Quarterly Investment Newsletter

2024 Q1 Economic and Market Overview

Economic and Market Outlook

Performance and Market Outlook

Performance

Equity markets rose in the first quarter despite a sharp rise in bond yields. Equity leadership was rather narrow in the technology sector after broadening in November and December of last year. The rise in interest rates has been driven by inflation trends that have remained stickier than expected, which has pushed out the timing of Fed rate cuts. As a result of the rise in interest rates, fixed income markets sold off by -0.7% as measured by the Bloomberg Aggregate Bond Index. Gains in equities were led by US large cap stocks, which rose by 10.6%. US small caps and emerging markets each rose by approximately 2% with the Dow Jones Industrial Average increasing by around 6%. The real estate sector fell by -1.3% while commodities rose by 0.9%.

Market Outlook

- We remain cautiously constructive on equity and fixed income markets with asset class and security selection remaining key. Asset class performance dispersion has remained historically wide which makes markets susceptible to sharp trading reversals due to crowded positioning. As a reminder, pullbacks and corrections happen frequently in equities with an average of a fourteen percent peak to trough drawdown at some point each year.
- The run in what is known as the "Magnificent 7" (referred to as "Mag 7" hereafter) stocks has continued into the first quarter; however, there are some cracks starting to develop as performance of this group narrows. We continue to be highly selective within the Mag 7 as the largest stocks within an index, such as the S&P 500, historically and consistently detract from annual performance by around 2-3%. In markets where most readily available information is priced into the value of a security, it is important to "skate to where the puck is going, not where it has been" as the hockey great Wayne Gretzky famously stated, which we believe is equally true when it comes to investment selection.
- Artificial intelligence (AI) has been a major theme driving markets over the last 18 months and will likely continue being a dominant driver of markets over the next decade. Beyond the obvious plays that have mostly been bid up, we see AI driving incremental copper and power usage demand- which would be positive for copper miners and utility companies. We do not see this new demand driver for these areas as priced into markets and are taking advantage in client portfolios as appropriate.
- We continue to see the potential for a market environment for large vs small cap equities reminiscent of the 1999-2006 time period, which saw small caps outperform their large cap counterpart by just over 100%, or 10% per year. Starting point valuations can be a reasonably good predictor to the long-term returns for an asset class and by this metric US large growth appears priced for paltry forward-looking returns, which highlights the need for adequate diversification and thoughtful portfolio construction.
- The US economy has remained resilient and has defied the recession forecasts due to aggressive fiscal policy, labor scarcity, the growth in AI, and the lagged effects of monetary policy. Given the historical experience of hiking cycles resulting in financial and economic stress, we are still somewhat skeptical that the US will be able to avoid a recession this cycle. The corporate refinancing cycle that starts in earnest in 2025 could be a catalyst for economic deterioration.
- The Fed is now likely to cut rates sometime in the back half of 2024 due to the sticky nature of inflation in recent months. We would still anticipate at least 1-2 cuts in 2024- although some have pulled their cut expectation out of 2024 entirely- and a more aggressive cutting cycle in 2025. We would highlight the fact that new rents have collapsed, which should feed into disinflationary trends given the nearly 40% mix of shelter in core inflation.
- Overall, we remain cautiously constructive with the respect to the outlook for financial markets with the greatest near-term risks being a recession and geopolitical turmoil.

In client portfolios, as always, we remain diversified to be prepared for any market environment while also positioning to take advantage of valuation and fundamental distortions we see in the market.

US Economic Growth Remaining Resilient Thanks to Aggressive Fiscal Policy

Many economic and financial market prognosticators have been predicting an economic recession due to the aggressive tightening in monetary policy by the Fed and a rollover in high quality lead economic indicators.

Stimulative fiscal policy via the $1.9 trillion American Rescue Plan Act of 2021, the $891 billion Inflation Reduction Act (IRA) in 2022 and the $53 billion Chips and Science Act together have been a significant reason we have not yet seen an official US recession.

Government expenditures rose by a remarkable 6.1% in 2022 and 6.7% in 2023- this compares to average annual growth of 4.0% over the last 20 years. As a result, deficit spending is ballooning with annual deficits as a percent of GDP running around 6%, which can be seen in the bottom pane of the deficit to GDP chart below.

Fiscal spending historically does not slow in an election year for obvious reasons, but comparisons here will be challenged due to the high levels of spending in 2023. Fiscal largesse has made the Fed's job tougher in getting inflation back down to their target of 2.0% and has resulted in higher long-term interest rates due to Treasury supply.

