

Two steps forward, one step back?



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Most major equity markets had posted new all-time highs by April 2024, China excepted. After an initial push to a new high, the equity market often checks back to the breakout point as part of its two steps forward, one step back pattern of climbing to new high ground. Such a pause has played out through April and may not be finished yet.

This time, the catalyst for the market retreat was yet another huge change of mind, which arrived late in Q1, about where the U.S. Federal Reserve was headed next, and when. For most of Q1, investors were confidently expecting a first Fed rate cut in May as a prelude to a series of further reductions before year end. But then a few tenths of a percent rise in the March U.S. inflation data and a stronger-than-expected jobs report kicked that scenario into the ditch.

The market pushed its expectation for the first Fed cut out into the second half and dramatically scaled back expectations for follow-up reductions. Some commentators wondered aloud if another hike was needed rather than a cut. The 10-year Treasury yield reversed course and backed up by a market-rattling 75 basis points.

Fast forward just 30 days to the end of April where a jobs report that was weaker than expected by the market, a one-tenth of a percent rise in the

Equity views

Region	Current
Global	=
United States	=
Canada	=
Continental Europe	=
United Kingdom	-
Asia (ex Japan)	=
Japan	+

+ Overweight; = Market Weight; - Underweight
Source - RBC Wealth Management

unemployment rate, and a couple of words in a Fed press release following the central bank's May meeting have threatened to turn Fed policy expectations back into a "jump ball."

This would mark at least the fourth 180 degree turn in investor hopes for a Fed easing cycle to get underway over the past 12 months. It's difficult to imagine just how much brain power, ink, and screen time have been marshalled over that time to report on, explain, and allegedly analyse all this. Sheets of paper covered with small print and laid end to end circling the globe come to mind.

Here's what we know:

The Fed has not yet cut. Monetary conditions are still tight or, in the words of the CEO of one of America's

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All values in U.S. dollars and priced as of market close, April 30, 2024 unless otherwise stated.

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largest banks, “very tight.” (The yield curve has now been inverted for 22 months and counting.)

Even if the Fed were to cut in June, the impact on the economy of that cut won’t be fully felt before 2025, in our view. Arguably, the U.S. economy and most of the rest of the developed and emerging world are still contending with/digesting the rate increases put in place in the first half of last year.

Does that mean a U.S. recession is inevitable? No. But we think it does mean the period of vulnerability has further to run, even if rate cutting were to start next month. In eight of the past 10 recessions the Fed had already been cutting the funds rate before the recession started.

And a first Fed rate cut, when it comes, likely won’t bring any more clarity to the collective expectations for monetary policy. Is it “one and done”? How long until the next cut? How many times will the Fed cut, and by when? Did policymakers wait too long? Did they move too soon? Will Fed policy be stymied by the U.S. presidential election in November? You get the picture.

What does this extended runway of monetary policy uncertainty mean for equities? First, we think it signifies the pullback/consolidation that began in early April could easily have further to go. The sharp back-up in bond yields appears to have been the chief culprit behind this latest equity market retreat, and a full retest of the 10-year Treasury yield’s October 2023 highs at almost 5% can’t be ruled out.

That said, we think this pullback will prove to be no more than a temporary respite in the longer-term equity market upleg, which kicked off back in the fall of 2022 and, in our view, has not yet run its course.

We think Q1 index earnings for the S&P 500 were good enough at +4% q/q to make the consensus full-year estimate of \$244 (up 10% y/y) look reasonable. At the same time, corporate guidance remained mostly positive among the large-

cap contingent, although small-cap business surveys reveal a much less optimistic outlook. Meanwhile, investor enthusiasm for AI continues to put a shiny gloss on expectations for 2025 and beyond.

We continue to look for more new highs in the coming months, but the economic and earnings picture needs to hold together to make that outlook feasible. At its end-of-March peak, trading at 23x latest 12-month earnings and 21.5x this year’s consensus estimate, the S&P 500 had already “paid for” at least two Fed rate cuts. New highs from here would imply a willingness to pay for more, in our view.

If a series of Fed rate reductions were to be delivered in response to an inflation rate that was convincingly subsiding towards 2% with the U.S. economy doing no worse than temporarily slowing down, the S&P 500 and other large-cap indexes might go on setting new highs for some time punctuated by occasional corrections/consolidations.

But if, as has so often been the case in past cycles, Fed cutting comes to be seen by investors as an urgent response to a more serious economic downturn, then we think stocks could enter a more challenging market phase.

The fact that market breadth has been rising in sync with the broad large-cap averages persuades us to remain committed to equities for now. But new highs, fuelled in part by price-to-earnings valuations rising from already rich levels, argue for a watchful, cautious approach to portfolio management.

Research resources

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