PGIM QUANTITATIVE SOLUTIONS

March 2024

Q2 2024 OUTLOOK

PGIM Quantitative Solutions Multi-Asset Team

Executive Summary

Economic Outlook

- The global economy remains resilient in early 2024 even as major central banks maintain elevated policy rates to bring inflation, a dominant concern throughout 2023, back toward their targets.
- The near-term US growth outlook is still solid, with economic data continuing to surprise on the upside. Labor market strength is helping the economy weather the impact of the Federal Reserve's (Fed) rate hikes.
- Eurozone economic growth stagnated in late 2023. Although labor market strength and rising real incomes are supports for the consumer, higher-for-longer interest rates and weaker demand from China are negatives for manufacturing.
- Japan is expected to post moderate growth in early 2024, driven by improving consumer sentiment and strong wage growth prospects following recent trade union wage negotiations.
- China's economy remains solid in early 2024, with the People's Bank of China and government financing providing targeted aid to the ailing real estate sector.
- On the inflation front, expectations are for a significant decline from last year's levels after both G7 headline and core inflation pulled back sharply from their 2023 peaks.
- While global core goods inflation eased significantly, services inflation is stickier, driven by solid service sector activity and tight labor markets. These have eased expectations of rate cuts by major central banks.
- Central banks and markets are eyeing the start of policy rates cuts, with the Fed signaling it will take an unhurried approach and remains on hold.
- Meanwhile, the European Central Bank indicated in March that the first rate cut in this cycle could be in the coming months. In contrast, the Bank of Japan ended its ultra-loose monetary policy in March by exiting negative interest rates and Yield Curve Control.

Market Outlook

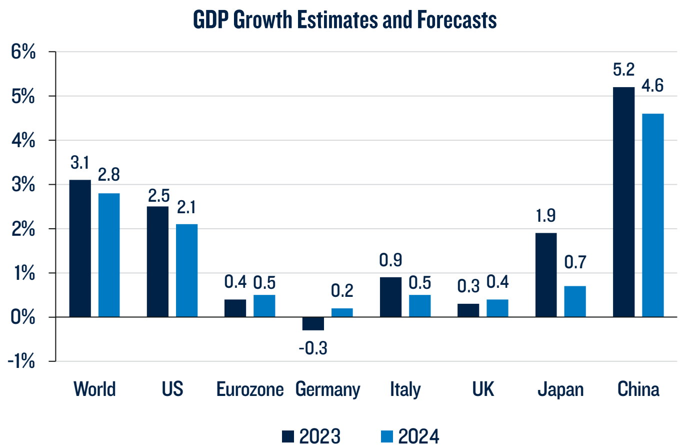
- Following robust gains in 2023, equity markets maintained their rally in Q1 2024 with growth stocks continuing to lead the way, though by a smaller margin than in 2023.
- Globally, US equities continue to lead, spurred by a supportive macro backdrop. Japan is an exception, with the Nikkei 225 Index setting a 35-year-high in late February.
- Consensus expectations for 2024 global earnings are for low double-digit growth in the US, moderate growth in other developed markets, and a double-digit rebound in emerging markets after declines in the past two years.
- Following the aggressive equity rallies, earnings yields are near their lowest levels since before 2004, illustrating how expensive global equities are on a historical basis.
- Despite rising sharply since the beginning of 2022, global bond yields still lag global earnings yields, though that gap has now fallen to its lowest level since before 2004.
- The outlook for bonds remains tenuous. Barring rapid economic deterioration, a sizeable duration rally seems unlikely, and rates could move higher still if inflation remains above the Fed's 2% target.
- Among large-cap stocks, the breadth of stock performance has started broadening and if this trend continues, the equally weighted S&P 500 could fare better in the rest of 2024.
- Regionally, Japan is relatively more attractive, with still-easy monetary policy, fiscal stimulus to boost both consumer and business spending, along with the fastest earnings growth expectations. The earnings outlook for emerging markets is also attractive and stands to benefit from easing Fed policy.
- Commodity returns are likely to be moderate after a down year in 2023. While commodities are generally supported by supply constraints, there are still downside risks from sharply slower global growth and higher-for-longer interest rates.
- Our outlook for asset outcomes for the balance of 2024 hovers in flat-to-moderately positive territory.

Economic Outlook

Soft Landing Optimism Despite Still Elevated Inflation

The global economy remains resilient in early 2024 even as major central banks maintain elevated policy rates to bring inflation, a dominant concern for much of 2023, back toward their targets. Global GDP growth is expected to moderate slightly in 2024 to 2.8%, down from 3.1% in 2023 (Figure 1). Economic activity in the US appears solid, while Japan and the Eurozone are growing more moderately. China continues to post slower but still solid GDP growth while growth in other emerging economies has been strong. Despite the healthy growth environment, inflation appears to be tracking toward central bank targets although the last mile is proving to be a bit stickier than initially expected.

