Could Fed cuts drive broader stock market performance?

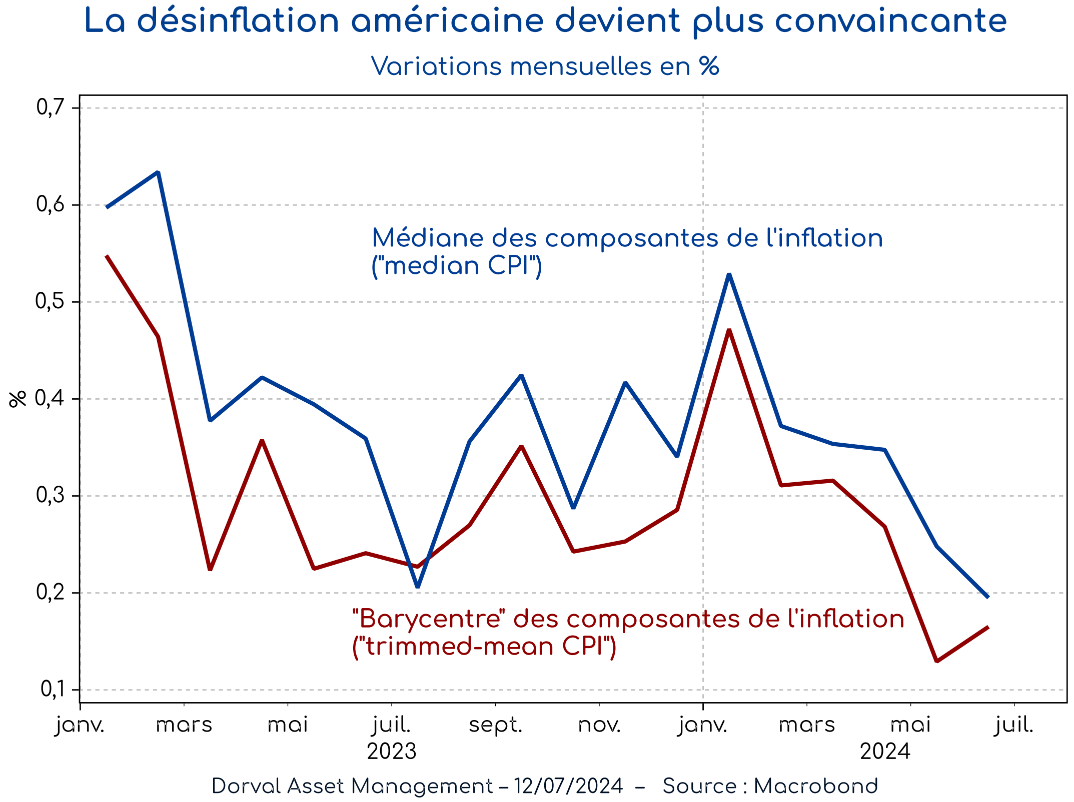
15 July 2024

Dear Clients and Partners,

A cornerstone of the global financial markets, the US Federal Reserve may be about to lower its rates. This could bolster market performance beyond the "Magnificent Seven" stocks, but other factors are also at stake.

The latest US inflation news is very encouraging. After significant renewed growth in the first months of the year, consumer prices stalled abruptly in May (+0.0%) and June (-0.1%). These good figures are all the more compelling because they reflect wider disinflation across the market basket rather than the effect of price decreases for just a few products (cf. chart 1).

American disinflation is becoming more compelling
Monthly changes (%)

