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INVESTMENT STRATEGY STATEMENT | MARCH 1, 2024

Data Driven Fed Policy

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Equity Markets

Stock Prices Rose in February Despite a Repricing of Rate Cuts

Investors spent the first half of February adjusting their expectations for the timing of the first rate cut and the extent to which rates could be cut in 2024 — fully pricing out all of the enthusiasm for rate cuts which fueled the sharp gain in stock prices from late October to the end of 2023 — as the data pointed to the economy maintaining solid forward momentum.

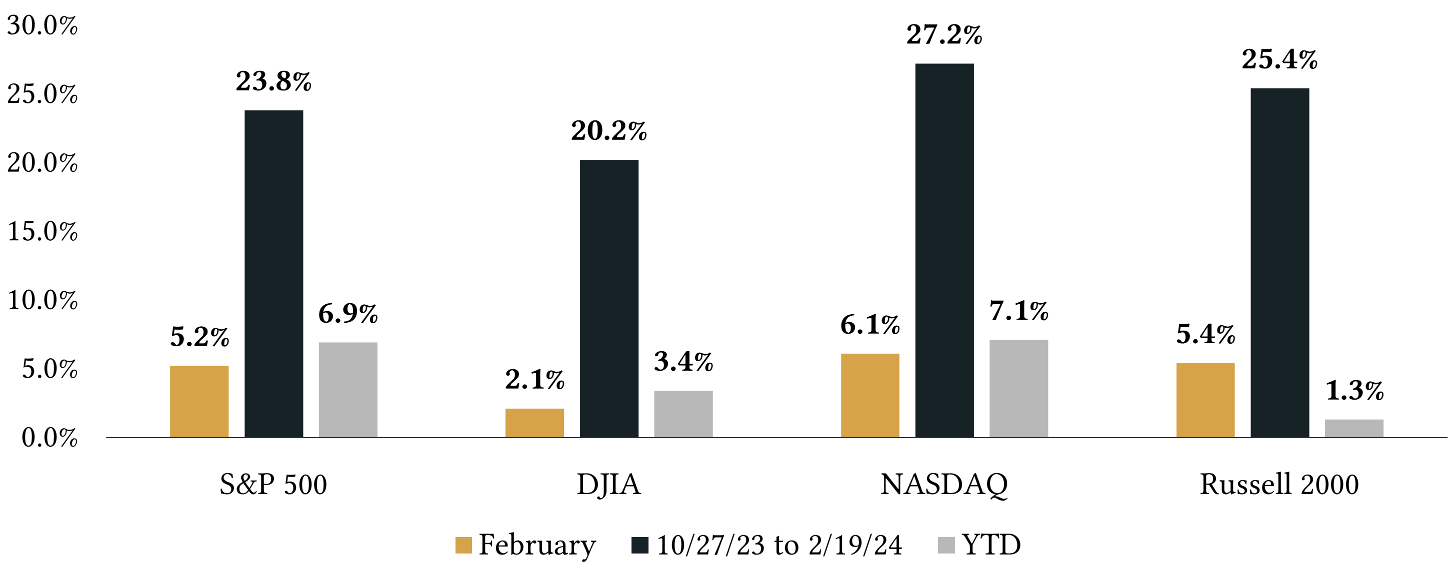
+2.1% to 6.1%

February Increase in Major Stock Measures

+1.3% to 7.1%

YTD Increase in Major Stock Market Indices

Major Stock Market Indices - Price Change Only



Source: Bloomberg

Following a near perfect report on fourth quarter 2023 real GDP — solid growth and inflation around 2% — the University of Michigan consumer sentiment measure posted its largest two-month surge since 1991, nonfarm payrolls rose a whopping 353,000 in January with net revisions of 126,000 in November and December, and the service sector purchasing managers' survey reported a widespread increase in activity in January. All signs of the economy continuing to grow at a healthy pace.

