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GLOBAL RESEARCH

The Carlyle Compass

By **Jason Thomas**
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*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team. This week's edition offers a midyear review of some of the macro developments anticipated in our annual outlook piece, Five Questions for 2024. Received this email as a forward? Subscribe here.*

1. Continuity of Government
2. A Market Unwind?
3. Office Rebound

1. Continuity of Government

To describe President Biden's withdrawal from the Presidential race as shocking would be an overstatement. On Friday, prediction markets offered bettors 20-to-1 odds he'd be re-elected President and 5-to-1 odds he'd be the Democratic nominee, despite having secured 99% of committed delegates. But even expected news can prove startling and this was no exception.

The greatest policy triumph of the Biden Administration doubled as its most obvious vulnerability. At 8% of GDP, the March 2021 American Rescue Plan Act (ARPA) experimented with money-financed fiscal transfers that were nearly 3x larger than the hole in demand they sought to fill. U.S. labor markets healed faster than at any time in 40 years, but some participants in this clinical trial complained of side-effects.

In many ways the ARPA was just a continuation of policies put in place in March 2020 and December 2020. And this was true of much else that has occurred over the past four years. As a candidate, Vice President Biden blasted President Trump's irresponsible tariff war with China; as President, he expanded it. President Biden also delivered the bipartisan infrastructure bill President Trump had promised, and enacted the most sweeping incentives

for American reindustrialization in more than a generation.

As we wrote in January: "It is difficult to overstate the complexity that the simultaneous intersection of geopolitical rivalry, energy transition, and industrial transformation introduces to the global economic picture... Subsidies, mandates, and trade barriers are embraced to counteract subsidies, mandates, and trade barriers."

This complexity seems unlikely to resolve itself no matter who is elected President. Differences between the parties remain with respect to taxation and energy, but consensus surrounds much else in the economic policy realm (including a shared refusal to deal seriously with the fiscal imbalance). Americans will head to the polls in November mainly to choose who best to set the precise mix of subsidies, mandates, and tariffs going forward.

2. A Market Unwind?

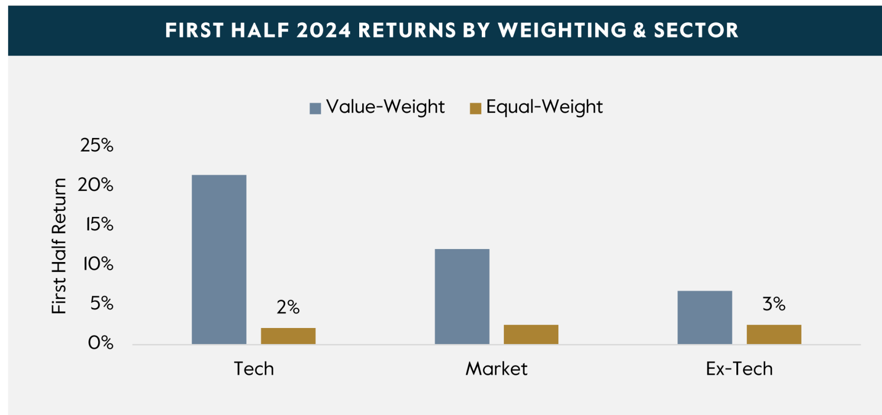
Rates markets opened the year a bit over their skis. Futures priced nearly seven rate cuts for 2024, an aggressive path one might expect the Fed to pursue in the context of recession or financial dislocation. But these cuts were to arrive amidst an otherwise benign macro backdrop, with double-digit growth in corporate earnings.

Something had to give. Since fundamentals held up largely as expected—first-half U.S. GDP growth was nearly 2% and earnings are expected to finish Q2-2024 nearly 10% above year-ago levels—the rate cuts were dialed back. This was easy to foresee. Our question from January centered on the market fallout.

Higher rates were not the headwind to broad market indexes that some may have expected. Instead, they spurred aggressive buying of stocks least impacted by elevated finance costs and discount rates.

This was not, as commonly supposed, a rotation into "tech" per se. On an equally-weighted basis, tech stocks underperformed the broad market and an equally-weighted portfolio of stocks outside of the tech sector (Figure 1). It has not really been a rotation into large caps either, as profitability ratios explain 60% more of the variation in returns than company size.

