MONTHLY VIEW

International Investment Strategy

A rapidly slowing US labor market puts the Fed in a difficult position

AUGUST

2024

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International Markets

Global financial markets had a strong month in July as investors anticipate rate cuts by the US Fed and other central banks in the coming months. The strength in the markets was despite rising geo-political tensions with the attempted assassination of former President Trump, President Biden dropping out of the next presidential race, and further conflicts in the Middle East.

There was also a noticeable shift in some of the consistent market trends witnessed so far this year. The Japanese Yen, which had weakened 15% this year to the 162 level in July, sharply reversed and strengthened 7% during the month to end at 150. US technology and growth stocks, which had very strong performance this year to early July, reversed course and ended down for the month while value stocks had one of the best months of the year.

At the beginning of August, these trends are continuing as a weakening US employment market could spur the US Fed to a series of larger than expected rate cuts starting at its September meeting. This has led to continued declines in Treasury yields and when combined with rising rates from the Bank of Japan, a further strengthening of the Yen.

A gradually weakening economic outlook, or "soft landing" of the economy has generally been good for equity markets. But a sharper weakening in the economy leading to a "hard landing" or a possible recession scenario is negative for equities as it could lead to lower corporate earnings. This is especially the case as equity valuations look very expensive.

While some data is suggesting a recessionary scenario, it is still unclear if the economy has shifted from a soft to a hard landing scenario and this means market uncertainty and volatility will remain high. A continued economic slowdown (either gradual or rapid), the start or continuation of central bank rate cutting cycles, and further geo-political uncertainty are likely for the coming months. In this environment, we believe maintaining diversified investment portfolios is especially important. We are not making any tactical adjustments to our model portfolios this month.

Source: Bradesco – August 2024

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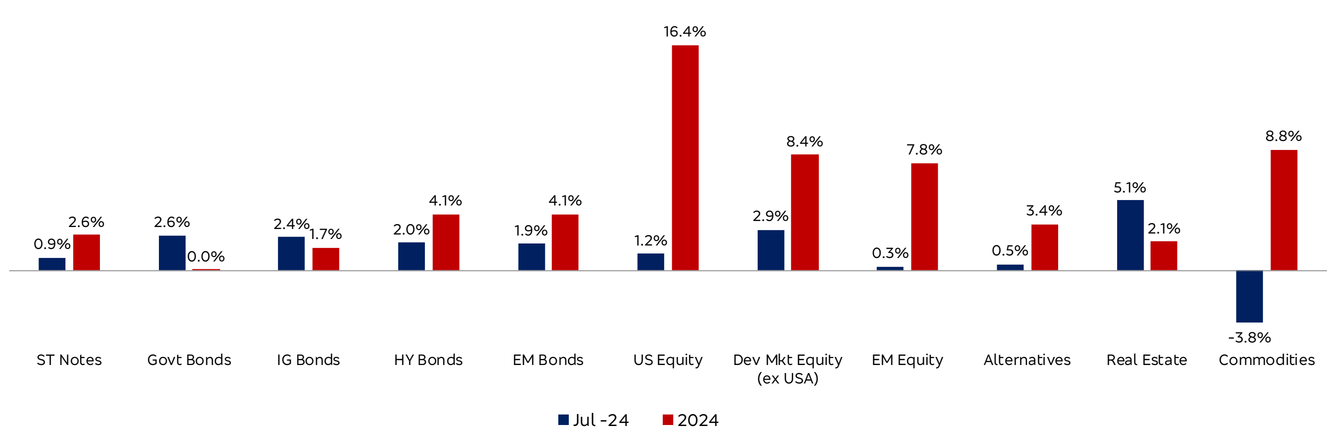
Asset Class Performance

Global asset classes had a good month in July as fixed income yields declined and equities gained



Source: Bloomberg/Bradesco – 1 August 2024

Cash/Short Term – BofAML 0-3 Year US Treasury Index / Gov. bonds – BofA Global Government Ex Japan /Investment Grade- BofAML Global Large Cap Corp / High Yield Global - BofAML Developed Markets High Yield Index / Emerging Market Bonds - J.P. Morgan EMBI Global Core / US Equities - S&P 500 Net Total Return Index / Dev Markets (Ex US) Equities - MSCI EAFE Net Total Return USD Index / Emerging Market Equities - MSCI Emerging Net Total Return USD Index / Alternatives - Credit Suisse Hedge Fund Index / Commodities - Thomson Reuters/Core Commodity CRB Commodity/ Real Estate - Wilshire Global REIT.

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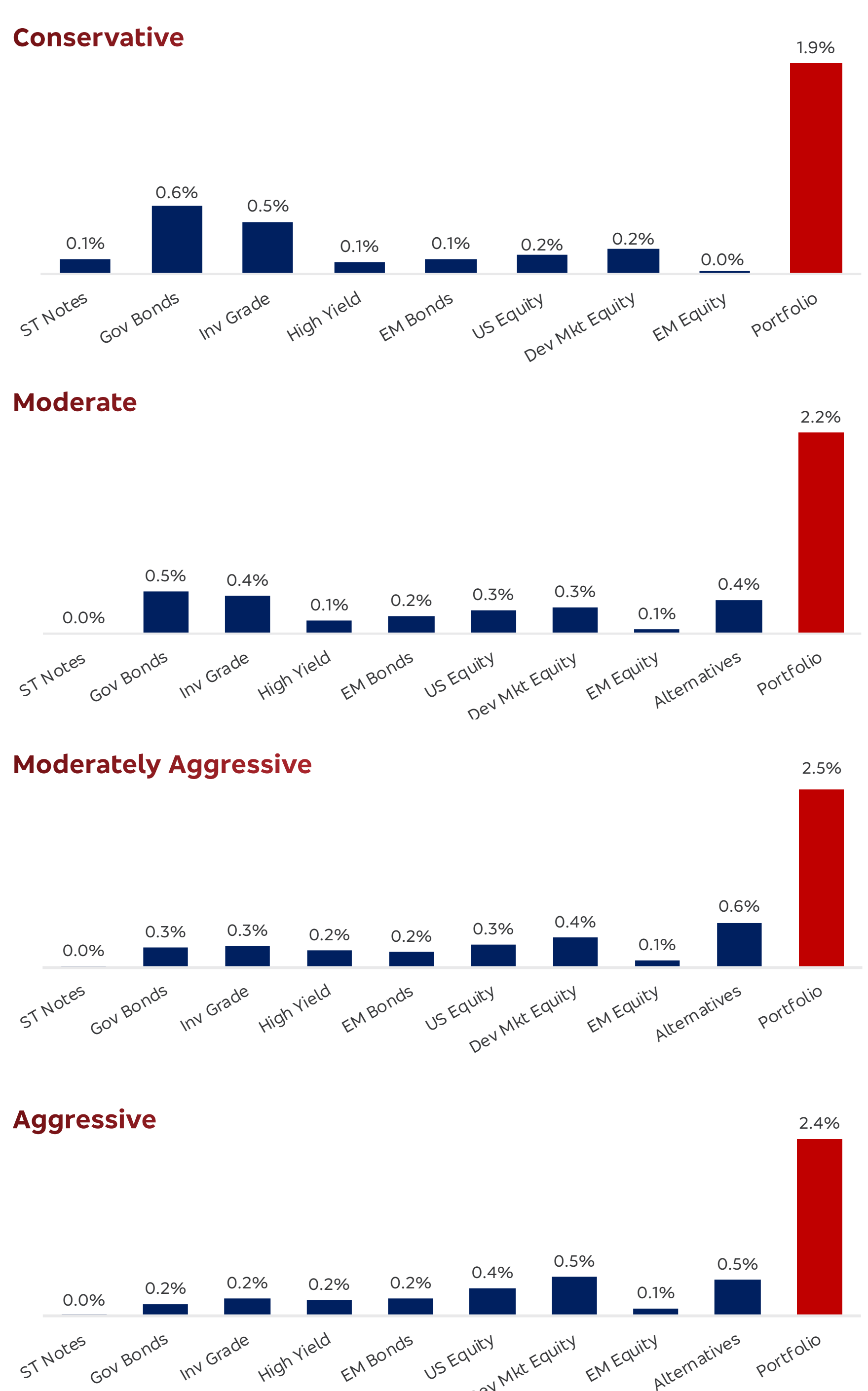
Model Portfolio Contribution to Returns – July 2024



Past performance is not a reliable indicator of future results. Performance was calculated in USD. The return may increase or decrease as a result of currency fluctuations. Returns of the Model Portfolios are based on the allocations approved in the Bank's Strategy Commission and represent the weighted performance of each asset class component. For illustrative and informational purposes only.

