BNY MELLON

iFlow

MACRO MORNING BRIEFING

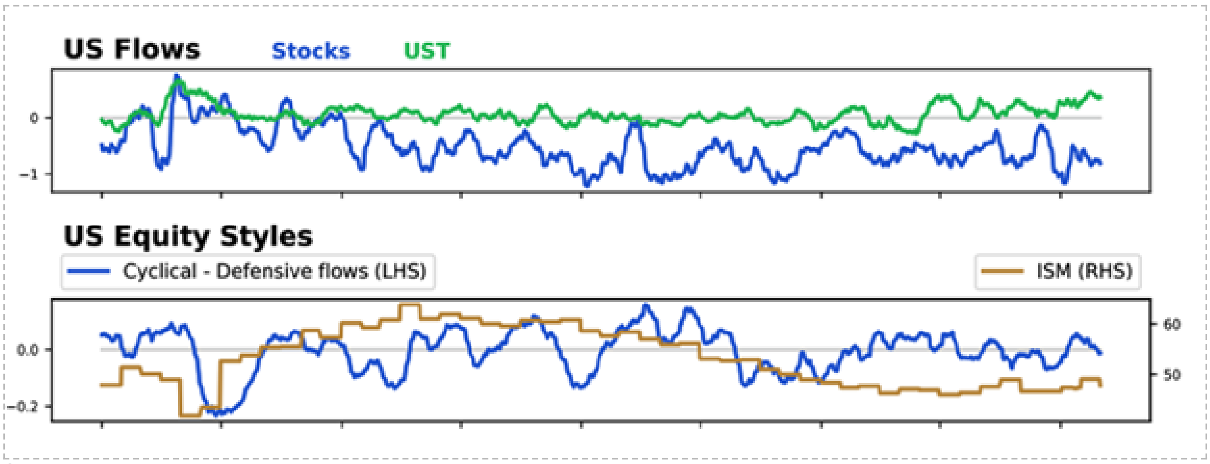
March 8, 2024

Equity Sectors And The Business Cycle

The US 'no landing' crowd has gotten bigger in the past month. The view that the US can avoid a recession and make a 'soft landing' via the Federal Reserve cutting rates from restrictive to neutral shifted with early Q1 data suggesting stronger growth and sticky inflation. The picture painted by our clients' US equity flows looks different. Tracking divergence between fixed income and equity market outlooks in the present price vs. actual flows is worth considering when looking at the overall risk environment ahead.

- iFlow shows more US bond buying than equity buying, with duration still leading – even as market pricing of Fed rate cuts has unwound from six 25bp moves to three.
- Style factors in US equity flows suggest a more Defensive stance than Cyclical upsurge. Sector flows in the last month indicate flipping from early-stage recovery to more late-stage fears: Energy beating AI and persistently positive Utilities flows.
- The role of China stimulus in emerging markets clearly shows in iFlow sector analysis. We see a risk of investors under-prepared for a bounce back in growth.

iFlow Shows Bias For Bonds Over Equities



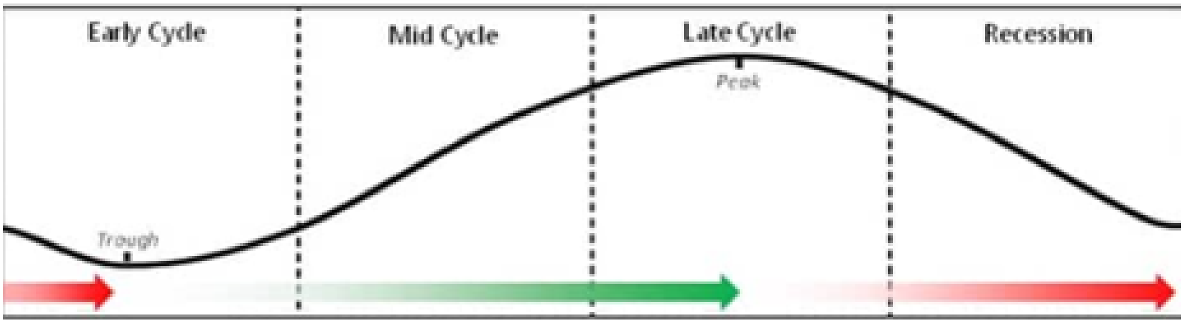
Source: iFlow, BNY Mellon

Labor-market data is critical to measuring the path for both US growth and FOMC rate cuts. Many see the 'no landing' debate resolved by ongoing sub-4% unemployment and solid job growth. Others see cracks in different sectors. There are other ways of measuring the US business cycle and where rates matter to Main Street. Consider also that the market in March has a seasonal bias for trouble – we are all taught to "beware the ides" and global stock market performance lags in the month, recovering in spring and through April. The tax season and the pressure on Q1 growth realities are part of the logic. This year we also have the added excitement of the US election and what it means for domestic policy shifts, along with foreign policy – tariffs and tax cuts are clearly part of the debate ahead.

