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Robust Q1 for stocks

Market Digest, April 2024

Editors: Owen Haffey, Technical Writer and Amy Lubas, CFA, VP, Investment Solutions

Executive Summary

In Q4, U.S. economic growth exceeded previous estimates, with real GDP rising to a 3.4% annualized rate, surpassing expectations. Upward revisions to consumer spending, business investment, and government spending were partly offset by decreases in inventories and net exports. Real final sales to domestic purchasers, excluding inventories and net exports, increased to a 3.5% annualized rate, indicating robust domestic demand. This trend suggests continued growth in the near term, supported by a drop in our recession probability model.

The global economy finished the first quarter of the year on a strong note, according to the latest global PMIs. The global composite (services and manufacturing) PMI climbed 0.2 points to 52.3 last month. It was the fifth straight month of expansion and the strongest growth in nine months, but still below its long-term average of 53.2.

Both Fed Chairman Powell and Governor Waller recently reaffirmed the Fed's cautious approach to rate cuts, stressing patience. Powell emphasized patience concerning the timing of rate adjustments and achieving the 2% inflation target, projected by the Summary of Economic Projections for 2026.

In the first quarter of 2024, the S&P 500 surged by 10.2%, marking its strongest start since 2019 and one of the best since 1926. This growth was widespread, with major indices, style boxes, and S&P 500 sectors all finishing higher. However, bonds did not contribute to this success, as the Bloomberg U.S. Aggregate Index fell by 0.8% due to factors like persistent inflation and economic growth, leading investors to favor stocks over bonds.

In March, the S&P 500 sustained its robust performance, rallying over 3.0% for a second straight month, exhibiting broad-based gains across all sectors. Notably, Value sectors such as Energy, Materials, Financials, and Industrials emerged as frontrunners, outpacing the index's overall growth trajectory.

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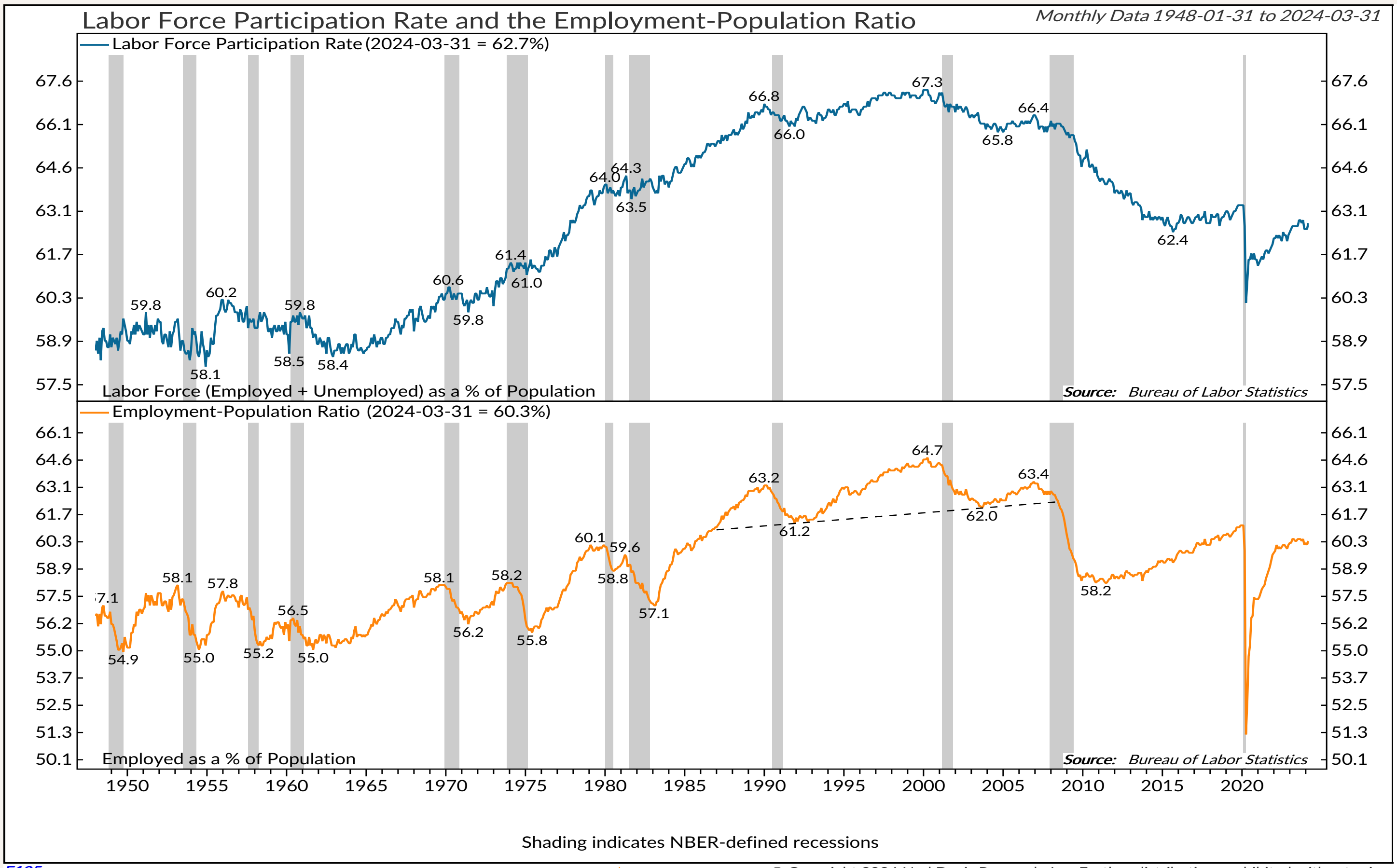
U.S. economy: 2023 growth exceed estimates

In Q4, U.S. economic growth exceeded previous estimates, with real GDP rising to a 3.4% annualized rate. Upward revisions to consumer spending, business investment, and government spending were partly offset by decreases in inventories and net exports. Real final sales to domestic purchasers, excluding inventories and net exports, increased to a 3.5% annualized rate, indicating robust domestic demand. This trend suggests continued growth in the near term, supported by a drop in our recession probability model. Fiscal stimulus exceeding $5 trillion during the pandemic, alongside ongoing government support, has kept the economy expanding, driving inflation. Despite the Fed raising rates in March 2022 to counter inflation, the economy grew beyond potential in the second half of 2023. With inflation persisting above 2%, there's concern that any Fed easing could risk overheating the economy, especially as fiscal policies like the Infrastructure Investment and Jobs Act continue to support growth. While supportive for equity markets historically, such policies may exacerbate inflation if they push growth beyond capacity.

