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ANALYSIS

Measure Twice,
Cut Once

**VANTAGE
POINT**

Q3 2024

ANALYSIS

BNY Advisors, Inc.
(BNY Advisors)

INTRODUCTION

Welcome to another edition of Vantage Point, the quarterly economic and markets outlook from the Global Economics and Investment Analysis (GEIA) team at BNY Advisors.

Regular readers will know that I believe markets are characterized by radical uncertainty. Many of the most important risks are undiversifiable or cannot be priced, while those that can be priced are multi-faceted. Markets deal with these problems by dealing in ‘narratives’ – a few relatively simple stories that describe the short-term uncertainty. They shift between narratives probabilistically as new data comes out that lends support to one or other of them. If markets are weakly efficient, it is because they are quite good at picking the stories that matter – new information is disseminated quickly and efficiently. If anyone has an edge over the market, it is because they see new narratives developing more quickly than others, or are better at seeing the story that is closest to the ‘truth’.

This belief motivates the scenario approach that Vantage Point has adopted since its inception. Unlike the sell side, which generally must pick a single narrative and stick with it until or unless the evidence overwhelmingly suggests it is wrong, those in investments have the freedom to think about all the stories that matter and pick and choose between them, designing portfolios that reflect our deepest convictions, while hedging against plausible alternatives. 2024 has seen markets consistently flip between two dominant narratives: one in which, thanks in part to Artificial Intelligence (AI), growth is strong, inflation falls quickly and interest rates come down rapidly; and another in which growth is slowing, but inflation is sticky and interest rates have to stay ‘higher for longer’.

The two stories have very different potential implications for asset performance. The first has equities and bonds doing well, while the second has them doing much worse. Interestingly, they both display positive correlation between the two major asset classes, which makes hedging difficult. The upshot has been volatility, and my quant colleagues at Newton have shown that asset price probability distributions have been ‘bi-modal’ for much of the year.

We go into this edition of Vantage Point without very much more evidence about which of the two main narratives is correct than we had three months ago. Growth appears to be slowing in the US and picking up in Europe, but not dramatically so in either. Inflation has continued to fall, but core services inflation remains an issue while labour markets remain tight. Markets are convinced rates will come down, and the European Central Bank (ECB), Swiss National Bank (SNB), Bank of Canada (BoC) and Swedish Riksbank have begun that process, but cuts are expected to come later and be less extensive than was expected a few months ago. Markets are also pricing in a relatively high terminal rate in a number of countries, in line with our conclusion that the global equilibrium interest rate has risen. China looks likely to hit, or even

exceed its 5% growth target this year, but that growth is supply- and export-driven and merely postpones the transition towards a domestically-driven economy.

So, our scenarios this quarter remain the same as last. Two of them, both odds against, are distinct versions of the competing narratives described above. The third, the single most likely, is a mishmash where elements of both occur. In that single most likely scenario (Muddle Through, 60%), growth slows further in the US and a degree of economic slack builds up. Employment growth slows and vacancies fall, so the labour market begins to loosen, and wage inflation moderates. The economy avoids recession, but the slowdown is sufficient to allow inflation to keep falling, notably in core services. As a result, the Federal Reserve is able to cut interest rates around September this year, continuing to reduce Fed Funds into 2025 to a trough of around 3%. Elsewhere, the euro area economy emerges from recession into a modest recovery, while China's stimulus, focused on manufacturing and exports, works to deliver target growth. China's export focus also means global goods disinflation continues and this puts a lid on inflationary pressure around the world, though inflation persistence remains an issue, meaning rate cuts everywhere come steadily but relatively slowly. AI exuberance remains real and focused on big tech AI producers, while the boost to productivity growth more broadly takes time to come through. Global equities make progress, though modest rate cuts in line with market expectations mean bond price returns are low.

We take a more optimistic view about the impact of AI in one of our other scenarios (New Economy, 20%). Global growth, led by the US, surprises to the upside thanks to productivity gains in sectors that are early to deploy AI. Unit labour cost inflation eases rapidly as a result, and core inflation falls more rapidly than markets expect as a result, undershooting inflation targets significantly, aided by significant goods price disinflation. Central banks respond by cutting rates more dramatically than markets currently expect. The combination of higher growth and lower rates is ideal for highly-indebted governments and firms, meaning sovereign debt concerns ameliorate and the high-yield credit markets do well. More generally, this is a great environment for risk assets and fixed income.

By contrast, in our final scenario (Second Wave, 20%), strong global growth turns out to be less benign. This is because it is led by aggregate demand, not aggregate supply and this, in conjunction with tight labour markets, causes inflation to start rising again. Arguably, the single most underpriced risk in markets is the possibility of further rate hikes, and in this world that is precisely what happens. Second waves are not unusual historically and central banks have frequently

declared 'the battle won' too early in the past. AI enthusiasm turns out to have been mostly hype and productivity growth begins to slow again. Fiscal policy remains overly loose in a year of global elections and sovereign debt concerns begin to mount, adding to upward pressure on bond yields as term premia rise sharply. The shift to rates rising is deeply destabilizing for risk and bond markets alike, global financial conditions tighten sharply and the world economy moves into recession, eventually bringing inflation back down, but not until late 2025 or 2026.

As usual, we construct detailed forecasts for each of these scenarios, probability weight them and display the results in the form of forecast fan charts. These suggest a central expectation of global growth convergence – slowing in the US, picking up in the euro area, China, Japan and the UK. Inflation and interest rates fall in our central paths, broadly speaking in line with market expectations, but the risks to growth, inflation and interest rates are all (slightly) skewed to the upside. Equities are expected to make modest progress, but the hit under 'Second Wave' outweighs the boost under 'New Economy', so risks are skewed to the downside. Similarly, bond returns are positive but modest, driven by income return along the central path, because rates come down in line with market expectations. But the risk of lower or negative returns is significant.

This has been the year of elections and we have already seen some significant and occasionally surprising results in India, South Africa and Taiwan. All have had an impact on local market performance. Elections to the European Parliament, to the French National Assembly and in the UK, all have the potential to impact market performance too. The main event remains the US presidential election in November of course, and markets may be volatile in the run up and in the immediate aftermath.

Let me close with a sign off. This is the 27th edition of Vantage Point, and my final one. I head off into retirement now, but working with my team to produce this and other publications has been one of my most rewarding career experiences. I leave in the certain knowledge that the GEIA team will continue deliver the highest quality research to clients, to whom our commitment has always been paramount. I hope you enjoy reading this edition, as you hopefully have previously, and will continue to into the future. Best wishes to all.




SHAMIK DHAR
CHIEF ECONOMIST

VANTAGE POINT SUMMARY

We summarize the outlook in the graphics below. These show: 1) our 12-month forecasts for global GDP growth, inflation, and monetary policy relative to their long-term paths; 2) how our fan chart forecasts differ from market expectations— in terms of expected returns and expected uncertainty; and 3) our investment conclusions, based on the largest discrepancies between our own views and what the market is pricing in. Our conviction around our investment views is higher when the level of uncertainty around our forecast is lower.

Table 1: Summary of our 12m outlook

How to read the heatmap. **Green** indicates above trend growth, below target inflation, policy accommodation and lower-than-average levels of uncertainty. **Grey** indicates economic growth in line with trend, inflation in line with target, a neutral policy stance, and average levels of uncertainty. **Red** indicates below trend growth, above target inflation, a tight policy stance, and higher-than-average levels of uncertainty.

		Growth	Inflation	Policy	Takeaway
Summary of VP outlook	Average expectations				Global growth is seen as positive but somewhat below trend in 12m; inflation is still somewhat above target and policy is a broadly neutral.
	Uncertainty				Uncertainty around the future path for growth, inflation and interest rates is higher than in the last few decades.

Table 2: Own forecast vs the market

How to read the heatmap. **Green** indicates that we expect growth to be higher than the market believes, inflation to be lower and policy accommodation to be greater. Green also indicates that uncertainty around our macro expectations is lower than the market is pricing. **Grey** indicates that expectations (or uncertainty around expectations) for economic growth, inflation and policy are broadly in line with the market. **Red** indicates worse than expected growth, greater than expected inflation and a tighter than expected policy stance. Red also indicates that uncertainty around our macro expectations is higher than what signaled by the market.