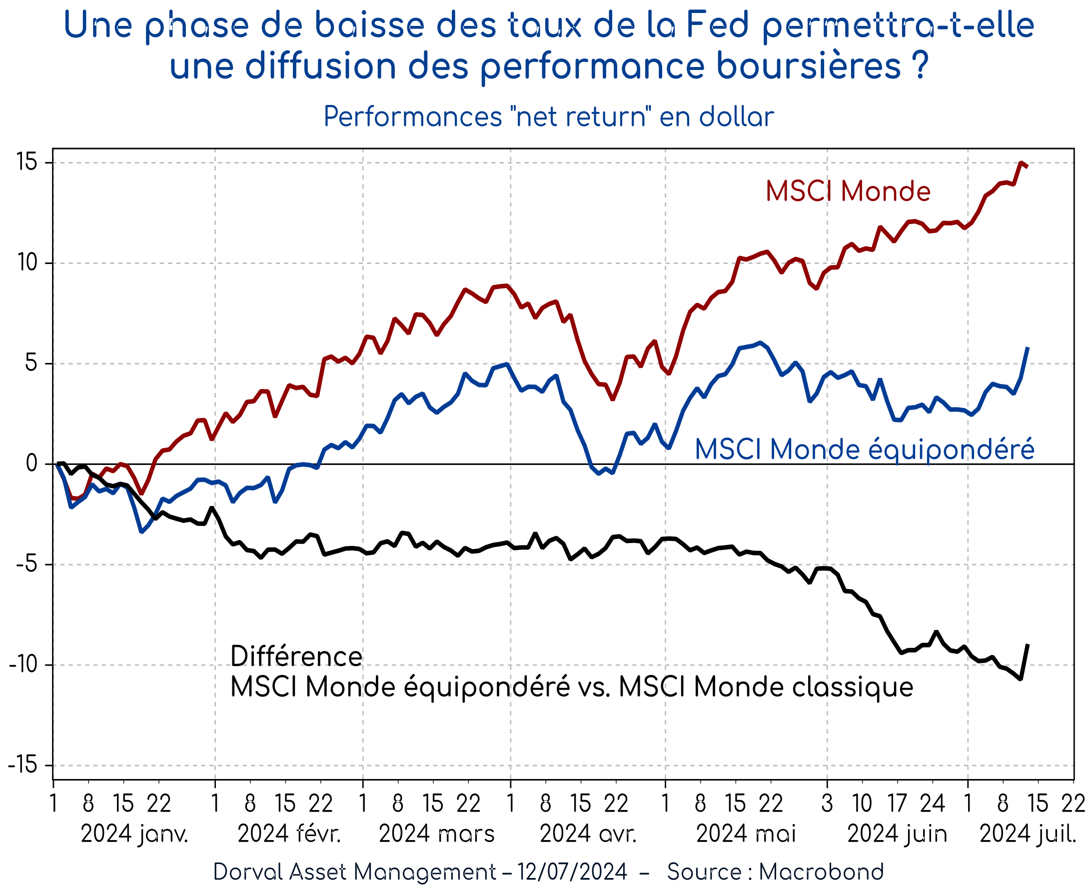


- *Median CPI/Trimmed-mean CPI*

Two monthly figures, however good they may be, will not convince the US Federal Reserve that the game is won. But, with the signs of economic overheating having almost faded away, the Fed may feel able to dial down the pressure and decrease rates gradually from September. And if the economy slows more than expected, it would be in a position to cut harder.

Such an environment is usually favourable for the financial markets. In a dollar-dominated world, Fed policy still greatly influences investors' "animal spirit". Should we therefore expect stock market performance to become less concentrated on major US stocks alone? The cap-weighted MSCI World index – of which the "Magnificent Seven" (Nvidia, Google, Apple etc.) comprise over 20% – has significantly outperformed the MSCI World Equal Weighted index since the beginning of the year (cf. chart 2).

Will a phase of Fed rate reductions spread stock market performance more widely?
Net return in dollars

