

Investment Strategy Outlook

FEBRUARY 2024

THE ECONOMY

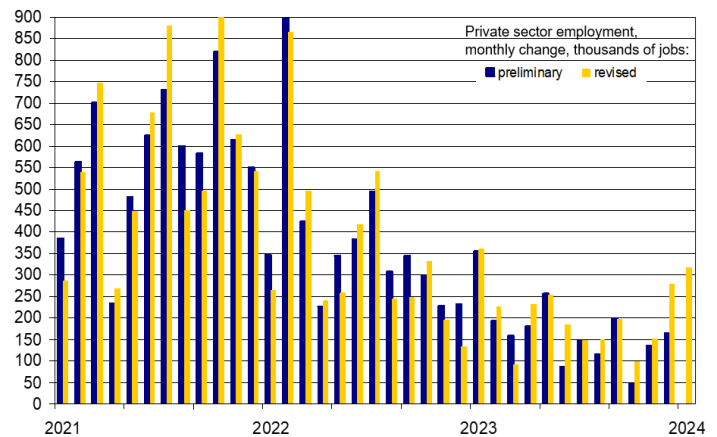
The Upside Surprises Keep Coming, But For How Long?

For those of us tasked with tracking, analyzing, and forecasting the economic data, a general rule is that you seldom actually know what you at first think you know. Inconsistencies between different data series purportedly tracking the same things, data collection – particularly for survey-based data – issues, faulty seasonal adjustment, and what can be large and seemingly out of the blue revisions to previously released estimates are some of the occupational hazards we’ve come to accept as part of the job. Since the onset of the pandemic, however, these issues have seemed much more pronounced than what we had become accustomed to dealing with over many years of having toiled at this task. To be sure, all of this keeps us on our toes and helps ensure that things are never boring, but at the same time these issues make it more difficult to produce forecasts that come with a high degree of confidence, let alone a high degree of accuracy. That many, if not most, of the surprises in the economic data of late have been to the upside is certainly preferable to the alternative but doesn’t alter the broader point here. After all, marking a forecast up for sure feels better than marking a forecast down, but the higher degree of volatility in forecasts, ours and others, from month-to-month seen since the onset of the pandemic isn’t desirable either way.

Okay, fine, before this turns into an episode of *Dr. Phil*, we’ll note that the initial estimate from the Bureau of Economic Analysis (BEA) shows real GDP grew at an annual rate of 3.3 percent in Q4 2023 which, need we say it, was considerably stronger than had been expected. Consumer spending, government spending, and net exports were the main drivers of Q4 growth. For full-year 2023, real GDP grew by 2.5 percent, which was far better than had been expected at the start of the year when many forecasters (though not us) had recession as their base case. Keep in mind that Q4 real GDP being higher than had been anticipated sets a higher base for real GDP in Q1 2024 and, in turn, for full-year 2024, such that we’ve upped our forecast for 2024 real GDP growth between our January and February forecasts.

The January employment report took the concept of upside surprises to a new level, to the point that it made us question every single assumption we’ve ever made about the labor market. Total nonfarm employment was reported to have increased by 353,000 jobs, with private sector payrolls up by 317,000 jobs, while average hourly earnings were reported to have risen by 0.6 percent. At the same time, the January employment data incorporated the annual benchmark revisions to the data on

Job Growth Reaccelerating?



Source: Bureau of Labor Statistics; Regions Economics Division

nonfarm employment, hours, and earnings, which showed job growth to be stronger and more broadly based over the latter part of 2023 than had previously been reported. All of which was, or at least seemed to be, in stark contrast to the signals sent by the labor market data over prior months which had shown a slowing trend rate of job growth, declining job vacancies, decelerating wage growth, and the rate at which workers were voluntarily quitting jobs falling back in line with pre-pandemic norms.

Beneath those surprisingly strong headline numbers, the January employment report is rife with noise. A low response rate to the January establishment survey calls into question how reliable the initial estimate of January job growth is, and there is ample evidence that reported January job growth was significantly bolstered by favorable seasonal adjustment. At the same time, however, weather effects related to unusually harsh winter weather across most of the nation held down job counts and hours worked in certain industry groups. To that point, the reported 0.6 percent jump in average hourly earnings is largely a product of the sharp decline in aggregate hours worked as opposed to genuinely faster wage growth. Sort through all the noise, however, and the January employment report was still stronger than we and most others expected.