		Growth	Inflation	Policy	Takeaway
Vantage Point vs market pricing	Average expectations				Our growth view is below market expectations 12m from now, and inflation is above. Our views on rates are broadly in line with market pricing (with risks to the upside).
	Uncertainty				Our fan charts imply greater uncertainty in the outcomes for growth, and policy, compared to what is priced in option markets.

Table 3: Summary of 12 Month Investment Conclusions

How to read the heatmap. **Green** indicates overweight. **Grey** indicates neutral. **Red** indicates underweight. Polarized possible outcomes for the economy mean this is an environment to tighten risk budgets and not make bold directional bets.

Asset class	Q2 '24	Q3 '24	Rationale
Cash			Cash is attractive given low volatility, income returns, and rates that are expected to fall slowly, but better opportunities are elsewhere.
Fixed Income			Benefits from high yields but low expected price returns seen as providing little uplift compared to cash, with greater risk. Risk/reward is expected to be worse than average.
Equities			A lot of optimism is priced in by the market over the near term, but expected returns are broadly in line with long term averages, and relatively better vs other asset classes.
Credit			Elevated yields are attractive, but spreads are very compressed, and expected to rise providing a drag to total returns.
Alternatives			With a more constructive views of growth and expectations that inflation will be broadly in line with consensus, we remain neutral.

EXECUTIVE SUMMARY

Our New Scenarios in Brief

PROBABILITY

60%

SCENARIO 1

Muddle Through

- US growth slows but does not slip into a recession. Europe slowly emerges from stall-speed to a modest recovery.
- China's stimulus remains predicated on boosting manufacturing rather than domestic consumption.
- As a result, global goods price disinflation and stable-to-weaker energy prices precludes a resurgence of inflation at major economies.
- But inflation persistence lingers – led by sticky services prices (healthcare and rentals), and positive real wage growth.
- AI exuberance boosts equities, loosens financial conditions, stretches valuations.
- Policy easing proceeds in a variegated fashion, and hesitantly, at the major economies, except Japan.
- But the extent of easing is considerably limited, and terminal rates are higher than pre-pandemic levels.
- Rising trade and elevated geopolitical tension maintains a bid for the USD.
- Credit spreads widen out to long-term averages.

PROBABILITY

20%

SCENARIO 2

Second Wave

- US growth surprises to the upside on a continuing positive fiscal impulse and terms of trade windfalls.
- Europe and China pick-up speed together, placing more pressure on resources and supply chains.
- Positive shocks to aggregate demand raise inflation expectations and worsen inflation persistence.
- Markets price out further central bank easing at the major economies and are forced to consider the possibility of near-term rate hikes.
- A reconsideration of the path of monetary policy, and an actual hike or two, raises the odds of a 'monetary recession.' In other words, central bankers conclude that aggregate demand must be crushed to defeat inflation.
- Spreads widen beyond historical means and USD gains on rising growth concern.
- US equities suffer as growth concerns eventually override AI optimism and multiples de-rate.

PROBABILITY

20%

SCENARIO 3

New Economy

- Global growth, led by the US, surprises to the upside thanks to productivity gains.
- AI adoption picks up speed, unit labor costs show signs of sustained easing.
- Supply chains adjust with less than expected trade and geopolitical friction.
- Fiscal and sovereign debt concerns in the US and other major developed economies are offset by stable-to-declining trends in overall non-financial debt.
- Other major emerging markets begin to play an increasingly important role in global growth, offsetting weakening trend Chinese growth.
- Risk assets learn to live with higher for longer rates and a stable-to-firming trend in the USD.

01

WHAT WE THINK

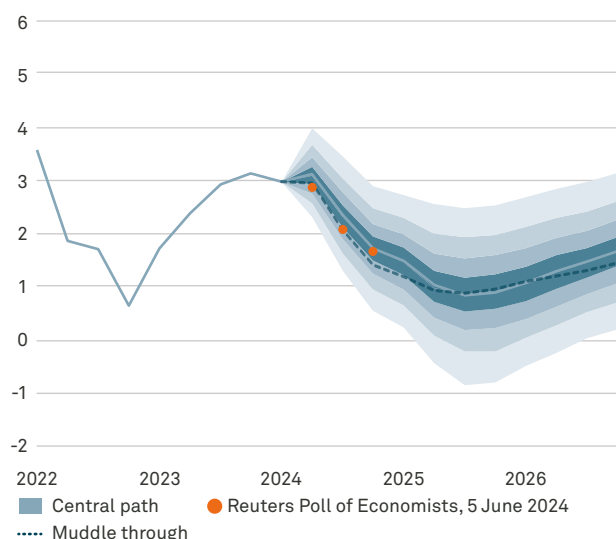


01 WHAT WE THINK: FORECAST SUMMARY

Over the past three months activity in most major economies has evolved broadly as set out in ‘Muddle Through’ – our single most likely scenario in the previous edition of Vantage Point. After a period of stagnation through the second half of last year, Europe returned to growth in Q1. And while the US economy slowed a little more rapidly than we had anticipated, payrolls employment remained solid, and business surveys point to a pick-up in growth through the second quarter, both in the US and elsewhere. The resilience of most major economies, and most notably the US, to a rapid tightening of monetary policy after a long period of near-zero interest rates, has been remarkable. ‘Muddle Through’ remains our central scenario.

While headline measures of consumer price inflation fell sharply through last year, driven by falling energy prices, progress towards the 2% target in both the US and Europe has stalled in recent months, and simple measures of domestically generated inflation, such as services price inflation, remain elevated. Wages in most major economies continue to rise somewhat more rapidly than the sum of 2% and trend productivity growth, suggesting that a sustainable return of inflation to target is in most cases not yet guaranteed. In our ‘Second Wave’ scenario, a further tightening of monetary policy is on the cards in some countries, threatening to derail the recovery. Finally, in ‘New Economy’, technological advances associated with AI, raise both trend growth and the equilibrium, or neutral real rate of interest in more or less equal measure. There is

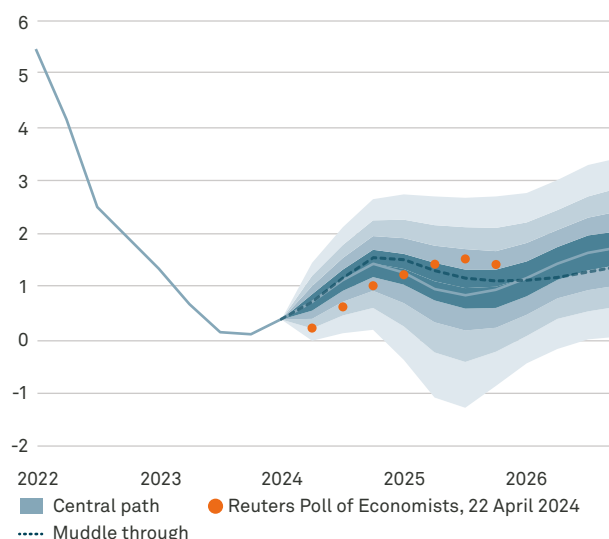
**CHART 1: US GDP
FOUR-QUARTER PERCENTAGE CHANGES**



Source: Refinitiv Datastream/Fathom Consulting.

Key Takeaway: In common with other forecasters, we expect US growth to slow from here. Recession risks remain, and are a little higher than normal.

**CHART 2: EURO AREA GDP
FOUR-QUARTER PERCENTAGE CHANGES**



Source: Refinitiv Datastream/Fathom Consulting.

Key takeaway: The recovery in euro area growth is likely to continue, albeit with the risk of a renewed slowdown next year. We expect stronger growth than consensus near-term.

Forecasts begin in Q3 2024 and were calculated as of June 7, 2024. Source: BNY Advisors and Fathom Consulting. The “central path” (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

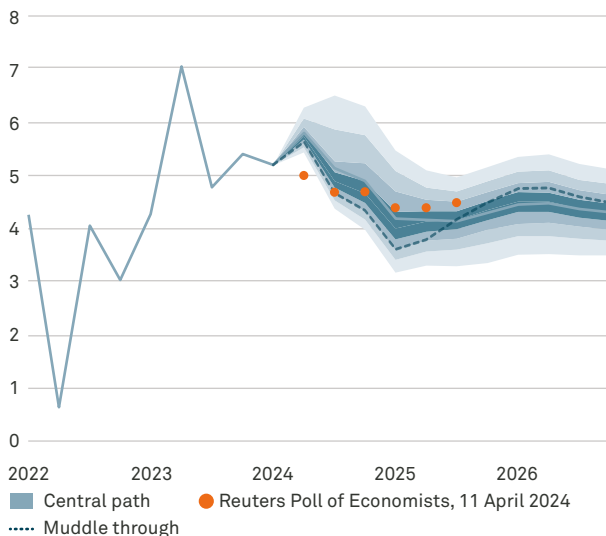
Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY product.

already a degree of slack in the US economy in this scenario, and inflation resumes its downward trend later this year despite continued high rates of economic growth.

