Goldman Sachs

SEPTEMBER 2024

Summer Review, Fall Preview

Goldman Sachs Ayco

Portfolio Strategy & Investments

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In our *Summer Review, Fall Preview* we recap key economic and financial market news from the summer and outline the Goldman Sachs Wealth Management Investment Strategy Group's (ISG) expectations for the rest of the year on the US economy, fixed income, and equities.

July was mixed for equities, with the S&P 500 reaching a new all-time high on July 16 before ceding most of its monthly gains in the second half. August performance was mixed too. The stock market sold off at the start of the month, experiencing the largest one-day drop of the year and spiking volatility on August 5 due to softer US economic data, notably a rise in the unemployment rate. That said, in the second half of the month, equities recovered to end up for the month following a string of better-than-expected economic data. Meanwhile, bond yields moved sharply lower over the summer months, particularly at the short end of the curve, as market participants gained greater confidence in the probability of the US Federal Reserve (the Fed) starting its rate cutting cycle in September.

Looking ahead to the rest of the year, key focus areas for investors remain US economic data, the Fed's easing cycle, and the outcome of the US election in November.

Summer Recap: Review of Financial Markets in July and August

Highlights From July...

July was a month of two halves for the markets. The first half saw the S&P 500 continuing to rise, reaching new all-time highs on July 16. The second half saw a pullback, led by a sell-off of technology stocks. That said, the S&P 500 still managed to end the month in positive territory with a 1.1% gain, outperforming the MSCI Emerging Markets Index, which fell by 0.1%, though lagging the remainder of the developed market universe as the MSCI EAFE Index gained 2.9%.

Turning to fixed income, in July the US yield curve bull-steepened — meaning short-term rates fell faster than long-term rates. The 2-, 10- and 30-year treasury yields fell by 49, 37, and 26 basis points respectively, as markets began to gain confidence the Fed would cut rates in September following softer inflation data.

On central bank monetary policy, both the Fed and European Central Bank (ECB) held interest rates steady at their July meetings, in line with expectations. Fed Chair Jerome Powell said a rate cut was “on the table” in September, while the ECB remained non-committal on its future path for interest rates. The Bank of Japan (BoJ) surprised analysts and hiked its policy rate from 0-0.10% to 0.25%.

In commodity markets, oil prices reversed most of their June gains. Gold hit a new all-time high, closing the month up ~5%.

Economic data for the month was mixed. Headline payrolls (released early August) slowed to 114k in July from 179k in the prior month, with private payrolls also slowing to 97k from 136k. Meanwhile, Q2 GDP came in at 2.8% annualized growth (later revised higher to 3.0%), above the 2.0% expectations.

Highlights From August...

August was a turbulent month for equities across markets, driven by a miss in the July non-farm payroll data (as mentioned above) and an increase in the unemployment rate that triggered the "Sahm Rule"[1]. The Bank of Japan's (BoJ) hawkish rhetoric added fuel to the fire, as markets experienced a substantial unwind in popular carry trades that had built up over past years as a result of the BoJ's accommodative monetary policy stance. The combination of a sharp strengthening in the yen and global growth fears saw Japanese equities, as measured by the Topix Index, fall by more than 20% over three trading days. The S&P 500 was not immune to the market volatility, falling by 6% to start the month and declining 8% from its peak on July 16. The VIX Index, often coined the market's "fear gauge", hit an intra-day high of 66 amidst the market stress — a level only surpassed during the COVID-19 pandemic and the Global Financial Crisis, based on data since 1992. Bond yields fell sharply during the turmoil as the market focused its attention on weaker growth. This helped cushion the fall in equities, before remaining relatively steady throughout the latter half of the month. Fears subsided by the end of August, following a string of better-than-expected US data releases. The S&P 500 also recovered, ending the month close to its all-time-high reached in mid-July. The VIX Index ended the month below its long-term average.

The annual Jackson Hole Economic Policy Symposium was held toward the end of August, with Chair Jerome Powell stating that "the time has come for policy to adjust" and that the "timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks." ISG's base case remains that the Fed will cut by 25 basis points per meeting for the rest of this year, totaling 75 basis points.

