



Investment Newsletter

First Quarter 2024

The S&P 500 continued its torrid rally from the October lows, posting a +10.44% total return in the quarter. International markets were also strong, with the MSCI All-Country World ex-U.S. Index returning +4.69%. Remarkably, this performance came despite multiple disappointing inflation reports that tempered expectations for when and how aggressively the Federal Reserve would cut interest rates this year, resulting in a backup of bond yields. In addition, yet another regional bank, New York Community Bancorp (NYCB), got into financial trouble and required a rescue package.

The stock market's impressive performance can be attributed to the following factors:

- Stronger-than-expected economic and corporate earnings growth.
- Continuation of the general downtrend in inflation and the Federal Reserve's unwavering commitment to lowering interest rates at some point this year.
- Accelerating growth in generative A.I. (GenAI) technology that broadened out to multiple companies and sectors. A.I. semiconductor market leader NVIDIA also posted another stellar quarter.
- Persistently sturdy labor market with good new job creation, low unemployment, and solid wage growth.
- Continued improvement in stock market breadth. The so-called 'Mag 7' were only 37% of the S&P 500's total return performance in the quarter, with an equal-weighted average total return of +16.94% versus +7.79% for all the other stocks. Despite NVIDIA's +82.46% total return, 'Mag 7' performance was held back by negative returns from both Apple (-10.82%) and Tesla (-29.25%).

In fixed income markets, total returns were slightly negative, largely tied to recent stronger economic data, which catalyzed a repricing of bond yields higher across all Treasuries with maturities over two years. The Bloomberg U.S. Intermediate Government/Credit Index declined -0.15% and the Bloomberg Barclays Municipal Bond 1-5 Year Blend Index returned -0.22%.

Because of the stronger economic data, investors now expect fewer interest rate cuts. Currently, investors expect the Federal Reserve to cut interest rates three times this year versus six times when the year began, to a level of 4.50-4.75% from 5.25-5.50%.

Municipal and corporate bonds outperformed Treasury bonds as investor demand remained high. For corporate bonds, credit quality is relatively high and balance sheets have improved – as reflected in more corporate debt being upgraded than downgraded by the rating agencies for the fourth year in a row. Overall, valuations are relatively expensive on an historical basis, but the sector is still attractive given the improvement in fundamentals.

Bond yield volatility is expected to remain high as the path to lower inflation remains bumpy, economic data uneven, and geopolitical issues constant. Our long-term concerns about bond yields are rooted in the projected \$20 trillion federal budget deficit over the next ten years and the historically unprecedented rate at which the U.S. is accumulating debt – and the lack of political will to address both issues. Consequently, our investment strategy is to conservatively structure client portfolios with high-quality, intermediate-maturity bonds.

The stock market's ongoing resilience is a testament to the favorable investment backdrop for equities, underpinned by strong corporate earnings growth – the key driver of stock performance. S&P 500 earnings are forecasted to grow +10.6% in 2024 versus just 0.4% in 2023. Technology, health care and financials companies are driving the majority of this acceleration in growth.

Inflation also continues to recede, albeit more slowly and from lower levels. The Personal Consumption Expenditures (PCE) Index, the Federal Reserve's preferred inflation gauge, has steadily fallen to +2.5% in February from its peak of +7.0% in June 2022. The Federal Reserve's long-term annual inflation target is +2.0%.

Consequently, the Federal Reserve is widely expected to begin lowering interest rates later this year. Other central banks are expected to follow suit, which should help bolster global growth. In fact, the Swiss National Bank has already begun to cut interest rates. The Bank of Japan is the only central bank currently raising interest rates, having just raised them out of negative territory for the first time in 17 years to 0.1%.

Low unemployment has also been a bedrock of support for consumer spending. The unemployment rate rose to 3.9% in February but was coming off a 54-year low of 3.4% set in January 2023 – and there are still 8.7 million job openings. This has allowed consumers to withstand both higher interest rates and tighter lending standards.

Sustainable growth requires innovation and the development of GenAI technology and its adoption have been key stock market catalysts. This has positive implications not only for future economic growth, but also for increased productivity and efficiency, which can strengthen corporate profitability.

The White House is also determined to help the consumer in a re-election year. A student loan cut is planned for July 1, and the Consumer Financial Protection Bureau is limiting consumer credit card late fees. Interestingly, the last time the S&P 500 fell in a Presidential re-election year was 1940.

Despite this favorable investment backdrop, there are always concerns to monitor. The S&P 500's valuation is now genuinely rich at 20.7 times next twelve-month earnings, only -15% below its all-time peak in March 2000.

Consumers have exhausted their pandemic-era savings surplus, credit card delinquencies have been consistently rising, the personal savings rate is below pre-pandemic levels at just 3.6%, and cracks in consumer spending have surfaced recently with weaker corporate earnings reports from Expedia, Nike, Tesla, PVH and Gucci.

Inflation comes in waves and may stay stubbornly above the Federal Reserve's target of 2.0%. Wage growth remains elevated at +5.0%, and California's new minimum wage law of \$20 per hour just went into effect; the price of crude oil is up +18.4% year to date, despite non-OPEC supply growth more than offsetting OPEC supply cuts; and the 'wealth effect' is as strong as ever with stocks, real estate, gold, and cryptocurrencies all at or near all-time highs – all of which might make it harder for the Federal Reserve to lower interest rates. Many at the Federal Reserve have argued the risk of cutting rates too early is greater than holding rates steady for too long.

The next U.S. President will have to address the country's debt and deficits, as well as prevent all of the individual provisions from the Tax Cuts and Jobs Act of 2017 from expiring at the end of 2025. Absent an extension of that law, individual income tax rates will revert to their 2017 levels (the top rate goes back to 39.6% from 37.0%), the standard deduction will be nearly cut in half (currently \$29,200 for married couples filing jointly), and the estate tax exemption will be cut in half (currently \$13.61 million but was \$5.49 million in 2017).

While we are pleased with the stock market's performance, we are vigilantly monitoring consumer spending trends and the acceleration in corporate earnings growth. We are also keenly focused on the execution of the investment thesis we have developed for each of our portfolio holdings. Although we are steadfastly guided by long-term performance, we acknowledge the stock market's recent stellar run, its current high valuation, and elevated investor expectations.

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