Nonfarm payrolls expanded by 303,000 in March, the most since last May, and above the consensus of 200,000. Additionally, the prior two months were revised higher by 22,000, and the average workweek ticked up to 34.4 hours. The unemployment rate fell to 3.8% from 3.9%, matching the consensus. Household employment rebounded nearly 500,000, as labor force participation jumped to 62.7% from 62.5% (chart below).

Labor force participation increased



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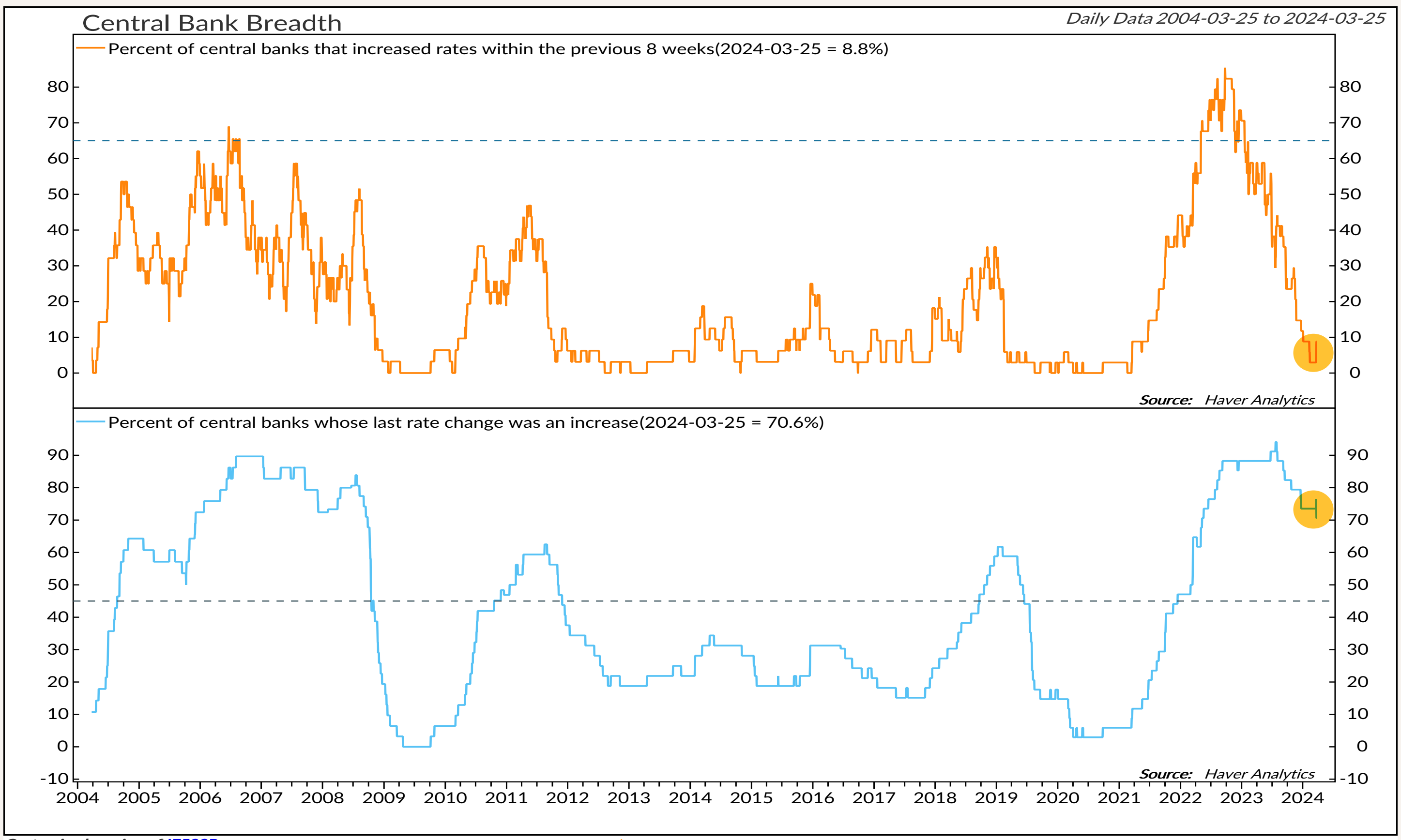
International economy: Faster global growth

The global economy finished the first quarter of the year on a strong note, according to the latest global PMIs. The global composite (services and manufacturing) PMI climbed 0.2 points to 52.3 last month. It was the fifth straight month of expansion and the strongest growth in nine months, but still below its long-term average of 53.2. Even so, the composite continues to move further away from historically recessionary levels, indicating diminishing risk of a sustained global slowdown. With the strong expansion has come inflation that has struggled to come down measurably over the past year, due to stickiness in services prices.

