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WEALTH

AI Enthusiasm, Fed Rate Cut Speculation, & Strong Growth Power Stocks to New Highs

First Quarter 2024

The 2023 stock market rally continued throughout the first quarter of 2024 fueled by a positive combination of stable economic growth, falling inflation, impending Fed rate cuts, and ever-growing enthusiasm towards artificial intelligence (AI). This caused the S&P 500 Index to rise above the 5,000 mark for the first time hitting new all-time highs.

The year began with a modest uptick in volatility, as traders and investors initially booked profits following the strong 2023 gains. However, those initial small declines intensified shortly after the start of the year when the December Consumer Price Index (CPI), an important inflation indicator, declined less than expected. That reading challenged the idea that inflation was quickly falling towards the Fed's 2.0% target and caused investors' expectations for that first rate cut to move from March to June. Fears of potentially higher-than-expected rates pushed stocks temporarily into negative territory early in January. However, the decline didn't last. For starters, fourth-quarter corporate earnings were once again better than anticipated helping stocks recover from earlier declines. Then, in late January, the Federal Reserve clearly signaled that rate hikes were over and strongly hinted that rate cuts would occur in the coming months. Investors seized on this positive messaging and the S&P 500 hit a new all-time high late in the month and finished with a modest gain.

The rally persisted even accelerating into February as fears of a potential rebound in inflation subsided. Inflation metrics released in February largely met expectations and implying that inflation was not reaccelerating. As such, investor expectations for a June rate cut were strengthened and that helped stocks extend the year-to-date gains. Then, on February 21st, Nvidia, the semiconductor company at the heart of the AI boom, posted much-stronger-than-expected earnings and guidance. Those solid results further fueled investor's AI enthusiasm and large-cap tech stocks powered the S&P 500 higher into month-end as the index hit another new record high. The domestic index gained 5.34% in February.

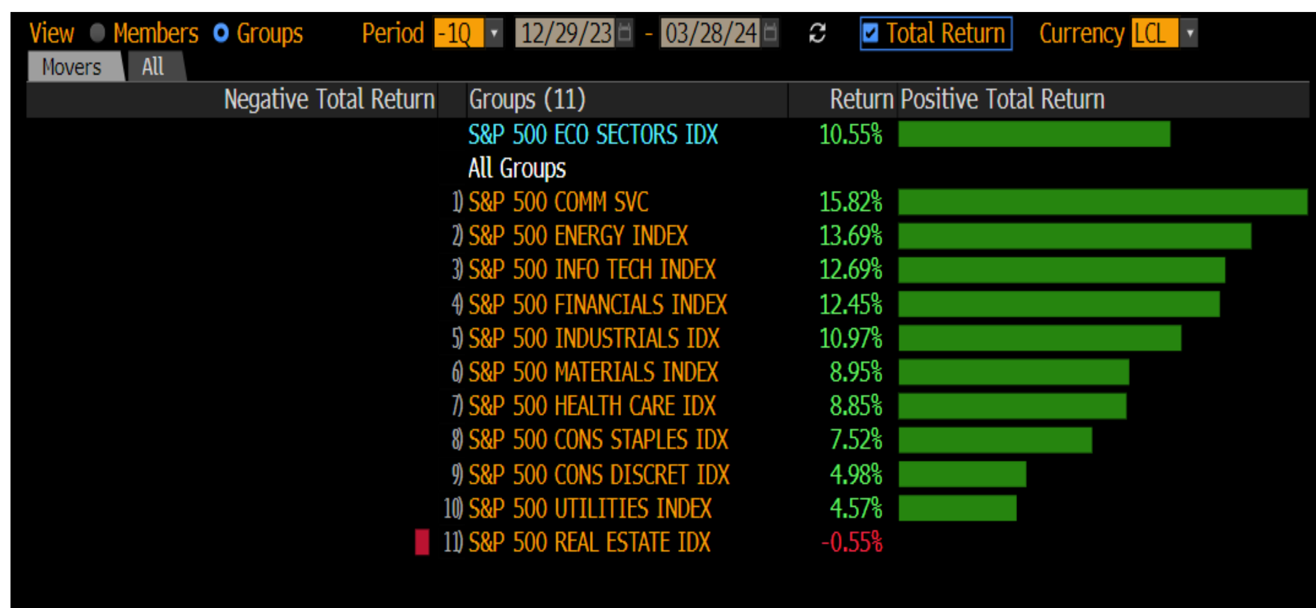
The final month of the quarter saw even more gains, aided by familiar factors such as solid economic growth, in-line inflation data, and bullish Fed guidance. Broadly speaking, economic and inflation data largely met expectations and continued to point towards stable growth and slowly falling inflation (disinflation). In mid-March, updated Federal Reserve interest rate projections pointed towards three rate cuts in 2024, further reinforcing investor expectations for a June rate cut. These positive factors, combined with additional strong AI-related earnings reports, continued to push markets broadly higher as the S&P 500 crossed 5,200 for the first time late in the month and ended March with strong gains.

First Quarter Performance Review

The first quarter of 2024 reflected a much more evenly distributed rally compared to the fourth quarter of 2023, where tech and tech-aligned sectors handily outperformed the rest of the

markets. Over the past three months, markets saw broad gains distributed more equitably amongst various sectors, industries and companies. However, while the rally in stocks did broaden out in the first quarter, small caps did not participate as they were some of the notable laggards over the past three months. Small caps registered a positive return for the first quarter but lagged large caps as concerns about stubbornly high interest rates weighed on their prospects as they are more sensitive to higher capital costs.

