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Investment Insights Quarterly

From the Desk of Bill Hornbarger, Chief Investment Officer

April 2024

Higher for Longer

The recent message from the markets and the U.S. Federal Reserve (Fed) is that the widely anticipated rate cuts are not going to come as fast and to the degree that they were previously anticipated. When the year began, market participants were expecting (as priced by trading in the futures markets) five to six quarter-point rate reductions for 2024 beginning in the first quarter. At the same time, the Fed was guiding toward three, based on rhetoric and the "dot plot." The Fed was clear in its communication that it wanted confirmation that inflation was headed convincingly toward the 2% target before it began lowering the target federal funds rate.

Fast forward to April, and the narrative has changed. Inflation has been surprisingly resurgent, the underlying strength of the economy better than anticipated, and the markets are now pricing for one to two rate cuts over the balance of this year. Fed Chairman Jerome Powell, in recent comments, stated that, "Recent data have clearly not given us greater confidence" that inflation is coming fully under control and, "instead indicate that it's likely to take longer than expected to achieve that confidence." "If higher inflation does persist," he said, "we can maintain the current level of [interest rates] for as long as needed."

In the past several weeks, data has shown that inflation remains stubbornly above the Fed's 2% target and that the economy continues to grow at a good clip. Year-over-year inflation grew at 3.5% as measured by the Consumer Price Index (CPI) in March, the third consecutive monthly gain, and core CPI (excluding volatile food and energy prices) rose to 3.8% in March. The stronger inflation data features some familiar themes: shelter inflation remains stubbornly high (5.7%), services rose 5.3% in March, and higher gas prices (up approximately 28% year-to-date) will keep inflation at the forefront for consumers and investors. In addition to higher inflation, the labor market remains strong, with nonfarm payrolls up 829,000 in the first quarter; personal income remains strong; and the Atlanta Fed GDPNow current estimate for second-quarter GDP is 3.9% (as of April 26), which would represent a strong rebound for a disappointing first quarter.

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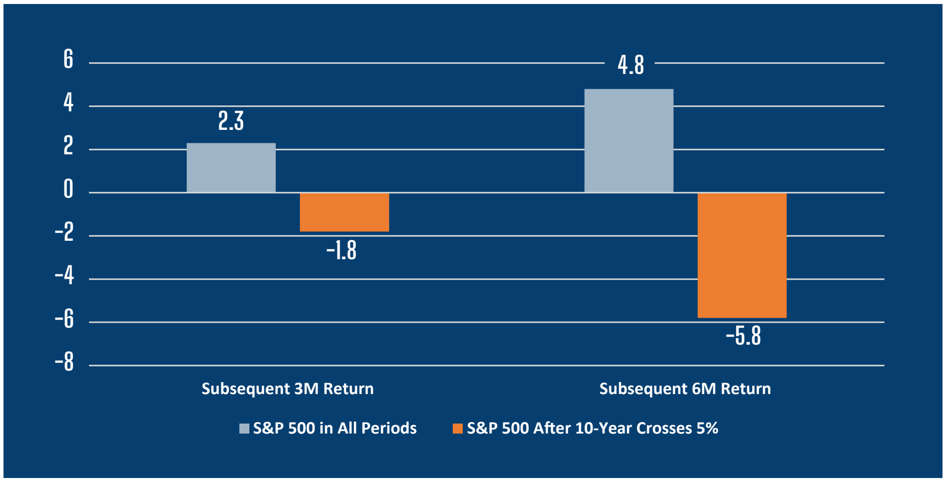
This ongoing repricing of Fed expectations and stronger inflation data have led to volatility in the financial markets. Equity weakness accelerated in the first two trading weeks of April, and bonds have not been immune to the selling pressure. The 10-year Treasury started the year with a yield under 4% and recently touched 4.67%, while stocks have generally struggled. While still higher year-to-date, the S&P 500 and NASDAQ are down 3.81% and 3.14%, respectively, in the second quarter, and small-cap stocks are off 7.4% since the beginning of April.

Interestingly, this weakness comes at the same time that the Bank of America-Merrill Lynch Fund Manager Survey shows that fund managers have turned more bullish. Per a J.P. Morgan note, for the first time since December 2021, fund managers are, on net, expecting a stronger economy. This share jumped 12% over the past month with overall growth expectations at their most bullish since September 2021. Typically, growth expectations from this survey have correlated with the path of the S&P 500. This bullish view is leading to repositioning, with equity allocations generally higher, and fully one-third of respondents overweight stocks, the highest since January 2022.

While the recent weakness and volatility have been unnerving for some, we would characterize this as relatively normal. We still believe that the next move from the Fed will be to lower rates and believe it will happen in 2024. We would suggest that rate cuts have been delayed as opposed to being taken completely off the table. The underlying strength of the economy is a good sign and, based on what we know today, argues that the economy remains on track to avoid a full-blown recession. The equity strength—from late October until late March's record high close for the S&P 500—was unsustainable, and this ongoing consolidation is natural and healthy.

In the days ahead, one thing to pay particular attention to is bond yields. Historically, bond yields have peaked before the last rate hike of a tightening cycle, and we were confident in our opinion that the high in yields was set last October at 5% for the 10-year Treasury. Recent activity can best be described as a rout, and while the 10-year didn't breach 4.70%, momentum was clearly toward higher yields. The 5% level would be significant psychologically, but stock performance has historically deteriorated with yields above that level.

S&P 500 When 10-Year Yield Crosses 5%
1978 - Current



Source: RWM

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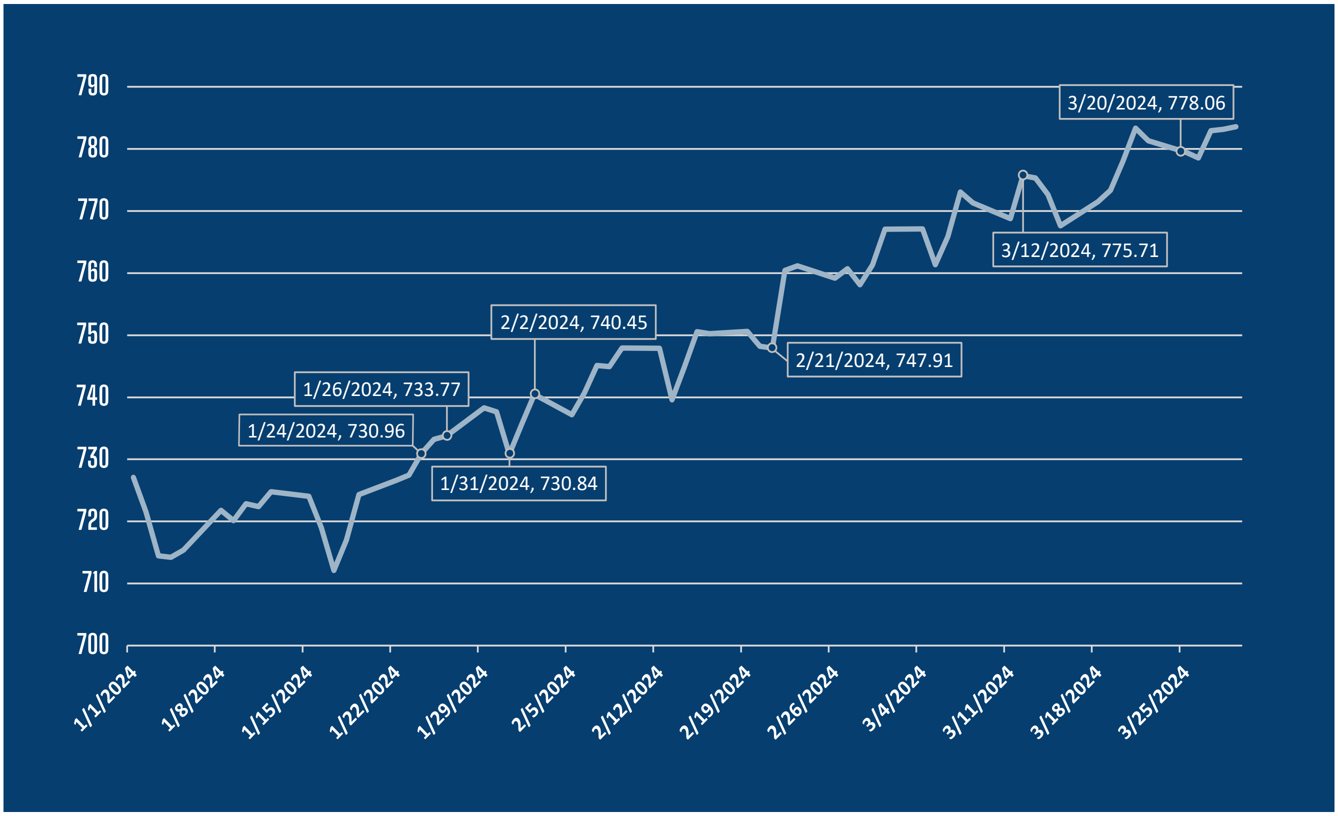
MARKET EVENTS

