MARKET UPDATE

Economic Market Update – First Quarter, 2024

April 15, 2024

- The economy and markets are off to a strong start in 2024
- Several key factors have led to resilient economic growth, defying expectations from experts that the U.S. economy would fall into recession and outperform global developed market peers:
  - Consumers and businesses have remained largely insulated from the impact of higher rates
  - The productivity boost that began during COVID pandemic appears like it is here to stay
  - Significant fiscal stimulus for manufacturing and infrastructure investment
  - Energy independence has largely allowed U.S. to avoid the energy challenges faced by global peers
- The most significant question facing the Fed in 2024 is when and how quickly to ease monetary policy

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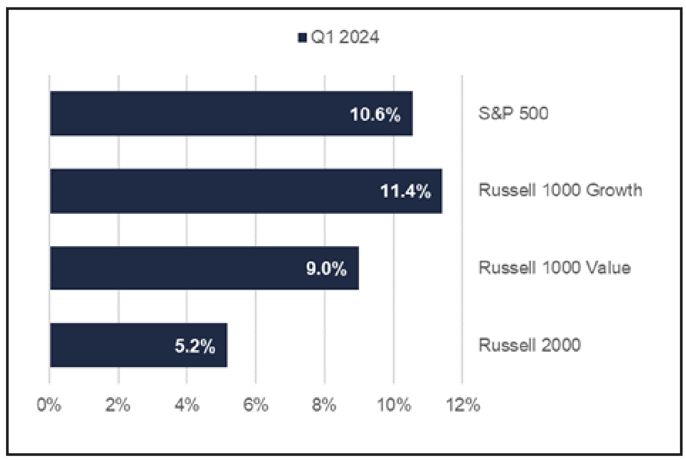
2024 is off to a strong start as economic growth in the U.S. continues to exceed expectations. After defying the pessimists in 2023, the U.S. economy continues to outperform, delivering strong growth without a return to the high levels of inflation seen in the early stages of the recovery from the COVID-19 pandemic. The experts are still playing catch up. In January, a composite of Wall Street estimates for 2024 GDP growth stood at 1.3%; by March, the experts had boosted their expectations for annual GDP growth to 2.1% for the year. Estimates were adjusted up again in early April, with growth expectations for 2024 now at 2.2% Risk markets have also continued their strong run of performance, with equity markets delivering strong returns in the first quarter and fixed income market outperformance coming from the riskier areas of the market. With robust growth and inflation continuing to trend towards target, it's looking more and more like the Fed is on track to pull off the sought-after soft landing for the economy. While we are continuing to keep a close eye on labor markets, the weight of the evidence suggests the soft landing may have even already been achieved. Given that the U.S. economy has outperformed expectations, an examination of the underlying dynamics that have led to the resiliency of the U.S. economy is warranted. After a review of market performance for Q1 2024, we review the factors that have led the U.S. economy to continue to defy the expectations of the experts and touch on where the economy is likely headed from here.

U.S. Equity

The strong uptrend in equity markets that began in November 2023 carried over into the first quarter of 2024, with every major market index posting positive performance for the first three months of the year. The S&P 500, the bellwether for U.S. stock returns, finished Q1 2024 up 10.6%.[1] Small cap stocks continue to lag their large cap peers, with the Russell 2000 finishing the quarter up 5.2%. Continuing the trend of broad-based strength in U.S. equity markets from 2023, all nine Russell and S&P style boxes finished the first quarter in positive territory. U.S. equity performance continued to vary widely by style. Growth continues to outpace value, but some cracks have begun to appear in the "Magnificent 7", with Apple and Tesla finishing the quarter down -10.9% and -29.3% respectively. Despite this weakness in two of the key stocks that have driven market performance in recent quarters, growth stocks continued the recent trend to outpace value, with the Russell 1000 Growth Index finishing Q1 up 11.4%. The Russell 1000 Value Index climbed 9.0% during the first three months of 2024, a welcome development after trailing growth by the second largest annual margin on record in 2023. Growth also outperformed in small cap, with the Russell 2000 Growth Index up 7.6% vs. the 2.9% return for the Russell 2000 Value Index. As usual, performance in Q1 varied across sectors, but outside of Real Estate, which was down -0.5% on the quarter, every other S&P 500 sector started off the year on strong footing. Communications stocks continued their recent tear, finishing Q1 as



