Commentary

Quarterly Market Update: Third Quarter 2024

Executive summary

THE FOLLOWING IS AN EXECUTIVE SUMMARY FOR THE "QUARTERLY MARKET UPDATE: THIRD QUARTER 2024" REPORT BY FIDELITY'S ASSET ALLOCATION RESEARCH TEAM

Dirk Hofschire, CFA
Director of Asset Allocation Research

Jake Weinstein, CFA
Senior Vice President, Asset Allocation Research

Azize Engin
Research Associate, Asset Allocation Research

Justine Jonathan
Research Associate, Asset Allocation Research

Market summary: Low volatility and stable economics fueled a narrow rally for stocks

A rally for equities continued in the second quarter of 2024, once again led by large cap growth stocks. The global backdrop for the economy and earnings growth remained largely constructive, underpinning a period of relatively low market volatility.

The global business cycle exhibited reasonably healthy stabilization trends across geographies. Disinflation trends and the move toward monetary easing continued around the world, despite persistent core inflation in the U.S.

Mixed trends in Q2: U.S. growth stocks, as represented by the Russell 3000® Growth Index, advanced 7.8% for the quarter, largely driven by the information technology and communication sectors. After a steep downturn in 2022, the share prices of the largest seven U.S. companies by market capitalization have nearly tripled since the start of 2023.

Other categories of U.S. and non-U.S. equities finished mixed. Emerging-market stocks managed a healthy gain, whereas U.S. value stocks and U.S. small cap stocks each posted a quarterly loss.

Fixed income assets posted generally flat returns amid a modest uptick in interest rates.

Continued stability overall: Global markets continue to enjoy favorable momentum and easier financial conditions, even though the pace and magnitude of global monetary easing remains uncertain.

The base case for a prolonged cycle implies a near-term preference for more economically sensitive assets, but upside surprises may be more difficult amid the stubborn inflation outlook and elevated valuations for riskier assets.

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Economy/macro: A prolonged global business cycle expansion

Many major economies, including the U.S., demonstrated persistent expansion amid improved global financial conditions and firmer manufacturing activity, even as the global environment became more varied.

The U.S. expansion demonstrates evidence of both mid- and late-cycle dynamics and muted near-term recession risks. Several large developing economies—India, Mexico, and Brazil—showed a rise in mid-cycle dynamics. Japan and Europe remained solidly late-cycle, while Canada showed increasing recession risks. China's policymakers remained in easing mode. China's cyclical trends are mixed, and it remains uncertain whether policy easing will translate into a full-blown economic reacceleration.

Global manufacturing momentum appeared to broaden across a wider swath of countries during Q2. Manufacturing activity improved, moving into expansionary territory across a majority of the world's largest economies for the first time since 2022.

Manufacturing bullwhips—leading indicators of industrial activity measured by new orders minus inventories—remained in positive territory for more than 60% of the world's biggest economies.

What about inflation? Global goods disinflation continued to moderate. Meanwhile, inflation pressures that tend to be more persistent, such as housing and other services, haven't abated in recent months and drove most of the recent inflation. Transitory pressures, such as supply-chain disruptions, had receded, but have now stabilized as the major disinflation in the goods sector subsided.

Services inflation, likely boosted by wage pressures, remained stubborn, while rental disinflation remained slow, underscoring the continued persistence of core inflationary pressures.

We believe returning to the stable, low core-inflation backdrop of the past 20 years will be challenging.

Fewer rate cuts are expected: During the June FOMC meeting, the U.S. Federal Reserve bumped up its inflation forecast and reduced its outlook for 2024 to one cut from three. The market followed suit, reducing its rate-cut expectations for the second straight quarter.

Historically, asset prices rallied during the period between the last hike and the first cut, with a more uncertain path for stocks after the Fed cuts began. So far this time, stocks and bonds have posted positive returns since the last Fed hike, with stock performance at the upper end of its historical range.

What about jobs? Job creation, worker sentiment, and wage increases moderated in Q2, indicating a slowing in labor demand.

However, employment markets remained historically tight, and some key indicators are still near peak pre-pandemic levels. On the supply side, the rally in participation rates has stalled, and our demographic estimates imply there may be fewer opportunities for labor force growth going forward. To this point, we characterize labor market activity as normalizing from high levels but not decisively turning disinflationary.

