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Investment Insights Monthly

From The Desk of Bill Hornbarger, Chief Investment Officer

February 2024

Three Charts

The Fed

One of the things we wrote about in December was the disconnect between the U.S. Federal Reserve's (Fed's) guidance on interest rates and the market pricing of Fed policy. At that point, the Fed had been indicating two to three interest rate cuts in mid- to late 2024, and the markets had been pricing six to seven cuts, with the first in March. The Fed is almost certainly done raising rates, barring a major surprise, but market expectations for 2024 rate cuts remain on the high side. While the markets are pricing in a slightly better than 50% chance of a rate cut in May, and five cuts in total, we choose to rely more on the Fed's guidance.

With the first Federal Open Market Committee Meeting of 2024 in the books, the gap between the two parties has narrowed (see "2024 Fed Funds Futures" chart below). In his press conference following the last meeting, Fed Chairman Jerome Powell indicated that the Fed wants to be confident that inflation is sustainably headed toward the 2% goal before lowering rates. While inflation has declined, sifting through comments from a variety of Fed speakers seems to indicate that the current consensus remains two to three cuts starting in June, based on current information. According to the futures markets, traders have now priced the best odds for the first cut in June, consistent with the Fed's rhetoric, but continue to price more aggressive cuts through the year. Stocks remain priced for the more aggressive scenario with a current projected 2024 price/earnings ratio more than 20 times, leaving the market vulnerable to a Fed or earnings disappointment.

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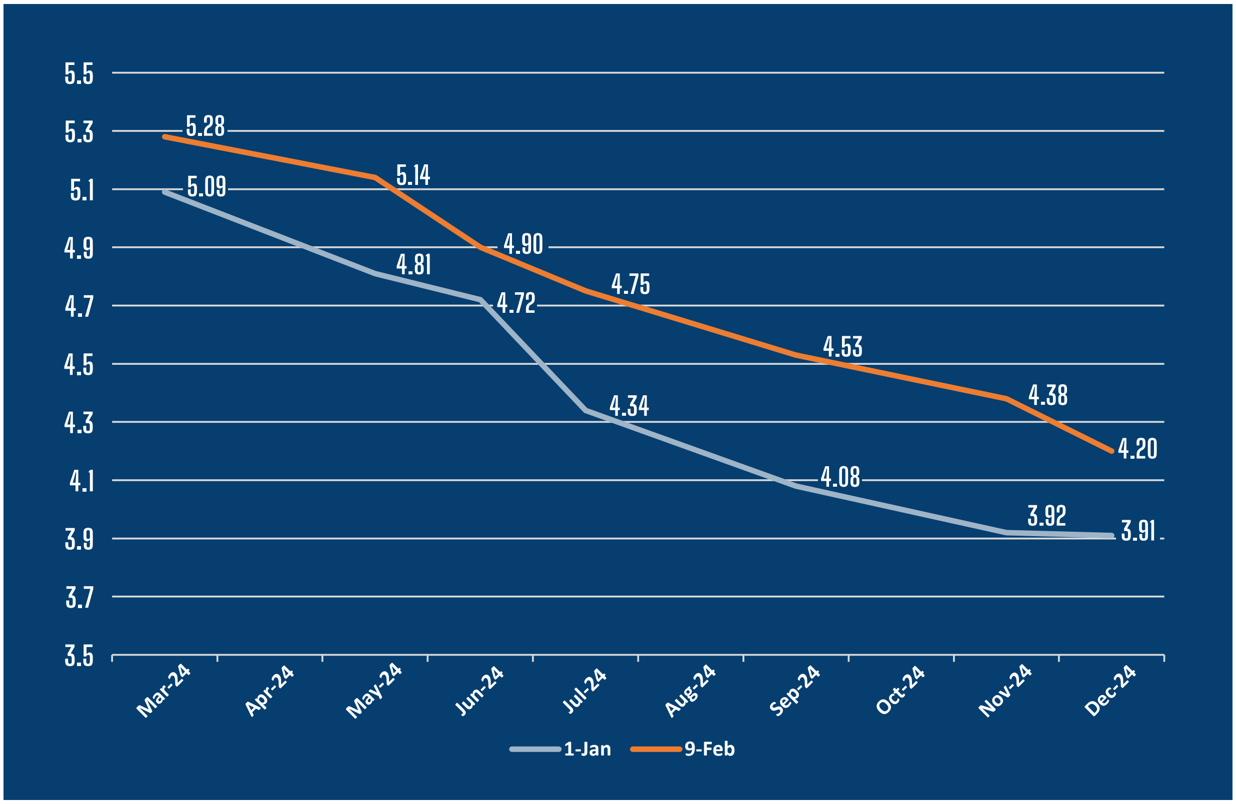
2024 Fed Funds Futures (Meeting Months)
%



