Investment Strategy Outlook

MAY 2024

THE ECONOMY

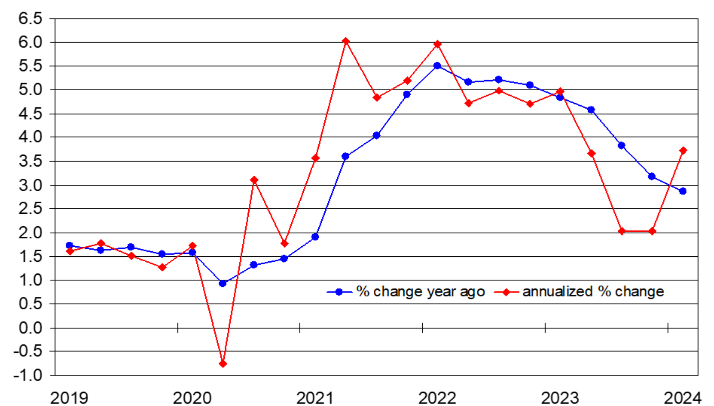
Growth Data (Seem To) Take A Softer Tone

The initial estimate from the Bureau of Economic Analysis (BEA) showed real GDP growth of 1.6 percent in Q1, well below expectations of growth closer to 3.0 percent. At the same time, the price data in the GDP report showed the core PCE Deflator, the gauge of inflation followed most closely by the FOMC, rose at an annualized rate of 3.7 percent in Q1. Suffice it to say that the day on which the report on Q1 GDP was released was not a particularly good day in the markets, with equity prices down sharply and yields on fixed-income securities shooting higher. The growth details of the report were seen as negative for equities, while the inflation details fed into the narrative that the FOMC would be on hold for longer, perhaps much longer, than many market participants had previously anticipated. On the whole, the report on Q1 GDP triggered fears that the U.S. economy was doomed to a period of stagflation, i.e., stagnant growth and high inflation.

It will come as no surprise to our regular readers that our reaction to the report on Q1 GDP was, let's say, a bit more tempered. It is often the case that inventories and trade, the two most inherently volatile components of GDP, team up to impact GDP growth in a manner at odds with underlying economic conditions, which we believe to be the case with the Q1 data. A slower pace of inventory accumulation in the nonfarm business sector and a sharply wider trade deficit combined to knock 1.2 percentage points off Q1 real GDP growth. In contrast, real private domestic demand, or, combined household and business spending adjusted for inflation, grew at an annual rate of 3.1 percent in Q1, a third straight quarter of growth at or above 3.0 percent.

Nonfarm business inventories increased in Q1, but that they did so at a slower pace than in Q4 2023 acted as a drag on Q1 real GDP growth. It is, however, difficult to draw any firm conclusions as to what the pace of inventory accumulation says about the broader economy given that the severe distortions to both production and sales wrought by the pandemic and the policy response to it have yet to fully resolve. Under GDP accounting conventions, a wider trade deficit acts as a deduction from real GDP growth. What is almost always overlooked, however, is that in any given quarter roughly one-half of all goods imported into the U.S. are either raw materials, intermediate goods, or capital goods used by firms in the U.S. to produce final goods and, as such, are supportive of future growth. The GDP math notwithstanding, it's hard to make a plausible case that this is a negative for the U.S. economy.

Neither Is Good, But Which Is The More Reliable Guide?



Source: Bureau of Economic Analysis; Regions Economics Division

We always, for better or worse, place far more emphasis on patterns in real private domestic demand than on patterns in real GDP to help us assess the state of the economy. As such, we'd be much more concerned about the state of the economy had the miss on Q1 real GDP growth been caused by shortfalls in the business and residential fixed investment components of private domestic demand, each of which was a bit stronger in Q1 than we expected. That said, the GDP data are backward looking given that they come with a lag, and thus far the initial data releases for the month of April have been on the soft side.

For instance, the Institute for Supply Management's (ISM) Manufacturing Index and Non-Manufacturing Index each slipped below the 50.0 percent breakeven line between contraction and expansion in April. As we often point out, however, the manner in which the ISM's diffusion indexes are calculated can lead to the headline index being out of alignment with the firm-level and industry-level details of the data. We believe this to be the case with the April data. The ISM's surveys query firms on whether metrics such as output, employment, and new orders increased, decreased, or stayed the same compared to the prior month. Aside from seismic events, say, a global financial crisis or a global pandemic, clear majorities of firms report no change in these metrics from one month to the next. So, just as life happens on the margins (economist humor!), so too do the changes in the ISM's diffusion indexes. For instance, in the April survey of the manufacturing sector, sixty-three percent of firms

reported no change in orders from March, and while more of the remaining firms said orders rose than said orders fell, that gap was smaller than was the case in March, yielding a decline in the new order index that, in turn, weighed on the headline index.