Recent central bank meetings saw significant policy shifts. The Bank of Japan (BoJ) raised interest rates for the first time in 17 years, ending negative interest rate policy and halting yield curve control. Despite maintaining quantitative easing, it ceased purchasing ETFs and REITs, surprising markets and causing yen depreciation, while also boosting expectations of a dovish BoJ. In contrast, the Swiss National Bank lowered its main rate, initiating an easing cycle among major developed central banks. Emerging market central banks, especially in Latin America, started rate cutting cycles last year, diverging from previous tightening cycles. Brazil and Colombia continued rate cuts, while Mexico, usually guided by the Fed, reduced its main rate for the first time since 2020. This led to a drop in the proportion of globally tightening central banks to 70%, the lowest since May 2022 (chart below).

Fewer central banks tightening, but still not at sweet spot



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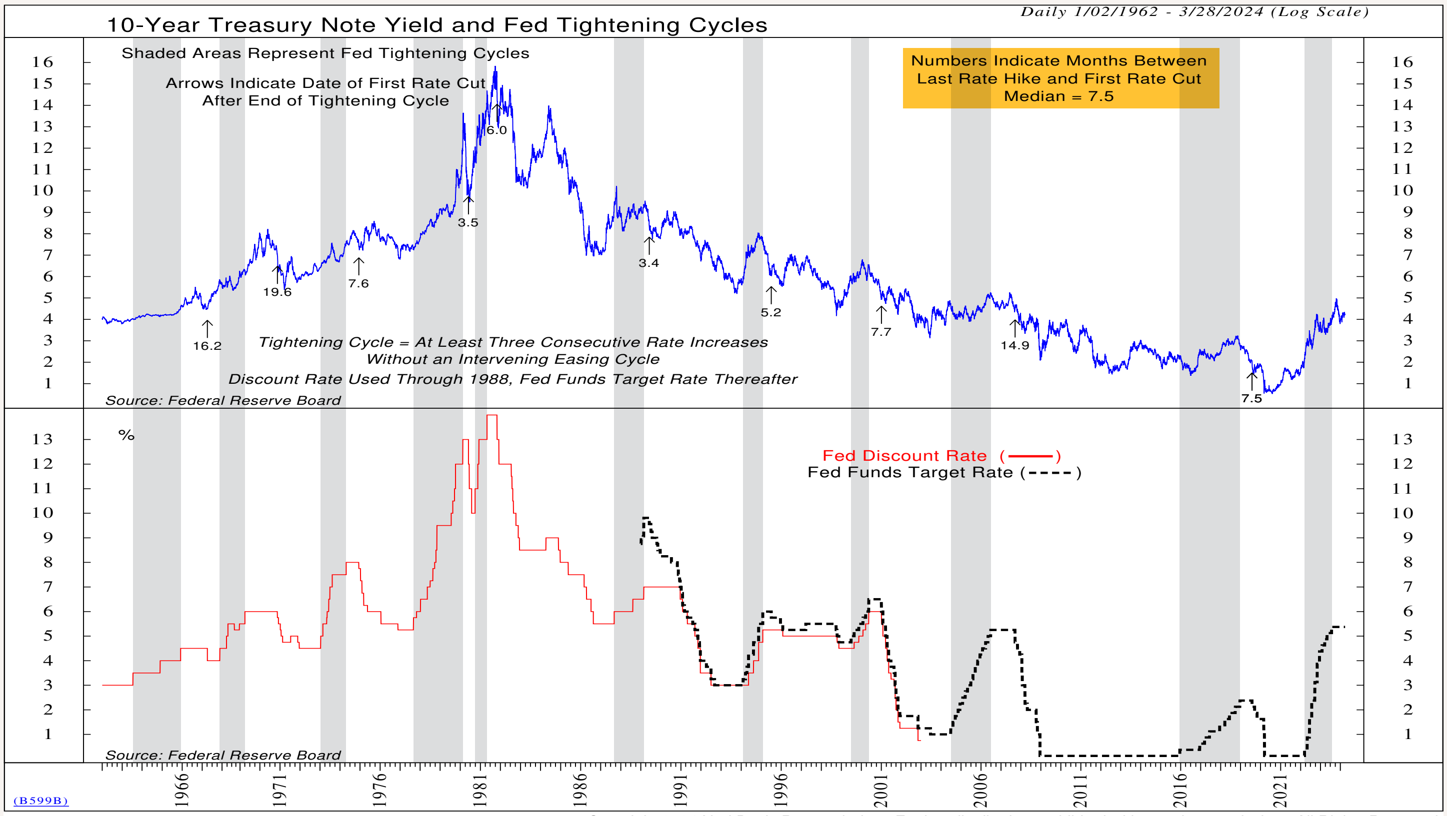
Fixed income: Powell preaches patience

Fed Chairman Powell and Governor Waller recently reaffirmed the Fed's cautious approach to rate cuts, stressing patience. Powell emphasized patience concerning the timing of rate adjustments and achieving the 2% inflation target, projected by the Summary of Economic Projections for 2026. Core PCE inflation remains elevated at 2.8%, surpassing the 2.0% target. Concerns are mounting regarding the repercussions of Fed rate hikes on the economy—five reasons have emerged suggesting the Fed should start considering rate cuts beginning in June:

1. Dwindling employment growth, declining from over 4% to 0.6% since March 2022.
2. Slower loan growth, plummeting from over 12% to 2.1% due to heightened capital costs and stricter lending standards.
3. Weaker residential construction, with spending plunging to -15% from 25% growth.
4. Diminishing durable goods orders, slipping below 2% from over 10%.
5. Escalating delinquencies and defaults, as consumer delinquencies surged from 1.53% to 2.62%, and charge-offs climbed from under 0.96% to 2.65% in Q4.

While historically the Fed typically waits around 7.5 months from the last rate hike to the first rate cut (chart below), a potential rate cut on June 12 would arrive 10.7 months after the last hike, suggesting a potential deviation from past trends. Supply chain improvement has helped to bring inflation down, but there are concerns if labor force growth slows, supply chain improvements fade, and demand remains strong that inflation will exceed the Fed's target.