The solid data on the economy was followed up by a somewhat hot, but rather misleading report on consumer prices in January. The CPI increased 0.3% month-to-month, while the core CPI rose 0.4%. However, the shelter component continues to distort the inflation data to the high side. The index for shelter rose 0.6% month-to-month, contributing 72% of the monthly rise in the headline CPI and 68% of the monthly rise in the core CPI. On a year-on-year basis with the shelter component higher by 6.0%, the CPI ex-shelter rose 1.5%, while the core CPI ex-shelter is higher by 2.2%.

Month-to-Month Changes

+0.3%	+0.4%
CPI	**Core CPI**

We highlight the upward bias in the reported inflation data arising from the shelter component because rent prices fell for six months in a row before rising 0.2% in February according to the Apartment List National Rent Report and are lower by -1% over the past twelve months. Falling rental costs are not showing up in the monthly inflation reports because the Labor Department's measure of rents reflects what renters at large are paying — both those who just signed leases and those who signed them up to two years ago.

Additionally, another issue with shelter costs is that roughly two-thirds of U.S. households own their home, which means the CPI measure of inflation misrepresents inflation experienced by most households. The actual "servicing cost" of a home is mostly the cost of the mortgage, which for fixed rate loans does not fluctuate year-by-year, let alone month-by-month.

There were also some backward-looking influences in the January inflation reports. In the CPI, price increases were particularly large in labor intensive sectors such as hospital services, motor vehicle repair, pet services, and trash collection, suggesting those employers felt compelled to raise prices to keep pace with the rise in labor costs in 2023. The producer price index rose a slightly hotter than expected 0.3% month-to-month in January largely due to difficult seasonal adjustments in the PPI skewed by "start of the year" price increases that reflect past rather than future trends.

With easing shelter costs only showing up in the inflation data with a lag, both headline and core CPI measures are running in line with, or below, the Federal Reserve's 2% inflation target once shelter is removed from the inflation data.

> *The bottom line is that disinflation is happening, but shelter inflation is keeping the CPI measure of inflation misleadingly high.*

Cooling prices for newly signed rental leases will eventually translate into lower shelter costs flowing through the reported inflation data.

A stronger read on manufacturing and the strong job gains in January pushed the yield on ten-year Treasury notes above 4.0% again in early February, from 3.91% at the end of January. The hotter than expected inflation reports and the rather hawkish tone of the minutes of the January FOMC meeting sent ten-year Treasury yields even higher, hitting 4.33% on February 21, the highest level since late November.

The yield on two-year Treasury notes also rose from 4.21% at the end of January to 4.71% on February 21. The yields on two-year and ten-year Treasury notes ended February at 4.63% and 4.24%, respectively.

Yields on U.S. Treasury Notes

(as of February 29 2024)

4.63%	4.24%
Two-Year	Ten-Year

During February, Federal Reserve officials picked up where they left off in January trying to tamp down market expectations for the timing of the first rate cut and the extent to which rates could be lowered this year by emphasizing that the central bank would take a cautious approach to lowering rates. After ending 2023 with the market pricing in about an 87% probability of the first rate cut happening in March and six to seven cuts during 2024, at the end of February markets were pricing in only a 3% chance of a March rate cut and three cuts during the year, right in line with the FOMC Committee's forecast of three rate cuts offered up at the December FOMC meeting.

Market Predictions

(as of February 2024)

3%	Probability of Rate Cut in March
3	Rate Cuts in 2024

Despite the reset in the markets over the past two months on the timing of the first rate cut and the extent of rate cuts this year, along with a backup in yields on Treasury securities during February, stock prices continued their advance last month as good news on the economy bodes well for the earnings outlook, consistent with the position we took at the beginning of the year that earnings would determine the path for stock prices in 2024.

After a pretty sharp selloff in common stocks following the release of the CPI data, investors digested a softer retail sales report and the shelter anomaly in the inflation data and concluded that the economy is expected to continue to roll, and inflationary pressures are expected to continue to roll off.

> *For the month of February, the major stock measures rose 2.1% to 6.1% with investors focusing on companies that will benefit from faster revenue growth and improved efficiency arising from the ongoing development of artificial intelligence.*

The major stock market indices are higher by 1.3% to 7.1% year-to-date and are higher by 20.2% to 27.2% since the recent low for the S&P 500 on October 27.

