A long autumn.

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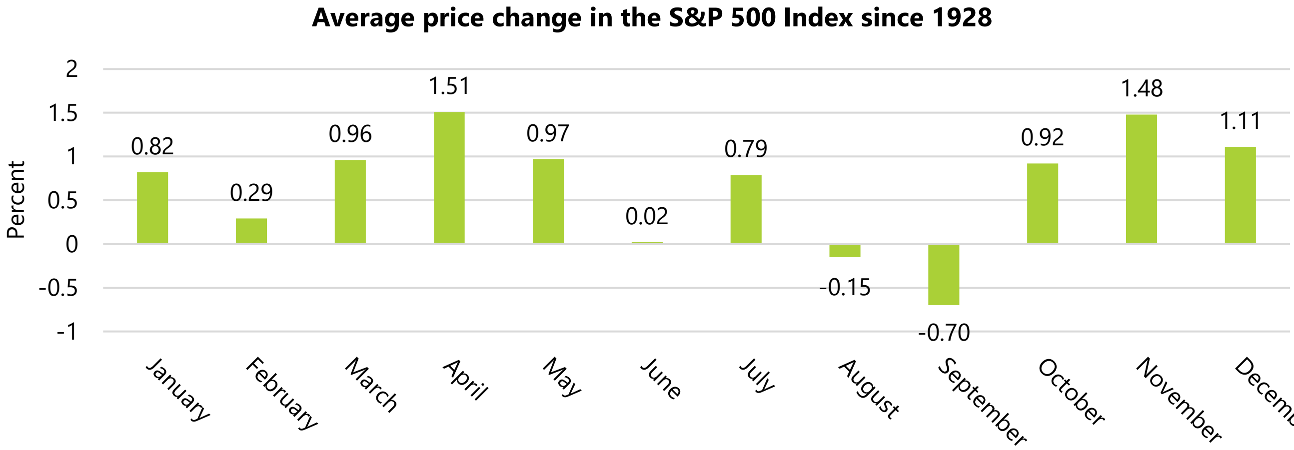
The late summer and early autumn months can be a lovely time of year as the weather turns less hot and humid. For investors in the equity market, however, that has oftentimes not proven to be the case.

Defying the autumnal equity knocks

From 2020 to 2023, the month of September was marked by unusually sharp declines in the S&P 500 Index. In fact, in seven of the 10 years between 2014 and 2023, the widely followed price index racked up negative returns. Even more remarkably, as we show in Exhibit 1, September has historically averaged a negative price change of 0.7% since 1928—the worst performance of any calendar month.

Exhibit 1: The stock market often falls with the leaves in September



Source: NDR, S&P Global, SEI. Index returns are for illustrative purposes only, and do not represent actual performance of an investment product. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Performance prior to 3/4/1957 is back-tested. Back-tested performance, which is hypothetical and not actual performance, is subject to inherent limitations because it reflects application of an Index methodology in hindsight. No theoretical approach can take into account all of the factors in the markets in general and the impact of decisions that might have been made during the actual operation of an index. Actual returns may differ from, and be lower than, back-tested returns. Past performance is no guarantee of future results.

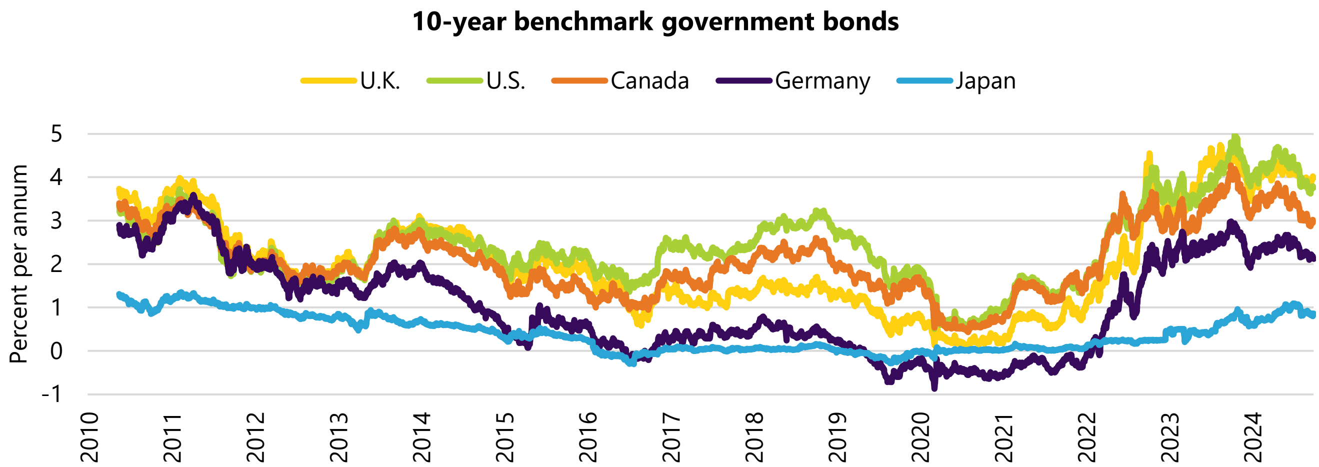
This September threatened to follow the same pattern, correcting sharply early in the month before recovering nicely by mid-month—turbocharged by the Federal Reserve's (Fed) decision to "go big" and lower the federal-funds rate by one-half percentage point (double the anticipated move). The S&P 500 price index, however, isn't much higher now than it was in mid-July.

