



# The Fed's Aim: A New Bull's Eye

Q1, 2024

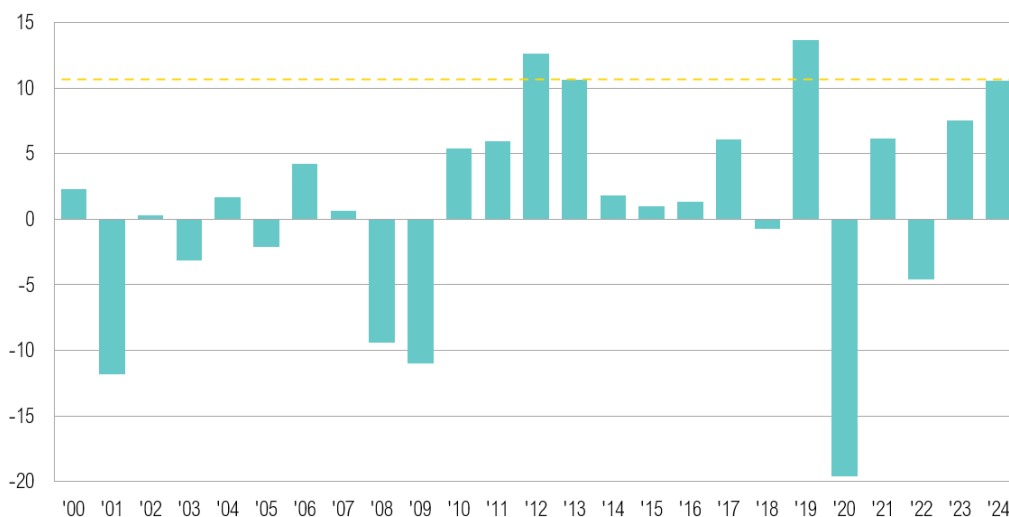
- Equity markets concluded the first three months of 2024 on a strong note as the S&P 500 achieved new all-time highs. The small cap Russell 2000 ended March at its highest level since January 2022.
- With inflation remaining persistently above its stated 2% target, the Fed's position may be shifting, and it seems more willing to tolerate these higher levels.
- Ongoing unchecked fiscal spending is driving up the federal deficit and interest costs.
- If inflation stays higher and long-term bond yields remain under control, higher equity valuations may be sustained, but persistently high interest rates may continue to challenge the interest-rate-sensitive areas of the market.

## Overview

Equity markets ended the first quarter on a strong note. The S&P 500 continued to climb to new all-time highs throughout the quarter. U.S. large cap stocks ended the quarter up a noteworthy 10.6%, making it the third-best first quarter since 2000 (tied with 2013). The Russell 2000 ended March at its highest level since January 2022, and U.S. small cap stocks ended the month up 2.5% and the quarter up 5.2% in a welcome sign that the equity market rally may be broadening. The Bloomberg U.S. Aggregate Bond Index ended the first quarter down 0.8%, and interest-rate-sensitive areas of the market continued to feel the pressure of higher rates as real estate was the only S&P 500 sector to end the quarter with negative returns, declining 0.5%.

### Q1 2024 Posted the Third-Best First Quarter Return Since 2000

Q1 Return, %



Source: Bloomberg

***U.S. large cap stocks ended the quarter up a noteworthy 10.6%, making it the third-best first quarter since 2000***

Final gross domestic product (GDP) results, released at the end of March, confirmed that the U.S. economy remained strong throughout 2023. Fourth-quarter GDP growth was