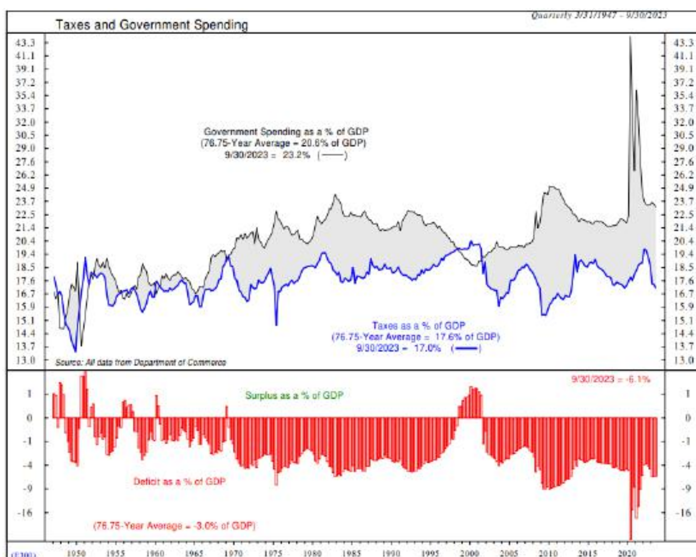
Some suggest, and we would agree, that the Fed will need to lean against easy fiscal policy by having slightly tighter than warranted monetary policy. While inflation is starting to appear sticky in recent months, we would note that many of the sticky elements- such as shelter, insurance, and health care- of inflation are highly lagging variables.

Shelter is around 40% of core inflation and with new rents running essentially flat year over year, we would expect the average rent (what's used in inflation data) to converge to new rents. As a result, we would anticipate a combination of some slowing in economic growth and a further moderation in inflation which will allow the Fed to cut rates sometime in the back half of 2024 and engage in a more aggressive cutting cycle in 2025.

We see the current consensus of two, 25 basis point cuts in 2024 and another 125 basis points of cuts in 2025 as a reasonable assumption. This would put Fed Funds at 5.00% at the end of 2024 and 3.75% at the end of 2025. The risk for 2024 is the Fed doing less in cuts and for 2025 it is for more cuts than anticipated due to the lagged economic impact of Fed hikes.

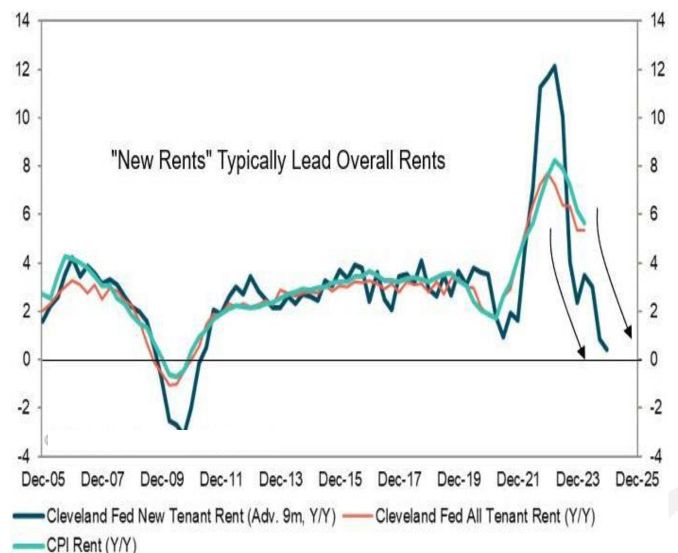
The US economy is expected to slow from 2.5% in 2023, to 2.4% in 2024, and 1.8% in 2025. We see this as a reasonable base case forecast with the risk to 2025 to the downside.