Stock markets globally have become more volatile in recent months; although the peak-to-trough declines have been limited. Even in the tech-heavy S&P 500 Index, the price correction reached its worst level in early August, amounting to a negative 8.5% before bouncing back to its previous peak level.

Risk assets have been pressed by a variety of concerns in the most recent calendar quarter. These include signs of slowing growth in some of the most important economies, including the U.S., China, Germany, France, and Canada. Geopolitical uncertainty also is rife, highlighted by the wars in Ukraine and the Middle East, a consequential election in the U.S. (marred by two assassination attempts on former President Donald Trump), a change in government in the U.K. and France, and a shift from established/centrist parties in several European countries that have benefited both the extreme right and the extreme left.

Offsetting all of this bad news has been an unexpectedly sharp move down in bond yields. Exhibit 2 tracks the 10-year government bond yields of Canada, Germany, Japan, the U.K., and the U.S. With the notable exception of Japan, the yield on the 10-year sovereign bonds of these countries peaked in October 2023. They then tumbled into year-end 2023 as investors started to price in a recession, but began climbing again in January of this year. Yields moved lower once again in May and June, and have since fallen close to their lowest levels of the year.

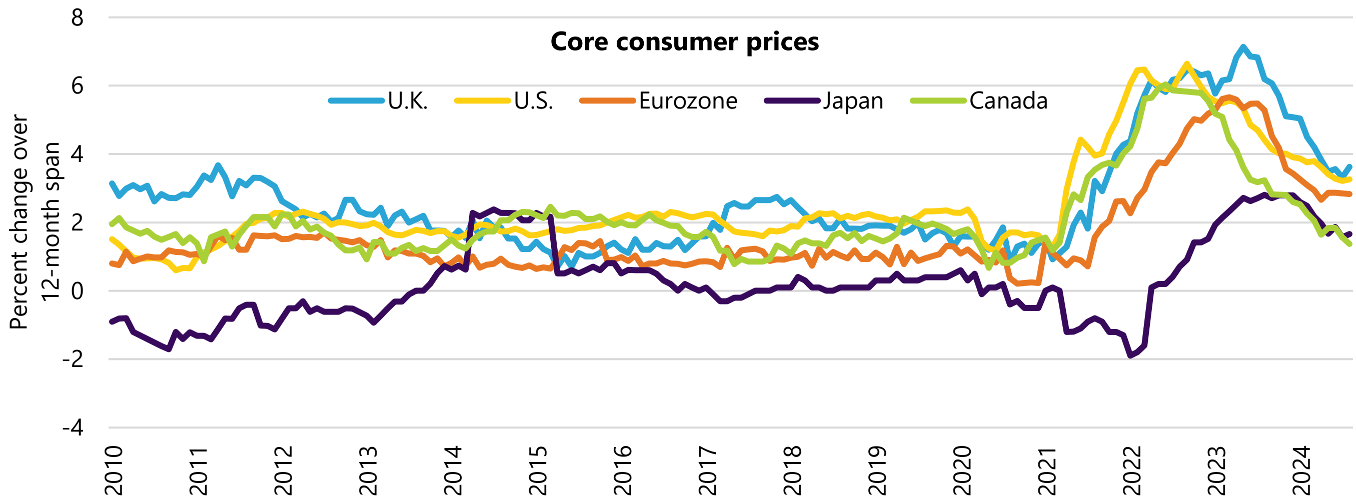
Exhibit 2: Bond bulls on the run



Source: FactSet, SEI.

Bond bulls have been heartened by the sharp improvement in inflation this year, which we highlight in Exhibit 3. The core consumer-price index, which excludes food and energy, has retreated dramatically over the past 18 to 24 months in most advanced economies. Although core inflation remains above 3% on a year-over-year basis in the U.S. and the U.K. and is still close to 3% in the eurozone, that has not prevented investors and central bankers alike from extrapolating further improvement in the months ahead.

