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February 20, 2024 – Investment Commentary

Equities

The S&P 500 returned -0.3% as rates rose in response to two sets of inflation data that surprised negatively to the upside, although small cap stocks were positive. Investors are nervous that sticky inflation will jeopardize the timing and extent of rate cuts from the Fed. Value outperformed growth across market caps. EAFE non-US developed markets returned 1.5% and Emerging Markets (EM) returned +2.1%, led by China (+3.7%) in what seems like continued optimism around the lunar New Year holiday and their central bank reducing borrowing rates.

Last year, the Magnificent 7 essentially drove all the S&P 500's returns and profit growth, with profits up an estimated 31% in the Magnificent 7 in 2023 compared to profits contracting 4.3% in the rest of the S&P 500. This year, that leadership should broaden out, with 39% of profit growth projected to come from the Magnificent 7 and 61% coming from the rest of the index. A backdrop of positive earnings growth after roughly flat growth last year is supportive of equity prices. That said, although profits should experience healthy growth this year, there are downside risks as forward guidance has been cautious and the economy, albeit positive, slows back to its long term trend. We continue to prefer quality in large and mid-caps over small caps.

Fixed Income

Investment grade fixed income sectors had negative returns as rates rose across the curve. Municipals returned -0.1%, while US Investment Grade returned -0.5%. HY bonds returned -0.3%, while bank loans rose 0.2%. EM debt returned +0.6% even as the US dollar rose slightly.

Rates

Rates rose across the curve as inflation data surprised negatively to the upside and traders continued to push back expectations on the timing of the first interest rate cut from the Fed. The recession-watch 3M-10Y spread compressed 10bps and closed the week at -111. The 2Y-10Y spread widened 5bps and is now -36. Rates rose slightly in other developed markets. The Italian Government Bonds (BTP)-German Government Bonds (Bund) spread is at 1.48%, which doesn't indicate much stress between leveraged and less leveraged sovereigns. The 5-year and 10-year breakeven inflation expectations rose and now sit at 2.42% and 2.33% respectively; the 10year real yield (nominal less inflation) rose 3bps to 1.95%. The market expects the Fed to cut between 4 and 5 times in 2024, with the first cut now coming in June (54% probability) versus the Fed's guidance of three cuts. At year-end 2024, the market expects the Fed Funds rate to be 4.25%.

Currencies/Commodities

The dollar rose 0.2%. The commodities complex rose 0.1% as energy prices moved higher by 0.3%. Brent prices moved higher to $83/bbl. US natural gas fell 12.9% to a three-year low on continued expectations of milder weather, while European gas fell 8.6% with ample inventories and lower demand.

Market monitors

Volatility rose for equities and bonds (VIX = 14, MOVE = 109); the 10-year average for each is VIX=18, MOVE = 75. Market sentiment fell to 15 from 26 as investors got spooked about the inflation data.

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