BNY MELLON

iFlow
MACRO MORNING BRIEFING

April 5, 2024

Equities Outlook For Second Quarter Of 2024

Drivers for markets in the coming week will shift from macro to micro as Q1 earnings reports, US Tax Day and related liquidity, bond issuance, politics, and a host of central bank rate decisions will all start to crowd out focus on economic data driving expectations. Nevertheless, US CPI (for March, released April 10) and the risk of further sticky inflation disappointing hopes for a June rate cut by the Federal Reserve matters too. The problem for many investors stems from momentum and entropy – money flows in the last five months show a rising fear-of-missing-out (FOMO) factor driving equities – against the lack of certainty that anything else offers a reasonable return. The hope for a soft-landing became a conviction that fed on trading dynamics. Our iFlow data, using our new AI data distiller, offers some interesting insights that suggest this faith in central bankers will soon be tested.

- Our client flows in equities are negatively correlated to bonds in a significant way, but that correlation turned from -0.85% in March to -0.50% this week. This suggests something is changing as yields rise to a level where bonds look attractive vis-a-vis risk in equities.
- The relationship of returns to our flows across different equity sectors has mixed correlations across the world, but the choppiness of this week's shows that momentum-chasing flows are dominant in APAC and EMEA.
- Sectors typically correlated to recoveries are seeing inflows in emerging markets, particularly in APAC, suggesting China's recovery has begun to drive asset flows for the region, even as foreign investors remain wary.
- The rise of duration buying in fixed income has stalled, as it clashes with equity flows into emerging markets as higher yields keep the US dollar bid and dampen equity returns.

Exhibit #1: Our Flows Show Shifting Correlations In FX, Bonds & Stocks

US Flow Correlations

DXY vs Equities

DXY 20d ret
EQ 20d flow
DXY vs EQ correlation
& 95% confidence limits

days > 0 367 (33.03%)
days < 0 247 (22.23%)
days ~ 0 497 (44.73%)

DXY vs Sovereign Bonds

DXY 20d ret
SB 20d flow
DXY vs SB correlation
& 95% confidence limits

days > 0 241 (21.69%)
days < 0 299 (26.91%)
days ~ 0 571 (51.4%)

Equities vs Sovereign Bonds

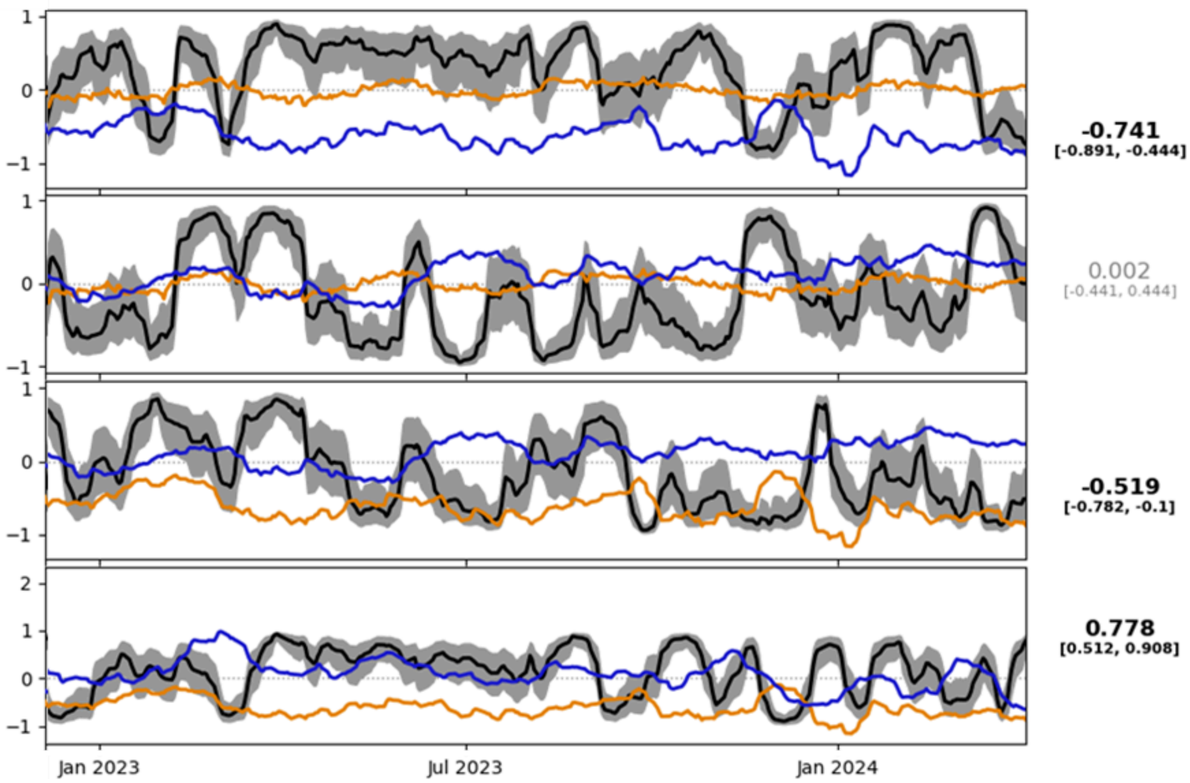
EQ 20d flow
SB 20d flow
EQ vs SB correlation
& 95% confidence limits

