Market Commentary

March 31, 2024

U.S. Equities Market

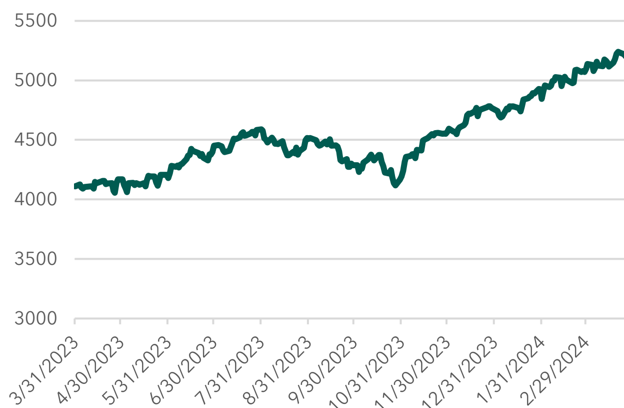
A Narrow Ascent

Equity markets had their best first quarter since 2019, with the S&P 500® Index finishing just over 10% higher. Communication Services, Energy, Information Technology, and Financials were the best performing sectors, with Real Estate being the only sector in the red with a very slight loss. Despite the strong performance of both Energy and Financials stocks, the Russell 1000® Growth Index outperformed its Value counterpart, and large-company stocks, as represented by the S&P 500®, slightly outperformed those of the small-cap focused Russell 2000® Index. Though this quarter saw more participation from the broader market, especially during March, equity markets in the last year have been quite narrow and influenced heavily by large-cap technology stocks. This quarter was no exception as the "Fab Four" – Nvidia, Microsoft, Meta, and Amazon – accounted for nearly half of the S&P 500®'s gain.

Despite higher interest rates, the economy and labor markets are doing better than most economists anticipated. The housing market is stable, and while consumer spending has slowed, it has been strongly positive. However, consumer demand, especially for services, has led to inflation remaining stubbornly above the Federal Reserve's (the "Fed") target level of 2%, though down substantially from a year ago. With inflation at nearly 3%, the Fed has kept rates higher for a longer period than most expected. As we begin the second quarter, rates markets now imply just a 50% chance of a Fed rate cut in June – far less likely than the near certainty expected just a few short months ago.

Market dynamics seem to imply a higher r*, which in economic models represents the "neutral" federal funds rate that neither stimulates nor inhibits growth. Key contributors may be resilient labor markets and fixed-rate mortgages that are less sensitive to near-term interest rate moves. Also, the economy has remained strong even as the Fed has increased its target rate by more than 525 basis points, suggesting that its current level may not be as restrictive as Federal Reserve Board Members expected.

The good news for markets is that this economic growth should lead to strong earnings in 2024. In fact, analysts estimate that earnings growth will broaden beyond the technology sector with other sectors recording faster growth by year-end. If such momentum can be sustained and inflation remain in-check, the Fed may lower rates and equities could continue their positive run. However, if inflation doesn't continue to fall and rates remain high, this could inhibit growth in the U.S. and exacerbate the lower growth rates already being seen globally.



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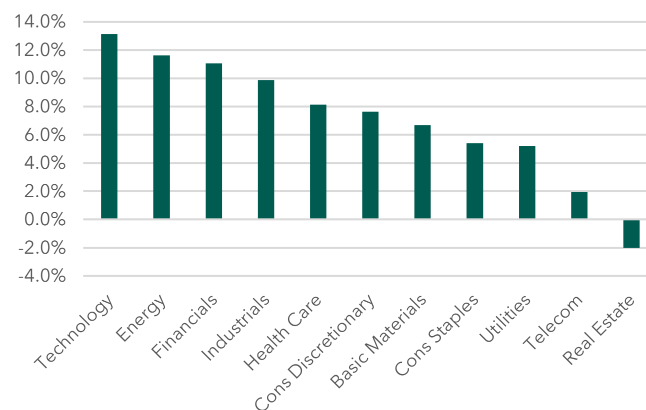

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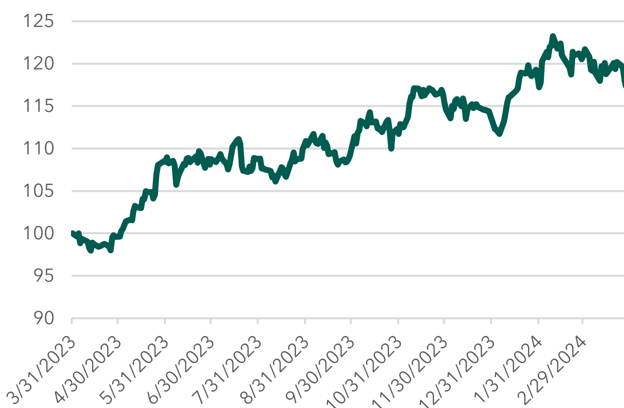