Finally, the majority of S&P 500 reported second quarter earnings by the end of August. Consensus S&P 500 12-months earnings estimates continued their upward trajectory through the reporting period. The current yearly change in consensus S&P 500 next 12-months earnings estimates is 11.5%, standing above the historical median of 6.8%.

[1] The "Sahm Rule" is an economic indicator used to identify recessions that uses the change in the three-month average of the unemployment rate from its low point in the prior 12 months.

Fall Preview: Expectations for the Rest of the Year

US Economic Outlook

Growth

US economic activity was strong in the first half of 2024 despite slowing slightly from the rapid pace seen in the second half of 2023. The continued resilience of the US economy has led ISG to revise up their 2024 GDP forecast this year. ISG now sees growth on track to reach 2.6% this year (broadly in line with the good case scenario projected in their 2024 Outlook and compared to a base case expectation of 1.9% at the start of the year).

While resilient, the US economy has begun to show some signs of softening, particularly in consumer spending. For example, personal consumption expenditure growth softened to a pace just above 2% in the first half of this year from around 3% in the second half of 2023. However, the moderation in activity should remain gradual, as continued jobs growth, healthy US consumer balance sheets, and expected Fed rate cuts continue to drive the expansion.

Recession Odds

The rise in the US unemployment rate, which stands at 4.2% in August, has rekindled recession fears, particularly after the rise triggered the "Sahm Rule".[2] These worries reflect the historical tendency for rising unemployment to catalyze an economic downturn as increasing layoffs lead to less spending, and in turn, further layoffs.

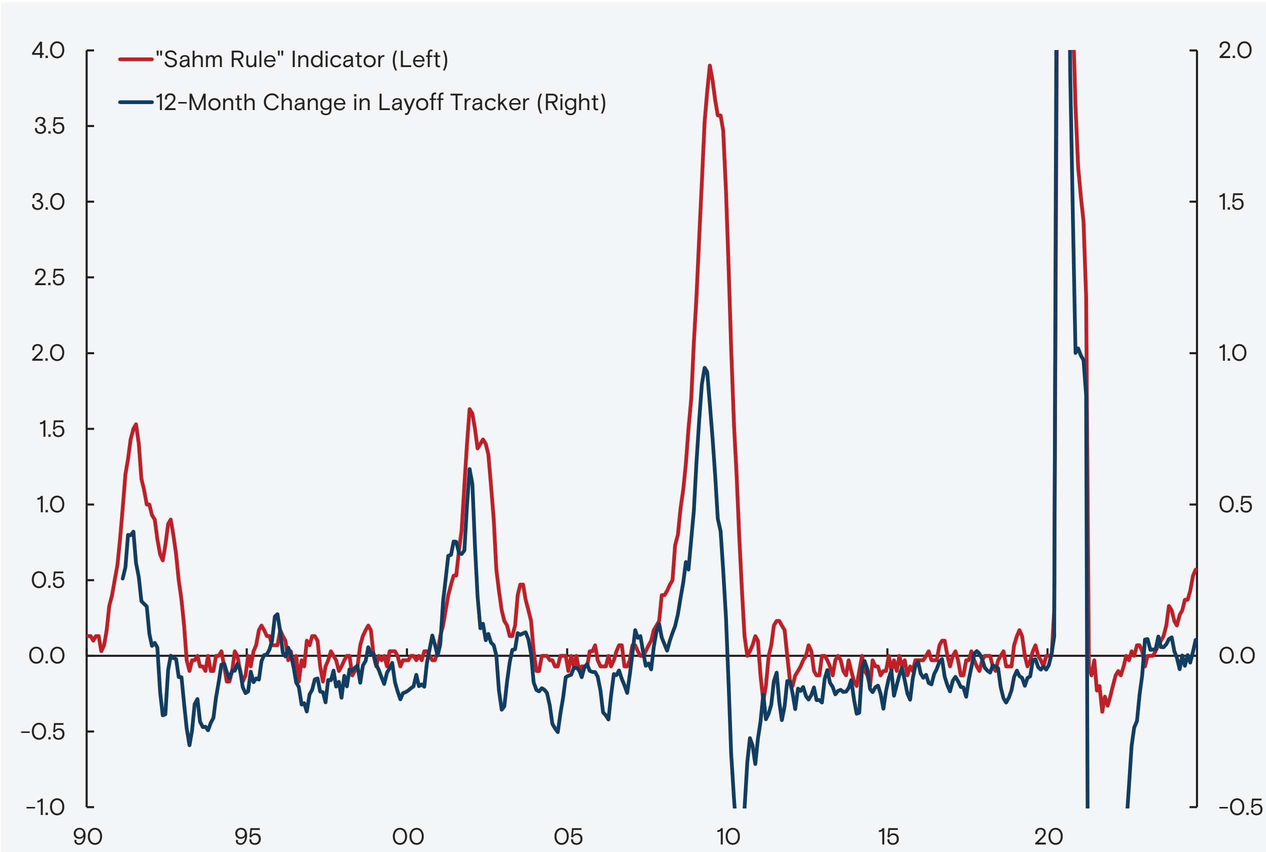
ISG's probability of a US recession over the coming 12-months has remained elevated at 30% since the start of the year, higher than the 18% unconditional odds since WWII and 13% odds since 1980. These elevated odds reflect the fact that historically reliable leading recession indicators — such as rising unemployment and inverted yield curves — still imply greater risks than normal for the longevity of the business cycle.

