The rip-roaring stock market rally that began in October of last year continued almost completely uninterrupted through the first quarter of 2024, with the benchmark S&P 500 gaining over 10% year to date. The index has now rallied 26% over the last 5 months, putting this rally in the 98th percentile of history since 1936 according to Bank of America Global Research. Technology stocks have continued to lead the charge, with the recent frenzy in Artificial Intelligence (AI) related stocks validated by robust earnings and guidance from many of these companies. AI technology itself remains in the very early days, with the ultimate impact on society still years or decades away, but it certainly has already made its impact on financial markets. While many of the aforementioned leaders from 2023 have continued to perform well in the early stages of 2024, the market rally has broadened. The industrial, energy, and financial sectors have all had impressive starts to the year, all areas that tend to do well in a strong economy. Defensive industries such as health care, consumer staples, real estate and utilities have continued to be the laggard sectors, all of which tend to outperform when the economy is faltering. On balance, the internals of the broad stock market have become healthier in 2024 despite continuing to be top heavy.

Recent market momentum has been driven first and foremost by a strong U.S. economy, with most recent data released in the first quarter pointing to continued expansion. The latest update from the Atlanta Fed's GDPNow forecast tool has real GDP growth in the first quarter of the year projected at 2.8%, following 2.5% real growth in 2023. The most recent payroll report was a blowout, with over 303k new jobs created in March and the unemployment rate falling from 3.9% to 3.8%, remaining near a generational low. Despite some high-profile layoff announcements by many corporate giants, the labor market has continued to remain remarkably durable. Most of the pain in the labor market thus far has been in high skill areas such as technology and finance, whereas lower paid areas continue to be defined by shortages. Wage gains continue to be over 4% year over year, higher than the current rate of inflation following a painful period of negative real wage growth. With GDP growing at a healthy pace and unemployment remaining very low, the long-forecasted recession continues to be deferred.

Despite the continued strength in the economy, the Federal Reserve has maintained a surprising level of dovishness in their public comments, which has added to risk sentiment and market excitement. Inflation readings on the Consumer Price Index (CPI) and Personal Consumption Expenditure Index (PCE) came in above expectations in January and February, leading investors to search for clues that the Fed is shifting its view on the need for rate cuts in 2024. However, during the March Fed meeting, Chair Jerome Powell emphasized that higher recent inflation data has not changed its overall downward trend and that strong hiring would not push the Fed to delay rate cuts. At this point in time, the Fed continues to expect that they will cut short term rates 3 times during 2024, with the market anticipating a 50% chance of the first cut occurring during the June meeting. As of now, the robust data to start the year has only pushed out the date for the Fed to begin cutting rates, but has not removed the need to do so in the Fed's current thinking. Many market pundits and investors have linked inflation and growth to the point of believing that the only way for inflation to get back to the Fed's 2% target is through recession. While historically this has often been the case, the data continues to suggest that we might pull

off a “soft landing.” The Goldman Sachs economic research team recently put out a note summarizing the environment as such: “We expect much stronger GDP growth this year than consensus but nevertheless expect core PCE inflation to fall meaningfully, enough for the Federal Open Market Committee to cut three times starting in June. We are often asked whether these forecasts are contradictory. We don’t think so.”

Taken together, the U.S. economy and markets are in a good place: solid growth, continued disinflation, buoyant stock and credit markets, and an accommodative central bank, with few indicators suggesting near term caution. Despite the rosy current “goldilocks” outlook, risks remain, as they always do. While the unemployment rate remains extremely low, there are some cracks forming under the surface. Most recent job gains have been in lower wage segments and part time work, while full time employment has been relatively stagnant for 2 years. Leading indicators of employment, such as the NFIB Plans to Hire and JOLTS Private Hire Rate are painting a picture of hiring trends losing steam in the second half of the year. Energy prices have risen since the start of the year, with benchmark WTI oil up nearly 20%. While the price of oil remains well off of the highs seen in 2022 following the Russian invasion of Ukraine, any further rise from here could start to weigh on consumer sentiment and corporate profits. In addition to energy, long-term interest rates have been steadily rising for most of the first quarter. We wrote in the fall about the rise in long term rates driving the equity selloff from August through October, as the 30 year Treasury yield rose from 4% to 5%. The start of the current stock rally coincided almost perfectly with the peak in 30 year yields at nearly 5.2%, and they subsequently tumbled back down to 4% by year end. Since the start of the year, that yield has once again risen to 4.5%, but this time has yet to derail the equity market. The key risk may be that the economy and markets are signaling that current interest rates are not actually “restrictive”, and that long term rates will need to go up and above 5% for a sustained period to cool growth and inflation further. We suspect that equity markets, anticipating rate cuts for the past 4 months, would not take kindly to this development. This could especially play out in valuation risk, as the S&P 500 is now trading at 21x forward earnings, a “rich” valuation multiple that was last seen in late 2021 and very rarely in the twenty years prior. Valuation is often overemphasized as a short-term risk for equities (i.e. high valuation is rarely a reason that markets sell off), but more a gauge of how far equities could fall should a negative catalyst emerge such as the aforementioned spikes in unemployment, energy prices, or long-term interest rates.

In client portfolios, we have been more active this past quarter than in every quarter of 2023. With the market rally now nearing 18 months since the October 2022 low, we have sold, trimmed and rotated some of our equity positions. While we remain constructive on equities moving forward, we believe the risk/reward has become less favorable after such strong recent performance and expansion in valuation multiples. However, the trend is often your friend in markets, and historically when the S&P 500 is up 10% or higher through Q1, the remainder of the year has been positive 13 out of 14 instances since 1936.