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Monthly Market Commentary

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US Economy

The US' business cycle is being ironed out by the economy's latest show of strength at the turn of the year, raising the possibility of our forecasted shallow economic cycle becoming a period of moderate-but-steady growth in 2024. Broadening strength adds resilience to an economy facing geopolitical turbulence and election-year uncertainties, not to mention potential upside surprises on inflation, interest rates, and financial stress. Early-cycle characteristics, like the twin recoveries in manufacturing and housing, lower inflation, and declining interest rates, have led some to believe that the economy is poised for extended growth in a new business cycle. Our view is that the recent strength is sustaining a late phase of the post-COVID cycle with greater vulnerability to outside shocks or to disappointing news on inflation, interest rates, and economic policy.

The economy has gone through few of the requisite adjustments for a new growth recovery, including deleveraging, pent-up demand from deferred spending, and accumulating economic slack keeping a lid on inflation characteristic of past recessions. What is unusual is late-cycle support to the economy from an unusually early peak in inflation, declining interest rates, and solid gains in employment. All are now tied to the aftereffects of the pandemic, the hallmark of this economic cycle. Support from each delays adjustment to financial and economic imbalances, leaving the economy more vulnerable to shocks as growth progresses this year.

US Markets

After reaching 3577 on October 12, 2022, the S&P 500 Index has experienced an impressive rally. Recently, the index touched a record closing high, which some would argue officially ends the bear market that started two years ago. Historically, when a bear market has exited without a recession and hit all-time highs, this has been positive for 12-month forward returns. Improving inflation readings, lower long-term yields, and anticipation of several rate cuts this year have supported equity prices. In addition, the market has rewarded potential artificial intelligence beneficiaries with premium valuations.

The surge in equity prices over the past year has been driven by price/earnings multiple expansion with earnings essentially flat in 2023. In our view, it is unlikely that valuations could carry returns again in 2024. Instead, earnings growth will likely be needed to support the continued upward trajectory in prices. Until broader participation is sustained, and earnings growth accelerates, we continue to be defensive and focus on quality in our guidance. However, with the economic outlook improving and the Federal Reserve potentially easing monetary policy later this year, we may look to add equity exposure as opportunities present themselves.

Fixed Income

In our opinion, the near-term path of longer-term rates is highly dependent on the state of the economy, particularly on the trajectory of inflation. We anticipate that if an economic slowdown accelerates, interest rates could fall as investors seek out the perceived safety of high-quality Treasury securities. However, given our expectation of a moderate slowdown followed by renewed economic growth in 2024, we believe long-term rates could move higher by year-end 2024.

We anticipate US Treasury yields could remain volatile in 2024. In our view, the year ahead will be the tale of two halves: a decline in yields during the first half of 2024 as the economic slowdown deepens, and the Fed pivots away from tightening monetary policy, followed by a climb in yields in the second half as the recovery begins to take shape. We anticipate modest policy rate cuts beginning in the second quarter of 2024 as the Fed works to slowly move the federal funds rate closer to neutral level.

International Markets

Europe skirted a recession in 2023 with flat fourth-quarter GDP. Firmer growth in Spain and Italy late last year offset a contraction in Germany that contributed to its steepest annual decline in 20 years (excluding 2009 and 2020). We believe a deeper downturn could be avoided as a composite index of Eurozone business activity stabilized at a low level in January. Europe's manufacturing recession moved a step toward bottoming out, but remains hampered by weak global trade, while the service sector contracted for a sixth straight month. Elevated fuel costs, geopolitical flare-ups, and tight credit conditions are among headwinds constraining growth. Disinflation appears to be buoying consumer purchasing power, but slower progress toward lower inflation likely will delay European Central Bank (ECB) rate cuts until mid-year unless signs of a recession reemerge.

