INVESTMENT OUTLOOK

A PEAPACK PRIVATE PUBLICATION

FIRST QUARTER 2024: MARKET RETURNS AND OTHER MOVEABLE FEASTS

Metrics are like a course in a meal. They should satisfy the need or want for something.
–Derek Huether

Some calendar facts are indisputable. We always celebrate New Year's Day on January 1st. And the Fourth of July on, when else, July 4th. Christmas, celebrating the birth of Christ, is—naturally—always on December 25th.

The modern era has introduced the dubious concept of alternative facts, but from a calendrical perspective there have always been alternative dates for many holidays.

This year, the Islamic holiday of Ramadan began on Sunday, March 10th and ended on Tuesday, April 9th. Ramadan is a 'floating' holiday that shifts by approximately 10 days each year. That is because the Islamic calendar is based on the lunar calendar, which is around 10 days shorter than the solar year.

MARCH 2024

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
					1	2
3	4	5	6	7	8	9
10 START OF RAMADAN	11	12	13	14	15	16
17	18	19	20	21	22	23 START OF PURIM
24	25 HOLI	26	27	28	29	30
31 EASTER						

Easter not only varies from one year to the next, but in any given year occurs on different dates in the Gregorian (western) and Julian (orthodox or eastern) calendars—the Julian calendar is 13 days behind the Gregorian calendar. Easter time is celebrated on the first Sunday following the Paschal full moon—which, in turn, is the first full moon on or after March 21st.

Somewhat relatedly, the Jewish festival of Passover occurs on the 15th day of the Hebrew month of Nisan, which is on the first night of a full moon after the spring equinox. Just to keep things complicated, the Hebrew calendar—which is pegged to the lunar calendar—is adjusted to align with the solar calendar in such a way that 15 Nisan always coincides with Sunday, Tuesday, Thursday, or Saturday.

And the Hindu festival of Holi falls on the last full moon day of the Hindu lunisolar calendar month of Falgun.

So what's the takeaway? There's more than one calendar, and more than one way to fix a date. And, as with calendars, so it is with market measures. By far the most popular way of measuring stock market returns is the Standard & Poor's 500 index. But the folks at S&P exercise some discretion, shall we say, in which securities comprise the index, and the construction of the index based on market capitalization is arbitrary and creates some distortions. The folks at Dow Jones & Company utilize a different methodology to measure stock market returns, both in terms of selecting securities in the Dow Jones Industrial Average and its construction as a price-weighted index. An entirely different methodology is followed by the NASDAQ 100 index makers.

These three measures of market returns produced widely discrepant results last year. The S&P 500 total return was 26.4%. The NASDAQ rose 44.7%. And the Dow Jones Industrials were up 16.2%. An alternative calculation for the S&P 500, equal-weighting all 500 stocks, led to a rise of 13.8%.

So, multiple measurement methodologies, resulting in vastly differing returns. The variance in the weighting of the 'Magnificent Seven' mega-cap technology stocks—which appreciated anywhere from 40% to 270% in 2023—accounts for much of the variance in the indices' returns.

HOLIDAY MOOD ON WALL STREET

Let's all celebrate and have a good time
We gon' celebrate and have a good time
–Kool and the Gang

Equity markets registered a strong first quarter, led by US Large Cap stocks. US Small-Mid and International Developed Markets stocks recorded good mid-single digit returns. Real estate securities, beset by higher interest rates and concerns about rents and vacancies in the office sector, were modestly in the red.

Asset Class	Index	1st Quarter Returns
US Large Cap Stocks	S&P 500 Total Return	10.6%
US Small-Mid Cap Stocks	Russell 2500	6.9%
International Developed Markets Stocks	MSCI EAFE	4.5%
Emerging Markets Stocks	MSCI EM	2.1%
Real Estate Securities	MSCI US REIT	-0.3%
Commodities	Bloomberg Commodities Futures	2.2%
Bonds	Bloomberg Barclays US Aggregate	-0.8%
Cash	FTSE USBIG 1-Month Treasury Bill	1.3%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

The tremendous out-performance of the Magnificent Seven last year gave way in the first quarter to the Thriving Three (Nvidia, Meta Platforms, and Amazon), as the other members of that distinguished septet performed in line with or under-performed the market in the first quarter. While the market remains momentum-driven, with investors still enamored of stocks with artificial intelligence haloes, it is recognizing that not all technology stocks are equally sainted.