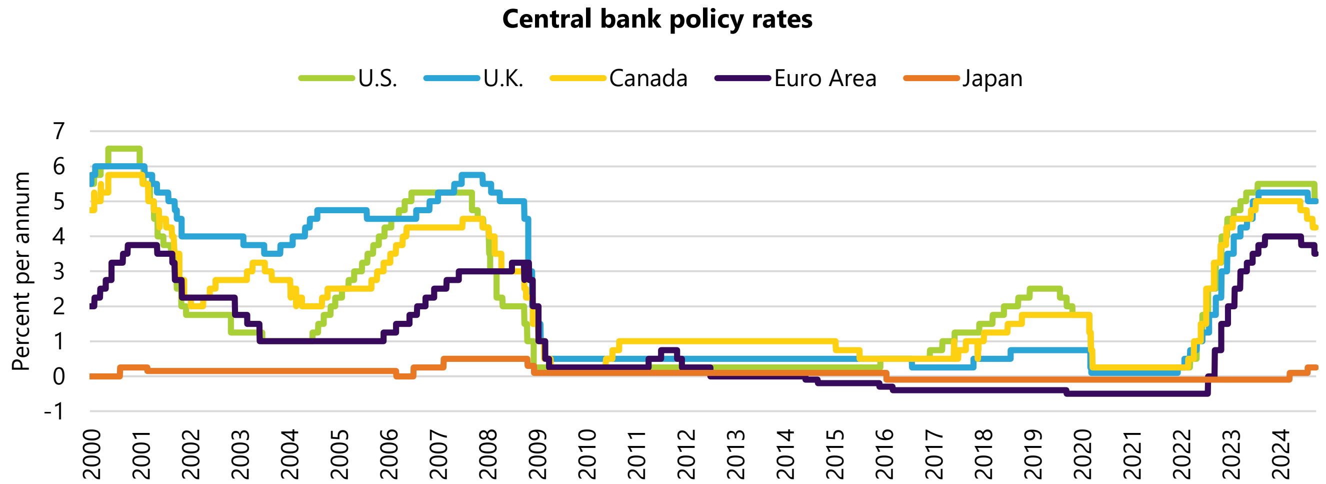
Exhibit 3: Mission accomplished?



Source: FactSet, SEI.

As we show in Exhibit 4, the Bank of Canada was the first among the major developed-market central banks[1] this year to cut its policy interest rate in June, followed by the European Central Bank in the same month, the Bank of England in August, and then, finally, the U.S. Fed in September. Although the Fed was the last to cut, it made up for lost time by cutting the federal-funds rate by half a percentage point. Japan is the outlier; despite having issued two increases so far this year, its overnight interest rate remains well below those of the other central banks.

Exhibit 4: The first cut is the deepest for the Fed

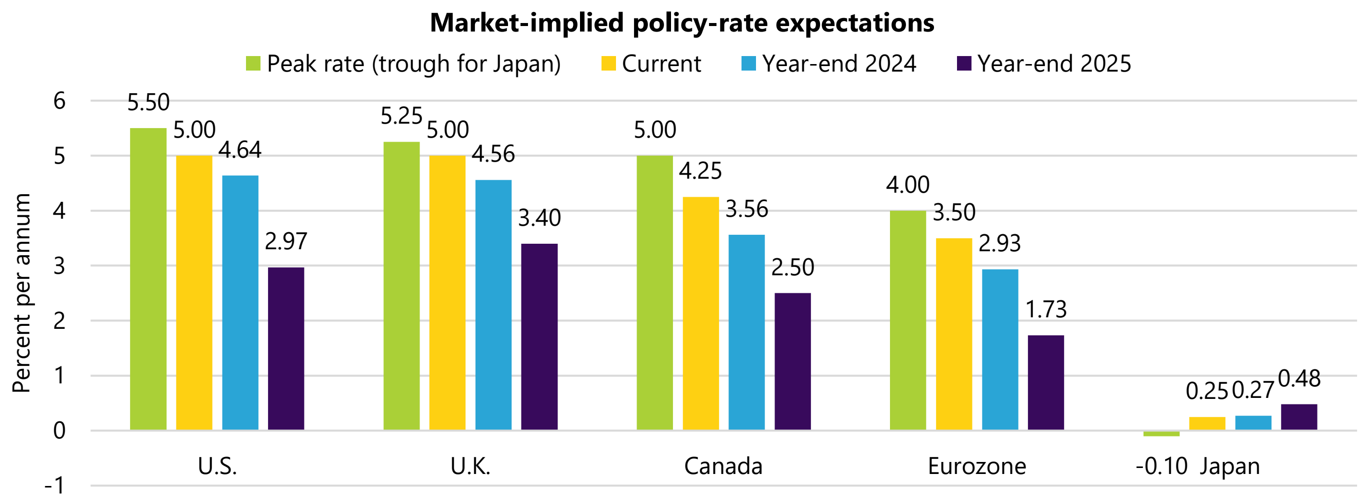


Source: FactSet, SEI.

Our take on the bond bulls: Curb your enthusiasm

The fact that major central banks in developed countries have entered an interest-rate cutting cycle is really no surprise given the easing of inflation pressures. What is surprising, though, is the number and magnitude of interest-rate cuts that have been priced into markets, especially as it pertains to the U.S. In the aftermath of the Fed's half-point reduction in the federal-funds rate to a range of 4.75% to 5.00%, traders have priced in a further drop to 4.50% to 4.75% between now and year-end, and an additional decline by year-end 2025 to a range of 2.75% to 3.00%. By comparison, the Federal Open Market Committee's median projection for the federal-funds rate by the end of 2025 is 3.4%. Exhibit 5 compares market participants' expected changes in policy rates across the major central banks, as implied by the pricing on overnight indexed swaps (OIS). Although the U.S. starts from a higher level, the magnitude of its rate cuts over the next 15 months exceeds those of the U.K., the eurozone, and Canada by 25 to 45 basis points.

