Insights: April 2024

Market Overview and Performance

For risk investors, 2024 began right where 2023 left off. Following a rally of over +16% from October 27th through the end of the year, the S&P 500 Index climbed higher in each of the three months to start the year. In fact, the +10% return experienced during the first quarter was the 14th best start to a calendar year dating back to 1928. According to Ned Davis Research, historical data shows that early strength like that seen in 2024 tends to persist. During the past 14 instances when the S&P 500 was up +10 in the first quarter, the remainder of the year displayed a median return of 7.6% with an 86% success rate (only 1930 and 1987 were negative). While investors certainly welcomed these outsized returns, diversified portfolios did not fare as well. Large cap US equities essentially doubled the returns of those achieved in non-US markets and fixed income investments continue to be challenged. There are reasons for these divergences – the US is growing twice as fast as any other G7 economy according to the IMF – but concerns primarily about the future path of inflation continue to dominate the market narrative. And clearly, sentiment can turn quickly as evidenced by the volatility present throughout the month of April. This was precipitated by Federal Reserve Chairman Jerome Powell's comment that, "We've said at the FOMC that we'll need greater confidence that inflation is moving sustainably toward 2% before it would be appropriate to ease policy. The recent data have clearly not given us greater confidence and instead indicate that it's likely to take longer than expected to achieve that confidence." This acknowledgement that inflation may in fact be more resilient than expected was not welcomed by the markets. Yields rose higher and equities declined. However, as always, fundamentals supersede passing shifts in sentiment and thus far, the first quarter earnings season has been a strong one which has helped to allay fears. As the US election year evolves, we will see if this trend continues. Thank you for taking time to read our market Insights.

	Quarter to Date March 31	***Year to Date March 31***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	10.56	**10.56**
Russell 2000 Index	5.18	5.18
MSCI EAFE Index	5.78	5.78
MSCI Emerging Markets Index	2.37	2.37
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.78	**-0.78**
Barclay's U.S. Aggregate Credit Index	-1.65	**-1.65**
Barclay's U.S. Aggregate Corporate High Yield Index	1.47	**1.47**
Barclay's Municipal Bond Index	-0.39	**-0.39**
Macro Measures		
Gold	7.64	**7.64**
Crude Oil	16.08	**16.08**
CBOE Volatility Index	4.50	4.50
USD Dollar Index	3.18	3.18

Current Theme – After a Notably Strong Start to the Year, Markets Adjust to the Idea that Rate Cuts May Take Longer than Anticipated

Equities Have Experienced Solid Returns to Start 2024 While Bond Yields Remain Elevated Due to Persistent Inflation Concerns Which Helped Commodities

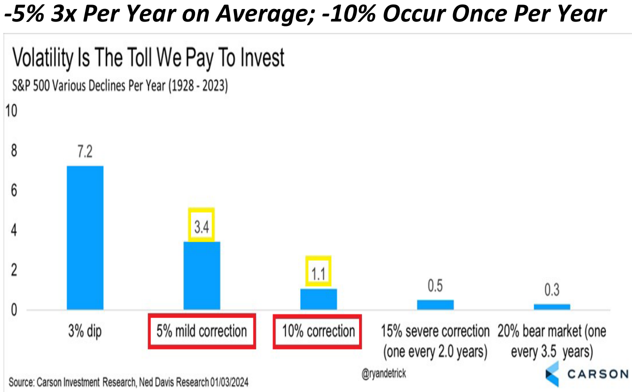
As long-term investors, we are well aware that volatility across asset classes, particularly within equities, is actually an important component of how markets work. Changes in prices create opportunities for both buyers and sellers. So, despite the pleasantness of consistent gains, an extended period of rising prices can sometimes be a source of concern.

S&P 500 Higher Lows Constructive for Further Advance

Source: Frank Cappelleri; CappThesis

As seen above, going back to 2022, the S&P 500 experienced three shallow drawdowns with each ending at a higher low. This is very constructive market behavior. What is more of an anomaly is the subsequent +27% move straight higher from October of 2023 through the end of March 2024.

