Q1 2024: Inflation Is a Moving Target

By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA. May | 2024

HIGHLIGHTS

- Equity markets ended the first three months of 2024 on a strong note as the S&P 500 achieved new all-time highs.
- With inflation remaining persistently higher than its stated 2% target, the Fed's position may be shifting to being more willing to tolerate these higher levels.
- Ongoing unchecked fiscal spending is increasing the federal deficit and interest costs.
- If inflation stays high and long-term bond yields remain under control, higher equity valuations may be sustained, but persistently high interest rates may continue to pose challenges to the interest-rate-sensitive areas of the market.

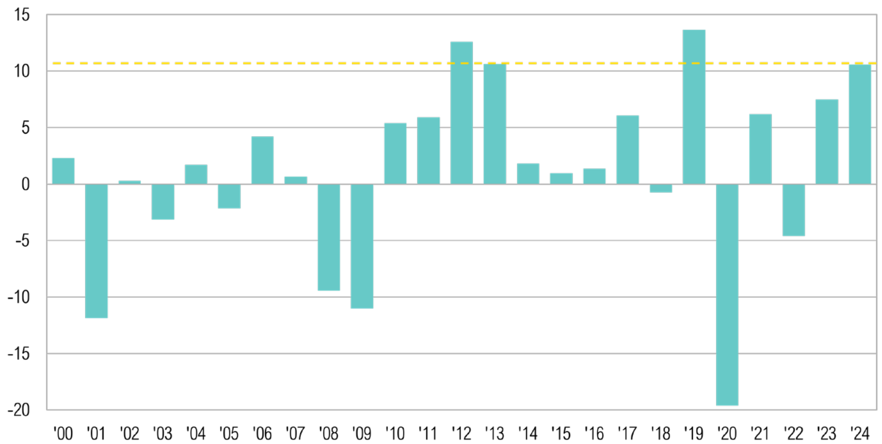
Overview

Equity markets ended the first quarter on strong numbers. The S&P 500 climbed to new all-time highs throughout the quarter, as U.S. large-cap stocks reached the quarter's end up a noteworthy 10.6%—making this the third-best first quarter since 2000 (tied with 2013).

The Russell 2000 rose to its March end at its highest level since January 2022 as U.S. small-cap stocks ended the month up 2.5% and the quarter up 5.2%, both of which are signs that the equity market's rally may be broadening.

Q1 2024 Posted the Third-Best First Quarter Return Since 2000

Q1 Return, %



Source: Bloomberg

The Bloomberg U.S. Aggregate Bond Index ended the first quarter down 0.8%, and interest-rate-sensitive areas of the market continued to feel the pressure of higher rates as real estate was the only S&P 500 sector to end the quarter with negative returns, declining 0.5%.

Final gross domestic product (GDP) results, released at the end of March, confirmed that the U.S. economy remained strong throughout 2023. Fourth-quarter GDP growth was revised upwards from 3.2% to an annualized

3.4%, and the personal consumption expenditure component of GDP grew from 3.0% to 3.3%.

There were other signs of economic strength in the first quarter of 2024. Manufacturing sector activity grew for the first time since October 2022, as evidenced by the ISM Manufacturing PMI's March reading of 50.3 (a reading above 50 signals an expansion in the sector).

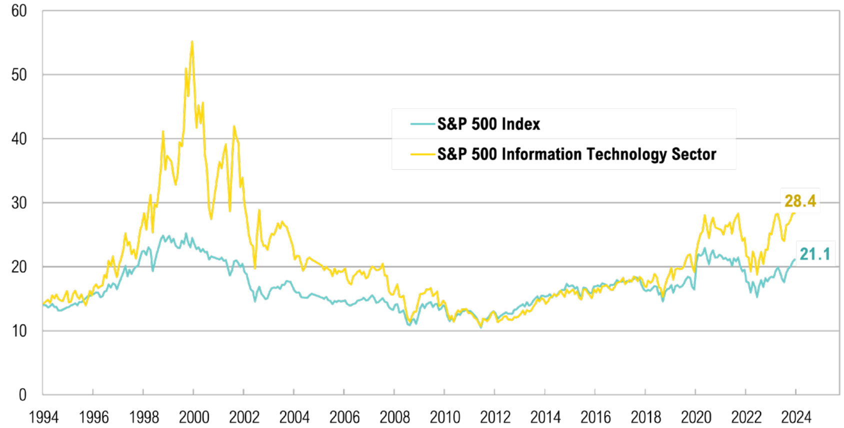
Following the conclusion of the fourth quarter 2023's earnings season, earnings growth for the period was revised upwards to 4.2% from an initial forecast of 1.5% at the end of 2023. Full-year earnings growth projections for 2024 were at 11.0% at the end of March.

