

Investment Strategy Outlook

SEPTEMBER 2024

THE ECONOMY

Yes, The Waiting Really Is The Hardest Part

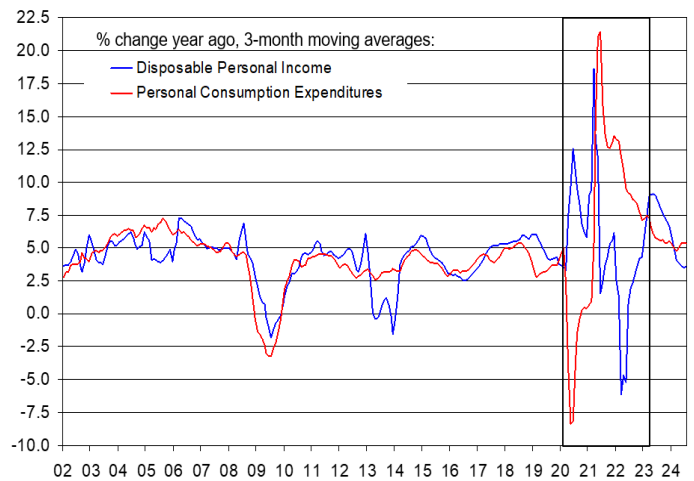
Perhaps the biggest question analysts, market participants, and central bankers alike are trying to answer is whether economic activity is finally normalizing after the significant disruptions/distortions brought about by the pandemic and the policy response to it or whether something less benign is underway and will end in recession. While our view is that it is the former, not the latter, the reality is that it will take some time to know the answer. In the interim, however, it seems that each and every economic data release is being interpreted as though it provides a definitive answer which, given the mixed signals being sent by the various data releases, 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.

The second estimate from the Bureau of Economic Analysis (BEA) puts Q2 real GDP growth at an annual rate of 3.0 percent, up from the initial estimate of 2.8 percent. Growth in real consumer spending on both goods and services was revised higher, putting Q2 growth at an annual rate of 2.9 percent compared to the initial estimate of 2.3 percent growth. This more than offset modest downward revisions in other components to push top-line real GDP growth higher. The BEA's monthly data on personal income and spending, which directly enter into the GDP data, show Q3 spending growth got off to a strong start. Real consumer spending grew by 0.4 percent in July, meaning that even if real spending were flat over the final two months of the quarter, real consumer spending would grow at an annual rate of 3.0 percent for Q3. We do not, however, expect that pace of growth to be sustained, and look for growth in consumer spending to slow sequentially over the final two quarters of 2024.

There are pockets of financial stress within the household sector, particularly amongst lower-to-middle income households which have exhausted any savings buffers they were able to build up during the early phases of the pandemic when sizable financial transfers to the household sector were a staple of pandemic relief efforts. Absent those savings buffers, many lower-to-middle income households are having a harder time dealing with the cumulative effects of inflation over the past few years, with higher prices for necessities such as food, energy, and shelter leaving less and less room for discretionary spending. While households in the higher income buckets are still able to spend comfortably, there are nonetheless signs that spending on discretionary services has softened, which could be a sign that there is increasingly less pent-up demand for such services rather than a sign of financial stress working its way up the income distribution.

Either way, slowing growth in discretionary services spending would be consistent with the slowing pace of growth in total consumer spending our baseline forecast anticipates. As pandemic-related supports for income and spending fade, it follows that growth in consumer spending will become realigned with growth in after-tax income, rekindling what for many years prior to the pandemic had been a fairly stable relationship. Given that labor earnings are by far the largest component of personal income, this points to the importance of labor market conditions in the outlook for consumer spending. Unfortunately, the labor market data are sending decidedly mixed signals. While there is

Income Growth, Spending Growth Realigning?



Source: Bureau of Economic Analysis; Regions Economics Division

no doubt that the trend rate of job growth has slowed over the past several months, what is far from clear is whether job growth is settling into a slower but more sustainable pace or whether a more pronounced deterioration in labor market conditions is, well, in the works.