That said, there are several reasons why recession is still not ISG's base case:

1. **Rising Unemployment is Being Driven by Labor Supply More Than Layoffs.** Unlike past episodes, the increase in the unemployment rate has occurred alongside a sudden expansion in labor supply. This has been driven by a surge in immigration over 2022-2023, rather than a sudden drop in labor demand and spiking layoffs. ***Exhibit 1*** shows a divergence today where layoffs have been broadly flat over the past year, despite rising unemployment. This is a critical distinction as fewer layoffs implies less of a headwind to spending which would typically precede a recession.

[2] The "Sahm Rule" is an economic indicator used to identify recessions that uses the change in the three-month average of the unemployment rate from its low point in the prior 12 months.

Exhibit 1: "Sahm Rule" Indicator Versus 12-Month Change in Layoffs

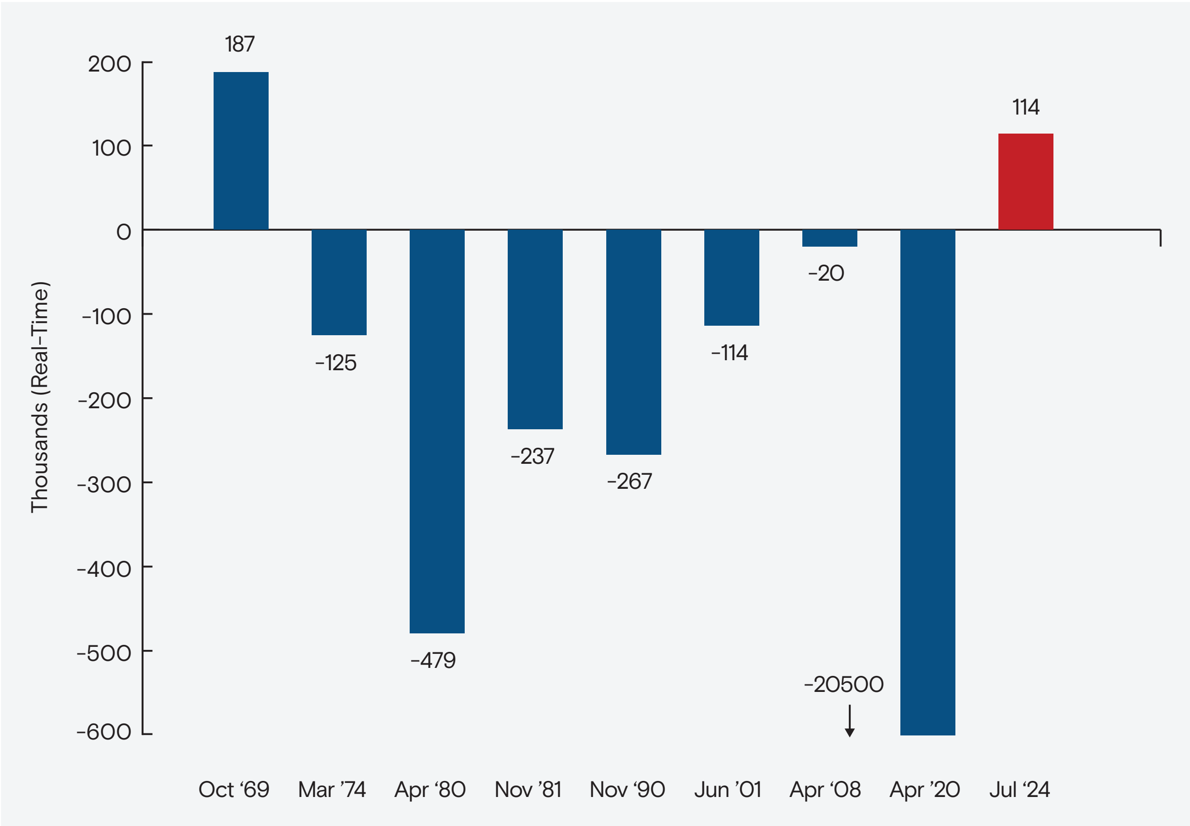


Note: The layoff tracker is an average of initial claims, JOLTS layoff rate, and employed to unemployed flows, expressed as z-scores.
Source: Goldman Sachs Wealth Management Investment Strategy Group, Bureau of Labor Statistics, Haver Analytics.