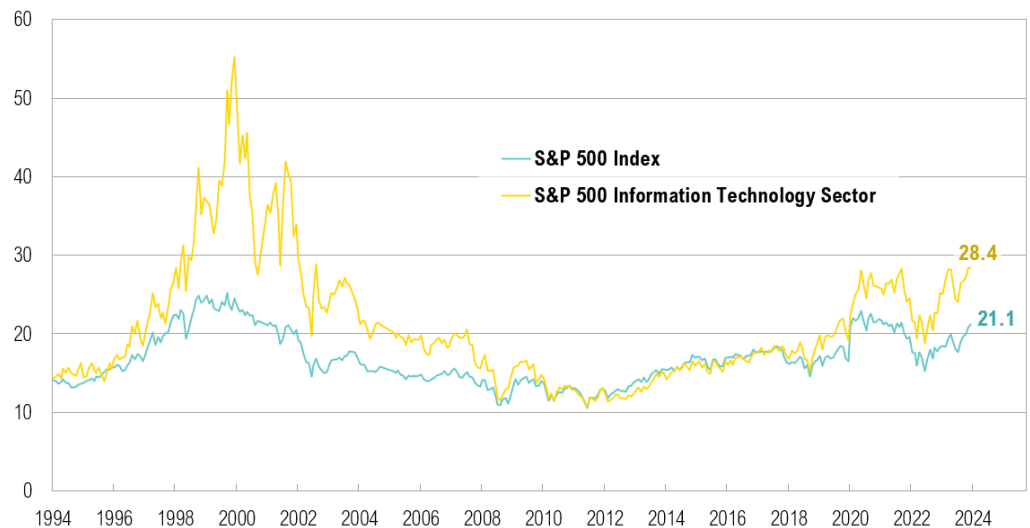
**Manufacturing sector activity grew for the first time since October 2022**

revised upwards from 3.2% to an annualized 3.4%, and the personal consumption expenditure component of GDP grew from 3.0% to 3.3%.<sup>1</sup> The federal government component of GDP grew by an annualized 2.4% in the fourth quarter.<sup>1</sup> There were further signs of economic strength over the first quarter of 2024. Manufacturing sector activity grew for the first time since October 2022, as evidenced by the ISM Manufacturing PMI's March reading of 50.3 (a reading above 50 signals expansion in the sector).<sup>2</sup>

Following the conclusion of the fourth quarter 2023 earnings season, earnings growth for the period was revised upwards to 4.2% from an initial forecast of 1.5% at the end of 2023.<sup>3</sup> This improved outlook was primarily driven by the communication services and consumer discretionary sectors. Full-year earnings growth projections for 2024 were at 11.0% at the end of March.<sup>3</sup> Current S&P 500 valuations remain well above historical averages. The forward 12-month price-to-earnings (PE) ratio has hit 21.1, surpassing both the 5-year and 10-year averages of 19.1 and 17.9, respectively. Within the S&P 500, information technology sector valuations reached new local highs, climbing from 26.7 to 28.4, as price gains outpaced earnings growth expectations. Even though tech sector valuations are high, they remain significantly lower than what was seen during the Tech Bubble, where forward PE ratios peaked at 55.2 in March 2000. The information technology sector's 12.7% gain over the quarter was largely dominated by AI-leader Nvidia, which ended the quarter up 82.5%. The communication services sector was the top-performing asset class during the quarter, rising 15.8%. Notably, Tesla, one of the 10 largest companies in the S&P 500 by market cap, ended the quarter down 30.6%, making it the worst-performing stock of the entire S&P 500 for the year to date.

**Market and Tech Valuations Are High, but Not Unprecedented**

12-Month Forward Price-to-Earnings Ratio



Source: Bloomberg

**Even though tech sector valuations are high, they remain significantly lower than what was seen during the Tech Bubble**

One year after the collapse of Silicon Valley Bank—an event that precipitated the failure of two additional U.S. banks—regional banks remain under close scrutiny. Regional banks have continued to grapple with an increase in delinquencies for commercial real estate loans and consumer loans, including credit cards and auto loans, and delinquency rates on these loans are approaching those last seen during the Global Financial Crisis. For example, the share price of New York Community Bank (NYCB) has fallen over 70% year to date, triggered by a report in early February that the bank's loan loss provisions had exceeded expectations by more than tenfold.<sup>4</sup> The bank's challenges primarily stem from

**Regional banks remain under close scrutiny**

issues within its loan portfolio, notably \$5 billion in multifamily loans that it acquired during the pandemic, which are starting to show signs of delinquency.<sup>4</sup> Regional banks ended the first three months of 2024 down 6.3%.

March also marked the second anniversary of the Federal Reserve's first rate hike of the current cycle. For the past three years, inflation has remained above 3% due to the combination of a strong labor market, robust spending rates, and strong economic growth. However, the Fed's apparent willingness to cut interest rates soon may indicate that its inflation target has shifted from two percent to a more easily reachable three-ish percent.