While total nonfarm employment rose by 142,000 jobs in August, prior estimates of job growth in June and July were revised down by a net 86,000 jobs for the two-month period. Moreover, the August employment report showed no signs of payback for a weak July print, which was something we expected to see given the apparent impacts of Hurricane Beryl in the July data. Average hourly earnings rose by 0.4 percent, while the average length of the workweek rose by one-tenth of an hour. Between the gain in employment, growth in average hourly earnings, and the longer workweek, aggregate private sector earnings rose by 0.8 percent in August, leaving them up 5.0 percent year-on-year, easily ahead of inflation. Hiring was more broadly based across the private sector in August, with the one-month hiring diffusion index rising to 53.4 percent. After having risen to 4.3 percent in July, the unemployment rate fell to 4.2 percent in August, largely reflecting a reversal of most of the sharp increase in the number of those reporting to have been on temporary layoff in July.

The August employment report did nothing to settle the question of whether what we are seeing is normalization or something less benign. That our preferred gauge of trend job growth, the running twelve-month change in not seasonally adjusted nonfarm payrolls (a measure which gets around any issues related to seasonal adjustment), has fallen back in line with the average that prevailed over the five years prior to the pandemic settles nothing, as that trend rate will almost surely slip further in the months ahead. We do think it relevant to once again note that the slowing trend rate of job growth has thus

far been a function of less hiring as opposed to rising layoffs. To that point, the not seasonally adjusted weekly data on claims for unemployment insurance benefits show initial claims below 200,000 in each of the past three weeks, a notably low number that leaves initial claims at their lowest level since last October. To be sure, diminished hiring will, given growth in the labor force, put upward pressure on the jobless rate, but any such increase will be far more moderate in the absence of rising layoffs than would otherwise be the case. That said, the weekly data – not seasonally adjusted – on initial claims is what we at present consider to be the most reliable and the most important labor market indicator at our disposal.

Though it is too soon to know how much further the labor market will soften, it does seem clear that the FOMC's focus has shifted away from inflation and toward the full employment side of its dual mandate. To that point, public comments by several FOMC members, including Chair Powell, have made it clear that the Committee will cut the Fed funds rate at this month's meeting, but whether the initial cut in the funds rate will be twenty-five or fifty basis points seems a much closer call than we and many others would have anticipated a few weeks ago. That call will likely come down to what the majority of FOMC members see as the rationale for cutting the funds rate. If it is believed the FOMC can, and should, cut the funds rate

to make monetary policy less restrictive than it currently is, which the sharp deceleration in inflation allows for, that would favor a twenty-five basis point cut, which would sit better with those members still concerned about inflation reaccelerating. If, however, more FOMC members are concerned that labor market conditions are, or could be, deteriorating to the point that threatens to trigger recession, that would favor a cut of fifty basis points.

Either way, the FOMC will release an updated set of economic and financial projections at this month's meeting, including an updated "dot plot." It could be that the Committee opts for a smaller rate cut at this month's meeting but makes it clear, in their post-meeting policy statement and in Chair Powell's post-meeting press conference, that they will move more aggressively at subsequent meetings should conditions warrant such a move. The reality is that the FOMC is in the same boat as are analysts and market participants, i.e., trying to discern whether the economy is normalizing back toward its pre-pandemic trend rate of growth or whether something less benign is playing out. There is, however, no quick or easy answer to this question, and until there is more clarity around the answer, the financial markets are likely to remain highly volatile.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics

