Q1 2024 MARKET COMMENTARY

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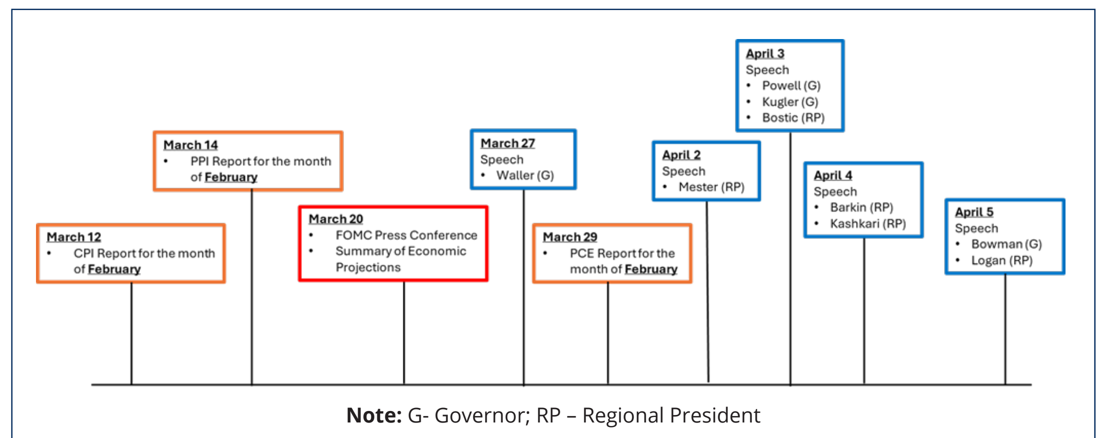
Introduction

Global equity markets had a strong start to 2024, continuing the momentum which started in November 2023 when the Fed indicated a pivot to its policy stance. Since then, the S&P 500 returned 25% (as of April 4, 2024). However, as we enter the second quarter, much of the uncertainty surrounding the Fed, economy and markets have returned. In this quarter's commentary we will explore these uncertainties and provide our perspectives on the respective issues.

The Fed



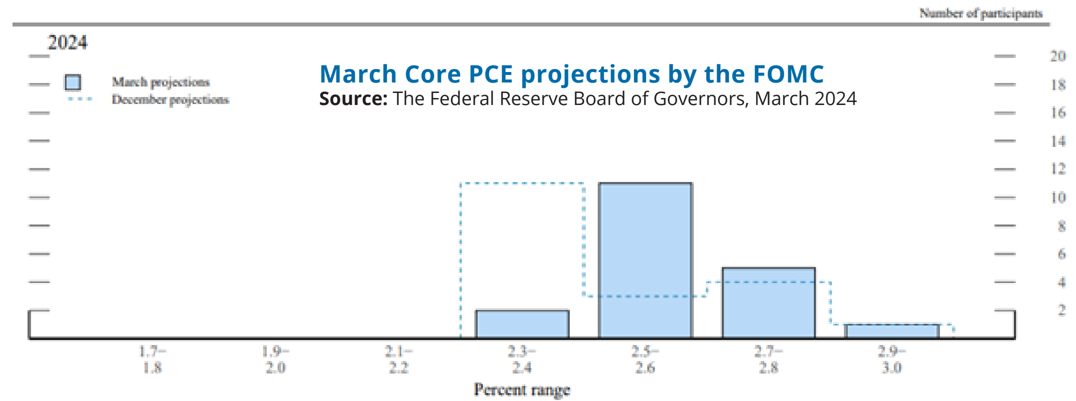
Note: G- Governor; RP – Regional President

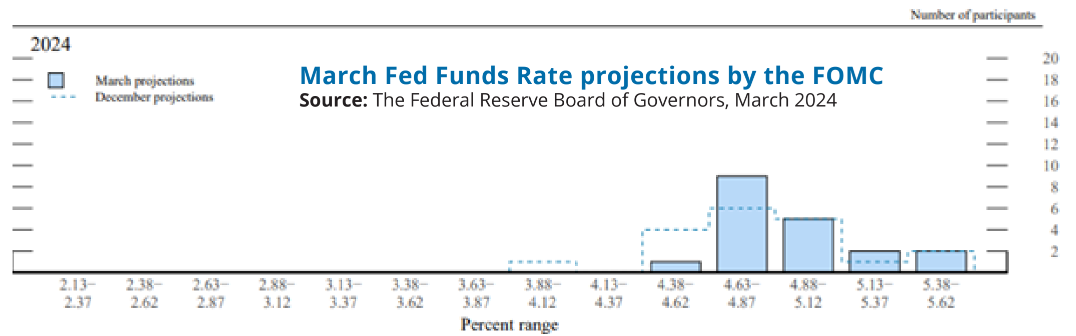
At the November's FOMC press conference, Jerome Powell hinted that rates may have peaked; this was further reaffirmed at the December's meeting, with the dot plot showing potentially 3 rate cuts in 2024 The message did not change in January and March (2024) either; furthermore, one could argue that Powell sounded dovish in March, indicating that the Fed would be open to lowering rates in response to any deterioration in the labor market conditions. Despite Mr. Powell's comments, market participants have been receiving contradictory signals since April; specifically from other voting and non-voting members of the Fed, who argue that the Fed may have to reduce the amount of rate cuts in 2024 or no cut at all.

