May 2024

MONTHLY MARKET INSIGHTS

Key takeaways:

- Stronger-than-expected inflation readings have reset the market's expectations for Federal Reserve ("Fed") rate cuts.
- Indications of prolonged restrictive monetary policy led to sharp increases in Treasury yields, which challenged equity markets.
- US corporate earnings appear strong, supported by continuous strength in the economy.

The S&P 500 registered a -4.16% loss for the month, breaking its five-month win streak as slowing growth, sustained high inflation, and rising Treasury yields weighed on risk assets.[1] Similarly, the small-cap Russell 2000 Index and the tech-laden Nasdaq were both down on the month, returning -7.09% and -4.41%, respectively.[2] Inflation remains stubbornly high as the core Personal Consumer Expenditure Index ("core PCE") gained 2.8% year-over-year in March, marking three consecutive months of inflation readings exceeding market expectations.[3] Wage inflation remains elevated as the first quarter employment cost index ("ECI") came in at 4.5% on an annualized basis, surprising to the upside.[4] Taken together, we are seeing further evidence that the last mile of inflation will challenge the Fed; in turn, this has led the market to lose hope of impending Fed rate cuts. Wall Street strategists have readjusted their interest rate forecasts to imply one or two cuts for the year, with some strategists even factoring in no cuts. Given that the Fed's policy decisions are highly reliant on the inflation outlook, we believe recent inflation data will spur the Fed to retain a restrictive stance, leading to a "higher-for-longer" interest rate environment.

Treasury yields rose sharply in April as the market's optimism over rate cuts faded. Over the month, the two-year Treasury yield rose 42 basis points ("bps") while the ten-year Treasury yield rose 48 bps to end the month at 5.04% and 4.68%, respectively.[5] April's significant move in Treasury yields added downward pressure on relatively stretched equity multiples, largely contributing to the price declines experienced last month. We anticipate further interest rate volatility throughout the year as sticky inflation forces the Fed to retain tight policy and the supply-demand dynamics of the Treasury market worsen. Accordingly, a volatile interest rate environment will likely lead to oscillating returns in equity markets. For that reason, we believe earnings growth will be the likely contributor to any equity gains experienced through the end of the year. All considered, we view quality stocks with strong fundamentals and fair multiples to be more attractive in the current environment.

As we enter May, S&P 500 earnings season has passed the halfway mark and, so far, earnings have been strong. Of the companies that reported, the majority have beaten consensus expectations, catalyzing a rebound in the market from the intra-month S&P low of 4,967 experienced on April 19.[6] From a sector standpoint, Technology and Communications are seeing the strongest growth rates, while the Healthcare and Energy sectors have proven to be laggards. While Healthcare has been the biggest drag on earnings this year, we would note that the sector's earnings are being significantly influenced by a one-time charge from Bristol Myers in relation to its acquisition of Karuna Therapeutics. Enthusiasm towards Artificial Intelligence ("AI") continues as reports from Mega-Cap Tech companies indicate sharp increases in capital expenditures ("capex") towards AI initiatives. Increased capex spending should bode well for companies that provide the chips and infrastruc-

1. Bloomberg, return indicates index's price return.
2. Id.
3. Bloomberg.
4. Id.
5. Id.
6. Id.

ture required to develop AI applications. However, Advanced Micro Devices ("AMD") and Supermicro ("SMCI"), two beneficiaries of the AI boom, both experienced major selloffs on the first trading day of May as their earnings reports failed to meet lofty Wall Street expectations. We continue to believe that AI will lead to long-term productivity growth, but we are curious to see whether recent reports from AMD and SMCI prove to be harbingers of fading AI enthusiasm in the short-term. We will keep a keen eye on Nvidia, which reports later in the month, to get further insight on the near-term sustainability of the AI trend. Overall, corporate earnings have been robust, which we believe should continue to provide relative support for equity prices in the near future.

Healthy economic activity continues to be a driver of strong corporate earnings; however, signs of slowing growth have appeared in recent data. The most recent ISM Manufacturing data slipped into contractionary territory, clouding the outlook for the health of the manufacturing sector. The labor market remains tight as initial jobless claims have remained at relatively low levels throughout the month. First quarter real GDP growth disappointed expectations, coming in at 1.6% for the quarter, well below consensus forecasts and the first reading below 2% since the second quarter of 2022.[7] Inventories and foreign trade accounted for the bulk of the miss, with the latter likely influenced by the strengthening dollar. Other areas of the report came in quite strong, suggesting that fears of declining growth may be overblown. Domestic demand growth was solid at 2.8%, underpinned by strong consumption growth of 2.5%.[8] The potential for a "soft landing" scenario is still intact, nonetheless, we remain concerned that a prolonged restrictive monetary policy environment will likely weigh on economic activity as the year progresses.

The US dollar continued to strengthen against global currencies during the month, most notably against the yen. Bank of Japan data suggests major yen-buying intervention at the end of the month as the Japanese currency weakened to a new three-decade low of around 160 to the dollar.[9] Dollar strength proved detrimental to US investor returns in international equity markets on an unhedged basis. Headline Eurozone inflation held steady in April at 2.4% while the core reading dropped to 2.7% from 2.9% the previous month.[10] Combined with relatively weak economic data, we believe Eurozone disinflation will likely lead the European Central Bank to cut interest rates as soon as this summer. As the monetary policies of the US and Europe diverge, we would expect this to be supportive of dollar strength.

The latest Federal Open Markets Committee ("FOMC") meeting concluded on May 1 with the Fed holding interest rates steady as was anticipated by the market. In their policy statement, the Fed highlighted stalling progress towards their inflation goal and signaled that rate cuts will likely be delayed until they observe more significant evidence of disinflation. Separately, the central bank approved plans to slow the ongoing reduction of its balance sheet by reducing the monthly pace of Treasury roll off from $60 billion to $25 billion starting in June.[11] In his press conference, Chairman Powell reaffirmed that the Fed would maintain policy at current levels until renewed evidence of inflation declines surfaces in the data. However, Powell did assuage some investors' fears by stating that it is unlikely that the Fed's next move would be a rate increase. With monetary policy set to remain in restrictive territory, we anticipate that the challenging rate environment will eventually create troubling headwinds for economic activity. Thus, we retain a cautious outlook towards risk assets.

7. Hatzius, Jan. "USA: Q1 GDP Growth Slows to 1.6% Despite Solid Domestic Demand; Core PCE Higher Than Expected; Goods Trade Deficit Widens." Goldman Sachs, 25 Apr. 2024, publishing.gs.com/content/research/en/reports/2024/04/25/eb0ee610-85d6-4e20-bb74-d75c2dfd40c0.html.

8. Id.

9. Fujikawa, Megumi. "Boj Data Suggest Yen-Buying Intervention of Tens of Billions of Dollars." Wall Street Journal, 30 Apr. 2024, www.wsj.com/finance/boj-data-suggest-yen-buying-intervention-of-tens-of-billions-of-dollars-405fa092.

10. Koranyi, Balazs. "Euro Zone Inflation Steady in April, Reinforcing ECB Rate Cut Case | Reuters." Reuters, 30 Apr. 2024, www.reuters.com/markets/europe/euro-zone-inflation-steady-april-reinforcing-ecb-rate-cut-case-2024-04-30/.

11. Timiraos, Nick. "Fed Says Inflation Progress Has Stalled and Extends Wait-and-See Rate Stance." Wall Street Journal, 01 May 2024, https://www.wsj.com/economy/central-banking/fed-says-inflation-progress-has-stalled-and-extends-wait-and-see-rate-stance-51b74bbf

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