Source: Bloomberg/Bradesco – 1 August 2024

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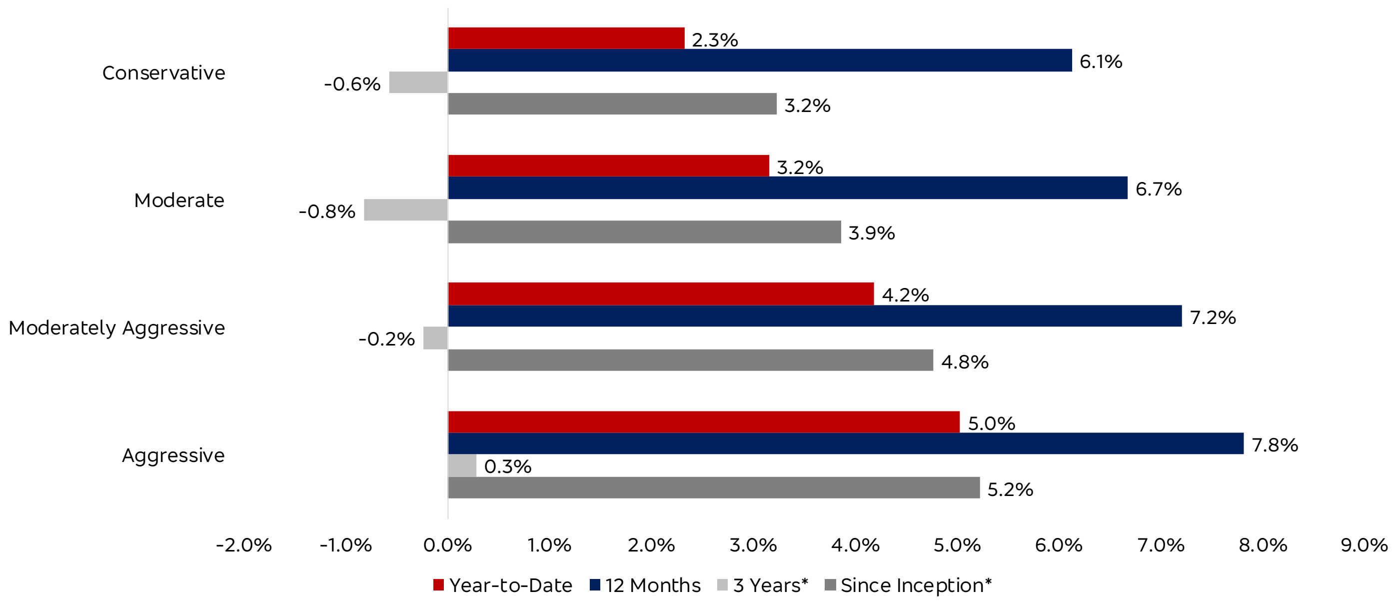
Model Portfolio Performance



Source: Bloomberg/Bradesco – 1 August 2024

*Since Inception: Jan/16. 3 years and since inception - annualised returns.

Past performance is not a reliable indicator of future results. Performance was calculated in USD. The return may increase or decrease as a result of currency fluctuations. Returns of the Model Portfolios are based on the allocations approved in the Bank's Strategy Commission and represent the weighted performance of each asset class component. For illustrative and informational purposes only.

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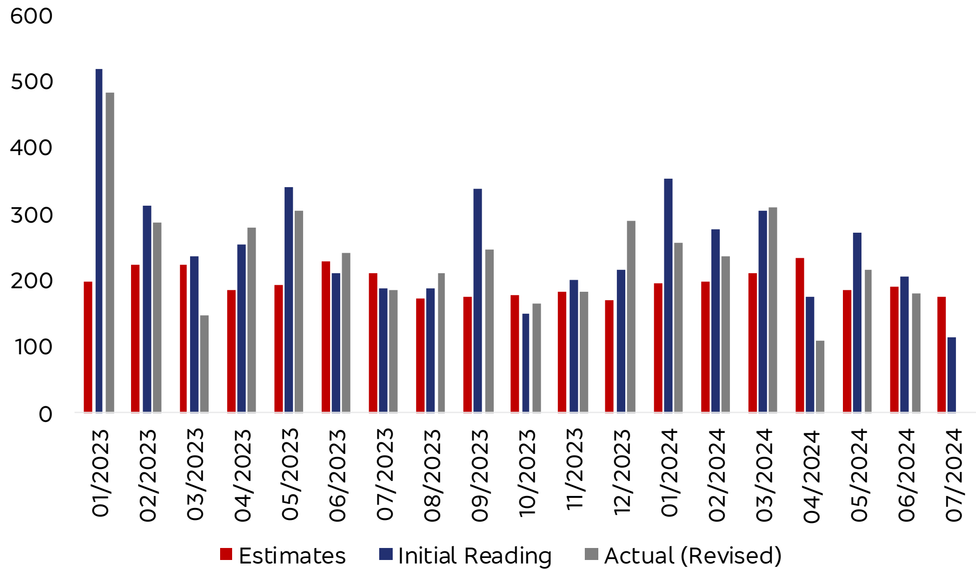
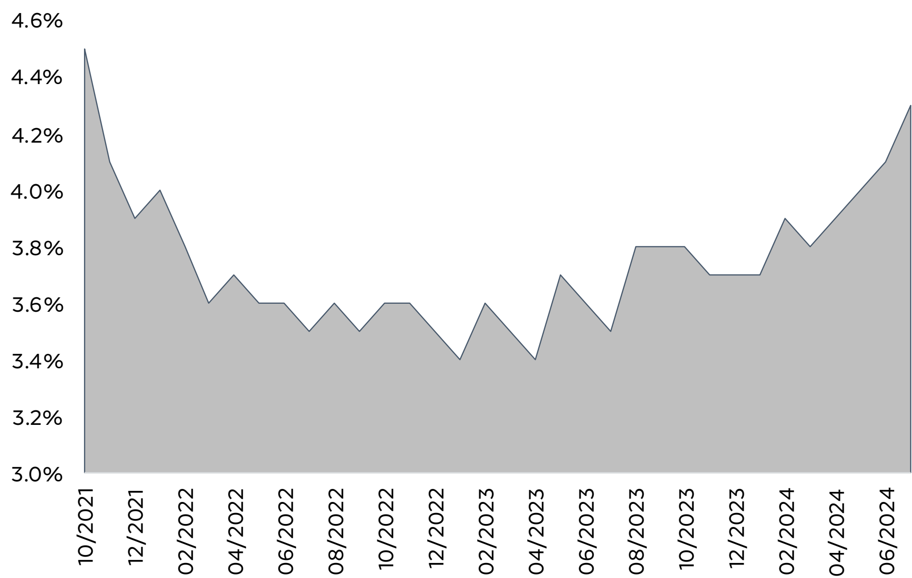
US jobs market is rapidly weakening, but not collapsing

The US economy added just 114k jobs in July, in a clear downtrend



The unemployment rate accelerated higher to 4.3%



- The US economy added 114k jobs in July, the lowest initial reading since early 2021. With further downward revisions to previous months' data, it is clear the employment market is rapidly weakening.
- The unemployment rate surprisingly increased by 0.2% to 4.3% in July as it had been expected to remain steady.
- The Fed will not be pleased with the deterioration in the employment market as it just finished its latest meeting two days before the jobs data was published. The Fed held its rates steady at this meeting, stating that the economy and jobs market were still healthy. Unfortunately, it looks like a downturn in the employment market (but not a collapse) has started and this will mean the Fed may need to cut rates aggressively in its upcoming meetings in September, November and December.

Source: Bloomberg/Bradesco – 5 August 2024

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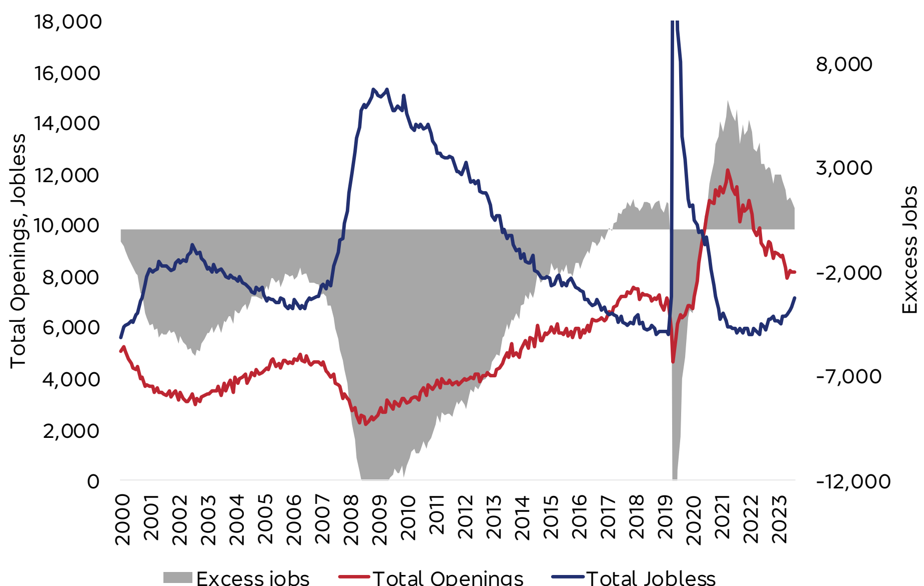
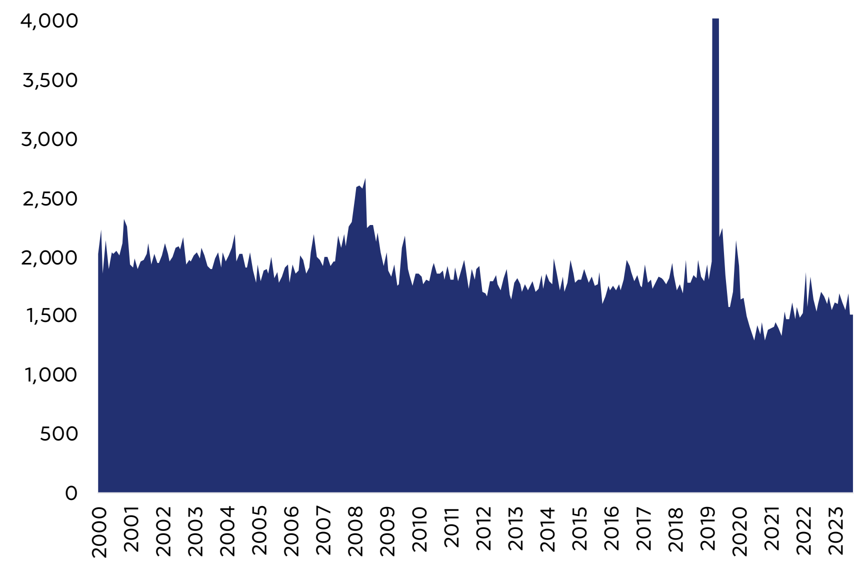
The US still has lots of jobs, and no rise in layoffs ... yet

The US has 8.2 million jobs available vs 6.8 million jobless



Layoffs at 1.5mn, still low historically and not yet rising



- Despite the concerns on the employment market, there overall picture still looks OK. A slowdown is evident, but not yet a collapse.
- There are still 8.2 million jobs available versus 6.8 million jobless, leading to 1.4 million "excess jobs". These excess jobs are down from the over 6 million peak in 2022 but are still above the pre-pandemic level.
- Layoffs are still near lower levels at 1.5 million and there has not been a rise over the past months. Companies have held on to workers when previously they may have fired them as hiring new workers has been difficult since the pandemic. This "labor hoarding" may limit the downside in the employment market if the economy weakens.