STOCKS

A Leadership Shift Into A Historically Tough Seasonal Stretch

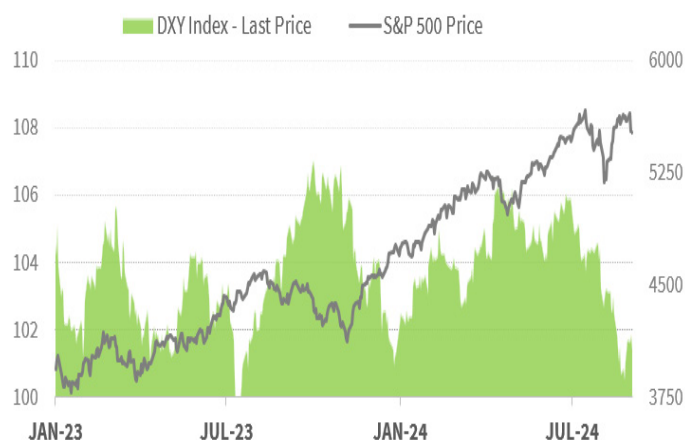
August was a choppy, albeit profitable, month for investors in large cap U.S. stocks as a sharp selloff early in the month on the Japanese yen carry trade unwind was quickly followed by a sharp rebound mid-month with the S&P 500 ultimately gaining 2.2%. The 'Magnificent 7' was a source of funds during the month as investors reduced exposure to this year's biggest winners and put capital to work in defensive (health care, consumer staples) and interest rate sensitive (financial services, real estate, utilities) sectors as Treasury yields fell amidst signs of softness in the jobs market which called into question the outlook for U.S. economic growth. While fears that labor market weakness could translate into weaker consumer spending, slower economic growth, and weigh on corporate profitability in the coming quarters were making the rounds, S&P 500 participation/breadth remained impressive and over 75% of index constituents were trading above their 50- and 200-day moving averages at month-end.

Encouragingly, strong breadth readings put the market on firmer footing as we enter a historically weak seasonal stretch -- from September into late October -- for stocks in presidential election years. The S&P 500's ability to quickly recover from the early-August doldrums and shrug off post-earnings weakness out of 'Mag 7' member Nvidia to close out the month within 1% of an all-time high makes it difficult to be anything but constructive on U.S. stocks, particularly with the equal-weighted S&P 500 making an all-time high as August ended. But with earnings season in the rearview mirror, and with a quarter-point rate cut in September priced in and potentially a 'sell the news' event should the FOMC move more aggressively and cut by 50-basis points, upside catalysts for U.S. stocks are more difficult to identify and appear limited in the near-term.

The U.S. Dollar Index (DXY) fell from \$104 at the end of July to \$101 at the end of August, taking its two-month loss to 4.2% as demand for the greenback has waned amid fears of a U.S. economic slowdown and as expectations the FOMC would cut, perhaps aggressively, in mid-September have risen. U.S. dollar (USD) strength is a double-edged sword as it highlights demand for dollars and U.S. economic strength but has historically acted as a modest headwind for U.S. large-caps stocks which derive approximately 40% of their revenue from overseas. The recent decline could boost S&P 500 revenue this quarter but, given the velocity of the recent dollar decline and seasonal factors in play, a reversal of the downtrend or stabilization could materialize in the coming months. Seasonal trends over the last 20-years show the greenback typically gaining ground from August through October before weakening modestly in November through December. In presidential election years, those seasonal stats hold as over the last four presidential cycles the dollar has moved lower in the 4th quarter by an average of 1.5%, likely a product of policy uncertainty that often proves less impactful than feared.

Should the U.S. dollar find its footing in the near-term, small and mid-cap (SMid) stocks, which have lagged as fears of a U.S. economic slowdown have grown, could fare a bit better as a relative beneficiary of U.S. dollar strength, and exposure to SMid remains warranted for diversification purposes, particularly if one views the dollar's decline as overdone. Where the dollar closes out the year is anyone's best guess given elevated political and monetary policy uncertainty, but by maintaining a diversified portfolio across market cap and geographies, investors should be well positioned to ride out currency volatility and react accordingly should market dislocations arise.

U.S. Dollar Trading Near A 1-Year Low - Where Does It Go From Here?