Source: Bloomberg
Pricing as of January 1, 2024 and February 9, 2024

Hard Landing, Soft Landing, No Landing?

The consensus outlook for the U.S. economy continues to improve, with a growing belief that the economy will forgo a "soft landing" and instead, will avoid any downturn. Nonfarm payroll growth has remained strong, and the unemployment rate has stayed below 4%, while both the manufacturing and service surveys from the Institute for Supply Management have improved in recent months. Lower inflation and higher wages have resulted in positive real wages, aiding the consumer as reflected in improved readings on consumer sentiment. Financial conditions have also eased, and inflation continues to decline toward the Fed's target of 2% core inflation (as measured by personal consumption expenditures).

Offsetting these signs of strength is the weakness in the index of leading economic indicators, concerns over commercial real estate and the potential impact on the banking sector, and the inversion of the yield curve and the relative weakness in small-cap stocks. The leading indicators have been negative for 22 consecutive months, although the rate of decline seems to be improving in recent months (see the "Index of Leading Economic Indicators" chart below).

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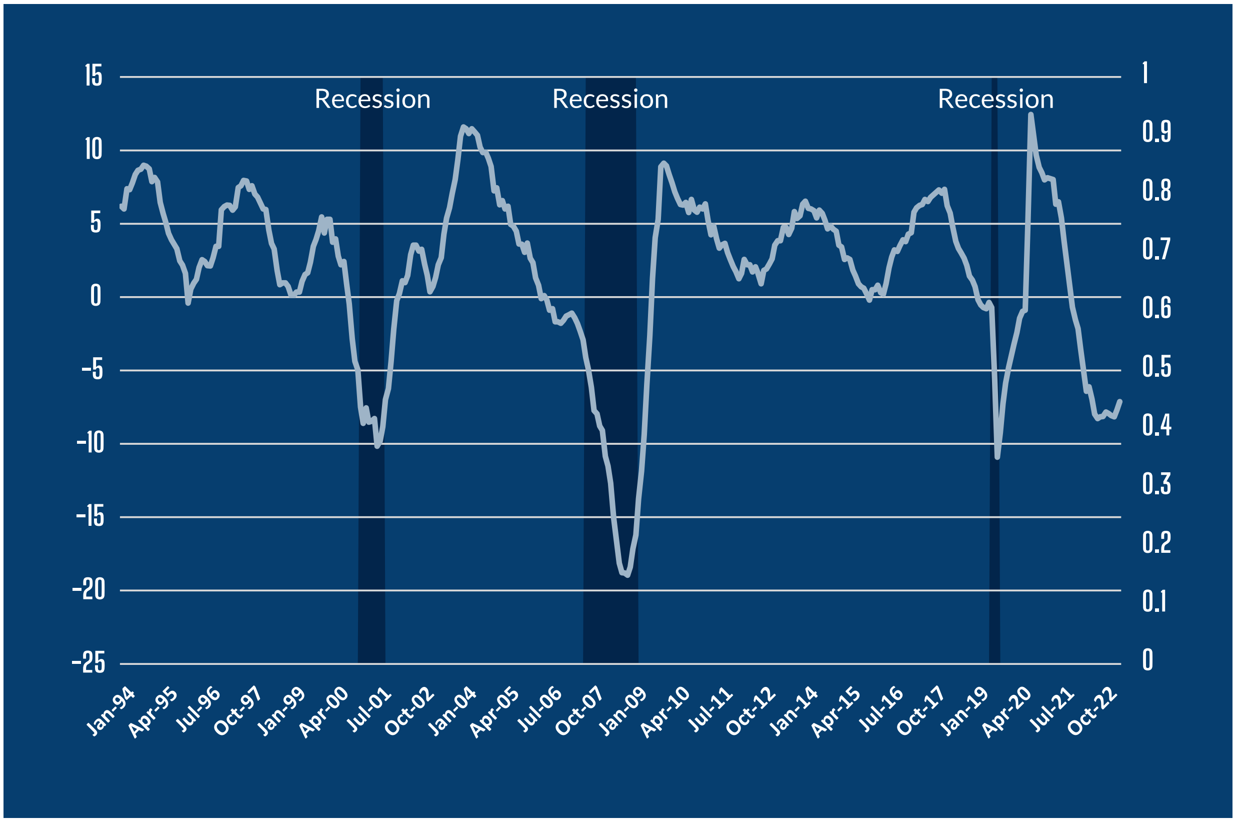
We continue to use the term "rolling recession" to describe the economy with portions (most notably manufacturing) in recession, while the overall economy continues to grow. We believe the biggest threat to growth at this point would be a policy mistake in the form of the Fed keeping rates too high for too long, and we remain encouraged that the Fed has outlined a path and timeline to easing monetary policy. In our opinion, the Fed remains on course to engineer something that looks and feels like a soft landing, although that outlook isn't without risks.