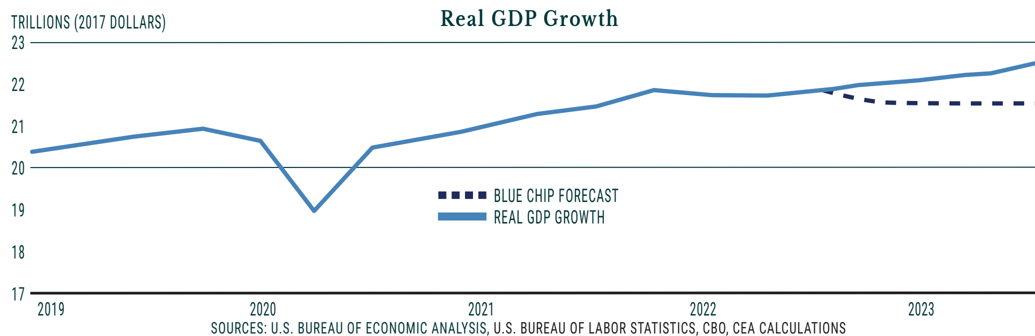
It was a different story for the bond market, as hotter than expected inflation data, driven by a more robust economy, pushed yields up and prices down.

CELEBRATING THE INVISIBLE HAND

I don't know why people are so keen to put the details of their private life in public;
they forget that invisibility is a superpower.
–Banksy (pseudonymous street artist, political activist)

Almost 250 years ago, Scottish economist Adam Smith coined the concept of the invisible hand. The invisible hand is a metaphor for unseen forces that drive economies—primarily consumers acting out of self-interest in the free market, resulting in beneficial social and economic outcomes.

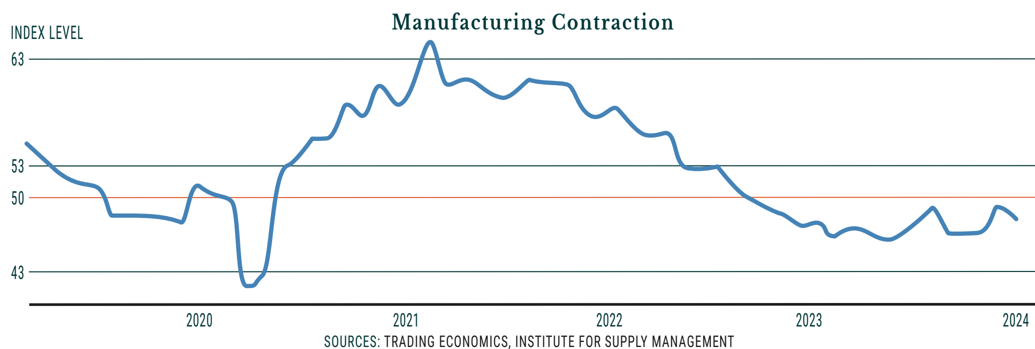
One could almost espy that invisible hand in revenge travel and other post-pandemic consumer spending enthusiasm last year. No wonder the economy entered the new year in fine fiddle, having advanced 4.9% and 3.3% in the third and fourth quarters of 2023. A year ago, economists, looking at leading economic indicators, the inverted yield curve, and sharply higher interest rates, forecast a recession that still has not materialized. Rather, a fully employed labor force has supported consumer spending, thereby sustaining economic momentum. GDP expanded at a strong 3.1% annual growth rate for the full year.



