Review & Outlook

First Quarter 2024

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Review and Outlook

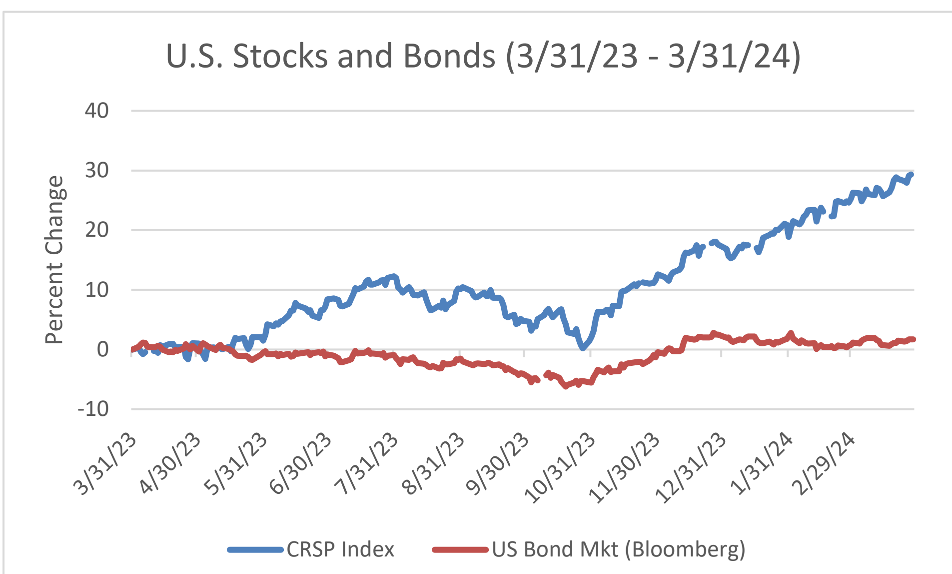
The U.S. economy has been resilient, to say the least, with recent headlines describing the "shocking" and "blistering" pace of growth at the end of 2023.[2,3] And not only did we see exceptionally strong growth, it all happened while we were supposed to be in a recession. Thinking back to the forecasts from early 2023, most called for a recession by the end of the year, and the widely accepted view was that consumer spending would slow as stimulus money faded and student loan payments restarted. Moreover, everyone was sure that the economy would slow given how quickly and how much the Federal Reserve had raised interest rates.

So much for the most promised recession in history that still hasn't arrived. (We think the jury is still out, with a downturn still possible.) The economy continues to show strength, as the wealthiest consumers are still spending, which has allowed the stock market to remain defiant. We say defiant because indexes like the Nasdaq and S&P 500 have been increasing since last November, despite what's been happening in the news. Back then, the narrative was that stocks would move higher because interest rates were about to fall. But in March, that story changed; stocks would now move higher given the strength of the economy, despite what interest rates were doing. While that defiance has been good for portfolio values, it raises questions about what may lie ahead.

Index Performance Data
Total Return as of 3/31/2024

Indices[1]	Q1 2024	Trailing 12 Months
CRSP U.S. Total Market Index Total Return	10.01%	29.33%
MSCI ACWI Ex-U.S. Total Return	8.40%	14.74%
Bloomberg U.S. Aggregate Bond Index	-0.78%	1.70%

The chart below shows the change in the CRSP index from the end of March 2023 to the end of March 2024, and includes the yield for the Bloomberg Aggregate U.S. Bond index.[4] Note the divergence between the two that begins in November: the bond market is reacting to news about inflation and other stressors, while the stock market turns a blind eye.



The bond market showed a bit of optimism at the end of 2023, with yields on 10-Year U.S. Treasuries falling, and the value of outstanding bonds increasing for the first time in quite a while. Unlike stocks, however, bonds struggled in the first quarter of 2023. Inflation proved to be more stubborn than many had hoped, and several key interest rates moved back up. As we write this Review and Outlook, yields on 10-year Treasuries are at their highest levels of the year, which puts downward pressure on the value of outstanding bonds. We expect yields to drop, but market dynamics could keep intermediate-term yields from dropping significantly.