Russell Style Box
Q1 2024 Returns

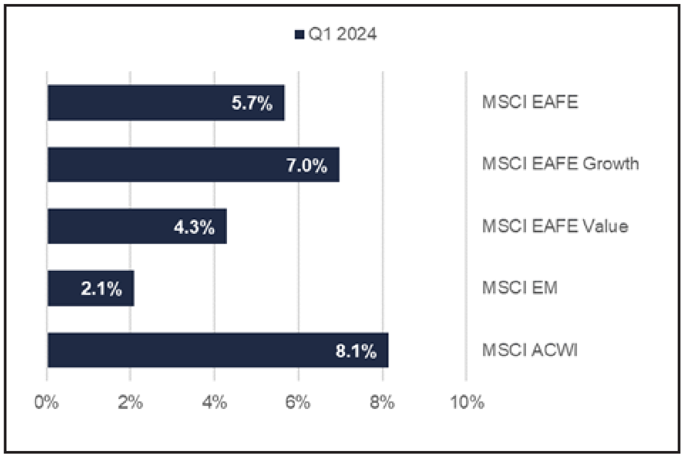
	Value	Blend	Growth
Large	9.4%	10.8%	11.7%
Mid	8.2%	8.6%	9.5%
Small	2.9%	5.2%	7.6%

[1]Return figures for U.S. indices are on a total return basis; international returns are net returns in U.S. dollars unless otherwise stated.

the best performing sector after rising 15.8% in the first three months of the year. Energy – perhaps surprisingly after a weak 2023 – was the second best performing sector on the quarter, up 13.7%. Tech, Financials, and Industrials were all also up double-digits in Q1. Consumer Discretionary and Utilities stocks were the laggards that still finished in positive territory, up 5.0% and 4.6% respectively, with the aforementioned Real Estate sector, where the impact of higher rates is being felt more acutely, the only sector to start off the year in the red.

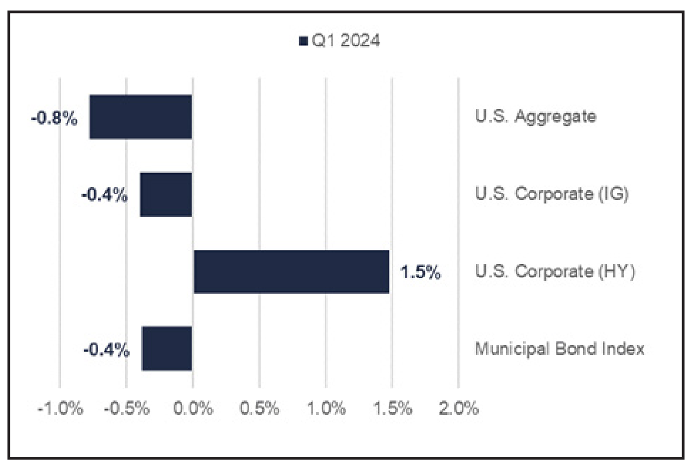
International Equity

Despite continuing to lag the U.S., international markets also produced strong returns to start the year. The MSCI EAFE Index, which tracks developed international markets, finished the first quarter up 5.7%. The split between value and growth was slightly wider internationally than in the U.S. Growth also outperformed internationally, with the MSCI EAFE Growth Index up 7.0% in Q1 compared to the MSCI EAFE Value's 4.3% return. The MSCI EAFE Index has a value tilt relative to major U.S. indices due to the lack of any significant multinational technology firms, which are primarily based in the United States. Much of the difference in performance between U.S. and international indices in recent years comes down to the significant differences in sector exposure. On the surface, emerging market stocks were the clear laggard on the year compared to the double digit gains in all other major stock market categories, with stocks in developing countries up just 2.1% to start the year. Digging beneath the surface, however, reveals that significant return dispersion across countries continues to be a prominent feature in the developing world. Chinese stocks have continued to struggle after a difficult year in 2023, finishing the first quarter slightly in the red. Stocks of firms based in Hong Kong fared even worse, with a Bloomberg index that tracks large- and mid-cap firms domiciled in Hong Kong down over -12.3% in Q1. As we've previously highlighted, though the weight of Chinese firms in the MSCI Emerging Markets Index has fallen from a peak of around 45% to just under 23% today, the performance of the Chinese market still has a significant impact on the return of the overall index. India, which has the second highest weight in the index after China, continues to perform well. Taiwan and Vietnam were other strong performers in the Asia Pacific region. Closer to home, stock markets in Argentina, Colombia, and Peru were all up double-digits to start the year. **Summing up the global stock market in Q1 2024, the MSCI All Country World Index, which tracks the global stock market, was up 8.1% over the first three months of the year.**



