Economic & Market Update

First Quarter 2024 Review & Second Quarter Outlook

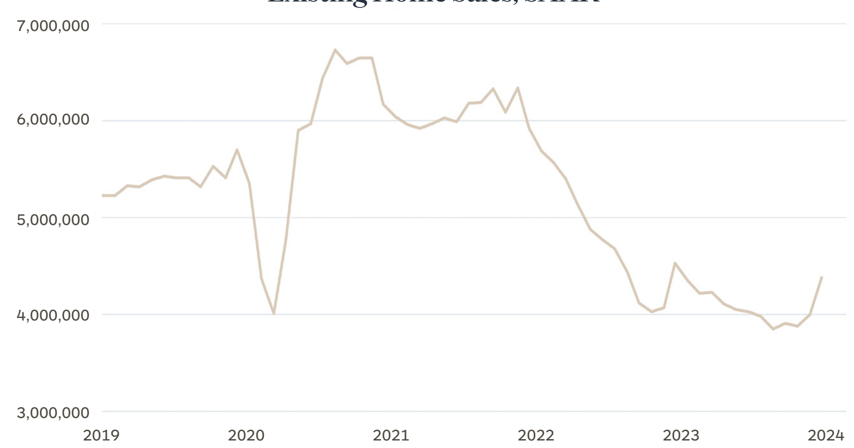
First Quarter Review

» The first quarter of 2024 saw a continuation of many of the same storylines as 2023. Inflation and the responding rate hiking cycle continued to exert pressure on certain pockets of our economy and financial markets, but none with enough severity to tip the overall economy into recession. Inflation continued along a slow and bumpy descent from its highs, but questions remained about the "last mile." Labor markets remained historically strong and economic growth continued near long-term trends. Interest rates drifted higher as solid growth delayed projections for the beginning of a rate-cutting cycle. Falling inflation in a strong economy suggests that at least some of the spike to a 9% inflation rate was indeed "transitory," but the stubborn pace of progress for stickier components is causing concern. Nonetheless, questions for Federal Reserve (Fed) members turned from "When will they stop hiking?" to "When will they start cutting?" Despite higher rates, enthusiasm about the mere prospects for cuts without the recession that typically accompanies them fueled gains in equity markets, although economic uncertainty was still reflected in tepid breadth and uneven earnings growth expectations. Growth outperformed value, and large caps outperformed small caps.

» Real gross domestic product (GDP) growth for the quarter looks set to come in near 3% (according to the Atlanta Fed's GDPNow estimate). Rate hikes certainly impacted the more leveraged and cyclical corners of the U.S. economy, but any weakness has been more than offset by resilient labor markets and consumer spending.

» Tight supply and strong demand continued to offset low affordability in housing markets. Despite little reprieve in rates, several measures of housing market health began to turn up in the first quarter. After almost two years with mortgage rates north of 5%, consumers appeared to be getting accustomed to a "new normal" in home prices and financing costs.

Existing Home Sales, SAAR



Source: NAHB/Wells Fargo, FactSet

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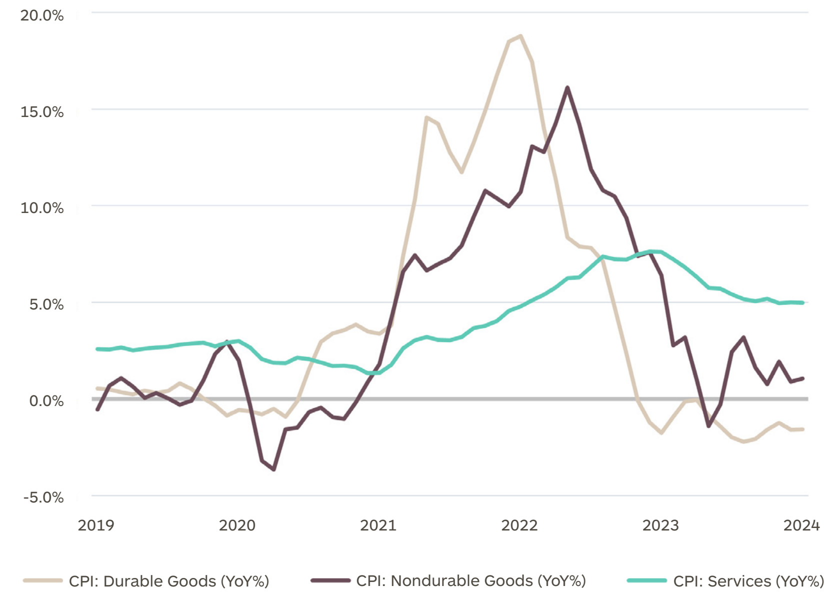
- The cyclically sensitive manufacturing sector seemed to show early signs of a trough in activity. After a year in contraction territory, the ISM's Manufacturing Index showed signs of life by rising into expansion territory in March. The forward-looking "new orders" component followed suit after briefly registering expansion in January. In our modern, services-driven economy, the manufacturing sector has proven that it is not the economic bellwether of the past. Even still, any turnaround would provide some welcome accompaniment to the red-hot services sector that drove growth throughout last year.