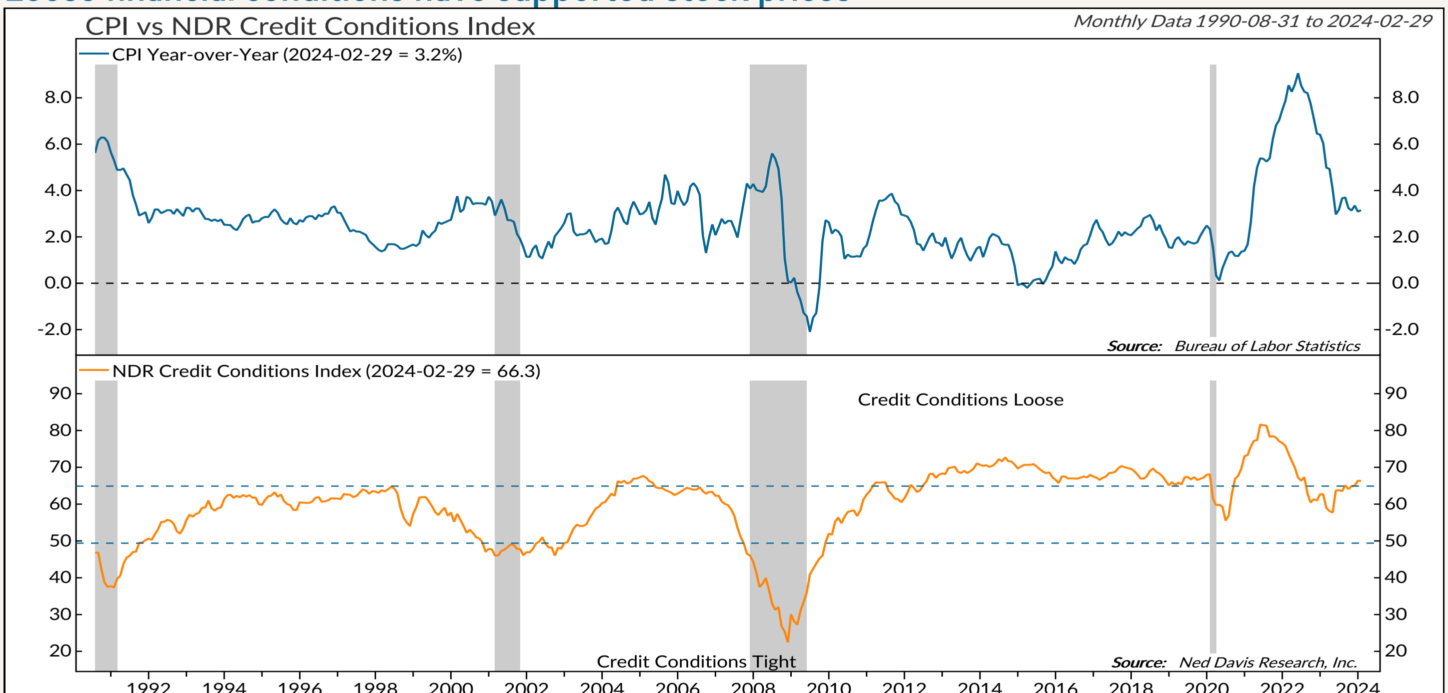
Time to first rate cut will be longer than average



The risk of looser financial conditions

- Financial conditions are crucial in transmitting Fed policy to markets and the real economy. Accommodative monetary policy stimulates growth, while restrictive policy weighs on it.
- Despite the Fed keeping rates steady, financial conditions have eased over the past year, as indicated by various metrics such as the Chicago Fed National Financial Conditions Index reaching its lowest level since February 2022. This easing has been supportive of equity prices and economic activity.
- Cutting rates when financial conditions are already loose should boost aggregate demand, which is not great for inflation (chart below). Although core PCE inflation has come a long way down from its peak in mid-2022 to sub-3.0% now, it is still above the Fed's target of 2.0%

Loose financial conditions have supported stock prices



CPI Y/Y Performance
Full History: 1990-08-31 to 2024-02-29

CCI is	Points/ Annum	% of Time
Above 64.9	0.57	33.82
49.4 - 64.9	-0.26	50.50
Below 49.4	-0.87	15.68

Buy/Hold = -0.07 Points/Annum

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U.S. equities: Rally continues in 2024

In the first quarter of 2024, the S&P 500 surged by 10.2%, marking its strongest start since 2019 and one of the best since 1926. This growth was widespread, with major indices, style boxes, and S&P 500 sectors all finishing higher. However, bonds did not contribute to this success, as the Bloomberg U.S. Aggregate Index fell by 0.8% due to factors like persistent inflation and economic growth, leading investors to favor stocks over bonds.

Historical trends suggest a positive outlook for stocks compared to bonds, albeit at a slower pace than Q1. Data shows that when the S&P 500 has risen by at least 10% in Q1, it typically adds a median of 7.6% over the following nine months, with exceptions like 1987 and 1930 (table below). Since 1976, when stocks have outperformed bonds by at least 10% in Q1, they have continued to outperform in Q2-Q4 by a median of 3.4%, albeit less than the long-term median.

In 2024, vol-related ETFs are again popular. The similarities to 2018 "Volmageddon" have prompted questions about whether the market is set up for a similar type of volatility surge. Our conclusion is that derivative strategies will likely exaggerate the next pullback. Whether it turns into a bigger correction or bear market will likely depend on macro conditions and how the Fed reacts to them, especially if inflation does not decline as it is anticipating.

