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April 1, 2024 – Investment Commentary

Equities
The S&P 500 returned 0.4% to end a stellar quarter for equities. The Fed's preferred inflation gauge came in in-line with expectations, boosting investors' hopes of a soft landing for the economy that will continue to drive profits for corporations. Value outperformed growth across market caps. Utilities (+2.9%) and real estate (+2.4%) were the best performing sectors in the S&P 500; information technology (-1.3%) and communication services (-0.8%) were the laggards. EAFE markets returned 0.1% with Japan (-1.0%) offsetting strength in Europe (+0.5%). EM markets returned 0.5% with positive returns in India (+1.5%) and Brazil (+0.8%).

Large companies, especially megacap technology giants, have helped equities march higher in the wake of the pandemic, with the major indexes sweeping to record highs in the first quarter of 2024. But over the past two quarters, small caps have begun to shine, too, as investors have bet on a resilient U.S. economy, a strong jobs market and easing inflation, all while expecting several interest-rate cuts this year from the Federal Reserve. The best performing Magnificent7 stock is up +82% YTD; the worst is down -29%. Deliberate stock selection even within the Mag 7 may complement a portfolio of passive solutions, where we anticipate performance should broaden out to the rest of the S&P 500 and abroad based on the trajectory of earnings growth in 2024.

From a valuation perspective, most markets are within ±1 standard deviation based on historical forward P/E ratios though the S&P 500 is at +1.9. For the next 12 months, EPS growth for S&P 500 is expected to be 8.5% (vs. 7.2% annualized over the last 20 years). For the next 12 months, EPS growth for NASDAQ is expected to be 37.5% (vs. 12.7% annualized over the last 20 years). The S&P 500 (US Large Cap) and NASDAQ trade above their 20-year averages based on forward P/E ratios, as does the MSCI EM (EM Equities), while the Russell Midcap (US Midcap), Russell 2000 (US Small Cap) and MSCI EAFE (Non-US Developed Market Equities) all trade below.

In the first quarter of 2024, the IPO market's green shoots grew further, with 30 IPOs raising a combined $7.8 billion. While deal
count was in line with the 1Q23, proceeds more than tripled, thanks to the continued return of larger offerings. Looking ahead, improving returns and an increasing IPO backlog signal a continuing IPO pickup through the spring and into the summer.

The strength in equity markets will likely persist for as long as the economy/earnings are resilient and bond yields don't rise in a disorderly manner. However, valuations increasingly putting pressure on the "margin of safety".

Fixed Income
Investment grade fixed income sectors had mixed returns as rates rose at the short-end of the curve. Municipals returned -0.2%, while US AGG returned +0.2% and US IG returned +0.3%. HY bonds returned +0.1% while bank loans rose 0.1%. EM debt returned +0.2% as the US dollar rose 0.1%.

Blue-chip corporates offered about $530 billon in investment grade bonds in the first three months of the year. This was the highest quarterly supply since the second quarter of 2020, or early pandemic, when more than $730 billion hit the market.

Corporates likely took advantage of two things: lower yields and investor demand. At the end of March, the effective yield on investment or high grade bonds was 5.36%. It has stayed largely unchanged in the first quarter, but is substantially down from the fourth quarter peak of 6.44%. That suggests a lower cost of borrowing for corporates. The supply also comes as investors are looking to nab higher yields on bonds before the **Federal Reserve** cuts interest rates. And there's also the question of a maturity wall. Nearly 15% of the U.S. investment-grade bond market is maturing in 2024 and 2025, according to **Fitch** estimates. This puts the spotlight on refinancing needs. April may be a different story. Yields have climbed and investors aren't so sure about all those Fed cuts after all. There could be a slowdown in issuance until the outlook is a bit clearer.

Rates

Rates rose at the short-end of the curve and fell at the long end. The recession-watch 3M-10Y spread compressed 1bps and closed the week at -118. The 2Y-10Y spread widened 3bps and is now -42. Rates were largely unchanged in other developed markets. The BTP-Bund spread is at 1.38%. 5-year and 10-year breakeven inflation expectations fell and now sit at 2.44% and 2.32% respectively; the 10Y real yield rose 3bps to 1.88%. The market now expects the Fed to cut 3 times in 2024, with the first cut now coming in either June (60% probability) or July (49% probability) vs the Fed's guidance of three cuts. At year-end 2024, the market expects the Fed Funds rate to be 4.5%.

When Wall Street says "Inflation" they are defining it in terms of the rate of change from last month. When Main Street says it, they're referring to the current cost of living, not focused on the pace but on the price itself. Two things are true at the same time, therefore: Inflation is slower today than a year ago. Prices are higher today than a year ago.

Currencies/Commodities

The dollar rose 0.1%. The commodities complex rose 1.5% as energy prices moved higher by 2.0%. Brent prices rose to $87/bbl. US natural gas rose 6.3%, still near its lowest levels in 5 years while European gas fell 1.6%.

Market monitors

Volatility was flat for equities and fell for bonds (VIX = 13, MOVE = 86); the 10-year average for each is VIX=18, MOVE = 76. Market sentiment rose to 28 from 16.