days > 0 303 (27.27%)
days < 0 353 (31.77%)
days ~ 0 455 (40.95%)

Equities vs Corporate Bonds

EQ 20d flow
CB 20d flow
EQ vs CB correlation
& 95% confidence limits

days > 0 392 (35.28%)
days < 0 247 (22.23%)
days ~ 0 472 (42.48%)



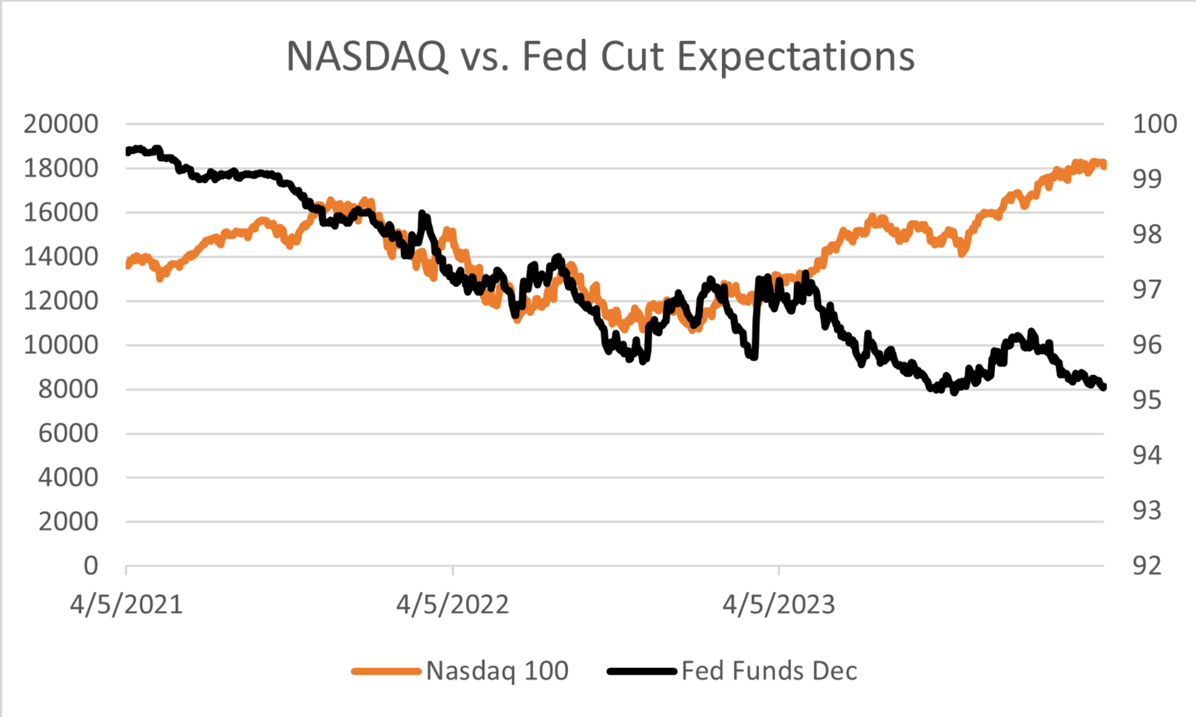
Source: iFlow, BNY Mellon

Factors that could stop US equity rally. In economic terms, higher inflation and lower growth which leaves high-for-longer policy at the Fed affects the rest of the world, as well. Goods inflation from the two ongoing wars adds to the problem.

- **Rest of world catches up.** Recoveries in China and Germany drive money into those markets at the expense of US equity positions. Tangential to this is value – other markets look "safer" than the US, whether that is about rates or growth in developed or emerging markets.
- **Bonds beat Equities.** As central banks shift policy to lower rates, duration trades in fixed income drive money out of higher-risk equities and back to "safer" bonds. The corollary of this is about recession risks rising, as lower rates follow shifting views on growth, should data surprise to the downside.