Manufacturing activity in trade-sensitive north Asia steadied in January, with improved demand in key markets offsetting China's slowing economy. South Korea's factory sector expanded for the first time since June 2022, while business surveys showed firming demand in Taiwan's important semiconductor sector cushioning the slowdown there. In Southeast Asia, an uptick in Vietnam's factory output added to ongoing support from Singapore, the Philippines, and Indonesia amid increased exports. A pickup in Japan was driven by strengthening service-sector growth masking ongoing weakness in manufacturing. In China, broad sluggishness across manufacturing and services persists amid disappointing domestic demand, tepid global trade, and ongoing property market turmoil – all increasing the likelihood of more fiscal stimulus to combat weak economic growth and deflation despite government officials wary of high debt loads.

Commodities

Recently, the Biden administration opted to pause liquified natural gas (LNG) export permit approvals. Over the short term, we are not anticipating impacts to global supplies or prices for LNG or dry natural gas. However, no timeline has been given by the Department of Energy for the duration of the pause. Should the permit approval ban remain in place beyond a few years, we would expect to see higher and more volatile global natural gas prices.

Natural gas has become big business in the US over the past two decades, as production has jumped since the turn of the century. The jump in production was sparked by breakthroughs in energy extraction, such as hydraulic fracturing and horizontal drilling, often called the Shale Revolution. Production eventually became so abundant that the US turned to exporting it as LNG. LNG, essentially frozen natural gas, makes it easier and more efficient to export via ship. Prior to the Shale Revolution, LNG was not a term heard often in the US, as the country had been a net importer of natural gas for years. That started to change in earnest in 2011, however, with the US' first large LNG export facility approval at Sabine Pass, LA. More approvals would soon follow, and by 2016 the US officially flipped from being a net importer of natural gas, to a net exporter.

Given this context, the recent decision to pause additional US LNG export permit approvals could be critical for demand and production, depending on how long it lasts. In our view, the longer the pause, the more likely the decision will be felt by US energy companies. We would also note that there are five large export projects currently in the pipeline, expected to nearly double US LNG export capacity by 2027, which are not expected to be impacted by this permit pause. The bottom line is that over the short term, we do not anticipate seeing much in the way of impacts to global supplies or prices for LNG or dry natural gas. Should the permit ban remain in place beyond a few years, we would anticipate seeing higher and more volatile global natural gas prices, long term.

What Does This Mean to Me?

Surprisingly strong US economic activity at the end of last year was sustained into 2024. The latest batch of robust economic data was punctuated by an increase in fourth-quarter gross domestic product (GDP) growth, an increase in non-farm payrolls, and the manufacturing and housing sectors regaining momentum. Continued disinflation in a still-vibrant economy is the central outlook issue, in our view. Headwinds to still lower fuel costs have been created by disturbances in the Mideast, OPEC+ (Organization of Petroleum Exporting Countries + Russia) output discipline, and by an unwinding slowdown in global manufacturing and trade. An emerging manufacturing recovery, combined with accelerating consumer-goods spending and inventory building supporting it, is bending the curve on other goods deflation in the US. Looking ahead, we anticipate the US economy to potentially regain momentum later this year and believe US equites could follow suit. As such, we continue to encourage investors to remain patient and strategically deploy sidelined cash, as opportunities present themselves.

If you have any questions or concerns, please do not hesitate to reach out to us at any time.

Sincerely,

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Stocks are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. Investments in equity securities are generally more volatile than other types of securities.

Investing in commodities is not appropriate for all investors. Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. The prices of various commodities may fluctuate based on numerous factors including changes in supply and demand relationships, weather and acts of nature, agricultural conditions, international trade conditions, fiscal monetary and exchange control programs, domestic and foreign political and economic events and policies, and changes in interest rates or sectors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks, including futures roll yield risk.

[2] https://www.eia.gov/dnav/pet/PET_MOVE_EXPC_A_EPC0_EEX_MBBLPD_M.htm

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. Investing in emerging markets accentuates these risks.

Investments in fixed-income securities are subject to market, interest rate, credit, and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can cause a bond's price to fall. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower rated bonds. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

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