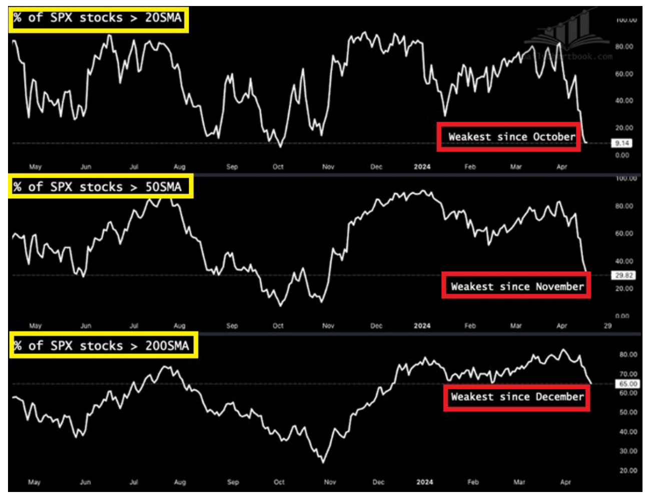
-5% 3x Per Year on Average; -10% Occur Once Per Year



Source: Carson Investment Research; Ned Davis Research

As the previous chart from Carson Research highlights, volatility is simply the price of admission for equity markets with -5% pullbacks occurring three times per year on average and -10% corrections occurring once per year. In fact, according to Ned Davis Research, since 1980 the average intra-year drawdown has stretched to -14.2%. Although it may seem counterintuitive, clearing some "froth" from the markets is a necessary and healthy process.

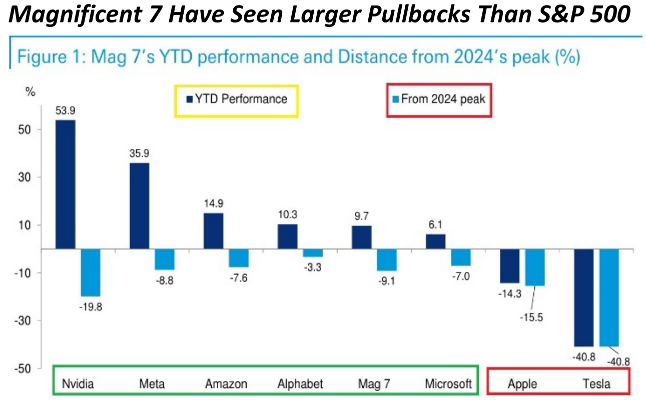
Market Breadth Has Fallen Off Sharply in April



Source: Daily ChartBook

And that is exactly what we have seen lately. As highlighted in the chart above, the percent of stocks trading above their 20-, 50- and 200-Day Moving Averages, common benchmarks of market breath, has fallen from over 80% to their lowest levels since last October. Again, this creates opportunity with "every" stock in the market no longer moving higher at the same time. This is especially helpful given the fact that 2023 was so impacted by the extreme performance of the "Magnificent 7" stocks.

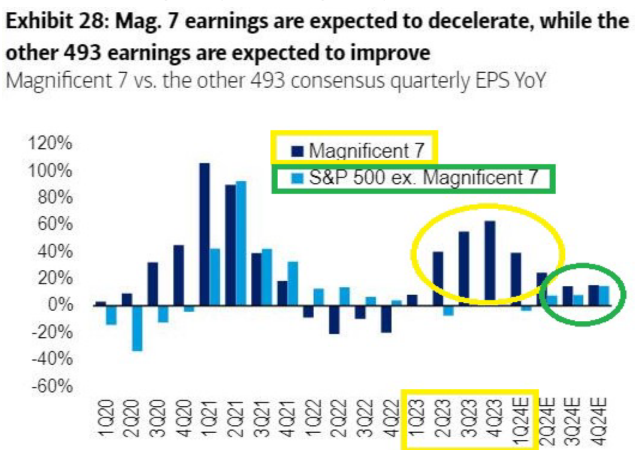
Magnificent 7 Have Seen Larger Pullbacks Than S&P 500



