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April 8, 2024 – Investment Commentary

Equities

Last week, stocks and bonds (price down / yield up) were down. The MSCI Emerging Markets index outperformed the S&P 500 and the MSCI EAFE. The best performing sectors in the S&P 500 were energy, communications, and materials. Across U.S. Russell style & market cap indices, large-cap growth did the best and the momentum factor led more broadly. Oil rose to over $90/barrel amid escalating tensions in the Middle East, triggering a sell-off in stocks and a flight to treasuries and bonds. However, a blowout jobs report on Friday helped the market recover losses as traders put faith that the strong economy will power corporate earnings even if rates remain elevated. A 39-month streak of sub-4% unemployment marks exceptional labor-market growth, but recovering labor participation holds promise for keeping wage inflation at bay. Meanwhile, traders' risk-off behavior for the week showed fear of inflation's resurgence alongside geopolitical risk. Energy (+3.9%) and communication services (+2.5%) were the only sectors in the S&P 500 with positive returns; healthcare (-3.0%) and consumer staples (-2.7%) were the laggards. EAFE markets returned -1.3% with Japan (-2.6%) leading the way down. EM markets returned 0.3% with positive returns in India (+1.7%) and China (+0.7%).

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 8.6% (vs. 7.2% annualized over the last 20 years). For the next 12 months, EPS growth for NASDAQ is expected to be 22.3% (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.

There were a number of themes that may have contributed to a historically strong first quarter of 2024:

1. **Optimism over the economy**, as expectations from investors are for a “soft landing”, meaning moderating inflation without a severe recession.
2. **Expectations for lower rates**, despite indications of fewer or delayed interest rate cuts, the Fed still holds a dovish stance, expecting to cut rates later this year.
3. **Inflation continues to moderate**, broadly speaking, as we see continued reports of falling prices.
4. **Energy stocks have rebounded**, benefitting from rising oil prices, which reached their highest levels in almost ten years.
5. **Artificial intelligence continues to boom**, as other companies outside of the tech sector start to realize their full business opportunities

Fixed Income

Fed Chair Powell had a keynote address over the week and his take was that the recent incoming data does not “materially change the overall picture.” However, other FOMC members are starting to think the incoming data may not support as many cuts this year. Neel Kashkari (although a non-voting member) floated in an interview: “If we continue to see inflation moving sideways, then that would make me question whether we needed to do those rate cuts at all.” Which was likely the cause of the reversal in markets Thursday, causing the largest S&P 500 decline in 7 weeks. The strength in the economic data is not suggesting a need for rate cuts (especially given another relatively strong monthly jobs report). We have another big CPI report coming out this week, and we will see if the inflation trends suggest it as well.

Investment grade fixed income sectors had negative returns as rates rose across the curve. Municipals returned -0.6%, while US AGG returned -1.1% and US IG returned -1.2%. HY bonds returned -0.5% while bank loans rose 0.1%. EM debt returned +0.1% as the US dollar fell 0.2%.

Rates

Rates rose across the curve as the strong jobs report pushed out expectations for the timing of the first rate cut. The recession-watch 3M-10Y spread compressed 20bps and closed the week at -98. The 2Y-10Y spread compressed 7bps and is now -35. Rates rose in other developed markets as well. The BTP-Bund spread is at 1.42%. 5-year and 10-year breakeven inflation expectations rose and now sit at 2.50% and 2.37% respectively; the 10Y real yield rose 15bps to 2.03%. The market now expects the Fed to cut 3 times in 2024, with the first cut now coming in either June (50% probability) or July (50% probability) vs the Fed's guidance of three cuts. At year-end 2024, the market expects the Fed Funds rate to be 4.6%.

Currencies/Commodities

The dollar fell 0.2%. The commodities complex rose 3.5% as energy prices moved higher by 4.5%. Brent prices rose to $91/bbl. US natural gas rose 1.2%, still near its lowest levels in 5 years, while European gas fell 2.5%.

Market monitors

Volatility was higher for both equities and bonds (VIX = 16, MOVE = 94); the 10-year average for each is VIX=18, MOVE = 76. Market sentiment remained bullish at 25.