Strong Q1 for stocks bodes well for rest of year

Returns After S&P 500 Index Up Big in Q1

	S&P 500 >10% in Q1		Stocks - Bonds >10% in Q1	
Year	**Q1 (%)**	**Q2 - Q4 (%)**	**Q1 (%)**	**Q2 - Q4 (%)**
1930	17.2	-39.0		
1936	11.1	15.2		
1943	18.5	0.8		
1961	12.0	10.0		
1967	12.3	7.0		
1975	21.6	8.2		
1976	14.0	4.6		
1986	13.1	1.4		
1987	20.5	-15.3	19.7	-14.4
1991	13.6	11.2	11.8	1.0
1998	13.5	11.6	12.4	5.8
2012	12.0	1.3	12.3	-1.1
2013	10.0	17.8	10.7	21.5
2019	13.1	14.0	10.7	10.0
2024	10.2	??	11.3	??
Median	**13.3**	**7.6**	**12.0**	**3.4**
% Positive	**100.0**	**85.7**	**100.0**	**66.7**
All Periods Median	**2.5**	**7.2**	**1.4**	**4.4**

Indices. For stock only: S&P 500 Index. For stocks vs bonds: S&P 500 Total Return Index and Bloomberg U.S. Aggregate Total Return Index Sources: S&P Dow Jones Indices & Bloomberg. Sources: S&P Dow Jones Indices & Bloomberg.

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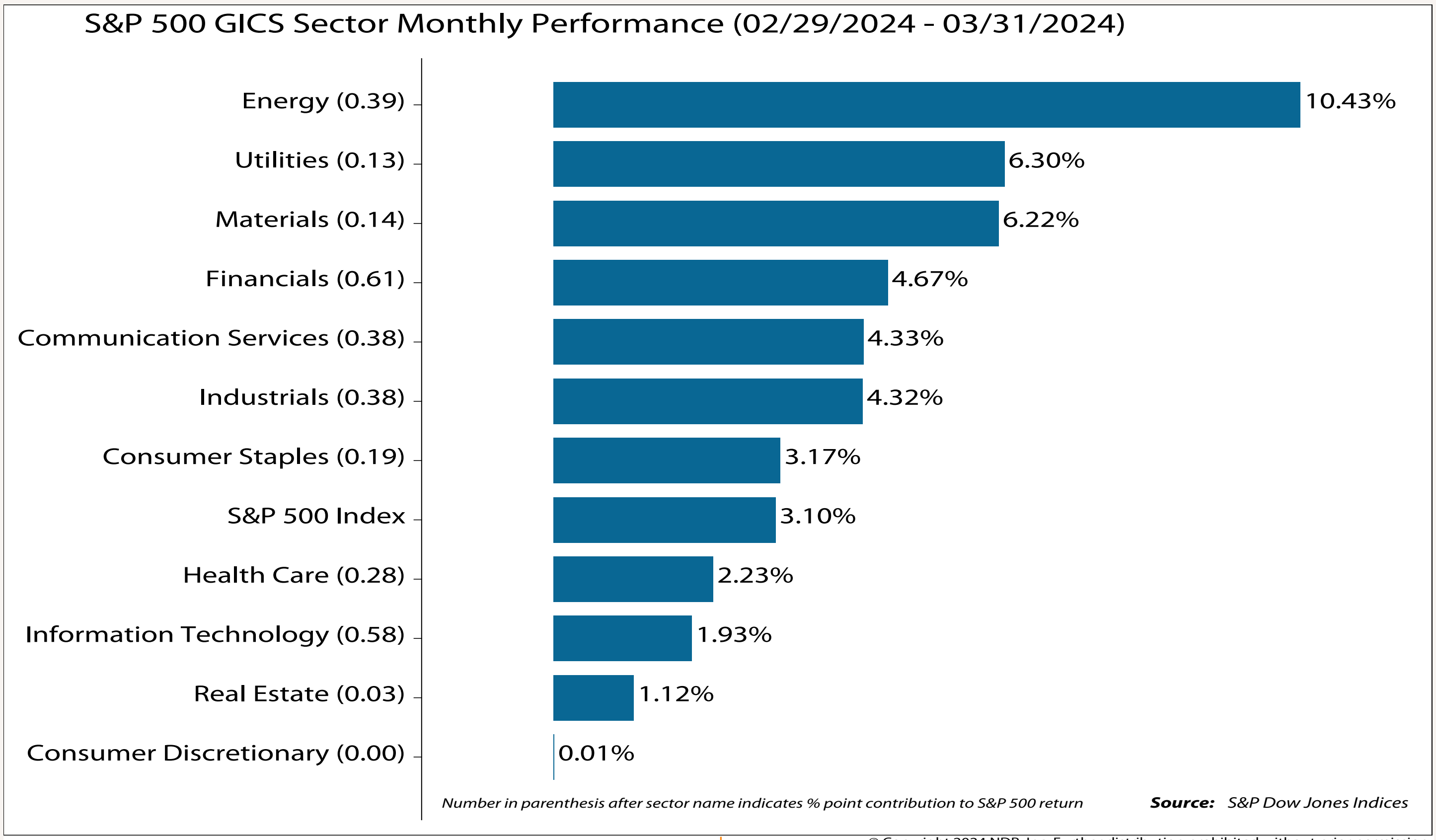
U.S. sectors: Equity rally continued to broaden

In March, the S&P 500 sustained its robust performance, rallying over 3.0% for a second straight month, exhibiting broad-based gains across all sectors. Notably, Value sectors such as Energy, Materials, Financials, and Industrials emerged as frontrunners, outpacing the index's overall growth trajectory (chart below). Meanwhile, Communication Services continued its upward trend, surpassing the market's performance. However, other cyclical Growth sectors like Consumer Discretionary and Technology faced challenges, trailing behind. Despite this shift in sector leadership, the overall sectoral landscape showed signs of improvement, with 10 out of 11 S&P 500 sectors now on golden cross signals (50-day moving average above the 200-day moving average)—a trend not witnessed since January 2022. Conversely, the tech mega-cap Elite Eight Index displayed weaker performance, showcasing discrepancies among its components compared to the previous year. In Q1, Nvidia notably excelled with the highest gain, whereas Tesla experienced a significant decline, highlighting the variability within the Growth sector. The correlation between Elite Eight components decreased, suggesting potential ongoing divergences among Growth sectors.