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### **The Fed's Aim: A New Bull's Eye**

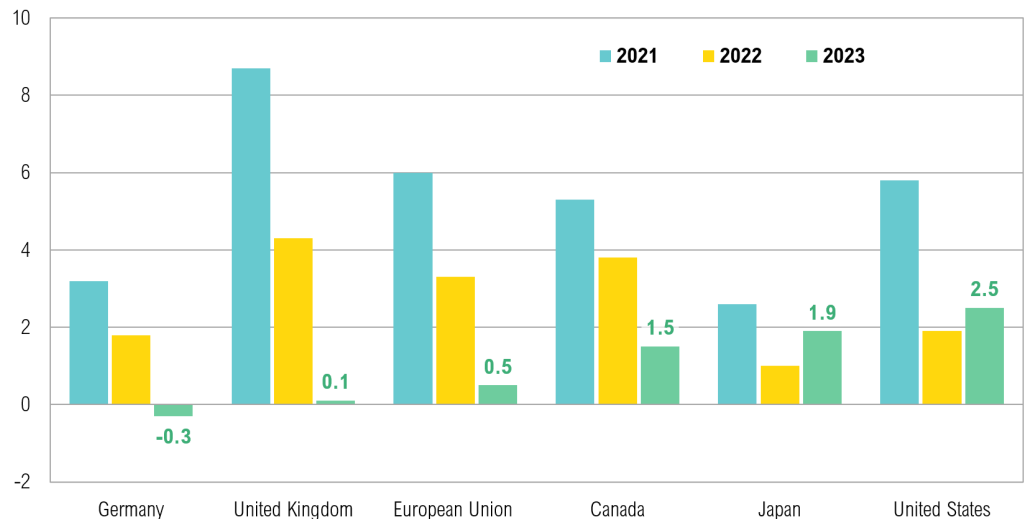
Rarely does one of the world's most influential and reputable central banks increase its forecast for inflation—from already-too-high levels—and growth, while simultaneously guiding to a dovish policy approach. However, on March 20, the U.S. Federal Reserve revised upwards its GDP growth and inflation projections while also improving its employment outlook for the year. It also communicated a readiness to accept elevated inflation for an extended period and a willingness to slow the reduction of its balance sheet.

***The U.S. remains a positive outlier in global economic growth, far outpacing developed nation peers***

Inflation has been above the Federal Reserve's stated target for three years. Robust spending (from both consumers and the government) has kept the U.S. economy strong throughout the Fed's aggressive rate-hiking cycle that started in March 2022 when headline inflation was at 8.5%. In 2023, real GDP increased by an annualized 2.5%, compared to a 1.9% increase in 2022. The U.S. remains a positive outlier in global economic growth, far outpacing developed nation peers. For example, in 2023, real GDP grew by 1.9% in Japan and 0.1% in the United Kingdom and declined by 0.3% in Germany.<sup>5</sup> The relatively strong growth in real GDP in the U.S. in 2023 was primarily reflected in consumer spending and government spending.<sup>1</sup>

## Outlier 2023 U.S. GDP Growth Fueled by Spending

Annualized Year-over-Year Growth, %



Source: Bloomberg, OECD.

**Consumer sentiment ticked up over the quarter, ending March at 79.4—the highest level since July 2021**

Consumer spending in the U.S. remains resilient, despite elevated prices and higher interest rates. Consumers continue to rely on credit cards to support spending, as evidenced by the \$14.1 billion monthly increase in consumer credit in February.<sup>6</sup> Additionally, the personal savings rate dipped to 3.6% in February, which remains well below the 2009 to 2019 average savings rate of 6.1%.<sup>7</sup> Contributing to consumers' willingness to take on new debt and save in lower rates, the unemployment rate remains near four-decade lows, at 3.8%.<sup>8</sup> Personal spending jumped by 0.8% in February, which was the largest monthly gain since January 2023.<sup>9</sup> Consumer sentiment ticked up over the quarter, ending March at 79.4—the highest level since July 2021.<sup>10,11</sup> Sentiment was boosted by a rising stock market and lower inflation expectations.<sup>11</sup> Many companies continued to report strong consumer demand throughout the quarter. According to Mastercard President Linda Kirkpatrick:

*"The consumer remains resilient and consumer spending remains robust. As we look to both macro factors as well as Mastercard's own data, we see that spending is quite healthy."*<sup>12</sup>

Wells Fargo CFO Mike Santomassimo shared a similar sentiment:

*"I feel that we say the same thing over and over the last number of quarters, but the consumer continues to be very resilient through a time where I think we all would have thought there would be more weakness at this point."*<sup>13</sup>

**Net interest payments through March climbed to \$429 billion—roughly equal to the \$433 billion that the U.S. spent on defense over the past six months**

Similar to consumers, the government is also spending at an impressive clip, and fiscal spending continues unchecked. The U.S. federal budget deficit expanded over the quarter, as March marked the halfway mark of the 2024 fiscal year. In the first six months of the fiscal year, the deficit rose to \$1.064 trillion as interest costs on the national debt also rose.<sup>14</sup> Net interest payments through March climbed to \$429 billion—roughly equal to the \$433 billion that the U.S. spent on defense over the past six months.<sup>14,15</sup>

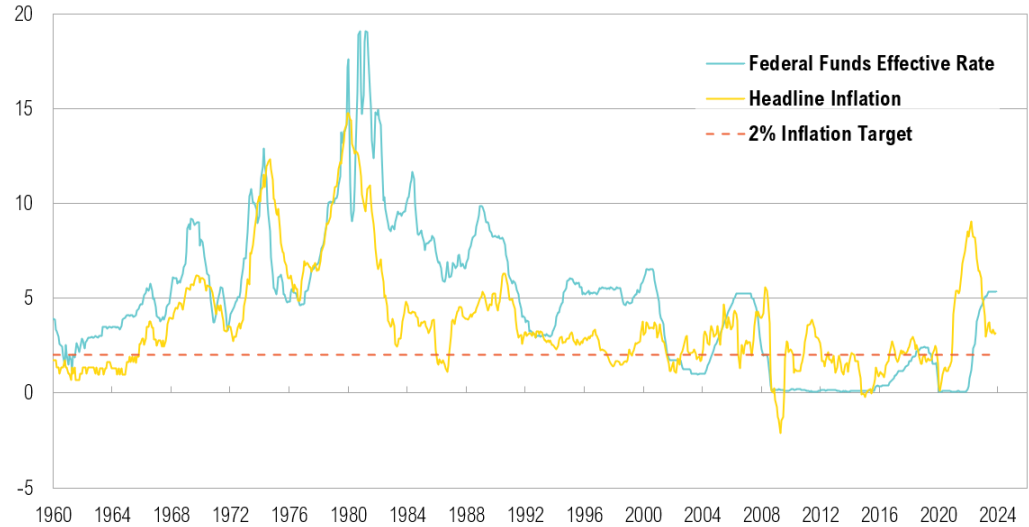
While economic evidence suggests neither the economy nor inflation is slowing down meaningfully, guidance from the Fed suggests an increasing likelihood that it could start cutting interest rates and dialing back quantitative easing into a major structural fiscal deficit and with inflation above their 2% target. At a conference on March 29, Powell indicated their revised approach to inflation:

*"We've said we would not wait for inflation to get down to 2% because, if you wait*

*for that, monetary policy works with long and variable lags. So, we've said for some years that we would start restoring the Federal funds rate to a more normal, almost neutral level. We're far from neutral now. And, we do plan, assuming the economy moves along the lines we expect, to start the process of dialing back restrictions."*<sup>16</sup>

### Fed Messaging Implies Rate Cuts With Inflation Above 2%

Federal Funds Effective Rate vs Headline Inflation (Year-over-Year), %



Source: Bloomberg

**Although Fed Chair Powell has consistently signaled the possibility of imminent rate cuts, market expectations for the timing of the first rate cut shifted throughout the quarter, moving from March to July**

