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OUTLOOKS

May 2024

ECONOMIC OUTLOOK

Summary

First quarter GDP showed a disappointing economic growth rate of 1.6%, below all estimates of the nearly 70 economists surveyed by Bloomberg. Growth expectations had been climbing steadily and were approaching 3% in the two weeks prior to the official release, which made the report even more surprising. This data initially put the strength of the overall economy into question as we experienced the slowest growth since the second quarter of 2022.

Fortunately, there is more to the story than just the headline number. Nominal GDP growth (not adjusted for inflation) increased by 4.8%, which is near the higher end of the range when looking back through the past 15 years. However, inflation accounted for 3.1% of that gain, causing GDP (adjusted for inflation) to be an uninspiring 1.6%. Net exports also pushed GDP lower, detracting 0.9%, but that is logical since the value of the dollar is high relative to the past 20 years. A strong dollar makes our goods more expensive to export to other countries and other countries' goods become less expensive to import to the U.S. Lastly, inventories also detracted from growth (-0.4%) as backlogs at the retail level continue to unwind.

So where does that leave consumer demand, which has kept the economy hot through the past several quarters? Thankfully, it remains solid. Consumer spending increased by 2.5%, which in turn contributed 1.7% to GDP. This furthers the belief that, while disappointing, first-quarter GDP is not a harbinger of poor growth for the remainder of 2024. It is our expectation the economy will remain near or above trend-level growth as long as the labor market, and subsequently consumer demand, remain strong.

That leads to the issue of the underwhelming payroll report for April where job growth missed expectations by 65k, the unemployment rate increased to 3.9% and average hourly earnings were slightly below expectations. For context, there were still 175k jobs created, which is in line with the pre-pandemic 10-year average and the unemployment rate is still historically low. This is not alarming but is certainly worth monitoring in the upcoming months.

Positives

Retail sales beat expectations by 0.3% (0.7% vs. 0.4% est.)

Weekly Initial Jobless Claims remain subdued in the low 200k's

Producer Price Index (PPI) was lower than expected (0.2% vs. 0.3% est.)

Negatives

April's non-farm payrolls missed expectations by 87k including net two-month revisions

The Employment Cost Index (ECI) for Q1 was higher than anticipated (1.2% vs. 1.0% est.)

Productivity decreased to its lowest level in a year (0.3%)

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EQUITY OUTLOOK

Summary

The hot start for equity markets in the first quarter of 2024 cooled substantially in April. The S&P 500 Index slipped 4.1% for the month and most other major indexes followed suit. Both the Russell 1000 Growth Index and Russell 1000 Value Index produced similar results, declining 4.2% and 4.3% respectively in April. More pronounced, the Russell Midcap Index fell 5.4% as the small-cap Russell 2000 Index dropped 7.0%.

One of the biggest frustrations for equity investors is inflation seems to be stuck at a level higher than expected. The path had clearly been trending lower but now appears to be stubbornly stalled in excess of the Federal Reserve's ultimate target. The result of which has been the repricing of the number of rate cuts expected by the Fed this year, which has caused equity investors to take some pause on the potential more restrictive policy for a longer period of time.

As we cross the heart of earning season, nearly half of the S&P 500 has now reported with results largely in line with expectations. Many companies have provided more conservative guidance in the upcoming quarters with different economic industries presenting varying outlooks. Corporations that are nearest the consumer, for example, have cautioned some hesitation to spend particularly among lower-wage earners. Still there are pockets of strength in other industries with some commenting on accelerating capital expenditures for anticipated growth.

All in all, the pullback in stocks last month was not all that surprising. Equity markets had clearly gotten ahead of themselves in the near term and were ripe for consolidation. We also continue to believe the markets could be locked in a relatively narrow trading range for the next few months as investors sort through the existing crosscurrents. Barring any unforeseen changes, markets should resume the uptrend later this year.

Positives

Innovation and productivity increases

Labor market trends remain strong

Negatives

Inflation's decline has stalled

Political and geopolitical tensions rising

Unknowns

Corporate earnings visibility mixed

Risk of another wave of inflation continue to climb, though still unlikely

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OUTLOOKS

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FIXED INCOME OUTLOOK

Summary

Early in this rate-hiking cycle the Fed described three components to their policy-setting playbook. They were how fast to raise rates, to what terminal restrictive level and how long to hold there. The Federal Reserve's Open Market Committee (FOMC) acted aggressively with 11 rate hikes over a 16-month period with 525 basis points (bps) in total of monetary tightening. Fed Chairman Powell then stated they believe a 5.50% (upper band) policy rate is "sufficiently restrictive" to restrain economic activity and reign in inflationary pressures without causing unnecessary economic distress. With the first two decisions in place, what is left to be determined is how long rates should stay at this rate. Coming into the year, the FOMC was expecting three rate cuts in 2024. As measured by the Fed Funds futures, the market was expecting six cuts with the first occurring in March. Over time, the futures market converged on the same outlook and, as one would expect, interest rates moved higher.

Then along came the month of April. Still with no economic weakness in sight, there was growing sentiment of a "no landing" scenario. Additionally, improvements on the inflation front all but stalled. Stubbornly high inflation reports were added to the year-over-year statistics just as low-inflation months rolled off. Instead of the Fed gaining confidence inflation is trending towards their target, the reports shook the confidence they previously established. Rate cuts were pushed back even further with the market now pricing in just one or possibly two rate cuts for this year. Interest rates soared with the 2-year Treasury note increasing by 42 bps to 5.04% and the 10-year increasing by 48 bps to end the month at 4.68%. Even with investment-grade credit spreads tightening by a few bps, April was a terrible month for bond investors with returns in the bottom 5% of historical monthly returns across all broad bond market indexes.

Concerns about the unsustainable pace of budget deficits, budget and associated level of Treasury debt issuance likely played a bit part in changing investor sentiment. Nine months since achieving a restrictive monetary policy stance, some are rightfully questioning its effectiveness when it is offset by expansionary fiscal policy. Higher interest rates might actually be fueling the economy with higher interest payments to investors. According to Bloomberg, the Treasury Department paid interest at a pace of $2 million per minute.

The prospects of no rate cuts this year has increased, but we are inclined to believe Fed Chairman Powell when he stated they are not considering tightening policy further. With most of the rate cuts already removed from expectations for this year and little probability of a rate hike, we find the current yields attractive and recommend extending portfolio duration to 105% of benchmark levels with the idea of adding more duration if the 10-year increases closer to 5%.

Positives

High yields should attract net new flows into bond funds and ETFs

Volatile equity markets should create bond demand at current yields

Negatives

The Fed may be confirming signaling fewer rate cuts than previously expected

Federal budget deficit and heavy Treasury debt issuance

Unknowns

Escalation of Middle East conflict with Iranian proxies. Domestic protests.

Resolution of Russia/Ukraine war and impact on global trade