Investment growth continues: The growth in business investment and labor-market productivity remained in an upswing. Capital expenditures (CapEx) likely received a boost from artificial intelligence (AI) projects and domestic manufacturing reshoring, with new factory construction boosting investment in structures.

If sustained, growth in CapEx and productivity could provide a disinflationary path for increased wages and profits that may raise the odds of returning to mid cycle. However, new investments often take multiple years to sustainably raise productivity rates.

Looking ahead to November: The November elections will determine who decides how to address the $4.5 trillion of 2017 personal income tax cuts that expire at the end of 2025.

The fiscal deficit is expected to remain large over the next several years (6%–7% of GDP), in part due to rising interest rate payments on federal debt. Interest

payments are set to grab an even larger share of deficits over the next several years even if rates don't rise, making fiscal choices even more politically difficult. Bond markets may watch the fiscal situation closely in 2025.

Asset markets: Q2 2024 shows mixed results by category

Global equity returns were positive during Q2. However, the rally was relatively narrow.

Stock prices: Growth and large caps added to their gains in the second quarter, whereas value (-2.3%), small caps (-3.3%) and mid caps (-3.3%) each posted a negative return for Q2.

Among U.S. equity factors, momentum (+5.8%) and quality (+4.5%) rose the most during Q2, whereas size (-2.6%) lost slight ground.

Outside the U.S., emerging market stocks led the way for the quarter, especially emerging-market Asia. Conversely, Japan, Canada and the EAFE region each recorded a negative return.

Valuations became somewhat more expensive amid the Q2 stock rally, especially for the U.S. The trailing one-year price-to-earnings (PE) ratio for U.S. stocks remained well above its long-term average. Emerging markets trailing valuations are slightly above their long-term average, while DM finished below the long-term average.

Fixed income: Riskier fixed-income categories, such as leveraged loans (+1.9%) and high yield (+1.1%) gained, whereas U.S. Treasuries, mortgage-based securities, and municipal bonds each returned flattish results.

Treasury rates rose modestly during Q2, with most fixed-income categories ending with yields near their long-term historical averages. Meanwhile, credit spreads ticked up in most sectors, generally ending the quarter around the lower end of their historical range.

Overall, fixed income yields suggest valuations that are roughly in line with long-term averages and better than the past decade of low yields.

Earnings: Investors continued their optimism for 2024 earnings. After contracting modestly in 2023, investors expect a double-digit rebound for corporate earnings growth in 2024 and beyond.

Buybacks remain a tool to boost aggregate EPS but have been highly concentrated. The largest 20 companies by market capitalization accounted for half of all buybacks this year.

After dropping from record-high levels, profit margins have stabilized. Investors expect margins to remain elevated, but the ability of companies to maintain pricing power will be key to the outlook.

Currencies: The dollar rally extended through Q2, continuing a multiyear trend of relative outperformance underpinned by strong U.S. economic growth.

However, there are some signs that the degree of U.S. economic outperformance is no longer supporting the value of the dollar at the same rate. With the dollar expensive according to long-term valuation metrics, major non-U.S. currencies could provide portfolio diversification benefits to U.S. investors.

Authors

Dirk Hofschire, CFA
Director of Asset Allocation Research

Jake Weinstein, CFA
Senior Vice President, Asset Allocation Research

Azize Engin
Research Associate, Asset Allocation Research

Justine Jonathan
Research Associate, Asset Allocation Research

The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation..

Fidelity Thought Leadership Vice President Mike Tarsala provided editorial direction for this article.

Indexes: U.S. growth stocks—Russell 3000® Growth Index; U.S. equities and U.S. large cap stocks—S&P 500®; Non-U.S. equities—MSCI EAFE Index; Emerging-Market Stocks—MSCI EM Index; High-Yield Bonds—ICE Boa High Yield Bond Index; EAFE (Europe, Australasia, and the Far East)—MSCI EAFE Index; Japan—MSCI Japan Index; Canada—MSCI Canada Index; Value—Russell 3000® Value Index; Small Cap—Russell 2000® Index; Mid Cap—Russell Midcap® Index; Leveraged Loan—S&P/LSTA Leveraged Loan Index; High Yield—ICE BofA U.S. High Yield Index; Treasuries—Bloomberg U.S. Treasury Index; MBS (Mortgage-Backed Securities)—Bloomberg MBS Index; Municipal bonds—Bloomberg Municipal Bond Index.

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