2. Other Economic Indicators are Stronger Than Past Periods When the “Sahm Rule” Triggered. Considering the muted growth in layoffs, it is perhaps unsurprising that other labor market indicators look relatively healthy. For example, the change in non-farm payrolls was already negative in seven of eight of the past episodes when the “Sahm Rule” rose above 0.5%, whereas July payrolls grew by 89k and August payrolls, released on September 6, grew by 142k (*see Exhibit 2*).

3. Other Real Time Recession Models Have Not Triggered. Keep in mind that the “Sahm Rule” is not the only recession indicator with a proven track record. The other historically reliable indicators which ISG tracks are not corroborating the warning from the ”Sahm Rule”.

Exhibit 2: Change in Nonfarm Payrolls



Source: Goldman Sachs Wealth Management Investment Strategy Group, Bureau of Labor Statistics, NFIB, Haver Analytics.

Inflation

Inflation proved stickier than expected at the beginning of the year, though reports through the summer — as measured by the consumer price index (CPI) — have shown inflation is cooling. If recent monthly core CPI prints were annualized, core inflation would be consistent with inflation at the Fed's 2% target.

Given stickier than expected inflation in the early part of the year, ISG now expects annual core PCE inflation (personal consumption expenditures) to hover around 2.6-2.8% in the second half of 2024 — higher than the 2-2.5% range they had expected at the beginning of the year.