Government Spending and Deficits



Source: Ned Davis Research

Inflation - New Rents Suggest Disinflation

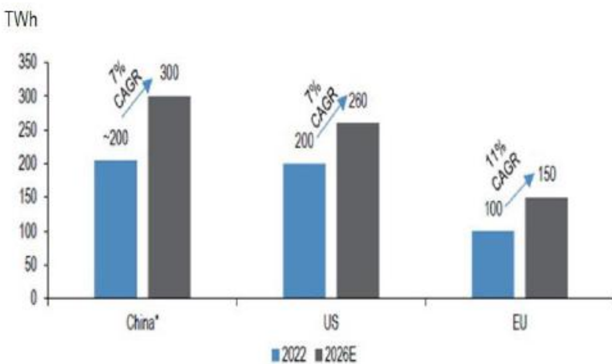


Source: Trahan Macro Research

Artificial Intelligence (AI) Beyond the Picks and Shovels of the AI Revolution

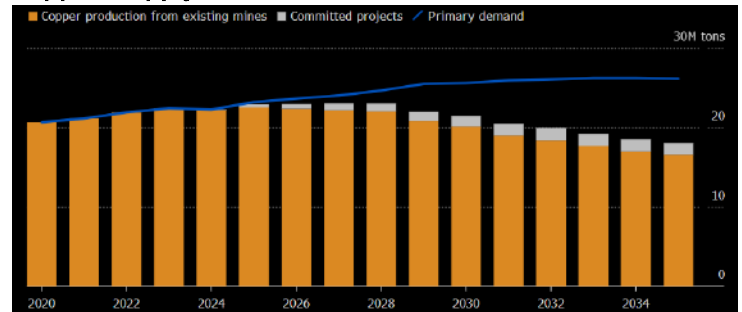
The trend of AI has dominated markets over the last 18 months. We see this as a long-term investable theme that will disrupt sectors and industries and create many winners and losers in the market. Outside of the picks and shovels (chips and semiconductor equipment companies) of the AI revolution, we are exploiting two second derivate impacts that have not been priced into markets but will benefit in a meaningful way in our estimation. First, a historically boring and slow growth sector is getting a growth impulse thanks to the surge in data center power consumption demand. Utilities have traded poorly in recent years due to the rise in interest rates; however, we see utilities offering a hedge to downside in markets due to their earnings predictability in addition to attractive relative valuation multiples with a growth uptick due to AI. The CEO of Exelon, Calvin Butler, recently stated that AI is poised to help drive a 900% jump in power demand from data centers in the Chicago area, which will potentially require as much electricity as around four nuclear power plants can produce. Second, AI will create additional demand for copper. Datacenter power capacity is highly copper intensive. This is already in the context of a tight supply environment for this commodity. We expect significant deficits in the copper market in the back half of this decade, which is likely to result in meaningfully higher copper prices than the current market price.

Electricity Consumption from Data Centers



Source: IEA, J.P. Morgan Research

Copper- Supply & Demand Outlook

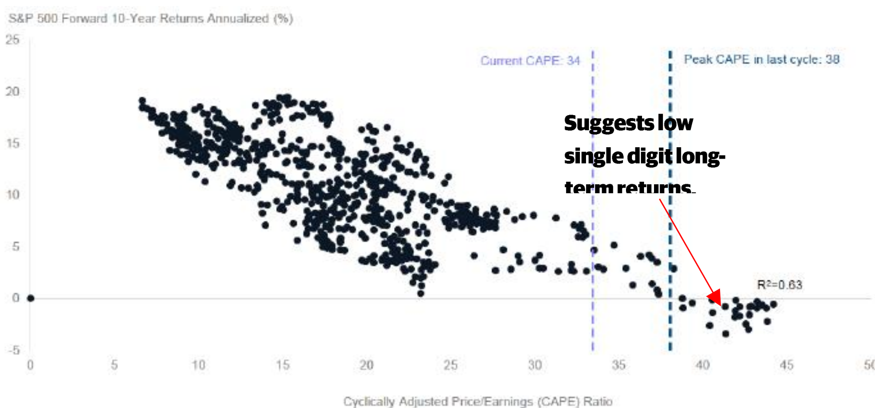


Source: Bloomberg

Portfolio Diversification Remains Important

Returns the last few years have been driven by a few large US companies, which has resulted in a high degree of index concentration in the S&P 500. While it can be tempting to "chase" what has worked in the market, it is important to consider a range of possibilities, historical returns, and risks to the base case scenario. As Wayne Gretzky famously stated, skate to where the puck is going, not where it has been. This anticipation is critical in markets where most known information is already imbedded. Today, US large caps are trading at levels that would indicate the 5-10 year annualized return would be paltry- low single digits. Returns in other, cheaper asset classes offer better longer-term returns based on historical probabilities and current valuation multiples. It is important to remain adequately diversified in portfolios.

Starting Point Valuations are a Good Predictor of Long-Term Returns



Source: Goldman Sachs Asset Management

As always, we remain diversified in client portfolios and will adjust positioning as market opportunities or risks dictate.

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