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"Spring Is in the Air"

Dear Clients and Friends: April 15, 2024

As spring approaches, the weather is starting to warm up. For the stock market, the temperature has been rising for a while now. Ever since "The Big Pivot" by the Federal Reserve last October, equity markets have steadily grinded higher. Upside surprises in economic growth with manageable inflation helped support a banner start to the year. Spring is in the air!

In the U.S., it certainly has been a steady grind. Since December, the S&P 500 has not experienced a pullback of even 2%. Every down day has been met with an immediate rebound. The index finished the first quarter strong, eclipsing 5200 for the first time and erasing the losses experienced from the 2022 bear market. This led to a 10% return for the quarter. Small cap and international stocks, while not back to all-time highs, also showed strength, returning 5% and 4% respectively.

Fixed income's performance was more mixed. Late last year, the 10-year Treasury bond yield fell from over 5% to 3.9%. The first quarter saw it drift back higher, settling at 4.2%. Higher yields result in lower bond prices, so longer dated bonds saw negative returns. The U.S. Aggregate Bond Index finished about -1% lower. Money markets and shorter dated bonds eked out small positive gains.

Threading the Needle

The past couple years brought mostly negative speculation, predictions, and concerns about the direction of the economy. It centered on the uncertainty posed from COVID and the way the Fed was fighting inflation. The Fed appears to have threaded the needle. The American economy is in a "soft landing" that is both lengthening and broadening. Economists' calls for a recession and job losses never really materialized. Now, it looks like the economy is reaccelerating out of its post-pandemic slowdown phase. Leading indicators have started to improve, measures of financial conditions have eased substantially, and gross domestic product (GDP) estimates are rising.

How have things been so robust against such gloomy predictions? The U.S. continues to be led by consumers, which represent around 70% of the economy. Post pandemic, their demand has been relentless. As inflation has declined, real wages are increasing, and consumer fundamentals are improving. Also considerable is the wealth effect. The rebound of the stock market from last year's lows has added $11 trillion to household wealth. Higher wages and larger 401Ks have kept people in the stores… or on Amazon.

Further factoring in are employment and immigration. This cycle's unemployment rate has stayed consistently below 4.0%, causing immense difficulties for businesses to hire and retain workers. Whether it was early retirements, regular retirements, or job "pivots," there have not been enough workers to fill all the available jobs. This resulted in wage inflation that has been passed on to consumers.

Immigration has started to help mitigate some of these issues. There is no denying

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that U.S. immigration policies are in dire need of repair and the chaos occurring at the southern border cannot be excused. However, a combination of both legal and illegal immigration appears to be having a positive side effect on the economy. Economists increasingly believe that the post-pandemic surge in immigration is a key reason the economy has been able to grow steadily without pushing inflation higher. New arrivals have helped employers fill the most difficult (lower wage/lower skill) jobs at levels of pay that have kept a lid on overall price growth. Immigration is expanding the workforce and creating new consumers at the same time.

The business community is also chipping in to growth. The sudden artificial intelligence boom means everyone needs an AI plan. This realization and the passage of the Inflation Reduction Act and CHIPS Act in 2022 resulted in robust business fixed investment spending. There is also a real intent for American businesses to reorganize their supply chains. China is slowly being replaced by logistically closer and perceived friendlier countries like Mexico. Rebuilding this infrastructure requires heavy spending and investment today to reap the benefits later.

Unfortunately, the pickup in widespread economic activity raises the risk inflation stalls in the 3% to 4% range. The last leg move from 4% back to the Fed's target of 2% was always going to be the most difficult, and is proving so. Energy and commodity prices were the first to roll over and help bring inflation down. They have recently bottomed and started modest moves higher. At the same time, housing, hotels, airfare, and specifically auto insurance are proving very uncooperative and sticky. Chairman Powell recently acknowledged some risk that higher inflation in recent months could presage a stalling in the disinflation trend and delay its rate cut projections.

Outlook

The broadening of economic growth is also translating into a broadening of profit growth and therefore stock performance. For several quarters we have talked about how narrow the market had become with a majority of the performance coming from just a handful of large technology companies. These companies' earnings took off last year on AI prospects. While the *Magnificent 7* has recently become the *Fabulous Four* (Tesla, Apple, and Google are now struggling), many other areas are starting to perform better. As expectations for rising earnings in an economy with stronger growth and higher inflation increase, hopes for a cyclical upswing are starting to be priced into the stocks that have lagged.

Cyclical laggards, like energy, materials, and the industrials, that were hurt by high interest rates and slower economic growth are now beginning to reflect hopes for a stronger broad-based economic pickup, with robust demand and rising pricing power. The pickup in growth in recent months raised the profit outlook for these sectors causing them to join the bull run. If we are heading into an environment where the Fed cuts rates slowly, over a longer period of time, these more traditional cyclical sectors will likely continue to perform well. In a situation where the Fed is forced to reduce rates quickly, defensive sectors, like healthcare and consumer staples, usually outperform. The assumption in the latter situation is a recession is usually in the mix. Since our client portfolios are usually more diversified and not concentrated too heavily in a few stocks or sectors, obviously we prefer the more broad-based economic outlook.

However, spring is not blooming everywhere. There are several points on our radar worth watching. The first is investor sentiment. Traditional measures of how investors feel are often contrary indicators. When everyone starts to become complacent, risk and stock market volatility are not usually far away. While not at extreme levels currently, five straight months of positive equity returns have investors pretty content.

There are also some concerns that the Fed's expectations for rates could get detoured. Any volatility associated with the stock market over the last eighteen months has generally been linked to when and by how much the Fed would reduce interest rates. Markets had been expecting six rate cuts starting about now. The Fed has been preaching fewer cuts and starting later in the year. The recent pickup in both growth and inflation has brought market and Fed expectations much more in line. However, it's understandable to ask the question of whether rate cuts are advisable at all for an economy that is just now coming off the inflation boil?

Chairman Powell's big headache is an economy that reaccelerates too much, requiring further rate hikes. This is the so-called "no-landing" scenario. An economy that ran too hot and stayed there was the fate of Paul Volcker, who led the Fed in the late 1970s and early 1980s. Volcker presided over a "double dip" recession as he fought inflation that at one point spiked to 15%.

It would be ironic if the same fate befell Powell, forcing another round of uncomfortable rate hikes, just as cuts are on the horizon. Volcker was a bit of a maverick who famously targeted the money supply as opposed to interest rates or the size of the Fed's balance sheet. It wasn't until his successor Alan Greenspan that we even got an official monetary policy statement after a Fed meeting describing their intentions. Clearly, the Fed is a different animal than it was decades ago – as is the U.S. economy – as is the world at large.

It's tempting to listen to Wall Street prognostications that handicap rate cut odds to three decimal places and predict exactly where stocks will be on the final day of the year. If the last several years have taught us anything, it's that everything seems unpredictable. Therefore, we work with our clients to build solid financial plans, diversified portfolios, and to be longer-term oriented with the purpose of easing uncertainty that comes our way.

Don't forget to stop and smell the roses, it's spring outside.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Stay safe and well.

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