Exhibit 5: Pricing in more cuts than seem likely

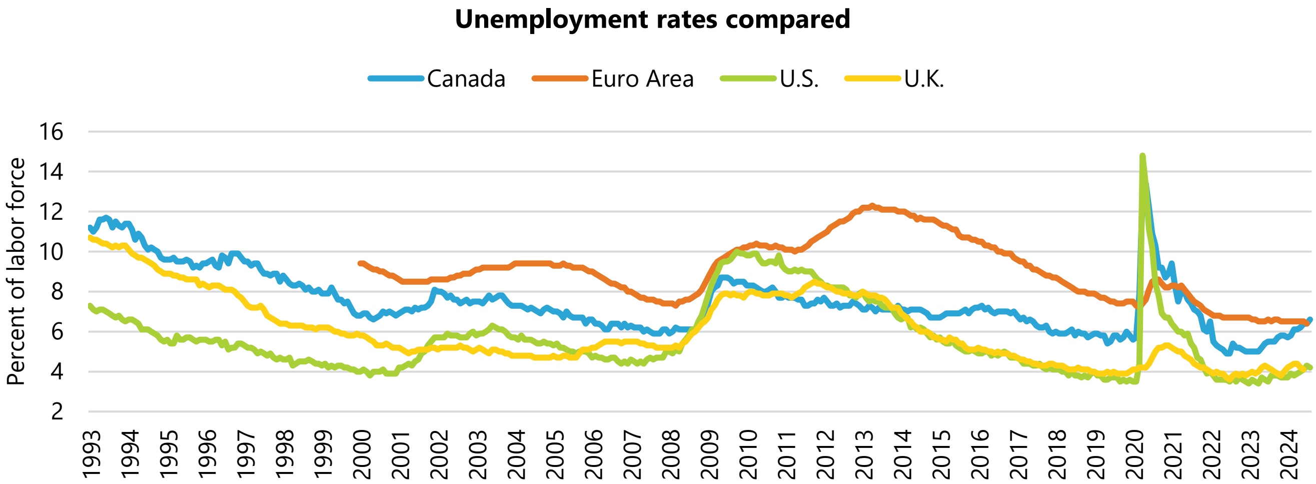


[1] The Swiss National Bank was the first of any developed-market central bank (including outside of major central banks) to cut its policy interest rate.

Source: Bloomberg, SEI.

We can only conclude that markets are pricing in a full-blown recession in the U.S. in 2025, reacting to what we view as a misreading of current trends in the labor market. Exhibit 6 underscores the fact that, despite the rise in the U.S. unemployment rate to 4.2%, it is still low relative to its own history and remains much lower versus the jobless rates reported by other countries. Only Canada has recorded a sharp deterioration in its labor market over the course of the past 18 months, providing a justification for a more aggressive monetary policy response by the Bank of Canada compared to other central banks. The unemployment rate in the eurozone is near the same level as in Canada, but it is lower than at any time in its own history over the past 25 years.

Exhibit 6: A recession in the making or just back to normal?



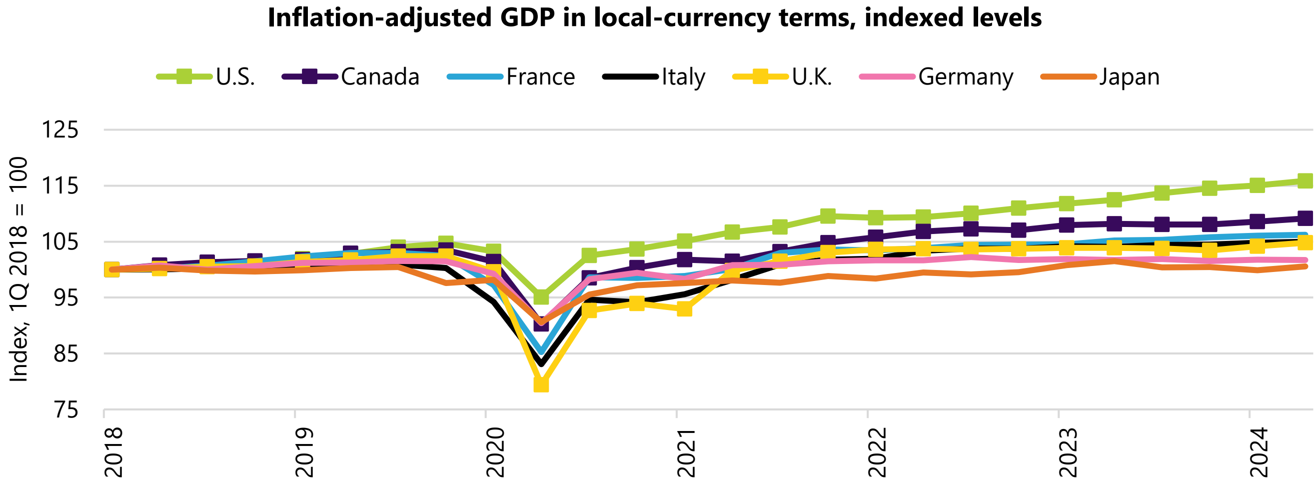
Source: FactSet, SEI.

Economists and policymakers are worried that this mild deterioration in the U.S. labor market will turn into a major bloodletting. It happened in the 2001-to-2002 and the 2007-to-2009 periods (we view the COVID-19 lockdown of 2020 as a special case that's not relevant to the discussion). The 2001-to-2002 experience, however, was marked by the tech bust and the additional disruption caused by the 9/11 terrorist attack. The 2007-to-2009 episode, of course, featured the global financial crisis and the residential real-estate bust. The economic and financial backdrop in the current cycle is notably different—and much more benign.