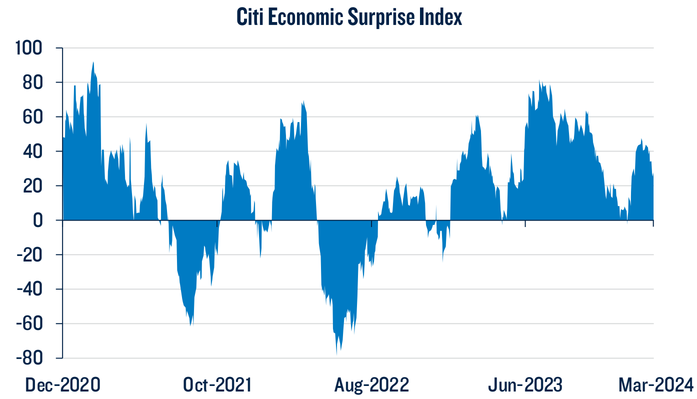
Figure 1: 2024 Growth Expectations Remain Solid



Source: Bloomberg as of 3/15/2024

The near-term growth outlook for the US remains solid, with economic data continuing to surprise on the upside (Figure 2). Labor market strength, evident in robust jobs growth, is helping the economy weather the impact of the Federal Reserve's (Fed) rate hikes. Labor market tightness, measured by the ratio of job openings to unemployed, remains significantly higher than one. We put this labor market tightness into historical perspective in a recent piece. While support from excess savings has largely waned, spending has held up well amid expanding payrolls and improving real income growth. Meanwhile, fixed investment spending growth has remained stable with improvement in residential investment adding to slower but still solid capital spending growth.

Figure 2: US Economic Data Surprisingly Positive



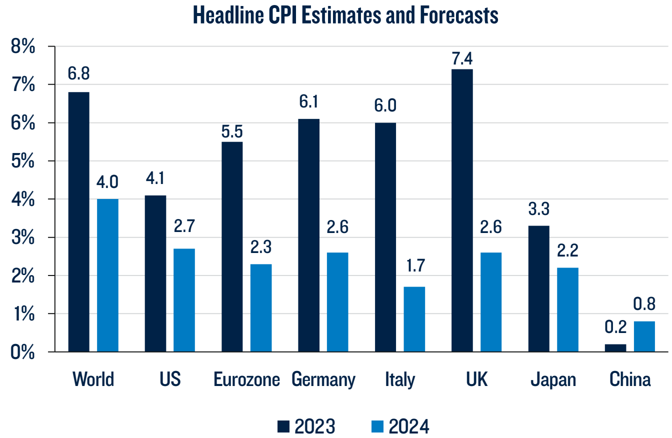
Source: Datastream as of 3/15/2024

Eurozone economic growth stagnated toward the end of 2023 with widening divergence among eurozone economies. In contrast to the post-2010 recovery, German GDP growth remains the weakest, France is middling, while growth in southern European economies is solid. Although labor market strength and rising real incomes are supports for the consumer, higher-for-longer interest rates and weaker demand from China are negatives for manufacturing.

Despite narrowly missing a slip into a recession for two consecutive quarters in the second half of 2023, Japan is expected to post moderate growth in early 2024, driven by improving consumer sentiment and strong wage growth prospects following recent trade union wage negotiations. Japanese manufacturing continues to benefit from low interest rates and a weak yen, while demand is supported by capital goods imports by the US and an upturn in the global semiconductor cycle.

China's economy remains solid in early 2024, with the People's Bank of China (PBOC) and government financing providing targeted aid to the ailing real estate sector. Policy measures announced during the latest session of the National People's Congress indicate that the main focus remains on supporting the economy from downside risks rather than stimulating the economy outright.