Index of Leading Economic Indicators
Year-over-Year % Changes



Source: Haver
As of December 3, 2023

Stocks

The S&P 500 has been on a tear recently, up more than 20% since last fall, and it recently eclipsed the 5,000 level for the first time. Many investors become reluctant to invest with stocks near all-time highs, particularly so when cash offers enticing yields. Over the history of the market, stocks have never failed to regain highs, and the starting point matters less over long investment time horizons. This is consistent with our view that the economy isn't a balloon that inflates and inflates to a predetermined size but instead that wants to continue to grow (including profits). We saw the following chart and "Fun Facts" in a piece from J.P. Morgan and thought they were worth sharing.

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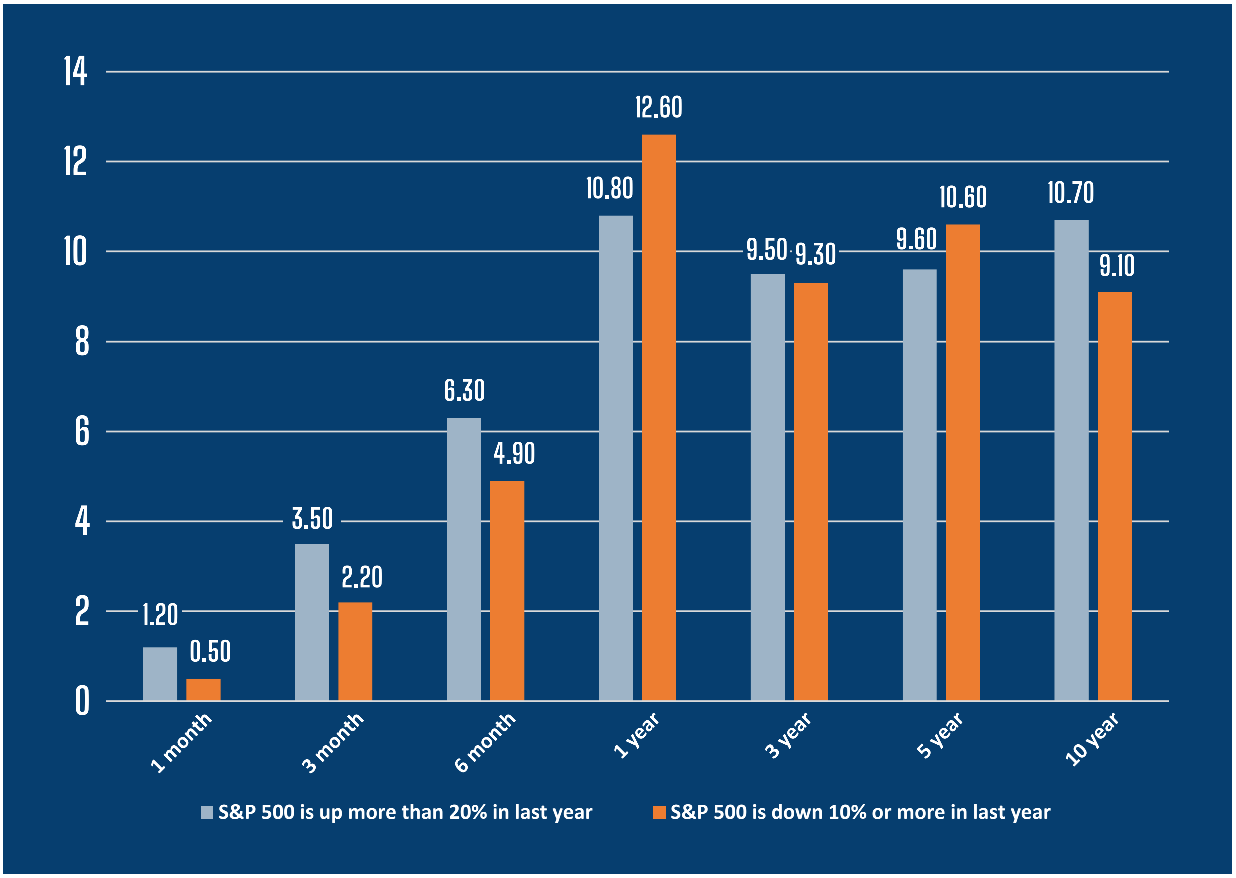
Forward Returns After S&P 500 Rally vs. Drawdown