Monetary Policy

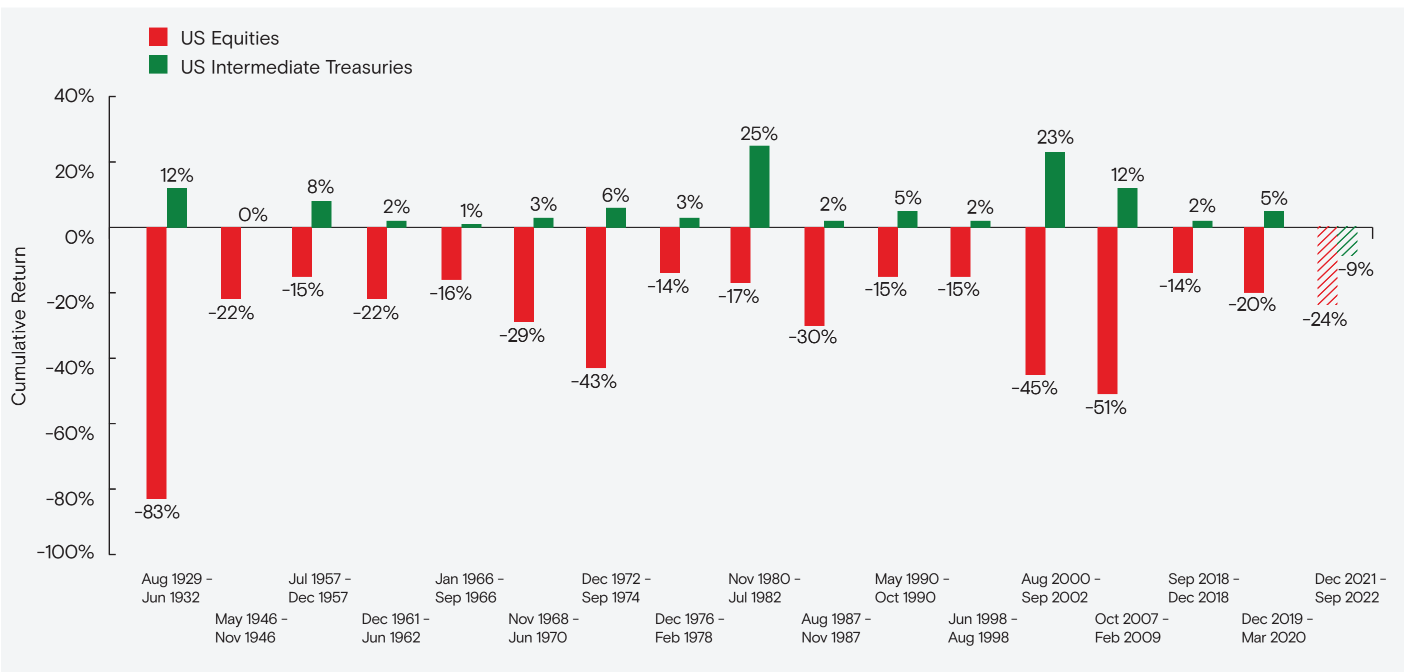
ISG's base case expectation is now for three, 25-basis-point rate cuts this year, starting in September. Stickier inflation data from the first half of 2024 delayed ISG expectations for the start of the cutting cycle. ISG initially tempered their expectations for cuts down to two this year, before increasing to three following weaker recent employment data. Further labor market weakening would likely prompt deeper and quicker cuts.

US Fixed Income Outlook

With still elevated recession odds — recall ISG assign a 30% probability to a US recession in the next 12 months — the role of duration in a portfolio becomes even more important. Although expected returns for cash and Intermediate Treasuries are similar through year-end, duration provides superior expected returns in scenarios with negative growth shocks. In fact, high-quality fixed income is the only asset class that has effectively hedged against deflationary shocks in the past. Of note, bonds rose in value in all but one of the large equity downdrafts in the last 100 years, providing a valuable source of diversification (*see Exhibit 3*).

ISG continues to recommend that clients stay invested in high-quality fixed income in line with their strategic duration target, which is four years for a US taxable moderate portfolio. ISG expects the US 10-year bond yield to end the year at a target range of 3.80-4.20%.