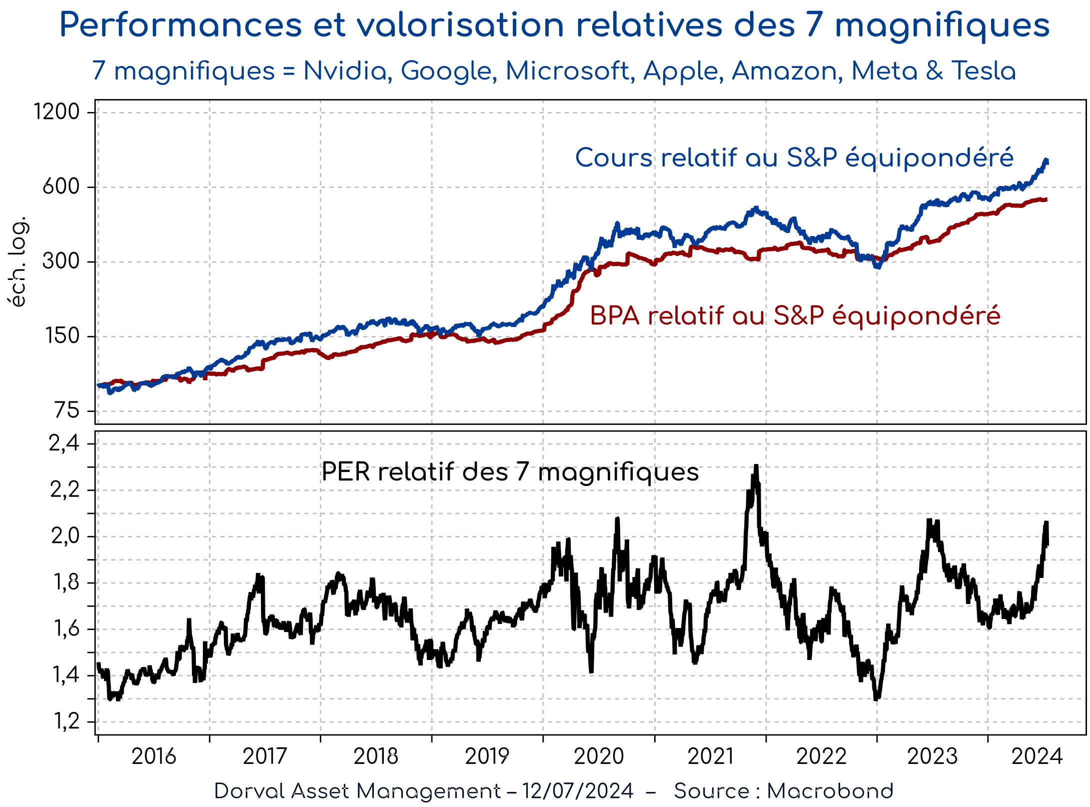


- *MSCI World / MSCI World Equal Weighted / Divergence of MSCI World Equal Weighted vs traditional MSCI World*

While Fed rate cuts may be necessary for portfolio diversification and more widespread appetite for risk, they alone are not sufficient. First, the relative valuation of the American giants must be high enough that investors are encouraged to consider other options. That may now be the case. With a PER twice that of the S&P 500 Equal Weight Index, their relative valuation is now well above the average seen in recent years, although the ratio did briefly reach 2.3 at the end of 2021.

Relative performance and valuation of the Magnificent Seven

Magnificent Seven = Nvidia, Google, Microsoft, Apple, Amazon, Meta & Tesla



- *Price relative to the S&P Equal Weight / EPS relative to the S&P Equal Weight /Relative PER of the Magnificent Seven*

If a more widespread pattern is to emerge, investors will also need to be convinced that overall growth is evening out, with a slightly less robust growth in the US and more momentum in Asian and European economies. Business climate surveys were heading in this direction until May, but more recent data is somewhat less compelling, with PMIs declining in June.

Lastly, political risks come into play. The prospect of Donald Trump's re-election, which now seems likely, raises fears of renewed trade wars and fiscal policy that would put interest rates at risk. Unless Wall Street gambles that Trump will not be able to do as he says. Meanwhile in France, investors are contemplating the aftermath of the legislative elections. Uncertainty and potential tax increases are causes for concern, but other European countries (Spain, United Kingdom) have recently experienced these without major damage to the economy or the markets. The financial markets would be more in danger if the French president were to resign, triggering new elections that would raise the spectre of a successful candidate who might clash with our European partners. This scenario currently seems unlikely, but it is not impossible.

Our global and European flexible funds remain heavily invested in equity markets, which continue to benefit from stable global growth, declining inflation and the prospect of gradual reductions in short-term rates. In Europe, we believe the French political risk premium priced in by the markets is probably sufficient, with the CAC 40 having already lost almost all of its gains since the beginning of the year.

Our exposure rates are as follows:

- **Dorval Convictions:** The equity exposure rate is 70%.

Dorval Asset Management

Public limited company with share capital of €303,924

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