Market & Economic Commentary

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INVESTMENT SERVICES

Market Performance Recap

The first quarter flew by as the market continued riding a wave of strength that started early last year. The appetite for increasing equity exposure seemed insatiable throughout the start of 2024, with large cap stocks rallying 10.6% as measured by the S&P 500. That would be a strong return for a whole year, yet it happened in just the first three months. But this rally started behaving a little differently than last year, and dare we say a little healthier? Throughout 2023 you heard us reference the 'narrow' market rally which was led by seven high flying stocks. Some of those stocks continued to lead the rally this year, like Nvidia and Microsoft, while others began to struggle, like Apple and Tesla. In isolation, that movement is not healthy or unhealthy, however the theme you're going to hear now is 'the market rally is broadening.' Small cap equities outperformed large cap equities in March. Despite the significant headwinds from a stronger dollar, European, UK and Japanese equities are rallying and hanging around with the S&P 500 returns. For the first three months of the year, just about everything seemed to be moving up.

At the beginning of November 2023, the chairman of the Federal Reserve indicated an end to increasing interest rates, which immediately turned into the market speculating about interest rate cuts. In fact, in late 2023, the futures market priced in six cuts for 2024! That's a full 1.5% of interest rate cuts that were priced in quickly. The lower interest rate expectations fueled the sharp rally into the end of the year. Something has changed though in 2024. The interest rate cut expectations have now dwindled to only two, and some prognosticators are saying none for 2024. Higher interest rates? Higher cost of capital? That means higher borrowing costs, higher discount rates, and higher return hurdles - since you can just buy a short-term Treasury and pick up more than 5%. Yet the market still rallied, why?

First, economists and strategists have been negative about the US economy for a couple of years now, but have recently turned positive. Instead of constantly saying a recession is just a quarter or two away, most media pundits have been forecasting growth. Second, earnings for companies listed in the US seem to have troughed in Q3 and are now turning up. This is largely due to a resilient and expanding economy along with an uptick in productivity. Businesses that laid off staff are still producing at or above their previous levels, while those unemployed people seem to be finding new opportunities in a still robust job market. Even geopolitical risks seem to have stabilized. Downside risks can be quantified, and while tragic for humanity, the market can hedge against risks it understands. The risk now is to the upside, as resolutions to these crises would be viewed positively by the global economy. Lastly, when thinking about the global economy, it has been held back by China, the second largest contributor, over the last few years. That changed in the first quarter as well, and economic stimulus and pent-up demand have finally positively impacted consumption and growth for China, which is seeing a resurgence in its appetite for commodities and new orders. A stronger Chinese economy would have a positive impact for the world.

In the US, large cap stocks and growth stocks led the way. However, small caps are trying to catch up. The small cap index (Russell 2000 Index) returned 5.2% for the quarter, trailing the large caps by 5.4% for those three months.

However, in March the small caps returned 3.6%, 0.4% ahead of large caps; that's the broadening out referenced above. While value trailed growth throughout the quarter, it too had a resurgent March as more companies participated in the equity market rally. Again, we believe that more stocks participating in the rally is a healthy sign for continuation.

Chart 1: US Equity Index Returns

	March	1st Quarter
S&P 500	3.2%	10.6%
Russell 1000 Growth	1.8%	11.4%
Russell 1000 Value	5.0%	9.0%
Russell 2000	3.6%	5.2%

Source: OIS, FactSet

Outside of the US, the developed world returned 5.8% for the quarter on a US dollar basis. This is despite a 2.5% increase in the US dollar versus the euro, and even more versus some other currencies, which is directly subtracted from the local market return to get the US dollar return. If we look at returns in local market currencies, the developed world performed very well to start the year. Emerging markets lagged, but still managed a positive return, up 2.4% for the quarter. The weaker gain is reflective of the stronger dollar and broader impact of geopolitical issues and lingering uncertainty around dozens of elections pending throughout the year.