Our assessment of the prospects for US growth is summarized in the first fan chart. Weighting together the three scenarios, we expect the US economy to continue to slow, with growth a little below trend through next year. Risks to our central scenario lie moderately to the upside, reflecting the prospect of a longer period of above-trend growth in ‘Second Wave’, and ongoing improvements in potential supply in ‘New Economy’. Recession risks remain, with the odds of a four-quarter contraction in US GDP peaking at around 1-in-4 during the second half of next year.

We expect euro area growth to continue to strengthen from here, peaking at a little above trend on a four-quarter basis later this year. In contrast to the US, risks to euro area growth lie moderately to the downside, with demand faltering as inflation picks up in ‘Second Wave’, and with the benefits from new technology slower to arrive here than in the US in ‘New Economy’. Recession risks remain in the euro area, where they are also concentrated in the second half of next year. Near-term risks to growth in China lie to the upside, reflecting the prospect of further fiscal stimulus in ‘Second Wave’ and stronger demand from overseas in ‘New Economy’.

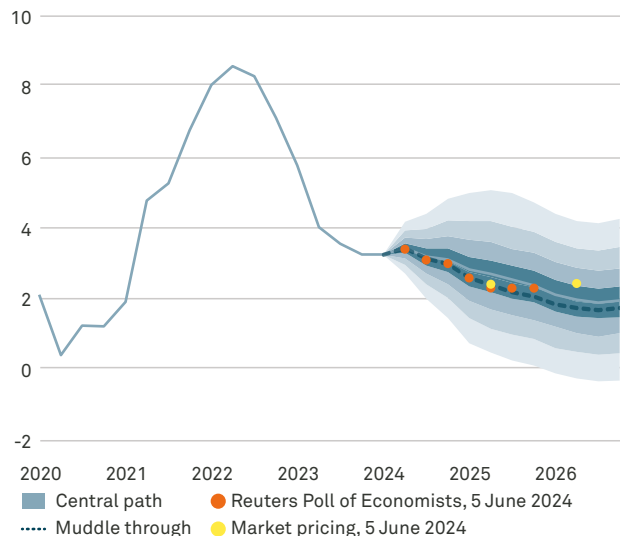
**CHART 3: CHINA GDP
FOUR-QUARTER PERCENTAGE CHANGES**



Source: Fathom Consulting.

Key Takeaway: China’s economy is set to slow from here, and by more than the consensus among other economists in our ‘Muddle Through’ scenario. We see around a 1-in-3 chance that official growth targets for this year are missed.

**CHART 4: US CPI
FOUR-QUARTER PERCENTAGE CHANGES**



Source: LSEG Datastream/Fathom Consulting.

Key Takeaway: It is more likely that US inflation will be above rather than below the 2% target for most of our forecast horizon.

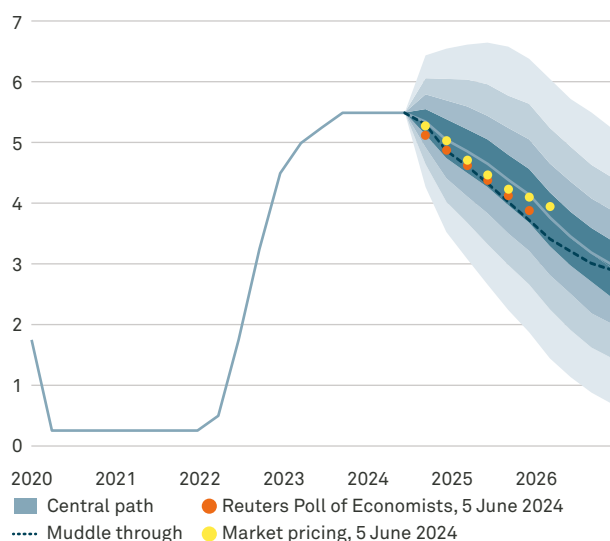
Forecasts begin in Q3 2024 and were calculated as of June 7, 2024. Source: BNY Advisors and Fathom Consulting. The “central path” (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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We expect US inflation to fall steadily, but slowly towards 2% over the next two to three years, with inflation more likely to be above than below target until mid-2026. Our single most likely path for US inflation lies very close to the consensus among economists. Nevertheless, the width of our fan chart highlights the considerable uncertainties that lie ahead. We see close to an even chance that US inflation rises through 2024 as a whole, with only a slightly lower probability of this occurring in the euro area.

Although US inflation is more likely to lie above target than below for much of the next two years, we expect to see easier monetary policy well within that timeframe. A cut of at least 25 basis points before the year is out is more likely than not, with a close to even chance that the federal funds rate is reduced by 50 basis points or more. The near-term outlook for the policy rate is particularly uncertain, as it often is close to a turning point, and we see around a 1-in-4 chance of another hike before the year is out. In our central scenario, ten-year US Treasury yields drift a little lower from here, with risks moderately to the upside reflecting, in part, the weight we attach to the 'New Economy' scenario, where the equilibrium or neutral real rate of interest turns out to be higher than previously thought.

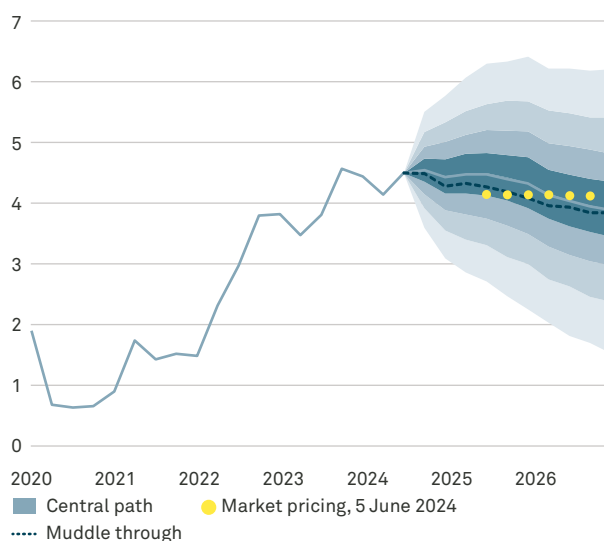
CHART 5: US FEDERAL FUNDS RATE PER CENT



Source: LSEG Datastream/Fathom Consulting.

Key takeaway: We are likely to see one or two 25 basis point cuts from the Fed this year. At the same time, the uncertain outlook means that there is nevertheless a 1-in-4 chance of further tightening from here.

CHART 6: US TEN-YEAR GOVERNMENT BOND YIELDS PER CENT



Source: LSEG Datastream/Fathom Consulting.

Key takeaway: Long-term US rates are likely to drift a little lower, but there is a greater-than-usual degree of uncertainty embodied in our fan chart reflecting the possibility that there has been an increase in the equilibrium, or neutral real rate of interest.

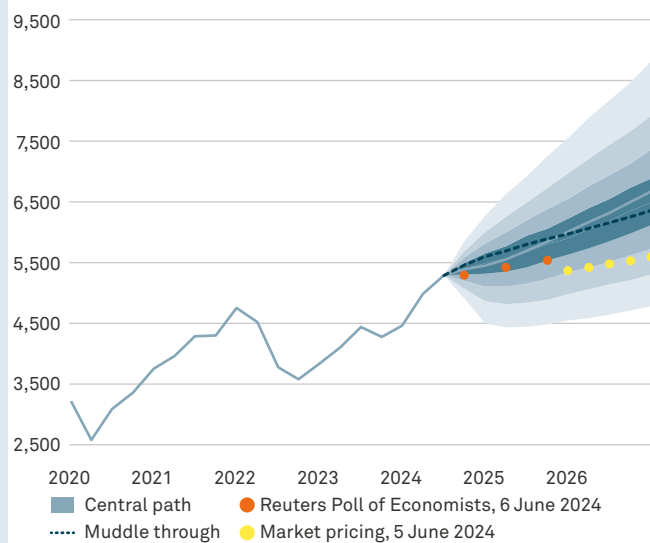
Forecasts begin in Q3 2024 and were calculated as of June 7, 2024. Source: BNY Advisors and Fathom Consulting. The "central path" (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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Although our mean path for long-term interest rates is close to that implied by market pricing, we remain more optimistic than other investors about the prospects for US equities. This reflects, in part, the weight we attach to our ‘New Economy’ scenario, which sees productivity growth improve across the major economies, led by the US. Risks around our central path for US equities lie a little to the downside in the first year of our forecast, reflecting the potential for a sharper slowdown in US growth in ‘Second Wave’, but to the upside further out, where the consequences of our ‘New Economy’ scenario begin to dominate.