Source: Bloomberg/Bradesco – 5 August 2024

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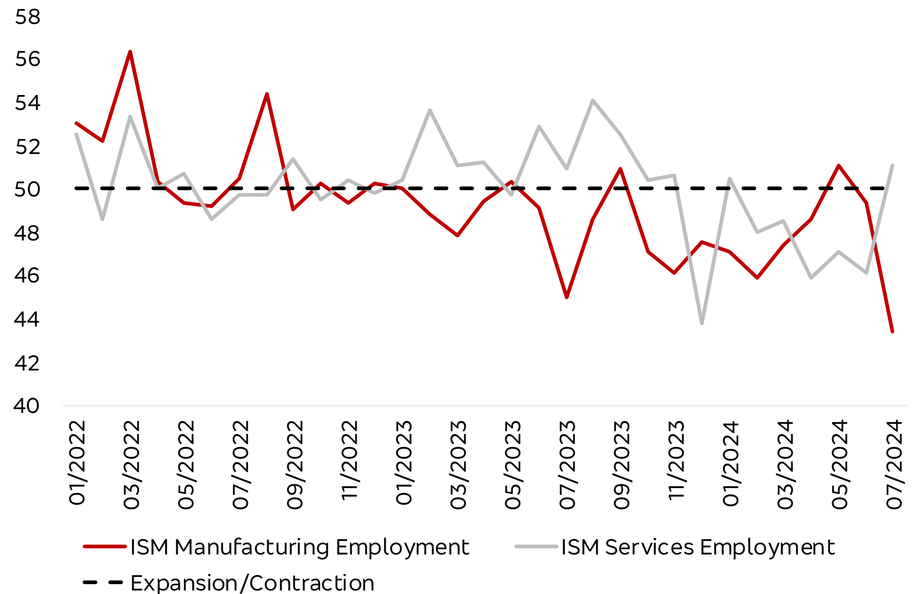
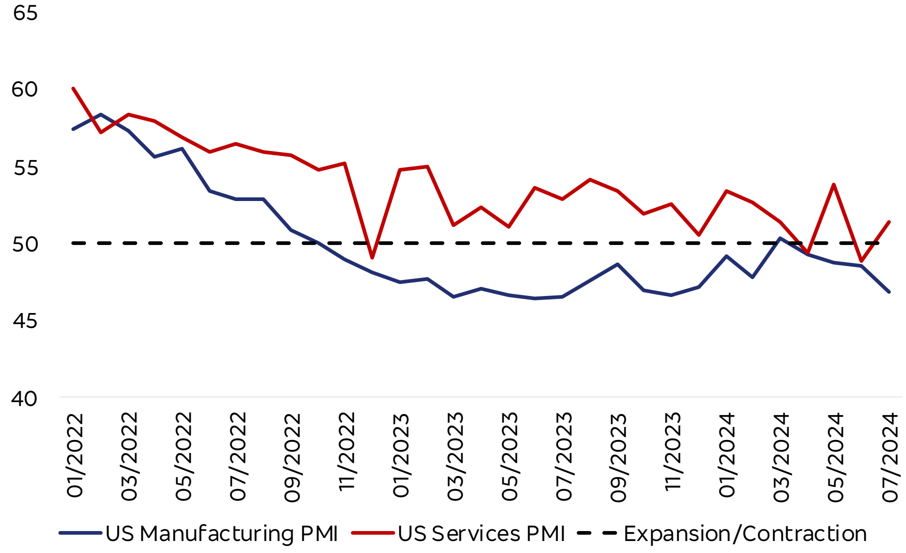
ISM PMIs are inconclusive on recession prospects

Employment PMIs: Manufacturing weak, Services improving



PMIs: Manufacturing in contraction, while Services back to expansion



- ISM PMIs are showing mixed messages on the state of the economy. Manufacturing has been in contraction territory since 2022. Services has been hovering around 50 but has mostly stayed in expansion territory.
- Employment has been more volatile, jumping above and below the expansion/contraction line since early 2022. Recently though manufacturing employment fell to 43.4, reaching levels only seen during major crises. Services did the opposite, after being in contraction for most of the year, it jumped above 50 into expansion.
- These surveys show that although some sectors of the economy are slowing, others are still growing which does not support the outlook for a hard landing of the economy or even a recession at all. Additional data in the coming weeks on inflation and retail sales should give some more insight into the state of the economy.

Source: Bloomberg/Bradesco – 5 August 2024

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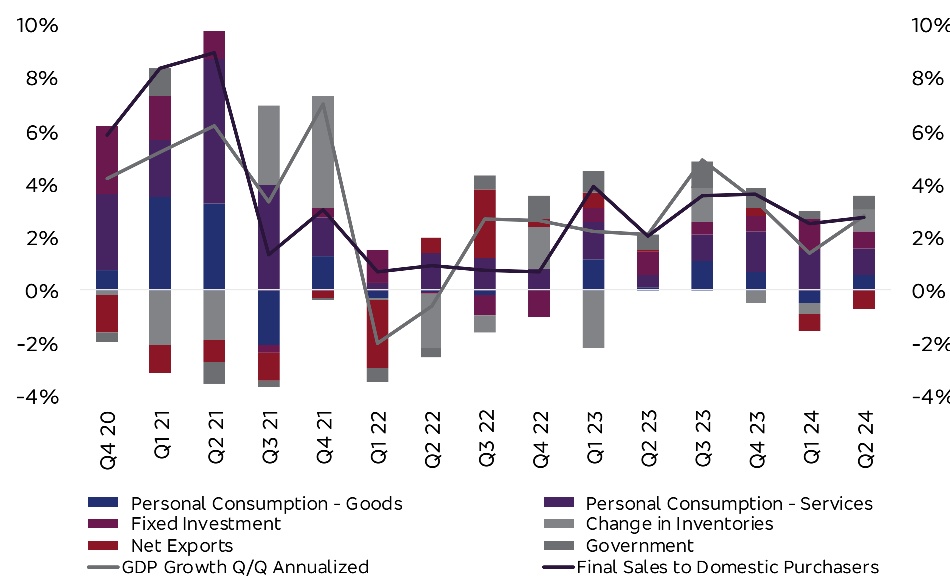
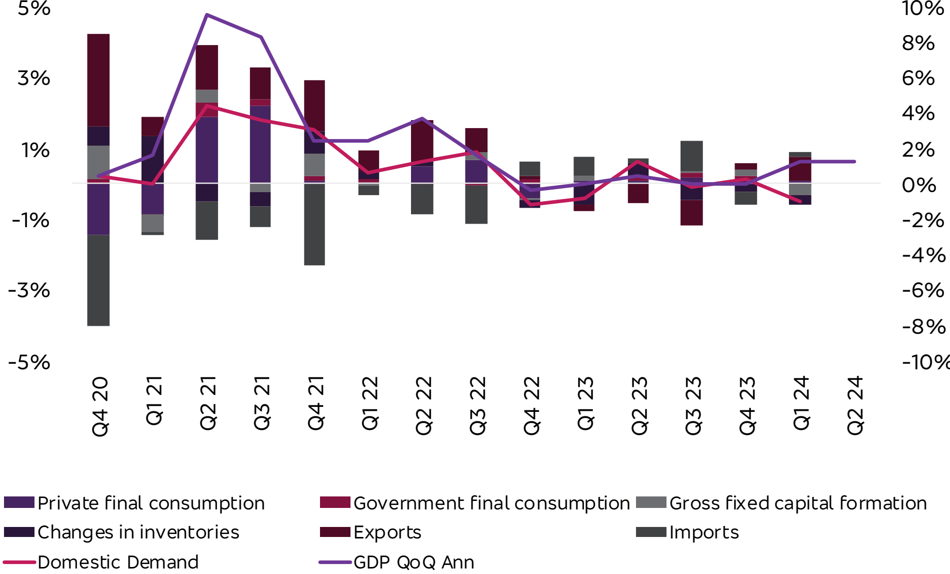
US GDP growth increases to 2.8% QoQ Ann from 1.4%; Eurozone growth remains stagnant

GDP grew 2.8% in Q2, Final Sales to Domestic Purchasers 2.7%



Eurozone grows 0.3% for second consecutive quarter



- US Q2 GDP was 2.8% QoQ Ann, vs 1.4% in Q1 and 3.4% in Q4. Final Sales to Domestic Purchasers, which strips out Change in Inventories and Net Exports was 2.7%.
- First half growth showed a clear slowdown versus 2H 2023 and we expect a further slowdown in the 2H 2024. With the employment market rapidly weakening, consumption is likely to slow, limiting GDP growth in the second half of 2024. We do not believe the weakness will turn into a recession, but slower than currently expected growth is very likely.
- Eurozone GDP grew at 0.3% in the second quarter (1.2% annualized). Growth has been weak for the past 1.5 years, much of this due to weakness in Germany.