Outside of investor enthusiasm for artificial-intelligence-related equities, it's hard to see the current major imbalances that could lead to a recession anytime in the next year. Granted, manufacturing has been less than stellar, not only in the U.S. but also in most other developed countries. Service industries, which are a more important driver of growth, continue to roll along. According to the Federal Reserve Bank of Atlanta, the latest GDPNow reading of 3.1% as of September 27 is still well above the economy's long-run growth potential of roughly 2.0%.

The U.S. is still delivering better performance than many other countries, expanding 3.0% over the year-ended June. The U.K. posted comparable growth through the first half of this year, following two full years of stagnation; growth in the one-year period ending in June, however, was still a modest 0.9%. France (+1.0%) and Italy (+0.9%) have also been recording slight gains. Germany (-0.2%) has been stuck in stagnant and modestly recessionary conditions since 2021; it continues to feel the hangover of high energy and labor costs, increasing auto imports from China (now declining in the wake of tariffs imposed on electric vehicles), and sagging exports of cars and capital goods to the same country. Exhibit 7 tracks the fluctuations in gross domestic product (GDP) since 2018 for the G-7 countries.

Exhibit 7: What U.S. recession?



Source: FactSet, SEI.

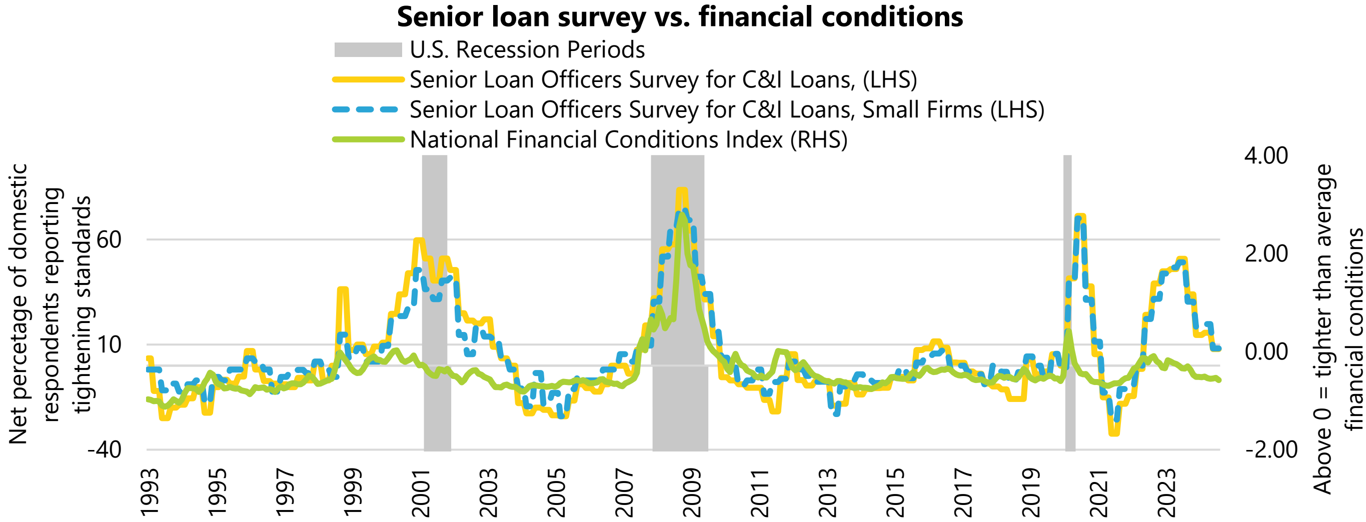
The U.S. economy still appears to have some momentum behind it. We believe the U.S. should continue to grow at a faster rate than other major developed economies, but at a slower clip than in previous years. We forecast a growth rate in the 1.5% to 2.0% range over the next 12 to 18 months. A true recession still seems quite unlikely in the near-term. This forecast is somewhat contingent on fiscal policy decisions that end up being less drastic than those suggested by either the Democratic or the Republican presidential nominee (about which we have more to say below). The U.K. could see slightly less growth, perhaps 1.0% to 1.5%. France, Germany, and Italy are each more likely to be in the 0% to 1.0% area.

Keep in mind that economists have had a poor record of successfully forecasting the path of GDP in recent years. When Silicon Valley Bank and a handful of other ill-positioned community banks blew up in March 2023, recession calls were rife. They turned out to be wrong. There were more predictions of recession at the start of this year, and markets priced in as many as six or seven cuts in the federal-funds rate by the middle of 2024. In reality, real GDP has been running at a healthy pace this year, with the first rate-cut not materializing until September.

Now market participants are obsessing over the 0.7% increase in the U.S. unemployment rate as it rises from an extraordinarily low level to a still-low level. On the contrary, in our opinion, the underlying strength of the labor market remains quite solid. We see the higher jobless rate not as a harbinger of recession but rather as a normalization of labor-market conditions. Labor-force participation of prime-aged persons has recovered from post-COVID-19 lows to reach its highest level (83.9%) in more than 20 years. Female participation is at a new all-time high, and prime-aged male participation hit 90% for the first time since the global financial crisis. In the past 12 months, over 1.5 million foreign-born persons aged 16 and older entered the labor force, while the native-born workforce recorded a slight decline. The influx of immigrants into the labor force has contributed to the upward pressure in the unemployment rate. In the absence of this surge, the unemployment rate would be closer to 4%.