Fixed Income

After rallying to close out 2023, most major fixed income markets reversed course in the first quarter of 2024 as strong economic data and slight uptick in inflation pushed expectations for the first rate cut from the Federal Reserve further out on the calendar. The Bloomberg U.S. Aggregate Bond Index, a broad measure of the performance of investment-grade fixed income markets in the U.S., fell -0.8% in Q1.



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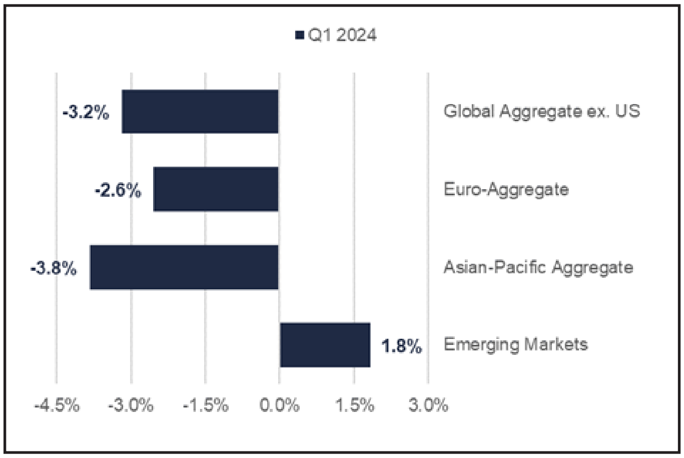
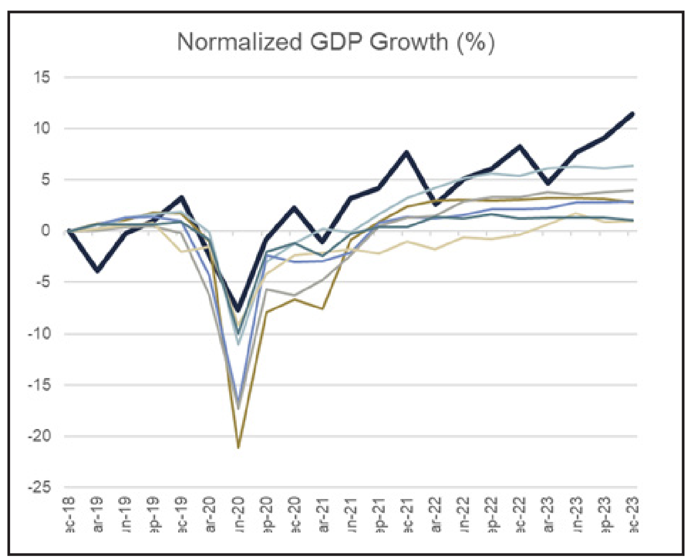