How markets have shifted from the start of the year to now is clearly part of the puzzle for the month with FOMC rate cuts back to 3+ from 6 and with equities making new record highs. The dichotomy of rates to shares stands out. FX markets have been uncharacteristically calm. Lower volatility there has inspired carry trades more than cross-border flows of consequence. Many investors are waiting for a rate cut from the FOMC to justify chasing returns abroad. The hopes: recession ending in Europe and APAC driving returns.

Business Cycle And Equity Sectors

Early	Mid	Late	Recession
- Fiscal and monetary stimulus	- Fiscal and monetary stimulus start receding	- Fiscal and monetary restrictions	- Fiscal and monetary stimulus
- Economic growth starts to increase	- Economic growth slows but still positive	- Economic growth stagnates or even decreases	- Economic contraction, falling manufacturing and retail activity
- Employment and manufacturing activity picks up	- Hiring and manufacturing activity still growing	- Employers have trouble finding available workers and wages increase	- Unemployment increases
- Profits bounce higher	- Margins start to peak and management increases share repurchases to boost profits	- Earnings start to disappoint against high expectations	- Earnings and credit lending drop quickly



Countries 1Q 2023 by stage

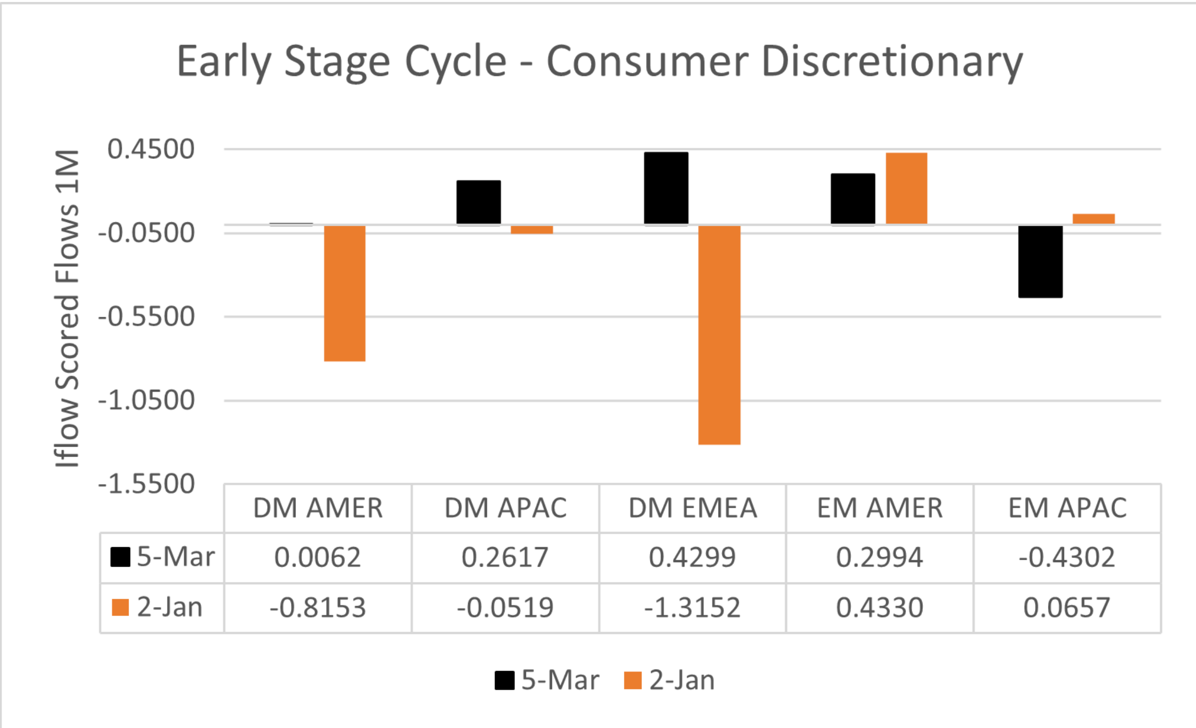
Early	Mid	Late	Recession
Japan, Korea	US	UK	Canada, Germany