Chart 2: Non-US Equity Index Returns

	March	1st Quarter
MSCI Emerging Markets	2.5%	2.4%
MSCI EAFE (Developed)	3.3%	5.8%
MSCI ACWI-Ex US	3.1%	4.7%

Source: OIS, FactSet

While the opening paragraphs of this letter were decidedly positive, they were largely devoid of references to fixed income. The fixed income markets were generally weak to start the year, pressured by dwindling rate cut expectations throughout the quarter. The broadest measure of investment grade bonds in the US, the Bloomberg US Aggregate Index, returned -0.8% for the quarter, while the Bloomberg Municipal Bond Index fared modestly better, returning -0.4%. The only positive segment of the investment grade fixed income market was the 3-month US Treasury bill, which posted a 1.4% return for the quarter, essentially returning its yield. When you drop below investment grade (think junk bonds), stronger returns await as the appetite for risk in equities spilled over into demand for lower quality fixed income, as measured by the ICE BofA US High Yield Index, which returned 1.5% for the quarter.

Similar to outcomes experienced in equities, the rest of the world lagged the US fixed income returns in the first quarter. The FTSE World Government Bond Index returned -2.4% for the quarter, while the broadest measure of the global investment grade bond market, the Bloomberg Global Aggregate Index, returned -2.1%.

Chart 3: Fixed Income Returns

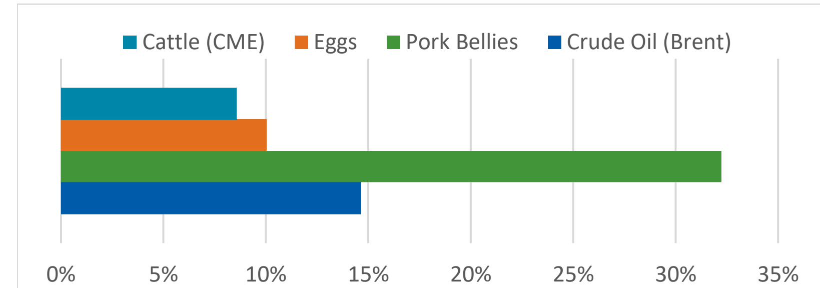
	March	1st Quarter
FTSE WGBI (USD)	0.4%	-2.4%
Bloomberg Global Aggregate	0.6%	-2.1%
Bloomberg US Aggregate	0.9%	-0.8%
Bloomberg Municipal Bond	0.0%	-0.4%
ICE BofA US High Yield	1.2%	1.5%

Source: OIS, FactSet

Economy

The US economy continued to exceed expectations and proved resilient in the face of higher interest rates, geopolitical concerns, and inflation. With respect to the latter, inflation fell continuously throughout the last year, but it seems to have leveled out. The next few months will be critical for economic growth. Since late October, economic conditions in the US have been easing, meaning liquidity is increasingly abundant and capital is readily available for those who seek it. These easier economic conditions have been predicated on the Fed easing rates, which it will only do if it is comfortable that inflation is moving lower. Inflation stabilizing at around 3% could prove problematic and prevent the Fed from cutting rates at all in 2024; a possibility not fully discounted by the markets. Why would inflation be sticky? Oil prices have been rising, impacting the global consumption supply chain through higher fuel costs. Other commodities have been rising too, like meats and metals, and then there is cocoa. Cocoa had a move to start the year that would make speculative AI stocks jealous; after an abysmal crop in the Ivory Coast, the commodity has sky-rocketed 150% to start the year. Higher commodity prices lead to higher costs for consumers, also known as inflation.

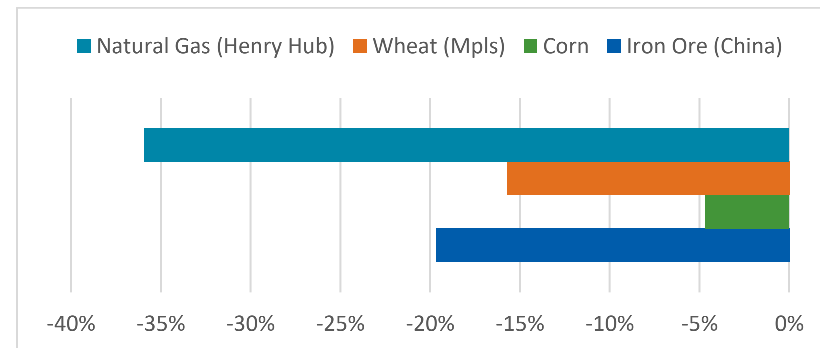
Chart 4: Commodities Rising to Start the Year



Source: OIS, FactSet (Returns 1/1/24 – 3/31/24)

While the trend seems higher, not all commodities have been increasing as US natural gas fell on restrictions to new export facilities, and wheat declined on stronger crop yields due to increased planting to make up for Ukraine's lost production.