Equity Markets Abroad Beneficiaries Of The U.S. Dollar's Slide. The U.S. dollar's August slide provided a tailwind for equities outside of the U.S. in August with developed markets benefiting the most. Country indices tied to Germany, Italy, Spain, and Switzerland all generated returns north of 4.5% on the month in U.S. dollar terms. Strong monthly gains abroad can be attributed largely to the falling U.S. dollar relative to the euro and Swiss franc as currency translation effects propelled

the MSCI Germany USD index, specifically, to return 4.7% in August versus just 2.4% for the local currency index. Strong relative performance out of international developed markets could prove short-lived should the tailwind from a weaker U.S. dollar wane in the coming months, in keeping with historical patterns. Longer-term fundamental headwinds such as lackluster earnings growth along with regulatory and political uncertainty abroad remain, which prevents us from getting too constructive on international developed market stocks despite appealing valuations and dividend yields, leaving us neutral relative to our strategic benchmark.

Emerging market equities on the other hand have been building momentum in recent months as the fundamental outlook outside of China has improved as the U.S. dollar has weakened, and relatively attractive valuation metrics including a one-year earnings growth estimate of 31.9% and a 12-month forward price-to-earnings (P/E) ratio of just 13 have garnered interest from relative value and growth investors alike. Though we're receiving positive signals out of the broader EM asset class, dispersion at the country level leads us to favor a more active approach as even in August the best performing EM country, Brazil, posted a 5.5% gain, while the worst performer, Mexico, notched a 5.4% decline. The remaining pieces of the puzzle to make us more bullish on emerging market assets lie with better technical breadth and improved relative strength readings, which would be signs that investors are appreciating recent fundamental improvements in the space and are allocating capital accordingly.

BONDS

Risks Now Skewed To The Upside For Treasury Yields?

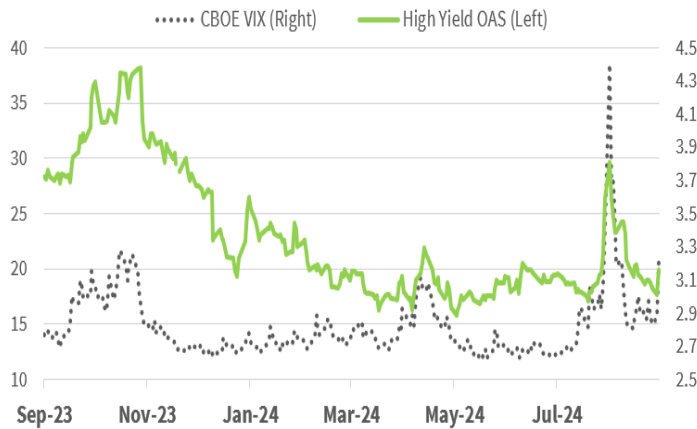
Bonds of all types have staged an impressive summer rally with Treasury yields across the curve sharply lower in recent months as the labor market has cooled and market participants became increasingly convicted in their belief that a rate cutting cycle would begin this month. At the start of September, the 10-year U.S. Treasury carried a yield of 3.91%, which compares to 4.51% at the end of May, 4.36% at the end of June, and 4.09% at the end of July. This three-month downtrend in yields has been quite profitable for investors in longer duration Treasury bonds while also generating sizable gains for investment-grade corporates and emerging market debt. Our view is that the U.S. economy is normalizing, not on the brink of collapsing, with growth expected to hover in a range of 1.5% to 2% over the next several quarters and with inflation gradually trending toward 2% and little in the way of progress on curbing government spending in the offing, near-term downside for yields on long-term Treasuries is likely limited from here.

It stands out to us that even a more dovish than expected speech from FOMC Chair Jerome Powell in late-August failed to push the 10-year yield below the 3.75% to 3.80% range, and the 10-year yield has, so far, held the 3.70% level on the heels of a softer August employment report. This range provided resistance and a floor of support in July and December of 2023 as well with yields bouncing from that zone. A third retest and failure to break below implies to us that it could take some shockingly weak economic data releases in the coming months for this resistance level to give way and for the downtrend in yields to be sustained. As a result of this view, risks appear to be skewed to the upside for yields and downside for prices of U.S. Treasury bonds in the coming months. Maintaining an allocation to higher quality long duration Treasuries is still

advisable for diversification purposes as these bonds provide a portfolio ballast and mitigate volatility, allowing investors to maintain exposure to riskier stocks and bonds, but it's difficult to find value at present and price appreciation is limited near-term.