SOURCES: U.S. BUREAU OF ECONOMIC ANALYSIS, U.S. BUREAU OF LABOR STATISTICS, CBO, CEA CALCULATIONS

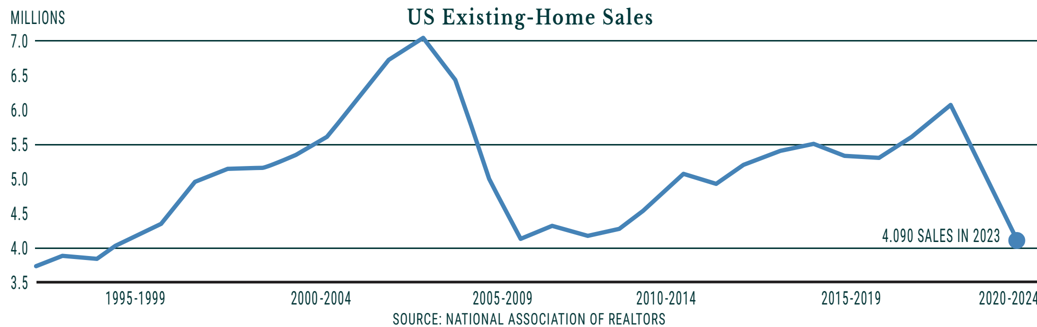
That said, the economy does appear to be decelerating. Growth in the first quarter is estimated by the Atlanta Fed at 2.1%, and many economists anticipate a further slowdown for the balance of the year and into 2025. The Fed itself, in its March Summary of Economic Projections, forecasts real GDP growth of 2.1% for 2024.

Among the sectors of the economy that have experienced a soft patch are housing and manufacturing. The chart below shows the Institute for Supply Management's manufacturing index; readings below 50 indicate contraction in the manufacturing sector. Both the overall index and the new orders component have been in contractionary territory for over a year.



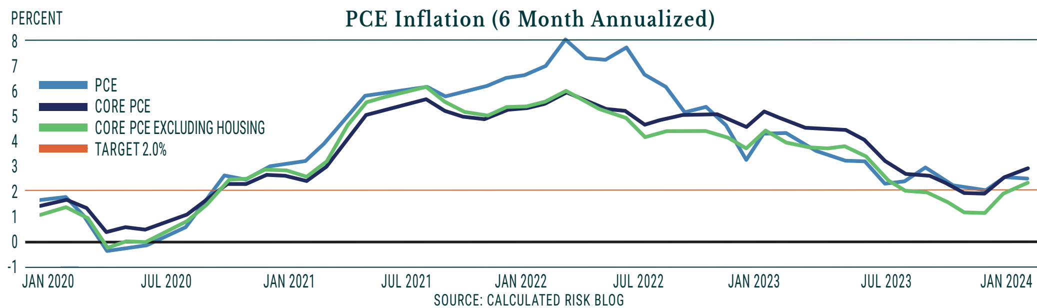
SOURCES: TRADING ECONOMICS, INSTITUTE FOR SUPPLY MANAGEMENT

In the housing sector, high mortgage rates, low inventory of homes on the market, and substantial home appreciation over the past four years have led to a nearly 30-year low in housing turnover.



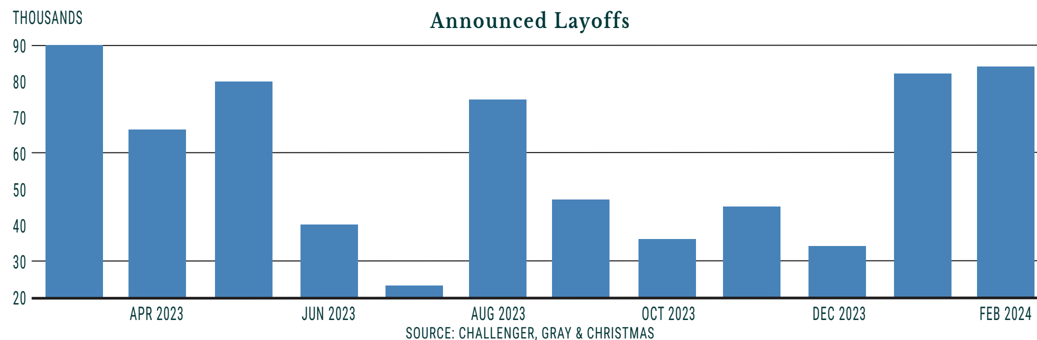
Affordability remains a challenge for the housing sector, flashing a caution sign. Housing turnover is important for the economy given downstream effects on industries such as home improvement, furniture, and appliance sales.