We go into this detail here not only to help explain how we routinely process the economic data but to also illustrate a point we often make, which is that for any given data release, the details are more important than the headline numbers. The April employment report is another illustration of that point. Total nonfarm payrolls rose by 175,000 jobs in April, well short of expectations. Additionally, average hourly earnings rose by just 0.2 percent, yielding a year-on-year increase of 3.9 percent, the smallest such increase since June 2021, while the unemployment rate rose to 3.9 percent. The April employment report was roundly cheered by market participants, as the appearance of softening labor market conditions inspired hope that the FOMC would be free to start cutting the Fed funds rate this year after all, in stark contrast to the mood in the markets in the wake of the Q1 GDP report.

In keeping with our theme here, appearances can be, and often are, deceiving. While we've for months pointed to signs of a cooling labor market, we think the April employment report meaningfully overstates the degree to which that is the case. The main culprit, at least in our view, is the calendar. Specifically, the survey period for the Bureau of Labor Statistics' (BLS) April establishment survey ended prior to the middle of the month, which historically has held down response rates to the establishment survey and biased estimates of nonfarm employment, hours, and earnings lower. The initial response rate to the April establishment survey was the third lowest since the onset of the pandemic, and the increase in nonfarm employment shown in the not seasonally adjusted data was much smaller than the typical April increase, meaning the estimate of seasonally adjusted job growth was biased lower. That, in turn, flowed through to estimates of hours worked and average hourly earnings.

So, while the headlines on the data releases for the month of April seen to date suggest a marked slowing in the pace of economic activity, the details of the various releases don't necessarily back that up. Time will tell whether our take is way off base or on the mark. But, even if the pace of growth is slowing, the FOMC won't be moved, nor will the Fed funds rate, unless and until the inflation data tell the same story. Circling back to the ISM's April surveys, in both the manufacturing and services sector there was further evidence of broadly based upward pressure on prices for non-labor inputs, which in and of itself is at odds with the narrative of slowing growth, let alone contraction.

While we think a large part of the market's dismay over the price data in the report on Q1 GDP is the manner in which the data are presented, i.e., annualized rates of change from the prior quarter which, in the case of the core PCE Deflator, we think overstates the case. To be sure, the monthly data show progress in pushing inflation lower has stalled, and the year-on-year increase of 2.8 percent in Q1 is too high for the FOMC's comfort. In that sense, while the markets' collective hopes seem to rise and fall with each individual data release, we don't think the data for the month of April seen thus far have changed the thinking within the FOMC one bit, leaving the Committee a long way from seriously considering Fed funds rate cuts.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Institute for Supply Management

STOCKS

Tailwinds Building Into The Summer

Some of the froth was taken out of stock prices during April's pullback after allocations to stocks had grown unchecked as the S&P 500 rallied 23% in the October through March time frame. When viewed through a longer-term lens, the S&P 500's 4% monthly decline appears to be little more than a garden variety correction that should prove healthy, as investor sentiment and expectations were recalibrated to varying degrees. Sentiment shifting from decidedly bullish in the first quarter to neutral in April could lay the groundwork for another move higher in the coming months as upside catalysts for stocks are often more powerful when enthusiasm is tempered than when everyone is already carrying overweight allocations as they were at the end of March. After April's sentiment shake out, stocks are on stronger footing entering May as healthy skepticism and discernment have returned, a welcome development.

At the end of December, Fed funds futures were pricing in 175 basis points of cuts to the Fed funds rate during 2024, but after a series of hotter than expected inflation prints to begin the year, the futures market view has shifted meaningfully and now the FOMC is expected to cut the funds rate by just 25- to 50-basis points in 2024. With some signs labor costs are cooling evident in the April payrolls report and gasoline prices falling as tensions in the Middle East eased in the back-half of April, inflationary pressures could shift in a more desirable direction for policymakers. To be clear, our constructive outlook on stocks over the balance of this year isn't dependent upon the FOMC cutting rates, but less restrictive monetary policy would certainly be a welcome kicker under the right economic circumstances. The FOMC cutting because it can, not because it must due to something breaking in the economy would likely boost consumer confidence and investor sentiment pushing stock prices higher still.