- **Correlations shift from negative to positive.** As the dollar's negative correlation to equities shifts with market risk, hedging of the dollar could unwind and lead to it falling sharply, particularly against safe-haven currencies like JPY and CHF. Similarly, the bond correlation to stocks could flip if economic data shifts back lower to a stall-speed, reigniting expectations of a so-called "Fed put".

The correlation between the NASDAQ and December 2024 Fed rate-cut expectations is now negative after more than two years of having been significantly correlated. The explanation for the split starts with the shift of money into AI and how it adds to the tech-heavy index, but it continues with the view that the economy benefits from the investment flows into AI as it adds to growth and productivity, affording the FOMC room to wait for lower volatility.

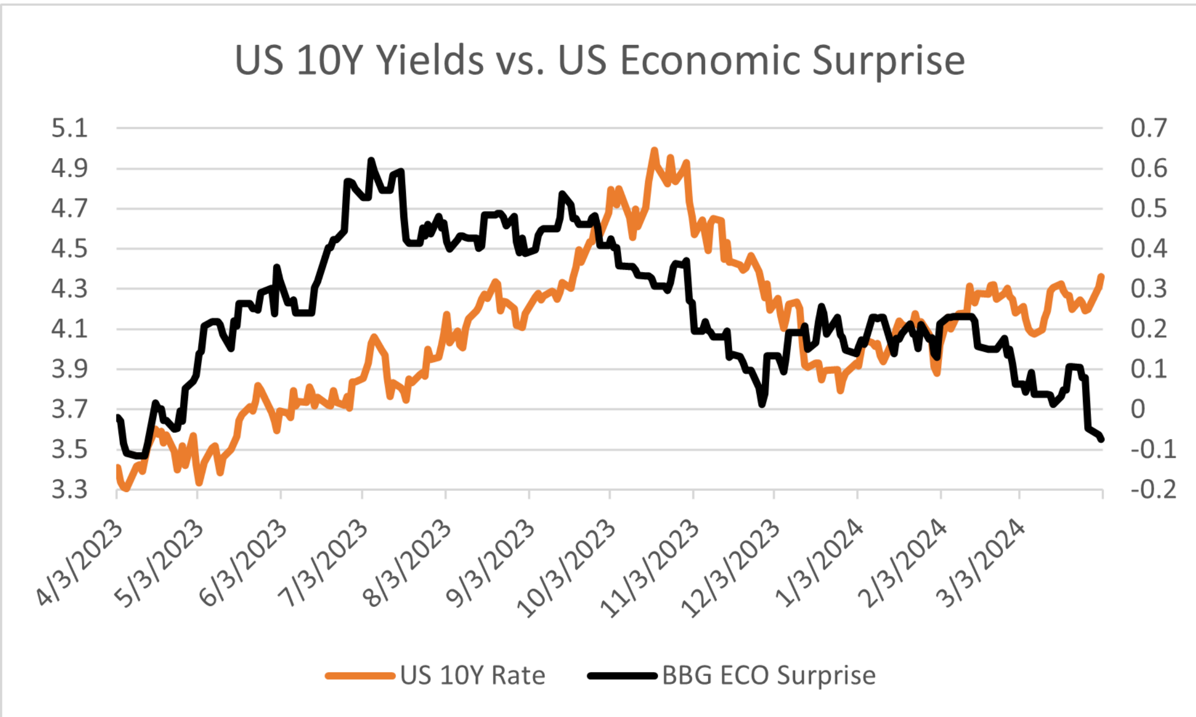
Exhibit #2: Rates-Tech Correlation Breaks