Current S&P 500 valuations remain well above historical averages. The forward 12-month price-to-earnings (PE) ratio has hit 21.1, surpassing both the 5-year and 10-year averages of 19.1 and 17.9, respectively.

Within the S&P 500, the information technology sector's valuations reached new local highs, climbing from 26.7 to 28.4, as price gains outpaced earnings growth expectations. Even though tech sector valuations are high, they remain significantly lower than those seen during the Tech Bubble, when forward PE ratios peaked at 55.2 in March 2000. This sector's 12.7% quarterly gain was dominated by AI-leader Nvidia, which ended the quarter up 82.5. Notably, Tesla, one of the 10 largest companies in the S&P 500 by market cap, ended the quarter down 30.6%, making it the worst-performing stock in the S&P 500 for the year to date.

Market and Tech Valuations Are High, but Not Unprecedented

12-Month Forward Price-to-Earnings Ratio



Source: Bloomberg

One year after the collapse of Silicon Valley Bank followed by the failure of two more U.S. banks, regional banks remain under close scrutiny. These banks have continued to grapple with an increase in delinquencies on commercial real estate loans and consumer loans, including credit cards and auto loans. The delinquency rates on these loans are approaching those previously seen during the global economic crisis in 2007 and 2008. Regional banks ended the first three months of 2024 down 6.3%.

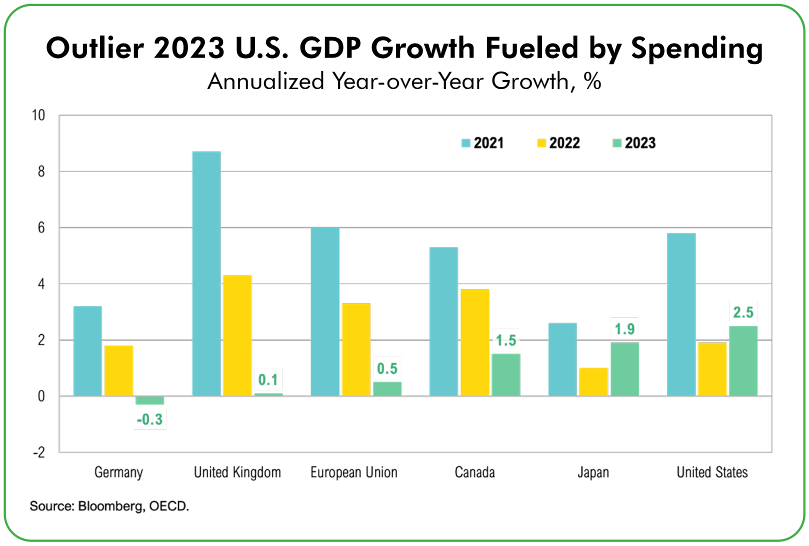
March also marked the second anniversary of the Federal Reserve's first rate hike of the current cycle. For the past three years, inflation has remained above 3% due to the combination of a strong labor market, robust spending rates, and strong economic growth. However, the Fed's apparent willingness to cut interest rates soon may indicate that its inflation target has shifted from 2% to a more easily reachable 3-ish%.

The Fed's Aim: A New Bull's-Eye

Rarely does one of the world's most influential and reputable central banks increase its forecast for inflation from already-too-high levels and growth, while simultaneously guiding toward a dovish policy approach.

However, on March 20, the U.S. Federal Reserve revised upwards its GDP growth and inflation projections while improving its employment outlook for the year. It also communicated a readiness to accept elevated inflation for an extended period and a willingness to slow the reduction of its balance sheet.

