First Quarter 2024 Key Takeaways:

In the first three months of 2024, the U.S. economy remained resilient despite short-term interest rates sitting near 20-year highs.

Robust labor markets, strong corporate earnings and the prospect of Fed rate cuts provided a supportive backdrop for stocks.

The U.S. economy has continued to prove resilient. A main driver of this better-than-expected economic growth has been the continued strength of the U.S. consumer.

Inflation (CPI) has declined meaningfully over the past year, falling from 6% to just over 3%, though still above the Fed's long-term target of 2%.

Lowered expectations for a rate cut from the Fed have led to choppiness in the stock and bond markets recently.

Given supportive U.S. economic data, a contraction in the U.S. economy seems unlikely at this time. With the economy seemingly on firm footing, there's less reason for the Fed to cut rates to stimulate an already growing economy.

Years of low interest rates have left most corporations in good shape. As a result, the recent spike in rates is having a more muted effect than has been the case in the past, when rates were already elevated prior to the Fed raising rates.

U.S. large growth company stock valuations remain significantly elevated relative to historic valuation metrics. This should be concerning to investors, as an overdue correction in the values of these stocks could be the catalyst for a broader market selloff.

Market Recap

In the first three months of 2024, the U.S. economy remained resilient despite short-term interest rates sitting near 20-year highs. Noteworthy in the quarter was the continuing robustness in the labor market, stronger-than-anticipated corporate earnings, and a convergence of market participants' aggressive forecast of rate cuts with the Fed's own projections. Retail sales pulled back, but the trend remains positive.

These factors provided a supportive backdrop for stocks. The S&P 500 Index continued to reach new highs throughout the quarter, gaining 10.6% in the three-month period. Large-cap U.S. stocks (S&P 500 Index) outperformed small-cap U.S. stocks (Russell 2000 Index), and growth stocks (Russell 1000 Growth) again beat value stocks (Russell 1000 Value).

Developed International and emerging-market stocks also posted gains but did not keep pace with the U.S. market. Developed International stocks (MSCI EAFE) gained 5.8%, while emerging-market stocks (MSCI EM Index) posted a 2.4% return.

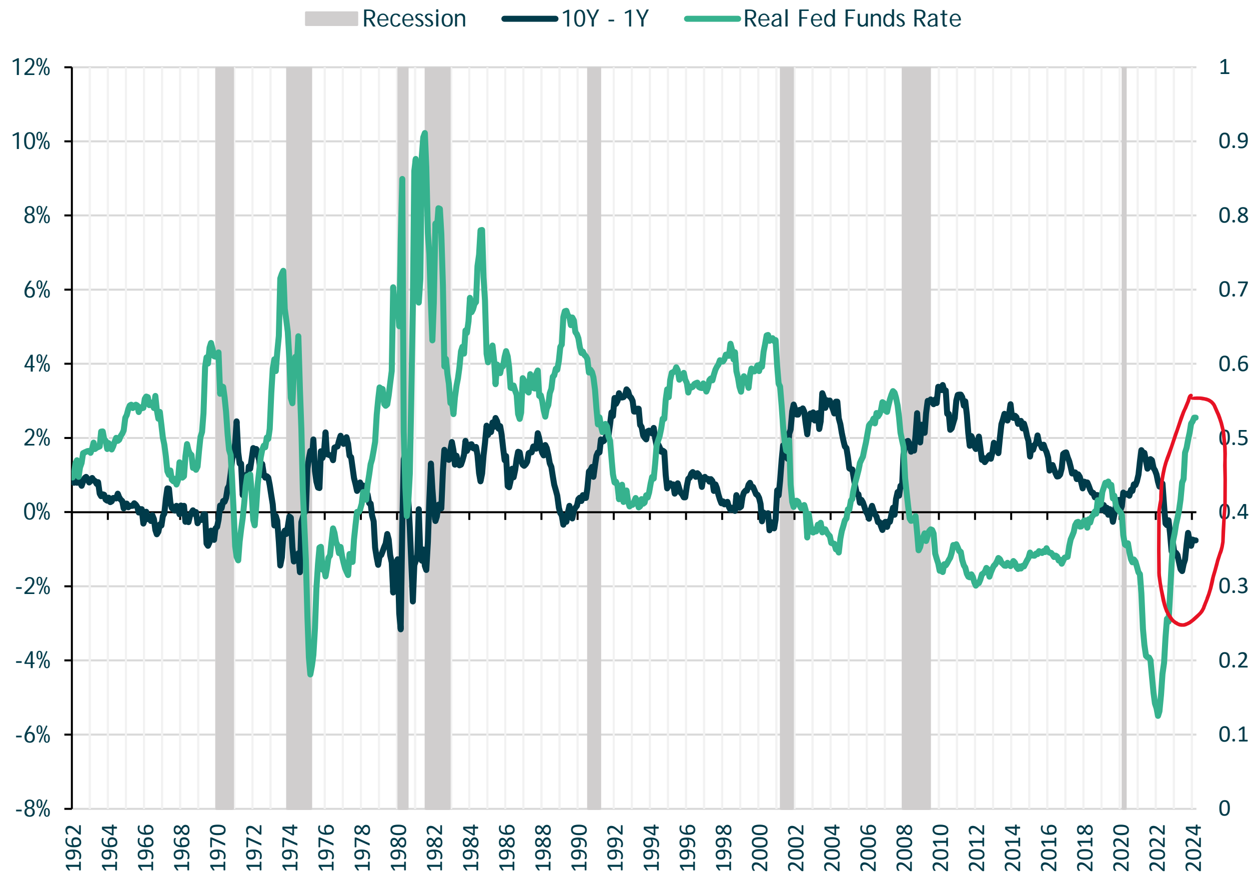
Bond returns were mixed as the benchmark 10-year Treasury yield rose from 3.88% to 4.20%, with market expectations for rate cuts tempered in terms of timing and magnitude. In this rising-yield environment, the more interest-rate sensitive Bloomberg U.S. Aggregate Bond Index declined 0.8%. Credit performed relatively well in the quarter, as high-yield bonds (ICE BofA High Yield Index) were up nearly 1.5%.