- Year-over-year Consumer Price Inflation held stubbornly above 3% each month in the first quarter. Durable goods inflation (which reached nearly 20% in early 2022) has fully reset back to its longer-term deflationary trend, while nondurable goods have settled back into a comfortable 1-2% range. Services inflation remains a point of consternation, having stalled out near 5% for the past few months.

ISM Manufacturing PMI

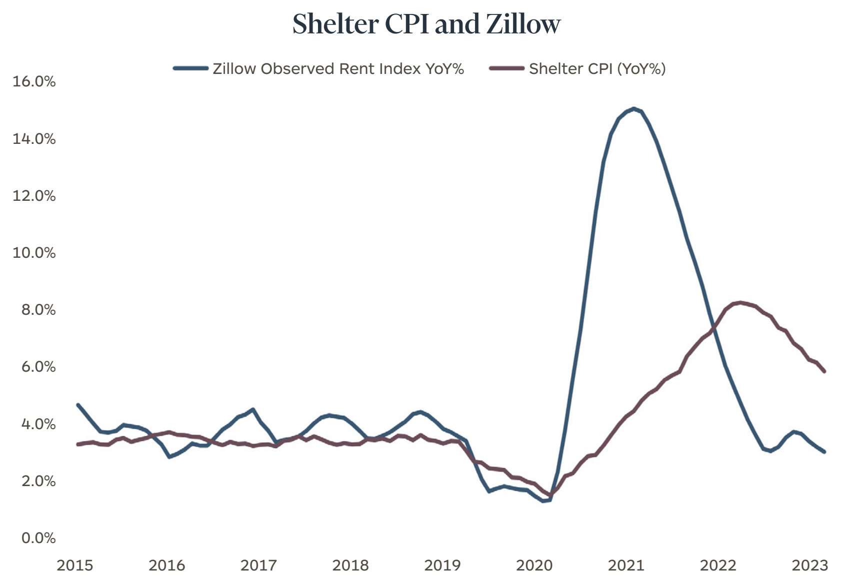
Source: ISM, FactSet. Figures above 50 indicate expansionary conditions, while figures under 50 indicate contractionary conditions.

Consumer Price Inflation (CPI)



Source: FRED

» Although strong services consumption and higher wage pressures were contributors, shelter costs were also a major culprit. Official statistics lagged market-based measures when rents and home prices rose dramatically from 2021–2022. Now that real-time measures have rolled over, the shelter component of CPI should "catch down" over time and function as less of a headwind on headline inflation.