The Institute for Supply Management’s (ISM) read on the manufacturing sector for January hardly constitutes a surprise, upside or otherwise. After all, with the headline index coming

in at 49.1 percent, the ISM's gauge shows a fifteenth straight month of contraction in the factory sector, with only four of the eighteen industry groups represented in the survey reporting growth in January while thirteen reported contraction. In keeping with our general theme here, however, there were indeed upside surprises in the details of the ISM's survey. The index of new orders rose to 52.5 percent, indicating growth in new orders after sixteen straight months of contraction, while the index of production rose to 50.4 percent, indicating manufacturing output rose in January. Many immediately seized on these details as pleasantly surprising signs that the long-running contraction in the factory sector has run its course. We, however, saw these readings as having more to do with quirks in how the ISM calculates its diffusion indexes rather than being signs of genuine growth. To our point, only five industry groups reported higher new orders and only four reported higher output in January, while ten industry groups reported declines in new orders and eleven reported lower output.

The ISM Non-Manufacturing Index rose to 53.4 percent in January, indicating continued expansion in the broad services sector, and also offered a useful reminder that not all upside surprises are pleasant surprises. The prices paid index, a gauge of changes in the costs of non-labor inputs, jumped from 56.7 percent in December to 64.0 percent in January, the largest monthly increase since early-2021 – when inflation began its rapid acceleration. This is noteworthy given that prices for non-energy services remain the main hub of inflation pressures. One thing to keep in mind, however, is that January is the month in which new pricing structures tend to take effect, which may

have biased the ISM's gauges of price pressures higher for January – the ISM's manufacturing survey showed a similarly large increase. Clearly, though, this will be something to watch in the months ahead.

The FOMC meeting that concluded on February 1 wasn't so much a surprise as it was a cold smack in the face of those market participants who had been betting on/hoping for six Fed funds rate cuts this year commencing with the March FOMC meeting. Though dropping the implicit tightening bias that had long been a staple of their post-meeting policy statement, the Committee signaled that Fed funds rate cuts are not coming soon, a message Chair Powell strongly reinforced in his post-meeting press conference. Though acknowledging the marked deceleration in inflation, the Committee sees itself in a risk management role, with its priority being preventing inflation pressures from reigniting. The economy's surprising resilience validates this view, allowing the FOMC to be patient in deliberating their next move, which we still expect to be the first of four 25-basis point cuts by year-end 2024.

We closed last month's edition by reiterating our call that by the end of 2024 the economy was unlikely to look as we, at the start of 2024, expected it to. We thought, however, it would take longer than the end of January for things to look so much different. At this point, we think it safe to say that in next month's edition we'll be explaining yet more surprises in the economic data and the financial markets. Whether those will be upside or downside surprises, however, is not a call we're willing to make right now. Instead, we'll let you know next month . . .