The biggest issues facing the economy are inflation and the labor market. On the inflation front, the Fed has made good progress, as higher interest rates and supply chain improvements have brought price appreciation down significantly from peak levels in 2022. The chart below shows the Fed's preferred inflation gauge, core personal consumption expenditures, heading in the right direction but still above its 2% target.



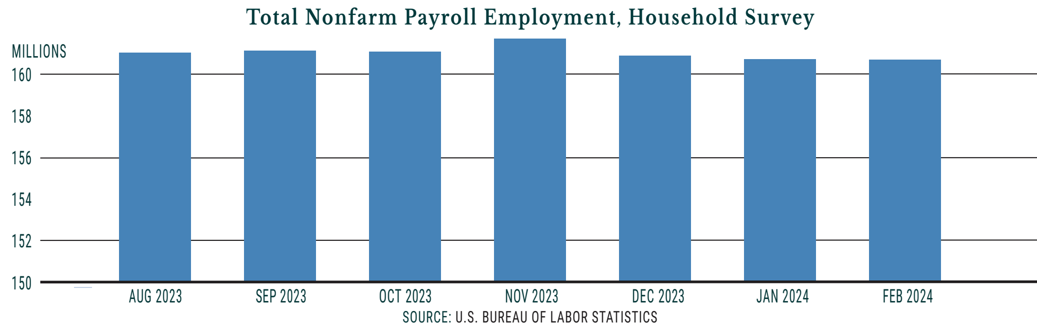
Still, this measure has ticked up this year, perhaps reflecting a stronger than expected economy. The Fed clearly believes it is too early to declare mission accomplished and has repeatedly pushed back against market expectations for earlier and more rate cuts.

On the labor front, unemployment remains low, under 4% for two years now. (That said, at 3.9% unemployment has risen meaningfully from its cyclical low of 3.4%.) And nonfarm payroll growth has been above trend. But as companies experience less pricing power and face greater challenges passing through higher costs, they are beginning to turn to layoffs to try to preserve profit margins.



According to Challenger, Gray & Christmas, announced layoffs have jumped in the first two months of the new year. Firms are citing economic conditions and cost-cutting as the reasons. Rising layoff announcements are not yet being reflected in initial claims for unemployment, but the labor market appears to be slowing. Hiring has moderated and companies' total hiring plans are historically soft.

Another note of caution for the labor market comes from the Household Survey, which reports the total number of employed persons. The chart below indicates that employment peaked in November and has fallen for three consecutive months, by a total of almost one million jobs.



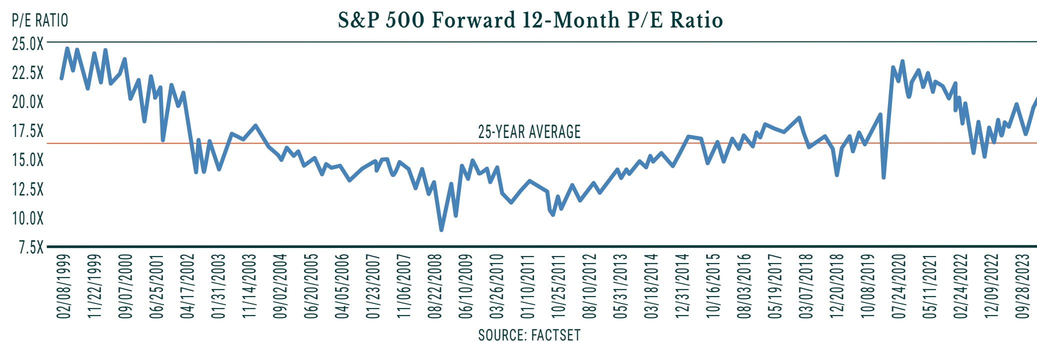
If the labor market continues to show signs of weakening, consumer spending will of course be impacted.