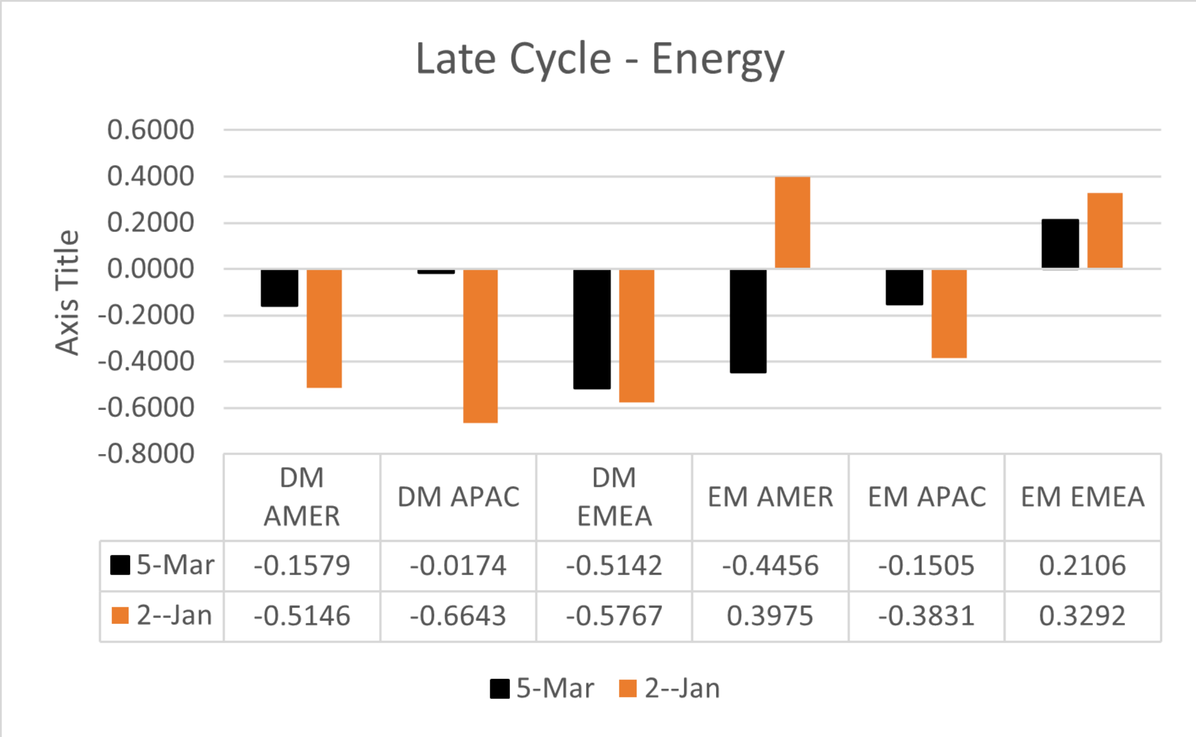
Source: World Bank, BNY Mellon

- Traditionally, equity sector flows are used to reflect the view of investors on where they are in the business cycle. **Recessions see equity sector returns only in Utilities**, with broader averages down 15% – but such periods usually last less than a year. Health Care also usually performs well with high dividends key. Cash becomes a significant part of the asset allocation decision. A recessionary environment usually leads to central bank rate cuts, inventory adjustments, and an eventual recovery.

- The **early stages of a boom typically start with Consumer Discretionary** +20% y/y, then Real Estate and Financials with rates attractive to a leveraged economy.
- The **middle stage is the longest** and the most difficult to trade. The 14% y/y average returns are dominated by IT and Software. Later, Industrials, Materials and Consumer Staples start to matter more, which sees rates rise and margins suffer.
- The **late stage varies, with 1-2 years of 5% y/y returns dominated by Energy** and a shift to cash with risk concerns dominating.