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U.S. Taxable Fixed Income Market

Heads You Win – Tails, Better Than You Think

Economic growth has decelerated in early 2024 versus 2023 but appears durable. The U.S. labor market continues to produce jobs in excess of 200,000 per month and the unemployment rate remains below 4%. Initial jobless claims point to a firm labor market. The U.S. Consumer's willingness and ability to spend money remains constant. Consumer spending, measured by the U.S. Personal Consumption Expenditure Index, is growing at 4.5% – above both pre-Covid levels and Gross Domestic Product (GDP) growth, but below the stimulus-fueled heights of recent years. Consumer financial obligations as a percent of disposable income – a reliable measure of consumer balance sheet health – sits at 14%, considerably below the long-term average of 16% and nowhere near the pre-Financial Crisis levels of 17-18%. However, inflation readings in early 2024 show inflation is still uncomfortably above target and the widely anticipated Fed rate cutting cycle could be as shallow as 2 or 3 cuts (down from 6 initially expected) in 2024.

This combination of a stronger economy and somewhat sticky inflation has pushed interest rates higher thus far in 2024. The current debate has shifted back to inflation, and whether or not it will fall enough to allow the Fed to begin lowering rates mid-year. Our way of thinking is less focused on the precise timing of the cutting cycle and more on the magnitude. We are considering two possible scenarios. The first is a continuation of the current backdrop – strong economy/labor market and slowly falling inflation. We would expect the Fed to take its time cutting rates and stop at a level that is higher than many expect – well above 3%. U.S. 10-Year Treasury rates (long rates) would likely be flat or up in this scenario. The second scenario centers on a rapidly deteriorating labor market – where we would expect the Fed to forget inflation and aggressively cut interest rates – stopping somewhere between 1-2%. Quickly cutting rates to this magnitude would meaningfully stimulate the economy and possibly avoid a deep recession, given the underlying consumer health. In either case, we are expecting a higher floor concerning interest rates driven from either a resilient economy or a Fed ready to aggressively defend the labor market and there by economic growth.

As investors embraced risk assets given the improved economic situation and outlook for Fed cuts, corporate credit spreads tightened significantly. Agency mortgage-backed securities benefitted less from this dynamic, offering an attractive alternative to corporate bonds by offering similar yields and less credit risk.

Source: Bloomberg

Source: Bloomberg

Source: Bloomberg, Federal Reserve Board

Market Commentary

March 31, 2024

U.S. Municipal Fixed Income Market

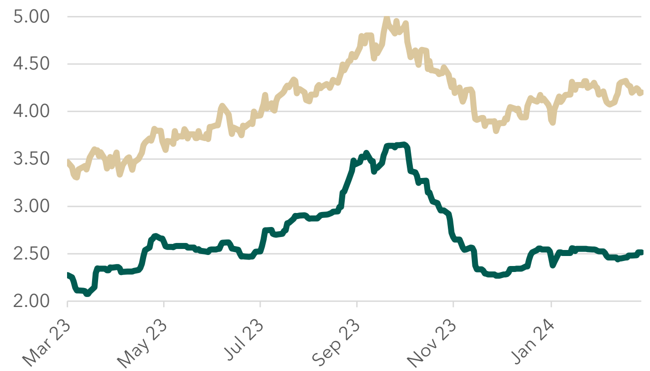
Demand Despite Uncertainty

The municipal market entered 2024 after of one of the most pronounced rallies in decades, as participants increased their expectations of Fed rate cuts late last year and yields fell sharply. However, as the first quarter progressed, incoming economic data was not fully supportive of this narrative, showing that both inflation and the labor market were not cooling at a pace consistent with the timing and magnitude of market anticipated easing. This was reinforced by updated Federal Open Market Committee forecasts which reiterated their view that fewer cuts would be warranted this year. This realization of a potentially higher-for-longer rate environment saw the 10-Year U.S. Treasury yield increase from 3.88% to 4.20% over the quarter and the Bloomberg 10-Year AAA Muni yield adjust from 2.27% to 2.52%.

Despite this upward move in yields, municipal demand remained strong, even in the face of what is a historically weaker seasonal period ahead of the April tax deadline and increased quarterly issuance of approximately $100 billion vs. the $75 billion brought to market this time last year. Leading the recent demand cycle has been the consistent growth in municipal managed account assets and a shift in flows within the mutual fund complex after investors pulled nearly $29 billion from municipal funds in 2023, according to Lipper data. Q1 of 2024 saw fund investors add approximately $7 billion, as tax-exempt yields remained well above their 10-year averages. Additionally, higher tax bracket investors remain keenly aware that tax rates could rise further as Congressional Business Office estimates show the U.S. budget deficit approaching $1.6 trillion in fiscal year 2024 and growing to $1.8 trillion in 2025.