Our final fan chart records our assessment of the prospects for the trade-weighted dollar. In ‘Muddle Through’, our single most likely scenario, the dollar largely drifts sideways, as the widening differential between US and overseas policy rates ensures that the dollar remains attractive, even though in effective terms, and after adjusting for relative prices, it is close to multi-decade highs. Indeed, in each of our two risk scenarios, the dollar rises further from here, as the Fed tightens again in ‘Second Wave’, and as US productivity growth improves faster than that of its peers in ‘New Economy’. As a consequence, we see risks to the US dollar as skewed to the upside, with large rises more likely than large falls.

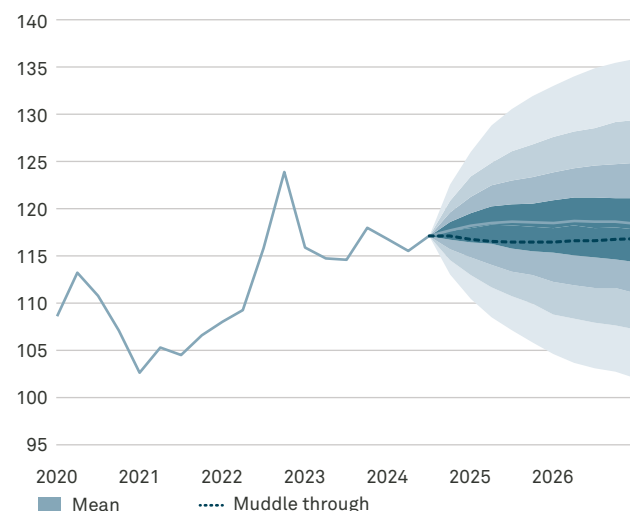
CHART 7: US S&P 500 INDEX



Source: LSEG Datastream/Fathom Consulting.

Key Takeaway: Downside risks to the S&P 500 remain, particularly in the near term. Further ahead, the potential for an improvement in trend productivity growth means that we are a little more optimistic than the consensus.

CHART 8: USD ERI AGAINST MAJOR CURRENCIES INDEX, JANUARY 2006 = 100



Source: Fathom Consulting.

Key Takeaway: Our central scenario sees the dollar drift sideways through the forecast, with risks skewed to the upside.

Forecasts begin in Q3 2024 and were calculated as of June 7, 2024. Source: BNY Advisors and Fathom Consulting. The “central path” (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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02

WHAT THE MARKET THINKS



02A WHAT'S PRICED IN

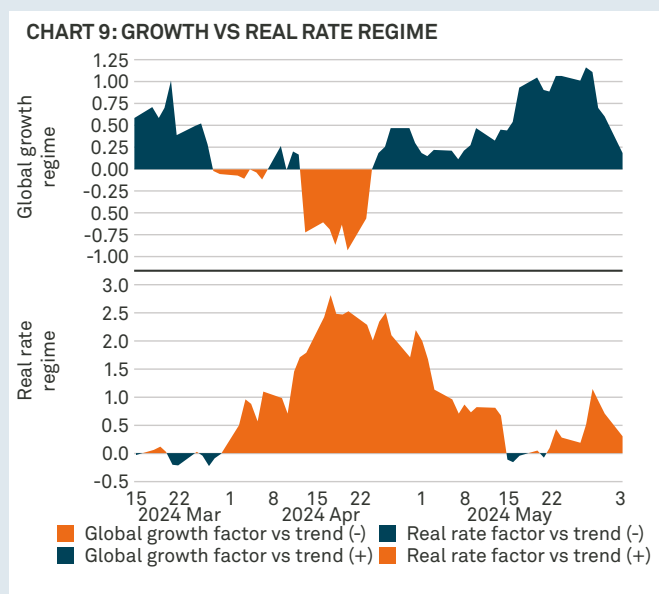
Summary: The positive performance of equities and broad commodity indices, paired with the unwind of rate cut expectations and the rise in longer-term bond yields, signal expectations of a robust nominal growth environment ahead. Cross-asset returns broadly aligned with a rising probability of our “muddle through” scenario and, to a lesser extent, our ‘second wave’ scenarios. Growth is expected to remain healthy, and inflation robust. Monetary policy is still seen as loosening but settling at a higher terminal rate, with a shallower loosening cycle compared to past episodes. Consistent with our previous Vantage Point, the market is not only pricing a ‘soft landing’ for the global economy but is also expecting a different economic cycle characterized by stronger nominal growth and higher interest rates. The market no longer appears to be particularly concerned about a possible recession. The compensation to take risk in assets sensitive to growth is low (in some cases the lowest since before the Global Financial Crisis), and so is the cost of protecting against a meaningful deterioration in growth expectations, particularly in US assets. To some extent, compressed valuations can be explained by the stage of the global business cycle. But the AI shock is also contributing

to lowering risk premia across assets, something we had anticipated last year and still think will keep driving investment performance in the years ahead.

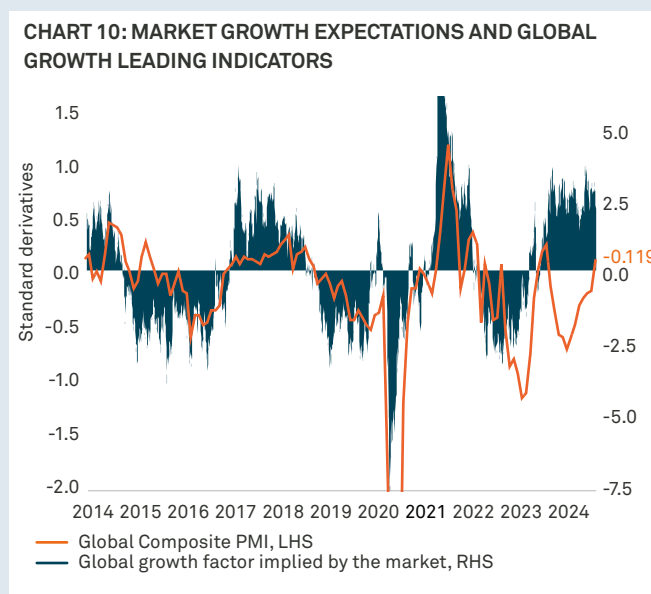
Market-based growth expectations: Global market-implied growth expectations rose somewhat over the period. Asset classes and strategies most sensitive to the economic cycle outperformed: e.g., copper versus gold, and cyclicals versus defensives. As a whole, markets expectations for growth improved the most for emerging markets (EM), with US and UK not coming far behind, while euro area growth expectations fell somewhat. The level of growth expectations is elevated but not stretched, and around the average seen since mid-Summer '23. In aggregate, market pricing is consistent with positive and rising global growth. The market view of growth still appears to remain somewhat more optimistic than economic survey indicators – such as the global Purchasing Managers Indexes (PMI) – but macro data has been catching up. Although this gap does not necessarily favor defensive allocations, it implies greater sensitivity of risk assets to negative growth surprises. Leading growth indicators that tend to anticipate changes in

Summary: Market returns over the quarter are consistent with a stronger growth, higher rates regime.

Growth: Market view of growth is more optimistic than economic survey data, but macro data appears to be catching up.



Source: Macrobond, BNY Advisors.
Data as of 13 June 2024.



Source: Macrobond, BNY Advisors.
Data as of 11 June 2024.