Did the Fed pivot from its rate cut expectations? From March 27 to April 5, several FOMC participants delivered remarks on the economy and monetary policy, including Jerome Powell. While media outlets reported that rate cuts may not come in 2024, this message was not shared among everyone who spoke; specifically, both Mester and Kuglar indicated that their expectations for rate cuts are consistent with the FOMC projections, that is 3. Furthermore, Powell also didn't deviate too much from what he said in March. This by itself should give an indication that a pivot may not be the case, but there are more nuances to this development.

The more hawkish tone- that is fewer or no rate cuts, came from a larger group of the FOMC participants - Waller, Bostic, Barkin, Kashkari, Bowman, and Logan; however, both Kashkari and Logan are non-voting members in 2024. Their primary concern is inflation; specifically, its potential reacceleration and slower disinflationary progress relative to the one saw in 2023. However, such stance on rates and inflation is mainly a reflection of views held prior to the March meeting since the March PCE inflation report, which came out 9 days after the March meeting, unlikely to have changed their perspectives on the respective issue, mainly because the report didn't deliver any surprises. Furthermore, inflationary concerns that most cite were known prior to the March meeting (CPI and PPI reports were released before March 20); therefore, if pivot was the case, it would have come at the March meeting, not after. Indeed, looking at the Fed's core PCE projections, released as part of the March Summary of Economic Projections (SEP) material, most participants did revise their inflationary outlook upwards; furthermore, the rate distribution did shift rightward, but the majority view remained near the prior level, suggesting 3 rate cuts.

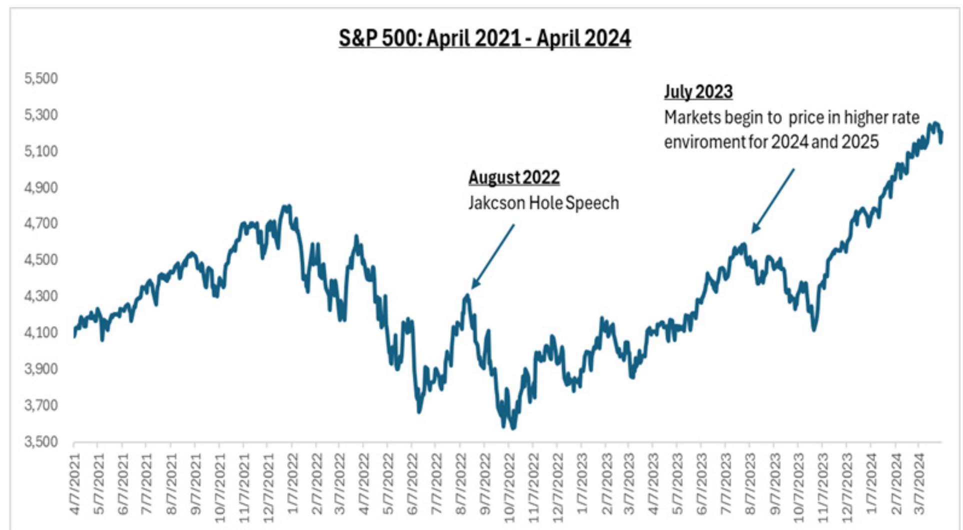
For that reason, what we are observing may not be indicative of a pivot but rather of a divide within the Fed: one camp (hawks) would like to wait a little longer before making a rate move, while the other camp (doves) does not mind taking preemptive action. However, the CPI report for March may have tilted the balance of power in favor of the hawks, and Powell may have no choice but to officially pivot at the next FOMC meeting. So, what implications do these developments have on the rate policy and the equity markets?