With three consecutive months of positive returns, some believe this bodes well for stocks in 2024. At the same time, there are some increasing concerns about investor complacency, as a few indicators are hinting at the possibility of a recession. All eyes continue to be on the Federal Reserve, with an increasing—but still low—possibility of an alternate scenario where rate cuts will not occur in 2024.

Investment Outlook and Portfolio Positioning

The U.S. economy has continued to prove resilient despite the Fed maintaining a higher level of interest rates for longer than most expected. A main driver of this better-than-expected economic growth has been the continued strength of the U.S. consumer. The combination of robust job gains and steady real income growth has allowed consumers to continue spending despite higher rates. The strong consumer has also benefited corporate earnings. And after a decade of near-zero interest rates, companies are generally well positioned financially with balance sheets that are healthier than they have been in past tightening cycles.

Inflation (CPI) has declined meaningfully over the past year, falling from 6% to just over 3%, though still above the Fed's long-term target of 2%. My expectation is that inflation will continue to trend lower over time, due in large part to shelter costs, which I expect to moderate.

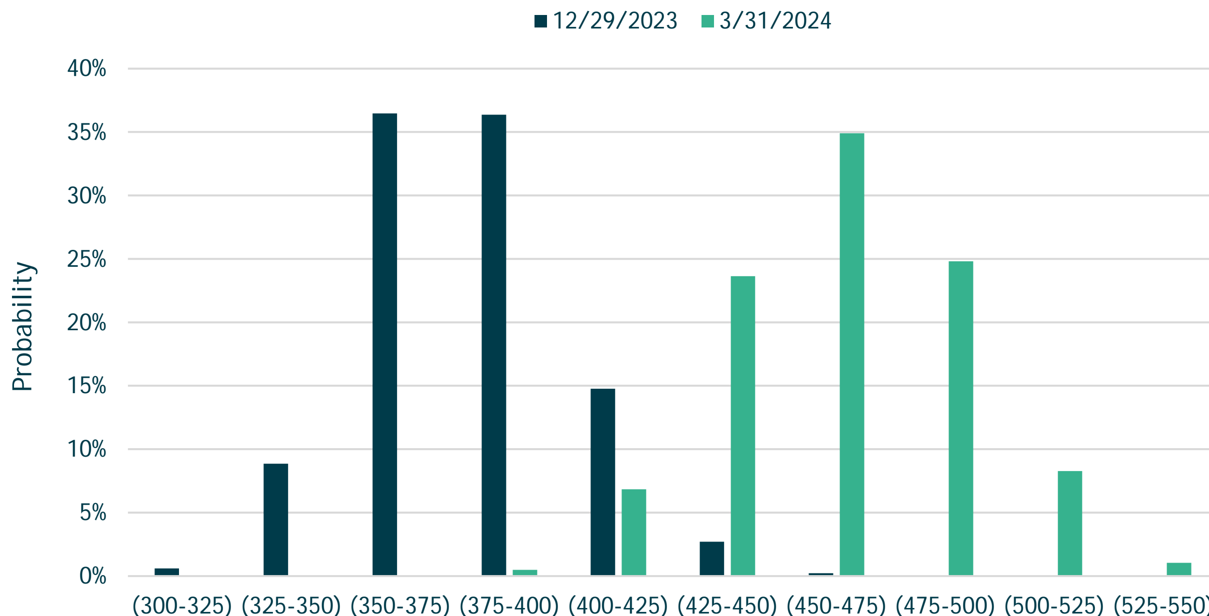


Source: Bloomberg. Data as of 3/31/2024.

With the steady decline in inflation, I believe Fed policy has crept into borderline restrictive territory. The chart above shows the Yield Curve (10-year minus 1-year maturity, blue line), alongside the real fed funds rate (i.e., fed funds rate net of inflation, green line). Going back to 1960, an inverted curve combined with a sharply higher real fed funds rate has preceded a recession (gray bar). In the most recent cycle, however, we can see that while the yield curve has been inverted since July 2022, Fed policy has been very accommodative for most of that time, i.e., the real Fed Funds rates were sharply negative when the curve first inverted. It's only more recently that Fed policy has started to move toward restrictive levels due to the combination of a higher fed funds rate and falling inflation. Simply put - to the extent that inflation continues to fall, and the Fed keeps rates unchanged, monetary policy will become proportionately more restrictive, and could reach a level that significantly slows the economy.