This supply and demand imbalance has been a consistent theme within the municipal market since late last year, driving municipal-to-Treasury ratios from above 75% to approximately 60% in the 10-year portion of the curve. While it is possible that increased supply helps to normalize these ratios modestly in the coming quarters, most market participants anticipate that any weakness will be met by buyers looking to put cash to work and lock in longer-term yield levels. Household cash balances are estimated to be in the $400-600 billion range or higher.

From a credit perspective, municipal fundamentals remain broadly favorable. For state and local governments, a combination of higher economic growth, elevated home prices, and residual Covid-era stimulus have seen tax receipts rise and reserves balances bolstered. This, coupled with strong investor demand, has seen spreads tighten in similar fashion to the corporate market, with spreads between AAA and BBB municipals declining approximately 25 basis points over the quarter, placing even greater emphasis on the credit and security selection process as we look for relative value opportunities.



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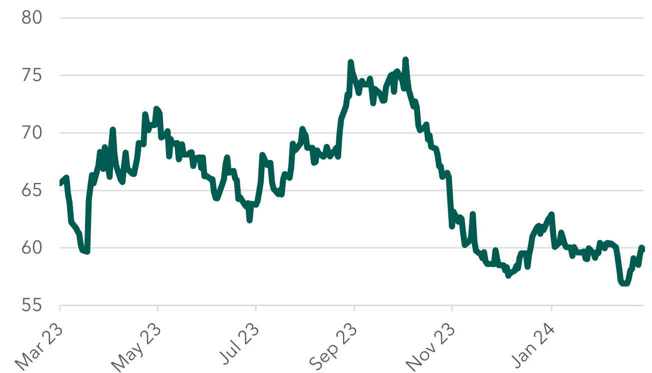

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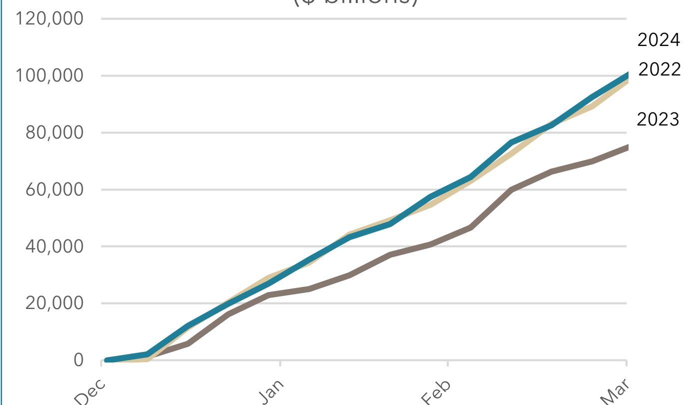

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International Equities Market

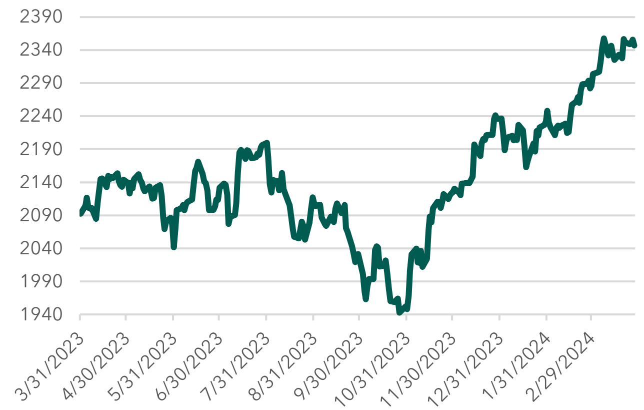
Mixed Signals

International equities generated positive returns in the first quarter of 2024. The MSCI EAFE Index led with a 5.8% return. The MSCI Emerging Markets Index returned 2.4%. Both segments underperformed domestic equities, which had a strong quarter. The dollar was a modest headwind to performance with the Bloomberg Dollar Spot Index appreciating 2.7%.

In developed markets, the quarter was a mixed bag. Japanese stocks continued to do well. The Bank of Japan (BOJ) finally ended its eight-year negative interest rate policy. The BOJ now believes "inflation is taking root." Europe, however, continues to be plagued by war. With U.S. support of the war in Ukraine wavering, Europe is scrambling to fill the gap. This has put pressure on fiscal resources, as well as supply of energy and materials. Adding to this pressure is the conflict in the Red Sea which is delaying the shipment of goods and material. Consequently, inflation remains higher than the European Central Bank's target taxing an already burdened economy and serving as another headwind to economic growth.