Interest-rate-sensitive sectors of the economy, especially home sales and smaller businesses dependent on bank lending, have certainly been hurt by the jump in interest rates since 2022. Housing affordability hasn't been this bad since the early 1980s, a time when mortgage rates were considerably higher than they are today. But the damage still appears to be rather limited. Exhibit 8 reveals that bank-lending standards have eased considerably over the past year, even for small businesses. Meanwhile, the National Financial Conditions Index, published by the Federal Reserve Bank of Chicago, suggests that financial stress remains low and consistent with continued economic expansion. Corporate credit spreads are still tight, and companies that have the ability to tap the capital markets for financing have taken advantage of the recent decline in bond yields to extend maturities further into the future. There is no looming "debt wall" for the bulk of corporate America.

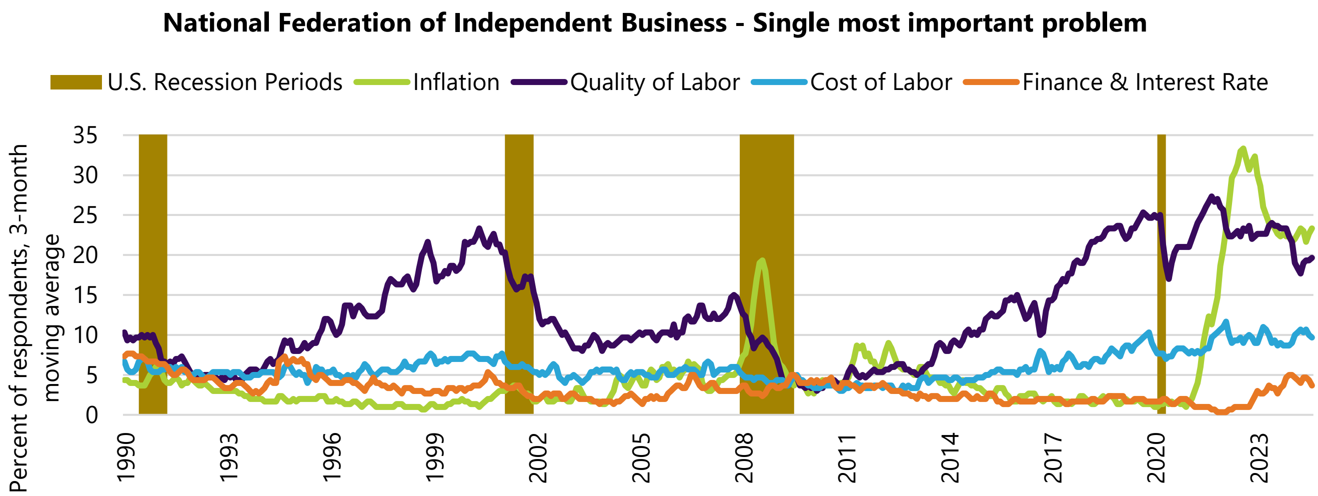
Exhibit 8: Financial conditions are restrictive but not deadly



Source: ECRI, Federal Reserve Bank of Chicago, Federal Reserve System (FRB), SEI.

It should therefore come as no surprise that the level of interest rates ranks rather low as a problem for smaller businesses, according to the National Federation of Independent Business (NFIB), which we highlight in Exhibit 9. Although financing costs are a bigger headache now than they have been since the end of the global financial crisis, less than 4% of respondents to the NFIB's monthly survey cite them as their biggest problem. Inflation and the quality of labor continue to rank #1 and #2; although both issues have been cited with decreased frequency over the past two or three years.

Exhibit 9: Inflation and labor quality are the big problems facing small businesses



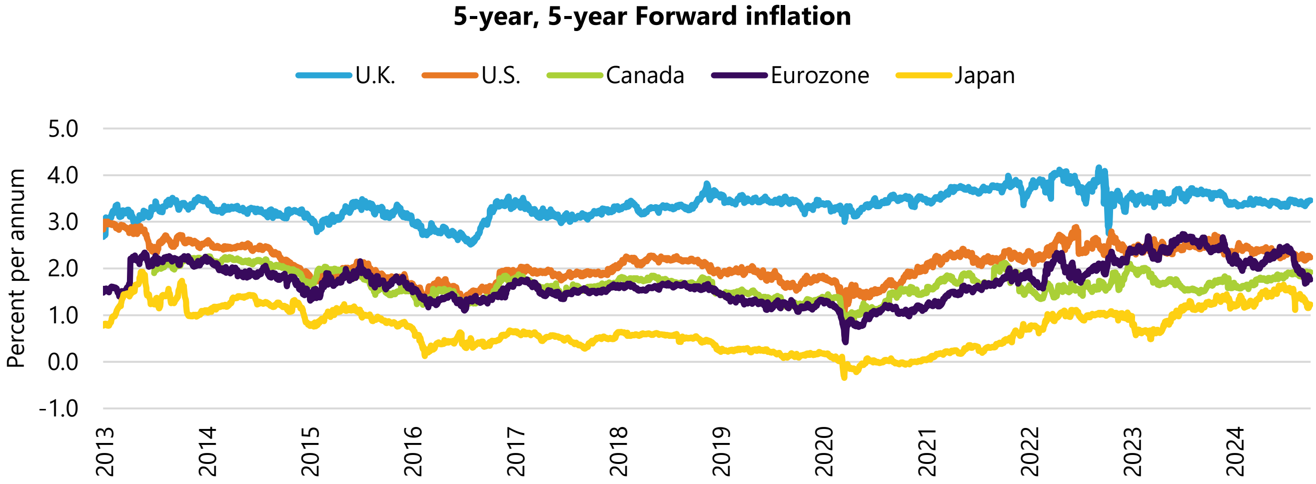
Source: NBER, NFIB, SEI.