The prevailing narrative among economists is that the Fed has achieved a soft or no landing. It's pretty to think so, but it's also prudent to guard against downside risks.

BY ANY MEASURE: EQUITIES RICH, BOND YIELDS RICH

Price is what you pay, value is what you get.
—Warren Buffett

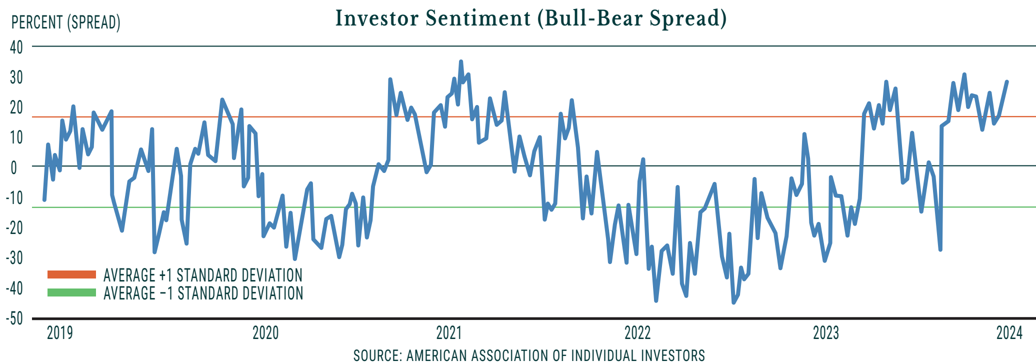
Stock prices rose more than earnings in the first quarter. As a result, equity valuations are more elevated.



The S&P 500 is trading at 21 times expected 2024 earnings, well above its 25-year average of 16.4 times. What's more, 2024 earnings are expected to rise a hefty 10.7%. There are, of course, multiple ways to determine valuations in the stock market. All measurements—price to book ratio, price to cash flow, dividend yield, etc.—tell the same story, however. Across a variety of metrics, US large cap stocks trade between 1 and 2 standard deviations richer than long term averages.

Strong earnings growth depends on the no-landing scenario panning out. There are two principal drivers of stock prices: higher earnings, and higher multiples paid for those earnings. Higher multiples provide flimsier support for valuations, as they in turn depend on one of two things: falling interest rates, and increasing investor enthusiasm.

There are many ways to determine investor sentiment. But here too most measures tell the same story: investors are bullish. The chart below uses data from polling done by the American Association of Individual Investors, and illustrates the spread between bullish and bearish investors. It clearly indicates that investor optimism about the stock market is stretched.



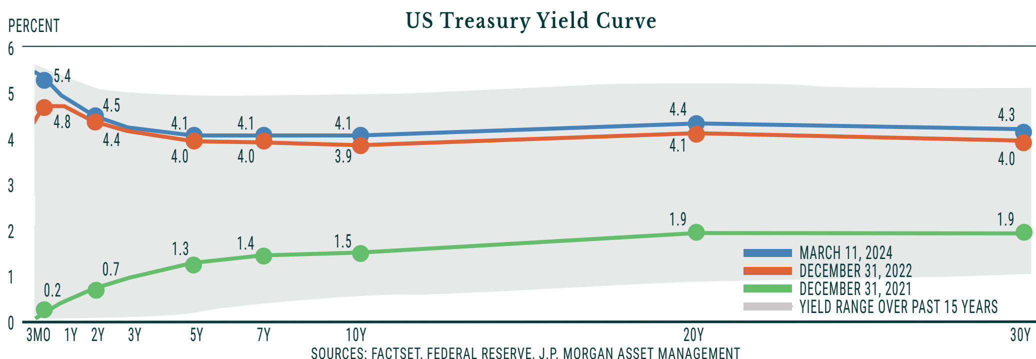
SOURCE: AMERICAN ASSOCIATION OF INDIVIDUAL INVESTORS

