RESEARCH

2024 Midyear Investment Outlook: Steady Growth Boosts Stocks and Bonds

May 29, 2024

Investors may look to European and Japanese equities, which potentially could offer up to 18% returns, and corporate credit and agency mortgage-backed securities for opportunity amid a backdrop of steady growth, declining inflation and interest rate cuts.

Key Takeaways

- Equities and fixed income assets should find support in the second half of 2024 amid steady growth, declining inflation and interest rate cuts.
- European and Japanese stocks offer attractive valuations and could gain support from positive earnings revisions.
- In core fixed income mortgage-backed securities, leveraged loans and investment grade corporate bonds appear attractive.
- Harder-to-model events including the U.S. election create a more uncertain outlook for the first half of 2025.

Morgan Stanley's outlook for most equity and fixed-income markets is largely positive heading into the second half of 2024, as global interest rate cuts are finally on the horizon: The European Central Bank is likely to start cutting in June, the Bank of England in August with the U.S. Federal Reserve predicted to follow in September. These interest rate cuts have been much anticipated by investors, who pushed markets up and down in the first half of the year as they adjusted expectations about when and how quickly policy rates would begin their descent, while volatile data kept central bankers from acting.

"Investors priced in and out a soft landing, a hard landing and no landing, reacting to every surprise in the economic data," says Serena Tang, Morgan Stanley's Chief Global Cross-Asset Strategist. "The second half should see the paths of disinflation, growth and policy become clearer, setting up a constructive outlook for nearly all markets."

In particular, European and Japanese equities offer investors attractive valuations, with share prices expected to rise as earnings estimates revise upward. U.S. stocks, meanwhile, are likely to see robust earnings growth but may not see a corresponding lift in share prices, as is typical of a mid-to-late cycle environment. In core fixed income, mortgage-backed securities (MBS), leveraged loans and investment grade corporate bonds are attractive.

"Roughly $6 trillion accumulated in money-market funds as the Federal Reserve raised rates," says Tang. "As the Fed starts to cut, investors are likely to rotate that money into other assets such as high-quality fixed income and equities—probably in that order."

Bullish and Cautious

Morgan Stanley Research sees global equities bringing positive returns this year, helped by the macroeconomic environment and the potential for increases in corporate earnings. In standout Japan, returns potentially could reach 17% while European stocks could reach 18%. Investors should be on the lookout for stocks whose performance is inversely correlated to bond yields, such as real estate, construction and materials and utilities, as well as quality growth sectors such as software, aerospace and defense, pharmaceuticals and semiconductors.

"This is the highest our weighted average base case forecast has been, outside of bear market and pandemic recoveries. For Japan's TOPIX benchmark index, the upside forecast is the highest ever," says Tang. She notes, however, that valuations are likely to be high in many markets, prompting caution from investors.

In fixed income, strategists favor "spread" products that offer yield above what investors can generally get from Treasury bonds. These include public and private corporate credit, securitized credit, MBS and emerging-market sovereign credit. Investment-grade corporate bonds, for example, can help hedge broader market uncertainty. If global growth is more robust than expected, credit spreads can potentially tighten, even though they are already narrow. If growth grinds to a halt, total returns can benefit from duration.

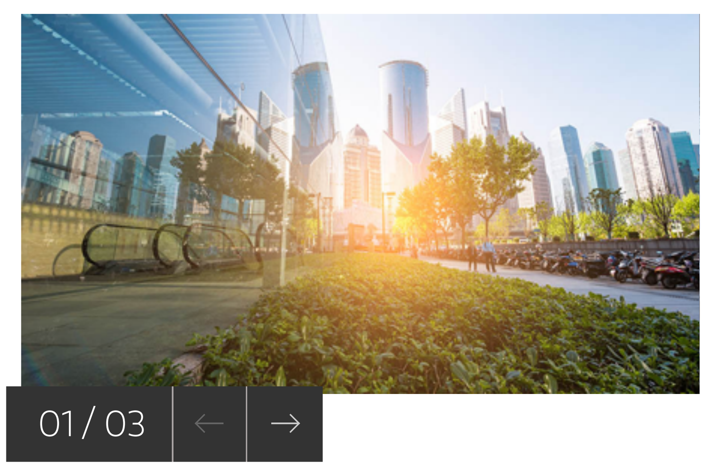
Looking back at similar historical periods can offer a perspective on how the current environment might play out in terms of investors' portfolios. In prior years when the Fed has cut rates and bonds and stocks have done well—as Morgan Stanley expects this year—the optimal mix in a multi-asset portfolio has been to increase allocation to bonds. In 2007, for example, an investor with perfect foresight would have wanted a mix of 58% stocks, 26% core fixed income, 8% other, 5% commodities and just 3% cash. (We remind our readers that past performance is not a guarantee of future results.)

Hedging the Unknowns

There are uncertainties in the outlook going into 2025, based on unpredictable events—including the outcome of the U.S. presidential election and changing patterns in immigration, household formation and consumer preferences, to name a few.

With this in mind, investors should consider assets that might offer "convexity," with the potential for positive returns and controlled risk of losses. European stocks are one example: Companies in the MSCI Europe index derive about 25% of their revenue from the U.S. and about 30% from emerging markets. This means investors can potentially benefit from hotter growth in either region while benefiting from cheaper valuations than the S&P 500 and lower volatility compared with emerging market stocks.

One other theme that can help with the uncertainty is carry, which may allow investors to benefit from differences in interest rates between two currencies. As an example, for a U.S. dollar-based investor, the expected dividend yields of European and Japanese equities, when hedged for foreign exchange risk, are above historical averages.



01 / 03

INSTITUTE FOR SUSTAINABLE INVESTING

Companies' Sustainability Priorities and Challenges

Companies' top reason for pursuing a sustainability strategy is the opportunity for value creation. The biggest hurdle? The high level of investment that's needed.

RESEARCH

The Dollar Is Poised to Keep Its Crown

RESEARCH

The New T

Healthier