It is still too early to tell whether we will actually see less than 3 rate cuts this year. Looking at the Fed's FOMC meeting calendar, May and June seem unlikely at this point; however, July meeting is still far out (given that the meeting is right at the end of the month), and if the data moves in the right direction, the Fed may be inclined to move on rates then. If July is also out, then the rate move may not take place until after the election (the fed may be reluctant to make a move in September, right before the election, unless they absolutely have to). Nevertheless, this still leaves room for potentially 2 rate cuts this year – one in November (right after the election) and one in December. Therefore, from a probabilistic standpoint, 2 rate cuts still appear reasonable. This assessment looks like the ultimate outcome in 2024; however, in the interim, if rate expectation dip below 2, equity valuations can be vulnerable to a correction, similarly to the ones we saw in August 2022 and July 2023, when Fed's action deviated from market expectations.

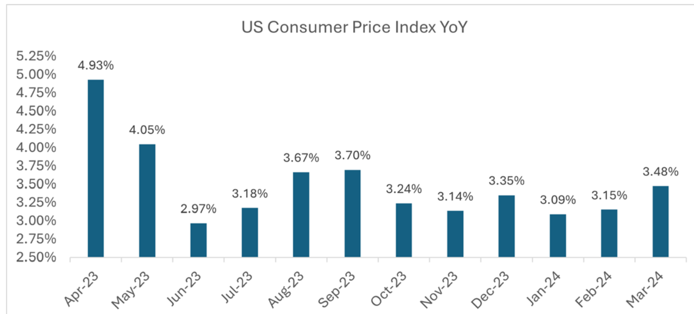
FOMC Meeting Dates	
May 1, 2024	September 18, 2024
June 12, 2024	November 7, 2024
July 31, 2024	December 18, 2024



Source: The Federal Reserve Board of Governors, Liberty One, March 2024

Inflation

Inflation has proved to be relatively sticky, with year over year inflation measures increasing for 3 consecutive months to start 2024. As pointed out earlier, several Fed officials are concerned with the stickiness of inflation.



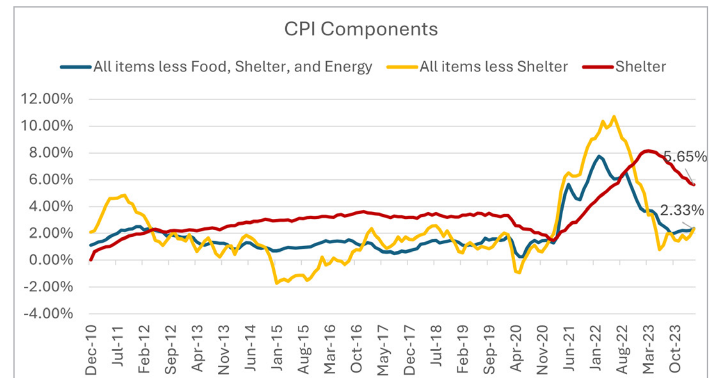
Source: Bureau of Labor Statistics, March 2024

At the individual component level, shelter and transportation services have been the primary forces behind the strong uptick in sticky CPI inflation. In the first quarter of 2024, transportation services accounted for approximately 2/3th of the total increase in MoM change in Core CPI less shelter inflation. Two areas driving the increase: motor vehicle insurance and motor vehicle maintenance and repair. Both are likely to be influenced by higher vehicle and components prices as a result of the pandemic. Additionally, it is also costing a lot more to repair and replace vehicles due to technological advancements in new vehicles. Sensor technologies, lane departure warning systems, and other tech features create complexities and additional vehicle expense. Anecdotal evidence suggests that vehicle insurance price increases may slow as insurance companies begin to lose pricing power in light of greater push back from customers. However, this is not yet reflected in the data.

	Transportation Services		
	January	February	March
MoM Increase	1.0%	1.4%	1.5%
Contribution to MoM Change in CPI all items less Food, Energy and Shelter	68.6%	66.5%	72.0%

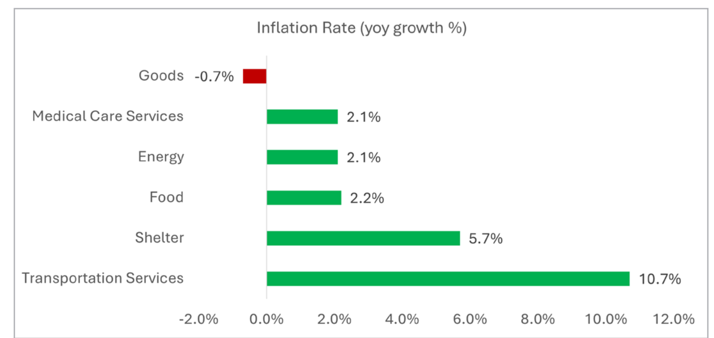
Source: Bureau of Labor Statistics. Authors Calculations

Shelter inflation has also been stubbornly high for some time. Current market rent measures point to a slower pace of rent inflation, which feeds into shelter inflation. However, this characteristic has yet to appear in the official data, and it is not clear when the measure will return to its pre pandemic level. A recent national development may explain why we are seeing some stickiness on that front, and reasons for concerns that shelter inflation may remain sticky or pick up in the future. This development will explored in a later section.