Different Sectors For Different Regions



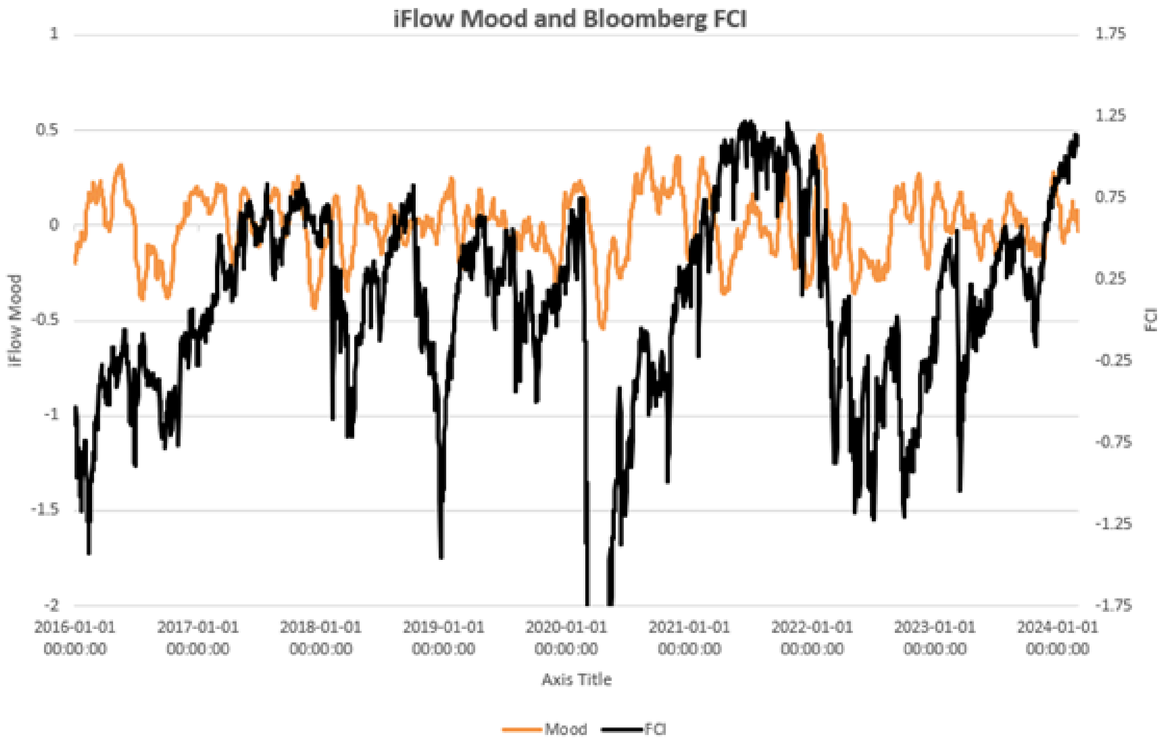


	DM AMER	DM APAC	DM EMEA	EM AMER	EM APAC	EM EMEA
5-Mar	-0.1579	-0.0174	-0.5142	-0.4456	-0.1505	0.2106
2--Jan	-0.5146	-0.6643	-0.5767	0.3975	-0.3831	0.3292

Source: iFlow, BNY Mellon

iFlow sector flows by region suggest that the world did change from January to now: views of growth but less in the US than in other places – particularly Europe where the shift in Consumer Discretionary flows has been most significant. Frustration with China's stimulus and recovery stands out as well, with Consumer Discretionary flows in the EM APAC region flipping to negative. The contrast to developed markets in APAC – Australia, Japan – is also notable and suggests a clearer view on where opportunities can be found in equities should the FOMC indeed sound dovish enough for divergence in rate policies.

The relationship of US equities and financial conditions to how the Fed and other central banks see the world is clearly part of the Q1 2024 focus for investors as they search for certainty. Many investors are waiting for rate cuts before allocating more aggressively. Cash holdings (or money market instruments under 1y) are one place to watch. The simplest iFlow gauge that captures investor bias is the iFlow Mood index – it's neutral and not matching the run financial conditions run from October that the Fed inspired with the flip in bias from rate hikes to cuts. There is a subtle yet significant difference between 'higher for longer' and 'high for longer'. Markets now await the lower rates indicated by Fed Chair Powell. The shift from a cut in March to June is clearly part of the dynamic and risk for the year. Bloomberg's Financial Conditions Index and iFlow Mood mostly move together, but when they diverge the risks of the market skew. This surely seems one of those moments. Whether FCI leads or lags FOMC policy is clearly central to the timing debate ahead for all central banks.



Source: iFlow, BNY Mellon

Bottom Line: The divergence of iFlow sector flows globally stands in contrast to the record-high equity markets of the last month. Whether this can continue remains interlinked to how fixed income and rate markets play out, with the FOMC still seen as leading rather than being different from other central banks. The convergence of business cycles that dominated the 2010-2020 pre-COVID markets has changed. The risk we see is more differentiation and volatility in policy prescriptions from governments and central bankers for the rest of the year.

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