THE MACRO BALANCING ACT

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Phillip Nelson, NEPC's head of asset allocation, sifts through the many macroeconomic factors—elevated geopolitical conflict, shifting monetary and trade policies, and fiscal expansion—at play, and discusses their potential impact on the global economy and investment portfolios in a sit down with Aparajita Bubna, NEPC's managing editor.Furthermore, we have seen short-term underperformance in emerging markets equities is often due to index construction and country/sector weights, and not a breakdown in the quality factor itself. Historically, we have seen quality as a factor has delivered superior returns in all major equity indexes, including emerging markets, and we expect this trend to continue as market conditions normalize.

1. The Federal Reserve's next policy meeting, in September, will be crucial with many anticipating a rate hike as inflation remains sticky. What are your views on the potential impact of a more restrictive monetary policy on markets?

Currently, the market is expecting the Federal Open Market Committee to hike rates over the rest of the year. We are skeptical of that. Historically, the Fed generally doesn't raise rates just once; a rate hike is usually part of a cycle, and when we look at the most recent trajectory of inflation, along with the jobs data, we would be surprised to see multiple hikes.

I think what the market is getting wrong today is conflating the volatility in energy prices with underlying long-term inflationary pressures. There are certainly headline inflation pressures from the higher price of energy due to the conflict in Iran. However, the overall U.S. economy is less sensitive to energy prices, and it takes a much higher price of oil to create underlying core inflationary issues. That might be different for the rest of the world, but for the U.S., we think the most likely outcome is the Fed may hold rates steady for a while.

2. On the topic of the Fed, does the new Chair's preference for more limited communication change your view of Fed policy?

Kevin Warsh has moved away from providing forward guidance around how the Fed is thinking about potential changes to monetary policy. Chair Warsh has characterized the change in FOMC forward guidance as reteaching markets to "play the ball, not the referee." There is plenty of healthy debate regarding the effectiveness of the change in communication policy, but it does not change our underlying view of how the Fed will react to rising or falling inflation, or shifts in the job market.

But for day-to-day market participants, it likely results in greater volatility for Treasury rates. The market seems to be in a waiting period to better understand how the new Fed chair is looking to implement and communicate monetary policy. Some have interpreted the sparse communication as a sign of more uncertainty and, as a result, long-term interest rates have risen, and that's increased yields for some parts of the Treasury market.

That said, in our opinion, the market dynamics of inflation and the job market appear to be biased towards the Fed not taking any action. This is challenging for some market participants to interpret when there's less communication coming from the Fed. As a result, they're pricing in a higher risk of inflation. In our minds, from a valuation basis, Treasury yields will start to look relatively attractive if Treasury rates keep rising.

3. How is the ongoing conflict with Iran impacting NEPC's assessment of geopolitical risk? Do you view it as a temporary market shock, or has it fundamentally altered the investment outlook for energy, defense, and global supply chains?

When the hostilities began in February, we, like many market participants, viewed it as a temporary geopolitical event that caused the price of oil to rise. We thought as long as the conflict stayed somewhat contained, and did not result in widespread damage to the energy infrastructure across the Middle East—not just Iran, but Kuwait, UAE and Saudi Arabia—there would not be a lasting impact on the global economy.

That said, in recent months, we are starting to rethink that premise and are viewing the ongoing tensions with Iran as potentially the base case scenario. We believe there may be more volatility in oil prices amid the off and on dynamic with periods of military action followed by periods of negotiation; this could continue for the foreseeable future.

Meanwhile, the bigger risk we are focused on is if there is a deterioration in supply in terms of oil reserves and other oil derivative products around the world. The reserves for diesel, jet fuel and oil are at the lower end as countries are depleting their stock.

If there is a greater restriction in supply in energy products coming out of the Middle East, it will be very problematic for the global economy, and the risk will transition from energy price volatility to "how to keep the lights on" for some countries. So far, that doesn't appear to be the base case, but we are closely looking at reserve levels across the energy market.

4. Given today's combination of greater geopolitical uncertainty, changing monetary and trade policies, and fiscal expansion, where do you currently see the most attractive risk-adjusted opportunities?

Every investor is going to have their own investment policy and asset allocation. That said, when we look at global markets, we believe U.S. equities, especially within the growth segment, are attractive despite their strong run in the last several years.

To be sure, there's increasing cynicism around returns for the elevated capital expenditures associated with AI, and the earnings forecasts from many of the largest companies in the S&P 500. But when we look at the next several years, the potential for outsized earnings growth and the current valuation levels—whether it's the S&P 500 or the NASDAQ—are relatively appealing compared to the last five-to-10 years. We believe investors should be thinking about leaning into these growth segments.

Meanwhile, managing diversification, especially for passive S&P 500 investors, remains a challenge given the concentration of the top 10 names within the index. Finding that right balance between leaning into the companies that are growing the most and generating the most earnings growth, especially within that growth segment, while also managing some level of diversification amongst U.S. large-cap exposure is not an easy proposition.

Also, we are monitoring non-investment grade credit spreads. While we don't have concerns about balance sheet risk or credit quality, credit spreads are relatively low. When markets are healthy and spreads are below 300 basis points, we generally encourage looking at high-yield debt as a rebalancing source and to potentially redeploy those funds into equities. On the other side of the coin, Treasury yields appear to be elevated, so we think being slightly overweight Treasuries and equities may be a sound position for investors in today's market.

5. What portfolio diversifiers do you have the highest conviction in?

Coming back to our core principles, we want to ensure our investors have appropriate levels of safe-haven fixed-income securities to support their spending and liquidity needs. For some, that might mean U.S. Treasuries, while for others, it could be high-quality municipal bonds. But no matter what, it is vital to set the appropriate risk budget and parameters to ensure you have the right amount, so if there is a surprising economic downturn, there is not only a buffer for the portfolio, but also appropriate liquidity.

Typically, when the economy does well, there should be a higher level of nominal growth, which likely means an above average level of inflation. Those are good problems to have. But in that type of environment, when we look at where real interest rates are and the potential for the U.S. economy to outperform, we're more favorably inclined towards TIPS. We don't view TIPS as a direct inflation hedge, but as a solid diversifier within a portfolio; TIPS provide both an adequate real return and can respond favorably to a surprise uptick.

6. Do you believe the U.S. economy is headed for a soft landing, a recession, or a reacceleration in growth?

At present, we are not concerned about the trajectory of the U.S. economy. We think, if anything, the economy has the potential to surprise to the upside. We see potential for economic growth, given the strong consumer base, continued expansion of investment associated with AI, the aggregate benefits of fiscally stimulative policies flowing through, and the prospect for greater M&A activity amid a looser regulatory framework.

The ideal scenario would be a continued deceleration of core inflation which, over time, gives the Fed space to potentially reduce rates or maybe, more importantly, allows long-term rates to come down. This would be beneficial to not only corporate borrowers, but also the housing market and mortgage activity.

7. What economic indicators are you watching most closely?

Historically, jobs and employment numbers are closely watched. For a recession to occur in the U.S., we likely need to see cumulative job losses of at least a million jobs within a six-month period. In the current environment, it's hard to see a catalyst that would cause that type of attrition in the job market.

Other big data points to focus on are overall capital expenditures and industrial construction levels; some of this is associated with data centers, but we are also looking at a potential resurgence in manufacturing in the United States. Then of course, there's consumer spending. As long as the U.S. consumer remains comfortable taking that next vacation and making that extra purchase, the economy is likely to be on solid footing.

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