Source: Bloomberg: Deutsche Bank

As seen in the previous chart from Deutsche Bank, the Magnificent 7 stocks have diverged thus far in 2024. While NVIDIA continues to display extraordinary strength, Apple and Tesla have each suffered significant declines in 2024 – Telsa is down by some -40%. What's more, six of these companies (excluding Google) have seen their stock prices fall much more than the -5.5% decline of the S&P 500.

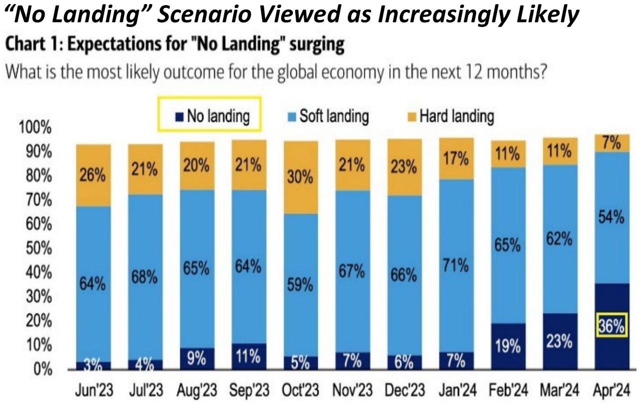
Market Earnings Beyond Mag 7 Expected to Accelerate



Source: BofA US Equity & Quant Strategy; Factset

To a ceratin degree, some invetors still believe that the only reason the S&P 500 was up over 20% in 2023 was due to investors chasing of these seven names. While it is unequivocal that they led the market hitgher, it also clear why that was the case. Consider the chart above from Bank of America. During 2023, the Magnificent 7 names were growing earnings by some +60% while the remaining 493 companies weren't growing earnings at all. As we look forward in 2024, that dynamic is anticipated to shift with bulk of the index looking to grow at the same rate as the Magnificent 7.

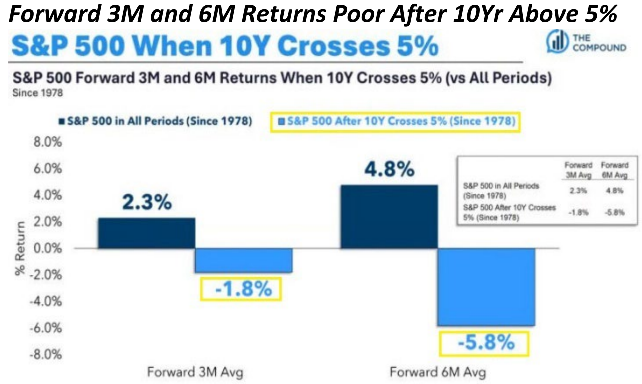
"No Landing" Scenario Viewed as Increasingly Likely



Source: BofA Global Fund Manager Survey

That type of leadership rotation and broadening out of growth is what sustains growth, the "lifeblood of Bull markets" as it is often referred to, so it is a welcome development. However, market participants are now questioning whether this is all a bit too much too fast. As the previous chart highlights, global fund managers increasingly believe that there will be "No Landing" in the US economy, meaning no slowdown of any kind.