Source: Bureau of Labor Statistics, March 2024

Despite some challenges within shelter and transportation services, other CPI components are nonetheless showing encouraging signs of stabilization. For example, inflation within the "goods" component which include apparel, new and used vehicles, and other commodities have shown year-over-year declines in prices. Medical Services, Food, and Energy are also close to the Fed's 2% target, although Food and Energy tend to be more volatile.

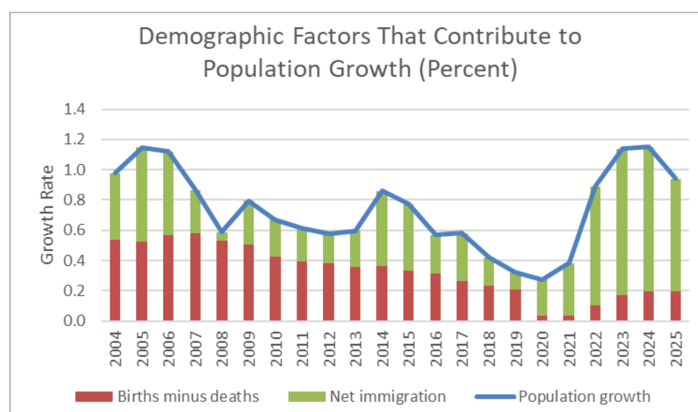


Source: Bureau of Labor Statistics, March 2024

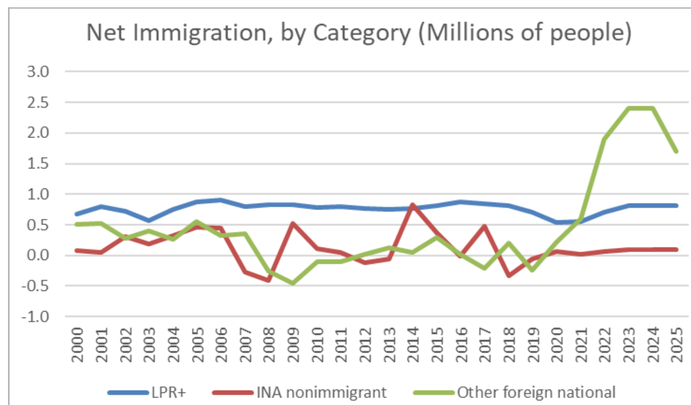
Immigration, Labor Supply, & Shelter Inflation

A strong economy could give the Fed additional time to be patient with their rate cut decisions. Positive real wage growth, a rise in stock and housing prices, and stimulative fiscal policies have all supported household sentiment which fosters spending. However, the main part of the economy that has defied all odds is the labor market, or more specifically, its remarkable strength despite a tightening cycle that began two years ago. Since the Federal Reserve began their rate hike campaign, the labor market has added 3.3 million new workers. In 2023 alone, seasonally adjusted total payroll growth totaled 2.78 million people, or approximately 232,000 workers per month (more than the 2010 to 2019 average of 189,000 workers per month). The momentum has not been lost in 2024 either, with the first quarter registering approximately 276,000 workers per month.

Why is job growth so strong while the unemployment rate remains low? Is this a sign of overheating? Well, these are the questions that most had pondered until January 18, 2024, when the Congressional Budget Office (CBO) released its estimates on population growth. The CBO estimated that in 2022 and 2023, net immigration inflows amounted to 2.6 and 3.3 million people, respectively; both numbers substantially exceeded the average of 0.9 million people per year from 2010 to 2019. Furthermore, CBO's estimates that for 2024 and 2025, 3.3 million and 2.6 million people will be added through net immigration inflows.



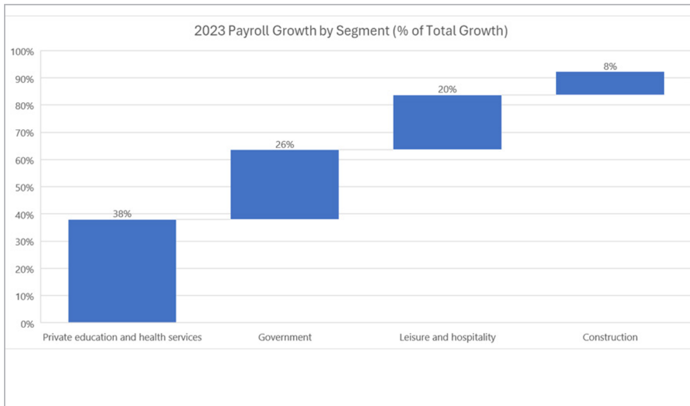
Source: Congressional Budget Office (CBO). 2024, January 18. "The Demographic Outlook: 2024 to 2054." https://www.cbo.gov/ publication/59697