Towards the end of March, the sector model underwent five position changes, favoring overweight positions in Financials and Utilities while downgrading Technology. Financials, boasting the highest overall model score, is being closely monitored for potential further upgrades. Overall, the sector model exhibits a preference for cyclical sectors, particularly Value, reflecting the widest margin observed in over a year.

All sectors posted gains in March



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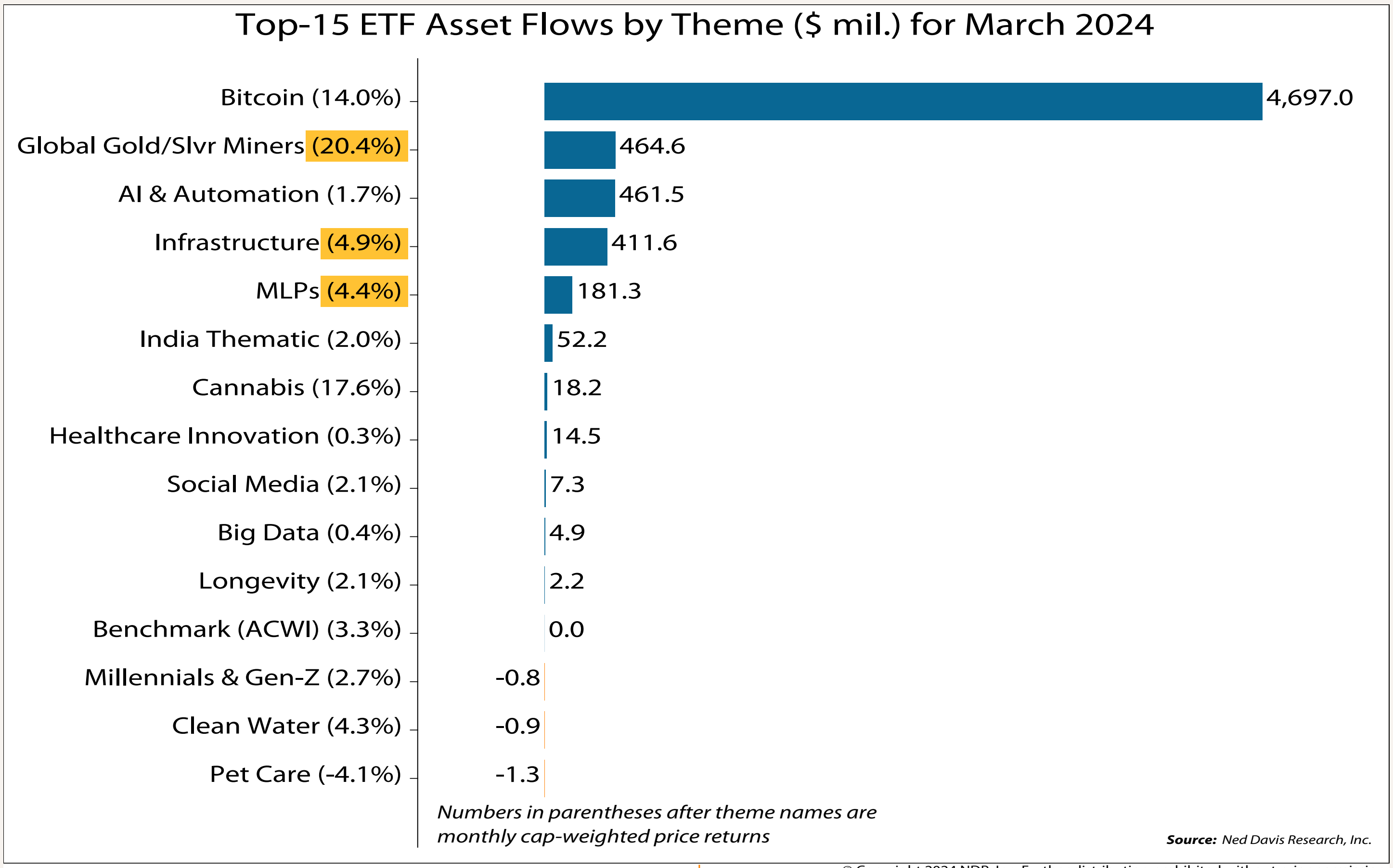
Themes: Physical over Digital in March

We saw thematic breadth hold up again in March, with only modest deterioration as 19 of 48 (40%) themes outperformed the S&P 500 (+3.1%) vs. 23 of 48 (48%) in February (chart below). Our thematic landscape breaks theme coverage into three major categories: Technology, Demographics, and Global Shock/Environmental.

- Technology (+2.1%) saw six of 17 themes outperform (29%) in March versus nine of 17 (53%) outperform in February. Internet, Metaverse, and AI outperformed in February but not in March, reflecting Big Tech underperformance. The group was looking overbought and rising rates may be the reason for a bigger Tech Titan correction. The bright spot again for this group was Blockchain (+9.5%) aided by Bitcoin's 16.5% gain in March.
- Global Shock (+3.9%) saw eight of 15 themes (53%) outperform, a tie for its best breadth in 14 months. Gold & Silver Miners (+20.4%) spiked on GLD's 8.7% gain in March. Last month, we said "we suspect the Global Shock Group could have a sharp rebound if the CPI continues to surprise to the upside", and both suspicions came true.
- Demographics (+2.1%) saw six of 16 themes (38%) outperform in March, down from nine of 16 (56%) outperforming in February. The best performing theme was Cannabis (+17.6%), as the Biden Administration continues its push to reclassify it from a Schedule I to a Schedule III drug.