Economic growth in and of itself does not cause inflation, and ongoing modest economic growth is not a reason for the Fed to avoid cutting rates. However, persistent growth of around 2% does make it difficult to foresee aggressive rate cuts, and I've seen this reflected in the market's expectations for the Fed Funds rate during the quarter.

In the chart below, we see that at the beginning of the year, the market was anticipating fed funds' rate cuts from the current 500-525 (5.00% to 5.25%) to a range of 300-325 to 425-450 (shown in blue). But as of the end of March, the market's expectations (shown in green) have tempered, and the consensus is a range of 400-425 to 525-550. In other words, as of 12/31/23 the market expected rate cuts by the end of 2024 of 0.75% to 2.25%. But now the market expects rates cuts of a more modest -0.25% to 1.25%. This change in expectations explains in large part the recent choppiness in both equity and bond markets.



Source: CME Group. As of 3/31/2024.

With inflation still running slightly hot the Fed must balance cutting too early and potentially causing a second wave of inflation, against delaying cuts too long and putting pressure on the consumer and the economy. What the Fed ultimately decides will depend on the economic data that unfolds.

For now, U.S. economic data seems supportive of growth, not contraction. If the Fed can engineer a 'soft landing' of the U.S. economy with inflation converging to 2% and growth continuing, they can incrementally lower rates and ensure that policy does not become too restrictive. If a recession does occur later this year, the Fed will have the ability to swiftly and meaningfully cut rates given current levels.

I believe that inflation is under control for now, and that short-term interest rates have peaked and will likely decline slightly over the course of the year. For corporate bonds, I do not foresee a near-term risk of a spike in default rates given the still-attractive corporate fundamentals. In this environment, there is an opportunity to take advantage of the inverted yield curve, emphasizing short and intermediate-term higher-yielding securities with yields in the 5.0% to 6.0% range, while also maintaining some exposure to longer-term bonds with yields around 4.5% to 5%, which can also provide protection in the event of a stock-market downturn. And if long-term rates climb, I'll look at adding exposure to capture these yields while adding defensive ballast to portfolios.

Turning to portfolio positioning, after a broad review of portfolio exposures, which involved a deep dive into our bond allocation, I will be eliminating from portfolios that hold it the Schwab Treasury Inflation Protected Securities ETF (SCHP). With inflation moderating, prospective returns for this fund are limited. In its place, I will purchase a target maturity high quality corporate bond fund. I expect to identify the specific fund shortly and will send an announcement at that time. For most investors in taxable accounts, this will have a secondary benefit of realizing a capital loss on the sale of the Schwab fund.

One of the features of target maturity bond funds is that all the bonds it holds mature in *the same year*, so unlike most bond funds – which have no particular "maturity year" – these funds offer the certainty of $1,000 returned to the fund for each bond that matures, assuming of course the company that issued the bond doesn't default prior to maturity. By focussing on high quality corporate bonds or Treasury bonds, these funds hope to reduce the probability of defaults. If successful, these funds currently offer investors a known return, provided the fund is held through its target maturity year. And with rates up, those returns are looking attractive, especially if inflation continues to fall.

Because these target maturity bond funds are similar to our existing position in the Vanguard Intermediate Term Bond fund (BIV), I will be consolidating balances in the Vanguard fund into the target maturity bond fund. For most investors in taxable accounts, this will have a secondary benefit of realizing a capital loss on the sale of the Vanguard fund.

Finally, I will be reducing equity exposure and increasing hedged-equity exposure in our more conservative and moderate portfolios. Specifically, in our 25/75, 40/60 portfolios, I will eliminate allocations to international small companies and to U.S. small growth companies. The proceeds from these positions will go to the J.P. Morgan hedged-equity fund (HELO), which offers some downside protection should the market correct.

There will also be a few changes in our Dividend Payers portfolio, but I haven't completed my research just yet, so those changes will be announced shortly.

Closing Thoughts

The U.S. economy currently appears to be in in decent shape. The stock market continues to hit new highs as economic growth continues. There continues to be a high level of concentration in the "Magnificent Seven" stocks, which comprise about a quarter of the value of the S&P 500. In my view this creates relative opportunity in the remaining 493 stocks in the S&P 500, which have not seen valuations so stretched. The possibility of a recession isn't off the table by any means, but if it does happen the timing is likely pushed back until late this year or 2025.

As I look ahead, I anticipate there will be pockets of choppiness given headline risks related to Fed policy, geopolitical events such as the ongoing wars in Europe and the Middle East, and the upcoming U.S. presidential election (election years have historically been more volatile for the equity markets). In anticipation, I am prepared to be opportunistic and take advantage of any attractive risk/reward opportunities that arise.

Thank you for your continued trust and confidence.

Best,

Kelly D. Kane, ChFC, CFP©