The Data Will Drive Federal Reserve Policy

At the beginning of the year the markets were looking for the Federal Reserve to fairly aggressively shift its conduct of monetary policy this year, with the futures market pricing in about an 87% probability of the first rate cut taking place in March and the central bank delivering six to seven rate cuts this year. While the central bank provided no guidance on the timing of the first rate cut at the December FOMC meeting, the median forecast for the federal funds rate contained in the FOMC Committee's Summary of Economic Projections indicated that rates would be cut three times in 2024.

Federal Reserve officials spent January and February pushing back against the market's expectations by frequently citing that policymakers would "proceed carefully." Chair Powell added at the press conference following the January FOMC meeting that the Committee "wants to see more good data" on inflation coming down before cutting rates and that he did not "think a March rate cut is likely based on the meeting today." Taken with data showing the economy maintaining solid forward momentum and the January CPI report that raised questions about further progress on easing inflationary pressures, the probability of a March rate cut fell to 3%, May to 22%, and the number of rate cuts expected this year is now at three.

It is very clear that the officials at the Federal Reserve are haunted by the surge in inflation under Arthur Burns in the early 1970's and again in the late 1970's/early 1980's under G. William Miller. Chair Powell wants to be remembered as the second coming of Paul Volcker who broke the back of the inflationary spiral in the early to mid-1980's after pushing the economy into a serious recessionary period from 1980 to 1982. Healthy jobs growth and an unemployment rate below 4% puts the Federal Reserve in a position to not be in any hurry to lower rates and to allow the disinflationary influences in the economy to continue to play out.

> *In lieu of rate cuts, the Federal Reserve is signaling additional rate hikes are no longer on the table and that it will remain data dependent regarding both the timing and magnitude of future rate cuts.*

The central bank does not want to cut rates in the near term and later on this year be put in a position where it needs to consider raising rates again to cool down a too hot jobs market and a rekindling of inflationary pressures.

The Federal Reserve has the luxury currently to watch the data and if the economy falters and the labor market takes a turn for the worse with a spike in the unemployment rate, the central bank can switch gears and rate cuts will come faster and to a greater extent than currently expected. Remember that the central bank has 525 basis points of rate cuts at its disposal before the target range for the federal funds rate will hit zero.

In other words, the Federal Reserve is not expecting to fight an inflation war this year, but rather is poised to manage the business cycle should the central bank's full employment mandate come into greater focus.

Rate cuts are on the table this year because the Federal Reserve is keenly aware that failing to lower the target range for the federal funds rate will bring about an inadvertent tightening of monetary policy as the real, or inflation-adjusted, policy rate increases as the pace of inflation slows. On that score, using the core PCE inflation measure, the real federal funds rate has increased to 2.5% currently from 1.2% last summer with no rate hike taking place following the July hike. The market currently has a 63% probability of a June rate cut.

+1.3%

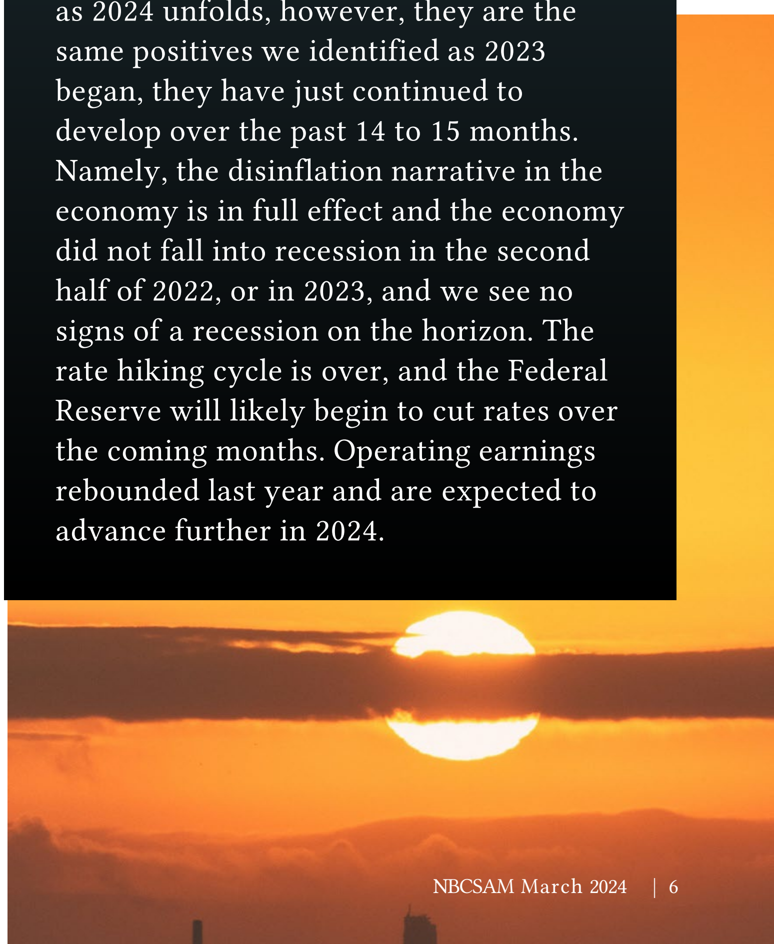
Increase in Real Federal Funds Rate Since Summer 2023