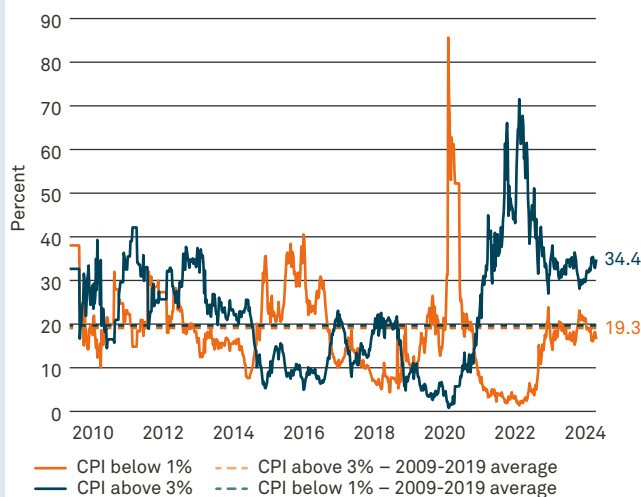
the global PMIs, provide some conviction in further progress in the global macro data from here. But some macro data paint a more worrying picture for growth. And given past evidence around the probability of recession following periods of sharp monetary policy tightening, we find that measures of downside tail risk derived from equity option markets show an excessively optimistic picture for growth risks in major economies, with very little probability of a growth scare priced in for the next 12 months.

Market-based Inflation expectations: Market implied inflation expectations moved up modestly on the quarter but remain consistent with a return to target across most economies. US inflation is seen declining from above 3% to about 2.5% in the next 6 months. In the euro area, inflation is expected to dip briefly below 2% around September and then bounce back to ~2.5% by year-end. Long term, inflation is seen as remaining robust, particularly in the US versus Euro area. The UK remains an outlier, with the market pricing in continued stickiness in inflation in the near term, and above target inflation in the distant future. For Japan, the market sees inflation remaining at about 1.5% in the long-run. This is lower than target but significantly above the levels seen pre-Covid. Option markets signal a ~35% probability of US inflation remaining at 3% or above over the next 5 years, and about a 50% probability in total of US inflation printing outside the 1-3% range over the same period.

Market-based monetary policy expectations: Global monetary policy expectations repriced higher over the quarter, despite several developed market central banks starting to cut policy rates (the SNB, Riskbank, BoC, and ECB). Following the early June cut, the ECB is expected to deliver 4-5 additional cuts by the end of 2025. The Fed and the BoE are seen as loosening policy only towards the end of 2024, for a total of ~4 cuts by end next year (compared to 5-6 rate cuts priced in March). The expected level of interest rates at the end of the loosening cycle is broadly consistent with a higher real neutral rate of interest (R^*). For example, long term forward US real rates are trading 70-100 bps above the (slowly revised) Fed's real long run dot (at 0.8%), and not much above model implied estimates of R^* . Such expectations are broadly consistent with our previous work pointing to a rise in global R^* by the end of the decade. Outside of the Americas and Europe, some divergence in monetary policy is expected, with the Bank of Japan seen as normalizing policy further with 1 rate hike by end 2025, and the Reserve Bank of Australia expected to deliver only 1 rate cut over the same period.

Inflation: US inflation options market still point to historically elevated risks of above target inflation over the next years.

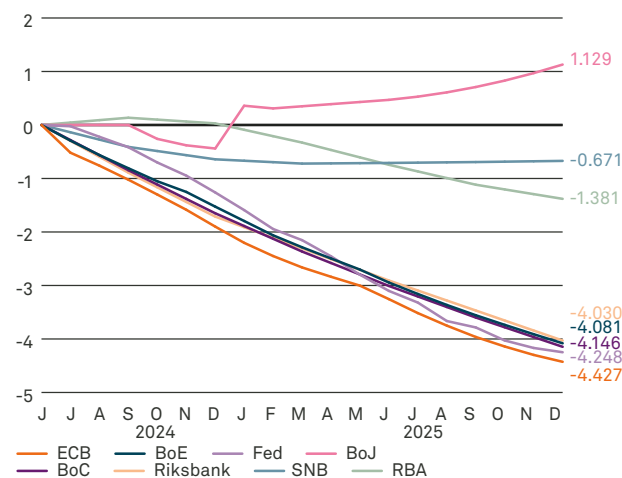
CHART 11: US CPI OVER 5 YEARS – OPTION IMPLIED PROBABILITIES



Source: Macrobond, BNY Advisors.
Data as of 11 June 2024.

Policy: Apart from the BoJ, all major central banks are expected to cut rates in the coming quarters, but the SNB and the RBA are seen as diverging.

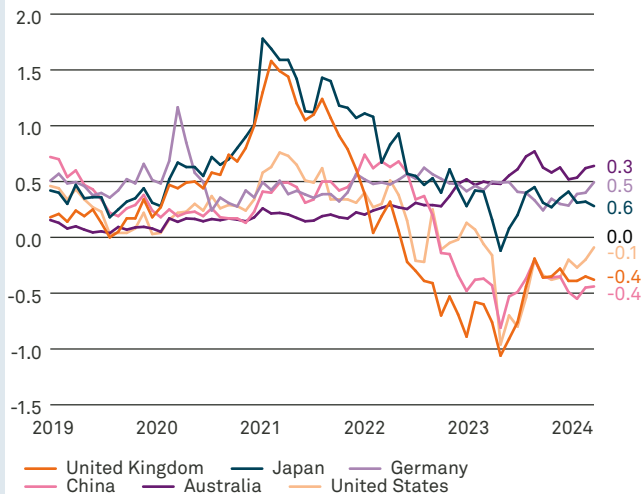
CHART 12: MAJOR CENTRAL BANKS – RATE HIKES (+) AND CUTS (-) PRICED IN



Source: Macrobond, BNY Advisors.
Data as of 11 June 2024.

Bonds: Yield curves in Japan, Australia and China are significantly steeper than elsewhere in DMs.

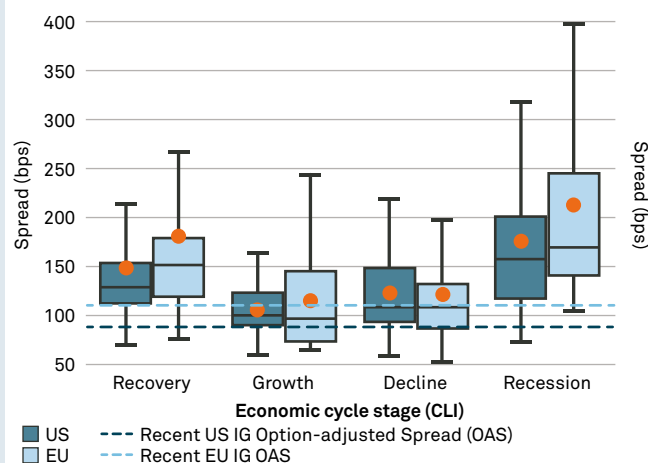
CHART 13: GLOBAL GOVERNMENT YIELD CURVES
10Y – 2Y YIELD



Source: Macrobond, BNY Advisors.
Data as of 11 June 2024.

Credit: Credit spreads are very compressed even when accounting for the stage of the economic cycle.

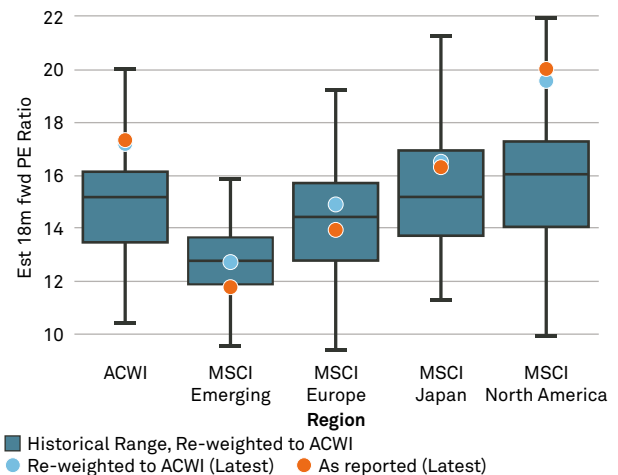
CHART 15: CREDIT SPREADS BY ECONOMIC CYCLE –
INVESTMENT GRADE (IG)



Source: Macrobond, BNY Advisors.
Data as of 11 June 2024.

Equities: US and Japanese equity valuations are expensive relative to their own history. Instead, European and EM equities show valuations in line, or cheaper, than history.