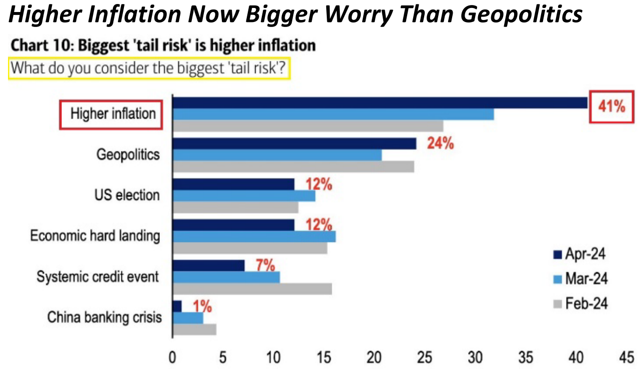
Forward 3M and 6M Returns Poor After 10Yr Above 5%



Source: RWH, YCharts; Bloomberg

At first blush, no slowdown would seem to be a good thing. However, no slowing in the economy would mean that the Federal Reserve cannot cut rates and perhaps even implausibly, may have to raise rates again at some point. That scenario is unlikely, but the fact that no rate cuts appear imminent has allowed bond yields to rise this year despite the consensus view that they would decline meaningfully in 2024. This comes with consequences. As seen above, when the 10 Year Treasury Bond crosses above 5% yield, the forward 3 and 6 month returns for the S&P 500 have not been good, falling -1.8% and -5.8% respectively.

Higher Inflation Now Bigger Worry Than Geopolitics

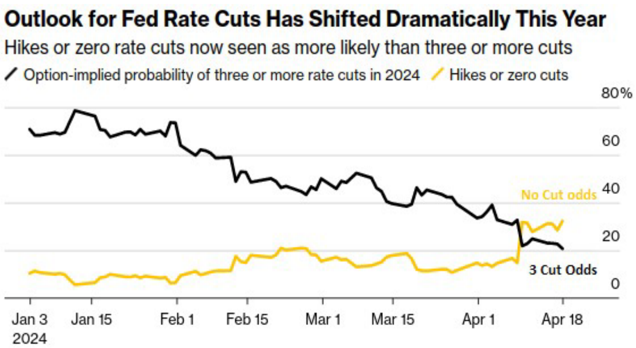


Source: BofA Global Fund Manager Survey

What's more, the view among fund managers according to BofA, is that inflation is now the predominant risk in the market, not Geopolitics.

As one can clearly see in the previous chart, almost half (41%) of global fund managers see Inflation as the largest threat to markets at present. Given the strong economic data and stubborn inflation data reported during the first quarter, this view has now largely become the consensus lens to view the market.

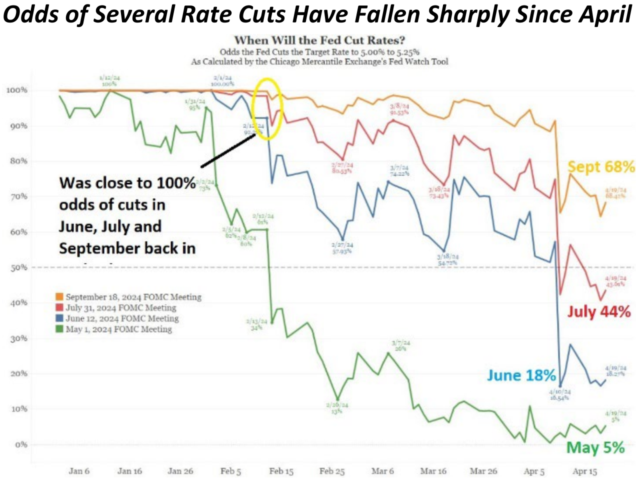
Odds of No Rate Cuts (or Hikes) Now Higher than 3 Cuts



Source: Bloomberg; SOFR Options

As a result, the once "sure thing" of at least three interest rate cuts in 2024 has deteriorated and in fact reversed course. As seen above, according to the options market, the odds of either no rate cuts or even a rate increase has surpassed the odds of three rate cuts during calendar 2024.

