Market Update: Q1 2024

While many pundits in the investment world are willing to offer their opinions about the future, what makes a market isn't any one person's perspective: it's the collective opinion of all participants.

At the start of the year, that collective opinion wasn't very optimistic. Most discussion revolved around how a recession in the U.S. economy would unfold in the wake of the Federal Reserve interest rate hikes. Would it be a 'hard landing' or a 'soft landing'?

The prospect of a recession with higher unemployment, lackluster consumer spending, stagnant corporate earnings, and falling inflation seemed unavoidable. In response, the Federal Reserve would be expected to cut interest rates to stimulate growth. It is clear the collective view of the economy and interest rate cuts has changed, but this was among several surprises in the first quarter.

Key Takeaways

- The U.S. economy outperformed expectations in Q1
- Fed rate cuts are no longer a given
- Performance was more evenly distributed, with positive returns in 10 of 11 sectors
- Positive surprises were a theme, with NVIDIA being a standout example

INDEX	Q1 2024	TRAILING 12 MOS.	ANNUALIZED 3-YEAR
S&P 500	10.6%	29.9%	11.5%
Russell 2000 Small Cap	5.2%	19.7%	-0.1%
MSCI EAFE - International	5.9%	15.9%	5.3%
MSCI Emerging Markets	2.4%	8.6%	-4.7%
Bloomberg US Agg Bond	-0.8%	1.7%	-2.5%

SOURCE: BLOOMBERG

Bond Market Wisdom?

Many seasoned investors view the bond market as the steady and wise big brother. It's larger than the stock market, less impetuous and erratic, and more focused on the big picture.

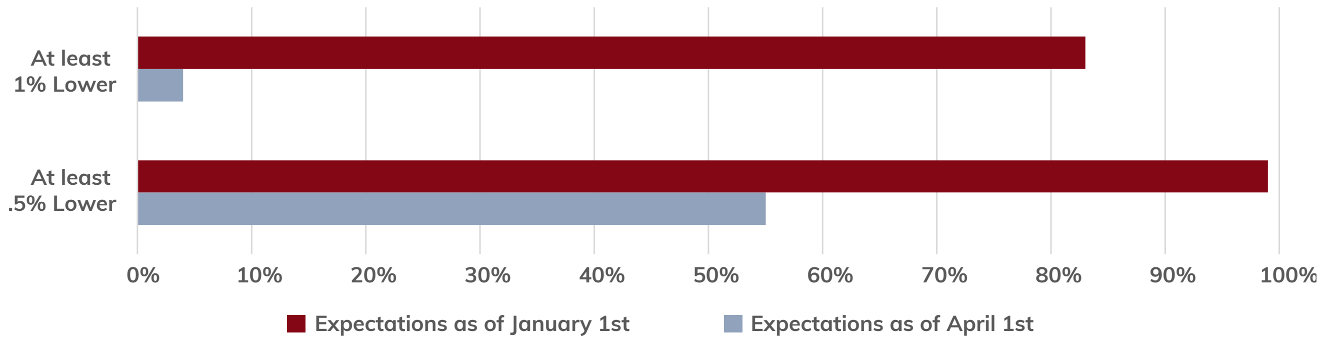
The Bond 'futures' market is a way for traders to hedge risk or make a bet on what will happen in the future. It is something of a crystal ball of the bond market, offering a snapshot in time of expectations for different outcomes. Importantly, it is not one person's or firm's opinion of the future. It is the collective view of the market that can be objectively quantified.

At the start of the first quarter, the market was assigning a 99% chance that the Federal Reserve would lower rates by at least .5% by the end of 2024 and an 83% chance that the Fed Funds rate would be at least a full 1% lower.

While the expected change in the Fed Funds rate may seem small, its stimulative effect on the economy would be significant. The market was all but certain the economy would sputter, and stimulus would be needed. Over the course of the first quarter, that view shifted dramatically.

As of April 1, the futures market implied a 55% chance of rates being lowered by at least .5%, and only a 4% chance of rates being lowered by at least 1%. The strength and resilience of

BIG CHANGE IN BOND MARKET EXPECTATIONS OF LOWER RATES BY YEAR-END 2024



SOURCE: CHICAGO MERCANTILE EXCHANGE

the economy has clearly surprised the markets and the Federal Reserve.

The Federal Reserve may still lower interest rates in 2024, but that is no longer a given and the chances of significant rate cuts have fallen sharply. As economic data continues to exceed forecasts, it will be difficult for the Federal Reserve to justify cutting interest rates and risking re-igniting inflation.

Interest rate cuts are like a sugar high for stocks and bond prices. A strong economy should help profits over time, but interest rate cuts can have a powerful, short-term psychological impact that would help push stock and bond prices higher. The strong performance of the U.S. stock market in the first quarter is even more impressive without the sugar high of interest rate cuts helping to push prices higher.