Key Q1 Dates

- January 24 – The People's Bank of China delivered a surprise 50-basis-point (bp) cut to its reserve requirement ratio.
- January 26 – PCE came in as expected bolstering thoughts that inflation was declining to Fed's target.
- January 31 – Fed left rates unchanged.
- February 2 – The employment report was very strong with upward prior-month revisions. Nonfarm payrolls increased by 353,000.
- February 21 – NVIDIA beat earnings and raised guidance reinforcing the strength in AI-related companies.
- March 12 – U.S. CPI was hotter than expected for the second consecutive month.
- March 20 – Fed left rates unchanged and maintained three-cut guidance for this calendar year.

Global Stock Market
MSCI ACWI in USD



As of March 31, 2024
Source: Bloomberg

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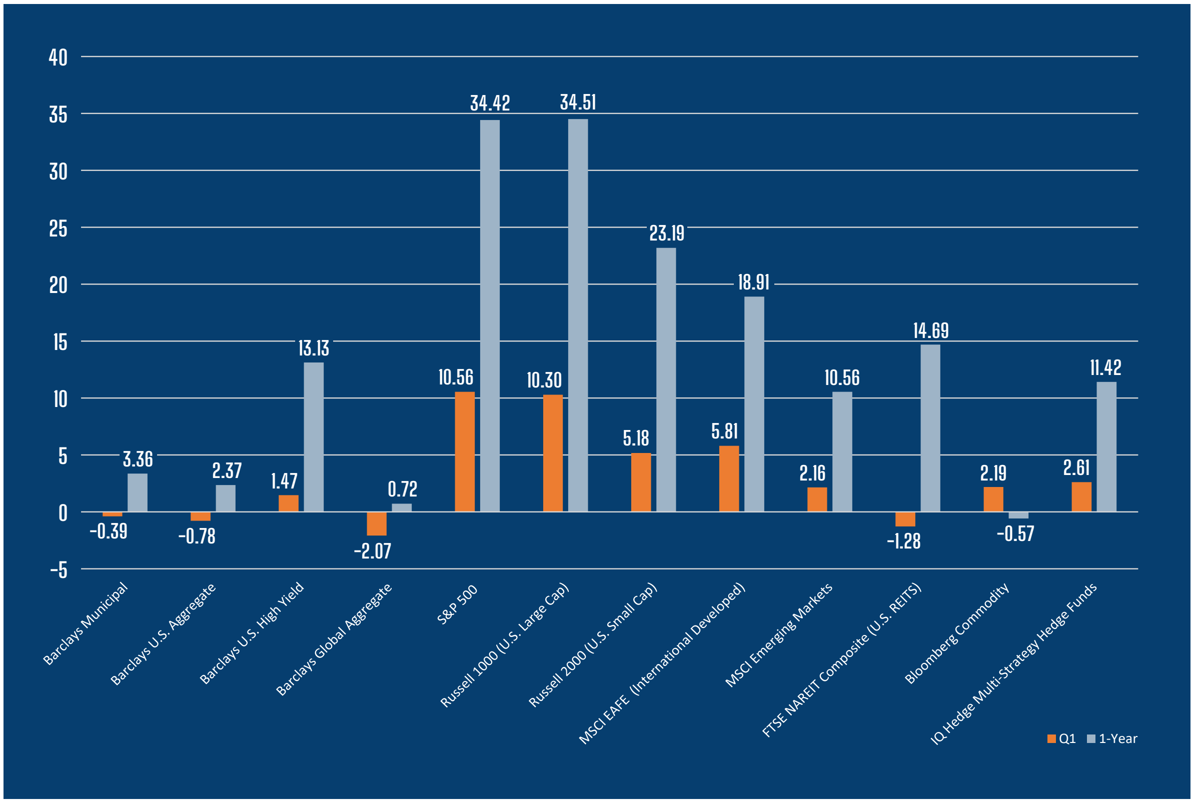
Asset Class Returns

Q1 2024



As of March 31, 2024
Source: Conway

Fixed Income

- Treasury and other sovereign debt yields fell across the board in March, creating a small tailwind for core fixed income. Municipals were flat last month as the asset class is often technically driven.
- Credit spreads continued to tighten in March, fueling gains in high yield, floating rate loans and emerging-market debt.
- The U.S. dollar weakened in March, providing another tailwind for non-U.S. assets.

Equities

- U.S. equity markets remained resilient in March, led by solid gains in small caps and value stocks. The Nasdaq was the laggard, but still gained 1.8%.
- Small caps beat large caps last month, and value stocks outpaced growth stocks across all market caps.
- U.S. equities ended the first quarter with some of the best quarterly gains ever.
- Non-U.S. equities generally outperformed U.S. equities in March, led similarly by small caps and value stocks.
- While small caps slightly outperformed large caps, value beat growth within EAFE markets by about 200 bps.
- Emerging markets lagged developed markets last month, dragged down by weakness in Eastern Europe, Latin America and China.
- Currency provided a boost to non-U.S. equities.

Alternatives

- Real estate had a weak (and negative) quarter primarily due to higher yields.
- Energy prices were very strong leading to strong gains in master limited partnerships and some gains in the broader commodity complex.

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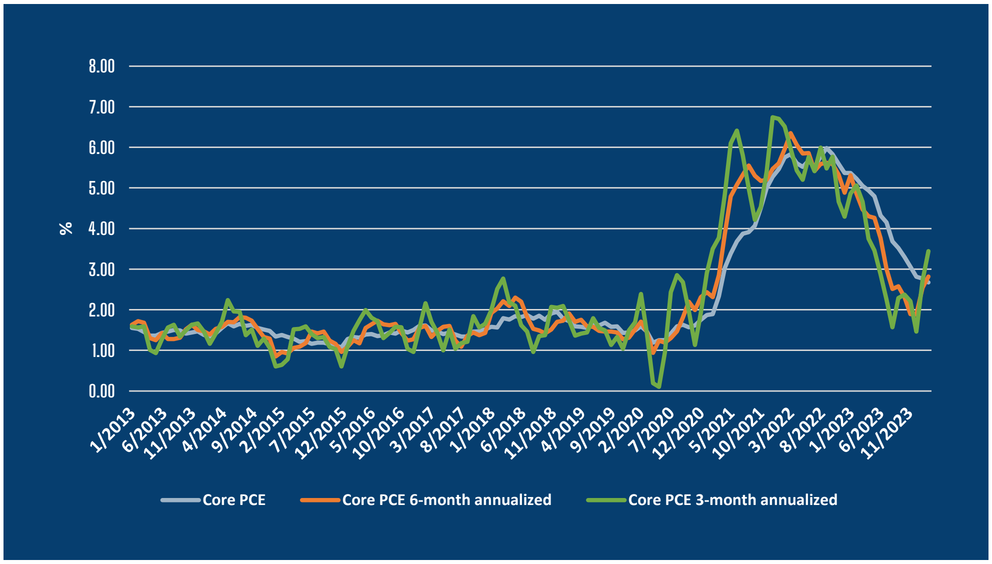
Inflation