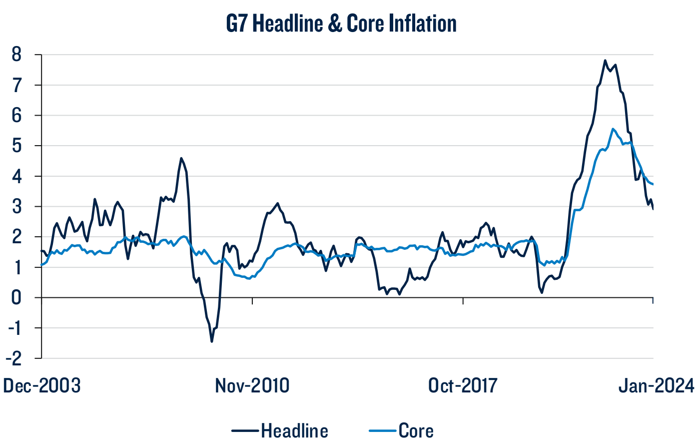
Figure 3: Headline Inflation Easing from Elevated Levels



Source: Bloomberg as of 3/15/2024

On the inflation front, expectations are for a significant decline from last year's levels (Figure 3) after both G7 headline and core inflation pulled back sharply from their 2023 peaks. Although these expectations are partly an extrapolation of those declining trends continuing into 2024, more recent inflation readings suggest that core inflation is turning out to be stickier (Figure 4). While global core goods inflation eased significantly with the removal of supply chain bottlenecks, falling commodity prices, and weak goods demand during 2023, this decline has been fading recently amid a pick-up in goods demand and firming input costs. Services inflation is stickier as a result of solid service sector activity and tight labor markets. These have given pause to expectations of rate cuts by major central banks.

Figure 4: Headline Inflation Easing While Core Remains Sticky



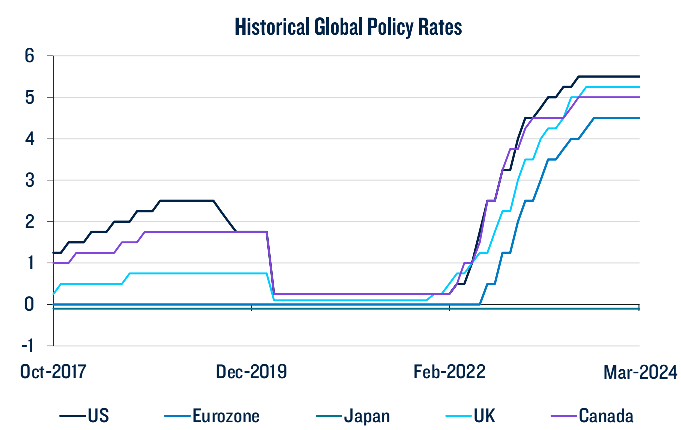
Source: Haver Analytics as of 1/31/2024

Against this backdrop, major central banks have remained on hold (Figure 5) over the course of 2023 and early 2024. However, both central banks and markets are eyeing the start of the policy rate cut cycle ahead. The Fed's rhetoric continues to signal it will take an unhurried approach to cutting rates and remains on hold following March's meeting of the Federal Open Market Committee (FOMC). Despite upside surprises to core inflation in early 2024, the Fed views the risks moving into better balance and has signaled around 75bps of easing through the rest of the year. With inflation continuing its bumpy progress towards the Fed's target and slower predicted growth over the rest of the year, we expect the Fed to start its easing cycle sometime toward the middle of 2024. Meanwhile, the European Central Bank (ECB), which has kept policy rates unchanged since September 2023, has also indicated in its March meeting that the first rate cut in this cycle could be in the coming months. In contrast, the Bank of Japan (BoJ) ended its ultra-loose monetary policy in March by exiting negative interest rates and Yield Curve Control. However, even the BoJ has signaled that it won't tighten policy any further for now given its focus on avoiding significant disturbance to the economy.

In emerging markets, China maintains an accommodative monetary policy with the PBOC maintaining implementation of targeted measures to support the housing market. Given its focus on risk control, the PBOC remains reluctant to deliver sizeable and broad-based rate cuts necessary to drive a strong acceleration in credit growth and economic activity.

With expectations for solid 2024 global GDP growth and continued positive surprises to growth data, particularly in the US, central banks are likely to take a measured, patient approach in starting their rate cut cycle. And while GDP growth in the US is expected to slow over the course of 2024, sticky core inflation could result in a stagflationary environment, thereby forcing the Fed to keep policy tight. Therefore, policy missteps remain key risks for the global economy, with the Fed and other central banks either staying too high for too long, or cutting too much, too soon.