Physical over Digital in March

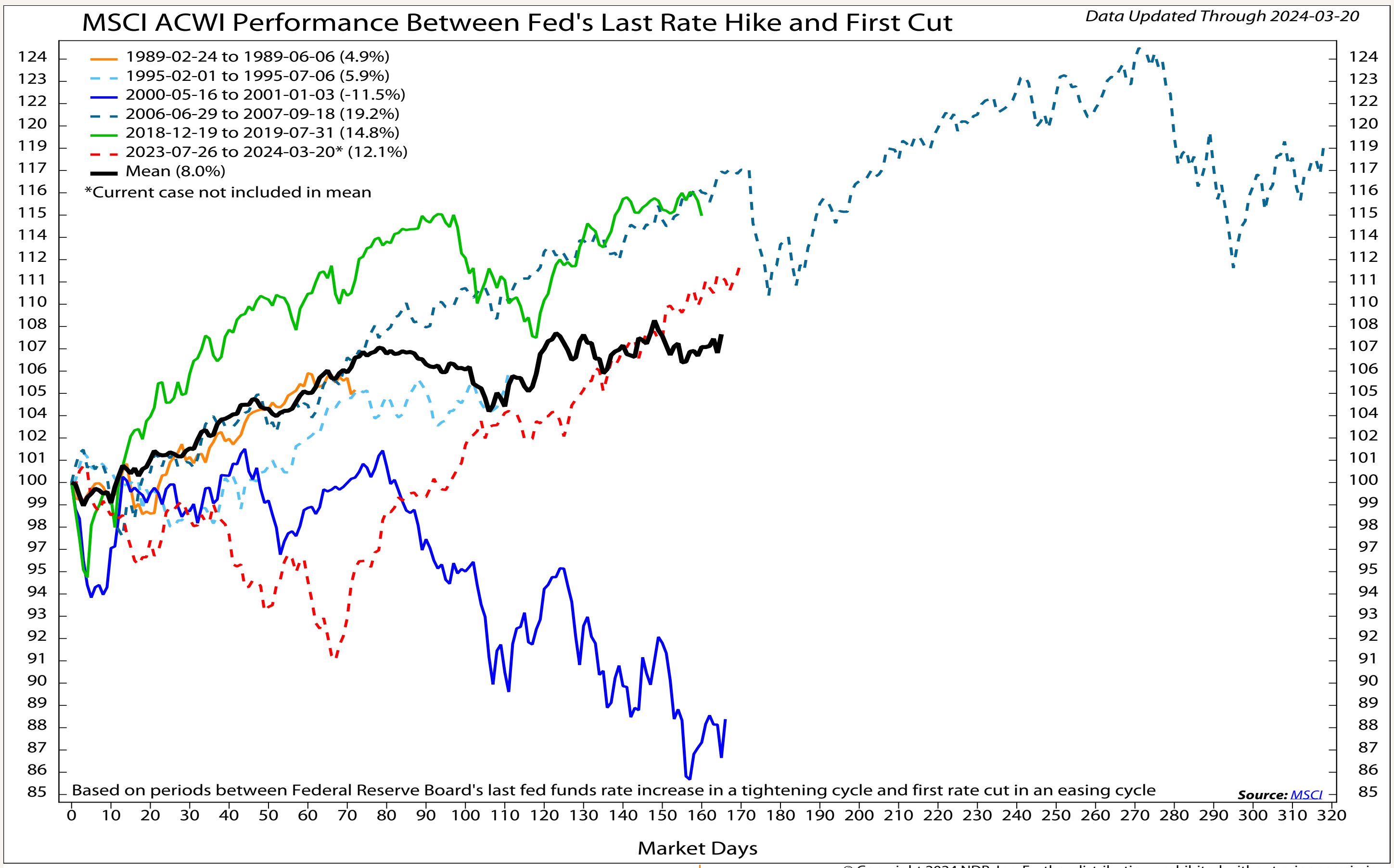


Global equities: Be wary of excessive optimism correction

As the market approaches the end of its historically strongest six-month period, concerns arise due to weakening seasonal trends. Typically, from September to March, the global benchmark All-Country World Index (ACWI) has a median gain of 9%. However, this year's gain has been double, up 39% from the October low. Now, as the market enters historically weak periods beginning in February, March, and April, signs point to a potential consolidation or correction. Excessive optimism adds to these concerns, with new highs across markets, sectors, and stocks fueling a prolonged period of optimism since mid-January. The one-year ACWI cycle, the four-year cycle, and extremely optimistic sentiment are warning of weakness, as much as they were ahead of the August-October correction. But what we haven't seen is the kind of breadth deterioration evident last August when the correction was getting underway.

The Fed and other central banks will also be potentially cutting rates on the increased confidence that inflation has been defeated. Between the last rate hike of a tightening cycle and the first cut of a new easing cycle, it has been normal to see corrections, as the policy reversals create uncertainties and the potential for volatility. The ACWI has usually trended higher between the final hikes and the initial cuts (chart below). As long as rate cuts remain likely, the cyclical bull market is expected to continue, albeit with increased volatility.

Tendency to rally between last hike and first cut



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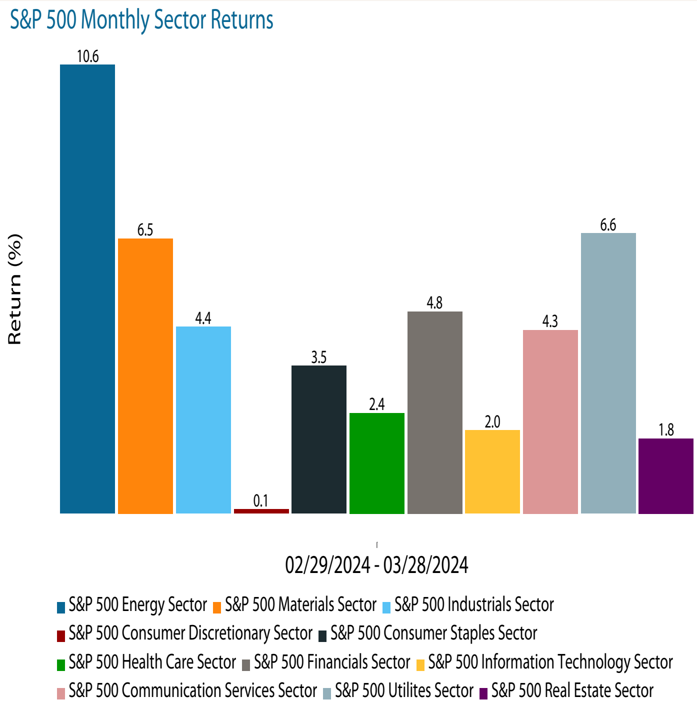
March Returns