Source: Zillow, FRED

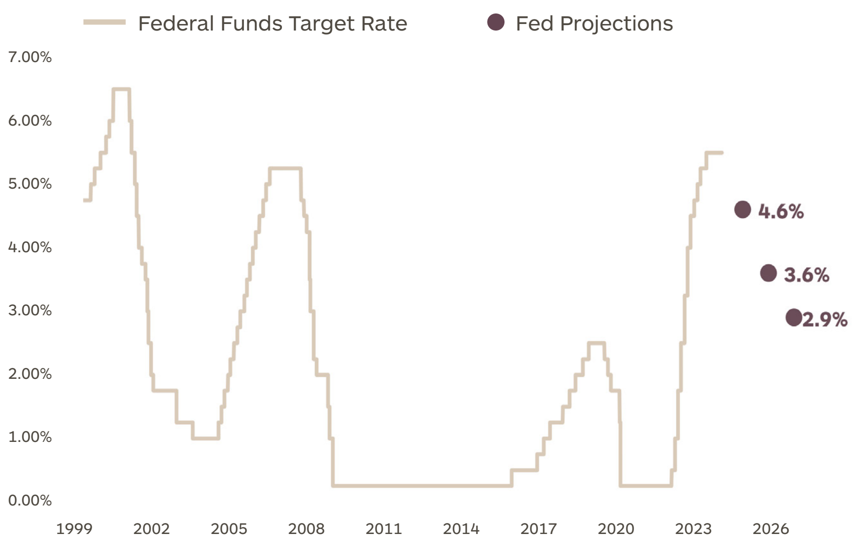
» A major driver of continued economic resilience was the ongoing impressive strength of the labor market. Supply and demand for labor converged through lower job openings and reduced job hopping, likely driven by a mediocre corporate earnings environment in 2023. With that said, hiring still occurred at an impressive pace, with over half a million new jobs in the first two months of 2024. Widely predicted mass layoffs failed to materialize, holding the unemployment rate below 4% for 25 straight months. Although small cracks seemed to appear (e.g., falling average weekly hours, slightly elevated continuing jobless claims), a strong overall profile kept consumers well-employed and apt to spend.

» Wage growth continued to outpace overall inflation, which helped consumers continue to spend and absorb higher price levels. At the same time, sticky wage growth created uncertainty for the path of inflation going forward. Fortunately, a revival in the country's productivity growth reduced some pressure from higher wages on corporate bottom lines.

» On the back of continued economic strength and somewhat stalled progress on inflation, interest rates began to drift higher during the quarter. The 10-year U.S. Treasury Note yield rose decisively back above 4% to settle near 4.25% by quarter-end. Corporate credit markets showed few signs of stress, with investment-grade and high-yield spreads continuing to tighten. Despite higher rates, primary markets remained open for issuers in need of capital. Corporate bond issuance in each of the first two months of 2024 was higher than any month in 2023 for both investment-grade and high-yield issuers. Like the housing market, corporations appeared to be starting to adapt to a new cost-of-financing regime.

Source: FRED

» Fed Chair Jerome Powell attempted to strike a nuanced tone that balances acknowledgment of the progress made with the progress that remains on the path to sustainable inflation. With GDP above 2% and unemployment below 4%, monetary authorities have the luxury of time and are determined to avoid the "stop and go" mistakes of the 1970s. As inflation appeared to have temporarily stalled above 3%, some questioned the Fed's plans for rate cuts to begin sometime this year. However, the Federal Open Market Committee took the opportunity to reconfirm its expectations for 75 basis points (bps) of cuts in the most recent Summary of Economic Projections. With solid economic data and the Fed holding its ground, Fed funds futures markets finally converged on the Fed's three-cut communications after entering the year pricing in an overly optimistic six rate cuts.



Source: FactSet, FOMC Summary of Economic Projections

» Economies outside the United States had less sanguine outlooks. Eurozone GDP growth continued to hover near zero as the impacts of the global rate hiking cycles persisted. China continued to struggle to find its footing amidst a bursting property bubble and exodus of foreign direct investment. Chinese officials set a GDP target of "around 5%" for 2024, which to many seems ambitious given its lack of willingness to offer meaningful fiscal or monetary support. Japanese investors celebrated the return of inflation, but sustained economic growth remained elusive. The Bank of Japan (BOJ) signaled confidence that its years of falling prices and wages are in the past by scaling back its asset purchases and abandoning the world's last negative policy rate, setting the new range for its overnight rate at 0.0%–0.1%. Although still highly accommodative relative to most other central banks, the BOJ's move marked a historic shift in a long saga of monetary experimentation for the struggling economy.

» Back in the United States, as fears of recession gave way to excitement about rate cuts, expanding valuations drove large cap equity markets to an impressive 11% gain in the first quarter. Thanks to continued enthusiasm about artificial intelligence, the technology and communication services sectors led the charge. Interestingly, leadership also came from the energy sector as oil prices drifted from the low \$70s to over \$80 by quarter-end. The only S&P 500 Index sector to post losses in Q1 was real estate, which felt the effects of higher rates paired with continued fears of fallout in commercial real estate markets.

» Within the S&P 500, the so-called "Magnificent 7" again delivered strong performance in aggregate, but disparities within the cohort began to emerge. Nvidia led the way with another fantastic quarterly return of +83%, but three of the seven (Apple, Tesla and Alphabet) failed to match the S&P 500's quarterly gain of 11%.