Odds of Several Rate Cuts Have Fallen Sharply Since April

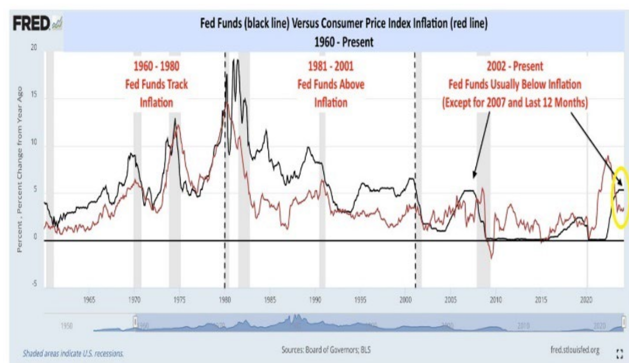


Source: Jim Bianco Research

The chart above chronicles this cascading dynamic well. As of mid-February, there was a +90% chance of cuts in the June, July and September Federal Reserve meetings. Those numbers drifted lower through March and then precipitously after Chairman Powell's "longer than expected" comments in April. As of late April, the odds of rate cuts had fallen further to just 12% in June, about 30% in July and 58% in September.

A valid question some may have is why does the Fed need to cut rates at all? If the economy remains solid (low unemployment, wage growth above inflation, 3% yearly GDP growth), and inflation remains stable at least and likely declining, why change? There is no one "right" answer to this, but generally speaking, the Fed has a dual mandate, "achieve maximum employment and keep prices stable". With unemployment at 50-year lows, the question remains simply one of price stability. As DataTrek charts below, from 1960-1980, fed Funds Tracked CPI (inflation). During the Volcker period of 1981-2001, rates were held above CPI to combat inflation. For most of this century, investors have become accustomed to rates below CPI. With CPI slowing meaningfully and the economy strong, there are few valid reason to keep rates so much higher than CPI – it may simply be too restrictive to growth.

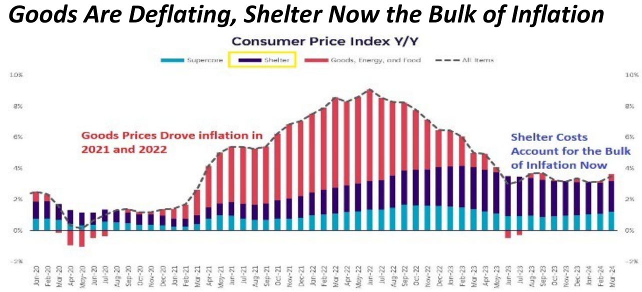
Markets Have Enjoyed 20+ Years of Rates Below Inflation



Source: DataTrek; Board of Governors; BLS

It's important to keep in mind that the economy does not move linearly. While the latest CPI reading of 3.5% disappointed markets, understanding what is driving the current trend is vital. As the chart from Sofi below illustrates, the inflation that spiked to 9% in 2021 and 2022 was driven be increasing goods prices. Now almost the entirety of inflation is being driven by shelter costs which may shift soon as well.

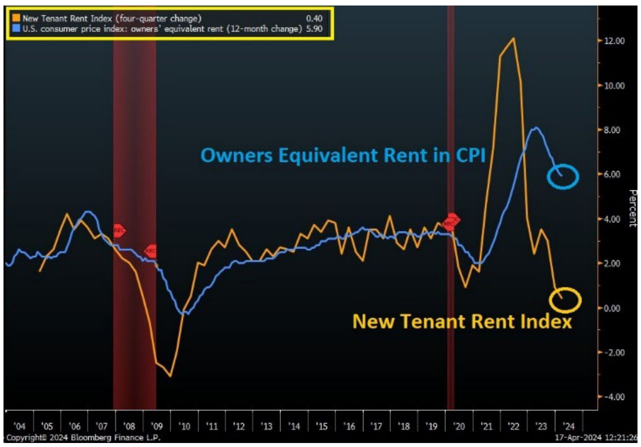
Goods Are Deflating, Shelter Now the Bulk of Inflation



Source: Sofi; BLS; Bloomberg

Shelter now represents 43% of CPI according to FundStrat which is an all-time high. The Federal Reserve uses an odd measure of shelter costs that estimates what a homeowner would have to pay in rent to live in their house. As the chart below highlights, this measure remains high at about 6%. If one looks at data that represents what is actually happening in shelter costs like new tenant rents, it becomes apparent that shelter costs are falling rapidly – new rent increases are now close to 0% which is the lowest level since 2010.

