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OUTLOOKS

April 2024

ECONOMIC OUTLOOK

Summary

Most of the data released in March showed the economy is back on track after a slightly bumpy start to the year. Non-farm payrolls exceeded expectations by more than 100k jobs (when including two-month net revisions) and the unemployment rate dropped by 0.1%. Factory, durable and capital goods orders all beat expectations, while retail sales rebounded nicely from January's negative values. February also marked the first time in 16 months that the ISM manufacturing purchasing managers' index (PMI) moved into expansionary territory. Most importantly, core personal consumption expenditures price index (core PCE), the Federal Reserve's preferred measure of inflation, was in line with expectations and decreased year-over-year.

After two months of elevated inflation data, market participants have once again become hyper focused on the Federal Reserve. This is not a new development since much of the economic discussion over the last two years has centered on the Fed's interest rate policy decisions. Traditionally, when rates are at a restrictive level, there is a decline in demand due to the higher cost of capital. Despite an aggressive rate-hiking cycle that peaked at 5.5% - well ahead of our current levels of inflation – we have continued to see a resilient economy. The Fed believes "trend-level" GDP growth is currently 1.8% per year. Surprisingly, growth has exceeded that level for nearly the entire rate-hiking cycle, all while the Fed was trying to slow demand, the economy and inflation. Now, the Atlanta Fed is currently projecting 2.5% GDP growth for the first quarter of 2024.

How is it the Fed could have a restrictive policy, yet the economy continues to grow at an above-trend pace? There are two different thought processes for this: (1) The economy has not fully passed through the cumulative impact of the Fed's rate-hiking cycle. However, it has been two years since the first hike and nine months since the last hike. As more time passes and growth remains strong, this seems less likely. (2) The Fed's interest rate policy isn't actually as restrictive as they believe it is. While monetary policy (the Fed) has been becoming more restrictive, fiscal policy (Congress) has been more accommodative. The current regime of deficit spending by the U.S. certainly provides an economic boost, and when coupled with post-pandemic demographic shifts it may suggest the neutral rate has increased. If true, this could explain why the Fed hasn't had to cut rates yet and why they might not need to for longer than many expected.

Positives

The labor force participation rate (62.7%) increased while the unemployment rate (3.8%) fell

Core PCE year-over-year declined for the 14th consecutive month (2.78%)

The final revision of fourth quarter GDP increased by 0.2% to 3.4%

Negatives

Headline and Core CPI month-over-month increased at a nearly 5% annualized rate (0.4%)

While still reasonable, weekly initial jobless claims touched their highest levels in nine weeks (221k)

Month-over-month new home sales unexpectedly declined in February (-0.3%)

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EQUITY OUTLOOK

Summary

The S&P 500 finished the month of March up 3.2% bringing the quarterly gains in the index to 10.6%. That marked the first time in over a decade the S&P was up over 10% in two consecutive quarters and finished once again at a new record high.

The first couple of months of the quarter exhibited a continuation of equity market trends that have been in place for some time: growth stocks outperforming value, large companies outperforming small, and domestic outperforming international. However, there were signals of market breadth widening in March, which could be a welcome change. The Russell 1000 Value Index was up 5.0% in March while the Russell 1000 Growth Index rose 1.8%. More specifically, the value-oriented energy, utilities, and materials sectors were the best performers adding 10.6%, 6.6% and 6.5% respectively.

It is also notable equity markets have rallied in spite of the bond market recently repricing more hawkish expectations for Fed policy later this year. A more restrictive, or perhaps better said slower to accommodate, Fed would typically be a troublesome signal for equity markets. The fact stocks have continued to climb as the bond market has recalibrated may speak to a couple of important possibilities. First, markets may simply be pricing out the likelihood of a hard landing and assigning a greater possibility of a soft landing. Equity markets may also be attempting to quantify the vastness of productivity gains that will result in the future because of artificial intelligence and related innovation.

Artificial intelligence, quantum computing, robotics and automation, as well as other related technologies have the potential to be transformative. These advancements are also likely to create disruption and opportunity for the companies in which we invest. Keep in mind, these concepts and rudimentary applications of those concepts have been around for decades, but recent advancements have created a step-change that should not go unnoticed. Many of the top performing stocks over the last few years are those that are involved with the development of the infrastructure needed to support the next stage of advancement (think Nvidia, for instance). It is likely short-sighted to think that is where the opportunity ends. We believe there are few industries that won't be significantly impacted by advancing technology over the next decade. As a discounting mechanism, stock markets are attempting to assess the future economic benefit relative to current stock prices.

While we remain optimistic about the future, equity markets probably need a short-term breather to digest recent gains. It would not be surprising to see the market move sideways as we move into the late spring and summer months.

Positives

Innovation and productivity increases

Improving economic visibility

Negatives

Inflation's decline has stalled in recent weeks

Unknowns

Domestic elections and geopolitical risks

Second wave inflation possibility

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FIXED INCOME OUTLOOK

Summary

Coming into March, expectations for Fed rate cuts had already been reduced from six at the beginning of the year to just three. The probability of a March cut was completely taken off the table as a strong labor market combined with disappointing inflation reports during the first months of the year. So it was no surprise when the Fed held rates steady at their March 20 Federal Reserve's Open Market Committee (FOMC) meeting. The take away reinforced by Chairman Powell, the media and even the investment community was the outlook for policy remained the same. Considering the market had just converged on the Fed's projections after previously expecting twice the number of cuts this year, a relative calm was set. Moving the goal posts on the market might not have gone over well. It would have likely sent shock waves across the Treasury market as well as into the riskier markets of equities and credit.

Bond investors have grown accustomed to heightened levels of volatility, so a relatively quieter month was welcomed. Overall for the month of March, the 10-year traded within a 25 basis point (bp) range which was about one-half of a standard deviation from the average range of 33 bps since the start of this century. Yields inside of three years to maturity were little changed. Yields on the 5-year Treasury declined by 3 bps and the 10-year yield fell by 6 bps. Following two months of record issuance, the investment-grade supply fell in March. Even with this drop, the first quarter of 2024 set a record for all first quarters. Credit spreads declined another 6 bps to the tightest levels in about two years. Intermediate investment-grade bond returns, at +0.96%, were nearly double that of intermediate Treasury notes, +0.49%.

Soon after the FOMC meeting a number of local Fed officials began downplaying the need to cut rates anytime soon. Many also questioned the need for multiple rate cuts this year and some stated that we might not need any. These comments appear in stark contrast to their collective consensus of just a few weeks earlier. Given the continued strength of the labor market we are more inclined to believe that just one or two rate cuts will be enacted this year. If we are right, the yield curve could move a bit higher as expectations of a third cut is removed. From a technical perspective, we are watching 4.35% on the 10-year Treasury. A close materially above that level could fuel another move upward with about 4.50% as the next stop. Even with full consideration of the technical, we are inclined to add to duration as yields increase. We suggest moving a few percentage points longer than benchmarks with the idea portfolios will "age" back to neutral within a month or two. We also recommend maintaining a higher allocation to corporate bonds as new issuance is expected to slow from the record setting pace.

Positives

Net new flows into bond funds and ETFs are helping to absorb record issuance

Reallocation from strong equity markets should create bond demand

Negatives

The Fed may be signaling fewer rate cuts than the market is currently expecting

Federal budget deficit will continue to require a rapid growth in Treasury debt issuance

Unknowns

Escalation of Middle East conflict with Iranian proxies

Resolution of Russia/Ukraine war