Source: Congressional Budget Office (CBO). 2024, January 18. "The Demographic Outlook: 2024 to 2054." https://www.cbo.gov/ publication/59697

Note: *LPR+ category includes lawful permanent residents (LPRs) plus people who are eligible to apply to become LPRs on the basis of their current status, such as asylees and refugees; The INA nonimmigrant category refers to people admitted as nonimmigrants under the Immigration and Nationality Act (INA), including students and temporary workers; The other-foreign-national category consists of people in the United States who are not in the first two categories and who have not subsequently become U.S. citizens or received LPR, asylee, or nonimmigrant status—such as people who entered the United States illegally and people who were permitted to enter through the use of parole authority and who may be awaiting proceedings in immigration court.*

Large immigration inflow can in part explain the strong increase in the labor supply. As mentioned earlier, in 2023, total non-farm payroll increased by 2.78 million people, of which 4 segments – Private Education and Health Services, Government, Leisure & Hospitality, and Construction – accounted for approximately 92% of the total growth. Looking at the breakdown, it is unlikely that the immigration inflow had contributed to the supply of labor in Private Education and Government sectors; However, it might have contributed to the Leisure, Hospitality, and Construction sectors. Firstly, both Leisure & Hospitality and Construction do not require licensing or specialized training to be undergone in the US. Secondly, the language barrier in both segments is low. These two factors give employers an opportunity to absorb new labor supply with less friction.

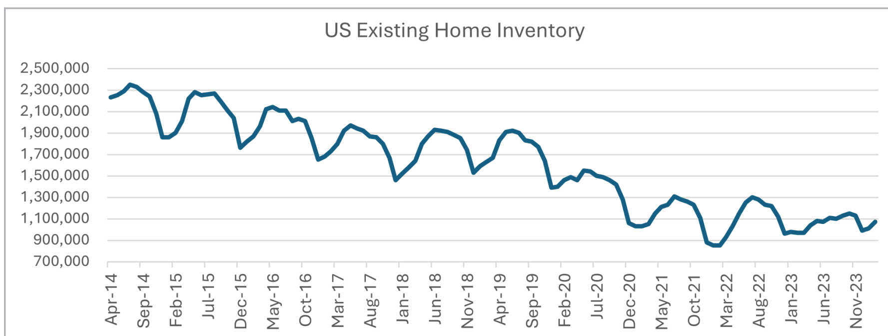


Source: Bureau of Labor Statistics, March 2024

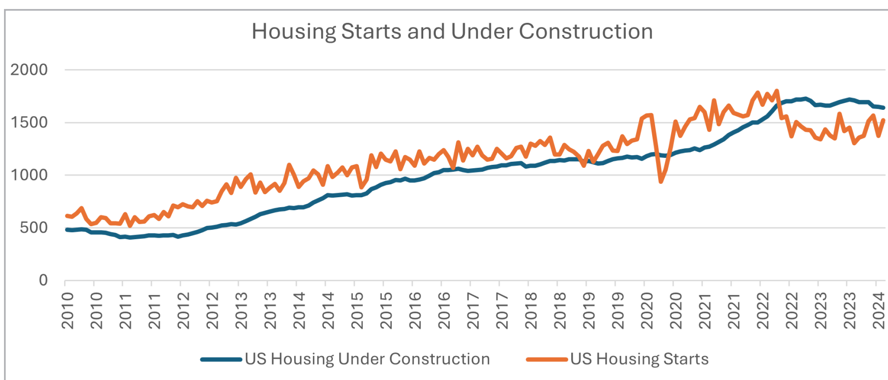
Given these developments, three takeaways can be made. First, the economy and therefore the demand for labor is strong; otherwise, the increase in the labor supply would not be absorbed. Second, given that the expected labor supply will likely continue to increase (due to CBO's projections of 5.9 million net immigration inflow in the next two years; although, this may depend on who wins the election), payroll growth can be a good gauge for the Fed to see whether economic conditions are cooling, without having to worry about inflationary impact since the labor supply pipeline is strong. Third, and the most concerning of the three, large inflow of immigration may be inflationary.

If the estimates are correct, and we do see an inflow of 5.9 million people over the next two years (2024 and 2025), that would bring net immigration inflow from 2022 to 2025 to 11.8 million. This is a considerable increase in population that could put upward pressure on rent inflation. With existing home supply already dropping to record lows and housing starts have declined since the onset of the Fed's rate hike campaign, we could see a continued imbalance in the housing market which puts upward pressure on rent inflation.