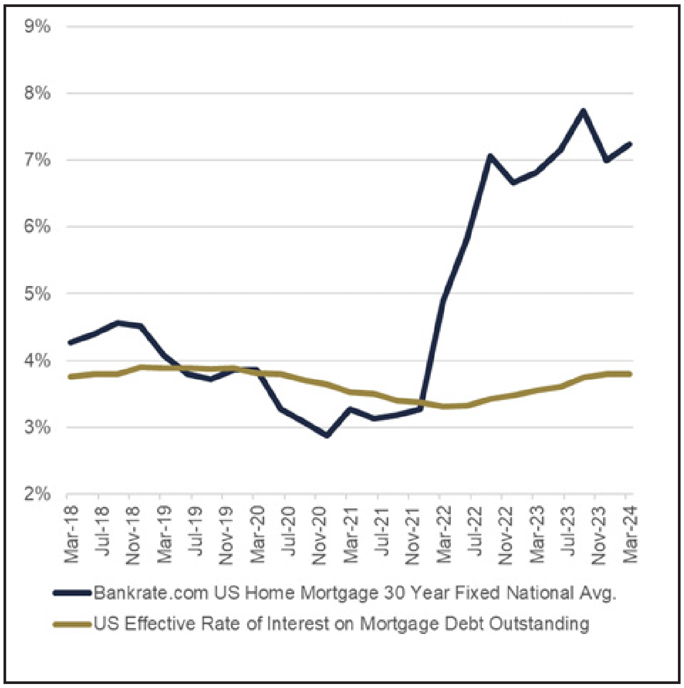
Investment-grade corporate bonds fared slightly better but also fell on the quarter, with the Bloomberg Investment Grade Corporate Index dropping -0.4%. Riskier areas of the credit market continued to outperform, with floating-rate securities up 2.4% and high yield corporate bonds up 1.5% for the first three months of the year. Cash continued to post competitive returns relative to longer dated fixed income instruments, with short-term U.S. Treasury Bills finishing the quarter up 1.3%. The pattern of returns for municipal bonds followed the same pattern, with only high yield municipal bonds in positive territory for Q1. With a Fed pivot in the offing, longer dated bonds are likely to outperform in 2024 as well. Developed International fixed income returns were even weaker than returns in the U.S., with the Bloomberg Global Aggregate Bond ex USD Index finishing the quarter down -3.2%. Developed Europe was the slightly better region, with the Bloomberg European Aggregate Index down -2.6% in Q1. The Asia-Pacific region, which is dominated by Japan, fell -3.8% in Q1, driven by the first interest rate hike from the Bank of Japan in a generation. Emerging markets performed well in Q1 relative to developed markets, with the JPMorgan Emerging Market Global Core Index finishing the quarter up 1.8%. **Summing up the global fixed income market in Q1 2024, the Bloomberg Global Aggregate Bond Index fell -2.1% over the first three months of the year.**

Explaining the Resiliency of the US Economy

In January 2023, the experts charged with predicting the future trajectory of the US economy were in almost total lockstep – they strongly believed that the US would experience a recession at some point during the year. Instead, the economy delivered a surprise to the soothsayers on Wall Street as growth accelerated throughout the year and red hot inflation rates slowly but surely continued to ebb. Though growth has decelerated slightly and inflation has inched up moderately in the first quarter of 2024, the story from 2023 remains largely intact. The type of economic environment we are currently experiencing is exceedingly rare. Alan Blinder, a professor of economics at Princeton University, examined the 11 previous tightening cycles over the last 60 years when the Federal Reserve raised rates in order to bring down inflation. Only once, in 1994-1995, was the Fed able to quash inflation without also inducing some economic pain. The US economy stands out amongst peers; an examination of developed economies during the last four years puts America's exceptionalism in stark relief. Since the start of 2020, the US economy has grown by more than 8% in real terms after accounting for inflation. Contrast that with economic growth for the rest of the Group of Seven (G7), a forum of developed nations, and America is a clear outlier. Economic growth in the Eurozone during that period has been a middling 3% in real terms, with Germany growing just 1% over the past four years, the same growth rate experienced in Japan. The British economy has barely budged during the same period. Canada, which counts the US as its largest and most important trade partner, has fared slightly better, but that can largely be attributed to the spillover effects from such robust growth in the American economy.