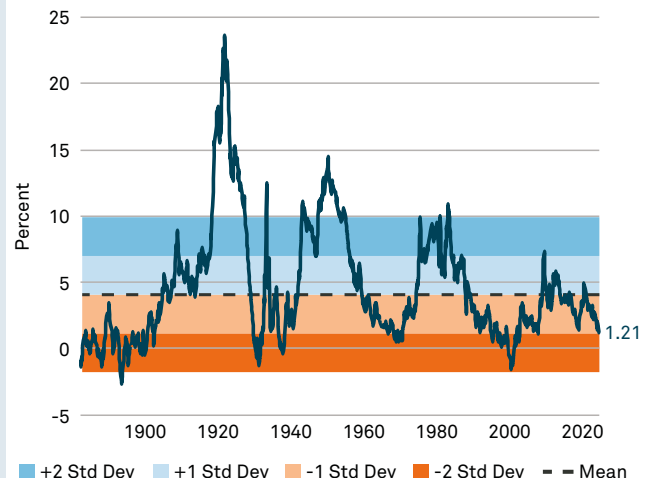
CHART 14: EQUITY MARKET VALUATIONS



Source: Macrobond, BNY Advisors.
Data as of 11 June 2024.

Cross-asset (bond/equities): Equity valuations are historically high compared to the yields offered on government bonds.

CHART 16: S&P 500: EXCESS CAPE YIELD
CAPE YIELD MINUS 10-YEAR US TREASURY YIELD – MEAN
AND STANDARD DEVIATIONS SINCE 1950



Source: Macrobond, BNY Advisors.
Data as of 11 June 2024.

02B MARKET SENTIMENT

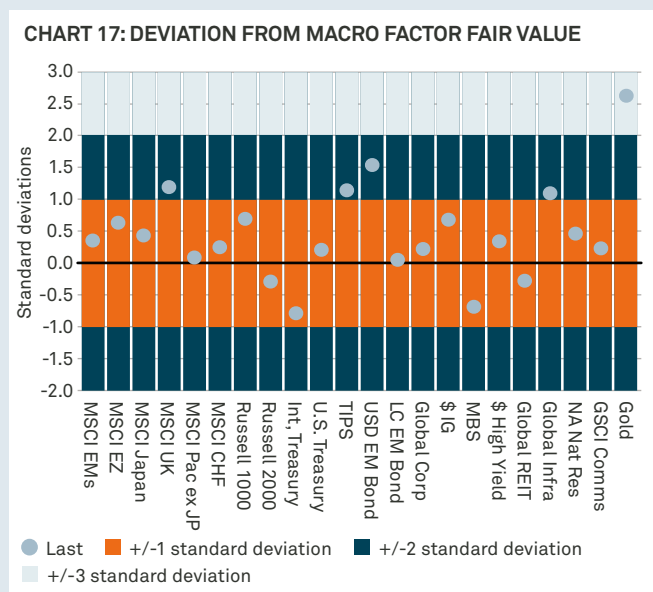
While bullish sentiment and positioning remain pervasive, key contrarian signals remain quiet for the moment. In other words, although markets have continued to progress with sentiment generally firming, extreme levels have not yet been reached and momentum signals remain positive, especially for global equities. Moreover, we see relatively few major assets trading far out of line with their macro factor implied fair value. A “glass half full” interpretation of the results is that markets have done well because the macro factor backdrop has been supportive of higher valuations.

Take European equities, where positive economic surprises have paired with rising consumer sentiment surveys just as the ECB carefully begins the rate easing cycle. Nascent signs of accelerating growth, although growth expectations moderated somewhat this quarter (see above), are contributing to an improving outlook for the asset class.

While the year-to-date rally in European equities means it's trading above what our macro factors would imply, valuations are within a reasonable range, so does not appear to be a near-term constraint, especially as we expect a modestly improving macro backdrop in Europe.

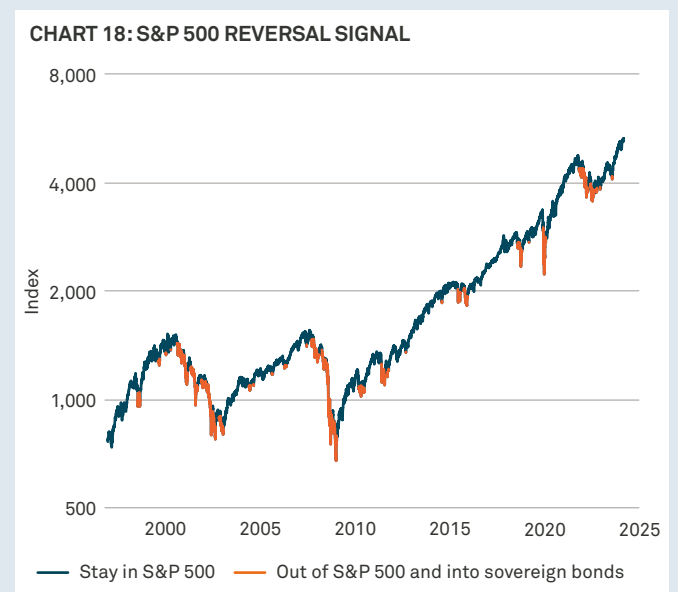
In the US, positioning and sentiment remain quite bullish, but our reversal signal model suggests it's not time to flip defensive based on these levels of sentiment. Investor surveys, such as the Bull-Bear Spread, are positive but in line with long-run average (~7 percentage points in favor of the Bulls over Bears). Similarly, the put/call ratio is near its long-run average after consistently being above average in the second half of 2023. Aggregating several of these measures, our US market sentiment index remains above average, but within 1 standard deviation after April's brief pullback. Finally, as with Europe, current US large cap equity valuations are above what our macro

Few assets are trading at stretched levels compared to our macro factors.



Source: Macrobond, BNY Advisors.
Data as of 10 June 2024.

Technical signals remain quiet, which suggests maintaining risk-on positioning.



Source: Macrobond, BNY Advisors. Data as of 10 June 2024. No lag in implementation, no minimum holding period, no trading costs assumed.

Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY product.

factors would imply for fair value, but (maybe surprisingly) not extremely so. Whereas US small caps are trading slightly below implied fair value. Bottom line: at current valuations, there is neither a strong buy or sell signal based on macro factors or sentiment basis.

One recent standout performer has been Japan equity. Unlike earlier in the year, when valuations looked elevated compared to macro factors (i.e., overvalued). Today, the macro data are better aligned with the asset class's valuation. This partially reflects a moderate pullback in Q2, but also reflects the macro data catching up with the market. Unlike other developed markets (DM), Japan continues a structural reflationary journey, which is paired with corporate governance reforms that support improving profitability. These developments likely provide the foundation for ongoing equity market gains.

Fixed income provides a contrasting picture to equities. Sovereign bonds continue to lack momentum despite the recent start of DM cutting cycles. This likely reflects the uncertainty surrounding the inflation outlook that has continually upended rates expectations and restrained a more broad-based rates rally. Positioning remains broadly neutral to slightly negative, as are measures of bond market sentiment. With no indication of stretched sentiment or positioning, and lacking momentum, we take little signal for a fixed income overweight or underweight decision based on technical grounds.

Equity momentum remains positive across the board, while sovereign bonds continue to struggle.

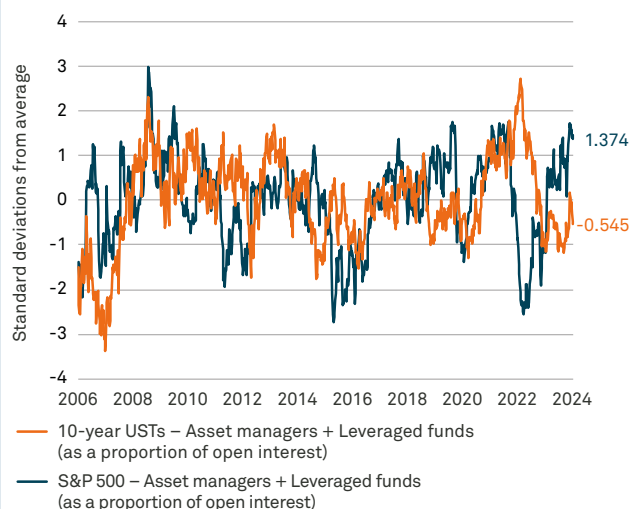
TABLE 2: CROSS ASSET MOMENTUM SIGNAL

Cross asset momentum signal (-1 to +1)	Last	Current
Equities	0.7	0.9
S&P 500	1.0	1.0
Nasdaq 100	0.6	1.0
FTSE 100	1.0	1.0
Eurostoxx 50	1.0	1.0
Topix (Japan)	1.0	1.0
Hang Seng (China)	-0.3	0.7
Emerging Markets	0.6	0.9
Sovereign fixed income	-0.8	-0.7
US 10-year	-1.0	-0.9
Canada 10-year	-0.9	-0.5
Germany 10-year	-0.7	-0.8
UK 10-year	-0.4	-0.2
Japan	-0.8	-1.0
Credit	0.0	0.4
\$ Investment grade	-0.6	0.0
\$ High Yield	0.5	0.8
Alternatives	0.9	0.5
Gold	1.0	1.0
Oil	0.8	0.1

Source: BNY Advisors using Bloomberg data.
Data as of 6 June 2024.

