Monthly Market Review & Outlook
2/26/2024

A Fast Start for Some

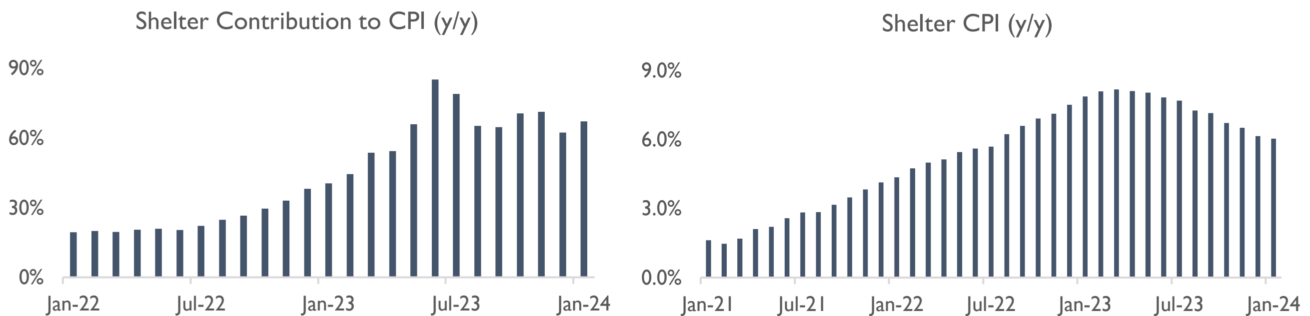
2024 is off to a bullish start for stocks. The S&P 500 and the Nasdaq indices are both up over 6%, which represents a continuation of the bullish end to last year. The fact that the S&P 500 is keeping pace with the technology-heavy Nasdaq suggests market breadth has increased as other non-technology stocks are posting solid returns. Sectors that lagged last year such as Financials, Healthcare and Energy have posted solid returns this year and have notably outperformed during the month of February. It is, however, too soon to call this a change in market leadership, as artificial intelligence continues to power the Technology sector and the overall market upward.

Fixed income, on the other hand, has gotten off to a rocky start with the Bloomberg US Aggregate Bond index currently down slightly (-2%) for the year. Driving this underperformance is higher interest rates. Recall, that the US 10 Year Treasury yield fell dramatically from nearly 5.0% in November to 3.9% by year end. We noted in our monthly webinar two months ago that the market had gone too far pricing in six Fed rate cuts in 2024, so bonds were susceptible to a sell-off. During the last two months, rosier economic data and hawkish Fed-speak has caused a small correction. The fixed income market now expects just three rate cuts, and the US 10 Year Treasury yield has moved up to 4.3%. Until the Fed actually begins cutting and we have more data on the direction of the economy, the fixed income market is fine tuning yields.

Housing Inflation

During the month, there was some consternation over a "hotter" than expected Consumer Price Index inflation report[1]. This inflation gauge reported 3.1% year-over-year growth, which was higher than the 2.9% consensus expectation, but still lower than the prior month and inline with the October and November reports. Some have commented that what is keeping inflation higher than the Fed's 2% target is "sticky" Services inflation due to higher wages.

The truth is that the CPI component for Shelter (i.e., housing) is the culprit.

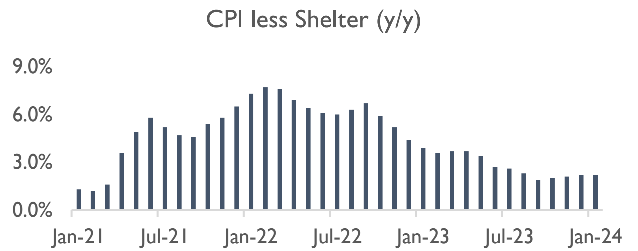


Source: Bureau of Labor Statistics

[1] Bureau of Labor Statistics

Depicted above, Shelter inflation is responsible for two-thirds of overall inflation and, although it is steadily declining, it still reflected 6.0% inflation during January. In fact, if we exclude Shelter from overall CPI, inflation has really been running at 1.9%-2.2% for the last four months. In other words, if the Fed ignored housing price data, inflation in the economy is running comfortably near their 2% target.

