MARKET COMMENTARY

Policy Tug of War

April 2024

- In April, rising bond yields and increased geopolitical tensions pressured the stock market, and U.S. large cap stocks declined 4.1% while small cap stocks ended the month down 7.0%.
- Preliminary estimates show the U.S. economy grew by 1.6% in the first quarter, the slowest pace in nearly two years. With three consecutive warmer-than-expected CPI prints, inflation remains well above 2%, and market expectations for rate cuts are fading.
- A policy tension has emerged between the U.S. Department of Treasury, which is pushing for robust economic growth, and the Federal Reserve, which should be prioritizing their 2% inflation goal.
- The tug-of-war between these two groups will cause opportunities and risks to ebb and flow, but it remains critical that inflation and interest rates stay contained to support the economy and markets.

Overview

Throughout April, rising bond yields and geopolitical tensions placed pressure on the stock market. U.S. large cap stocks ended the month down 4.1%, making it the third-worst April since 1980. U.S. small cap stocks ended the month down 7.0% due to sticky inflation and dwindling hopes of interest rate cuts. U.S. intermediate-term bonds ended the month down 2.5% on similar concerns.

Preliminary estimates indicate that in the first quarter of 2024 the U.S. economy expanded by an annualized 1.6%, the slowest pace in nearly two years. This gross domestic product (GDP) figure falls below the estimated 2.5% and is nearly half the 3.4% that the economy grew by during the fourth quarter. The slower-than-expected growth was largely due to a decline in government spending, which dropped from 4.6% in the fourth quarter to 1.2% and highlights the economy's reliance on this source for its growth.[1] Trade and inventories, the most volatile GDP components, declined by 0.9% and 0.4%, respectively, though these figures are subject to revision.[1] Domestic demand remained robust: the consumer spending component of GDP grew at 2.5% in the first quarter while business investment ticked up.[1] In the words of JPMorgan CEO Jamie Dimon:

> "*In spite of the unsettling landscape, including last year's regional bank turmoil, the U.S. economy continues to be resilient, with consumers still spending, and the markets currently expecting a soft landing. It is important to note that the economy is being fueled by large amounts of government deficit spending and past stimulus*."[2]

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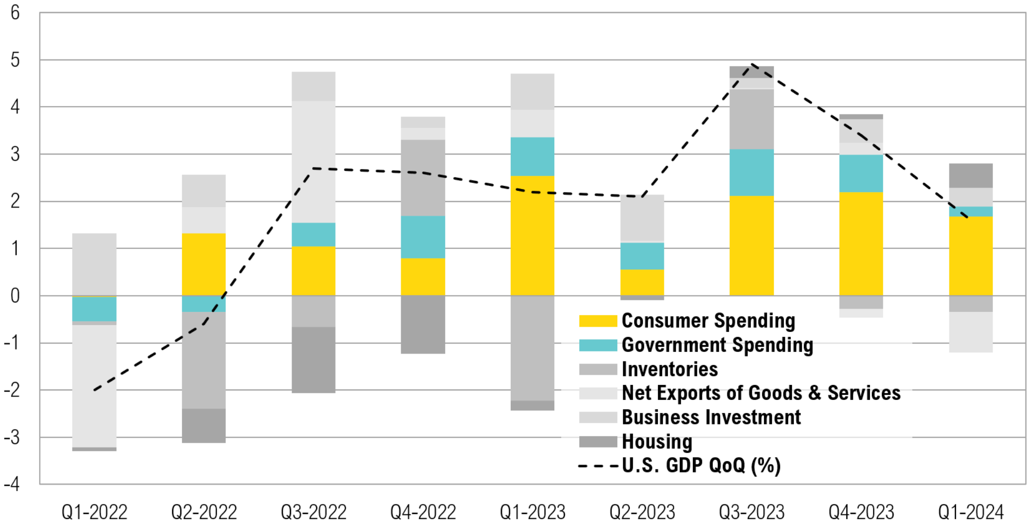
Initial Q1 Estimates Show U.S. Economy Growing at Slowest Pace Since Q2 2022

Contribution to Real Gross Domestic Product by Sector, %*



Source: Bloomberg. *Seasonally Adjusted Annualized Rate.