Equity positioning became more bullish, while bonds have moved away from neutral as rates pessimism resurfaces.

CHART 19: POSITIONING IN THE S&P 500 AND 10-YEAR US TREASURIES



Source: Macrobond, BNY Advisors.
Data as of 10 June 2024.

03

INVESTMENT CONCLUSIONS



03 INVESTMENT CONCLUSIONS

Summary

Markets remain broadly underpinned by expectations that the global economy will soon begin exiting tightening cycles of recent years, and critically, will do so having inflicted relatively minor economic pain. Said differently, the market expects a 'soft landing', but a different economic cycle ahead, one where nominal growth is stronger and interest rates higher.

With this backdrop, equities continue to charge higher despite mixed messages on the inflation front that stymied hope of a consistent bond rally (so far). Overall, multi-asset portfolios are doing reasonably well in 2024, but mostly due to stronger-than-expected equity gains and higher commodity prices, offsetting underwhelming bond performance. Although spreads generally tightened year-to-date (YTD), key benchmark rates are higher, which may be surprising given the closeness of policy loosening, and in some cases already realized cuts. Higher rates YTD reflects mostly pricing out of unrealistic rate cut expectations at the start of the year and inflation disappointing consistently in Q1.

Our scenarios continue to paint a picture of moderating (but unlikely recessionary) growth, paired with slow disinflationary progress, and central bank loosening cycles starting and gathering pace (most notably from the Fed). Similar to last quarter, our proxy portfolios clearly show an odds-on probability of an equity-heavy portfolio outperforming a bond-heavy portfolio over the outlook horizon. This suggests a pro-risk bias is appropriate, but caution remains warranted considering the still wide distribution of outcomes. The downside and upside risks are reasonable well-balanced in our estimation, but the spread between "good" and "bad" outcomes remains large, which constrains turning more aggressively pro-risk for now.

Our most likely scenario, 'Muddle Through', quite appropriately doesn't lead one to imagine outsized near-term market gains. But it's not necessarily a "bad" outcome. Ongoing inflation uncertainty is clearly a key risk that could adversely impact equity and bonds if that uncertainty gives way to a 'Second Wave' of inflation. However, if inflation uncertainty simply leads to delaying the start to cutting cycles, or even more moderate cutting paths through 2025, we expect markets can continue to progress (see 'Muddle Through' in nearby table for S&P 500 expectations). So long as growth remains benign, earnings will likely deliver without significant downside misses and given our expectations of the broadening AI tailwind, sentiment will stay firm. 'Muddle Through' may not provide the macro clarity immediately to boost the rally in the coming quarter or into year-end, but it's also unlikely to result in deep sell-off.

The table shows the potential paths for the S&P 500 using estimates of P/E and EPS (price/earnings and earnings per share, respectively).

Muddle Through	Year End Values		
	2024	2025	2026
EPS Estimate	239	271	295
Earnings Growth	7%	13%	9%
Price/Earnings	23	22	21
Approximate Level	5,503	5,953	6,191
Annual Return Estimate	15%	8%	4%
New Economy	Year End Values		
	2024	2025	2026
EPS Estimate	250	275	302
Earnings Growth	12%	10%	10%
Price/Earnings	24	25	25
Approximate Level	5,994	6,868	7,555
Annual Return Estimate	26%	15%	10%
Second Wave	Year End Values		
	2024	2025	2026
EPS Estimate	239	251	276
Earnings Growth	7%	15%	10%
Price/Earnings	19	20	20
Approximate Level	4,534	5,011	5,512
Annual Return Estimate	-5%	11%	10%
Prob. Weighted S&P 500	5,408	5,948	6,328
Annual Return Estimate	13%	10%	6%

Forecasts were calculated as of 3 June 2024. BNY Advisors.

Although we see multiples as vulnerable to de-rating should inflation spook markets, this is odds against. A sharp and sustained de-rating would materialize only if a genuine resurgence of inflation occurred (20% probability in our estimation). Instead, mixed reports providing ambiguous inflation signals will continue to cause temporary market gyrations but likely keep trading range-bound (60% probability).

The key to keep the equity rally going, in our view, is linked to a solidification of the belief that inflation will return and remain at target. This would focus markets on the AI tailwinds gathering force, rather than playing the monetary policy guessing game. Our fan charts suggest risks to

US equity are skewed slightly to the downside near-term, reflecting the potential for a sharper-than-expected slowdown in US growth in our main downside scenario ('Second Wave'), but skewed to the upside in 2025 and beyond, where the benefits of our upside scenario ('New Economy') begin to dominate. Our positive views around AI's equity impact are shaped by our in-depth research, which can be found [here](#).

Inflation uncertainty will likely be a larger constraint on near-term bond market performance, but the 'light at the end of the tunnel' is maintaining the attractiveness of increasing duration exposure. Market expectations are now much more reasonably priced than earlier in the year, but like the market, we expect only a moderate decline in rates in the near-term, limiting our total return expectations.


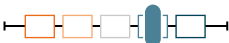
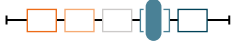



Based on our probability weighted scenarios, we derive risk-adjusted return estimates across assets, and in the tables that follow, we lay out our tactical (2024 and early 2025) and strategic (multi-year) views. Our projections point to a preference for European and EM ex China equities near-term, and US and Japan equities on a multi-year basis. On the fixed income side, we favor exposure to DM sovereign debt over credit exposure and local currency debt in EM.

ASSET CLASS VIEWS



Major asset class	Tactical view	Strategic view	Comments
Equities			A lot of optimism is priced in by the market over the near term, but expected returns are broadly in line with long term averages, and relatively better compared to other asset classes. We see regional opportunities to add value as economies converge.
Fixed Income			Benefits from high current yields but low expected price returns seen as providing little uplift compared to cash, with greater risk. Risk/reward is expected to be below average. Within credit, elevated yields are attractive, but spreads are very compressed, and expected to rise, which will drag on total returns. Given tighter than average credit spreads, we continue to lean in favor of sovereign debt and higher quality credit exposure over high yield.
Alts/Real Assets			With more constructive views of growth and expectations that inflation will be broadly in line with consensus, we remain neutral.
Cash			Cash is attractive given low volatility, elevated income returns, and rates that are expected to fall more slowly, but better expected return opportunities are appearing elsewhere.
Equity	Tactical view	Strategic view	Comments
Developed Markets Equity			The macro backdrop remains moderately supportive as benign growth and disinflationary trends, paired with nascent loosening cycles will reduce equity headwinds and support risk appetite. Inflation uncertainty remains a key risk that could spook markets near-term but our expectation is that uncertainty will most likely give way to inflation moving slowly, but sustainably toward targets. This will allow equity markets to re-focus on fundamentals (earnings) rather than playing the monetary policy guessing game. Overall, the risk outlook appears broadly balanced with expected returns closer to long-run averages.
US Equity			Near-term risks slightly skewed to the downside given inflation uncertainty in coming months and elevated multiples at risk of de-rating if confidence in the rate cuts evaporates. However, benign economic growth, earnings momentum, AI tailwind, and a broadening rally counterbalance inflation uncertainty concern and support a Neutral tactical view. Risks skewed to upside in 2025 as near-term constraints fade and expected positive AI impact dominates.
UK Equity			Cheap valuations on both a relative and historical average basis remain attractive and imply that minimal less bad news could spur on markets to re-rate. 12m fwd EPS growth expectations are negative and low compared to peers. And the UK general election which will likely deliver a change in government may also bring some greater optimism on longer run growth prospects. But the sectoral composition of the index is unhelpful (e.g., UK vs. US equity performance is strongly correlated with Value vs. Growth). And current weak labor market dynamics in the country make us more worried about risks of recession in the UK.
Europe ex UK			We upgrade European equities on the back of expected positive earnings revisions. The vast majority of the leading indicators we track suggest the cycle is picking up the euro area, yet earnings expectations remain weak. Income returns are significant, with dividend + buyback yields providing more than 4%, or about ~70+% of the total return assumed in our long term capital market assumptions. Uncertainty around the outcome of the French elections pose a near term risk, but also a good entry point given the sell-off seen so far.