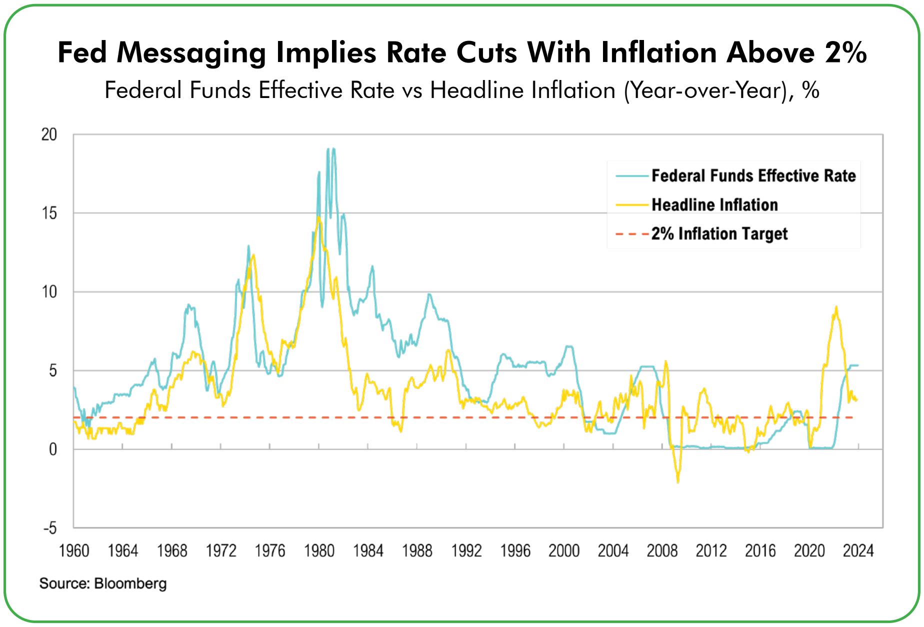
Inflation has remained above the Federal Reserve's stated target for three years. Robust spending (from consumers and the government) has kept the U.S. economy strong throughout the Fed's aggressive rate-hiking cycle that started in March 2022 when headline inflation was at 8.5%.



In 2023, real GDP increased by an annualized 2.5%, up from a 1.9% increase in 2022. The U.S. remains a positive outlier in global economic growth, far outpacing its developed nation peers. For example, in 2023, real GDP grew 1.9% in Japan and 0.1% in the United Kingdom and declined 0.3% in Germany. The relatively strong growth in real GDP in the U.S. in 2023 was primarily reflected in consumer spending and government spending.

Consumer spending in the U.S. remains resilient, despite elevated prices and higher interest rates. Consumers continue to rely on credit cards to support spending, as evidenced by the $14.1 billion monthly increase in consumer credit in February.

The personal savings rate dipped to 3.6% in February, which remains well below the 2009–2019 average savings rate of 6.1%. Contributing to consumers' willingness to take on new debt and save at lower rates, the unemployment rate at 3.8% remains near four-decade lows. Personal spending jumped 0.8% in February—the largest monthly gain since January 2023. Consumer sentiment ticked up over the quarter, ending March at 79.4—the highest level since July 2021. Sentiment was boosted by a rising stock market and lower inflation expectations. Many companies continued to report strong consumer demand throughout the quarter.



Similar to consumers, the government is spending at an impressive clip and that spending continues unchecked. The U.S. federal budget deficit expanded over the quarter, as March marked the halfway mark of the 2024 fiscal year.

In the first six months of the fiscal year, the deficit rose to $1.064 trillion as interest costs on the national debt also rose. Net interest payments through March climbed to $429 billion compared to the $433 billion that the U.S. spent on defense over the past six months.

While economic evidence suggests neither the economy nor inflation is slowing meaningfully, guidance from the Fed suggests an increasing likelihood that it could start cutting interest rates and dialing back quantitative easing into a major structural fiscal deficit and with inflation above their 2% target. At a conference on March 29, Fed Chief Powell indicated the revised approach to inflation:

> *"We've said we would not wait for inflation to get down to 2% because, if you wait for that, monetary policy works with long and variable lags. So, we've said for some years that we would start restoring the federal funds rate to a more normal, almost neutral level. We're far from neutral now. And, we do plan, assuming the economy moves along the lines we expect, to start the process of dialing back restrictions."*
> – Jerome Powell, Chairman of the Federal Open Market Committee

Consumer Price Index

CPI reports in 2024 have so far exceeded expectations. The January CPI print surpassed the expected 2.9% level, reaching a year-over-year level of 3.1%. The February CPI print rose to a year-over-year increase of 3.2%, and the March print climbed to 3.5%.

After these higher-than-expected CPI reports, market expectations for interest rate cuts in 2024 shifted significantly over the quarter. In early January, markets expected six to seven rate cuts; however, this fell to three anticipated cuts by the end of March, which aligns more closely with the Fed's predictions.

Even though inflation has recently risen, the Fed's latest economic projections, released at the March Federal Open Market Committee (FOMC) meeting, indicate that the Fed expects faster economic growth, lower unemployment, and an increase in core personal consumption expenditures (PCE) inflation to 2.6% in 2024, up from the 2.4% projection in December.

Although Fed Chair Powell has consistently signaled the possibility of imminent rate cuts, market expectations for the timing of the first one of these rate cuts has shifted throughout the quarter, moving from March to July.