In emerging markets, the Chinese stock market set a new 5-year low before rebounding and ending the quarter with a positive return. Government intervention most likely played a role in the rebound. Their focus, rightly so, is on rebalancing the economy towards internal consumption and away from infrastructure and real estate investment. Regrettably, the government's mercantilist approach is hurting investor and consumer sentiment, delaying the economy's eventual recovery. In addition, China's inflation rate is now negative putting it into deflationary territory resulting in nominal GDP lagging real GDP for the first time. Driving these economic challenges are an aging and shrinking population, a rising unemployment rate, and declining consumer confidence, among many other factors. In contrast, Indian stocks surged, lifted by optimism about the country's growth trajectory. By the end of the first quarter, the Indian stock market index (SENSEX) reached all-time highs.

With respect to monetary policy, both the Fed and the ECB have indicated they will reduce interest rates sometime this year. Given how stubborn inflation has proven to be, it will be interesting to see if policy makers will be able to proceed with their plans. This has follow-on effects for international markets, as interest rate differentials have currency effects which in turn impact international investment performance. Inflation may serve as a leading indicator of their eventual actions and hence relative performance.



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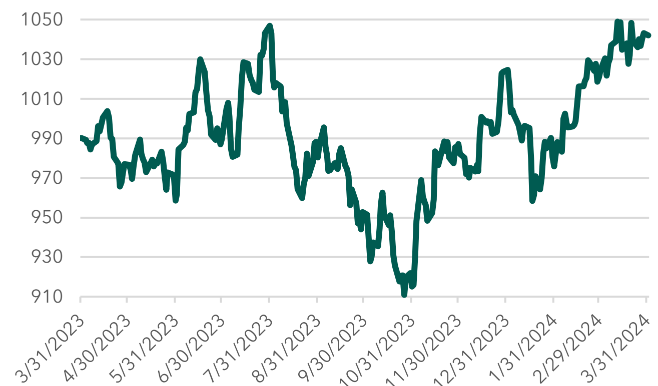

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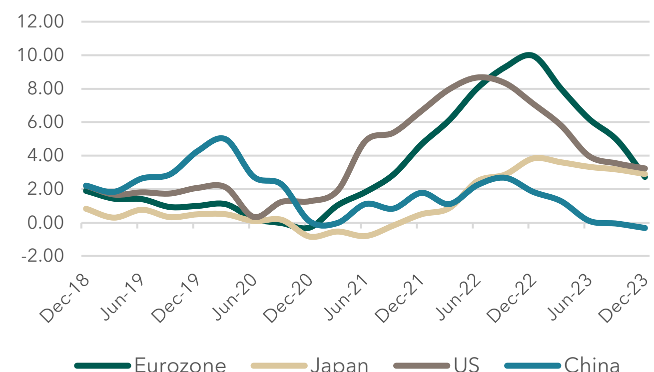

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Disclosures

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The S&P 500® Index is a gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

The Russell 1000® Growth Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected.

The Russell 2000® Index measures the performance of the small-cap to mid-cap segment of the U.S. equity universe. It includes the bottom two-thirds in terms of company size of the Russell 3000® Index.

The U.S. Personal Consumption Expenditures Index is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The change in the Index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

Gross Domestic Product (GDP) is the total monetary value of all finished good and services produced within a country's borders in a specific time period. It serves as a comprehensive measure of the country's economic health.

The financial obligations ratio is a national statistic produced by the Federal Reserve. It measures the ratio of household debt payments to total disposable income in the United States. The debt service ratio is a primary measure to assess the extent of American household indebtedness and to provide a view of the financial health of the overall consumer sector.

The Bloomberg AAA 10-Year Municipal Index is populated with high quality U.S. municipal bonds with an average rating of AAA from Moody's and S&P.

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The MSCI EAFE Index is broadly recognized as the pre-eminent benchmark for U.S. investors to measure international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia and the Far East, excluding the U.S. and Canada. Numerous exchange-traded funds are based on the MSCI EAFE Index, and the Chicago Mercantile Exchange, NYSE Liffe U.S. and the Bclear platform of Liffe are licensed to list futures contracts on this index as well.

The MSCI Emerging Markets Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The Bloomberg Dollar Spot Index tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar. It has a dynamically updated composition and represents a diverse set of currencies that are important from trade and liquidity perspectives.

The Consumer Price Index is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. It tracks changes in the purchasing power of a country's currency and provides information about inflation and price levels and is calculated using a representative basket of goods and services.