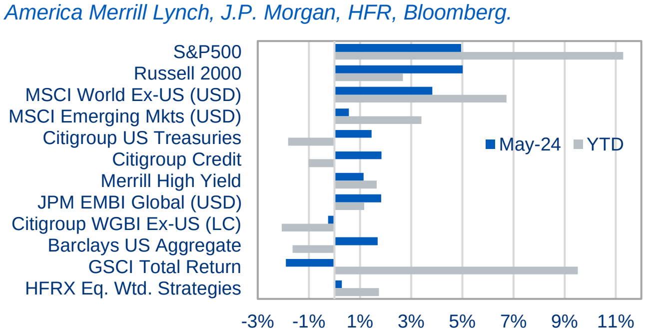
Global Market Review

Global equities surged in May led by the U.S. market which touched record highs. Hopes for moderating price pressures, easier monetary policies, rising corporate earnings, and an incipient AI boom underpinned the strong rally. NVIDIA, whose market capitalization jumped by $537 billion in May, was a major catalyst to market gains that have been largely driven by a handful of AI-related, mega-cap stocks. In the credit markets, spreads narrowed further across the rating spectrum, with high yield spreads approaching the lows prevailing in 2007 just prior to the great financial crisis (GFC). The AI frenzy was also apparent in commodity markets. Copper prices jumped 5.1% in May and are up over one fifth so far this year, driven by speculative flows and tight U.S. supplies. Oil prices, in contrast, lost 6% in May, reflecting excess capacity and rising shale production. The trade-weighted U.S. dollar index fell but remains higher so far this year.

Performance of Major Market Indices

Sources: S&P, MSCI, FTSE Russell, Barclays, Citigroup, Bank of America Merrill Lynch, J.P. Morgan, HFR, Bloomberg.



Global equity markets rally. Credit spreads tighten.

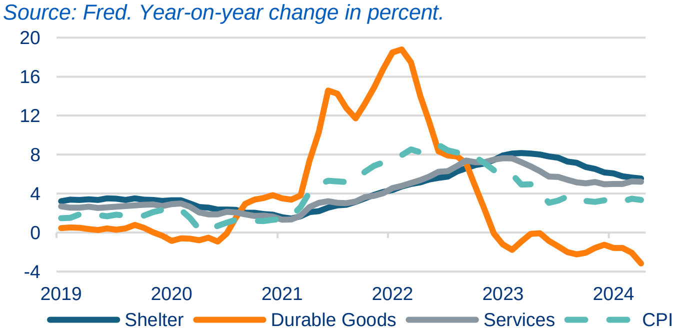
Inflation, the Fed, and Market Sentiment

Expectations that monetary policy will ease across advanced economies have been the main stimulant of investor risk appetite since October 2023. Swings in market sentiment have been driven by vacillating views on the persistence of inflation and the direction of policy. The equity market fell sharply in April largely on fears that inflation had become entrenched and would require a prolonged period of tight money to correct. The equity market rebounded strongly in May as the prospects for inflation appeared to be not so dire after all.

Although inflation in the U.S. remains above the Fed's target, it has moderated, and the remaining price pressures are in the service sector (Exhibit 1). Durable goods prices, in contrast, are falling. Shelter, which represents 30% of the index and whose impact on measured inflation is felt with a lag, remains a key factor holding up inflation. Although well down from its peak, the shelter inflation rate is running at 5.8%, contributing to inflation overall as well as in the service sector. At its most recent reading, inflation excluding shelter is up only 2.2% (compared with 3.4% for the total CPI) and has been below 2.5% for the past 11 months. Hopes that price pressures will moderate as shelter prices adjust contributed to May's strong equity market gains.

Exhibit 1. Divergent Inflation Trends

Source: Fred. Year-on-year change in percent.



AI Dominates U.S. Equity Market Gains

Speculation over the promise of AI has also been a prime catalyst for market gains. So far in 2024, the S&P 500 index is up 11.3%, representing a $4.3 trillion increase in market

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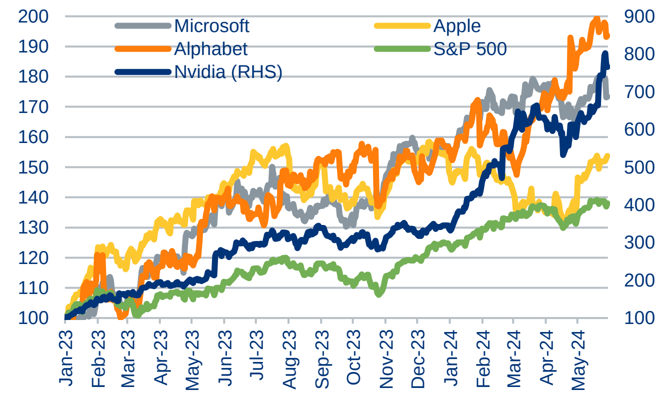
capitalization. It reached a record high level mid-month. The market's strong gains remain driven by NVIDIA and a handful of other mega-cap tech stocks. Strong earnings and the prospect of much more to come have sent NVIDIA's shares up 121% so far this year and increased its market cap by $1.5 trillion, equivalent to 34% of the total increase in the market cap of the S&P 500 in the first 5 months of the year (Exhibit 2). NVIDIA has gained 766% since the beginning of 2023. Three AI-related stocks – NVIDIA, Microsoft, and Alphabet – together account for over half of the increase in the S&P 500 index's market capitalization so far this year.