Fun Facts

1. Trailing 1-year returns are over 20% about one-third of the time.
2. Forward 3-, 5- and 10-year returns are positive greater than 80% of the time.
3. Near-term performance following rallies is stronger as markets tend to trend over time.

Source: J.P. Morgan
As of January 31, 2024

Studies routinely show that timing the market's ups and downs consistently is almost impossible. Over the long-term, we think the most important decision an investor in wealth building mode can make is to be exposed to the stock market. The stock market's higher returns through time come with volatility, which is the "risk" part of the risk and return equation, while the return is the long-term capital appreciation in excess of inflation. The S&P 500 has suffered an average intra-year pullback of -15% over the past four decades, yet the full-year return was positive 75% of the time. We think that investors are best served by staying invested and managing risk through asset allocation.

In closing, falling inflation, easier Fed policy, and a soft or no landing scenario are typically positive for stocks. Forward guidance from CEOs has also been relatively positive in terms of 2024 earnings. Short-term, we wouldn't be surprised if stocks post a correction, but the current environment tends to be friendly for the financial markets.

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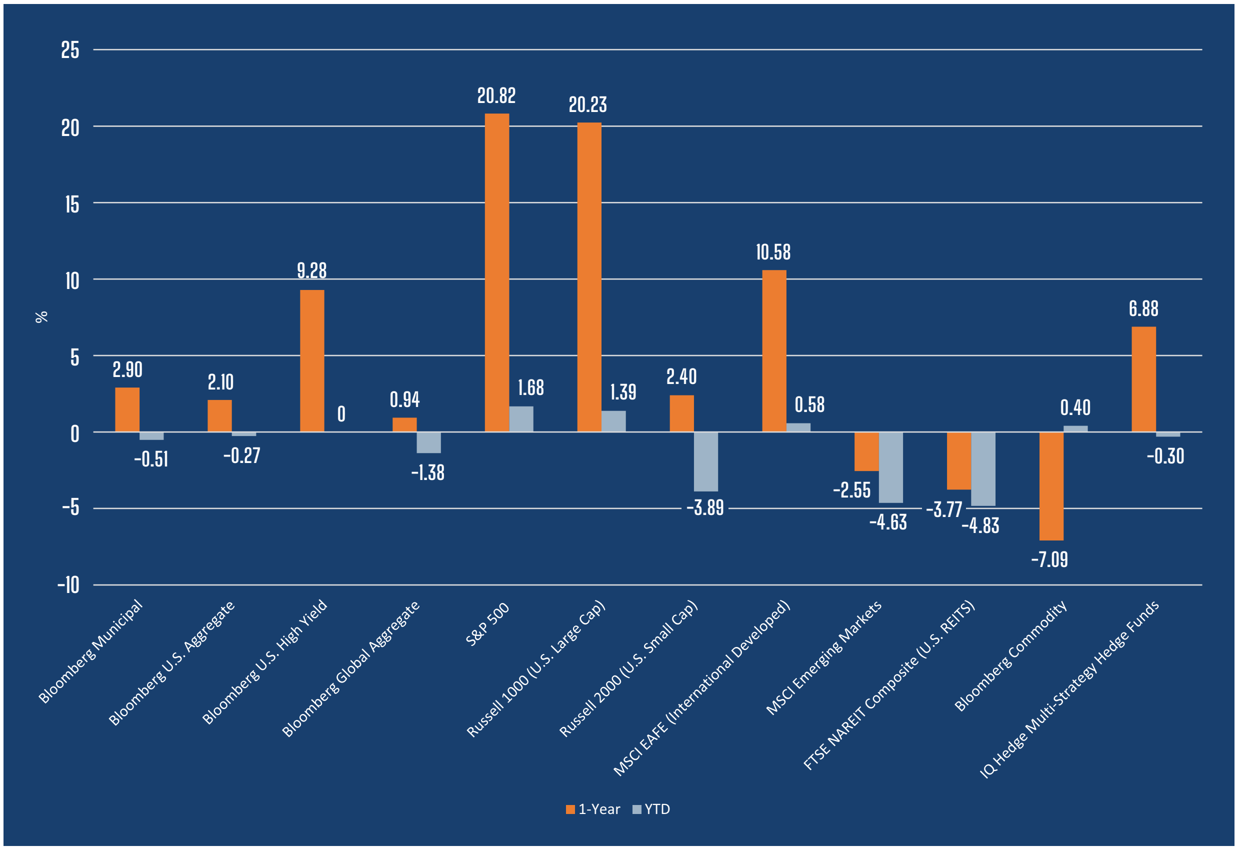
Asset Class Returns