Source: Bloomberg, BNY Mellon

Another chart that worries some now comes from the economic surprise index for the US vs. the US 10y yield. If markets believe that the Fed will ease with a slowing economy, then why are US yields going up? The correlation breakdown between bonds and economic data suggests something has changed. Some are worried about the US's fiscal position/debt. Others point to the risk that the Fed may not cut even with slowing growth if inflation remains sticky. The components of the surprise index clearly point to more weakness in survey data than in 'hard' economic data, adding to confusion about what really matters to rates.

Exhibit #3: US Economic Surprises Diverge From 10y Yields



Source: Bloomberg, BNY Mellon

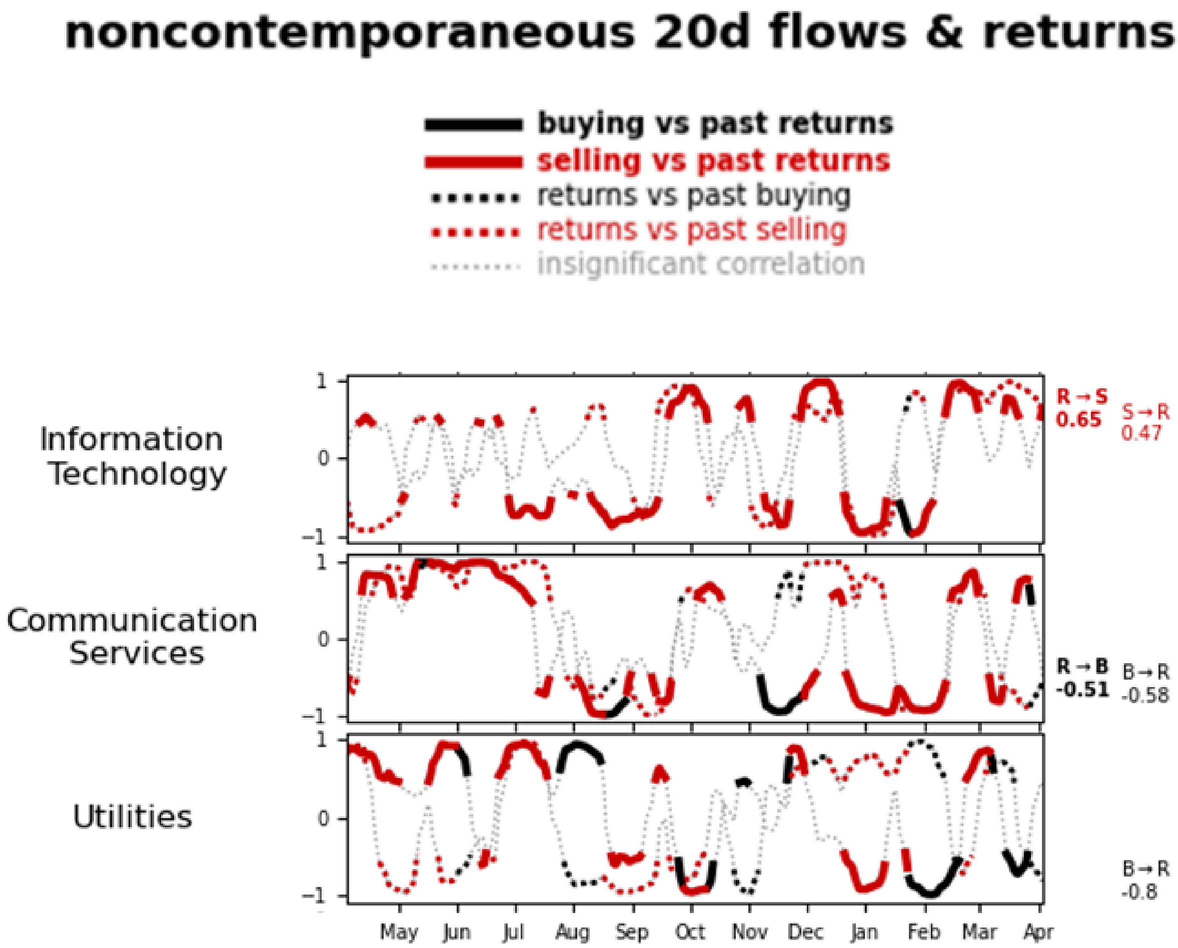
Factors that could add to US equity rally: In economic terms, Q1 GDP stronger than 2.5% and stable/lower inflation allows Fed to cut in June, adding to soft-landing hopes.