Source: Bloomberg/Bradesco – 26 July 2024

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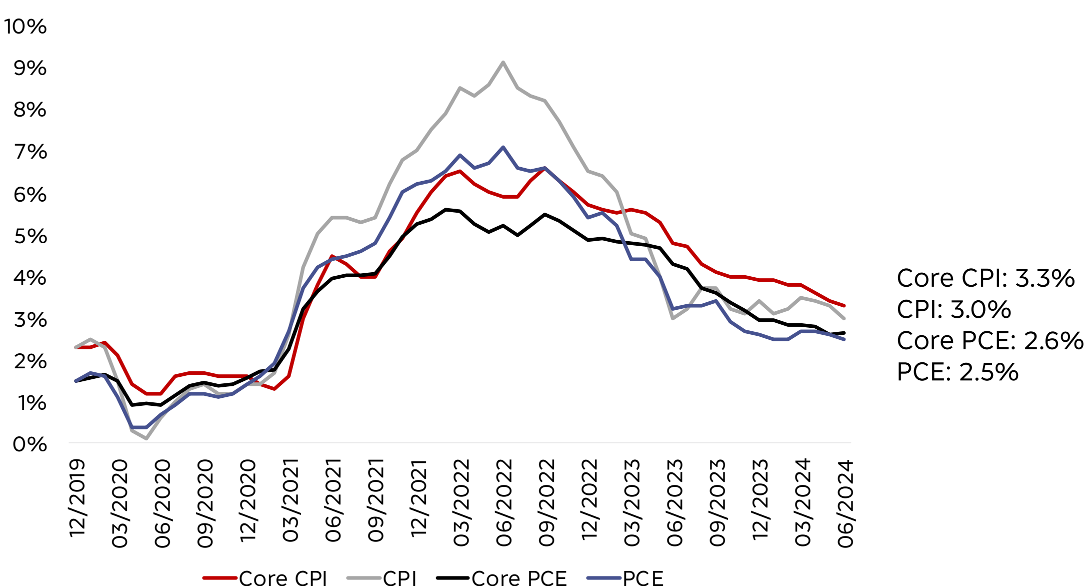
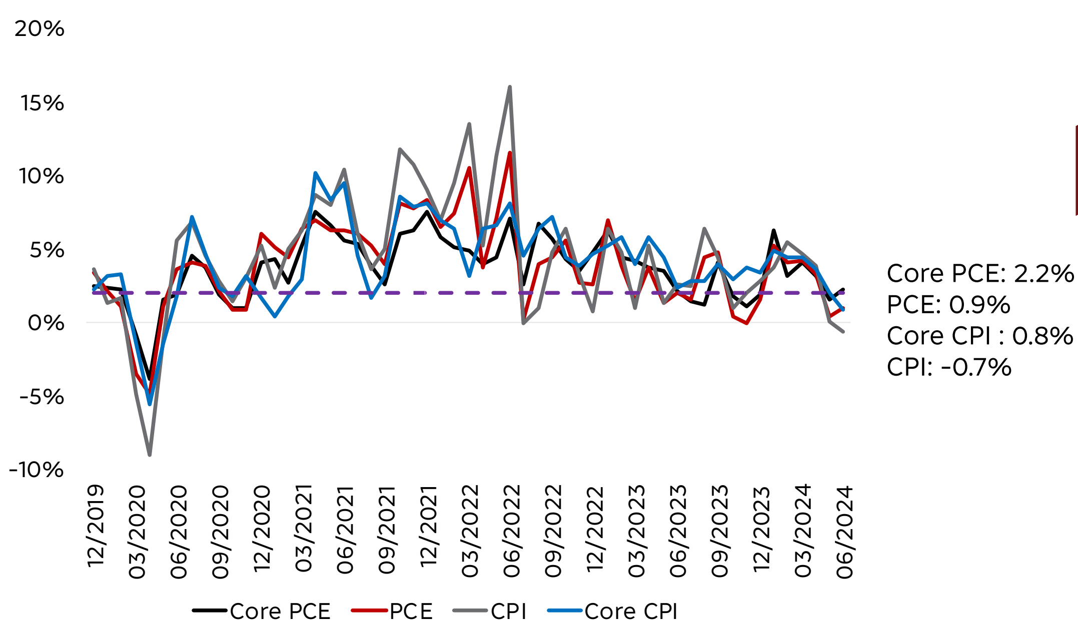
Inflation continues to fall, slowly approaching targets

US June inflation showed a continued decline



MoM annualized is around the Fed's target of 2%



- US inflation continued its shift downward in June with Core CPI declining to 3.3% though Core PCE stayed at 2.6%, both the lowest since early 2021. The month-on-month readings for PCE rose to 0.1% in June from 0% in May for the overall and climbed to 0.18% from 0.13% for Core, which remains near the lowest level since the end of 2020.
- MoM annualized numbers provide a very encouraging picture for the Fed. The 0.18% increase in Core PCE equals 2.2% when annualized, already at the target for the Fed. The other readings are already below the target.
- Continued monthly PCE readings in the 0.1%-0.2% range would reassure the US Fed that inflation is heading towards its 2% target.

Source: Bloomberg/Bradesco – 26 July 2024

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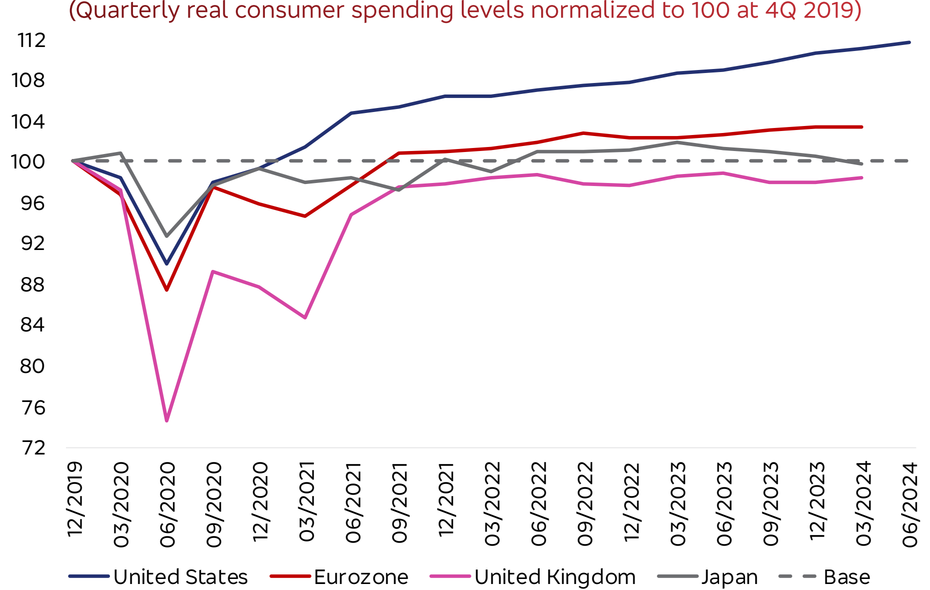
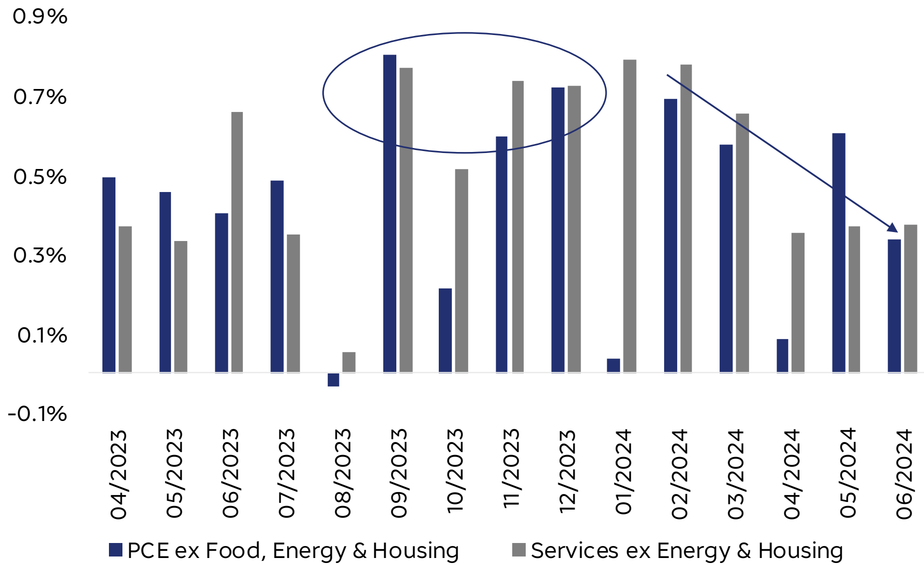
US consumer spending has been strong, but is clearly slowing





- US consumers have been spending far more than other regions since the pandemic. As of the second quarter of 2024, US consumer spending is up 12% since the pandemic. As of the first quarter 2024, Europe is up 3%, the UK down 2% and Japan is flat.
- Spending growth (demand) has been slowing, and this has allowed inflation to also moderate. There are signs from recent data that show US consumer spending is clearly slowing. Monthly spending data show discretionary spending is slowing as Personal Consumption Expenditures (PCE) ex. food, energy and housing as well as Services Spending ex. energy and housing are moderating after strong growth in the second half of 2023.
- A weaker jobs market should also mean consumers become more cautious in spending and could lead to even weaker spending ahead.