On the heels of the FOMC's meeting in early May, both stocks and bonds rallied as Chair Jerome Powell talked down the possibility of the Committee's next move being a hike, but what really provided a jolt for the bulls was the FOMC's decision to taper the pace of balance sheet runoff, or quantitative tightening. Starting in June, $25B per month of Treasury bonds will be allowed to roll off the Fed's balance sheet, down from the current pace of $60B per month, which implies that the FOMC will be buying $105B more in U.S. Treasury issuance starting in the third quarter than it otherwise would have. This announcement put significant downward pressure on U.S. Treasury yields as the market interpreted this move as the 'Fed put' being alive and well. The Fed's balance sheet shrinking at a more gradual pace beginning in 3Q24 is a positive from a liquidity perspective, as is the U.S. Treasury's decision to focus the lion's share of issuance in short-term bills as opposed to notes or bonds. These two variables combined are expected to boost liquidity on a net basis by between $250B and $300B between now and the end

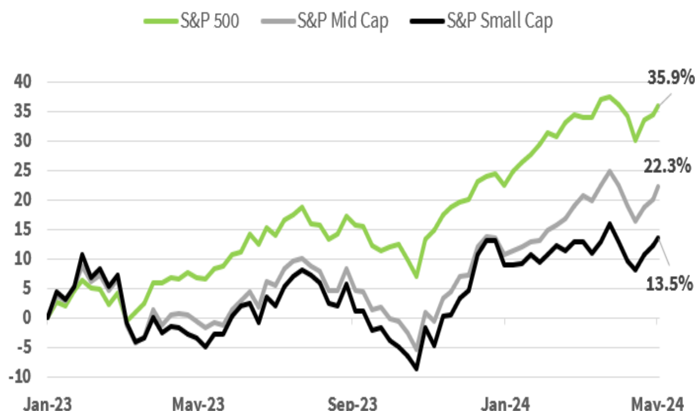
of the third quarter. Improved liquidity should provide another tailwind for bulls leading up to the election.

All of the above, combined with a positive seasonal backdrop in the May through July timeframe, could boost investor risk appetite over the coming months, contribute to less volatility in U.S. Treasury yields, and put modest downward pressure on the U.S. dollar. An environment characterized by an improving liquidity backdrop, a cooling, not cracking labor market, and inflation and interest rates falling gradually from elevated levels should lead to improved relative performance out of U.S. small and mid-cap (SMid) stocks. However, we don't expect the S&P 500 to pass the leadership baton so easily and as a result we maintain neutral allocations to both U.S. large cap and U.S. SMid.

SMid Set To Play Catch Up If Treasury Yields Cooperate. April was the worst month for small caps since last October, with the S&P Small Cap 600 Index registering a 5.6% decline as Treasury yields jumped across the yield curve. Thankfully for investors in smaller capitalization stocks, much of the sharp move higher in yields has reversed in May as the FOMC announced that Treasury securities would run off its balance sheet at a slower pace than expected, a move that could prevent Treasury yields from re-testing October 2023 levels. Falling Treasury yields put a bid under small caps and improved sentiment for the asset class, allowing the segment to gain ground on the S&P 500 early in the new month.

With monetary policy uncertainty contributing to volatility in yields in recent months, investors have viewed small caps as short-term rentals, preventing this cohort of stocks from building enough momentum for a sustainable advance. For a secular rally to take root, interest-rates likely need to stabilize and pressures on profit margins stemming from rising costs tied to goods and labor need to subside. It's still early, but with 60% of the S&P Small Cap 600 index having reported, quarterly earnings have posted a 7% upside earnings surprise in aggregate, a feather in the cap of downtrodden small cap bulls. Smaller companies have been challenged by higher interest rates and elevated labor costs, but those headwinds appear to be easing to varying degrees, bolstering the case for increased allocations to small and mid-cap (SMid) in equity portfolios. However, the asset class remains prone to shakeouts and sharp reversals, and while we are encouraged by recent price action, we would like to see inflationary pressures trend lower in a more durable manner before increasing exposure to the asset class.

Plenty Of Room For SMid To Play Catch Up



*Cumulative Returns
Source: Bloomberg

Remain Constructive On Emerging Market Stocks As China Joins The Party. Emerging markets were a notable outlier in April as the MSCI EM index posted a surprising 0.5% gain, despite facing numerous headwinds. Understandably, many country-specific indices fell during the month as energy prices, the U.S. dollar, and Treasury yields moved against developing markets, but China and India, which together account for 44% of the MSCI EM index, were bright spots with the MSCI China index, specifically, turning out a 5.4% gain. China's resurgence has been a long time coming, and with many portfolio managers carrying underweight allocations relative to their benchmark's exposure to the country in recent years, just getting back to neutral could drive sizable gains from here. While China's resurgence is encouraging and cause for optimism on emerging markets broadly, we see other reasons to remain positive on developing markets as we move into the summer months.