- **Q1 earnings surprises**. GDP at 2.5% and inflation at 3.5% have many expecting earnings growth of 6-8% and positive for Q2. FactSet analysis shows fewer companies than normal cutting outlooks, setting up higher market expectations.
- **Liquidity continues**. This starts with the Fed still talking about easing policy and extends to other central banks willing to act ahead of the Fed. The lack of noise or pain in money markets from the shift from cash to bills amid the Fed's ongoing quantitative tightening (shrinking the balance sheet) has yet to matter to markets as excess money shows up ready to go to work. Many point to the rise in gold and Bitcoin as examples of the market fearing central bank easing too soon.
- **Productivity gains from AI**. The investment cycle speeds up and produces faster gains than many expect, driving up early adapters and doubling the investment process for the laggards. Measuring the power of AI on markets in jobs, as some middle-office roles are replaced, and how companies refocus employment will be a key part of the narrative.

A deeper dive into our iFlow equity data shows that in the US over the last three years, our flows have led returns in the following sectors – Materials, Industrials, Information Technology, Communication Services, and Utilities. The average of flows leading market returns has been 76.7% in Utilities – suggesting a keen focus on yields. Notably, the sectors where US flows have lagged returns are Energy, Consumer Discretionary, Consumer Staples, Health Care, Financials, and Real Estate. Where flows lag returns – suggesting 'chasing the tape' – most notably is in Financials, at 79.4% vs. 72.5%. The implication is that our data should be useful to investors in understanding the risk of reversals.

One standout of our new data distillation comes when both leading and lagging factors are at work – when investors get positive rewards for investing in a market you have a set-up for overextended positioning. We see that most clearly today in Information Technology – not just in the US but also in APAC and EMEA. As we described in our new factor centrality index – dependence on one story can keep a market stable, but vulnerable in the longer term – we can now highlight when correlations shift between our flows and returns across different sectors globally. Clearly, the dominant theme for equities as we start Q2 and see Q1 earnings will be AI and whether it delivers on the narrative.

Exhibit #4: US Flows Lead Returns In Utilities



Source: iFlow, BNY Mellon

Bottom Line: Markets are set up for volatility with equity positions in Information Technology, divergence of short-end rate expectations and yield curve positioning in bonds, and shifting correlations of FX to both, leading risk in Q2. The week ahead and the rest of the month have a seasonality bias to own equities and shun bonds, while the USD usually does little. But the hangovers of trends and positions and narratives from Q1 matter, leaving markets vulnerable to surprise outcomes in policy and economic data.

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNYMellon.com

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