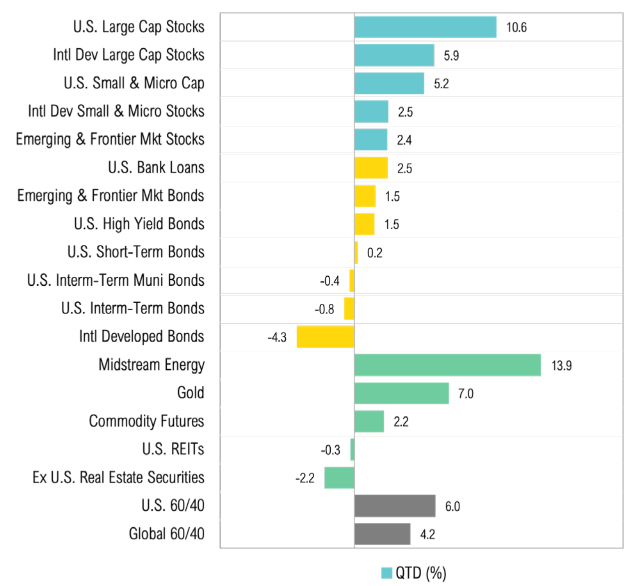
U.S. and International Markets

Both U.S. and international equity markets ended the quarter on a strong note, though U.S. markets outperformed their international counterparts. The S&P 500 ended the quarter up a very respectable 10.6%, while the MSCI EAFE ended the quarter up 5.9%. U.S. small-cap stocks fared well, gaining 5.2% over the quarter. in contrast was the slow start to the year for fixed income markets, as investors continued to wait for potential interest rate cuts. The Bloomberg U.S. Aggregate Bond Index closed the quarter down 0.8%.

Gold price per ounce, which ended the quarter up 7%, hit a new all-time high on March 3 and ended the month at another new all-time high above $2,200 per ounce for the first time due to persistent central bank buying and gradually improving investor sentiment.

West Texas Intermediate (WTI) crude prices also climbed higher over the quarter on ongoing geopolitical tensions, rising past $80 per barrel for the first time since November. This has led to higher gasoline prices as the national average per gallon rose by the end of March to $3.53—its highest price in more than a year.

Q1 2024 Key Market Total Returns



Source: Bloomberg

China and Japan

In international news, China's economic growth has shown signs of improving. The country's manufacturing activity expanded in March after a five-month contraction, and its official purchasing managers index rose to 50.8. Further, Chinese inflation data show that the country has inched out of deflationary territory, and headline CPI rose to a year-over-year 0.7% in February, but it dropped to 0.1% in March. The Shanghai Shenzhen CSI 300 Index ended the quarter up 4.8%.

On March 19, another influential central bank announced its major monetary policy shift. The Bank of Japan ended the world's only negative interest rate regime and hiked interest rates for the first time in 17 years. This marked the end of an era and a historic shift (albeit a small one) away from an aggressive monetary easing program that had been in place for years to combat economic challenges in Japan.

The Bank of Japan raised its short-term rate to around zero to 0.1% from -0.1%. The yen weakened after the announcement and remained above 150 against the dollar for the rest of the month, as the bank took a dovish tilt by noting that financial conditions would remain accommodative for the time being.

Looking Forward

The Fed has maintained that it will likely cut interest rates three times this year, meaning it has acquiesced to a higher inflation target. If policymakers can contain longer-term bond yields while tolerating higher inflation, then the economic backdrop could continue to support above-average equity valuations. Additional productivity gains from artificial intelligence (AI) could fuel this support.

Although the Fed wants to cut short-term rates, longer-term rates may stay higher for longer if inflation remains elevated. Historically, tightening cycles, such as this one, have constrained bank lending; however, in the current climate, the relatively new and growing private credit asset class—holding nearly $2 trillion in assets—is filling the lending void left by banks. Rampant fiscal spending, which shows no signs of abating, has also become a key driver of economic growth.

Finally, the Fed may be motivated to avoid a liquidity crisis in an election year, and so it could taper bond sales and become more accommodative due to issues unrelated to economics, much like what occurred in 2018. Higher longer-term rates would continue to pressure areas such as commercial real estate, regional banks, and highly indebted smaller companies.

If longer-term rates move much higher, then those headwinds could creep into other areas of the market, too. Thus, policymakers' aim and accuracy remain critical as we move toward the second half of 2024. In light of this situation, we remain comfortable with the shorter-than-benchmark duration positioning within fixed income portfolios and continue to favor owning gold in portfolios.

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

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Chief Investment Officer

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