Core Inflation

Personal Consumption Expenditures less Food & Energy

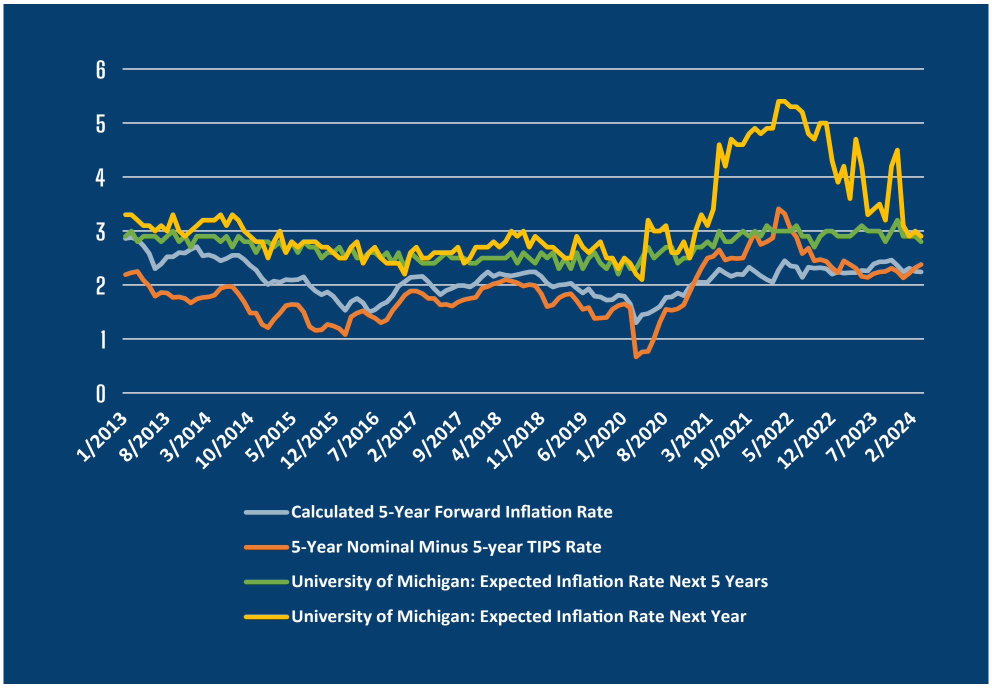


As of February 29, 2024
Source: Haver

- Inflation continued to decline during the first quarter on a year-over-year basis and is nearing the Fed's target.
- The Fed's favored measure of inflation (core PCE) fell to 2.7% (year-over-year) in February (latest data available).
- Housing-related inflation remains "sticky."

Inflation Expectations

Market- and Survey-Based Inflation Expectations



As of March 31, 2024
Source: Haver

- Survey-based inflation expectations remain high, relative to market-based indicators.
- Both have declined from peak levels this cycle.
- The University of Michigan-expected inflation rate for the next five years is 2.8%, while the five-year inflation rate from the spot TIPS market is 2.4%.
- The Fed pays close attention to inflation expectations as a leading indicator of consumer spending habits.

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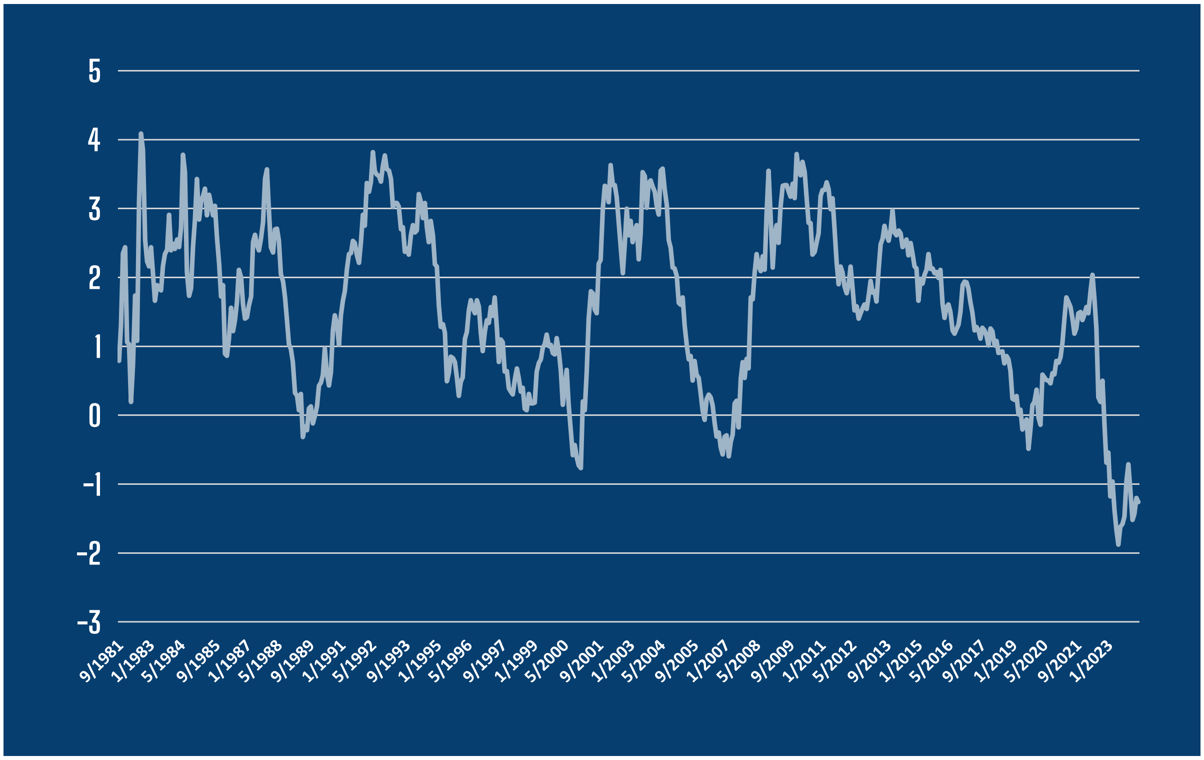
Recession Fears

Federal Reserve Bank of Saint Louis – Smoothed Recession Probability	Federal Reserve Bank of New York – Probability of U.S. recession predicted by Treasury spread, 12 months ahead (yield curve model)	Federal Reserve Bank of Cleveland – Probability of recession calculated from the yield curve	Federal Reserve Board – Excess bond premium implied recession risk over next 12 months	Bloomberg consensus of private economists
1.5%	58.3%	64%	18.2%	35%
Steady	Steady	Improving	Steady	Improving

Source: BFE, Haver

- Economists continue to worry about a recession in 2024.
- Yield curve-based models are forecasting a recession.
- The majority of other models and surveys are not.

Restrictive U.S. Monetary Policy
10-Year Treasury Minus 3-Month Treasury Bill



As of March 31, 2024
Source: Haver

- The yield curve (10 years versus 3 months) has been inverted for 17 consecutive months.
- This persistent inversion has increased fears of recession.

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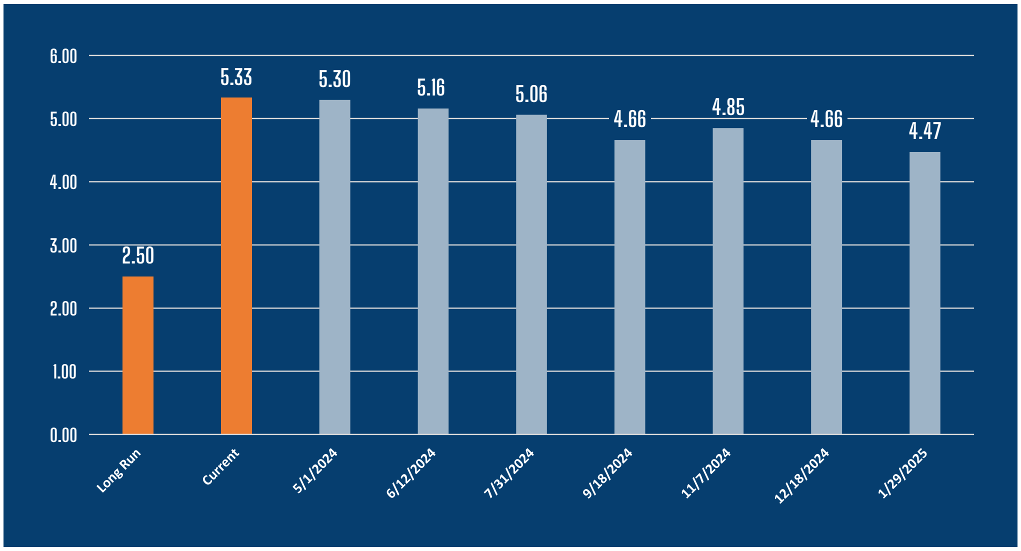
Monetary Policy

Implied Policy Rate (%)