Equity	Tactical view	Strategic view	Comments
Japan Equity			Japan is recovering from a weak growth patch and reflating more durably --underpinned by rising nominal and real wages, strengthening corporate sector reforms, a pick-up in business investment and more entrenched inflation expectations. BOJ policy normalization will be gradual, not unduly restrictive. Corporate earnings to remain buoyed by domestic improvements, however, tailwinds from Yen weakness to wane. Valuations have perked up but remain reasonable. We turn neutral, tactically, in the near-term after outsized gains in last 1-2 years. But we remain overweight strategically.
EM Equity			The drag from China is lessening, as China's weight in MSCI indices wane, but it persists. From a fundamental standpoint, many EMs are also gradually adapting to a prolonged China slowdown. But range-bound commodity prices, easing US growth, lingering USD strength and heightened export competition from China limit significant near-term upside. Longer term trends -- such as favorable trade, FDI and supply chain shifts and a larger growth contribution from several large EMs-- keep us optimistic.
EM ex China Equity			EM equity excluding China looks increasingly attractive. The drag from China is technically and fundamentally curtailed. Underlying price trends also reflect a variety of secular themes: AI-driven semiconductor-led gains in Taiwan; domestic-demand strength in India; and friend-shoring in places like Mexico and Central Europe. Even with lingering USD strength, modest rate cuts from an increasing number of EM central banks will also help. Valuations remain balanced with P/Es in the mid-teens. Political volatility could present entry opportunities. We suggest Overweight tactically, as well as strategically.
China Equity			Chinese equities remain cheap versus history and its peers. They remain less correlated with global equities and are also under-owned. These considerations, and our expectation of further manufacturing-focused stimulus, keep us neutral on a tactical basis. However, economy-wide deflation risks will linger on account of the downturn in property, excess production capacity, deficient demand-side stimulus. We struggle to see credible drivers for sustained medium-term growth and earnings recovery. As such, we hold on to our underweight recommendation on a strategic basis.
Fixed Income	Tactical view	Strategic view	Comments
US Treasuries			The high level of nominal yields still offers attractive income returns, as does extending duration to lock in multi-year rates. We continue to expect Fed cuts to begin later this year. However, we see less risk of a strong deterioration in growth that would merit sharp rate cuts. Our main downside scenario, although odds against, is a negative one for rates as it sees possibility of reaccelerating inflation prompting a hawkish turn.
Intl. Sovereign Debt			With the loosening cycle now underway in the euro area, and risks to growth that remain (e.g. in Germany), we expect decent risk-adjusted returns over the next 12 months. However, we see less compelling income returns compared to USTs. Japanese bonds remain unattractive given low income returns and negative price return expectations. We find UK gilts to be relatively more attractive given high income return, and a better relative expected risk/reward more broadly.
Global IG			High grade corporate spreads have become somewhat rich. Amid a gradual economic slowdown, especially in the US, and hefty new issuance needs, we expect spreads to widen to long-term means. But yield levels are also elevated on a historic basis and provide some buffer. On net, and on a probability weighted basis, total returns to be constrained to low single-digits. As such, we are less optimistic on IG credit and recommend Underweights on a tactical basis. We remain Neutral strategically. Prefer peripheral EU sovereign paper over US IG.

Fixed Income	Tactical view	Strategic view	Comments
High Yield Debt			Recession avoidance and peak U.S. rates allowed HY to rally sizably. But rich credit valuations, coupled with a gradual economic slowdown, slow rate cuts, and elevated re-financing needs weigh on HY's near-term prospects. Yield levels still provide a decent income buffer, but returns are highly uncertain on vulnerability to a downturn in earnings, tighter lending and higher real rates. We remain Underweight tactically, but Overweight strategically on the medium-term prospect of higher income returns.
EM Local Currency Debt			Peak US rates, better EM inflation fundamentals, decent real rate buffers and cheap currency valuations keep EM locally debt attractive. EM rate cuts have been slowed by higher for longer US rates but could be catalyzed by policy easing at other (non-US) DMs. Several large EMs (excluding China) are also key beneficiaries of gradual supply chain shifts and have better fiscal fundamentals. We, stay Overweight on a tactical basis. We stay Neutral on a strategic basis on relatively lower yields and income return prospects, versus USTs.
EM USD Debt			Tighter spreads and below trend growth in U.S. and China and a fragile recovery in Europe keep us cautious. But these concerns are balanced by historically wide yield levels, currency flexibility in mainstream EMs (which absorbs credit pressure) and improvements in frontier market debt restructuring and IMF assistance prospects. We stay tactically Neutral. Stabilizing credit fundamentals and greater economic flexibility keep us strategically Neutral as well.

Source: BNY Advisors, as of June 3, 2024.

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strategies may be leveraged and may engage in speculative investment practices that may increase the risk of investment loss. Investors should consult their financial professional prior to making an investment decision.

DEFINITIONS

Japan (Nikkei 225): The NIKKEI 225 is an index that tracks the performance of the largest 225 companies traded in the Japanese market. **10Y UK Gilt** – Average yield of a range of UK government bonds all adjusted to the equivalent of a ten-year maturity. **Phillips Curve:** An economic theory that inflation and unemployment have a stable and inverse relationship. **US Consumer Prices (CPI) Index** measure of prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rate represents the inflation rate. The **10Y US Treasuries Average Yield** of a range of Treasury securities all adjusted to the equivalent of a ten-year maturity. The **CBOE VIX Index (VIX)** is an indicator of the implied volatility of S&P 500 Index as calculated by the Chicago Board Options Exchange (CBOE). The **Majors Dollar Index (USD)** measures the value of the US dollar relative to a basket of currencies of the most significant trading partners of the US including the euro, Japanese yen, Canadian dollar, British pound, Swedish krona, and Swiss franc. The **MSCI EM Index (Emerging Markets Equities)** tracks the total return performance of emerging market equities. The **S&P 500 Composite Index (S&P 500)** is designed to track the performance of the largest 500 US companies. **Europe STOXX 600** Index represents the performance of 600 large, mid and small capitalization companies across 18 countries in the European Union. **Bloomberg US Corporate High Yield:** covers the universe of fixed-rate, non-investment grade corporate debt in the US. **Bloomberg US Corporate Investment Grade:** designed to measure the performance of the investment grade corporate sector in the US. **1-mth. 1-year forward swap:** the avg. interest rate for 1-mth. in 1-year forward. **GDP:** gross domestic product is the total monetary or market value of all the finished goods and services produced within a country's borders over a given time period. **Fed funds Rate:** the target interest rate for overnight lending and borrowing between banks. **Purchasing Managers Index (PMI):** An economic indicator derived from monthly surveys of private sector companies. A level above 50 indicates expansion compared to the prior month and below 50 contraction. Investors cannot invest directly in any index. **Soft landing:** a gradual and controlled economic slowdown, often aimed at preventing a recession or minimizing its impact. **Global Financial Crisis:** The severe economic downturn that began in 2007-2008, characterized by widespread banking failures, a collapse in housing markets, and subsequent global recession. **Neutral Rate of Interest (r-star or r*)** is the short-term interest rate that would prevail when the economy is at full employment and stable inflation. A rate at which monetary policy is neither contractionary nor expansionary.

STATISTICAL TERMS

Skewness in statistics represents an imbalance and an asymmetry from the mean of a data distribution. In a normal data distribution with a symmetrical bell curve, the mean and median are the same. **Probability-weighted mean** is similar to an ordinary arithmetic mean, except that instead of each of the data points contributing equally to the final average, data points are weighted by the statistical probability for a particular scenario outcome. **Duration** is a measure of a bond's interest-rate sensitivity, expressed in years. The higher the number, the greater the potential for volatility as interest rates change.

OTHER

QE: quantitative easing. **Fed:** US Federal Reserve. **ECB:** European Central Bank. **BOJ:** Bank of Japan. **BOE:** Bank of England.

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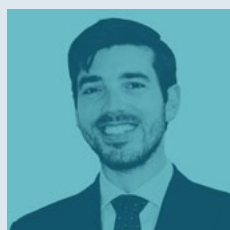
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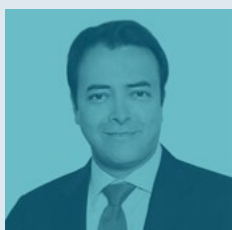
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