Given that there is a lot of uncertainty on how immigration inflow will ultimately impact the economy and inflation, coupled with other inflationary uncertainties mentioned in the inflation sections, a case could be made for the Fed to wait until the end of the year to see how things will develop before deciding on rates.



Source: National Association of Realtors, February 2024



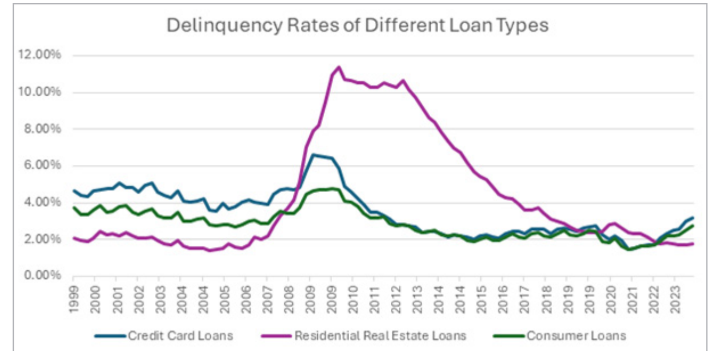
Source: Census Bureau, February 2024

Consumer Credit

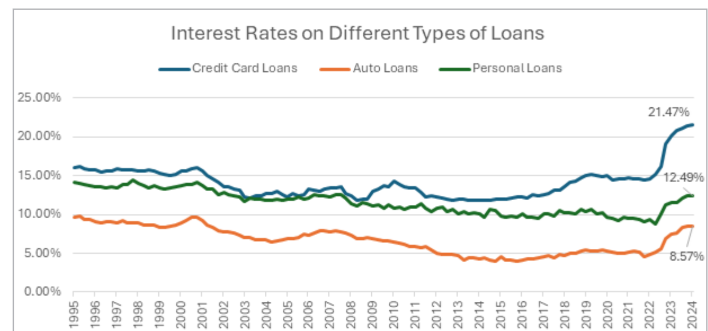
However, holding rates higher for longer could add additional pressure on US households. Both credit cards and auto loans delinquencies have climbed to their highest level since 2012, an ominous development considering that the unemployment rate was over 8% back then. Furthermore, interest rates on different loan types are at elevated levels, which means running an unpaid balance is becoming increasingly costly. Today, the average Annual Percentage Rate (APR) on credit cards interest have almost doubled from 12.9% in late 2013 to 21.47% in 2024 — the highest level recorded since the Federal Reserve began collecting this data in 1994.

Looking at the national debt levels relative to disposable personal income, growth in non-revolving credit (eg: car loans, education loans, boat loans, other loans not part of revolving credit and mortgage loans) has not kept up with growth in disposable personal income, implying that households are postponing purchases that would carry larger interest tag over the years. Revolving debt (eg: credit cards), even though in nominal terms has risen hastily, on the relative basis is still below its pre pandemic level. However, given the adjustable nature of these loans and higher interest rate environment, it is reasonable to assume that consumers' monthly payments are above the pre-pandemic levels. Nonetheless, disposable income has also risen in the last few years. Therefore, when looking at consumer debt service relative to disposable income, we are at levels similar to where we were before the pandemic.

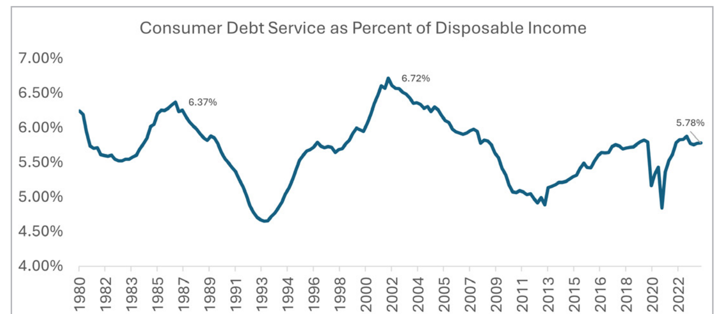
The household financial metrics described above, while currently do not exhibit signs of severe stress, are unlikely to improve in a high-rate environment. The longer the Fed waits to cut rates, the higher the likelihood that households will begin to tighten their spending, and potentially sending the economy into a recession. In the meantime, a strong labor market is giving the Fed some breathing room. However, if spending begins to decline as delinquencies rise and financial conditions tighten, this may give the Fed encouragement to start cutting rates, assuming inflation developments meet expectations.