The elections as a wildcard

While economists and the Fed seem to be overly worried about recession, market participants appear overly complacent about inflation, interest rates, and what the future holds for fiscal policy under either a Kamala Harris or Donald Trump administration.

Exhibit 10 tracks the so-called five-year, five-year forward inflation rate for the major economies, which shows what market participants expect the five-year inflation rate to be starting five years in the future. The U.S. forward rate has been falling for the past year, from 2.7% to 2.2%. We believe this is too low. In our opinion, it should be closer to 3%. If, as we expect, the economy remains resilient, the outlook for inflation should take a turn for the worse as we head into 2025, especially if fiscal policy continues on its profligate course.

Exhibit 10: Inflation expectations are deflating



Source: FactSet, SEI.

Elsewhere, the eurozone has recorded a particularly sharp decline in inflation expectations in recent months, with the forward five-year, five-year rate falling to 1.8%. This should give the European Central Bank additional room to cut its policy interest rate. The Bank of England, on the other hand, may feel constrained from cutting aggressively given the recent bounce in growth and how sticky inflation expectations have been. Note that the five-year, five-year forward inflation rate for the U.K. is based on the retail price index (RPI), not the consumer price index (as is the case for the other countries tracked in Exhibit 10). Historically, the difference between the two price indexes has averaged less than one percentage point. Even after making this adjustment, the five-year, five-year inflation rate for the U.K. remains one half of one percentage point above the central bank's target of 2%. Even the new Labour government finds it necessary to address its fiscal imbalance in order to reassure gilt investors.

It is surprising that investors are not more cautious heading into the November elections in the U.S. The race is too close to call, and the policies espoused by the two candidates are extreme in their own unique ways. Both Harris and Trump are engaging in a bidding war to get the votes they need to put them over the top. The Harris program features some $6 trillion of spending initiatives and tax cuts (the most costly include extending tax cuts that expire at the end of 2025 for most taxpayers, as well expanding both the child tax credit and the child and dependent care tax credit)—offset by some $5 trillion of tax increases on households earning more than $400,000, an increase in corporate taxes, and a higher capital-gains tax rate (including on unrealized gains for those at the upper reaches of the income scale). Even a Democratic Congress is likely to balk at the attempt to tax unrealized capital gains.

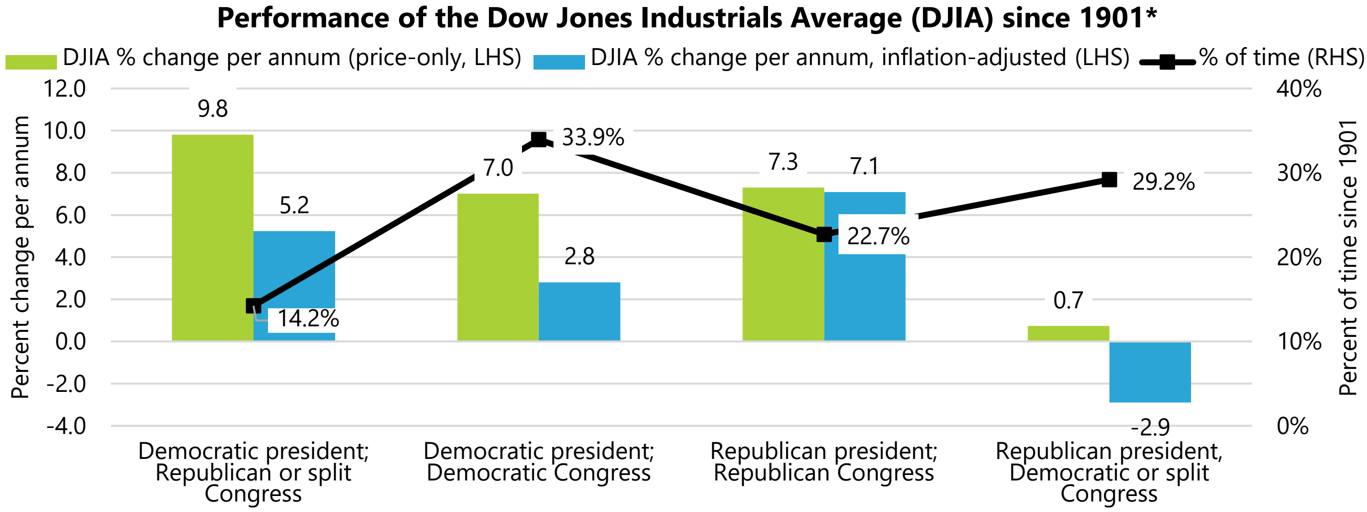
The Trump proposals, on the other hand, don't even attempt to offset much of the spending programs he mentions at his rallies. His tax-cut promises total at least $7 trillion over a 10-year period (the biggest items are extending all the cuts that will expire at the end of 2025 and eliminating the tax on Social Security income, overtime pay, and tips)— offset by less than $4 trillion in tax revenue derived from tariffs and the repeal of energy subsidies.