Source: Bloomberg/Bradesco – 26 July 2024

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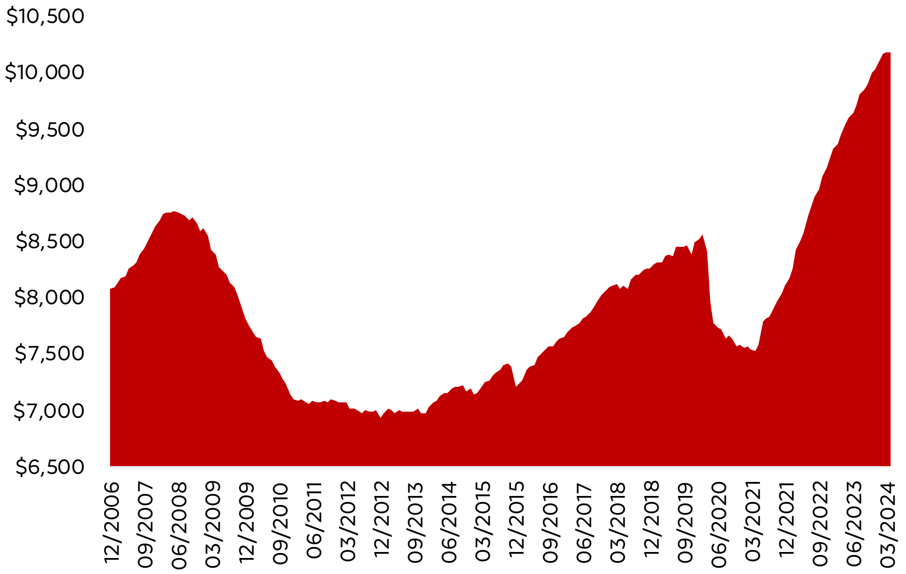
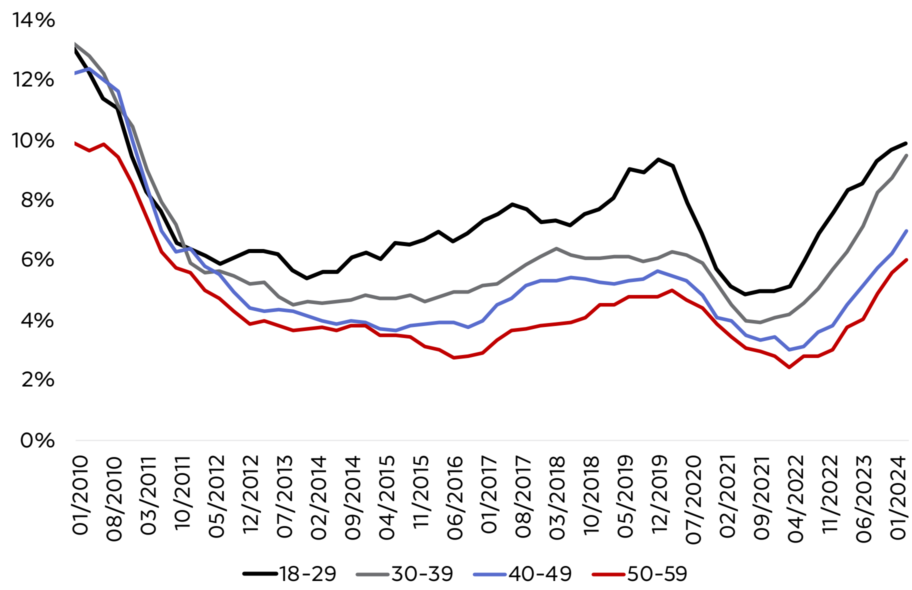
Consumers have relied on debt that they can't afford, but may be reaching limits

Credit Card debt / household reaching record highs



Credit Card delinquencies (90 day) rising rapidly



- Consumers are increasingly relying on debt to finance spending. At the end of 2020, credit card debt was $975 billion. It now stands at $1.34 trillion, with credit card debt/household above $10,000.
- Credit card delinquencies have increased rapidly and are now well above pre-pandemic levels. High balances and high interest charges (20-30%) are causing financial pain for consumers who are also being hit with high prices for goods and services.
- A reduction in credit card usage would mean reduced consumer spending and a further slowdown in economic activity. This could help bring inflation down but could also mean a rise in the unemployment rate if the economy slows meaningfully.

Source: Bloomberg/Bradesco – 26 July 2024

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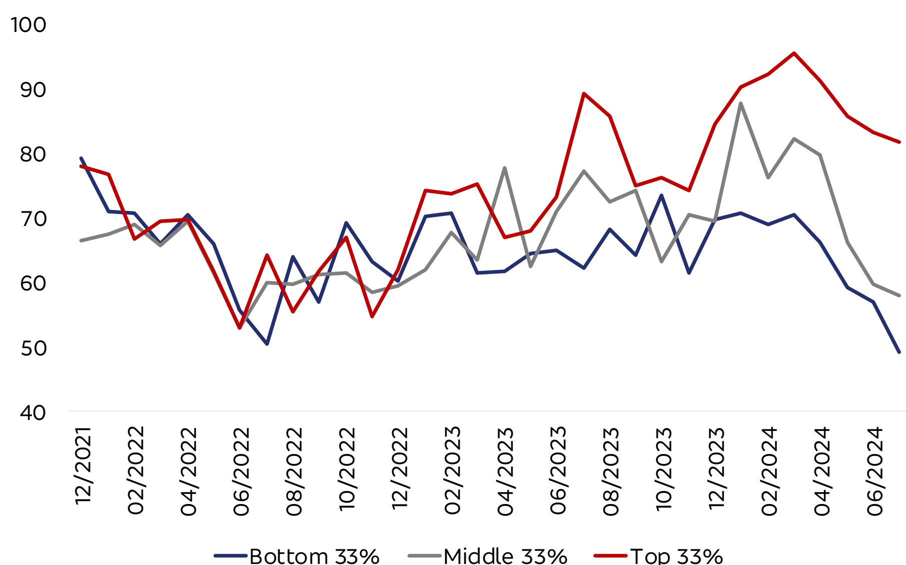
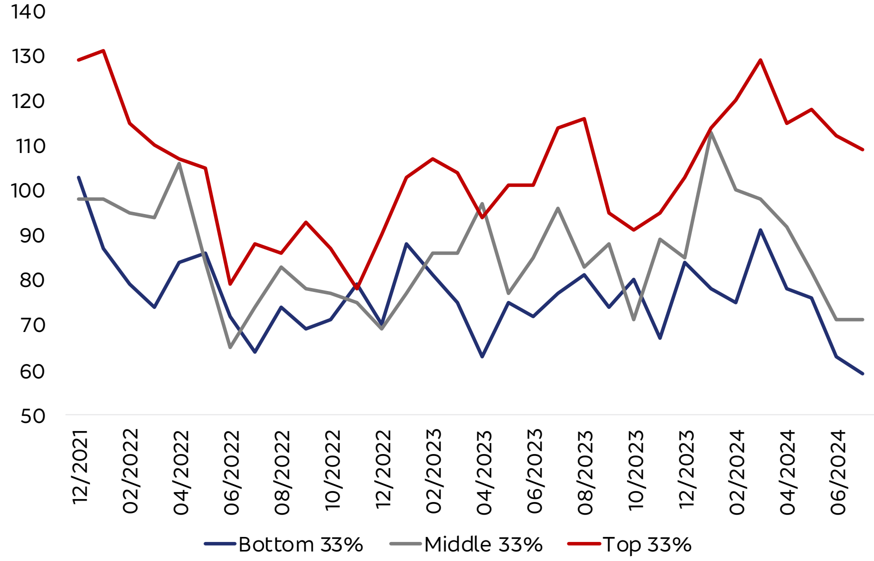
Consumer sentiment clearly divided between income groups

Current economic conditions are not good for those at the bottom



The difference is even larger for current financial conditions



- Consumers on the bottom of the earnings spectrum are struggling in the current economy. The University of Michigan Consumer Sentiment Survey shows a significant divide between those at the top and those at the bottom
- All cohorts view current economic conditions as deteriorating, but bottom earners are feeling the pinch much more than those at the top.
- Financial conditions are much better for those at the top than those at the bottom. Financial conditions have increased from the 2022 lows for those at the top while for the bottom earners, conditions are at levels only seen during the financial crisis.

Source: Bloomberg/Bradesco – 26 July 2024

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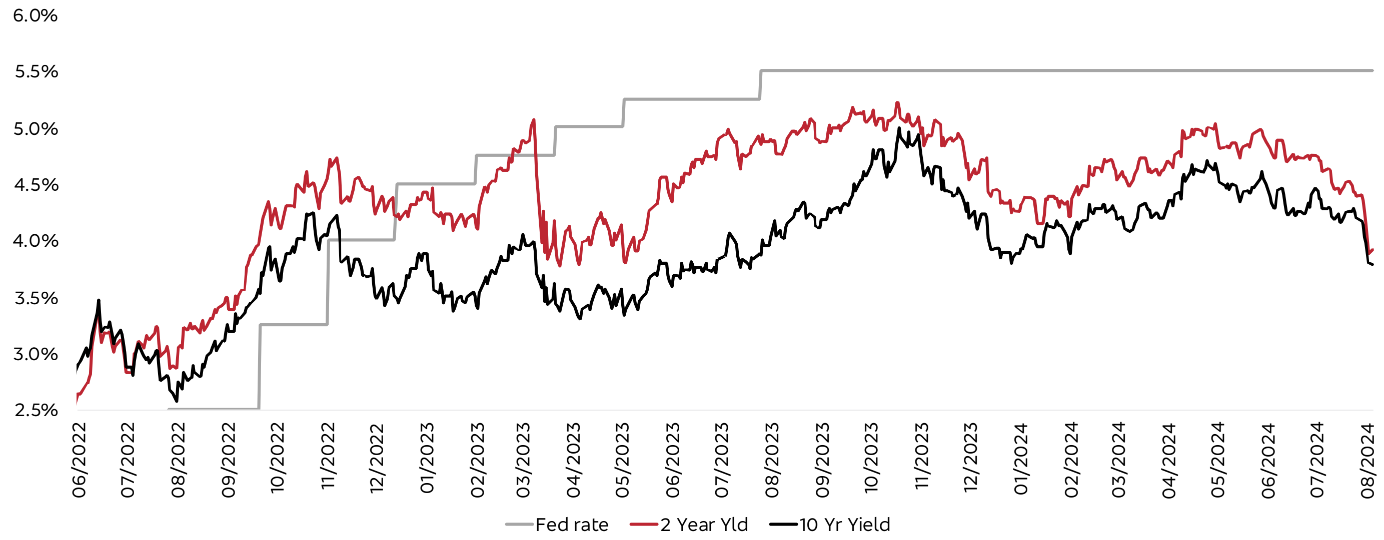
Markets think the Fed is late in cutting rates and will make things worse with the delay

Treasury 2 and 10-year yields falling rapidly while the Fed keeps rates high



Source: Bloomberg/Bradesco – 5 August 2024

- The Fed held rates at 5.25%-5.5% at its July meeting, as expected. But the weak employment data in the following days convinced the markets that the Fed will be late in lowering rates if it waits until the September meeting, and that this could make the downturn even worse.

- Treasury yields have fallen rapidly. The 10-year yield was 4.25% on July 22 and fell 55bps since then to 3.7% as of August 5. The 2-year yield fell 80 bps from 4.5% to near 3.7% during the same time.