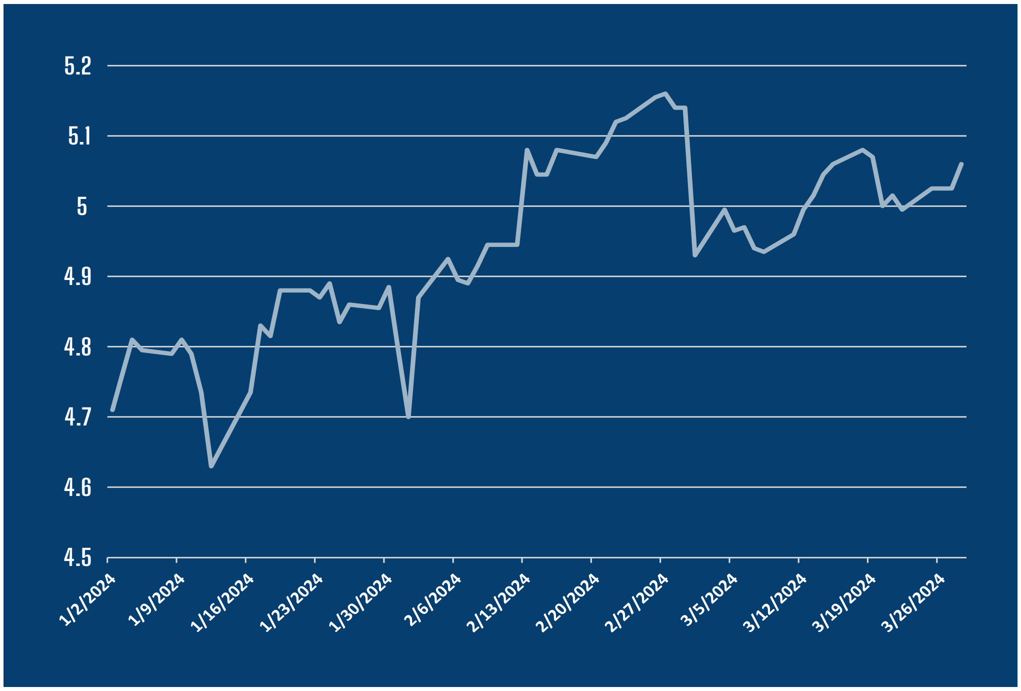


As of March 31, 2024
Source: Bloomberg

- Fed expectations were little changed during the quarter in terms of number of cuts.
- Market expectations and Fed guidance have converged around two to three quarter-point cuts this calendar year.
- Comments from multiple Fed officials have put forth that it is appropriate to wait until there is a clearer indication that inflation is slowing toward the 2% target before cutting rates. Recent strong data has pushed back the projected timing of those developments.

Implied Fed Funds Rate 6-Months Hence

%



As of March 31, 2024
Source: Bloomberg

- Fed funds futures show the change in Fed expectations over first quarter of 2023.
- The six-month contract (expected federal funds rate six months from now) yield increased over the quarter.
- Stronger-than-expected inflation data has pushed expectations of interest-rate cuts further into the future.

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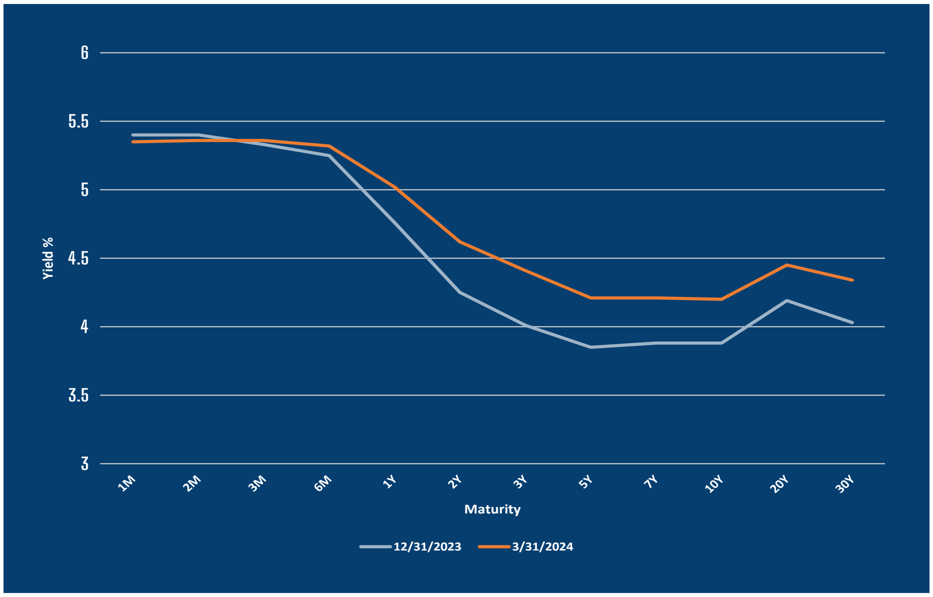
U.S. Treasury Curve

Yields at the longer end of the yield curve rose intra-quarter as inflation exceeded expectations early in the year. This raised concerns about the timing and magnitude of any changes by the Fed to policy.

U.S. Treasury Yield Curve



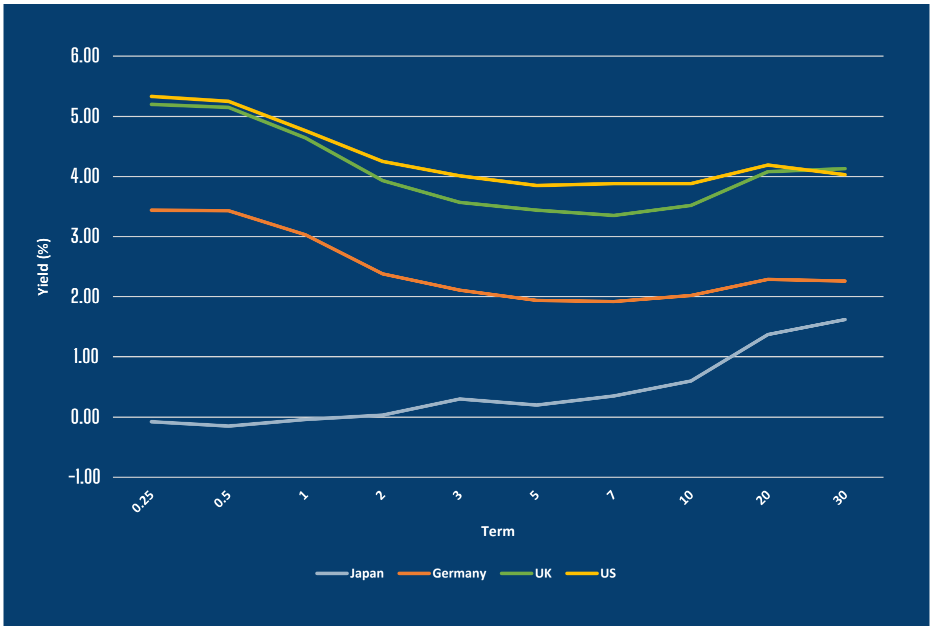
Source: Bloomberg

Government Bond Curves

Global bond yields were mixed during the first quarter as monetary policy is at/near an inflection point in many countries.

Government Bond Yield Curves

End of Q4 2023



As of December 31, 2023
Source: Bloomberg

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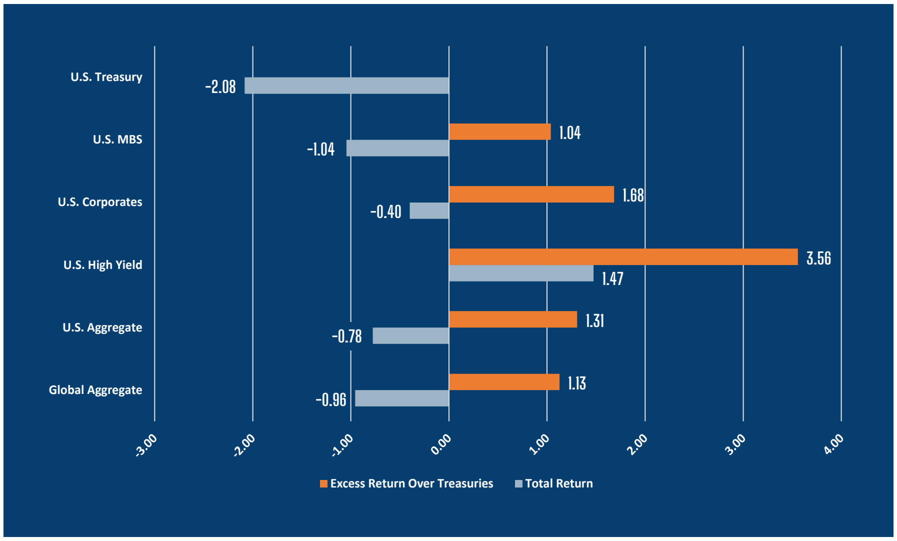
Fixed Income Performance (Q1)

Rising yields were a headwind for fixed-income investors in the first quarter. The benchmark Treasury index was down over 2%, and only high yield posted positive returns for the quarter. High yield was aided by "carry" of more than 7.5% and stronger equities.