The slower-than-expected growth was largely due to a decline in government spending

Inflation remains well above the Federal Reserve's stated 2% target. The March CPI report, released earlier this month, showed headline CPI increasing to 3.5% year-over-year, and core CPI climbing to 3.8% year-over-year. Further, the personal consumption expenditure (PCE) price index—the Federal Reserve's preferred inflation gauge—remains sticky, increasing to 2.7% year-over-year in March.[3] Notably, consumer inflation expectations have changed direction. In March, consumers were anticipating short-term inflation rates of 2.9% and longer-term rates of 2.8%, but by April, the short-term outlook had risen to 3.2% and the long-term outlook to 3.0%.[4]

The bond market remains highly sensitive to inflation and interest rate expectations

As recent and expected inflation has pushed higher, market expectations for interest rate cuts have been pulled in the other direction. At the start of January, markets were anticipating the equivalent of seven rate cuts in 2024. However, by the end of April, expectations had shifted dramatically, and markets priced in the equivalent of only one rate cut, which will likely not occur until the Federal Open Market Committee's (FOMC) meeting in September.[5] Notably, the bond market's sensitivity to inflation and interest rate expectations has been particularly pronounced. Over the past month, Treasury yields climbed to the highest level since November 2023. Specifically, the 10-year Treasury yield ended April at 4.7% while the 2-year Treasury yield closed the month at 5.0%.

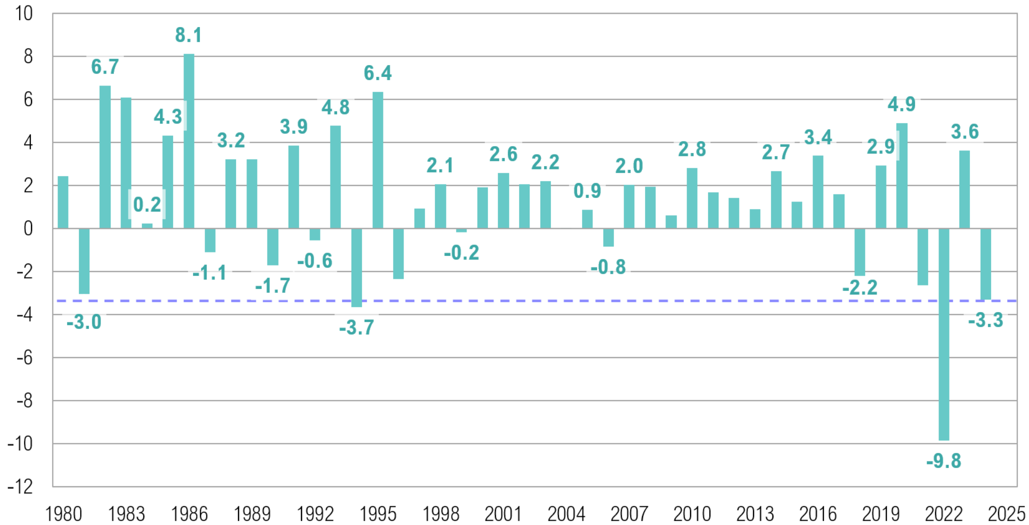
Policy Tug of War

A policy tug-of-war has emerged between the U.S. Department of Treasury and the Federal Reserve, each with a different goal in mind. The Treasury is prioritizing deficit-financed economic growth, even if that means a worsening U.S. fiscal situation and sticky inflation. In contrast, the Fed is focused—or at least should be focused—on setting policy that moves inflation back to the 2% target.

The Fed has kept interest rates unchanged since June 2023, opting to wait for further evidence that inflation is moving back down to 2% before cutting rates. For the past 10 months, interest rates have remained at their highest level in nearly two decades. Higher interest rates, and the increasing likelihood of rates remaining elevated, have been pressuring rate-sensitive areas of the market. U.S. REITs ended April down 7.1% (and are now down 7.4% year-to-date). Regional banks ended the month down 6.5% and the year down 11.0%. U.S. intermediate-term bonds, as measured by the Bloomberg U.S. Aggregate Bond Index, are down 3.3% year-to-date, making the first four months of 2024 the second-worst for U.S. bonds since 1994.