The Blue Chip Consensus forecast calls for GDP growth to fall back to the recent trend level between 2% and 2.5%. The forecast calls for further slowing in 2025, but, surprisingly, there is no call for a recession. The risks are largely to the downside, given what could happen with commercial real estate and escalation of the wars in Ukraine and the Middle East. But, for now, the forecast is quite positive. The consensus view is that unemployment will hover around 4% this year and into next, with inflation slowly falling toward the Fed's target of 2%. There is much debate about whether we'll see inflation back at 2% by early 2025, or if the Fed will decide that inflation slightly over 2% is fine. At any rate, stubborn inflation means that the Fed will likely keep interest rates higher for longer.

In late 2023, the markets anticipated six interest rate cuts, perhaps starting in March 2024. Now, most analysts expect the Fed to cut interest rates only 3 times, starting this summer. Higher interest rates mean higher borrowing costs, which puts pressure on commercial real estate developers and owners, while also reducing loans for cars and other items. The impact of higher interest rates hasn't been as dramatic in this cycle of rising interest rates because so many homeowners and developers locked in lower rates in 2021 and early 2022. (One article noted that 60% of the mortgages in the U.S. are below 4%.[5]) But developers and many owners of commercial spaces do not have access to 30-year fixed mortgages. They took advantage of the lower rates available a couple years ago as best they could, but the clock is ticking. The Wall Street Journal noted recently that more than $2 trillion in debt is maturing before 2028.[6] And, last year, a Bloomberg news article suggested that the refinancing burden would start being an issue or concern if rates stayed higher into the second half of 2024.[7] The likely outlook is that interest rates will, in fact, be higher going into the second half of this year.

The current outlook for the economy is positive, which means inflation could be slow to fall all the way back to 2%. And that means the Federal Reserve will not lower interest rates as much this year as everyone had hoped a few months ago. Higher rates could cause stress in the commercial real estate sector, especially given that occupancy rates in office buildings across the U.S. are about 60% of what they were before COVID, but the positive economic outlook means that lenders and developers should be able to navigate those challenges.

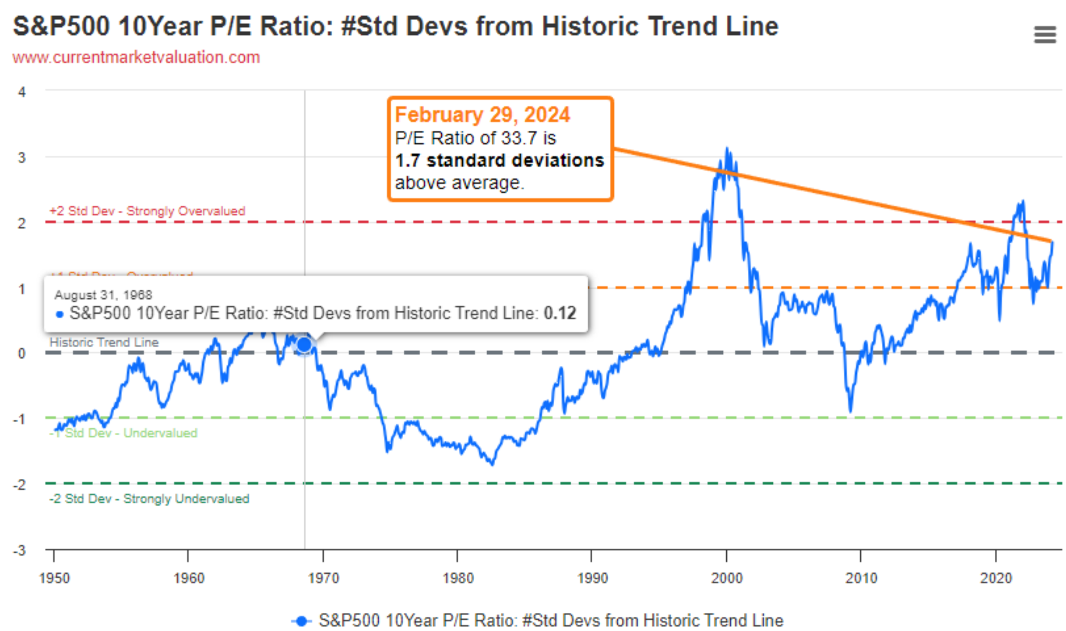
The widely accepted positive forecast presumes that a lot will go right and that very little will go wrong; that the Fed will thread the needle, without making any policy mistakes. Lowering interest rates too soon could allow inflation to accelerate again, and waiting too long to lower rates could slow the economy too much. It's an optimistic view, but plausible. However, we think it is just as likely that things will not go smoothly.