Fixed Income Performance

Q1 2024



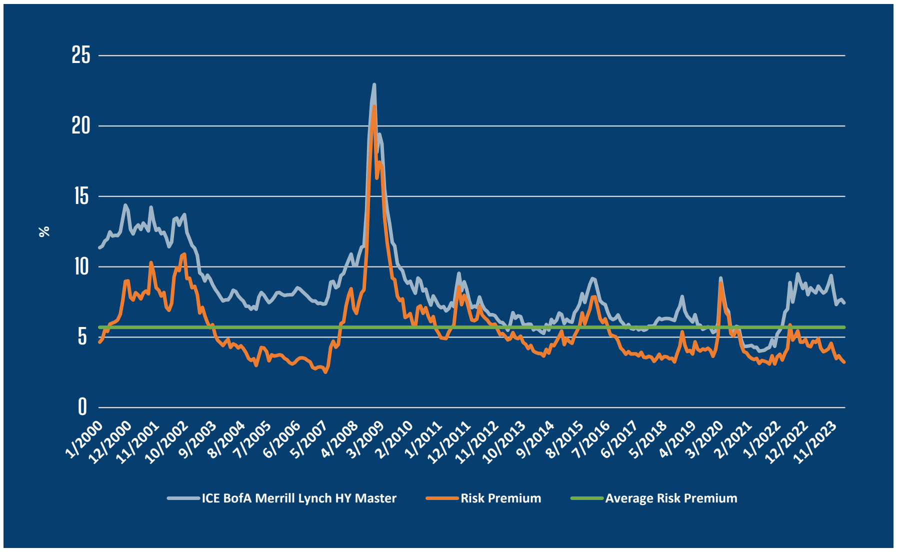
As of March 31, 2024
Source: Bloomberg

Credit

Strong equity markets provided a strong tailwind for high-yield bonds. Credit spreads remain narrow relative to history, but yields (carry) are compelling for multi-asset portfolios.

Junk Bond Yields vs. Junk Bond Spreads

ICE BofA Merrill Lynch High Yield Master less 5-Year Treasury



As of March 31, 2024
Source: Haver

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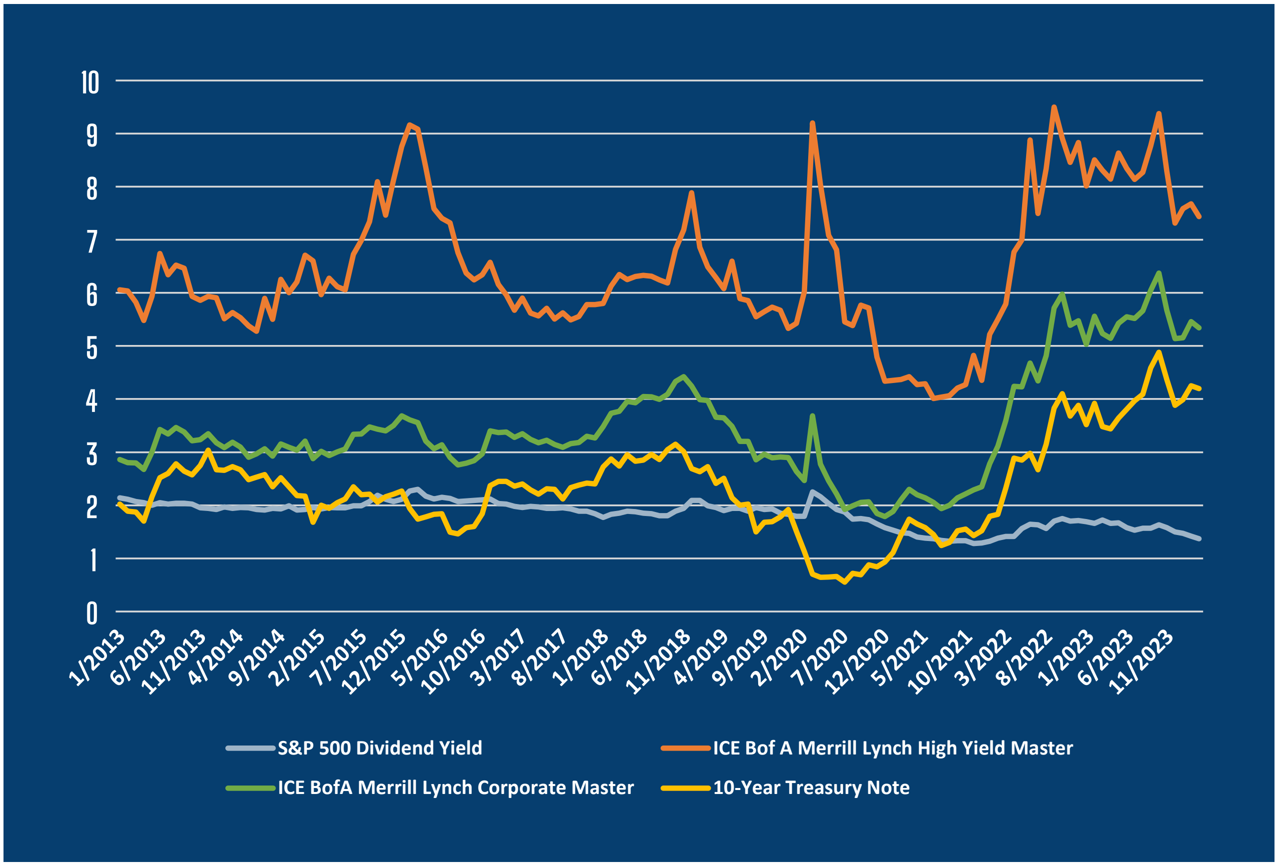
Credit

Fixed income continues to offer compelling yields, particularly relative to equity dividends.

Comparative Yields



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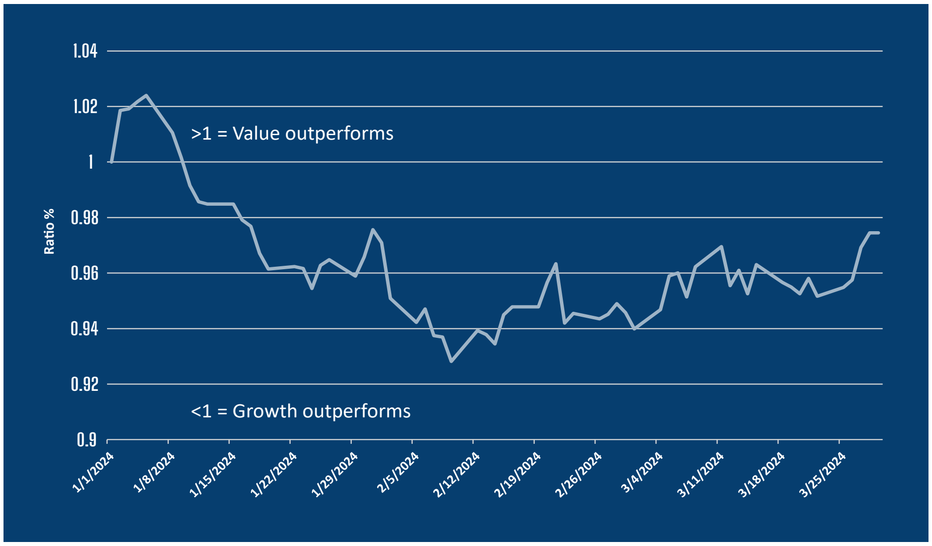
Equity – Value vs. Growth

Value outperformed growth across the size spectrum.