Exhibit 3: Performance of Bonds and Equities During US Equity Drawdowns

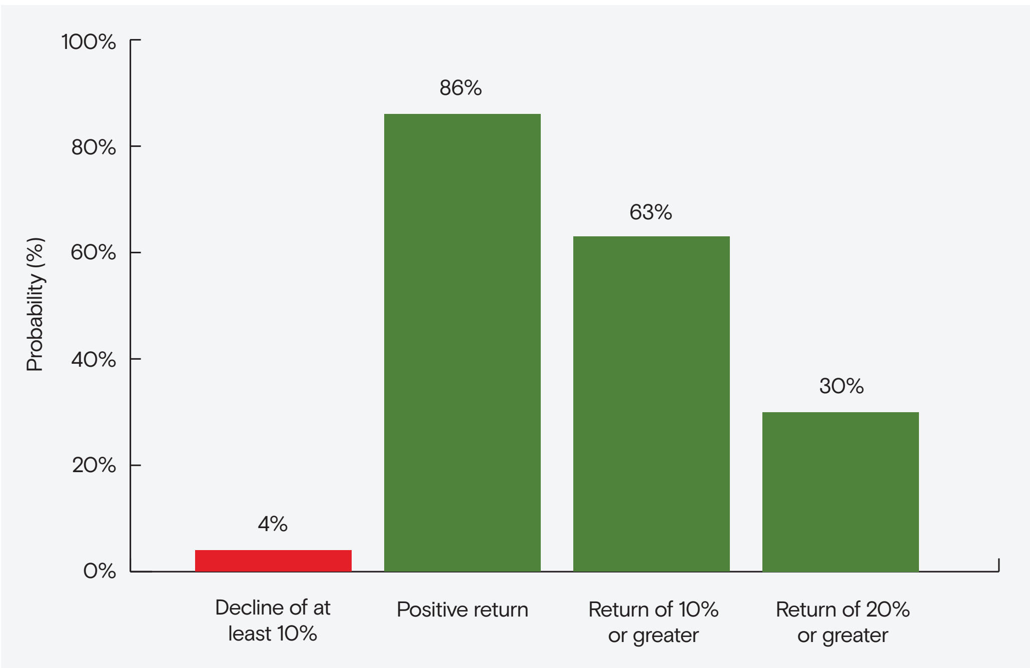


Past performance is not indicative of future result, which may vary.
Bonds are modeled using US Intermediate Treasuries. Equities are modeled using S&P 500 Index.
Source: Goldman Sachs Wealth Management Investment Strategy Group, Datastream, Ibbotson, Global Financial Data.

US Equity Outlook

ISG continues to recommend clients stay invested in US equities at their customized strategic asset allocation weight for several reasons. First, the macroeconomic backdrop remains supportive for equities. During past economic expansions, US equity markets have been much more likely to generate a positive return. In fact, since 1945, in years when the economy was expanding, the S&P 500 has generated a positive annual total return 86% of the time, and a 20% or greater total annual return about 30% of the time (*see Exhibit 4*). According to ISG, these favorable odds significantly raise the hurdle of underweighting stocks absent an imminent recession view that has not already been priced in.

Exhibit 4: Odds of Various S&P 500 One-Year Total Returns During US Economic Expansions[3]



Past performance is not indicative of future result, which may vary.
[3] Based on data since 1945. Source: Goldman Sachs Wealth Management Investment Strategy Group, Bloomberg.

Moreover, corporate fundamentals are equally supportive. Consensus earnings estimates over the next 12 months have resumed their upward trajectory, after declining or stagnating during much of 2022 and 2023. ISG continues to estimate an 8-10% earnings growth this year. Since the market ultimately follows the path of earnings, improving earnings provide fundamental support to the advance of the S&P 500.

Of course, some of this good news is already reflected in today's valuations, which have been cheaper than current levels at least 90% of the time historically. However, history has repeatedly shown that high valuations alone are not a sufficient reason to underweight stocks. The initial price-to-earnings ratio has explained only 6% of the variation in returns over the next year. During periods of elevated valuations in the past, investors have still achieved substantial subsequent returns and there can be a penalty for exiting equities prematurely (*see Exhibit 5*).

Exhibit 5: S&P 500 Forward Returns After Crossing 9th & 10th Deciles of Valuation