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

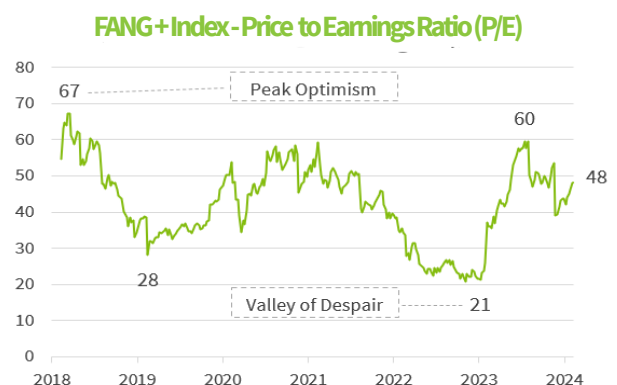
STOCKS

January Was Just A Calendar Change So Far

The first month of 2024 shared heavy resemblance with 2023 as large-growth companies dominated index returns for the better part of the month with the S&P 500 Growth returning 2.9% compared to the S&P 500 at just 1.7%. The phrase 'dance with who brought you' comes to mind regarding the largest names in the index as gains in the top companies reinforce our stance that portfolios benefit from meaningful cap-weighted exposure, but valuations give us pause. We're slow to draw past parallels to more frothy markets like the dot-com bubble due to the fact today's leading firms have far superior earnings. Though the January earnings season illustrated that no companies are impenetrable, with four of the six Magnificent 7 stocks that reported falling post-earnings. The highest exposures in the S&P 500 are there for a reason. They are industry-leading companies with strong earnings growth, and we're certainly not lining up to bet against them at this stage. However, history tells us the largest holdings won't retain those titles forever. In fact, Microsoft is the only company in the top-ten market cap that was there in 2000. The adage 'trees don't grow to the sky' certainly applies when weighing valuations, but decades of market data advocates for participating in top names rather than heading for the sidelines and 'waiting for trees to fall.'

That assertion prompted us to revisit historical analogs for the Magnificent 7. Comparisons could be made dating back 1970s with the Nifty 50, but we'd flashback to a more recent group with similar characteristics in the FANG+ Index. All three

cohorts saw tremendous gains backed by at least partially commensurate earnings growth, they also carried blistering valuations that seemed to temporarily defy gravity. Due to a lack of data and existence of an official Nifty 50 Index, a more recent group of highfliers will have to do. The FANG+ stocks that overlap with the Magnificent 7 saw a peak P/E ratio of 67 times earnings in 2018 before ultimately declining to just 21 times after prices returned to earth post-pandemic. Looking at last year and January in isolation, it's difficult to ascertain why portfolios shouldn't tilt further into the largest stocks but backing up to 2022 when the Bloomberg Magnificent 7 Index was down 45.3% puts the benefit of diversification into perspective.



Source: Bloomberg

No Surprise Small Companies Left To Save Themselves. The S&P 600 Small Cap Index was down -4.0% in January, a reversal from its elated end of year bull run. Smaller companies were swimming against the current for the better part of the month as lower borrowing costs seemed increasingly distant with upside surprises in economic growth and labor market data keeping the FOMC, and short end of the curve, anchored higher for now. Pricing rate cuts for March was always too aggressive in our view for an FOMC that emphasized caution at every turn, provided unemployment didn't ratchet significantly higher. That backdrop leaves SMid to fend for itself via revenue or earnings growth until the macro backdrop warms up, a tall order in the near-term given the street's expectations for revenue to climb modestly while earnings bottom. Like prices, a bottom in earnings is only clear in hindsight, from the potential bottom it just appears earnings are headed lower, but improved revenue growth so far this quarter unveils movement in the right direction. Multiples in the sub-asset class are even more appealing than when the month began, but we're waiting on firmer signals that fundamental expansion is afoot. The soft-landing thesis and subsequent benefit for small caps remains intact for now, but expectations around easing were due for adjustment, which would likely set the segment back until more dovish narratives thaw in the spring or technicals renew investor interest.

Dollar Headwinds Intensify For International Equities While China Stocks Sputter On Stimulus. Developed stocks ended the month in positive territory with the MSCI EAFE posting a 0.6% gain, while emerging equities struggled in January falling by 4.6%. The reset in FOMC expectations played a role in catapulting the dollar higher against most major currencies

to start the year, a tough environment for international stocks. China was a loss leader in the Emerging Markets Index, notching a double-digit decline despite stimulating the banking system by lowering reserves with speculation that the government would consider purchasing public equities. The country is plagued by an ongoing crisis of confidence, with domestic sentiment surveys reaching decade lows after harsh COVID zero policies and property sector woes have eroded consumer spending. We expect the China's government spending policy is set to persist as the determination, or desperation, to restart growth becomes more apparent. Throwing money at the country's issues should provide short-term sparks, but restoring long-term confidence likely requires structural changes such as welcoming capital from. The downdraft for stocks in emerging markets didn't stop in Asia, as the Latin America 40 ETF ended the month down akin to the broader index at 4.2%. Currency hurt the subset, but these economies appear to be fulfilling their end of the bargain with inflation that continues to moderate in some of the most heavily tracked countries like Mexico and Brazil. Equity prices haven't reflected success so far, but progress on inflation lends itself easier financial conditions that would lower the cost of capital for corporations. One of the strongest stories abroad was yet another continuation trend, as the Japanese Nikkei 225 registered an 8.4% gain over the period, though a significant portion of those gains can be contributed to a stronger yen, one of the few currencies that fared well against the dollar. The dollar-hedged Nikkei gained a more modest 4.4%, a subtle reminder that diversified currency exposures can be a valuable part of a holistic portfolio.