Figure 5: Rate Cut Cycle in View After Holding Steady



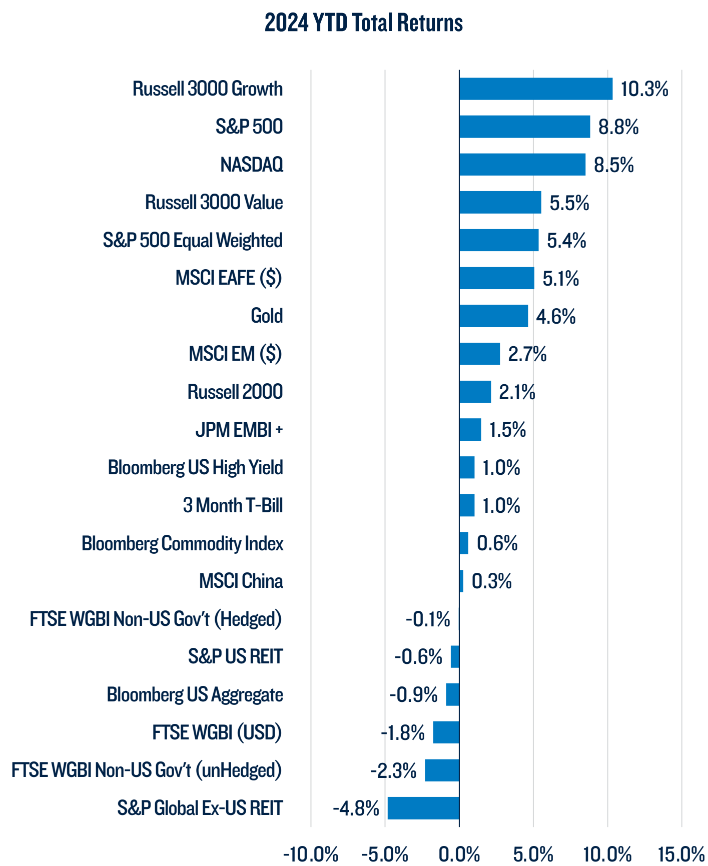
Source: Datastream as of 3/15/2024

Market Outlook

Risk Assets Remain Supported by Healthy Earnings Outlook

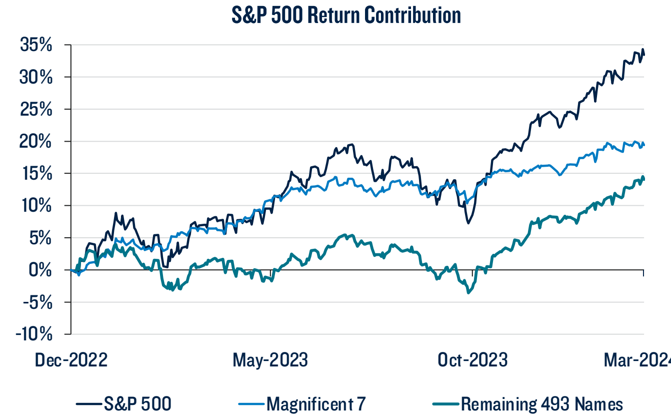
Following robust gains in 2023, equity markets continued their strong run in the first quarter of 2024 with the S&P 500 advancing 8.8% through mid-March (Figure 6). As in 2023, growth stocks continued to lead the way, though by a smaller margin, when growth trumped value by nearly 30%. The widening breadth of market participation (Figure 7) is another notable market contrast relative to 2023,[1] when the "Magnificent Seven" (M7) accounted for two thirds of the S&P 500's advance. So far in 2024, the M7 has contributed a still remarkable one third of the returns to the S&P 500, but the remaining 493 stocks in the index are now contributing the majority of returns. Globally, the US is still handily outpacing equity markets, spurred by a very supportive relative macro backdrop. One notable exception is Japan, which year to date has kept pace with US equities, with the Nikkei 225 Index setting a 35 year high in late February.

Figure 6: Though by Smaller Margin, Growth Stocks Still Lead the Way



Source: FactSet as of 3/13/2024

Figure 7: Magnificent Seven: Still Magnificent, but Less Dominant

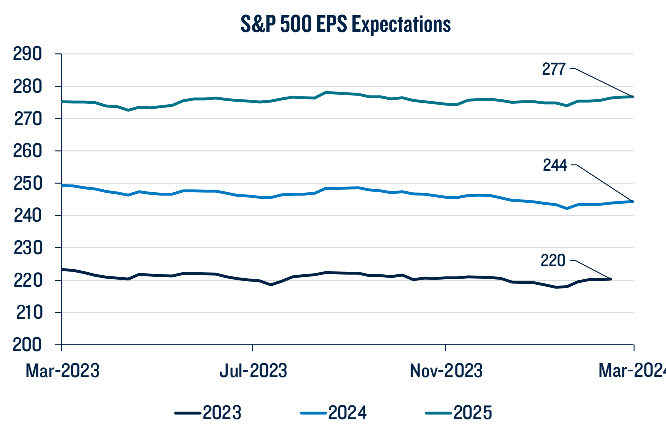


Source: FactSet as of 3/8/2024

Our outlook for asset outcomes for the balance of 2024 hovers in flat-to-moderately positive territory. There are overhangs from overly strong asset performance, including elevated equity valuations, moderating inflation trends, and still-subdued manufacturing activity. However, we don't consider these factors to be a danger to absolute positive performance, but instead, just a ceiling on what might happen.