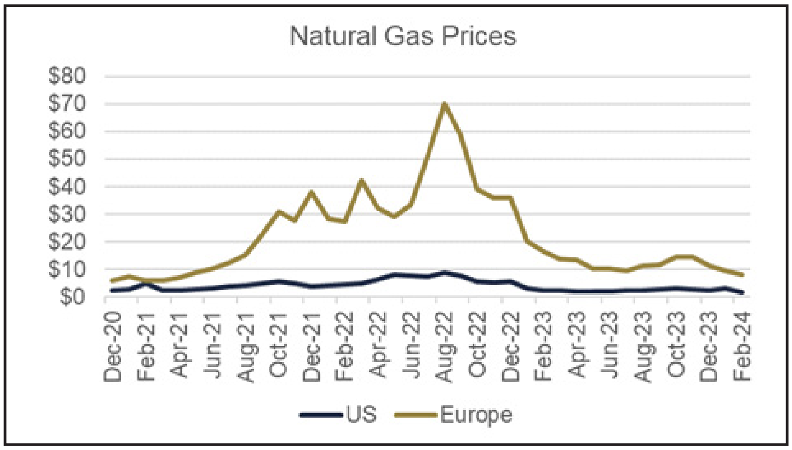


What has enabled the US economy to defy the experts and significantly outperform its peers in the developed world? Focusing on the demand side of the economic equation reveals several illuminating answers. The first is found in the impact – or relative lack thereof – of higher interest rates on both consumers and businesses. As the Fed increased rates, most experts expected the rapid tightening of monetary policy would significantly stunt growth – the entire point of increasing policy rates, after all, is to slow the economy in order to bring down inflation. During this cycle, however, both consumers and businesses have been far more insulated from the bite of higher rates than usual. Some of this effect can be explained by the significant amount of stimulus doled out during the height of the COVID-19 pandemic. During both 2020 and 2021, the federal deficit was around 14% of GDP, compared with a budget deficit of just 6% in the Eurozone. This differential in fiscal stimulus resulted in a significant increase in households' excess savings, which peaked at $2.1 trillion in August 2021 according to research by the San Francisco Fed. While that savings surfeit has been drawn down substantially since the peak, it has lasted far longer than experts predicted. As of the end of 2023, the researchers at the San Francisco Fed found that $400 billion of the savings glut remains, which they estimate will last through the first half of this year. Consumers have been further insulated from the impact of higher rates due to the mix between fixed and floating rate lending. The most salient example is found in the mortgage market. The rate on the benchmark 30-year fixed rate mortgage at issuance has increased substantially, rising from less than 3% in 2021 to over 8% at one point in 2023, ultimately settling just north of 7% as of this writing. The effective rate on all outstanding mortgages has barely budged, however, remaining below 4%. Given that housing costs make up the most significant portion of the average household budget, a large percentage of households locked in at low rates have remained substantially insulated from the impact of higher rates. A similar phenomenon is found in the private sector, with businesses largely locking in fixed rate debt at generationally low rates during the pandemic. The weighted average interest rate on the Bloomberg Corporate Bond Index, which tracks investment grade securities, is currently around 4.2%, and Goldman Sachs estimates that it will rise only slightly to 4.5% in 2025, well below the rates for newly issued debt. The balance sheet restricting undertaken by many firms during the pandemic means the impact of the rapid rise in rates has also been muted in the corporate sector.

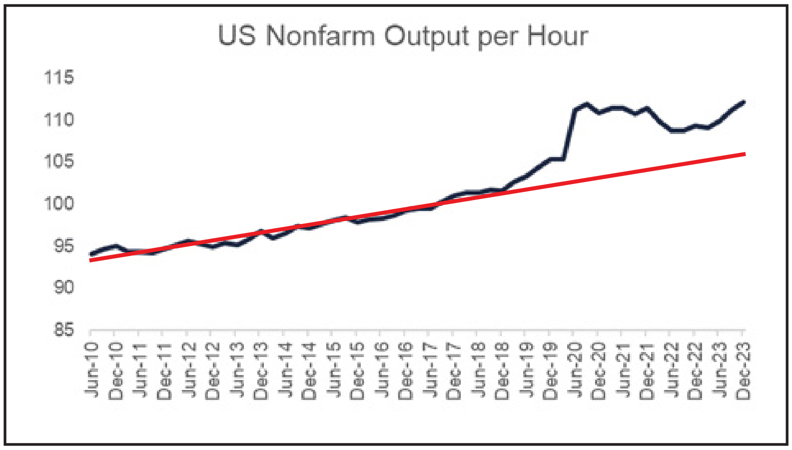


Another factor that sets America apart over the last four years has been fiscal policy. Congress has passed three significant spending bills targeting investment in infrastructure, semiconductors, and clean technology. This fiscal policy approach has led to a boom in capital investment; factory construction has surged after two decades in the doldrums. All told, investments in manufacturing added 0.4 percentage points to US economic growth last year. Infrastructure investment has taken a little longer given the multiple layers of bureaucracy involved at the federal, state, and local levels, but that appears to be revving up as well. This investment has likely delayed the timing of a cyclical slowdown, so the fact that implementation will be staggered will only make it that much more powerful an economic elixir.

