-covering as short interest in the some of the most heavily traded Chinese indices and fund proxies was closing in on 5-year highs midway through September. Prices of Chinese stocks appear to now be pricing in a pronounced policy pivot and potentially even quantitative easing (QE) out of the People’s Bank of China (PBoC), tethering their hopes to the belief that additional stimulus of some sort is still in the pipeline as promised by regulators, but whether or not there will be additional measures aimed at reviving the Chinese consumer will be the true test of the government’s resolve. Investors should not easily be convinced recent stimulus efforts will be successful, or sustained for that matter, and we would like to see the MSCI China index sustain recent gains over the coming weeks/months as a sign that institutional investors are finally willing to buy and not just rent exposure to stocks tied to one of the least shareholder friendly nations in the world. While we remain China skeptics for now, the country’s stimulus efforts serve to raise the floor on global growth to some degree which should improve sentiment surrounding EM broadly, leaving us relatively constructive on emerging market stocks and bonds.

China Stimulus Historically Helpful For Broader Emerging Equities



BONDS

Treasuries And High-Grade Corporates Hold Greater Appeal After Recent Back-Up In Yields

After five consecutive positive months out of the Bloomberg Aggregate Bond index, Treasury yields were strongly hinting at a potentially pronounced economic slowdown as October began. However, those fears have faded as more recent economic and labor market data point to an orderly slowdown back toward pre-COVID trends, not an economy at risk of a recession. As a result, market participants have been forced to ratchet up their economic growth and inflation expectations, thus putting upward pressure on yields across the Treasury curve. At the time of this writing, the 10-year yield is now back above 4%, a level last seen in late July, providing investors looking to lock in longer-term yields with a far more appealing income stream relative to the yields closer to 3.6% seen in mid-September closer. The move higher in

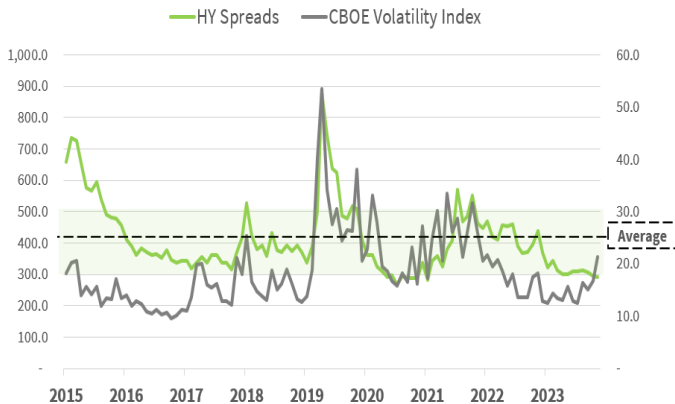
Treasury yields has pulled corporate bond yields higher as well, and the Bloomberg Investment Grade Corporate Index now carries a yield-to-worst of just shy of 5%. That yield-to-worst may not seem too impressive given where even money market yields have been over the trailing 12- to 18-months. But, with the FOMC expected to cut the funds rate further in the coming months, investors looking to lock in yields a few years out at/ around the current Fed funds rate may find a lot to like in higher quality corporate bonds. It’s worth mentioning that with a yield just shy of 5% at present, investment-grade corporate bonds are one of the few segments of the fixed income market with a current yield above the 30-year average for the asset class, even if it is by just a handful of basis points.

October Volatility Could Bring About Better Valuations, Opportunities In High Yield. September was a rocky month for high yield corporate bonds but falling U.S. Treasury yields contributed to a 1.6% gain for the Bloomberg U.S. Corporate High Yield Index as credit spreads round-tripped and ended the month virtually unchanged. Treasury yields have reversed course and moved higher so far in October while interest rate volatility has also contributed to elevated equity volatility with the CBOE Volatility Index, or VIX, rising to above 20 to start the month, evidence of increased demand for put options to hedge against a drawdown in stocks. Interestingly, while equity volatility has increased, which tends to happen when investors fear a selloff and risk appetite wanes, high yield bonds have held up surprisingly well amid the turmoil. The credit spread over comparable duration U.S. Treasuries for the U.S. Corporate High Yield Index was just 283-basis points at the time of this writing, a year-to-date tight level and evidence that investors still require little in the way of compensation for taking credit risk in the current environment. With quarterly earnings season beginning and less than one month remaining until election day, we expect volatility in stocks to remain elevated in the near-term, which could bring about wider credit spreads and a modest improvement in valuations for higher yielding corporate bonds.

Emerging Market Debt Still An Appealing Option, But Total Return Potential More Limited From Here. The Bloomberg Emerging Market (EM) USD Aggregate Bond Index returned 1.7% during September, taking its year-to-date total return to 8.1% and its trailing one-year total return to a jaw-dropping 16.9%, with the index outperforming the Bloomberg U.S. Corporate High Yield index over each time frame. After such a sizable year-to-date gain and an equity-like trailing one-year return, it's reasonable to ask how much upside might be left from exposure to this 'non-core' segment of the fixed income market and whether investors would be best served to take gains and look elsewhere for bargains. For context, the yield-to-worst on the Bloomberg EM USD Agg was 8% at the end of the Q3 2023 and 7% at the end of last year, well north of 6.28% as September ended. The yield-to-worst on an index provides a reasonable baseline for expected forward return, but when it comes to credit-sensitive and liquidity-reliant segments of the fixed income market such as high yield corporate bonds and emerging market debt, one must also take default expectations into account. In this case, the fundamental outlook for USD-denominated emerging market debt has improved over the past year.

Issuers such as Argentina, Brazil, and Saudi Arabia, among others, who make up a meaningful portion of the EM USD index have convinced market participants that they will rein in spending and be better stewards of investor capital moving forward and have seen their bonds rally as a result. With some of the largest issuers of EM debt expected to be in better fiscal shape, investors have ratcheted their expected return for the asset class higher, and with ample global liquidity finding its way into higher yielding assets, EM debt is on pace to exceed our lofty expectations for the asset class at the start of this year. With the EM USD Agg Index yielding 6.28% at month-end, we expect to squeeze another 1.5% or so out of the asset class between now and year-end, but credit spreads could narrow as sentiment improves, particularly should China follow up with additional stimulus measures, and the index could do a bit better than we expect when all is said and done. However, gains have been pulled forward with the asset class effectively generating two years of expected returns over the trailing twelve months, and with a yield-to-worst approximately 175-basis points below where it was one year ago, investors likely need to temper expectations for EM debt going forward.

Near-Term Volatility Could Bring Discounts In High Yield



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