- Market pricing implies investors believe the Fed will cut rates by 50 bps in September, 50 bps in November, then 25 bps in December, with further cuts in 2025. We believe these assumptions may be aggressive and if the economic data does not indicate a sharp slowdown, the Fed would not be this aggressive in cutting rates and yields could actually rise.

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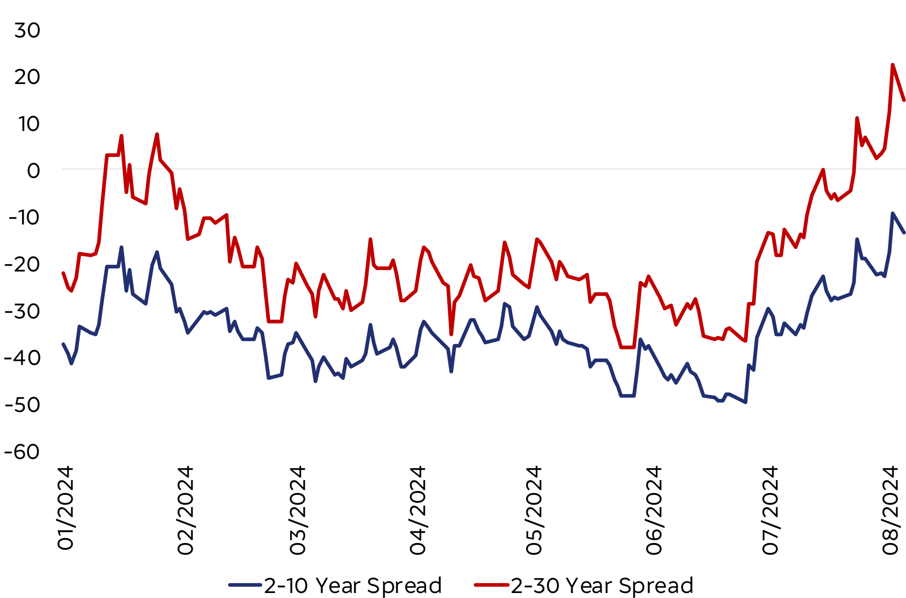
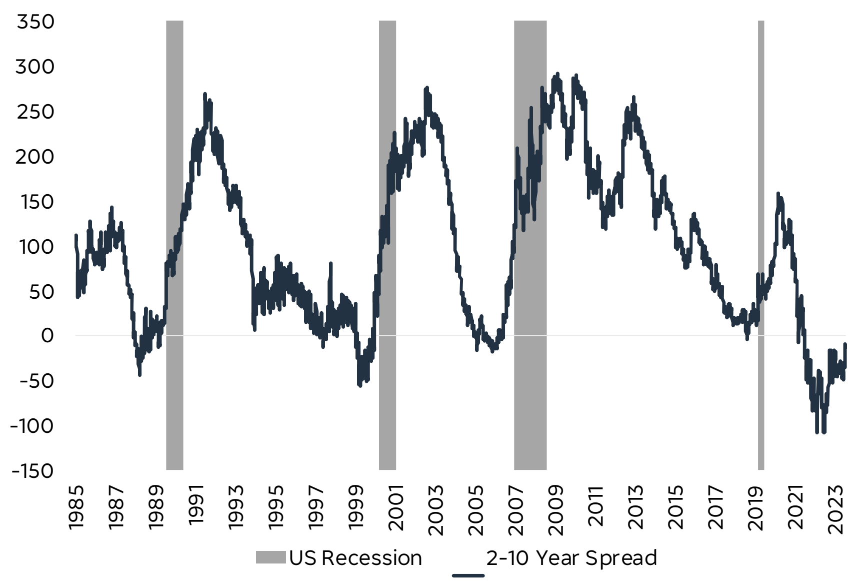
Does yield curve steepening signal a recession ahead?



Steepening could indicate a recession is near



- The Treasury yield curve has steepened sharply over the past month as 2-year yields have declined by nearly 85 bps in anticipation of Fed rate cuts and the 10-year yield has declined by about 60 bps (since end June).
- The 30-year yield has declined by just 50 bps since end-June showing the long-end of the yield curve has declined but is struggling to reach lower levels. Concerns about US fiscal deficits and potential inflationary policies (depending on the presidential election) are keeping longer yields higher (versus shorter yields).
- A steepening yield curve with the 2-10 spread rising above 0% has been a signal of a recession previously. The 2-10 spread will likely rise above 0% in the coming weeks or months and while this does indicate a slowing economy, it does not necessarily mean a recession is inevitable.

Source: Bloomberg/Bradesco – 5 August 2024

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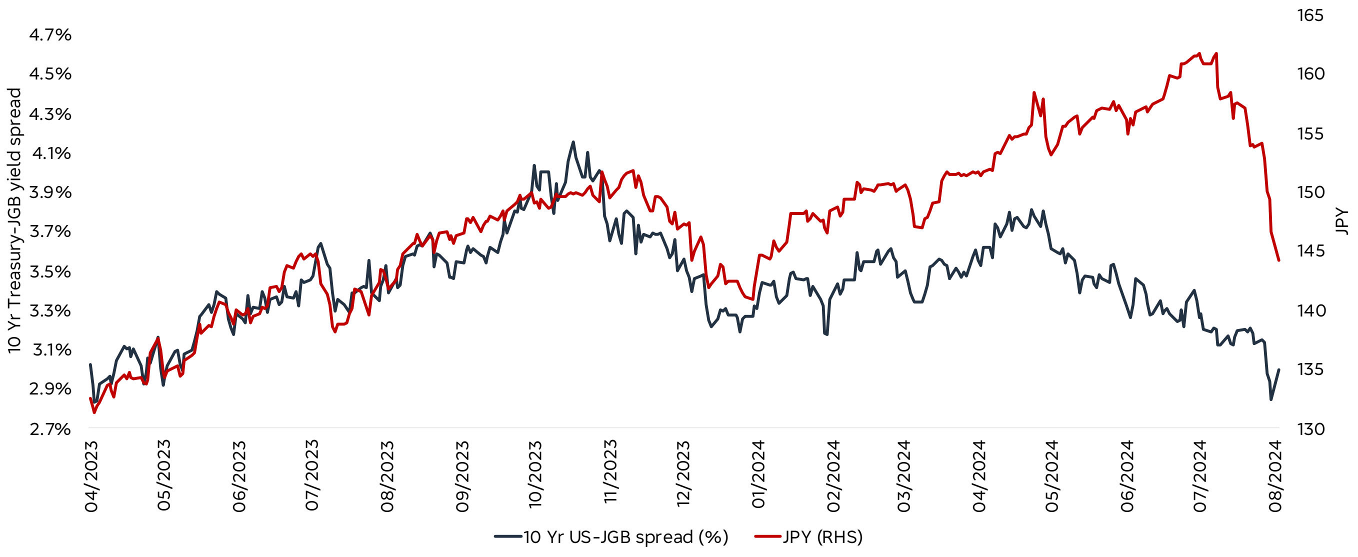
Falling Treasury yields and hawkish Bank of Japan has reversed the Yen weakness

The spread between the 10-year US Treasury and Japanese Government Bond yields could indicate where the Yen could reach



Source: Bloomberg/Bradesco – 5 August 2024

- The Japanese Yen previously traded on the yield differential between Treasury and JGB yields. But this year, the relationship broke down and the Yen weakened considerably as global "carry trades" pushed it to extreme weakness.
- In July, it reached 162, a 38-year low, when yield differentials indicated it "should" have been closer to 140. It has weakened to the 140-145 range as of early August and some further strengthening (decline in the JPY rate) could mean it is reaching fair value.

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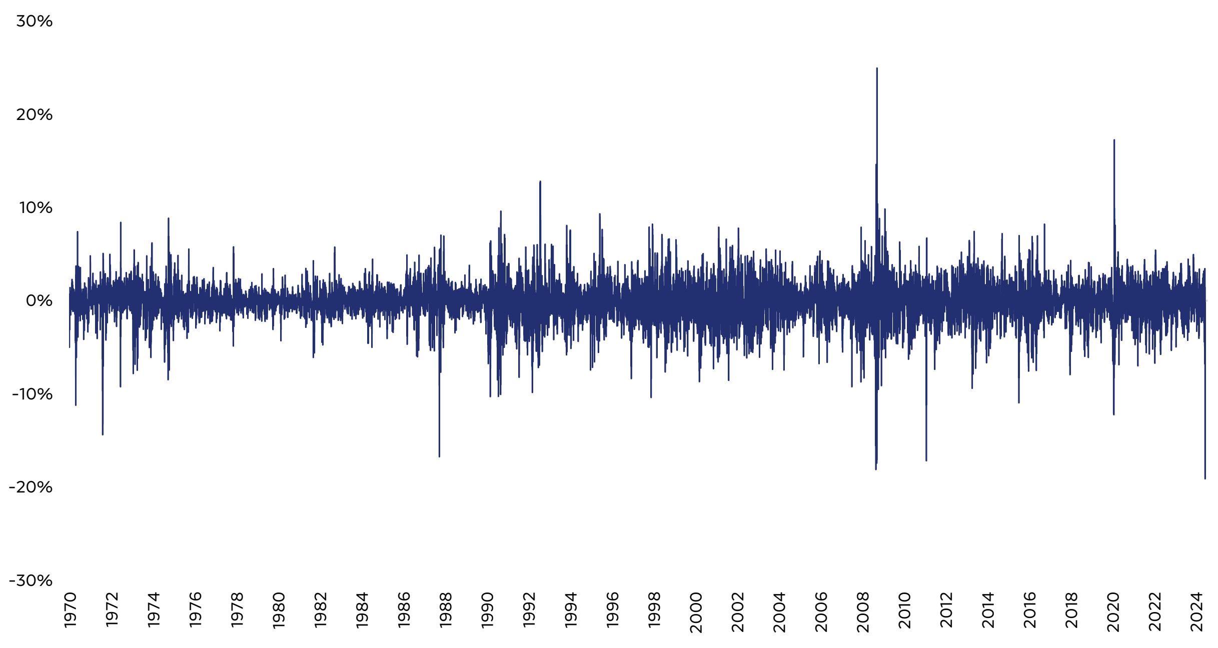
Stronger Yen led to a sell-off in global markets, Japanese equities historically weak

Japan's Nikkei 225 equity index had its worst 3-day performance for at least the past 54 years



Source: Bloomberg/Bradesco – 5 August 2024

- Concerns that the US is heading to a recession led to lower Treasury yields and a stronger Yen. A stronger Yen is not favorable for Japanese equities which had their worst day since 1987 and worst 3-day span since at least 1970.
- On August 5, the Topix and Nikkei indices were both down over 12% and around 20% over 3 days. Both had been up more than 20% this year at their peaks in July but with the falls went into losses for the year.
- The strengthening Yen has had global market impacts as de-leveraging and unwinding of carry-trades has led to global market weakness.