The boom in American energy production over the past decade also set America apart from its developed market peers. The US is now energy independent and a net exporter, which allows the American economy to benefit from higher energy prices around the globe while remaining relatively insulted from the effects of higher prices at home. US natural gas prices are around 75% lower than those in Europe, and due to the fact that the natural gas market is far more localized, US consumers did not see the price spike that European consumers faced upon the Russian invasion of Ukraine. Just last year, the US became the largest global exporter of liquified natural gas, and energy exports played a significant part in the 0.6 percentage points foreign trade added to US economic growth in 2023.



The economy operates at equilibrium, however, and the supply side of the equation has played an equally important role in the current economic dynamic in America. The significant boost in demand experienced over the last four years without any expansion in supply would only serve to put even more upward pressure on prices. To understand why we have seen an acceleration in economic growth concurrently with easing inflationary pressure, we can turn to the growth in America's productivity capacity. The basic economic growth equation can be distilled down to two components – the growth in the labor force multiplied by the productivity of that labor. Both labor components have grown substantially over the course of the last four years. The American labor force is now 158 million strong, 4% larger than it was at the start of the pandemic. The expansion of the labor force is only one part of the equation, however. The economy grew 3.2%[2] for the final quarter of 2023, yet hours worked were only up 0.6% during that same period. An increase in productivity accounts for that gap. Productivity surged during the pandemic, but as we emerged from the era of lockdowns, most economists expected the productivity boost to be an aberration that would revert to the pre-pandemic trend. Although there were a few bumps along the road as firms and workers adapted to the new hybrid environment, the evidence now indicates that the productivity boost was not a one-off. Productivity is a residual in the equation, meaning that anything left over after the growth in labor supply is accounted for as an increase in productivity. Academics have offered several potential explanations for the observed increase in productivity. Some may be explained by the ebbing of supply chain frictions experienced at the height of the pandemic. The tight labor market may be allocating workers to higher paying firms, which are likely more productive due to their economies of scale. The scarcity of labor as a result of the tight labor market is also likely inducing firms to swap labor for technology, with the resulting investment in labor saving technology boosting productivity. All these factors are likely playing a part. What is clear, however, is that this boost in US productivity appears to be here to stay.



[2]QoQ SAAR

Comparing the current cycle to the historical examples he analyzed, Alan Blinder notes that the Fed's performance during the current cycle is by far the most impressive, concluding that the Fed has indeed achieved a soft landing. We agree with this view. The challenge from here will be how to unwind the rapid increase in rates seen since 2022. The reason this task presents a challenge is that economists do not know with certainty what the neutral rate – the policy rate that neither spurs economic activity nor acts as a drag on growth – is in real-time. The job of policy makers at the Federal Reserve is to take an educated guess and respond to the data. The neutral policy is almost certainly lower than the current range of 5.25-5.50%, however, and the questions with which the Fed must grapple in the months ahead are when rate cuts should begin and how quickly should they fall. The greatest risk to the economy for the remainder of 2024 is the risk that the Fed gets the answers to those questions wrong, which would result in either the economy stalling or the reignition of inflationary pressure. Chair Powell has clearly stated that the Fed will need to start reducing rates before inflation actually reaches the Fed's 2% target in order to deliver the ideal glide path for the economy. With inflation nearing that level, the only question from here is when, not if, rate cuts will begin. Market participants will be closely watching and waiting in the months ahead.

We remain committed as always to focusing on your long-term financial goals and priorities and constructing portfolios designed to reach those goals while minimizing risk. The volatility environment experienced over the last several years demonstrates the value of disciplined professional management. Our clients' interests always come first, and our goal is to continue to separate the signal from the noise and focus on what truly matters to the economy and markets to help you achieve your investment goals.

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