On a sector level, gains were broad as 10 of the 11 S&P 500 sectors finished the first quarter with a positive return. As stated above, tech and tech-aligned sectors didn't substantially outperform. To that point, the best-performing sectors in the market in the first quarter were communication services, energy, information technology, financials, and industrials (see chart below). That sector mix reflected the influences of AI enthusiasm, strong financial stock guidance, solid U.S. economic data and rising optimism in emerging market economic growth. All in all, the broadening of market performance is a longer-term fundamental positive and a healthy indicator for investors.



Source: Bloomberg Professional

Internationally, foreign markets posted solid quarterly gains as well but nevertheless underperformed the U.S. indices. Foreign developed markets outperformed emerging markets thanks to better-than-anticipated economic data and expectations for early summer rate cuts from the European Central Bank and Bank of England. Emerging markets, meanwhile, logged only slightly positive returns for the quarter and solidly underperformed the domestic markets due to mixed Chinese economic data and a lack of substantial Chinese economic stimulus early in the year.

US Equity Indexes	Q1 2024	2023
S&P 500	10.55%	26.26%
NASDAQ Composite	9.32%	44.70%
DJ Industrial Average	6.14%	16.18%
S&P 500 Equal Weighted	7.91%	13.84%
Russell 2000 (Small Cap. Stocks)	5.17%	16.88%
MSCI EAFE (International Developed)	5.83%	18.95%
MSCI Emerging Markets (International EM)	2.13%	10.20%

Source: Bloomberg Professional

Switching to fixed income markets, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) realized a slightly negative return for the first quarter of 2024. Disappointing inflation readings were the primary reason for the weakness in bonds as they delayed the expected start of Fed rate cuts from March until June. This shift caused bond investors to consider that rates may remain higher than previously anticipated over the medium and possibly longer term.

Looking deeper, longer-duration bonds (10+ year or more) handily underperformed securities with shorter durations. The performance gap was primarily due to the slower-than-expected decline in inflation. While we don't expect this trend to materially delay the start of Fed rate cuts, it does threaten to keep rates "higher for longer," which is negative for longer-dated debt. For corporate bonds, higher-yielding but lower-quality "junk" bonds outperformed investment grade debt. Looming Fed rate cuts and buoyant inflation, amidst stable economic growth, led bond investors to "reach" for more yield in the riskier parts of the credit spectrum.

US Bond Indexes	Q1 2024	2023
Bloomberg US Aggregate Bond	-0.78%	5.53%
Bloomberg US T-Bill 1-3 Month	1.32%	5.14%
ICE US T-Bond 10-20 Year	-2.24%	3.30%

Source: Bloomberg Professional

What Lies Ahead

We begin the second quarter in the midst of a positive macroeconomic environment as economic growth appears stable and AI enthusiasm keeps earnings estimates high. But while this is undoubtedly a favorable set up, the strong rally of the last five months has left the S&P 500 at historically rich valuations. This, in turn, has led to bullish investor and analyst sentiment, and to some degree, complacency. While the outlook is currently positive, it's essential that we continue to monitor the macroeconomic horizon for potential risks. At

stretched valuations and with sentiment at bullish extremes, the market is vulnerable to a negative surprise.

Although economic growth has remained resilient in the face of higher rates, some data is pointing to a loss of momentum. Retail sales missed expectations in January and February, while the unemployment rate jumped to the highest level since 2022 during the first quarter. Neither number warrants concern about the economy at present, but both serve as reminders to watch data closely as continued economic expansion is not guaranteed.

Meanwhile, inflation is still retreating but the pace of that decline has slowed materially. Core CPI, one of the Fed's preferred measures of inflation, has barely declined over the past several months. It sat at 4.0% annualized year-over-year in October and in February it had declined to just 3.8%. Other anecdotal indicators of inflation have hinted at a rebound in prices. If inflation bounces back significantly, that will likely remove the timing and number of any Fed rate cuts in 2024. In turn, leading to disappointment by market participants, likely pressuring both stocks and bond performance.

Investor enthusiasm towards the potential for artificial intelligence remains a critical part of the bull market story. Strong earnings and forward guidance from Nvidia in February furthered investor's hopes that AI integration will lead to a profitability and earnings boom, not just for tech companies, but for the entire market. However, that's not guaranteed, and so far AI integration has produced a lot of flashy headlines but not much in the way of profit maximization for non-tech industries. If AI fails to deliver the expected boost in profitability and productivity, then that will be a significant negative for this market going forward as current valuations would not be justified.

In sum, this market rally is currently supported by positive fundamentals. But we cannot let the currently positive set up blind us to risks and that's why we are also focused on managing both risk and reward in portfolios. Despite the strong performance, the markets remain vulnerable to negative news. Therefore, we remain vigilant regarding risks to investment portfolios and the economy, and we thank you for your ongoing confidence and trust. Please rest assured that we are continually dedicated to helping you navigate the evolving fundamentals and economic impacts affecting financial markets.

Sincerely,

SlateStone Wealth's Investment Committee

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