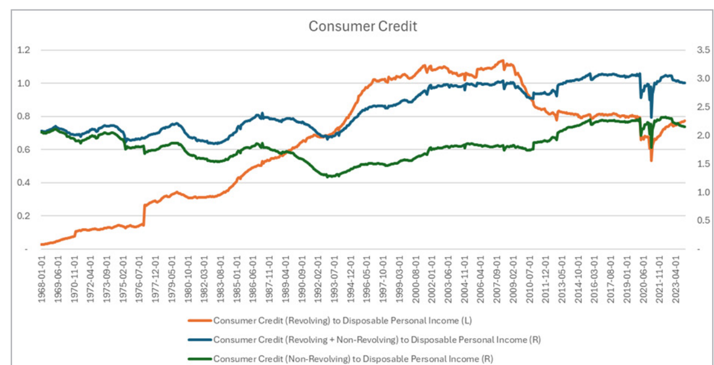
Source: Federal Reserve, March 2024, February 2024



Source: Federal Reserve, March 2024, February 2024



Source: Federal Reserve, March 2024



Source: Board of Governors of the Federal Reserve System; Bureau of Economic Analysis; through Federal Reserve Bank of Saint Louise

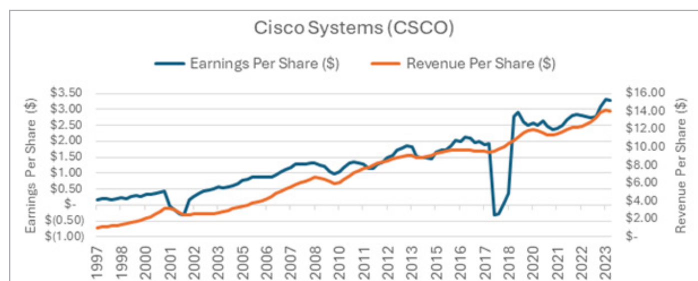
Magnificent Markets

One might argue that today's high valuations are justified by the dominance of tech stocks in the S&P 500. There is certainly some truth to that claim. While it is true that the S&P 500 would trade at only 18.8-times forward earnings if Alphabet, Amazon, Apple, Meta, Microsoft, and Nvidia were excluded from the index, it is equally true that the remaining 494 stocks saw earnings contract by -1.3% year-over-year in Q4 2023 vs an increase of +44.9% in those six stocks.

In any case, it is far from obvious that these so-called magnificent stocks will stay magnificent. Already, people are talking about the Magnificent 6 instead of the Magnificent 7 because Tesla has been the worst performing stock in the S&P 500 so far this year.

Magnificent stocks could stay magnificent longer than many investors expect, but we believe that being disciplined on valuations is paramount to long-term investing success. Consider, for example, the case of Cisco. In 2000, Cisco traded at 36-times sales, making it the most valuable listed company in the world. Since then, Cisco's earnings per- share have increased more than tenfold, with sales-per-share rising almost as much. Yet, the stock remains 38% below its 2000 highs.

Source: Bloomberg, April 2024



Source: Bloomberg, April 2024

Coincidentally, one of the Magnificent 7 stocks, Nvidia has a current price to sales ratio of 36 times, the same ratio as Cisco at its peak. While we are not discounting Nvidia's potential as a company, we are simply reminding investors that sometimes, a great company may not make a great stock, especially during times of excessive optimism.

Notably, we have a more favorable view on consumer staples, utilities, and especially, health care should the economy continue to cool down. While earnings momentum in the health care sector has been weak, the earnings picture should improve over the next few years as prices reset to a higher level (health care prices are often subject to long-term contracts, and hence, are not adjusted as often as prices in the rest of the economy). Health care stocks are also relatively cheap and could benefit from the long-term secular tailwind of an aging population.

Low Unemployment is Bad for Stocks While High Is Good... Historically.

It may seem counterintuitive that stocks perform worse when unemployment is low vs when it is high because low unemployment is typically synonymous with a strong economy. However, the relationship between unemployment and the stock market is relatively nuanced. A rise in unemployment typically signals a decline in interest rates, which is good for stocks, but having unemployment too high could mean a decline in future corporate earnings and dividends, which is bad news for stocks. The nature of the bundle — and hence the relative importance of the two effects, changes over time depending on the state of the economy. When looking at the relationship between unemployment rates and the average next 12 months returns in the S&P 500 since the Post-War era, we see evidence that the stock market tends to perform better when the unemployment rate is high.

