

March 11, 2024 – Investment Commentary

Equities

The S&P 500 returned -0.2% as information technology stocks, which had led the index to multiple all-time highs, seemed to take a breather. Value outperformed growth across all market caps. Utilities (+3.3%) and real estate (+1.6%) were the best performing sectors in the S&P 500; consumer discretionary (-2.5%) and information technology (-1.1%) were the laggards. EAFE markets returned 2.5%, with Australia (+3.4%), Japan (+2.6%), and Europe (+2.5%) leading. EM markets returned 1.2%, with Korea (+2.6%) weighed down by China (-1.8%). Over the last month, the MSCI Europe index (in USD) is +5.9% vs. the +2.7% of the S&P 500. The EUR is about 2% stronger than the USD over the period, making up the majority of the outperformance.

From a valuation perspective, most markets are within ± 1 standard deviation based on historical forward P/E ratios, though the S&P 500 is at +1.7 while the NASDAQ is at 1.3. For the next 12 months, EPS growth for S&P 500 is expected by sellside analysts to be 8.0% (vs. 7.2% annualized over the last 20 years). For the next 12 months, EPS growth for NASDAQ is expected to be 23.2% (vs. 12.7% annualized over the last 20 years). The S&P 500 (US Large Cap) and NASDAQ trade above their 20-year averages based on forward P/E ratios, as do the MSCI EM (EM Equities), while the Russell Midcap (US Midcap), Russell 2000 (US Small Cap) and MSCI EAFE (Non-US Developed Market Equities) all trade below.

Rates

Rates fell across the curve. The recession-watch 3M-10Y spread widened 12bps and closed the week at -132. The 2Y-10Y spread widened 5bps and is now -40. Rates fell slightly in other developed markets except in Japan. The BTP-Bund spread is at 1.32%. 5-year and 10-year breakeven inflation expectations rose and now sit at 2.39% and 2.28% respectively; the 10Y real yield fell 7bps to 1.79%. The market now expects the Fed to cut between 3 and 4 times in 2024, with the first cut now coming in June (55% probability) vs. the Fed's guidance of three cuts. At year-end 2024, the market expects the Fed Funds rate to be 4.25%.

There are two arguments for cutting rates, even if the economy is healthy. One, if inflation comes down and the Fed doesn't cut rates, then real rates (nominal interest rates less inflation) will increase. As a result, monetary policy would get tighter, and the Fed doesn't want that to happen. Two, Chair Powell has communicated that if the Fed's target is 2% inflation, it should cut rates before inflation hits 2% because monetary policy works with a lag.

The Fed's preferred inflation gauge, the core personal-consumption expenditures index, is due March 29. But a strong consumer-price index report this week is still important enough to force the market to reassess its plans for the first Fed cut.

Fixed Income

Investment grade fixed income sectors had positive returns as rates fell across the curve. Municipals returned 0.4%, while US IG returned 0.9%. HY bonds returned 0.6%, while bank loans rose 0.3%. EM debt returned +0.8% as the US dollar fell 1.1%.

Currencies/Commodities

The dollar fell 1.1%. The commodities complex fell 0.8% as energy prices moved lower by 2.1%. Brent prices fell to \$82/bbl. US natural gas fell 1.6% while European gas rose 3.4%.

It's worth revisiting cross-asset correlation to the U.S. dollar. The recent USD weakening has helped broaden market participation across other asset classes. The asset classes that are more negatively correlated (move in opposite directions) to the U.S. dollar relative to the S&P 500 are non-U.S. equities and emerging market debt/U.S. corporate bonds. Simply put, when the U.S. dollar is falling, these asset classes typically have more price appreciation upside. The driver for non-U.S. stocks is relatively easy to connect based on the foreign exchange in the equity exposure (unhedged) and will see an improvement from the currency translation (foreign currencies up, help foreign equity returns go up). However, on the bond side what we are seeing is that a weaker U.S. dollar is coinciding with lower treasury yields. Generally, lower treasury yields help longer duration fixed income, everything else being the same.

Market monitors

Volatility rose for equities but fell for bonds (VIX = 15, MOVE = 101); the 10-year average for each is VIX=18, MOVE = 75. Market sentiment rose to 30 from 25 as bullish sentiment rose to 51, "an unusually high level" per the AAI (American Association of Individual Investors).

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