Surprising Participation

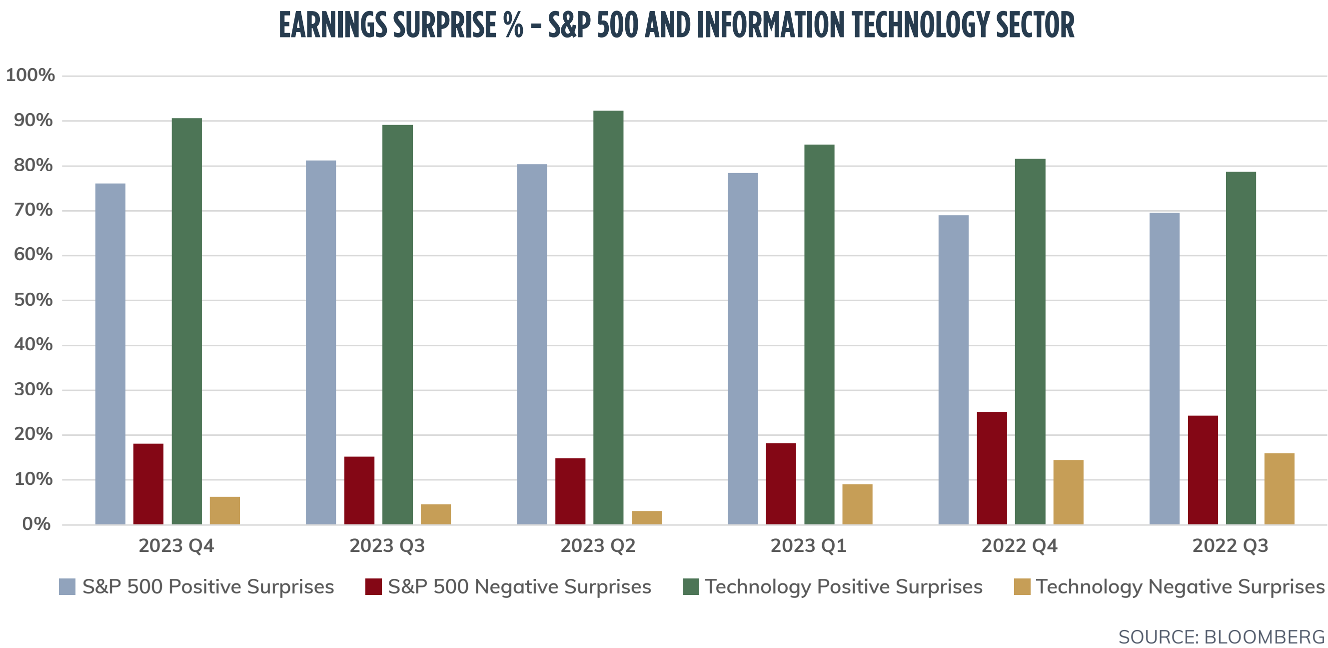
In recent Market Insights letters, we have chronicled the remarkable performance of the so-called 'Magnificent 7'. These huge technology companies pulled the market higher in 2023, and that momentum has carried into 2024. In the first quarter though, performance was more evenly distributed, with broader participation across U.S. sectors and global equities. In fact, 10 of 11 sectors posted positive returns in the first quarter. Technology and Communication Services continue to surge, with traditionally 'value' sectors like Energy, Industrials, and Financials also among the leaders. Smaller U.S. stocks, international stocks, and commodities also fared well.

Earnings Surprise

You can't have a surprise unless you have an expectation. In recent quarters, the surprise has come in the form of stronger than expected earnings. In market parlance, a 'positive earnings surprise' refers to a company reporting quarterly profits greater than the consensus analysts' expectation.

In recent quarters, the percentage of companies reporting a positive surprise has climbed, while those falling short of analysts' expectations (a negative surprise) has fallen. This is especially true in the technology sector, where 90% of companies have delivered a positive surprise in the past three quarters.

The semiconductor company NVIDIA continues to be a standout with a staggering 82.5% return in the first quarter. NVIDIA is a prime example of a company Wall Street analysts continue to underestimate. Over the past 4 quarters, it has beaten consensus earnings estimates by an average of 20%, surprising even



the most bullish analysts. By comparison, a typical earnings surprise would fall between 5% and 10% of the consensus earnings estimate.

Stepping back, the earnings momentum of NVIDIA should not be unexpected. Fueled by the growth of Artificial Intelligence and the insatiable demand for computing power, sales of NVIDIA's products have surged. They have superior technology that offers a competitive advantage and extraordinary pricing power. Profit margins are well above average, and their balance sheet is stellar. The company continues to innovate, driven by a strong leadership team. We believe these are the characteristics that drive long-term success in any business and the characteristics that drive stock prices higher.

A man in a hot air balloon gets swept up in a storm and thrown off course. As the clouds part, he descends and sees a man standing in the middle of a field. He calls to the man,'Hello, can you tell me where I am?' The man below replies, 'You are here.' The man in the balloon counters, 'You must be an economist. Because what you just told me is completely accurate and provable, but is of absolutely no use.'

Focus on the Business

There is a never-ending parlor game in the investment industry to predict short-term earnings trends, interest rate moves, or macro-economic outcomes. This 'top-down', short-term approach to investing is useful for the financial media, but is very difficult to execute profitably for clients.

The massive shift in interest rate expectations in the first quarter is an excellent example of how market sentiment can swing too far in one direction. While we need an awareness of broad economic conditions and external risks, fixating on the macro trends can be distracting and counterproductive. Our primary focus is on the businesses we own and identifying the key characteristics that drive long-term success. We believe stock prices will follow those characteristics with a lower probability of a negative surprise.