In Focus

We want focus on one area where we think the market's unbridled optimism has run a bit too far: stock prices. Many investors compare the price of a stock to the value of the company's underlying earnings, including its expectations for future growth, which results in a price-to-earnings (or P/E) ratio. And you can use the P/E ratio to decide if a stock's current price relative to its earnings is attractive or too high. Unsurprisingly, there are many different ways to look at the price and earnings of a given company. Do you consider past earnings or projected future earnings? How far back and how far ahead should you look? And over what time period do you analyze the data? Current P/E ratios are elevated, which concerns us given how far above historic norms they currently sit.

We've discussed before how the lion's share of the late-2023, early-2024 run-up in index valuations came from a very small handful of companies. We wrote about the AI craze in our last Review and Outlook, and how seven companies (including Nvidia, Meta, and Microsoft) accounted for almost all of the S&P 500's growth. Lately, that index's growth has been more diversified, which is a good sign. But we still we worry about stock valuations.

CurrentMarketValuation.com tracks P/E values for the S&P 500, and the following figure on the next page uses 10-year average P/E values to smooth out some of the volatility in the data (which is visible looking at monthly or even annual data due to very large, short duration changes caused by events like Covid and the 2008 Financial Crash).[8] Earnings will grow with a strong economy, which is what we currently have. Earnings growth usually means lower P/Es, but as long as investors continue to bid up prices as fast as earnings are growing, P/E values will not fall. Moreover, a strong economy means fewer interest rate cuts this year, which should put downward pressure on stock prices. Still, investors are applauding any positive economic news and talking about how the market can push noticeably higher, but the reality is that earnings growth has to be very, very strong for that scenario to make any sense.



We recognize that the amount of money pushed into the economy in the wake of the 2008 Financial Crisis, and then again with COVID, means that average P/E values today could be a bit higher than in the past. However, the underlying math used to calculate how much a company's stock is worth based on its earnings is still the same. Which means that means stock prices will have to come back down a bit at some point, especially given that interest rates are relatively high right now, and are expected to stay high well into 2025.

Markets are likely to go up and down based on underlying economic (and sometimes political) fundamentals, but reactions to those fundamentals can take time to show up. We think that stock prices need to come down to be more consistent with interest rates and earnings, but can't say how long that will take to happen.

You will see this conclusion reflected in our current rebalancing efforts. Given that yields on money market funds are better than yields for many investment grade bonds, we are currently using money market funds as part of our Fixed Income and Mutual Fund/ETF portfolios. As the Federal Reserve starts to lower interest rates, and as yields on money market funds start to fall as a result, we will begin investing in other bond and stock positions. We expect the Federal Reserve to start slowly lowering interest rates this summer, so you should expect to see changes in our bond holdings later in the second quarter. And as we complete our stock rebalancing in the second quarter, some of the final decisions will be informed by how stock valuations change over the next few months.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
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4. Chart data provided by YCharts!X
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8. Current Market Valuation. (2024, February 29). Price/earnings analysis indicates stock market is overvalued. Using P/E Ratio to Determine Current US Stock Market Valuation. https://www.currentmarketvaluation.com/models/price-earnings.php
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