» Despite the improved economic outlook and bump in valuations, earnings expectations for large caps in 2024 remained largely unchanged. The S&P 500 managed to squeeze out marginally positive earnings growth in 2023 but is still expected to bounce back with roughly 11% growth in 2024. Much of that growth is anticipated to come from the Magnificent 7, leaving behind a more reasonable estimate of about 7% for the average large cap stock (as measured by the S&P 500 Equal Weight Index).

» Small caps lagged again, with the Russell 2000 Index up 5.2% for the quarter. Valuations compared to large caps became increasingly cheap. However, the cohort's generally higher debt loads and lower profit margins are perceived to make them more sensitive to a potential "higher for longer" rate environment. Even after trailing meaningfully in 2023, expectations for small cap earnings growth are lukewarm for 2024 at little more than half the expectation for large caps.

» Overseas equity markets were mixed. Developed markets nearly kept pace with U.S. large caps, while emerging markets again lagged, still weighed down by China's economic malaise. Japan was a source of strength as the Nikkei 225 Index finally rose above its previous record high set all the way back in 1989. Other sources of strength were the U.S. dollar, gold and cryptocurrencies.

Outlook for the Second Quarter

U.S. ECONOMY

» The U.S. economy may be slowing from its red-hot growth in the second half of last year, but it appears to be merely decelerating to its trend rate of 2.0%, as any signs of an imminent recession have yet to appear in either the actual or the survey data. Jobs and wage growth are slowing but remain largely supportive of consumer spending. Appreciating financial assets and real estate values are further boosting consumer confidence, particularly among the higher income portion of the population. An important secular catalyst for continued spending growth is the increasing number of recently retired people who have been willing to draw down their ample savings in their early retirement years while they are still relatively healthy. This dynamic should help cushion any cyclical slowdown in spending caused by a weakening economy.

» Businesses have been more cautious than consumers in their spending patterns, as higher rates are having a more immediate impact on their willingness and ability to borrow. With inventories generally well-controlled and demand for goods beginning to turn higher, capital spending plans should begin to advance slightly in the second quarter and continue to improve through the remainder of the year. In an ongoing quest to increase workforce productivity, a healthy percentage of business spending should continue to be dedicated to technology investments. The peak and subsequent decline in mortgage rates should help housing to be additive to economic growth through the rest of the year as first-time buyer demand remains robust. With existing home inventory beginning to loosen somewhat, the sharp rise in the inventory of new homes may need to be worked down with lower prices and greater incentives offered by builders. Fiscal policy in a presidential election year is historically supportive and is expected to mildly add to GDP growth through policies such as student loan forgiveness.

GLOBAL ECONOMIES

» European economies are staggering and hardly growing in the early part of the year, but they are also not receding, which investors view as a positive signal that the worst of the stagnation may be over. Strength in exports to the United States is offsetting the weakness to China, but domestic demand needs to recover. Getting through another winter without a notable spike in energy prices should be supportive, although these economies likely need some policy support to catalyze a return to growth. The current recession in Japan should be near an end, as a favorable union wage settlement should drive a cyclical rebound in consumer spending that will complement the expected strength in exports.

» Chinese 2024 GDP growth will likely underachieve the government growth target of 5%, settling closer to 4% amidst an ongoing property debt crisis that will continue to stifle domestic consumer spending growth. The anticipated fiscal and monetary support from the government has been forthcoming but disappointing in its magnitude as policymakers want to maintain a level of discipline. A more business friendly approach to attract foreign capital appears to be a key initiative of the government, but potential investors still await tangible actions and policies as opposed to the welcoming verbiage.

CENTRAL BANK CAUTION

- The slight stall in the progress toward bringing inflation down to the 2% target is reminiscent of last summer and provides confirmation that the last mile of this inflation-fighting journey will be difficult. The longer-term inflationary implications of the COVID-19 pandemic and trade wars may have imposed some structural challenges in hitting a target level that central bankers may ultimately need to reconsider. The Powell-led Fed has been effective at managing the message, and while some members of the Fed have sounded quite hawkish given the surprising economic strength and stubborn wage and services inflation, the chair has been rather strongly signaling the June meeting for the first 25 bps federal funds rate cut. Given the expectation that the economy will slow to a more typical growth cadence and productivity growth will keep unit labor costs under control, a total of three 25 bps rate cuts in 2024 is the likely scenario. A reduction in the rate of balance sheet runoff will also provide incremental policy ease in the back half of the year.