Emerging markets have faced powerful headwinds in the form of higher U.S. Treasury yields raising borrowing costs, a stronger U.S. dollar, and rising energy prices in recent months, but the MSCI EM index still closed out April with a 2.8% year-to-date gain. Headwinds should abate over coming quarters with the U.S. dollar weakening over the balance of this year as economic growth abroad picks up, U.S. Treasury yields stabilize as inflation fears subside, and deescalating tensions in the Middle East allow energy prices to moderate. Should even one or two of these headwinds ease, we would expect emerging markets to garner increased interest and capital, driving improved absolute and relative performance.

After A Half-Decade Of Poor Performance, China Is Attempting To Take The Leadership Baton From India

*Cumulative Returns
Source: Bloomberg

BONDS

For Now, Credit Risk Still Preferable To Interest Rate Risk

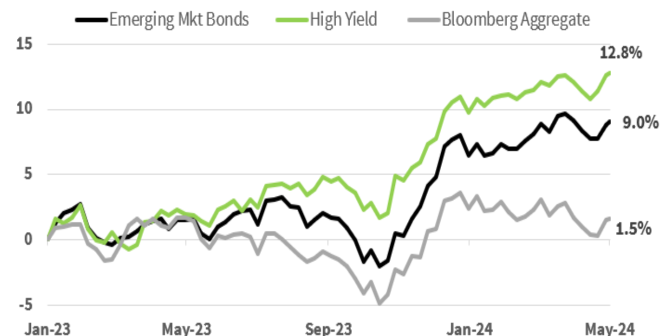
April was a reminder that credit is still king when inflation concerns are top of mind for investors. The Bloomberg U.S. Corporate High Yield index fell by 0.9% during the month, while the investment grade (IG) only Bloomberg Corporate Bond index declined 2.5%, a performance difference driven primarily by the IG corporate index's greater sensitivity to rising interest rates, known as longer duration. With yields on long-term Treasury bonds moving sharply higher into the back-half of April, both longer duration Treasuries and investment grade corporates were beginning to look more attractively valued/ priced as investors were being more appropriately compensated for taking interest rate risk. However, much of that rise in yields has now reversed, and investment grade bonds, broadly speaking, now appear fairly valued again, not relatively cheap versus lower quality credits as they were throughout much of April.

The Bloomberg U.S. Corporate High Yield index boasts a 7.8% yield-to-worst, down modestly from its peak of 8.3% in mid-April, but well below 9.5% reached at the end of last October, and with credit spreads extremely tight relative to historical levels, we can't characterize high yield as a slam dunk at this point. But given our view that the U.S. economy will remain resilient, and defaults will remain low throughout the balance of this year, it's not the time to get outright negative and move to an underweight allocation. With that said, lofty valuations for lower quality corporate bonds, along with mixed economic signals on the heels of the 1Q24 GDP release, suggest a selective approach to corporate bonds is increasingly warranted. At some point, our preference for higher yielding corporate credit will shift in favor of higher quality Treasuries and investment-grade corporate bonds, but we're not there yet and we expect high yield to perform well on a relative basis for a few more months, at a minimum.

Fundamentals Continue To Improve For Emerging Market Debt. As was the case with most fixed income segments last month, emerging market bonds turned out a loss but, the 1.7% decline for the J.P. Morgan Emerging Market Bond Index (EMBI) was below the Bloomberg Aggregate (Agg) Bond Index's 2.5% decline. April wasn't the first month in which the EMBI outperformed the Agg as yields moved higher as the Bloomberg Aggregate Bond Index has now posted a negative return in 8 of the last 12-months and the EMBI has outperformed the Agg in all but 2 of those down months. Interestingly, despite the broad nature of the bond sell-off during April, EM debt outperformed due to country-specific fundamental improvements keeping credit spreads tight, partially offsetting the move higher in yields.

From a currency standpoint, April was a tough month as the emerging market currency index fell 0.5% as the U.S. dollar advanced versus most developing market currencies. But as U.S. Treasury yields have moved lower in May, the U.S. dollar has weakened and the EM currency index has already reversed half of April's drop, we believe there's likely more room to run for both EM currencies and EM debt in the coming quarters. The case for EM debt isn't one that is easily made given the volatility profile of the asset class and the lack of confidence in the data flowing out of developing economies. With yields on higher quality bonds in the U.S. low relative to the rate of inflation, investors are being relatively well compensated for these risks via both a higher yield and diversification benefits.

High Yield, EM Debt Have Outperformed Investment-Grade And Should Continue To Do So Into The Summer Months



*Cumulate Total Returns
Source: Bloomberg

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