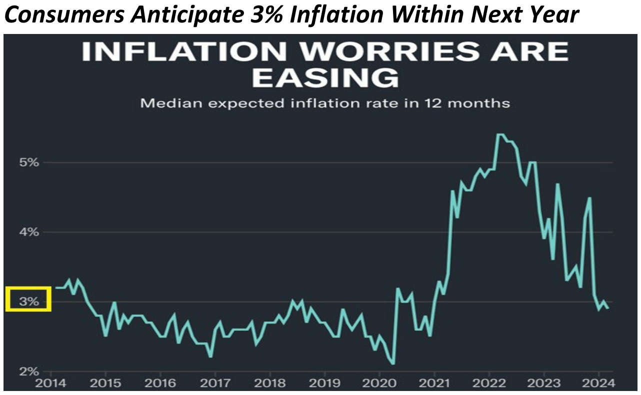
CPI Shelter Reading Lags Higher Frequency Market Data



Source: Bloomberg

Similarly, as we have pointed out many times in the past, the US consumer is the key to the entire global economy, representing almost 70% of US GDP at this point. Sentiment is therefore quite important as it dictates behavior. As Chairman Powell stated in early April, “Having the public expect inflation to return to 2%, despite it moving up, that's a very important factor in bringing inflation back down. If price-setters and wage-setters in the economy believe that inflation will be 2%, then that will actually happen."

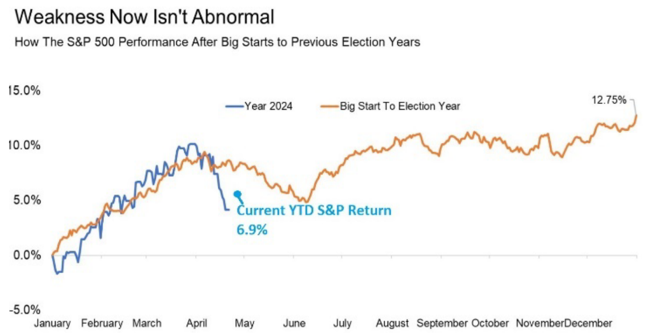
Consumers Anticipate 3% Inflation Within Next Year



Source: University of Michigan Consumer Sentiment Survey

The path of inflation is important in any given year, but particularly in a US presidential election year as the economy is often the main factor in determining the election outcome. The 10% move higher in Q1 of this is unusual in an election year, but not unprecedented. As Carson Research found, five other election years began with stock gains of +5% or more and the resulting full year return ended up almost +13% higher. One can see how 2024 has compared to this track thus far below.

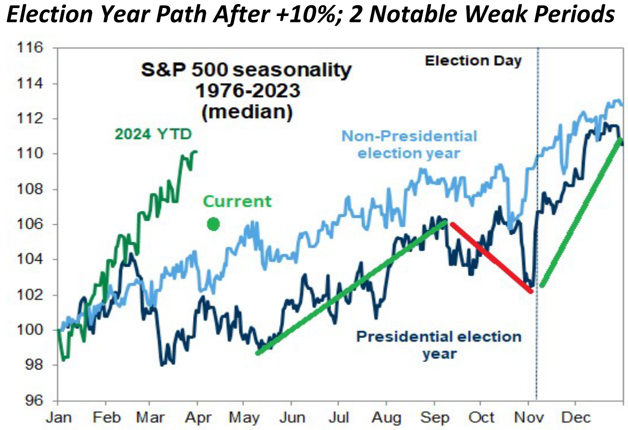
Election Years with +5% or Better Q1 Average 13% Gain



Source: Carson Research; Factset

Importantly, the path during election years has historically shown some very distinct patterns. As the chart below from Goldman Sachs illustrates, election years tend to start well and then pullback until roughly the end of May. Equities then typically rise throughout the summer before declining once again until just prior to the election in early November. Post election, regardless of outcome, the market has historically rallied aggressively until the end of the year. While 2024 has started with stronger gains than would have been expected, trend is more important than level when looking at historical comparison charts such as this. We will therefore be looking for confirmation of the election year pattern as the year progresses.