- Central banks in Europe and China are feeling more pressure to ease policy rates, as economic growth has been disappointingly slow and, in some cases, nonexistent. The Bank of England remains concerned that inflation progress is stalling at the services level and will likely follow the path of the Fed in the timing and magnitude of any monetary ease. However, the European Central Bank is sending signals that it may follow the lead of the Swiss National Bank in being early to implement a rate cut, as inflation is expected to improve at a more rapid rate in the continental economies.

- The People's Bank of China has already been easing policy through both mild rate declines and reductions in its reserve requirement ratio. These cuts should continue, although China remains vigilant around managing its currency and will be cautious around provoking more intense capital flight. While the BOJ has finally moved away from negative interest rates, the recent tightening to a slightly positive policy rate should still be considered aggressively easy policy, which will continue to be stimulative to the Japanese economy.

BOND MARKETS

- A slowdown in economic growth to long-term trend levels and continued progress on inflation should prevent much further weakness in intermediate-term bond prices. The inverted shape of the yield curve continues to imply an upcoming recession, but investors are becoming more dismissive of this leading indicator as the curve has been inverted for close to two years and the economy has strengthened during that time. Confidence appears to be growing that the Fed is about to embark on a rate easing campaign, which would bring short rates down, but the strength of the economy should keep intermediate- to longer-term maturity rates at roughly the same levels for the remainder of the year. The prospect of greater bond issuance in an expanding fiscal policy environment is another factor preventing a meaningful yield decline in the intermediate maturity space.

- Better-than-expected economic growth is keeping default rates low and further compressing the spreads of both investment-grade and high-yield corporate bonds. The absolute level of yield in the below-investment-grade space remains quite attractive, but the yield spread against Treasurys is historically low in an environment where refinancing maturing debt will be quite expensive for companies that already have balance sheet challenges.

EQUITY MARKETS

- The prospect of double-digit earnings growth and eventual monetary policy ease in a still growing economy drove US large cap equity markets through year end price targets by the end of the first quarter. Particularly encouraging was the broadening of the advance seen late in the quarter as the more cyclical sectors of the market as well as stocks in the small and mid-capitalization space outperformed the technology and communication services sectors that had been so clearly dominant. With cracks beginning to appear in the revenue and earnings outlooks for a few of the very large US industry champions, markets will need greater participation across both sectors and company size to maintain investor confidence.

- Given the surprisingly strong year to date advance in the broad equity market indices, some amount of pullback in prices is expected as the momentum trade wanes and investors wait for earnings growth to confirm the multiple expansion which has driven prices to rather lofty valuation levels. First quarter earnings to be reported over the next few weeks should grow at roughly 5% year over year, but with comparisons getting easier as the year progresses and cost inflation recedes, second quarter earnings are expected to grow close to 10%. Prospective Fed ease has likely been fully priced into equities, so it is necessary for earnings to take over as the primary driver of this ongoing bull market.

- Better breadth of participation in the equity bull market should also extend to international equities which are generally not trading at such high multiples. Monetary ease can help expand valuation multiples in many of these markets. However, the outlook for revenue and earnings growth is not as robust as in the US, but likely enough for developed markets in Europe and Japan to at least match the performance in the US on a currency adjusted basis through the rest of the year. The outlook for Chinese equities is less sanguine as the economic challenges mount. Policy relief from both the government and the central bank will provide downside support, but it is difficult to find a catalyst that will sufficiently offset the weakness in both export growth and domestic consumption.

What This Means for Investors

- The current state of the U.S. economy, with continued growth of around 2% and the inflation rate declining, is very favorable to equity investors and may be close to fully priced in during this recent market advance from the October lows. Some consolidation of the gains is likely in the second quarter, but this should be considered healthy and a potential buying opportunity for investors who have kept cash on the sidelines. Broader participation in the gains should continue as a confirming sign of a healthy equity market. Bond markets have generally normalized in this monetary tightening environment, and they now provide a more viable alternative to and competition with equites when constructing financial asset portfolios. Broader participation in the gains should continue as a confirming sign of a healthy equity market. Bond markets have generally normalized in this monetary tightening environment, and they now provide a more viable alternative to and competition with equites when constructing financial asset portfolios.

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