Market Commentary

First Quarter 2024

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The first quarter of 2024 saw continued volatility in financial markets. Investors continued to parse Federal Reserve comments attempting to infer when the central bank will begin to lower short-term rates. Equities, as measured by the benchmark S&P 500 Index, rose by 10.5% during the quarter, continuing the strong upwards move that began in late October. From the S&P 500 bottom on October 27 last year, the index has jumped an astonishing 28% in just over five months. As we explain in more detail below, we think equities may be extended here and will need to consolidate recent gains before moving meaningfully higher.

Fixed income yields moved higher during the quarter, bouncing back from what we had written were overdone rallies in the previous quarter. Shorter-term yields increased as investors recalibrated the timing for the first Fed rate cut. The 1-year Treasury bill rose to 5.03% from 4.78% at year end. The 2-year Treasury note began the quarter yielding 4.22% and rose to 4.59% at the end of March. Longer-term maturities saw rate bumps as well. The benchmark 10-year US Treasury note jumped to 4.21% after beginning 2024 yielding 3.87%. The belief the Fed will remain "higher for longer" has finally taken hold with investors. Fed funds futures more closely match the Fed's own 'dot plot' which lays out its internal interest rate forecasts. We believe there is a good possibility the Fed cuts rates less than the three times it currently projects during the remainder of 2024 as we explain below.

Economic and Market Outlook

The US economy continues to surprise with ongoing strength despite restrictive monetary policy for the past two years. We believe fiscal policy is still stimulative with the US government running annual deficits approximating $1.7 trillion despite a growing economy. Countering this argument is the fact a substantial portion of the deficit is accounted for by interest expense on the national debt along with targeted spending on the administration's favored projects. As capitalists, we do not believe the government should be picking winners and losers, preferring for the marketplace to determine where capital is best deployed.

Despite the continued headline economic growth, it is clear the run-up in both inflation and interest rates has asymmetrically hurt those on the lower end of the economic spectrum. The share of wallet spent on food, energy and rent rose disproportionately for lower income consumers. Elevated prices combined with slowing wage growth negatively affected this demographic. Higher interest rates can benefit those with net savings but hurt those who owe money. Increased monthly payments on credit cards and auto loans along with higher prices paid for essential items has fractured many family budgets.

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Earnings for the S&P 500 have been $220-222 for the past two calendar years. Earnings growth resumed in the third quarter of 2023 and is expected to continue for the next several quarters. The question is how strong that growth will be. Earnings estimates for the S&P 500 in 2024 have declined from about $250 at the start of the year to approximately $244 currently. Analysts are optimistically predicting a further jump to $270-275 in 2025, meaning there is no expectation of an economic slowdown in these estimates. If the economy remains strong enough to produce these types of earnings gains, there would be little incentive for the Fed to cut short-term rates meaningfully. Recent economic reports may keep the Fed on hold longer than many currently anticipate. In fact, there is a growing, albeit still low possibility that the Fed holds rates steady throughout 2024.

The narrowness of the market continues to concern us. Since the start of 2023, the S&P 500 has risen by 37%. Looking under the hood, we note the ten largest stocks have risen an astounding 84% while the remaining 490 companies have increased by only 13% during this period. The top ten stocks now account for 34% of the S&P 500 weight. As more investor dollars go into a smaller number of companies, the risk of a "hiccup" increases.

Oil prices advanced methodically during the three-month period. Geopolitical tensions, supply and demand dynamics, technological advancements, and environmental concerns all contributed to price fluctuations and the trajectory of oil prices during the quarter. Beginning the year at $71.65, the price for benchmark West Texas Intermediate (WTI) rose to end March at $83.11. Gasoline prices have risen slightly faster than crude oil, adding an additional headwind to consumer spending.

Portfolio Positioning

While the US equity market is modestly above fair value, there are several areas selling at reasonable or even discount valuations. The challenging part for investors is trying to ascertain which of these areas will remain "cheap" and which ones will more fully realize their fair value over the next 12-18 months. Meanwhile, certain expensive sectors like technology continue to grow even more expensive with valuations rising to levels not seen since the dot-com era in some circumstances. We do not believe the business cycle has been repealed so we watch asset allocation very closely. A jump of 28% in equities over a five-month period is cause for concern when so little has changed with the underlying economy and interest rate environment. Stepping back further, we note the S&P 500 has risen by 74% since the end of 2019. Earnings for the index have risen by a more pedestrian 35% over that time. Despite a global pandemic, the fastest increase in bond yields in 40 years, exploding budget deficits and two regional wars, stocks have risen by almost 14% annualized over the last 51 months. As risk managers, we tend to be cautionary when things look too rosy and endeavor to anticipate the next potential mishap in financial markets. We remain convinced that equities are the superior method of long-term wealth accumulation. Stocks also serve as buffers against inflationary pressures.

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Having said that, when equities reach certain elevated valuations, it behooves investors to look at alternative investment choices for capital deployment. The ability to earn 5% in money market funds and a similar amount in low-risk credit instruments look quite competitive with equities selling above 21x forward earnings estimates.

Conclusion

Investors are facing several challenges as they look through the balance of 2024. Stocks have enjoyed one of their sharpest rallies since the end of the COVID pandemic, with the S&P 500 rising by 28% since late October. While economic growth has held up better than anticipated, interest rates are stable over that period and earnings growth has been uneven at best. Thus, equities are more expensive than they were five months ago and are within a single P/E multiple point of their highest valuations since the tech bubble two decades ago. Investors are counting on lower interest rates and a resurgence in earnings growth for justification. The continuing wars in Ukraine and Gaza, high and rising budget deficits, and the 2024 Presidential election are just some of the potential exogenous factors to monitor as we move through 2024. It would be imprudent to not be cautious on equities here, understanding there are alternatives in fixed income and cash equivalents where decent returns are available. Investors have been stuck in FOMO (Fear of Missing Out) for several years. We are more concerned with FOMU (Fear of Messing Up) by overstaying a stock market rally with marginal fundamentals to support the level of stock prices in some cases. Caution does not necessarily mean selling, but rather to be hyper conscious of what you are investing in. Throwing money randomly into stocks works well during a bull market but can damage portfolios during bear markets or even choppy sideways moves. When asked what would make us less cautious, we have long responded we look at valuations along with alternative investment opportunities to judge where to invest client assets. When fixed income and cash were returning 1% or less, equities were the default investment vehicle. This is no longer the case.

In closing, we hope you and your families are enjoying the first days of Spring. We look forward to your questions and enjoy dialogue with our client base. As always, please inform us of any significant changes in your financial situation or if you have any specific questions or concerns about your investments.

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