Global earnings growth was modest in 2023, with significant declines in energy, commodity, and healthcare stocks offsetting gains in consumer discretionary and communication services holdings. In the US, earnings are on an improving trend (Figure 8).

Figure 8: Earnings Expectations for 2024 and 2025 Remain Solid



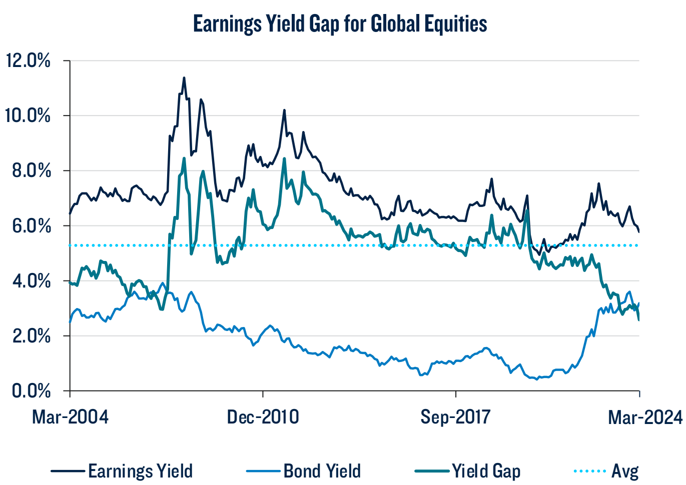
Source: FactSet as of 3/8/2024

[1] Magnificent Seven is comprised of AMZN, GOOGL, MSFT, AAPL, NVDA, META, TSLA

Following modest growth in 2023, the consensus is for low double-digit growth in both 2024 and 2025 as the economy is expected to grow at a moderate pace, with many industries having already experienced an earnings recession and a tightening of purse strings, setting the stage for margin improvement. Labor productivity has also accelerated in recent quarters. Even if current expectations are revised lower, earnings growth could still turn out moderate barring a significant economic slowdown that could be a hit to sales. Outside the US, expectations are for moderate developed market growth and for a double-digit rebound in emerging markets after GDP declines over the past two years.

Despite rising sharply since the beginning of 2022, global bond yields still lag global earnings yields (Figure 9), though that gap has now fallen to its lowest level since before 2004. Not surprisingly, following the aggressive equity rallies in 2023 and 2024 year to date, earnings yields are near their lowest levels since before 2004, again illustrating how expensive global equities are on a historical basis.

Figure 9: While Narrower, Yield Advantage of Equities Over Bonds Remains



Source: FactSet as of 3/8/2024

Rather than looking at equities as a whole, we continue to look for niches where we see better opportunities. The impact of a handful of stocks (M7) on overall equity returns could still be significant for the balance of 2024 but could moderate given their dominance over the past few years. If this trend continues, we could see the equally weighted S&P 500 fare better during the remainder of 2024. Regionally, Japan is relatively more attractive, with still-easy monetary policy, fiscal stimulus to boost both consumer and business spending, and among the fastest earnings growth expectations globally. The earnings outlook for emerging markets is also attractive and stands to benefit from easing Fed policy. With China remaining a drag on broad emerging markets indexes, an alternative might be to gain emerging markets exposure ex-China. Factor-wise, we favor quality as firms are likely to remain constrained by the steep cost of capital due to still-high interest rates.

Among fixed income investments, the Bloomberg US Aggregate Bond Index has started 2024 in the red as expectations for as many as six Fed rate cuts at the beginning of the year have evolved to just three possible cuts as of March 20th, leading to a year-to-date rise in yields across the curve. For the balance of 2024, the outlook for bonds remains tenuous. A return to a positively sloping yield curve will require rates to move higher on the long end of the curve, or short rates to move lower, or some combination of both. Barring a rapid deterioration in the economy, a sizeable duration rally seems unlikely in the near term, with a non-trivial risk that rates could move higher still if inflation continues to stay above the Fed's 2% target.

Commodities returns are likely to be moderate but remain volatile after a down year in 2023. While tight monetary policy and a strong dollar were negatives in 2023, year to date in 2024 commodities returns have essentially held flat. OPEC+ is expected to continue to manage supply expectations by maintaining its guidance on supply. However, there are still downside risks from sharply slower global growth and higher-for-longer interest rates.

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PGIM QUANTITATIVE SOLUTIONS

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