Large Cap Value/Large Cap Growth - Q1 2024

Russell 1000 Value/Russell 1000 Growth



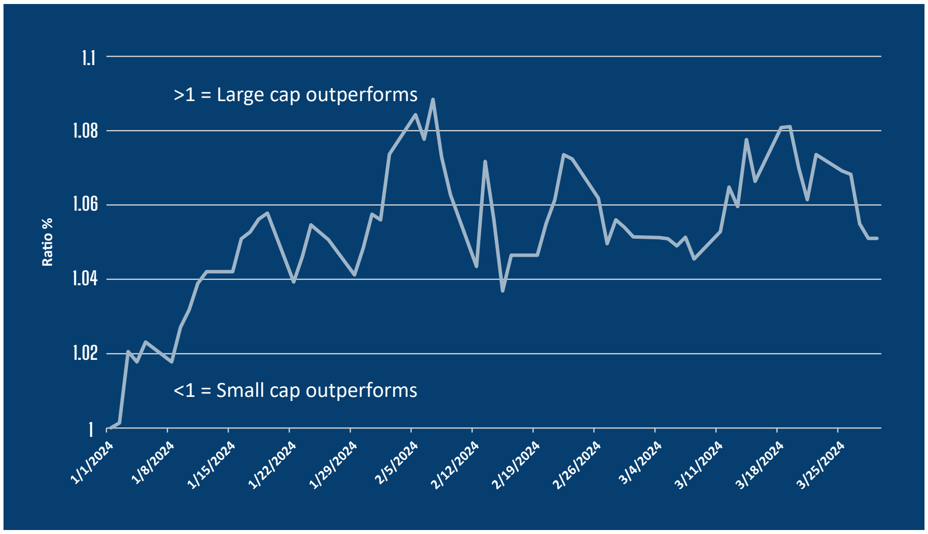
As of March 31, 2024
Source: Bloomberg

Equity – Large vs. Small

Large cap outperformed small cap during the first quarter.

Large Cap/Small Cap - Q1 2024

S&P 500/Russell 2000



As of March 31, 2024
Source: Bloomberg

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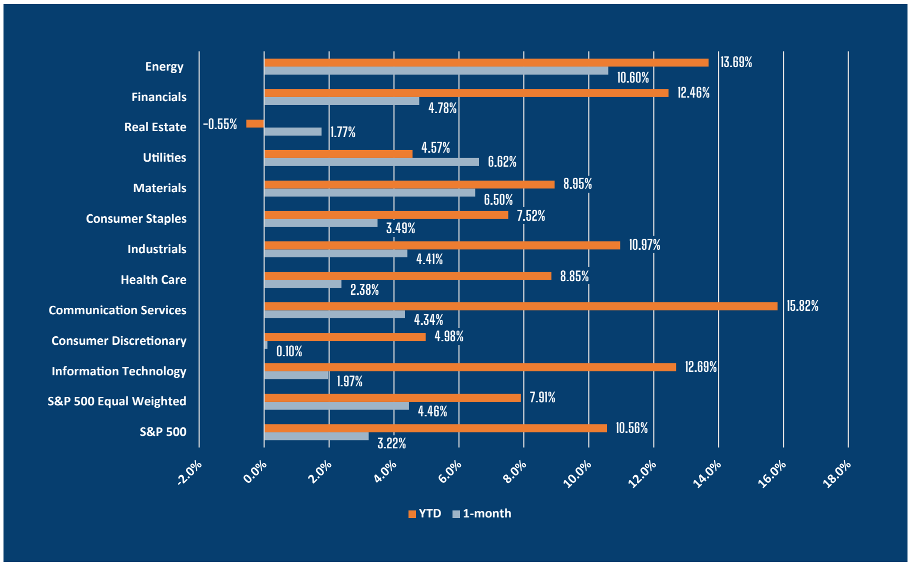
U.S. Equities – Return by Sector

The first quarter was very strong for equities, with all sectors higher. Market breadth broadened as evidenced by the performance of the equal-weighted S&P 500 vs. the cap-weighted index in March.

S&P 500 Sector Returns
Q1 2024

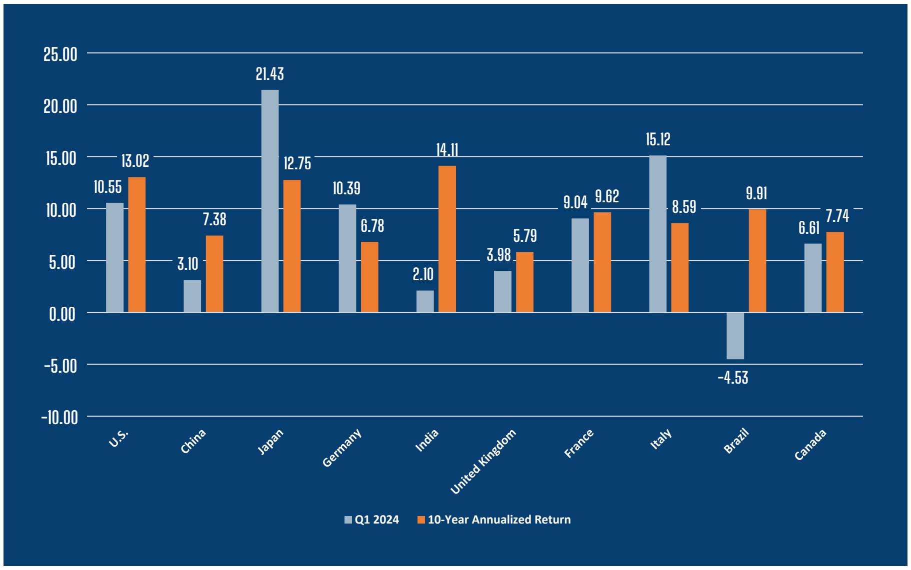


As of March 31, 2024
Source: Conway

Country Total Returns (%) – 10 Largest Economies

Global equities were generally higher for the first quarter with Brazil as the lone exception. Longer-term trailing returns have been very strong, led by the U.S. and, surprisingly, Japan.

Country Total Equity-Market Returns



As of March 31, 2024
Source: Bloomberg

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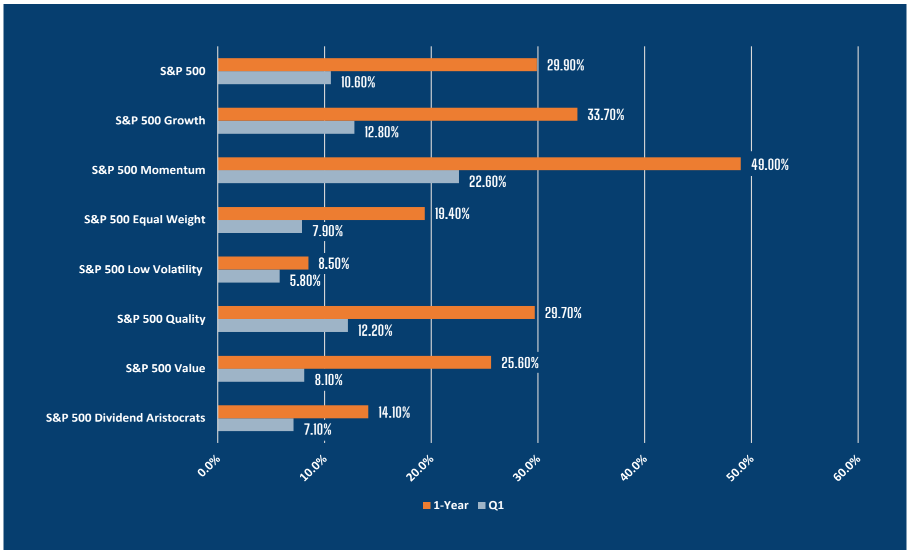
U.S. Equity Factors – Total Return Q1

Consistent with the broader markets, all of the core factors were broadly stronger in the first quarter, and all factors posted positive returns for the trailing year, with most in double figures.