2024 is the Second-Worst Year-to-Date Start for Bonds Since 1994

Bloomberg U.S. Aggregate Bond Index Total Return (January to April), %



Source: Bloomberg

Yellen has long advocated for the Federal Reserve to cut, rather than raise, interest rates

But U.S. Treasury Secretary Janet Yellen has different motives, and for now at least, she seems convinced that prioritizing economic growth above all else is in the best interests of the country. As such, Yellen has long advocated for the Federal Reserve to cut, rather than raise, interest rates. In a recent interview with Reuters, Yellen emphasized the strength of the U.S. economy and the likelihood that the preliminary 1.6% first-quarter GDP estimates would be revised higher.[6] Further, Yellen downplayed the recent spike in inflation, citing "peculiar" factors that are not indicative of the underlying strength of the economy.[6] She expressed confidence that inflation would return to the Fed's target of 2% without an increase in unemployment or a cooling of other sectors of the economy.[6]

Treasury's estimates show that it needs to borrow $243 billion in the second quarter and a whopping $847 billion in the third quarter

Treasury's push for the Fed to cut rates comes as high interest rates drive net interest payments to unprecedented levels. The U.S. federal budget deficit continues to grow, surpassing $1 trillion in the first seven months of the fiscal year, largely fueled by higher interest costs on national debt.[7] Treasury's recent borrowing estimates show that it needs to borrow $243 billion in the second quarter—$41 billion more than initially anticipated—and a whopping $847 billion in the third quarter.[8] Outside of 2023, this will be the largest third-quarter issuance in more than 20 years. The Fed's upcoming policy decisions will significantly influence the government's interest payments. According to the Bank of America, if interest rates remain unchanged, annual interest payments are projected to hit $1.7 trillion by April 2025. Conversely, six 25 basis-point cuts (a 1.5% overall reduction in the current interest rate) over the next year could reduce these payments by $500 billion, lowering them to $1.2 trillion by April 2025.[9]

On April 16, less than a week after the warmer-than-expected March CPI report was released, Fed Chair Powell told a forum in Washington:

> *"The recent data have clearly not given us greater confidence and instead indicate that it's likely to take longer than expected to achieve that confidence. Right now, given the strength of the labor market and progress on inflation so far, it's appropriate to allow restrictive policy further time to work."*[10]

The Fed's decision to taper quantitative tightening indicates a more accommodative approach to higher inflation

However, the Fed seems to be overlooking three months of higher-than-expected inflation and the fact that inflation has been above its target for over three years. Two weeks after making the above statement, at the May 1 Federal Open Market Committee (FOMC) meeting, Powell announced plans to slow the pace of the balance sheet runoff. Starting June 1, the Fed will lower the cap on the amount of maturing Treasury securities that will not be replaced from $60 billion to $25 billion.[11] Although the reduction in the balance sheet runoff was widely anticipated, it was implemented more aggressively than expected. The Fed's decision to taper quantitative tightening indicates a more accommodative approach to higher inflation, and it effectively incrementally eased monetary policy. The decision contradicts Powell's statement made on April 16 that monetary policy needed "further time to work" before the Fed would consider additional loosening, and it underpins both the challenging policy mix currently at play in the U.S. as well as the potential political implications in an election year.[10]

Washington's loose fiscal policy is at odds with the Fed's efforts to cool the economy and could make getting inflation back to 2% harder to achieve