Comparing Recent 1-Year and Year-to-Date Total Returns



Source: Conway Investment Research
As of January 31, 2024

Fixed Income

- U.S. Treasury and other sovereign debt yields moved higher in January, and this led to losses in core fixed income and municipal bonds.
- Credit generally benefited from its higher carry entering the year, helping to offset the move higher in Treasury yields. Investment grade was modestly positive, high yield was flat, and loans gained ground.
- After weakening in the fourth quarter, the U.S. dollar strengthened last month, creating a headwind for non-U.S. assets.

Equities

- U.S. equities were a mixed bag in January with gains in large caps and losses in small caps.
- Growth once again led value across all market capitalizations, and large caps trounced small caps.
- Similar to most of 2023, U.S. equities were led by only a handful of mega-cap tech stocks.
- Non-U.S. equities started the month on a weak note but rallied over the final week to post slight gains across developed markets.
- Similar to what occurred in the U.S., EAFE markets saw growth beating value and large caps outperforming small caps.
- The big story in January was the continued weakness in emerging markets, specifically driven again by China.

Alternatives

- REITs were one of the poorest performing asset classes in January, hurt by higher yields and renewed macro concerns about the sector.

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January 31, 2024	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Bloomberg U.S. Treasury Bill 1-3 Month	0.44%	0.44%	0.44%	5.24%	2.36%	1.92%	1.27%
Bloomberg Municipal	-0.51%	-0.51%	-0.51%	2.90%	-0.78%	2.00%	2.78%
Bloomberg US Govt/Credit Intermediate	0.39%	0.39%	0.39%	4.18%	0.21%	1.51%	1.29%
Bloomberg U.S. Aggregate	-0.27%	-0.27%	-0.27%	2.10%	-3.17%	0.83%	1.63%
Bloomberg U.S. High Yield	0.00%	0.00%	0.00%	9.28%	1.87%	4.44%	4.52%
S&P/LSTA Leveraged Loan	0.68%	0.68%	0.68%	11.12%	5.58%	5.41%	4.42%
Bloomberg Global Aggregate	-1.38%	-1.38%	-1.38%	0.94%	-5.67%	-0.89%	0.13%
U.S. Equity Indices							
DJ Industrial Average	1.31%	1.31%	1.31%	14.36%	10.58%	11.19%	11.82%
S&P 500	1.68%	1.68%	1.68%	20.82%	10.99%	14.30%	12.62%
Russell 1000	1.39%	1.39%	1.39%	20.23%	9.78%	13.99%	12.32%
Russell 1000 Growth	2.49%	2.49%	2.49%	34.99%	10.03%	18.04%	15.48%
Russell 1000 Value	0.10%	0.10%	0.10%	6.08%	9.23%	9.28%	8.80%
Russell Mid Cap	-1.42%	-1.42%	-1.42%	6.70%	5.50%	10.08%	9.48%