Total Return: Core Factors
Q1 2024

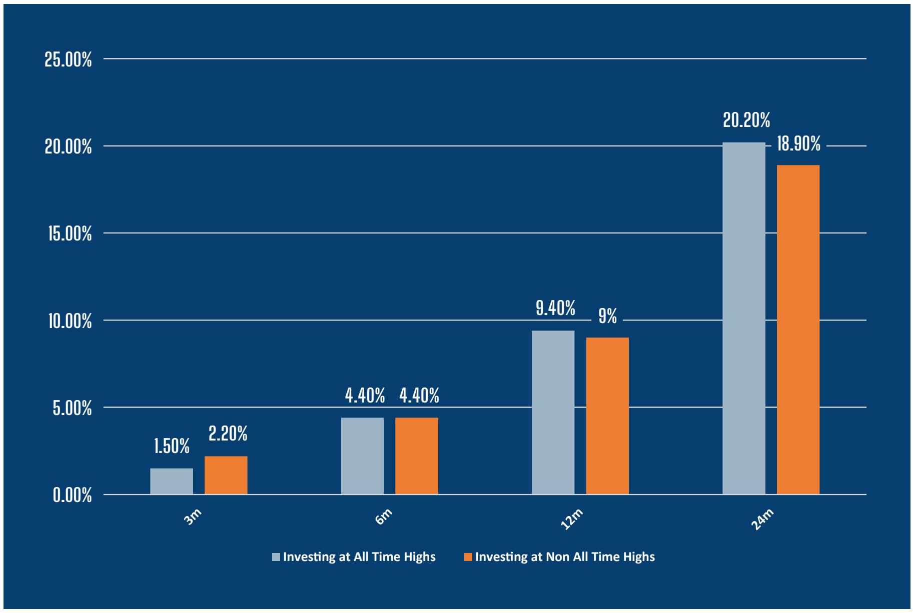


As of March 31, 2024
Source: S&P

Investing at Market Highs

The S&P 500 has achieved multiple record-high closes year to date. Over the long haul investing at all-time highs has not been detrimental to returns.

Investing at Highs Has Not Notably Impacted Returns
Average S&P 500 Forward Price Return Across Period: 1970-Present



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

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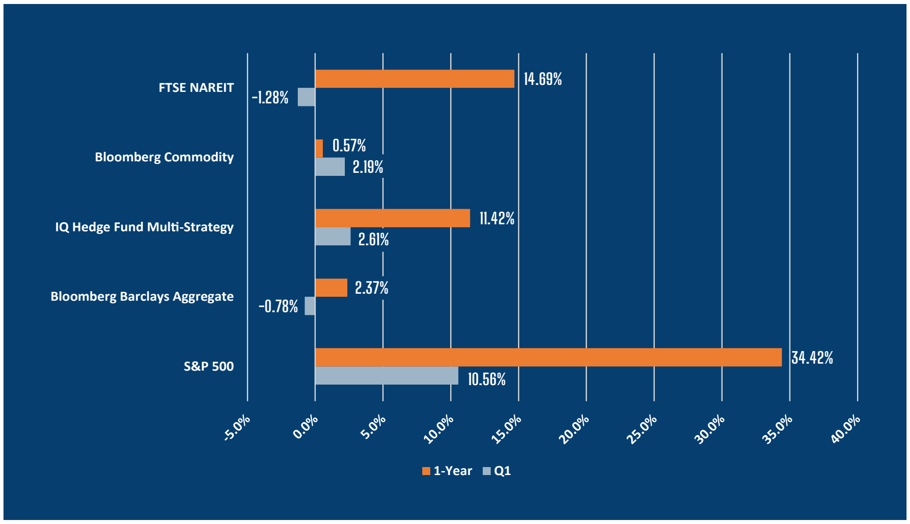
Alternative Returns

Alternative strategies and asset classes were generally positive in the first quarter and for the trailing year. Higher interest rates and broader equity market participation has helped hedge fund returns generally.

Alternative Returns

Q1 2024



As of March 31, 2024
Source: Conway

Oil and Gold

Oil and gold are both rising, with gold at record-high prices. Gold is often thought of as an inflation or fiat currency hedge while oil feeds inflation.

Oil and Gold Prices

As of March 31, 2024
Source: Bloomberg

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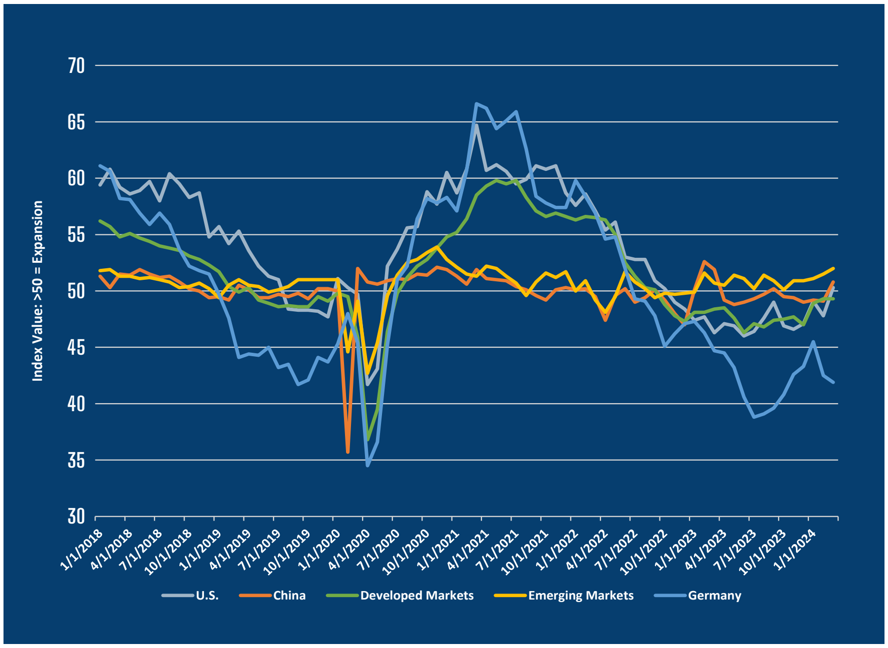
PMI Composites

The Purchasing Managers Index (PMI) is a survey-based measure of the prevailing direction of trends in the manufacturing sector. Readings >50 equal expansion and <50 contraction. Germany has trended lower in recent months while the U.S. is improving. U.S. manufacturing activity has been contracting for 16 consecutive months.

Global Manufacturing Surveys



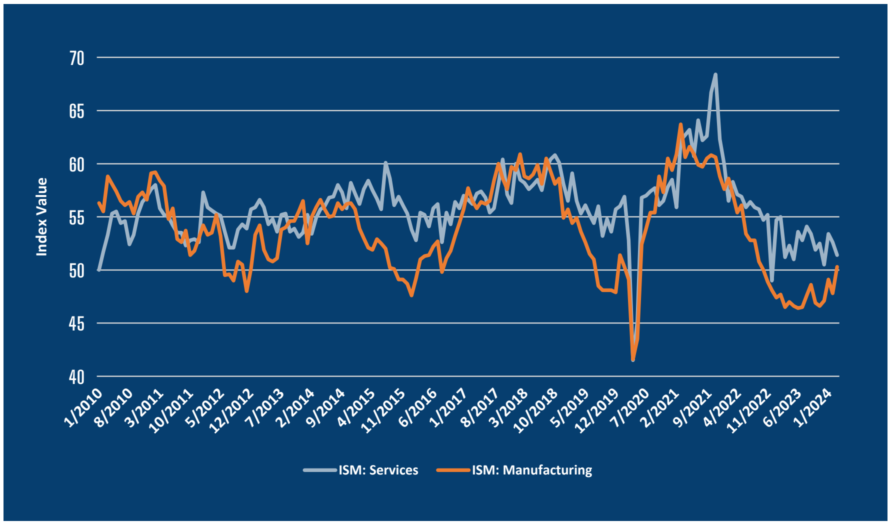
As of March 31, 2024
Source: Bloomberg, Haver

Manufacturing vs. Services

In the U.S., the service side of the economy remains in expansion mode versus the manufacturing sector. The most recent reading on manufacturing showed expansion (>20) for the first time since September 2022.

Institute for Supply Management Service and Manufacturing Surveys

>50=Expansion, <50=Contraction



As of March 31, 2024
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Manufacturing

Driven by improvements in new orders and production, manufacturing is showing signs of improvement. The hope is that employment gains will follow.