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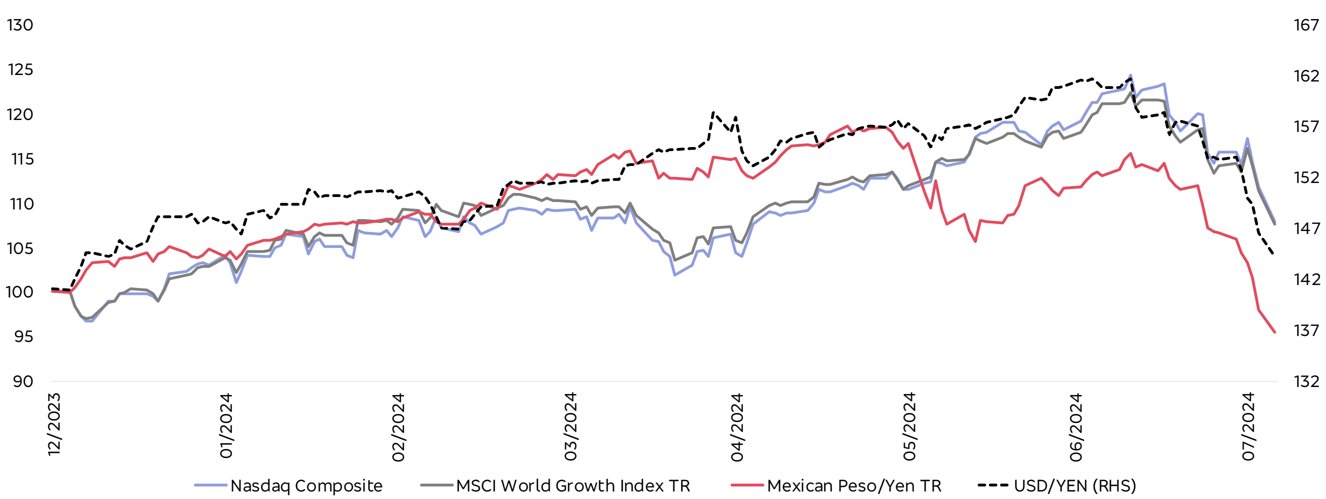
Weaker Yen has hit global markets on de-leveraging and unwinding of the carry trade



Source: Bloomberg/Bradesco – 5 August 2024

- The Bank of Japan was one of the few central banks to maintain ultra-low rates as inflation increased around the world after the pandemic. Global investors could borrow Yen at near 0% and invest in other markets at higher returns. This was the "carry trade" and it worked very well for the past years and especially this year until just recently.
- The Yen reached its weakest point on July 10 near 162 but has strengthened 10% since then (to August 5). Those who borrowed in Yen for the carry trade have had to sell their investments to fund the repayments. This has led to declines in many asset classes globally. The Nasdaq had gained 24% at its peak this year but has since lost 13%. The MSCI Global Growth index similarly gained 22% to its peak but has lost 12% since.
- A popular carry trade was to borrow in Yen and invest in the Mexican Peso at rates above 10%. While this strategy gained 18% through May, it has since declined and is now down 5%.

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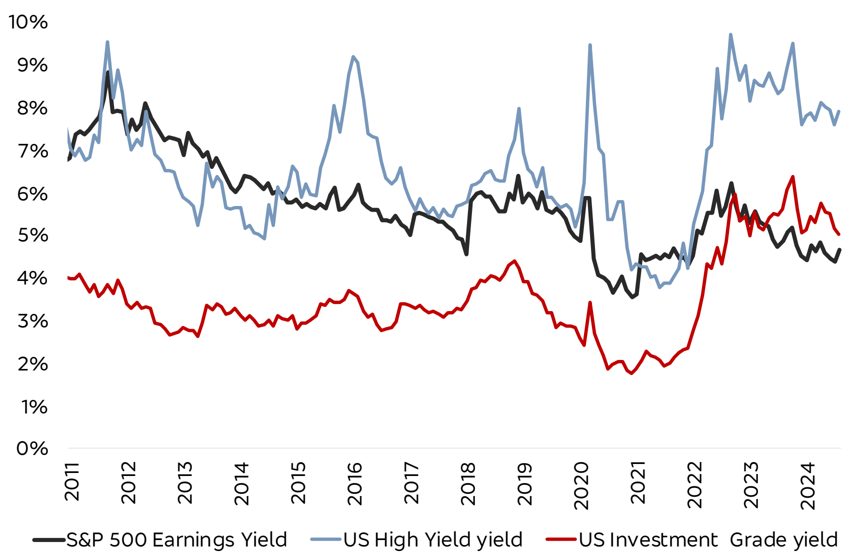
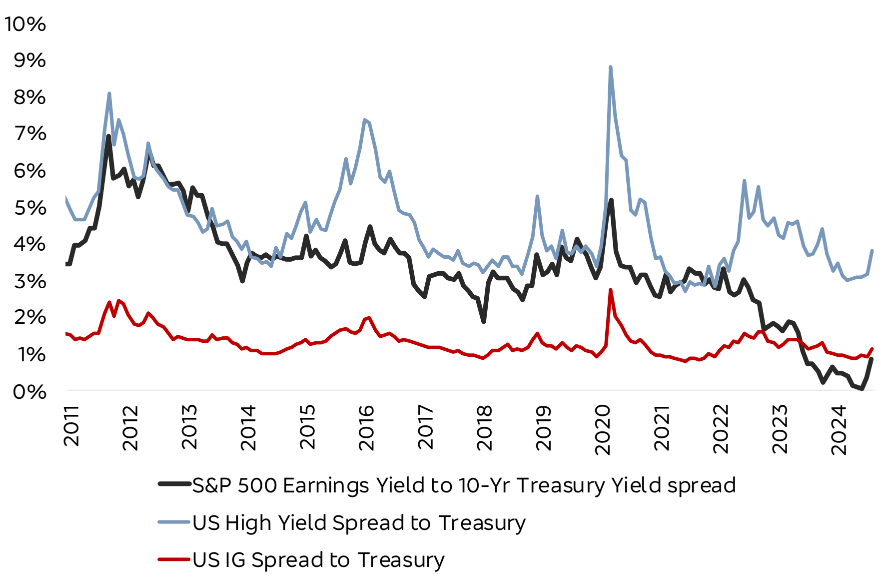
Yields down on recession fears, but spreads widening

S&P 500 Earnings Yield versus High Yield and Investment Grade yields
(Earnings yields = earnings per share/share price)



S&P 500 equity risk premium vs High Yield and Investment Grade spreads
(Equity risk premium = earnings yield spread to 10-year Treasuries)



Source: Bloomberg/Bradesco – 5 August 2024

- Fixed income yields have declined sharply (through August 5) as weakening US employment data increases concerns of a possible recession. Investment grade yields have fallen under 5% and High Yield yields are around 7.5%. Equity earnings yields (inverse of the Price/Equity ratio) have increased with the weakness in the equity market and are now 4.64.
- The S&P 500 Equity Risk Premium (difference between earnings yield and 10-year Treasury yield) has increased to 0.85%, still near the extreme lows near 0%, meaning equities are still expensive when compared to the fixed income spreads.
- High Yield spreads have increased with the market disruptions, rising 90 bps from the July lows to near 400 bps. Investment Grade spreads increased about 20 bps to around 110 bps.