As we stated in last month's ISS, the soft landing has arrived with the core economy growing at a pace just above 2% and the core PCE inflation measure running at the Federal Reserve's target of 2% over the second half of 2023. We expect a further slowing in the economy's growth rate this year toward the economy's long run potential growth rate of 2%, or slightly lower. We also expect the well-entrenched disinflationary influences in the economy to keep inflationary pressures under control, near the Federal Reserve's 2% target.

So, watch the data, just as the FOMC Committee is doing. The key is that the next policy move by the Federal Reserve will be a rate cut and a series of them will likely occur this year, the timing is not nearly as important. For the economy and the financial markets, the former headwind of Federal Reserve policy is likely to become a tailwind as rate cuts come into play. The data will determine the timing and extent of the rate cuts. As always, stay tuned!

Positive Backdrop for Common Stocks and Fixed Income

We continue to focus on four big themes as 2024 unfolds, however, they are the same positives we identified as 2023 began, they have just continued to develop over the past 14 to 15 months. Namely, the disinflation narrative in the economy is in full effect and the economy did not fall into recession in the second half of 2022, or in 2023, and we see no signs of a recession on the horizon. The rate hiking cycle is over, and the Federal Reserve will likely begin to cut rates over the coming months. Operating earnings rebounded last year and are expected to advance further in 2024.



S&P 500 Price Index (12/31/21 – 2/29/24)

Source: Yahoo Finance

We now know that much of the inflation surge to the 2022 peak was transitory in nature and dissipated as supply chain disruptions and bottlenecks were repaired — leading to declines in a wide array of goods prices — and a rebound in labor supply has eased the upward pressures on wages. As the reopening of the economy has matured, prices of many services, particularly travel-related, have fallen sharply from their mid-2022 and mid-2023 peaks.

The economy did not fall into the widely expected recession as a decline in open positions in the economy bore the brunt of policy tightening, rather than actual job losses, which supported household incomes and consumer spending. Additionally, the economy turned out to be not nearly as interest rate sensitive as it was during previous business cycles, as households and businesses locked in very low financing rates following the Financial Crisis through the end of the pandemic.

The economy did experience a series of sector specific recessions and recoveries over the past two years that were not coordinated — such as auto production, homebuilding, and business capital spending on structures — leading to rebounds in certain sectors of the economy offsetting downturns in other sectors.

As we have asserted previously, nothing about inflation and the economic cycle has been normal over the past couple years.

While we tend to rely more on hard data than survey results in terms of trying to understand the current state of the economy, the dramatic surge in consumer sentiment during December and January is noteworthy. While a healthy job market certainly helped, it appears that three categories of prices were largely behind the boost in sentiment, namely, stocks, gasoline, and grocery prices.

The DJIA and the S&P 500 hitting record highs and the sharp rise in stock prices, in general, since late October added $7 trillion to the value of U.S. common stocks according to S&P Global, providing a huge boost to household net worth.