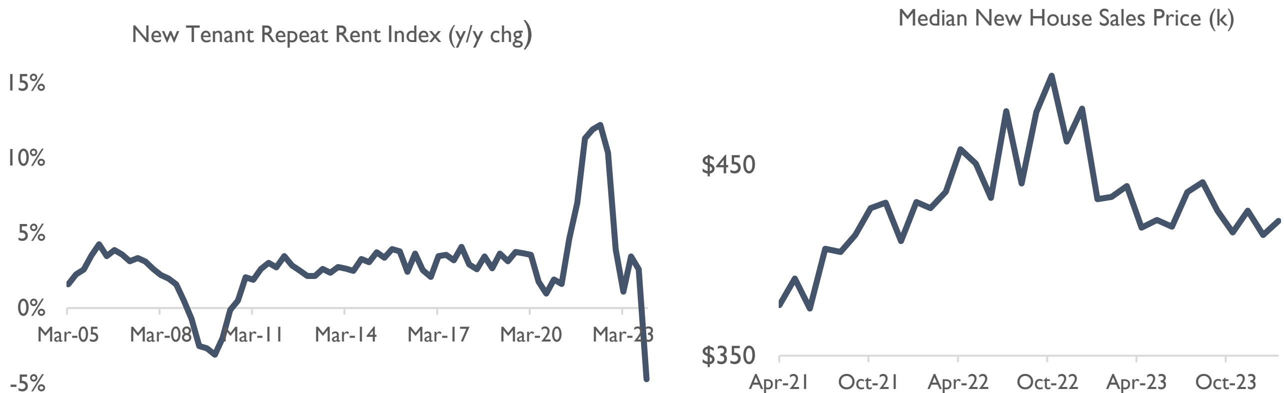
This means that investors should be laser focused on housing prices as the key driver of Fed policy and interest rates. We are going to spend a lot of time on this subject on the next Market Strategy webinar. To summarize, housing prices are set to fall nationwide and potentially substantially in places like Florida, areas of significant overbuilding and areas saturated with short-term rental homes (e.g., Airbnb).



Source: Bureau of Labor Statistics

Home affordability, as measured by the National Association of Realtors, is at its worst level ever recorded due to enormous home price increases and mortgage rates that now exceed 7%[2]. In addition, surging property insurance and property taxes could force many homeowners to sell in the coming months. If this happens there will be price discovery and early signs point to lower home prices. The upcoming Spring home buying season is just weeks away for most of the country, so we will see how this turns out. Nevertheless, there are some early indicators that the housing market is weakening.

Below, the Bureau of Labor Statistics and the Federal Reserve Bank of Cleveland's measure for apartment rents is already showing deflation. This measure tends to lead Shelter CPI by one year. In addition, newly built homes are currently selling at a 15% discount to the peak set in October 2022. This evidence suggests that eventually prices of existing homes, which is the largest segment of the housing market, will follow. Taking all of these datapoints into account, it seems that Shelter CPI is primed to continue declining.



Source: Bureau of Labor Statistics, Federal Reserve Bank of Cleveland

Market Outlook

With CPI poised to continue declining back toward the Fed's 2% target, it would be natural for interest rates to fall as well. The recent backup in interest rates, therefore, is likely a particularly good entry point for bond investors. As for the equity markets, there is an additional consideration required: a healthy economy. Lower inflation and lower interest rates will certainly help. However, the counter argument is that the damage from interest rates may already be done, and this will lead to a weaker labor market and, hence, weaker consumer spending. So far, we have not seen this. The economic data has remained robust overall.

From an industry and individual stock perspective, there are certainly some areas that are struggling with demand consistent with our view that the economy has undergone a rolling set of recessions. The trucking and

[2] Bankrate.

consumer goods sectors are still sluggish, but the worst may be behind them. Technology experienced a slowdown last year and yet those exposed to artificial intelligence and cloud computing are seeing explosive demand. Even the maligned banking sector is doing better than feared. However, real estate and homebuilding may be next to experience a downturn. The key is to pick the right stocks in the sectors of the economy seeing robust demand. This is why we believe it is so important to be invested in secular themes that provide strong tailwinds for those companies exposed. As a recap, here are some of the themes in which we are currently invested:

- Artificial Intelligence / Cloud Computing
- Energy infrastructure & power
- Medical device technology
- The Other 7 billion (India & Japan)
- Opportunistic fixed income

One the main reasons we invest in secular themes is downside protection. Should the economy slow, which is quite possible, these themes should protect against the potential demand destruction the broader economy experiences. Secular themes represent situations where there is an unavoidable need for a product or service.

Conclusion

2024 is off to a solid start. The inflation story is good, the economy continues to show resiliency and that should be a constructive backdrop for both stocks and bonds. We have some concerns with housing and office real estate at the top of the list. And, we do not believe we have seen the full effects of higher interest rates on corporate earnings. Time will tell. Our crystal ball is never perfectly clear, so we will tactically adjust portfolios as these issues unfold. As always, we remain vigilant.

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Definitions

The **S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The **Nasdaq Composite Index** is a market cap-weighted index, representing the value of all stocks listed on the Nasdaq Stock Market. The composition of the Nasdaq Composite is a mix of long-established companies that have been on the exchange since inception, to IPO newcomers, companies that grew from OTC exchanges or switched from other exchanges.

The **Dow Jones Industrial Average** is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

The **Bloomberg US Aggregate Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-dominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate pass throughs), asset-backed securities and commercial mortgage-backed securities.

The **S&P 500 Equal Weighted Index** is the equal-weight version of the S&P 500. The index includes the same constituents as the capitalization weighted S&P 500 index, but each company is allocated the same fixed weight at each quarterly rebalance.

The **Russell 2000 Index** is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 Index total market capitalization.