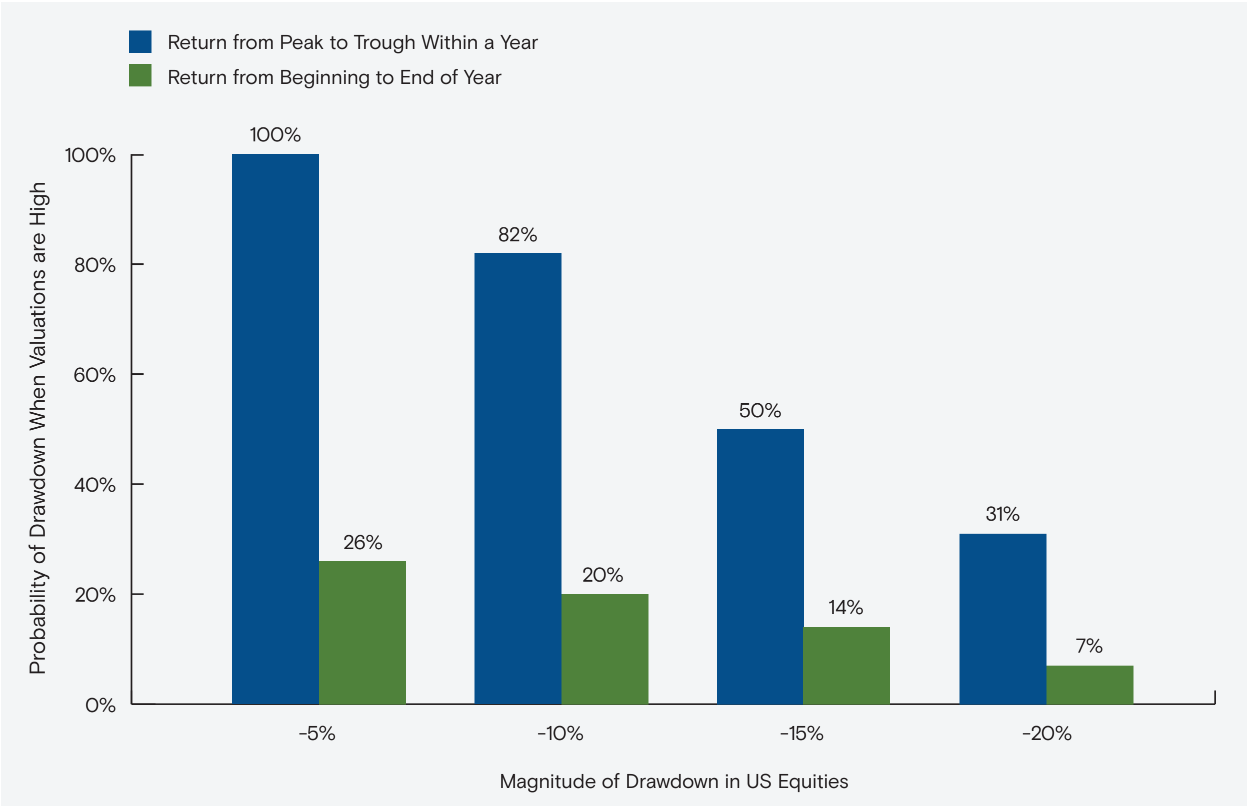
Source: Goldman Sachs Wealth Management Investment Strategy Group, Bloomberg.

Volatility, Pullbacks & Risks

ISG's recommendation to stay invested in US equities does not preclude occasional market pullbacks, which can happen at any time. Pullbacks of approximately 5-10% — the most recent of which occurred this summer from peak levels on July 16 — represent normal equity volatility, rather than a compelling reason to underweight stocks. In fact, the odds of a 10% pullback during a year are greater than 80% when valuations are elevated like they are today (*see Exhibit 6*). But the likelihood of that loss persisting through year-end is significantly lower at 20%, suggesting most pullbacks ultimately resolve in higher prices.

ISG acknowledges there are many risks to the outlook, notably geopolitical and political risks, that could alter the course or lead to volatility. ISG recommends portfolios be positioned at their customized strategic asset allocation, where they are designed to ride out volatility and provide staying power in the event of market disruptions or declines.

Exhibit 6: S&P 500 One-Year Drawdown Probability from 9th or 10th Decile of Valuations, Excluding 2017



Past performance is not indicative of future result, which may vary.
Source: Goldman Sachs Wealth Management Investment Strategy Group, Bloomberg.

Conclusion

ISG recommends clients stay invested in a well-diversified portfolio at their long-term strategic asset allocation consistent with their risk tolerance.

ISG also continues to recommend an overweight to US assets in their customized strategic asset allocation relative to market capitalization benchmarks, given their long-standing view of US preeminence. According to ISG, the drivers that underpin US preeminence are intact — including the resilience of US institutions, economic strength supported by abundant natural resources, human capital advantages, and a vibrant, innovative, and efficient private sector. These factors are set to persist into the foreseeable future and endure even in the face of social, cultural, and political fissures.

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