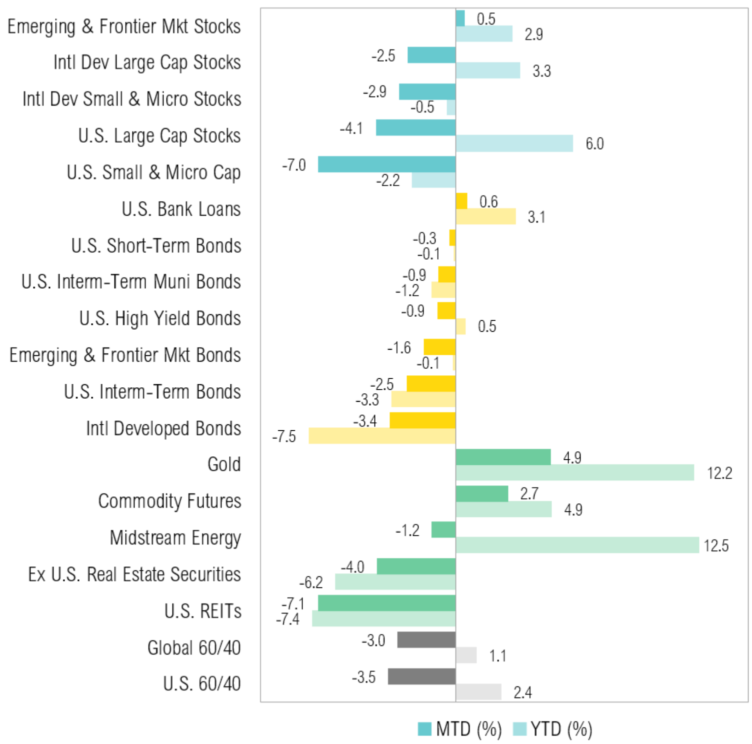
Washington's loose fiscal policy is at odds with the Fed's efforts to cool the economy and could make getting inflation back to 2% harder to achieve while exacerbating the government's debt burden. Despite continuing to navigate higher interest rates and sticky inflation, Fed Chair Powell remains apparently upbeat about the economy, finding common ground with Treasury Secretary Janet Yellen. However, given how the Fed was caught off guard by the persistence of inflation in 2022 and 2023, as well as the uptick over the past three months, one wonders how Powell's perspective on the economy will hold up throughout the rest of the year. As this policy tug-of-war continues, it is unclear who will ultimately prevail.

Markets

Returns were negative across most asset classes in April. International developed market large cap stocks fared slightly better than U.S. large cap stocks. The former ended April down 2.5%, and the latter ended the month down 4.1%. U.S. small cap stocks ended the month down 7.0% while emerging and frontier market equities ended the month up 0.5%. The only equity asset class to end April with positive returns was emerging and frontier market stocks, primarily due to strong performance in China (+11.2%), Turkey (+16.6%), and Hungary (+6.1%). U.S. intermediate-term bonds ended the month down 2.5% and are now down 3.3% year to date. Gold and commodity futures fared best, ending April up 4.9% and 2.7%, respectively.

The only equity asset class to end April with positive returns was emerging market stocks

April 2024 Key Market Total Returns



Source: Bloomberg

April was marked by a series of retaliatory attacks between Iran and Israel as tensions in the Middle East remain elevated

In international news, April was marked by a series of retaliatory attacks between Iran and Israel as tensions in the Middle East remain elevated.[12] West Texas Intermediate (WTI) crude spiked to $87.3 on April 12, but since dropped back to end the month at $81.3 per barrel. Similarly, gold jumped to a new record high of $2,426.9 before Iran attacked Israel but ended the month at $2,291.5 per ounce.

In other international news, the Japanese yen made a new three-decade low against the dollar, reaching a record ¥159.1 on April 28 before abruptly dropping to ¥155.8 on suspected currency intervention by the Japanese government.[13] Historically, the Japanese government has intervened with the yen above ¥150 to the dollar.[14]

Looking Forward

The Treasury is advocating for the Fed to support bond markets via rate cuts, as interest payments will continue to balloon if rates remain unchanged. However, loose fiscal policy makes the Fed's attempt to get inflation back to 2% more difficult, while exacerbating the growing U.S. debt burden. As such, we continue to monitor the bond market's reaction to incoming growth and inflation data, particularly at the longer end of the curve. With the 10 -year Treasury yield around 4.5% and the 2-year yield nearing 5.0%, we will see how well long bond markets will tolerate the Fed's relatively lax approach to the "last mile" of inflation. If yields rise much more, they will also likely affect the broader markets, especially rate-sensitive segments, including real estate markets, regional banks, non-profitable small caps, and the low-end consumer. Indeed, small business job creation plans are back to the lowest levels since May 2020, and in the words of the National Federation of Independent Business they are "below what would be typical in a strong growth economy."[15]

As for the rest of the market, our view remains that higher rates will continue to create a tailwind for active managers. Further, while the immediate impact of any further easing by the Federal Reserve will likely be viewed as a positive for all risky assets, persistent inflation could continue to frustrate to the upside.

It remains critical that inflation and interest rates stay contained to support the economy and markets

The back-and-forth nature of the ongoing policy tug-of-war means opportunities and risks will ebb and flow, with significant implications for inflation and interest rates, which will, in turn, dictate economic activity. It remains critical that inflation and interest rates stay contained to support the economy and markets. At present, it appears that Yellen and the Treasury have the upper hand; however, the ultimate winner will not be decided for some time.

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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