Consumer price index (CPI) reports in 2024 have so far exceeded expectations. The January CPI print surpassed the expected 2.9% level, reaching 3.1% year-over-year. The February CPI print rose to 3.2% year-over-year, and the March print climbed even higher, to 3.5%.<sup>17</sup> After these higher-than-expected CPI reports, market expectations for interest rate cuts in 2024 shifted significantly over the quarter. In early January, markets expected six to seven rate cuts; however, this fell to three anticipated cuts by the end of March, which aligns more closely with the Fed's predictions.<sup>18</sup> Even though inflation has recently risen, the Fed's latest economic projections, released at the March Federal Open Market Committee (FOMC) meeting, indicate that the Fed expects faster economic growth, lower unemployment, and, notably, an increase in core personal consumption expenditures (PCE) inflation to 2.6% in 2024, up from the 2.4% projection in December.<sup>19</sup> Although Fed Chair Powell has consistently signaled the possibility of imminent rate cuts, market expectations for the timing of the first rate cut shifted throughout the quarter, moving from March to July. In his post-FOMC press conference, Powell made several remarks that suggested the Fed's openness to reduce rates even with inflation above the 2% target:

*"We believe our policy rate is likely at its peak for this tightening cycle... The January CPI numbers were quite high; the February number was high. But I take the two of them together and I think they haven't really changed the overall story."*<sup>20</sup>

Earlier in the month, on March 1, Fed Governor Waller, in a speech at the 2024 U.S. Monetary Policy Forum, hinted that, due to declining excess reserves, the Fed may be forced to start tapering quantitative tightening—which was confirmed at the Fed's March 20 FOMC meeting.<sup>20</sup> Powell stated in the post-FOMC press conference that the Fed will start to slow the pace of the balance sheet runoff "fairly soon" but gave no further

**Quantitative tightening serves as a critical complement to rate hikes and has thus far removed a significant amount of liquidity from U.S. markets**

**There was a notable performance divergence within S&P 500 sectors over the quarter**

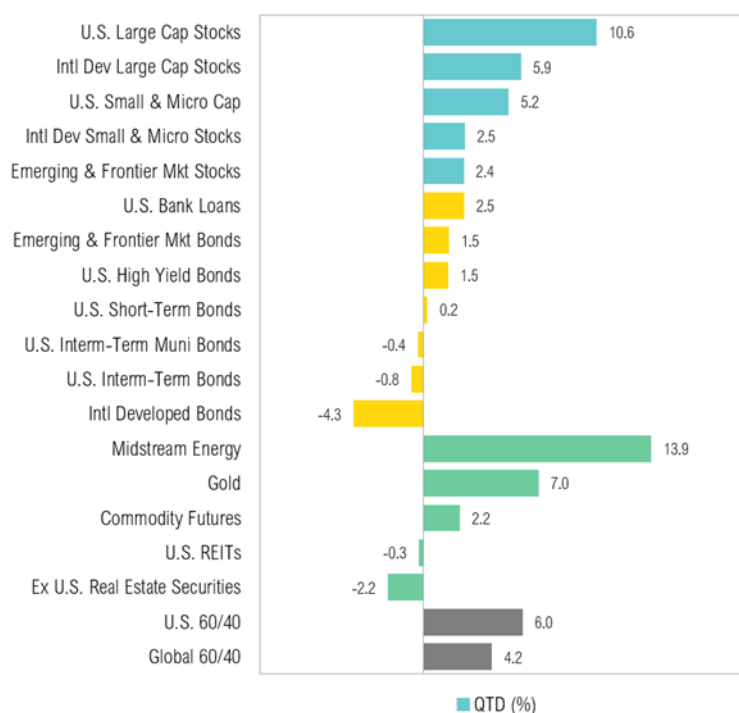
details.<sup>21</sup> Quantitative tightening serves as a critical complement to rate hikes and has thus far removed a significant amount of liquidity from U.S. markets. Further, the reverse repurchase facility (an unusual source of liquidity during the current rate hiking cycle) was depleted by \$424.1 billion over the quarter, to \$594.4 billion. At this rate, it is on track to empty out by June, which may be the Fed's new justification, rather than inflation, to end quantitative tightening.