Election Year Path After +10%; 2 Notable Weak Periods



Source: Goldman Sach Global Investment Research

Going Forward

In last quarter's letter, we wrote that at the end of 2023, "many market participants remained skeptical even in the face of a near +20% rally to end the year." With another straight +10% move higher in US equities over the first three months of the year, that skepticism began to transform into what some would call overenthusiasm. Investor sentiment readings reached prior peaks and we started to see some evidence of "chasing" performance in certain areas of the market. As we discussed, sentiment can turn very quickly and a good deal of the of the market excess in terms of overbought conditions has quickly rectified itself for the time being. We did take advantage of the strong market conditions in mid-February and booked profits in several areas that were demonstrating overbought conditions.

To a large extent, the recent emergence of a more cautious tone was driven by the development or lack thereof on the inflation front. As we will continue to stress, extrapolating point in time data will lead to bad outcomes. A longer-term view is required to achieve consistent results over time and fortunately there is a strong case suggesting that inflation will in fact resume its decline this year. As the CIO of UBS recently stated, "Inevitably markets reacted to US consumer price inflation headlines, but the details did matter. There is very strong evidence against inflation stickiness. Aside from rents and fictitious owners' equivalent rents, there is deflation in almost every consumer price subcategory somewhere in the US. With collapsing clothing prices in Tampa or plunging communication prices in Chicago, it is difficult to argue that structural inflation stickiness exists when every key sector has deflation somewhere in the country."

This quarter's earnings season has also provided reason for optimism. In aggregate, earning growth has been a better than anticipated +3.5% and revenue growth has been +4%. Importantly, forward guidance has proven to be quite strong and management commentary across industries has been largely constructive. As we noted, at the end of the day, the economic direction boils down to the health of the consumer and the outlook here appears bright. As the CEO of consumer banking company Capital One stated on their quarterly earnings call, "The U.S. consumer remains a source of strength…labor market remains strikingly resilient. Rising incomes have kept consumer debt servicing burdens relatively low by historical standards. And when we look at our customers, we see that they have higher bank balances than before the pandemic and this is true across income levels. On the whole, I'd say consumers are in pretty darn strong shape relative to historical benchmark."

Large cap technology names continue to deliver market leading growth in both earnings and revenues so we continue to maintain sizable exposure to the group and will continue to do so. Other areas of focus for us this year are financials and industrials, as well as healthcare and energy. Small and mid-cap companies valuations are at attractive levels when compared to their large-cap counterparts. In our view, there may be an opportunity for meaningful returns in the smaller segment of equities as we look forward to 2024.

Regions outside of the US have proven to be volatile this year. While gains have been solid, they have not kept pace with returns in the US as the Dollar strengthened. Valuations outside of the US are compelling on a historical basis and if improving fundamental data on inflation and growth continues globally, non-US markets could potentially prove to be another area of opportunity in 2024.

Within fixed income, we continue to place our emphasis on shorter duration exposures and unconstrained strategies. We have taken advantage of the climb in treasury yields to allocate a portion of our exposure into laddered short-term treasuries as a way to capture risk-free yield for fixed income portfolios. As rate decreases by the Federal Reserve continue to be pushed further out into the future by the market, we will continue to take advantage of the attractive yields.

We believe that commodity exposure, primarily via gold, but also industrial metals and energy, will continue to be additive in an uncertain macro-economic environment. Gold has served its purpose as a diversifying asset quite well in 2024 and there appears to be a consistent demand for Gold from Central Banks, particularly China.

Thank you for taking the time to read our thoughts on the markets and we look forward to speaking soon.

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