Chart 5: Commodities Falling to Start the Year

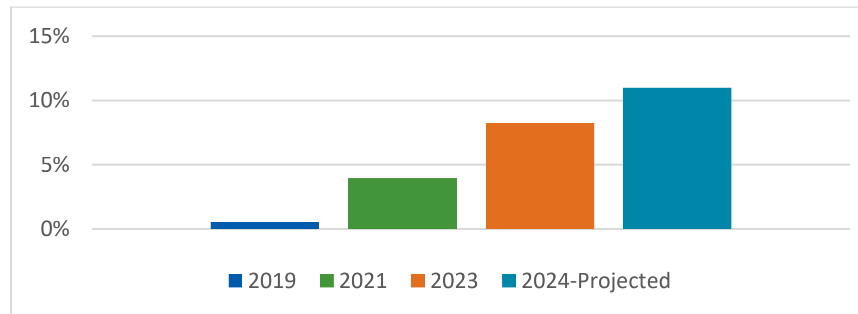


Source: OIS, FactSet (Returns 1/1/24 – 3/31/24)

Elsewhere, the European economy sputtered in the areas of traditional strength, France and Germany, while the peripheral countries, like Spain and Italy, enjoyed robust growth. The Europeans have seen energy prices fall, though they are still higher than before the war in Ukraine started. With a large manufacturing base, this is acutely painful for Germany which is now contending with Chinese automobile imports. The new entrants in the German market are significantly cheaper electric vehicles (EVs) than what can be produced domestically, pressuring manufacturing output.

Those fortunes are reversed in the developing world, with China growing again, as evidenced by its demand for raw materials and its increasing consumption. China may have been slow in getting into the auto-manufacturing game, but now that it's in, it is proving to be a highly formidable competitor. Over the last few years Chinese EVs have gobbled up market share across Europe, boosting Chinese exports and upskilling its manufacturing base.

Chart 6: Market Share of Chinese EV Brands in Europe



Source: Rahvusvaheline Kaitseuuringute Keskus, International Centre for Defence and Security Estonia, October 2023

The other juggernaut in the emerging world is India, and it continues to exhibit strong growth and strong stock market returns as the economy is in the process of lifting one billion people out of poverty and into the world's middle class. Elsewhere in the emerging world, South Korea has seen renewed interest in the equity market, which rallied more than 10% to start the year, as the country is adopting similar shareholder reforms to those enacted by Japan over the last several years. The Japanese reforms have unlocked shareholder value and resulted in sustained outperformance for Japanese equities versus the rest of the world for most of the last decade. Needless to say, the market is enthusiastic about what this could mean for South Korea.

The Year of Elections

Given the heading, one can be forgiven for thinking this might be yet another column about the US presidential election. Thankfully, it is not. Instead, we are talking about the other 75 countries, representing more than half the world's population, holding meaningful elections in 2024, a record amount. Some have already taken place, such as Russia where Putin won a landslide election with 87.8% of the vote resulting in more of the same for that country. Taiwan held elections already and maintained its westerly-leaning government, voting down pro-China parties. However, other elections are resulting in big changes, such as Turkey, where the opposition party won big in Istanbul and Ankara, the two major cities, as well as other economically important cities like Bursa and Antalya. The results were a rebuke of President Erdogan and his AKP party, as his party's candidates fell short nationwide and lost the popular vote. This signals changes in policy ahead for Turkey.

Most European countries have elections this year, and many will be closely contested with rival parties with different ideologies fighting for control. Elections around the world will make this year interesting as some will result in widespread changes, like the election of Javier Milei in Argentina, while others will result in continuity and stability like the election of Lai Ching-te in Taiwan. These can and will present investable opportunities, so we are staying nimble and focused as the results unfold.

If you would like to discuss any of these topics in greater detail, please reach out.

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