## Markets

Both U.S. and international equity markets ended the quarter on a strong note, though U.S. markets outperformed their international counterparts. The S&P 500 ended the quarter up a very respectable 10.6%, while the MSCI EAFE ended the quarter up 5.9%. U.S. small cap stocks fared well, gaining 5.2% over the quarter. It was a slow start to the year for fixed income markets, as investors continued to wait for potential interest rate cuts. The Bloomberg U.S. Aggregate Bond Index closed the quarter down 0.8%. International developed market bonds fared worse, ending the quarter down 4.3%.

There was a notable performance divergence within S&P 500 sectors over the quarter. Real estate, which is particularly sensitive to interest rates, fared worst (down 0.5%), while the second-worst performing sector, utilities, gained a solid 4.6%. Communication services was the top-performing S&P 500 sector over the first quarter of 2024, gaining 15.8%.

### Q1 2024 Key Market Total Returns



Source: Bloomberg

**WTI crude prices also climbed higher over the quarter on ongoing geopolitical tensions**

Gold, which ended the quarter up 7%, hit a new all-time high on March 3 and ended the month at another new all-time high, breaking above \$2,200 per ounce for the first time due to persistent central bank buying and gradually improving investor sentiment.<sup>22</sup> West Texas Intermediate (WTI) crude prices also climbed higher over the quarter on ongoing geopolitical tensions, breaking past \$80 per barrel for the first time since November. This has led to rising gasoline prices, and the national average per gallon by the end of March

***The Bank of Japan ended the world's only negative interest rate regime and hiked interest rates for the first time in 17 years***

was \$3.53, its highest price in more than a year.<sup>23</sup> Midstream energy enjoyed a stellar opening to the year, ending the quarter up nearly 13.9%. Bitcoin also reached new all-time highs in March, hitting a record \$73,135 on March 13. More than \$35 billion has gone into bitcoin spot ETFs since their launch in January. Bitcoin ended the quarter up 61.3%.

In international news, China's economic growth has shown signs of improving. The country's manufacturing activity expanded in March after contracting for five consecutive months, and its official purchasing managers index rose to 50.8.<sup>24</sup> Further, Chinese inflation data show that the country has inched out of deflationary territory, and headline CPI rose 0.7% year-over-year in February but dropped back down to 0.1% in March.<sup>25</sup> The Shanghai Shenzhen CSI 300 Index ended the quarter up 4.8%.

Coincidentally, on March 19, another influential central bank announced a major monetary policy shift. The Bank of Japan ended the world's only negative interest rate regime and hiked interest rates for the first time in 17 years. This marked the end of an era and a historic shift (albeit a small one) away from an aggressive monetary easing program that had been in place for years to combat economic challenges in Japan.<sup>26</sup> The Bank of Japan raised its short-term rate to around zero to 0.1% from -0.1%.<sup>26</sup> The yen weakened after the announcement and remained above 150 against the dollar for the rest of the month, as the bank conveyed a dovish tilt by noting that financial conditions would remain accommodative for the time being.<sup>26</sup>

## Looking Forward

The Fed has maintained that it will likely cut interest rates three times this year, meaning it has acquiesced to a higher inflation target. If policymakers can contain longer term bond yields while tolerating higher inflation, the economic backdrop could continue to support above-average equity valuations. Additional productivity gains from artificial intelligence (AI) could further fuel this support.

Although the Fed wants to cut short-term rates, longer-term rates may stay higher for longer if inflation remains elevated. Historically, tightening cycles such as this one have constrained bank lending; however, in the current climate, the relatively new and growing private credit asset class—holding nearly \$2 trillion in assets—is filling the lending void left by banks. Rampant fiscal spending, which shows no signs of abating, has also become a key driver of economic growth.

***Policymakers' aim and accuracy remain critical as we move toward the second half of 2024***

Finally, the Fed may be motivated to avoid a liquidity crisis in an election year, and so it could taper bond sales and become more accommodative due to issues unrelated to economics, much like what occurred in 2018. Higher longer-term rates would continue to pressure areas such as commercial real estate, regional banks, and highly indebted smaller companies. If longer term rates move much higher, then those headwinds could creep into other areas of the market, too. Thus, policymakers' aim and accuracy remain critical as we move toward the second half of 2024. In light of this, we remain comfortable with the shorter-than-benchmark duration positioning within fixed income portfolios and continue to favor the inflation hedges that have been a consistent feature of our strategy over the last few years.

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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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