Russell 2500	-2.62%	-2.62%	-2.62%	3.96%	2.50%	8.69%	8.32%
Russell 2000	-3.89%	-3.89%	-3.89%	2.40%	-0.76%	6.80%	7.03%
Russell 2000 Growth	-3.21%	-3.21%	-3.21%	4.46%	-6.03%	6.17%	7.00%
Russell 2000 Value	-4.54%	-4.54%	-4.54%	-0.09%	4.48%	6.74%	6.68%
Non-U.S. Equity Indices							
MSCI World	1.22%	1.22%	1.22%	17.59%	8.58%	11.95%	9.72%
MSCI ACWI	0.61%	0.61%	0.61%	15.26%	6.61%	10.70%	8.99%
MSCI ACWI Ex-U.S.	-0.98%	-0.98%	-0.98%	6.42%	1.63%	5.83%	4.70%
MSCI EAFE	0.58%	0.58%	0.58%	10.58%	5.11%	7.44%	5.27%
MSCI EAFE Growth	1.19%	1.19%	1.19%	10.02%	1.45%	8.07%	6.14%
MSCI EAFE Value	-0.05%	-0.05%	-0.05%	11.13%	8.57%	6.36%	4.15%
MSCI Europe	-0.10%	-0.10%	-0.10%	10.89%	6.93%	8.33%	5.14%
MSCI Japan	4.62%	4.62%	4.62%	18.96%	2.91%	7.01%	6.23%
MSCI AC Asia	-1.68%	-1.68%	-1.68%	1.95%	-5.03%	3.47%	4.86%
MSCI EAFE Small Cap	-1.64%	-1.64%	-1.64%	4.07%	-0.69%	5.02%	5.19%
MSCI ACWI Ex-U.S. Small Cap	-1.70%	-1.70%	-1.70%	6.57%	1.43%	6.37%	5.32%
MSCI Emerging Markets	-4.63%	-4.63%	-4.63%	-2.55%	-7.15%	1.37%	3.25%
MSCI EM Asia	-5.21%	-5.21%	-5.21%	-5.62%	-9.50%	2.12%	4.44%
MSCI China	-10.61%	-10.61%	-10.61%	-28.86%	-23.15%	-6.79%	0.60%
MSCI EM Eastern Europe	-2.41%	-2.41%	-2.41%	34.12%	-31.94%	-19.65%	-8.99%
MSCI EM Latin America	-4.79%	-4.79%	-4.79%	15.69%	11.26%	2.64%	3.02%
MSCI EM Small Cap	-1.71%	-1.71%	-1.71%	15.50%	6.34%	8.88%	5.84%
MSCI Frontier Markets	1.00%	1.00%	1.00%	8.41%	0.07%	2.93%	2.37%
Hedge Fund Indices							
IQ Hedge Multi-Strategy	-0.30%	-0.30%	-0.30%	6.88%	0.45%	2.86%	2.67%
Real Assets Indices							
FTSE NAREIT Composite	-4.83%	-4.83%	-4.83%	-3.77%	3.74%	3.81%	6.82%
Bloomberg Commodity	0.40%	0.40%	0.40%	-7.09%	9.96%	6.18%	-1.10%
S&P Global Infrastructure	-3.14%	-3.14%	-3.14%	-1.53%	5.67%	4.91%	5.47%
Other							
Oil Price Brent Crude	6.06%	6.06%	6.06%	-3.29%	13.50%	5.71%	-2.67%
CBOE Market Volitility (VIX)	15.26%	15.26%	15.26%	-26.03%	-24.31%	-2.84%	-2.46%

Source: Morningstar

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The return of principal for bond funds and funds with significant underlying bond holdings is not guaranteed. Fund shares are subject to the same interest rate, inflation and credit risks associated with the underlying bond holdings. Lower rated bonds are subject to greater fluctuations in value and risk of loss of income and principal than higher rated bonds. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value in your investment.

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