Gasoline prices are the one price that consumers pay that is displayed prominently on giant signs all across America and the roughly -12% drop since late October was very important to household finances. Groceries are the second largest frequent transaction behind food and drinks at restaurants and bars for households. Prices for items that consumers buy more often play an outsized role in shaping impressions of inflationary pressures. After rising 11.8% during 2022, grocery prices rose only 1.3% in 2023.

As mentioned previously, Federal Reserve officials are signaling that they are in no hurry to lower rates as they want greater assurances that inflation is moving sustainably toward 2%. The FOMC Committee does not want to be placed in a situation where it needs to restart rate hikes after cutting rates.

As inflationary pressures continue to ease, a passive tightening of policy is taking place as the real policy rate increases.

It is still our position that rate cuts are ahead and what is important is not the exact date of the first cut, but the direction the Federal Reserve is moving. To the extent that fewer rate cuts rather than more take place, that means the economy did not need as much support as was anticipated at the beginning of the year.

Finally, operating earnings rebounded in 2023 with the economy not tumbling into a recession, after operating earnings declined year-on-year over the last three quarters of 2022.

Positives for Profit Margins

Growing Economy

Lower Inputs Costs

Easing Wage Pressures

Ongoing Productivity Gains

A growing economy with lower inputs costs, particularly for commodity inputs, along with easing wage pressures, and ongoing productivity gains should be positives for profit margins.

We continue to view the backdrop for common stocks, as well as for Treasury and corporate fixed income securities, as being supportive of higher asset prices as we move through 2024. We encourage investors sitting on cash to begin averaging that cash into the market over the next several months ahead of the Federal Reserve cutting rates.

Treasury Market

Treasury Yields Rose in February as Rate Cuts Were Repriced

Treasury yields rose across the yield curve last month as investors priced out near term rate cuts and the extent to which rates could be cut in 2024. Yields on two-year Treasury notes rose 42 basis points to 4.63%, while yields on ten-year Treasury notes rose 33 basis points to 4.24%. A solid report on 4Q 2023 real GDP, a surge in consumer sentiment, a hawkish tone to the minutes of the January FOMC meeting, and strong jobs gains in January forced investors to rethink the extent to which a cautious Federal Reserve would ease policy this year.

Treasury yields likely would have risen a touch higher if not for retail sales falling -0.8% in January, manufacturing production dropping -0.5%, and housing starts tumbling -14.8%. With implied ten-year inflation expectations embodied in Treasury securities largely unchanged during February, almost all of the rise in Treasury yields can be attributed to better-than-expected growth in the economy, forcing investors to accept that the Federal Reserve will likely hold rates “high for longer” than expected at the end of 2023.

Two other factors which contributed to the rise in Treasury yields last month are the outsized supply of Treasury securities to be issued given the massive budget deficits flowing from Washington and the “quantitative tightening” program the Federal Reserve kicked off in June 2022 whereby the central bank shrinks the size of its bond portfolio by $95 billion each month. Last week a $16 billion sale of twenty-year Treasury bonds went very poorly, suggesting buyers’ concerns over the limits of investor demand for longer dated Treasury securities.

The backup in Treasury yields provides investors with another opportunity to add to their fixed income portfolios, or initiate a fixed income allocation, at attractive yields. The ongoing disinflationary forces in the economy, a further slowing in the economy’s growth rate from the 2.5% pace in 2023, and the Federal Reserve eventually cutting rates — if only to push back against the passive tightening of policy as inflationary pressures continue to ease — should set the stage for yields across the Treasury yield curve taking another run at 4%. The path to lower Treasury yields is unclear, but will be driven by the economic data, just as the Federal Reserve is data dependent currently on adjusting the policy rate.

Treasury Market Talks to Federal Reserve

	Ten-Year Treasury Yield	(minus)	Two-Year Treasury Yield	(equals)	Yield Spread
9/30/21	1.49%		0.28%		121bp
3/07/23	3.98%		5.07%		-109bp
10/31/23	4.93%		5.04%		-11bp
12/29/23	3.87%		4.25%		-38bp
1/31/24	3.91%		4.21%		-30bp
2/29/24	4.24%		4.63%		-39bp

Source: Bloomberg

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Disclosures