Institute for Supply Management Manufacturing New Orders

>50=Expansion, <50=Contraction

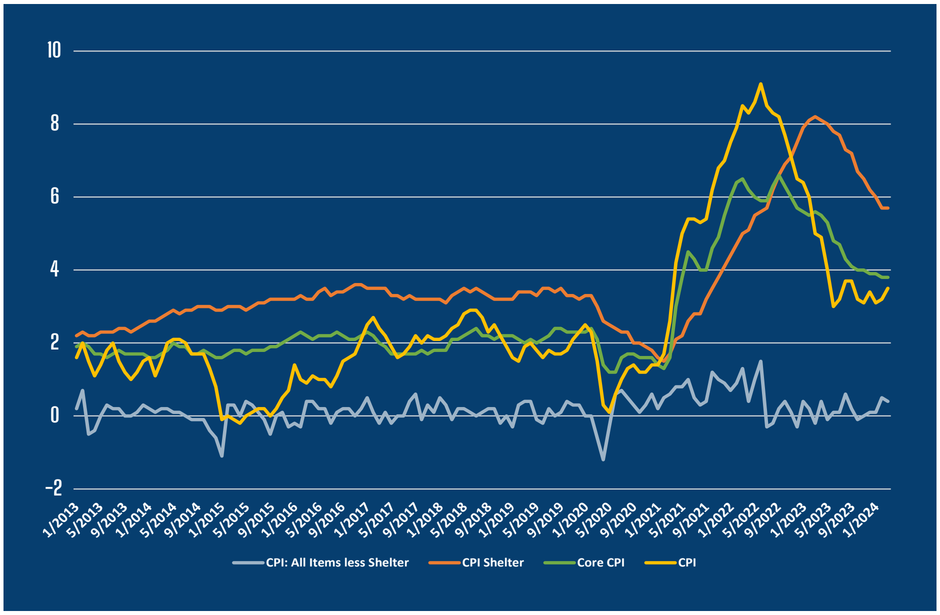
As of March 31, 2024
Source: Haver

Inflation

Inflation has surprisingly ticked higher in the first quarter. Housing (shelter) continues to remain stubbornly high. Shelter is the largest weight in CPI, accounting for 36.2% of the index. Shelter inflation is running at 5.7% year-over-year.

Consumer Price Index

% Change Year-over-Year



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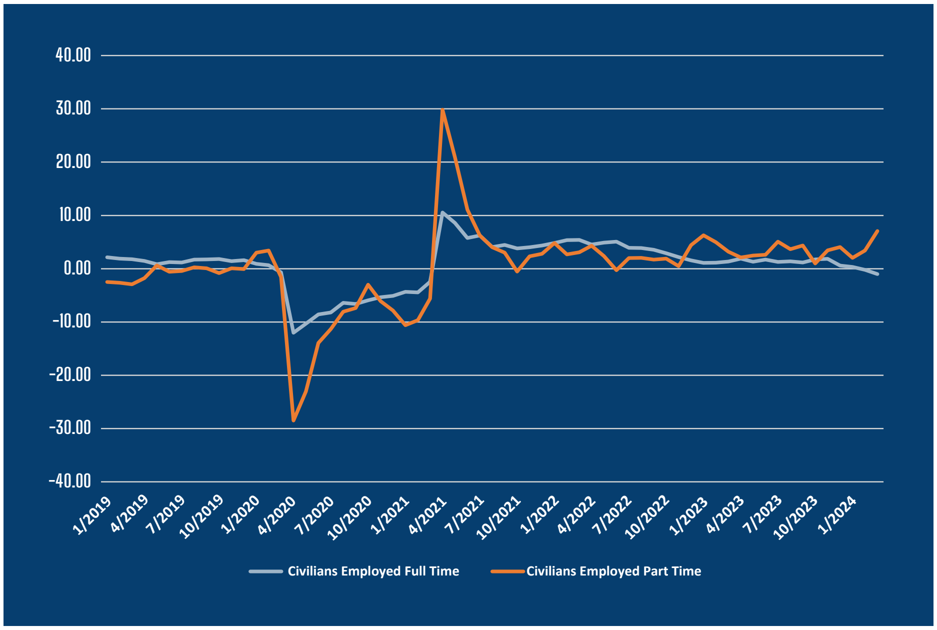
Employment

Part-time job growth over the past year has outpaced full-time job growth (+1.9 million vs. -1.35 million). Historically, a sustained period of such a trend has often signalized an impending recession.

Part Time vs. Full Time Employment

% Change Year-over-Year

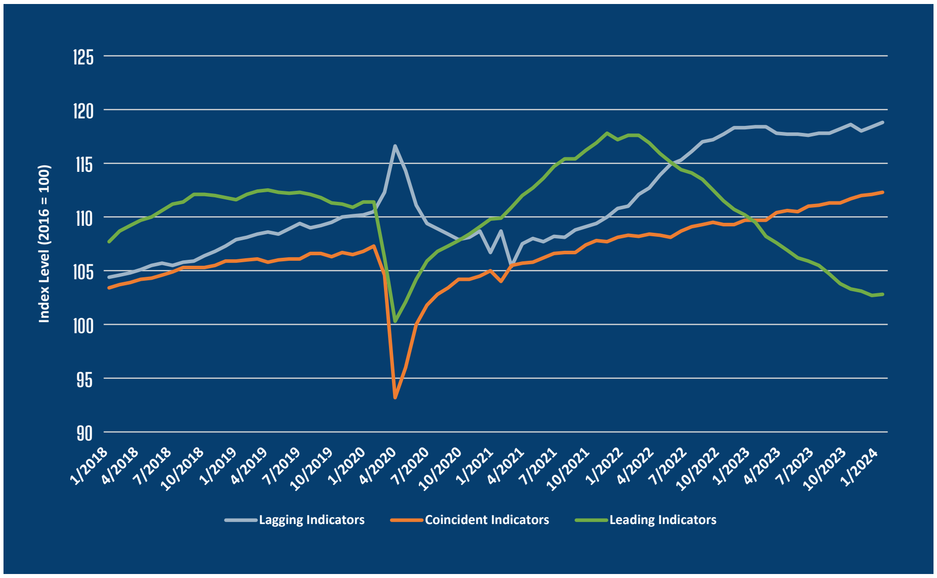


As of March 31, 2024
Source: Haver

Leading Indicators

Coincident and lagging indicators are still rising while leading indicators (down 21 consecutive months) paint a picture of a slowing economy. Leading indicators are consistent with what has been previously observed in recessionary environments, and this level of protracted weakness was last experienced during the Global Financial Crisis. Bearish economists point to this as a sign of a looming recession.

Leading, Lagging and Coincident Indicators



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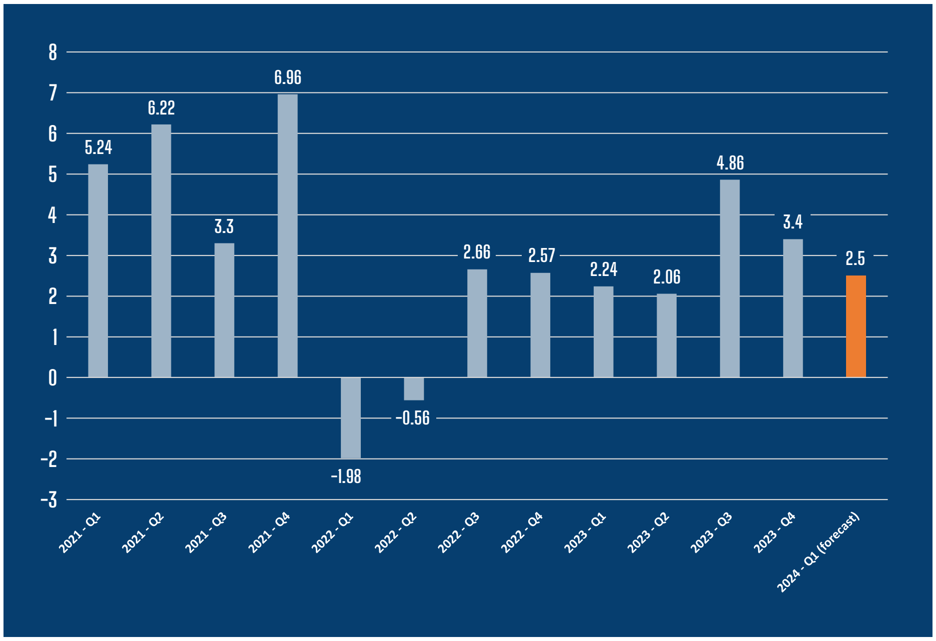
Growth

The first quarter is expected to grow at 2.5% according to the latest GDPNow forecast from the Atlanta Fed. That would be the third consecutive quarter at trend or above growth.

Real Gross Domestic Product

% Change - Annual Rate



Source: Haver, Atlanta Fed

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There are special risks associated with an investment in real estate, including credit risk, interest-rate fluctuations and the impact of varied economic conditions. Distributions from REIT investments are taxed at the owner's tax bracket.

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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