March and Q1 Returns



Chart's date range is 02/29/2024 to 03/28/2024. U.S. sector returns are based on S&P 500 GICS sectors and calculated using total return indices.
Source: *S&P Capital IQ and MSCI, Inc. (GICS)*

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Asset Class Benchmark Returns

2024 Q1	2024 January	2024 February	2024 March	Year-to-Date	Rolling 1-Year Through 03/31/2024
Communications 15.57	Communications 4.84	Cons. Disc. 8.60	Energy 10.43	Communications 15.57	Communications 48.43
Energy 12.69	Tech 3.91	Industrials 6.98	Utilities 6.30	Energy 12.69	Tech 44.79
Tech 12.48	Financials 2.90	Materials 6.27	Materials 6.22	Tech 12.48	Financials 31.02
Financials 11.97	Health Care 2.84	Tech 6.19	Financials 4.67	Financials 11.97	Cons. Disc. 27.62
Industrials 10.57	Cons. Stpls. 1.37	Communications 5.66	Communications 4.33	Industrials 10.57	Industrials 24.53
Materials 8.44	Energy -0.52	Financials 3.96	Industrials 4.32	Materials 8.44	Materials 15.21
Health Care 8.40	Industrials -0.92	Health Care 3.11	Cons. Stpls. 3.17	Health Care 8.40	Health Care 14.11
Cons. Stpls. 6.81	Utilities -3.06	Energy 2.58	Health Care 2.23	Cons. Stpls. 6.81	Energy 13.60
Cons. Disc. 4.75	Cons. Disc. -3.55	Real Estate 2.45	Tech 1.93	Cons. Disc. 4.75	Real Estate 5.70
Utilities 3.59	Materials -3.93	Cons. Stpls. 2.12	Real Estate 1.12	Utilities 3.59	Cons. Stpls. 4.34
Real Estate -1.36	Real Estate -4.79	Utilities 0.53	Cons. Disc. 0.01	Real Estate -1.36	Utilities -3.06

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S&P 500 Sector Q1 Returns

2024 Q1	2024 January	2024 February	2024 March	Year-to-Date	Rolling 1-Year Through 03/31/2024
Communications 15.57	Communications 4.84	Cons. Disc. 8.60	Energy 10.43	Communications 15.57	Communications 48.43
Energy 12.69	Tech 3.91	Industrials 6.98	Utilities 6.30	Energy 12.69	Tech 44.79
Tech 12.48	Financials 2.90	Materials 6.27	Materials 6.22	Tech 12.48	Financials 31.02
Financials 11.97	Health Care 2.84	Tech 6.19	Financials 4.67	Financials 11.97	Cons. Disc. 27.62
Industrials 10.57	Cons. Stpls. 1.37	Communications 5.66	Communications 4.33	Industrials 10.57	Industrials 24.53
Materials 8.44	Energy -0.52	Financials 3.96	Industrials 4.32	Materials 8.44	Materials 15.21
Health Care 8.40	Industrials -0.92	Health Care 3.11	Cons. Stpls. 3.17	Health Care 8.40	Health Care 14.11
Cons. Stpls. 6.81	Utilities -3.06	Energy 2.58	Health Care 2.23	Cons. Stpls. 6.81	Energy 13.60
Cons. Disc. 4.75	Cons. Disc. -3.55	Real Estate 2.45	Tech 1.93	Cons. Disc. 4.75	Real Estate 5.70
Utilities 3.59	Materials -3.93	Cons. Stpls. 2.12	Real Estate 1.12	Utilities 3.59	Cons. Stpls. 4.34
Real Estate -1.36	Real Estate -4.79	Utilities 0.53	Cons. Disc. 0.01	Real Estate -1.36	Utilities -3.06

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Citations

Excerpts from the following NDR publications:

“Central banks moving closer to net accommodation” by Alejandra Grindal, March 27, 2024

“Faster global growth, and more inflation too” by Alejandra Grindal, April 5, 2024

“Stronger 2023 finish for the economy, profits jump” by Veneta Dimitrova, March 28, 2024

“Another stunningly strong employment report” by Veneta Dimitrova, April 5, 2024

“The risk of looser financial conditions” by Veneta Dimitrova, March 28, 2024

“It’s mostly (but not all) about the Fed” by Veneta Dimitrova, March 13, 2024

“Powell preaches patience” by Joe Kalish, April 1, 2024

“Equity rally continues in 2024 as bonds take a breather” by Ed Clissold, April 1, 2024

“Is the market set up for Volmageddon 2.0?” by Ed Clissold, April 3, 2024

“Equity rally continued to broaden in March” by Rob Anderson, April 3, 2024

“Thematic update April 2024” by Pat Tschosik, April 3, 2024

“What would warn of a downturn” by Tim Hayes, March 21, 2024

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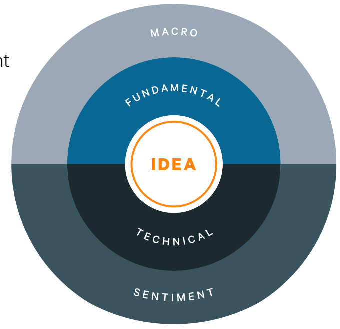

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