Investor bullishness is, perhaps perversely, a contrarian indicator. That is to say, investors tend to become bullish after the stock market has risen, and the market often declines following elevated levels of investor optimism. Thus, current sentiment levels suggest some caution about the near-term outlook for equities.

On a related note of caution, US equities have been driven by momentum traders. The momentum factor refers to the tendency of stocks that are outperforming to continue to outperform. Momentum combined with Keynesian animal spirits help explain the run-up in Bitcoin and the successful IPO of retail investor favorite Reddit this year. Momentum has carried Nvidia's price so high that its market capitalization exceeds that of the entire German stock market. And momentum has carried the Magnificent 7's stock prices so high that their market capitalization exceeds that of the entire Chinese stock market. Momentum is a short-term trading mentality that tends to favor a small number of stocks, and usually ends abruptly and without warning.

From a valuation perspective, small cap and international stocks are more attractively priced, relative to both US large cap stocks and their own long term average valuations. That said, valuation classically is not a timing tool, and investors have had to be very patient as they wait for small cap and international stock out-performance.

In the bond market, yields have risen this year in the face of faster than anticipated economic growth and sticky inflation. Real (net of inflation) yields are positive, and the absolute level of interest rates across all sectors of the bond market is well above average yields over the past 15 years. The chart below makes clear the extent to which the Fed's action to raise rates has been reflected in higher yields all across the maturity spectrum—and, most especially, at the short end.



SOURCES: FACTSET, FEDERAL RESERVE, J.P. MORGAN ASSET MANAGEMENT

The chart also reveals the inversion of the yield curve, which is to say that short term Treasury yields are higher than long term Treasury yields. The yield curve will most likely normalize as and when the Fed cuts short term rates, as inflation falls and restrictive monetary policy is no longer necessary. The Fed has been admonishing markets for a long time not to expect rate cuts before inflation is clearly trending closer to the Fed's 2% target.

Investors may be well served with a short-to-intermediate duration laddered bond portfolio consisting of Treasurys, agencies, and investment grade corporate bonds—and, where appropriate, municipal bonds. Spreads on high yield bonds are at historically very tight levels, which keeps us on the sidelines. High yield bonds also are highly correlated with equities, and thus provide limited portfolio diversification benefit.

EARLY SPRING: WARM SUNSHINE AND COOL WINDS

Spring is nature's way of saying, 'Let's Party!'
–Robin Williams

Spring holidays in most religions are joyous, celebrating rebirth and new beginnings, in rhythm with the season. And this spring finds economic prognosticators and market strategists generally in a partying mood, maintaining an upbeat perspective on 2024. The consensus view appears to be that the Fed has successfully engineered a soft landing, with inflation greatly reduced from its peak and falling gradually to the Fed's target while the labor market remains on sound footing. Stimulatory fiscal policy, healthy capital spending, a potential productivity boost from artificial intelligence, and re-shoring add to the constructive narrative.

"It's only until spring."

While acknowledging these constructive factors, we also want to sound some cautionary notes. Corporate profit margins are under pressure, economic growth is slowing, and cracks are appearing in the labor market. The office real estate market is undergoing a severe correction. The US is running extraordinary peace-time deficits, geopolitical tensions are arising around the globe, and a highly divisive election season is upon us. Amidst all this, investors are complacent, perhaps even euphoric.

In such an environment, investors should spend their risk budgets wisely, and stay vigilant to maintain their asset allocation. After all, perhaps the best measure of investment returns is whether, over time, investors are getting the returns they need to accomplish their goals.

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