BONDS

FOMC Closes the Door On March Cut, Making Markets Rethink May

January brought on more lackluster fixed income markets, evidenced by the Aggregate Bond Index loss of 0.3% after a year-end hot streak resulted in gains exceeding 2% in each of the final two months of 2023. Yields lacked clear direction during the month, oscillating to various economic before the FOMC meeting and another blowout payrolls number sent rates higher to early December levels. Those events paired with the increased services prices in January is casting fresh doubt that inflation is firmly on the path to the FOMC's 2.0 percent target, a proper reset from the unrealistic narrative bought by markets in recent months. Fed futures betting on an early spring cut embody these expectations, starting the month pricing an 96.5% chance of a cut in March with a 100% chance of a second cut in May. Those numbers aged poorly as the FOMC talked down the chance of a cut at the next meeting on multiple fronts and payrolls vastly exceeded estimates again. Early February futures now indicate a 21.2% chance of a March cut and just 60% chance of a cut in May. The FOMC appears refreshingly prescient in their patience in contrast to the market. Officials went so far as to mention they wouldn't religiously follow certain Taylor Rule models that suggest cuts, instead waiting on longer data streams to bolster their confidence.

Last month brought a narrowing of alignment between

market participants and monetary policy officials putting upward pressure on long-end yields, which could push higher if we see further volatility in the economic data. From our perspective, higher yields should be bought at this point in the cycle given the broader trends of moderating inflation and easing financial conditions. At this stage, we are hesitant to trade around duration exposure, as yield could prove scarce if inflation declines as predicted. Conversely, select active managers may be able to add value during the volatile period for rates by making incremental shifts on the curve and buying surges/soft spots in yields along the way. For now, we believe a balanced approach to duration with an eye towards rebalancing in price declines or satisfying near-term cash needs on rallies.

Corporates Issuers On A Borrowing Spree That Could Pressure Spreads. Investment grade corporate bonds turned out a 0.2% loss for the month, while the below investment grade subset of the market was flat. Credit spreads managed to tighten marginally across the quality spectrum over the course of January, despite moving wider at month end. That spread widening coincided with a further inverted yield curve, inferring that inflation surprises and linked higher-for-longer policy rates remain the most prominent risks to bondholders as a positive relationship between spreads and rates persists.

The spread between 2-year and 10-year treasury notes can serve as a gauge on broader risk appetite worth watching in this environment. Wider option-adjusted spreads appear more bark than bite to us, as any upticks in spread are being bought in short order based on primary market demand. Survey data indicates investors are still underweight the long end of the curve, and with minimal issuance that far out, investment grade paper longer than 10-years to maturity is likely to trade tight. From our seat, a hefty allocation to quality corporates can enhance yields without undue risk as strong demand and adequate balance sheets make the subset viable within a core fixed income portfolio.

High Yield Holds Steady While The Dollar Drags EM Bonds. High-yield bonds outperformed their higher-quality counterparts for the first time on a monthly basis since October after the rate-driven rally left the sub-asset class behind of late. Market activity has been healthy, with borrowers facing minimal hurdles when refinancing and extending maturities, including a handful of CCC-rated borrowers, an indication that sentiment remains intact for now. Similar themes are present abroad as below-investment grade emerging market bonds outperformed their BBB-rated brethren, though the technical backdrop is more balanced. Dollar strength that impacted emerging markets equities hampered these bonds as well, albeit to a lesser extent with the EM local currency index underperforming with a negative monthly return of 1.5% while the USD-bonds we preferred ended down just 0.5%. The dollar-bonds aren't impervious to movements in the currency, especially from interest rate shifts as spreads ended January wider, and the intermediate duration profile led to slight losses. Longer-term, we anticipate easing monetary policy at home should lend itself to a weaker dollar broadly, which improves the fundamental standing of emerging borrowers and by extension allows spreads to stay steady or grind tighter. When stacking the two non-core segments against each other, high yield has the edge based on its income advantage and technical environment, but we retain the belief that the two complement each other.

Spread Between 2Y and 10Y Treasuries (bps)



Source: Bloomberg



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