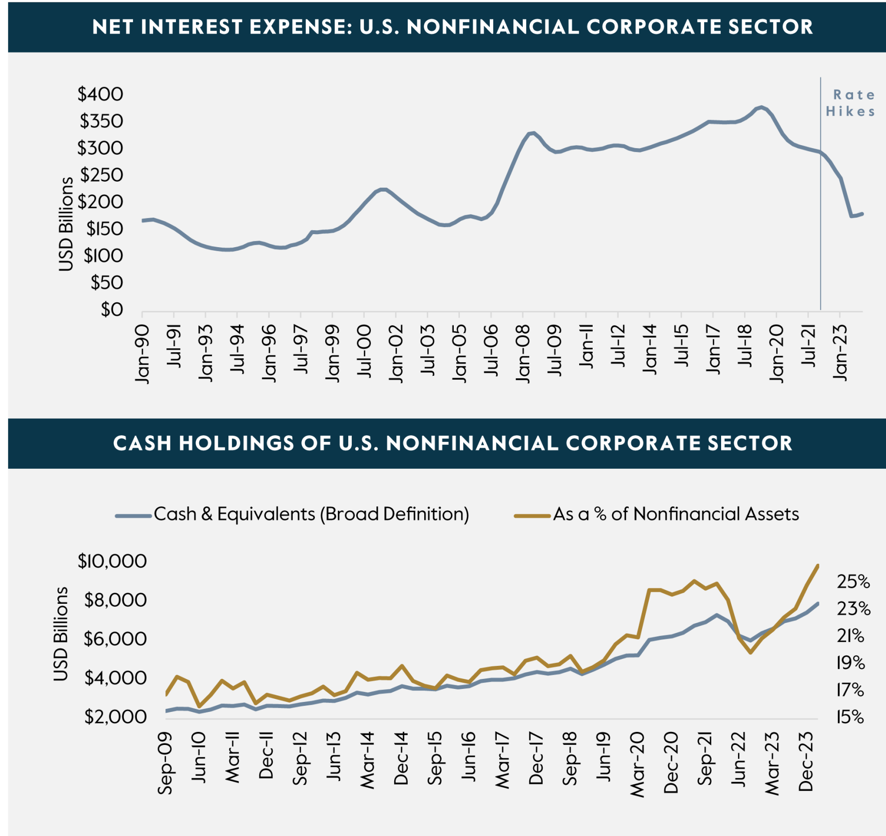
Figure 1: Hardly a Rotation into "Tech"



Source: Carlyle Analysis; MSCI, Bernstein, FactSet, July 2024. There is no guarantee any trends will continue.

Since the Fed began hiking rates in March 2022, the net interest expense of the U.S. nonfinancial corporate sector has *dropped* by 40%. The interest earned on operating companies' $7.9 trillion of cash and liquid securities rose more than the interest paid on their largely fixed rate liabilities (Figure 2). Those cash holdings are not evenly distributed across the corporate sector but held disproportionately by the mega-cap technology companies whose near-term cash generation capacity also increased their allure.

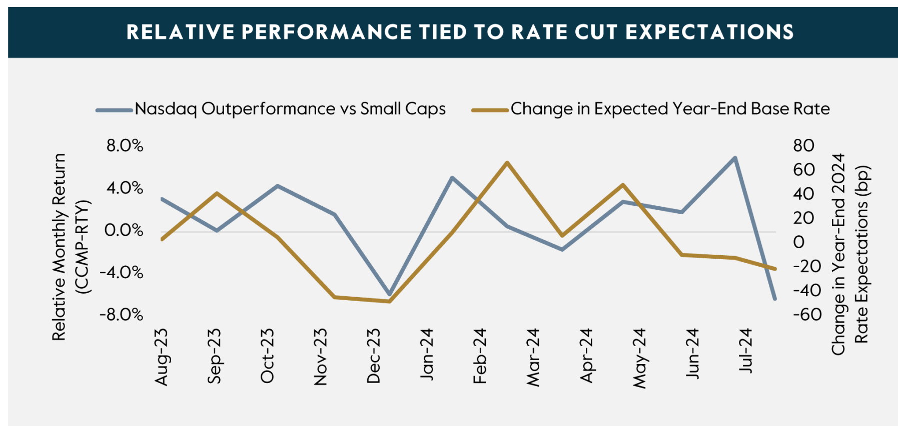
Figure 2: No Rate Cuts? No Problem



Source: Carlyle Analysis; Federal Reserve, July 2024. There is no guarantee any trends will continue.

Now that rate cuts really do appear on the horizon, this trade has begun to unwind. Over the past 12 months, the Nasdaq's performance relative to small cap stocks has waxed and waned with interest rate expectations (Figure 3). The inexplicable (relative) jump in the Nasdaq towards quarter-end was fueled by the same technical factors driving the violence of its reversal in recent trading days.

Figure 3: Market Unwind Tied to Changed Rate Expectations



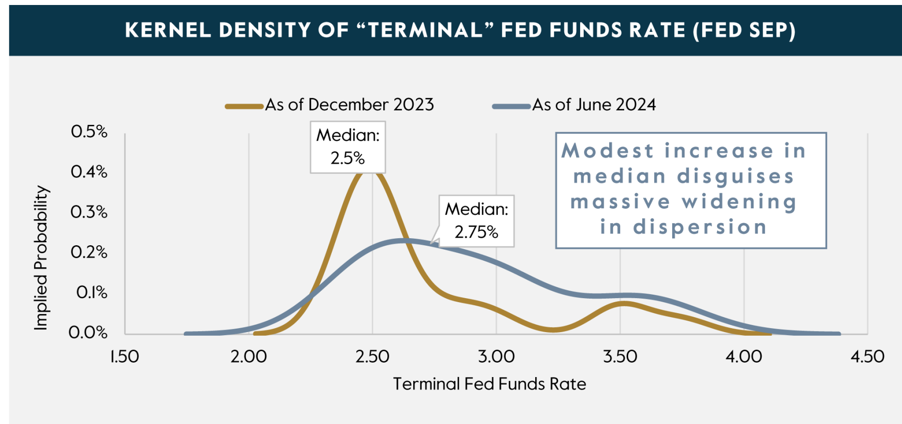
Source: Carlyle Analysis; Bloomberg, July 2024. There is no guarantee any trends will continue.