Unemployment Rate	Average S&P Returns Next 12 Months
Less than 4%	6.60%
4%-5%	7.97%
5%-6%	11.24%
6%-8%	14.48%
More than 8%	19.09%

Source: Bureau of Labor Statistics, Bloomberg, Liberty One, April 2024

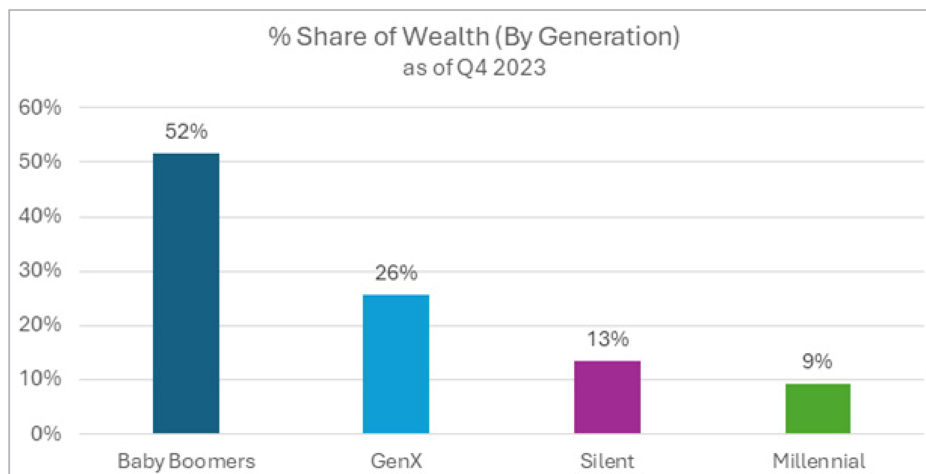
When unemployment rates are low, that typically coincides with a strong economy and most likely a strong market. That may indicate that valuations are stretched, and future returns expectations are lower. Conversely, a high unemployment rate may coincide with an already depressed market, which makes future return expectations higher. Although investors may place high attention to the jobs report and its implication for the stock market and economy, we believe that it is a lagging indicator, rather than a leading one based on this dataset.

For stocks as a group, and in particular for cyclical stocks, information about interest rates dominates during expansions and information about future corporate earnings dominates during contractions. As we are currently in an expansionary phase, interest rate expectations have been a key driver of market volatility, with markets mostly reacting negatively to a strong jobs report. We expect this reaction pattern to continue so long as the economy continues to expand.

Fixed Income

Structurally, many forces could support higher yields over a 5-to-10-year horizon. These forces include rising populism, ebbing globalization, transition to renewable energy, and unsustainable fiscal deficits, which could require trillions in new spending.

In addition, baby boomers are leaving the labor market en masse. In the US, baby boomers hold more than half of all household wealth. While they were working, they accumulated a lot of assets which provided a pool of savers. Now, rather than working and saving, they are spending down their wealth. The global pool of savings is shrinking, putting upward pressure on equilibrium real interest rates and bond yields.



Source: Bloomberg, April 2024

Although the disinflationary impact of AI could potentially counteract some of these inflationary forces, our view is that the 10-year Treasury yield would likely hover around 4% to 5% in the medium term. This suggests that investors with long-term horizons should be structurally neutral for duration.

In contrast to the longer-term outlook, the cyclical risks to bond yields are tilted to the downside. The 10-year Treasury yield could drop to 3% during the next recession, should the Fed cut rates to support the economy. For now, US inflation remains a bit sticky, and investors have become increasingly convinced that a recession has been avoided. Thus, we do not expect yields to fall much over the next few months. However, a big decline in yields could come when the fear of recession returns, and inflation has subsided.

Outlook

Despite the internal divide within the Fed, we believe that a baseline of 2 rates cuts is still likely this year. Strong economic activity gives the Fed time to be more patient with inflation in order to gain greater confidence that it is a on a sustainable path to 2%. However, a higher for longer rate environment could put added pressure on households and businesses which could push the economy into a recession. Although consumers and businesses are in decent shape currently, pockets of deterioration can already be observed, something that should be monitored closely for potential signs of further deterioration.

As the market approaches new highs across sectors and stocks, extremely optimistic sentiment could also be a warning of potential weakness or consolidation. However, we have not seen this kind of broad deterioration in markets yet since last summer when the S&P 500 fell -9.94% between August 1st to October 27th. Between the last rate hike of a tightening cycle and the first cut of a new easing cycle, it has been normal to see corrections, as policy pivots often create uncertainties and the potential for volatility. Markets have usually moved higher between the final hikes and the initial cuts. As long as rate cuts remain likely without any evidence of a broken economy, the cyclical bull market can be expected to continue, albeit with increased volatility.

References

Bryan, Michael & Meyer, Brent, (2010). “Are Some Prices in the CPI More Forward Looking than Others? We Think So.” https://www.atlantafed.org/-/media/documents/research/inflationproject/stickyprice/sticky-price-cpi-supplemental-reading.pdf

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