To us, if taken literally, all of these promises from both camps seem completely divorced from fiscal reality. One thing is clear: America's major political parties are not even pretending that fiscal responsibility is on the agenda. The net fiscal impact of either administration would likely be inflationary at a time when the economy is still running near capacity. Even as the Fed embarks on an easing cycle, bond yields are more likely to move higher than lower as inflation expectations rise and the term premium on longer-term bonds increases.

Investors probably would breathe a sigh of relief if the U.S. presidential winner faces a hostile or split Congress—simply because such an arrangement would put a brake on the spending and tax plans of the future administration. The chances look good that the Senate will flip to the Republican side; although the balance in their favor will probably be a paper-thin 51-49. The House race, like the presidential race, is much too close to call.

Historically, the stock market has done rather well under a Democratic president combined with a Republican or split Congress. We illustrate this in Exhibit 11. The performance has been even better in inflation-adjusted terms when the Republicans were fully in charge. But the Republican party of today under Trump is a different animal than the Republican party of years past. The worst combination for the stock market has been a Republican president facing a Democratic or split Congress. This might be an anomaly, however, since it includes the bear markets of 1931-1932, 1973-1974, and 2007-2008—three of the worst downturns on record.

Exhibit 11: Gridlock is good



Source: NDR, SEI. Index returns are for illustrative purposes only, and do not represent actual performance of an investment product. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. *Daily data from 3/4/1901 to 9/18/2024.

To summarize:

- Although equities and other risk assets remain near all-time highs, slowing growth in several countries, including the U.S. and China, has caused increased market volatility.
- Political instability appears to be on the rise as established and centrist political parties lose ground to parties and politicians that espouse more extreme economic and social positions.
- The presidential contest in the U.S. appears set to run down to the wire, and both candidates are expressing economic views that, if implemented, could well lead to higher inflation and/or slower growth.
- Interest rates have fallen sharply in response to the Fed’s policy-rate cut and its renewed focus on maintaining full employment.
- We believe that investors are overestimating the magnitude of interest-rate cuts over the next 12-to-15 months.
- There is too much concern over the slowing of economic growth in the U.S. and labor-market conditions, and too much complacency regarding the inflation outlook and the impact that further fiscal stimulus may eventually have on longer-term bond yields.

Please refer to the latest installment of Chief Investment Officer Jim Smigiel’s *SEI Forward* for more details about our views and positioning.

Glossary

Core inflation is a measure of inflation that excludes volatile food and energy prices.

The **G7** is an intergovernmental organization made up of the world's largest developed economies: France, Germany, Italy, Japan, the U.S., the United Kingdom, and Canada.

GDPNow is the Federal Reserve Bank of Atlanta's forecasting model for estimating GDP growth. It is designed to provide a "nowcast" (as opposed to a forecast) of GDP growth prior to the official release by the U.S. Bureau of Economic Analysis.

The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.

Gross domestic product (GDP) is the total monetary or market value of all the goods and services produced in a country during a certain period.

Policy rates are the interest rates set by central banks, used to influence other interest rates. This includes the Fed's **federal-funds rate** in the U.S.

Index definitions

Consumer-price indexes (CPI) measure changes in the price level of a weighted-average market basket of consumer goods and services purchased by households. A consumer price index is a statistical estimate constructed using the prices of a sample of representative items whose prices are collected periodically. The **core CPI** excludes volatile food and energy prices.

The **Dow Jones Industrial Average** is a price-weighted average of 30 large, publicly traded stocks listed on the New York Stock Exchange and Nasdaq.

Overnight Index Swaps (OIS) are interest-rate swaps based on overnight index rates, the rates banks charge each other for overnight lending (ex. the Secured Overnight Financing Rate (SOFR)). An interest-rate swap is an agreement between two parties to exchange interest-rate payments, which usually involves the swap of a fixed rate for a floating rate, or a floating rate for another floating rate.

Retail-price indexes (RPI) used in the U.K., measure average price changes in a representative basket of consumer goods and services purchased by households. The calculation methodology differs from that of the CPI and RPI is not an official statistic.

The S&P 500 Index is a market-weighted index that tracks the performance of the 500 largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market. The **price return (the S&P 500 price index)** excludes dividends and other payouts that would be included in the **total return**.

Important information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events or a guarantee of future results. Positioning and holdings are subject to change. All information as of the date indicated. There are risks involved with investing, including possible loss of principal. This information should not be relied upon by the reader as research or investment advice, (unless you have otherwise separately entered into a written agreement with SEI for the provision of investment advice) nor should it be construed as a recommendation to purchase or sell a security. The reader should consult with their financial professional for more information.

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