With mega-cap tech's share of total market capitalization up by over 75% since the pandemic (from 18.5% to nearly 33%), further unwind of these positions will not prove helpful to broad stock market indexes. But as we've observed, aggregates and value-weighted averages can be misleading barometers. One could imagine a scenario where a healthier market for individual stocks (and exits) coincides with somewhat weaker performance in these benchmarks.

3. Office Rebound

Before rushing out to buy interest-sensitive assets, there are two caveats to consider. First, the less certain the Fed is of its destination for base rates (Figure 4), the more slowly it's likely to proceed. No one should expect an uninterrupted series of rate cuts absent unforeseen economic or financial turmoil. And second, but more importantly, falling discount rates are not much help to assets without cash flows to discount.

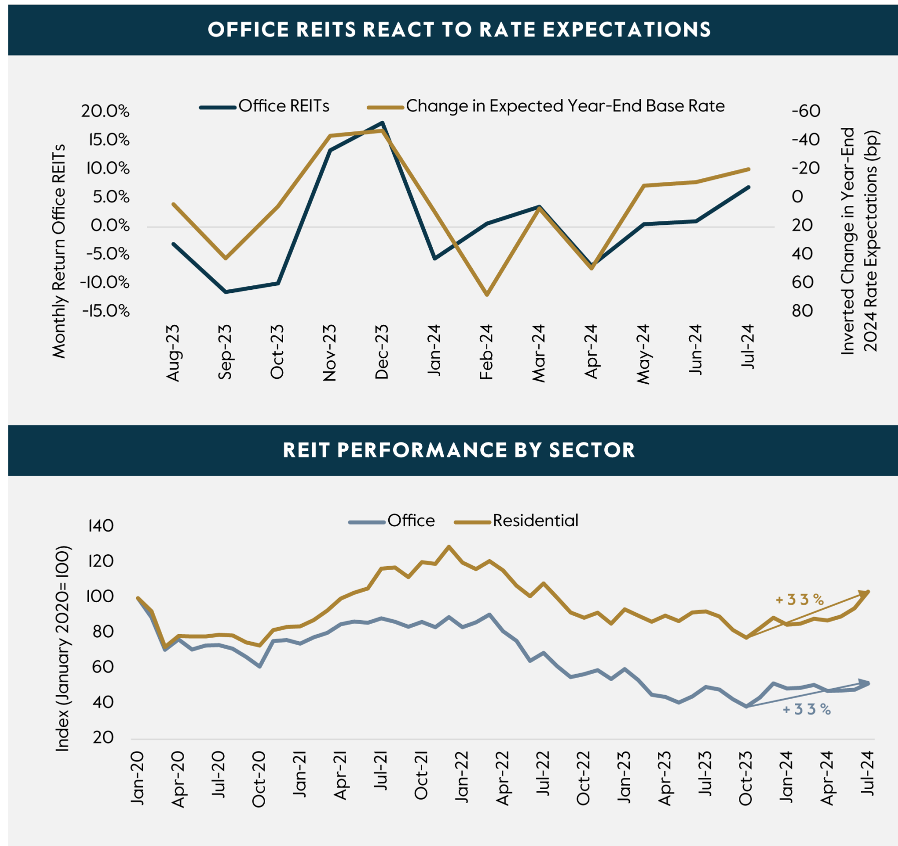
Figure 4: Wide Range of Opinions on Neutral Rate Among FOMC Members



Source: Carlyle Analysis; Federal Reserve, July 2024. There is no guarantee any trends will continue.

It's been no surprise to see REITs rebound as expectations for base rates have declined given property yields' sensitivity to equivalent duration risk-free rates (Figure 5). But lower interest rates do nothing to answer our question about what the sizeable decline in the value of economic activity occurring on-premise will mean for the fundamental value of office properties. If anything, the range of outcomes here have only widened, as remote work becomes more entrenched among employees in *office-consuming sectors*.

Figure 5: Office Rebounds on Reduced Rate Expectations



Source: Carlyle Analysis; Bloomberg, July 2024. There is no guarantee any trends will continue.

Traditional metrics such as vacancies and job creation have diminished predictive power in a world where uncertainty surrounds lease renewal rates, the share of new hires on hybrid or fully-remote work schedules, and the relationship between tenants' payroll growth and space extensions.

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