Exhibit 2. AI Boom Drives Gains, Concentrates Market

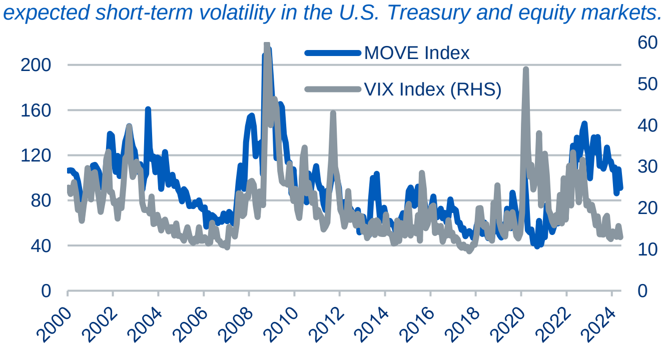
Source: Bloomberg. Index. January 1, 2023 = 100.



This market dynamic has contributed to elevated valuations and increasing market concentration, factors normally associated with heightened potential for future market instability. Nevertheless, expectations for equity market volatility derived from the options market remain quite low (Exhibit 3). In contrast, measures of expected bond market volatility are signaling continued substantial uncertainty over the likely path of inflation and interest rates. These divergent expectations for bond and equity market volatility are especially surprising given the strong impact that rate expectations have had on the equity market in recent months.

Exhibit 3. Volatility – Low for Equities, High for Bonds

Source: Bloomberg. Move and VIX indexes measure, respectively, expected short-term volatility in the U.S. Treasury and equity markets.



Hopes for Lower Rates Also Buoy Non-U.S. Markets

Equity markets in advanced economies followed the U.S. market higher. The MSCI World ex-U.S. index of advanced equity markets rose 3.8% in May, to bring its gain for the year to 6.7%. Europe led other advanced economy bourses in May, gaining 4.8%. Indications from the ECB that a rate cut was likely this year and possibly as early as June buoyed sentiment. Emerging equity markets, in contrast, have lagged other markets this year. After gaining 0.6% in May, emerging equities are up 3.4% in 2024, helped largely by a strong rebound in the Chinese market which is up 6.8% this year. Government measures to bolster the troubled Chinese property and financial sectors have contributed to the recent recovery of the Chinese equity market. Nevertheless, the legacy of high leverage, overbuilding, and speculative price increases in the property market are likely to represent a continued vulnerability of the Chinese economy and financial system. A vulnerability that is likely to be exacerbated by an aging population, declining labor force, and a slower pace of household formation.

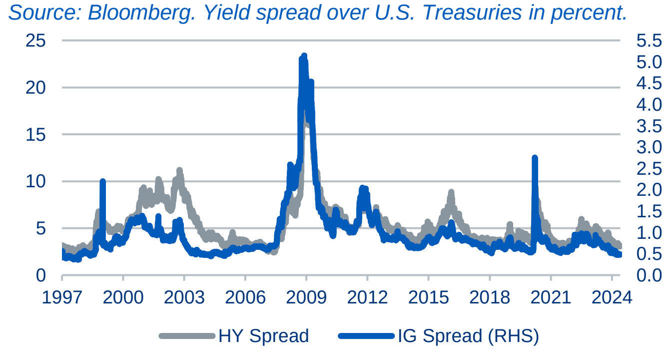
Treasury Yields Fall, Credit Spreads Narrow

Longer maturity U.S. Treasury yields declined in May while shorter term yields remained little changed. The declines were led by falling real yields, although lower inflation expectations also contributed. U.S. Treasury prices in aggregate rose by 1.4% in May but remain down so far this year.

Like the equity market, valuations in the credit market also appear stretched. Credit spreads narrowed to pre-GFC lows across the ratings spectrum (Exhibit 4). Spreads are narrow despite increasing issuance by corporate borrowers, an uptick in default rates, and high levels of bond market volatility. The investment grade and high yield sectors rose by 1.7% and 1.1%, respectively in May. So far in 2024, investment grade credit is down 1.6% while the high yield sector is up 1.7%.

Exhibit 4. U.S. Credit Spreads Narrow Further

Source: Bloomberg. Yield spread over U.S. Treasuries in percent.



Performance of Major Market Indices through 05-31-2024

Sources: MSCI, FTSE, Barclays, Citigroup, Bank of America Merrill Lynch, J.P. Morgan, S&P GSCI, HFR, Bloomberg.

	1-Month	QTD	YTD	1-Year	3-Year	5-Year
S&P500	5.0%	0.7%	11.3%	28.2%	9.6%	15.8%
Russell 2000	5.0%	-2.4%	2.7%	20.1%	-1.7%	8.6%
MSCI World Ex-US (USD)	3.8%	1.1%	6.7%	18.5%	3.0%	8.2%
MSCI Emerging Mkts (USD)	0.6%	1.0%	3.4%	12.4%	-6.2%	3.5%
Citigroup US Treasuries	1.5%	-0.8%	-1.8%	-0.2%	-3.3%	-0.7%
Citigroup Credit	1.8%	-0.5%	-1.0%	4.3%	-2.7%	0.9%
Merrill High Yield	1.1%	0.1%	1.7%	11.2%	1.8%	4.0%
JPM EMBI Global (USD)	1.8%	-0.2%	1.2%	9.7%	-2.1%	0.7%
Citigroup WGBI Ex-US (LC)	-0.2%	-1.7%	-2.1%	0.4%	-4.2%	-2.0%
Barclays US Aggregate	1.7%	-0.9%	-1.6%	1.3%	-3.1%	-0.2%
GSCI Total Return	-1.9%	-0.8%	9.5%	18.4%	13.7%	8.9%
HFRX Eq. Wtd. Strategies	0.3%	-0.4%	1.7%	5.9%	0.4%	2.9%