Corporate Bonds Remain Appealing Despite Economic Slowdown Concerns. Perhaps surprisingly given fears of an economic slowdown making the rounds early in the month, both investment-grade and high yield corporate bonds outperformed the S&P 500 in August. Both segments have fared well quarter-to-date, with the Bloomberg U.S. Corporate and U.S. Corporate High Yield indices rising 3.9% and 3.6%, respectively, versus the S&P 500's also respectable 3.6% gain since the end of June. Credit spreads widened materially in early August as economic growth concerns dominated, but Treasury yields fell during this timeframe, acting as an offset and limiting downside/drawdown for corporate bonds, particularly for longer duration investment-grade issues. With the growth scare short-lived, investors quickly found their way back into credit as widening credit spreads/higher yields attracted fresh capital waiting patiently for a buying opportunity. If economic slowdown concerns persist skittish investors looking for higher yields could increasingly favor higher quality investment-grade issues relative to high yield as we enter a historically tough seasonal stretch for riskier asset classes. With Treasuries appearing richly priced at month-end after a multi-month rally, we again see relative value residing with corporate bonds, broadly speaking, although we are tempering our expectations for price improvement with credit spreads only 10-15 basis points above the tightest levels seen year-to-date.

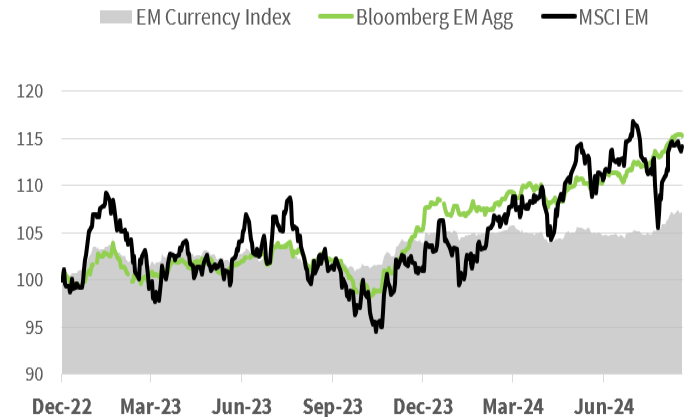
High Yield Bonds Holding Up Well Even As Volatility Rises



Weaker U.S. Dollar, Improving Fundamentals Boost The Outlook For EM Debt. The Bloomberg Emerging Market (EM) USD Aggregate (Agg) Bond index turned out a 2.1% gain in August as the U.S. dollar weakened and some improving country-specific stories abroad boosted investor risk appetite. The EM USD Agg has now returned 6.3% year-to-date, which is in-line with the return out of the Bloomberg U.S. Corporate High Yield index and is 3.2% above the Bloomberg Aggregate. Notably, 2.5% of the 6.3% year-to-date return is attributable to price gains/narrowing spreads as fundamentals have improved. The Bloomberg EM bond index is a well-diversified index and gains have been broadly based since the index bottomed in mid-April, an encouraging sign. Argentina, Brazil, Egypt, Mexico, Saudi Arabia, and the United Arab Emirates (UAE) are just a few of the strongest performer's year-to-date and together account for 1/3 of the Bloomberg EM USD Agg. China, which makes up 10.9% of the index, has participated in the rally as yields on Chinese Government Bonds have fallen, but we continue to see better opportunities to deploy capital elsewhere in the developing world. As a result of this view, we continue to allocate to U.S.

dollar denominated emerging market debt but do so via active managers capable of over/underweighting specific country's where the fundamental outlook is less clear.

Emerging Market Currencies, Assets Rallying In Tandem



Source: Bloomberg - Normalized by Factor (100)



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