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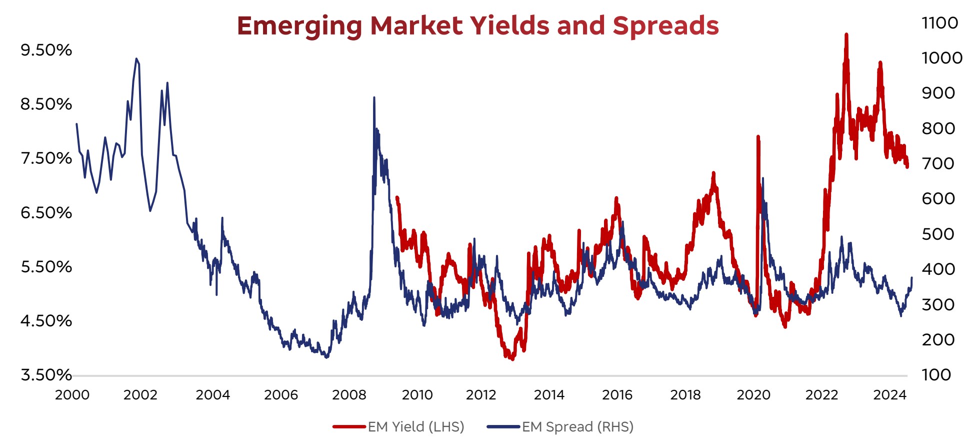
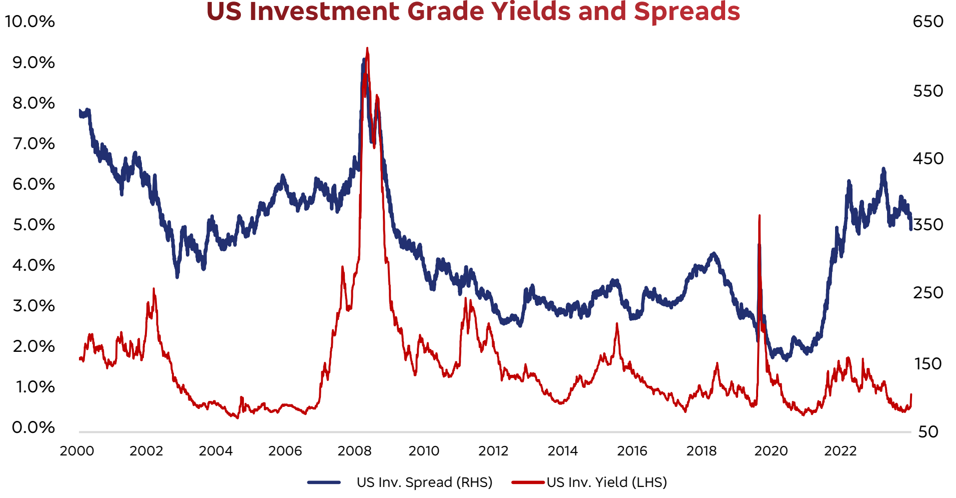
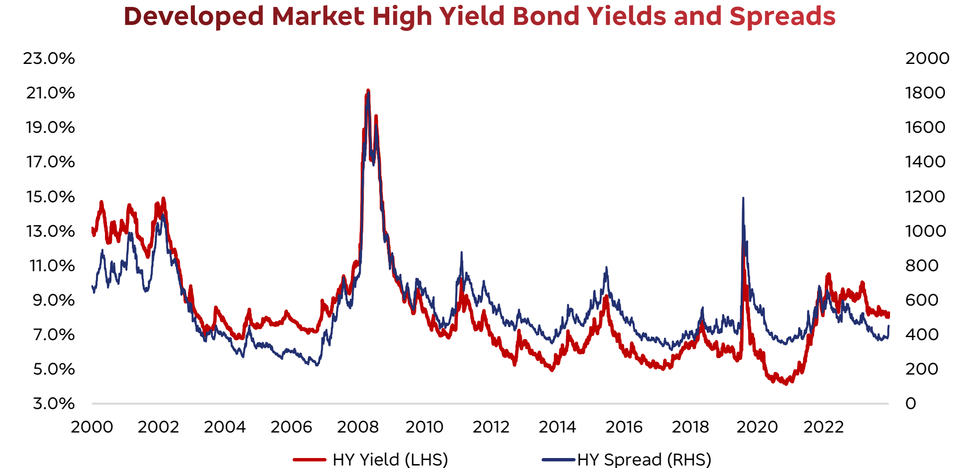
Fixed Income Yields and Spreads

	Yield	Spread (bps)	Spread Avg/Range	Duration
US Investment Grade	4.99%	111	149 (76-618)	7.3
US High Yield	7.90%	381	445 (262-1099)	3.6
Global High Yield	8.26%	450	543 (220-1803)	4.0
Emerging Markets	7.42%	379	354 (151-1001)	7.1







Source: Bloomberg/Bradesco – 5 August 2024

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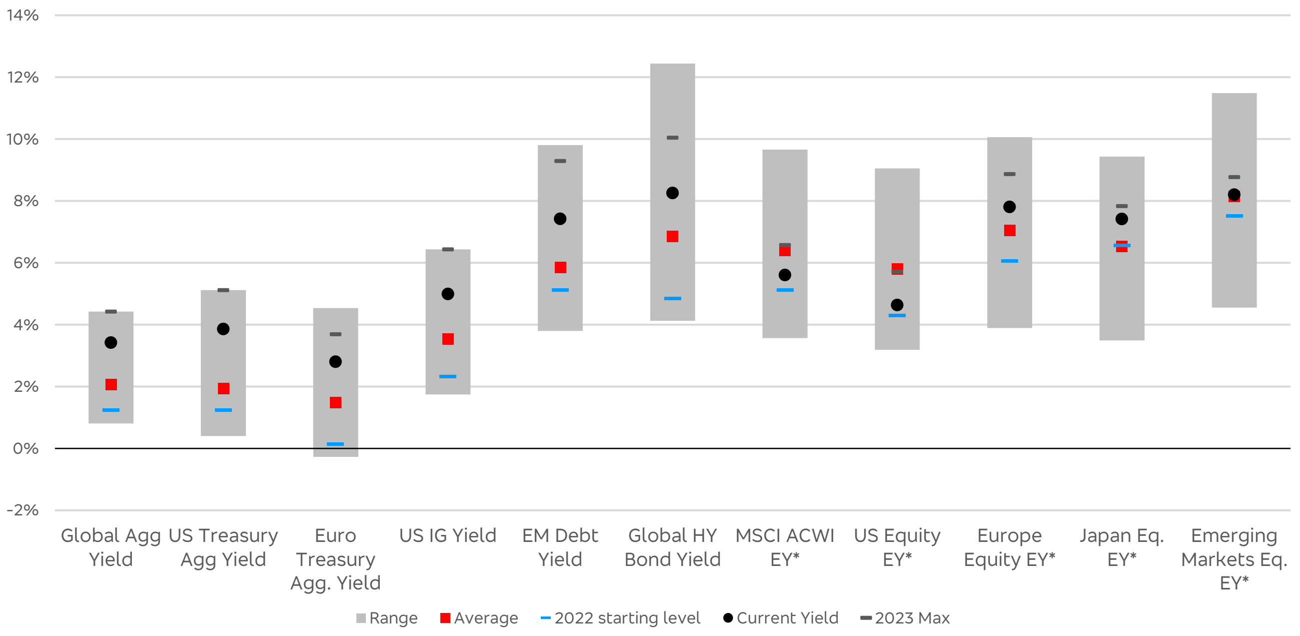
Fixed Income yields still high, US equities look expensive, other equities mixed

2010-present: Fixed Income Yields and Equity Earnings Yield (Inverse of Price / Equity ratio)



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Adjusting Tactical Allocations

		Under	Neutral	Over
Fixed Income	Liquidity/Short term		■	
	Developed Government Bonds			■
	Investment Grade Bonds		■	
	High Yield Bonds		■	
	Emerging Market Bonds		■	
Equities	US Equity	■		
	Developed Market Equity (Ex-US)		■	
	Emerging Market Equity	■		
	Alternatives		■	

Current Tactical Allocations

- Last month we reduced Investment Grade bonds to Neutral from Overweight as spreads had reached very low levels and we expected some spread widening (which occurred in the following month). We also initiating an allocation to Mortgage-Backed Securities (MBS) within our Government Bond asset class and increased the Government Bond TAA to Overweight.

- We are therefore Overweight Government Bonds in the TAA and still maintain a longer-duration stance within Government Bonds.

- We are Underweight US and Emerging Market equities given expensive valuations in the US and China's structural difficulties. In US equities we maintain our shift to Value factor exposure.

- We have not made any Tactical adjustments to the portfolios for this month.

Source: Bradesco – August 2024

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Model Portfolio: Strategic and Tactical Asset Allocations

	I CONSERVATIVE		II MODERATE		III MODERATELY AGGRESSIVE		IV AGGRESSIVE	
	SAA	TAA	SAA	TAA	SAA	TAA	SAA	TAA
FIXED INCOME	83%	**85%**	66%	**68%**	49%	**53%**	40%	**44%**
Liquidity/Short Term	18%	**18%**	6%	**6%**	3%	**3%**	2%	**2%**
Developed Government Bonds	28%	**30%**	21%	**23%**	8%	**12%**	3%	**7%**
Investment Grade Bonds	25%	**25%**	23%	**23%**	16%	**16%**	12%	**12%**
High Yield Bonds	5%	**5%**	6%	**6%**	10%	**10%**	10%	**10%**
Emerging Market Bonds	7%	**7%**	10%	**10%**	12%	**12%**	13%	**13%**
EQUITIES	17%	**15%**	26%	**24%**	39%	**35%**	50%	**46%**
US Equity	6%	**5%**	9%	**8%**	13%	**11%**	17%	**15%**
Developed Market Equity (Ex-US)	7%	**7%**	10%	**10%**	14%	**14%**	18%	**18%**
Emerging Market Equity	4%	**3%**	7%	**6%**	12%	**10%**	15%	**13%**
ALTERNATIVES			8%	**8%**	12%	**12%**	10%	**10%**

Source: Bradesco – August 2024

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August Economic Calendar

29	30	31	1 • **BOE Rate Decision** • S&P and ISM Manufacturing PMIs • Jobless Claims • EZ Unemployment	2 • **Nonfarm Payrolls**
5 • S&P and ISM Services PMIs • S&P Composite PMI • EZ PPI	6 • Trade Balance • EZ Retail Sales	7 • Consumer Credit • **CH Exports/Import**	8 • Jobless Claims • **CH CPI and PPI**	9
12 • JP PPI	13 • **PPI** • NFIB Small Business Optimism • UK Unemployment	14 • **CPI** • **EZ GDP** • EZ Industrial Production • **UK CPI, RPI, and PPI** • **JP GDP** • CH Industrial Production • CH Retail Sales	15 • Jobless Claims • **Retail Sales** • Industrial Production • **UK GDP** • UK Industrial and Manufacturing Production	16 • University of Michigan Consumer Sentiment • UK Retail Sales
19 • Leading Index • **CH 1- and 5-year Loan Prime Rate Decision**	20 • **Eurozone CPI**	21 • FED Rate Decision	22 • Jobless Claims • S&P Global Manufacturing, Services, and Composite PMIs • Existing Home Sales	23 • New Home Sales
26 • Durable Goods Orders • Dallas Manufacturing Survey	27 • Conference Board Consumer Confidence • Richmond Fed Manufacturing Index	28 • **Nvidia Earnings Report**	29 • Jobless Claims • GDP Second Reading • Personal Consumption Second Reading • JP Unemployment	30 • **PCE** • University of Michigan Consumer Sentiment • **EZ CPI** • EZ Unemployment

Source: Bradesco – August 2024

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