

Monthly Market Commentary

May 2024

US Economy

The US economy continues to lose momentum, toward what we believe could be a mild or moderate slowdown later this year. A recent disappointing jobs report was accompanied by the first contraction in dominant services activity since December 2022¹. That followed an advance estimate of first-quarter gross domestic product (GDP) growth of just 1.6% annually, less than half its fourth-quarter pace. Unbalanced growth between upper-and lower income consumer spending, manufacturing and services activity, and larger and smaller firms have left the economy vulnerable to the slowdown we anticipate could unfold in the coming months.

Rising auto and credit card delinquency rates, coupled with a low savings rate have added to that vulnerability, along with pressure on real (inflation-adjusted) wage gains from the recent buildup of price pressures. Furthermore, consumer confidence continues to decline on concerns over tight credit conditions, an erosion of job-market confidence, and the high cost of essentials. Still, we believe overall financial conditions could be supportive enough to help cushion an economic pullback from becoming too severe. Moreover, it appears interest rates have not moved high enough to tighten financial conditions sufficiently for a bona fide recession.

US Markets

US equity markets trended higher in May after a pullback in April. Inflation trending in line with investor expectations, slowing retail sales, and a slowing job market all eased investors concerns about a too-strong economy. With expectations that inflation could continue to moderate, investors have repriced in one to two Federal Reserve (Fed) rate cuts this year. Our near-term expectation is that equity markets could struggle to advance meaningfully past recent highs as we move into summertime as investors try to further decipher the timing and magnitude of Fed rate cuts. We would view any periods of near-term weakness in equity markets as opportunities to deploy sidelined cash, as our 2025 outlook includes a broad-based recovery that supports improved revenue growth and expanding margins.

Fixed Income

Back in May of 2022, the Fed announced that it would begin reducing its balance sheet, which peaked in April of 2022 at more than \$8.5 trillion due to all its post-pandemic stimulus efforts. Two years later, the Fed has already managed to reduce its balance sheet to \$6.9 trillion. During the Fed meeting that

¹<https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/april/>

concluded on May 1st, the Fed noted that beginning in June, the Fed will slow the pace of decline of its securities holdings by reducing the monthly redemption cap on Treasury securities from \$60 billion to \$25 billion.

In our view, the Fed is being cautious, attempting to reduce the risk of volatility in the funding markets and a recurrence of events similar to those of September 2019 (when overnight money market rates inclined sharply, accompanied by significant volatility). For now, bank reserves remain ample, and the overnight reverse repo (or RRP: Reverse Repurchase Agreement) facility is still a source of liquidity. Furthermore, because of the large increase in federal debt issuance, the Fed's holdings as a percentage of the entire Treasury market have fallen below 17% after peaking near 30% in 2022² – this allows the Fed to use balance sheet expansion down the road if needed. The Fed could become a marginal buyer of US Treasuries in the upcoming months as a result, which could also help put a ceiling on intermediate- and long-term yields.

International Markets

Chinese equities have been recovering from its late-January lows (as of this writing), driven by authorities' policy measures to help support the economy and financial markets. After initial skepticism, investors appear to have warmed up to the idea that Chinese equities might finally be making a sustainable turn. Unfortunately, we believe investors are at best premature and at worst falling for another false dawn.

The true nature of the issue lies in the fact that Chinese consumers remain very cautious due to a combination of economic slowing and concerns about the property market. In the absence of a consumer rebound, China turned to the old playbook of export-driven growth alongside a quickly developing Information Technology sector. Therein lies another facet of the problem – much of the world no longer needs China's excess capacity, and trade protectionism has continued to intensify. And while China's Information Technology sector is meaningful in size, the US and other Western nations are working to impede China's technological advancements.

This combination of factors suggests that China's recovery could eventually fade and does not even account for future risks, such as further increases in tariffs and the possibility of increased diplomatic and economic strains with the US and its allies. As such, we continue to recommend an underweight towards emerging market equities, for which China accounts a significant weighting.

Commodities

Gold has had a tremendous year, up over 12% as of this writing. A key driver of gold's performance has been persistent, and historically elevated, purchases by central banks. In fact, since 2022, central banks have become a dominant force driving global gold demand. In the first quarter of 2024, central banks accounted for an impressive 23% of global demand.³

Emerging market central banks have been the main buyers, especially China. This is because gold is that

²<https://fred.stlouisfed.org/series/FDHBFRBN>

³<https://www.gold.org/goldhub/research/gold-demand-trends/gold-demand-trends-q1-2024/central-banks>

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rare reserve asset with no counterparty risk, unlike other reserve assets, such as US Treasuries. With debt levels of many countries on the rise, to historic levels in some cases, counterparty risk has become a growing concern for central banks. Holding gold is one way a central bank can protect its reserves from being devalued by another nation's debt. The bottom line is that persistent central-bank gold buying continues to support global gold prices. Emerging market central banks, especially, have been buying gold to diversify their reserves and protect against a strong US dollar. We suspect that this trend in central bank buying could continue for the foreseeable future, potentially supporting gold prices in the near-term.

What Does This Mean to Me?

Odds of an economic slowdown later this year have increased with signs of weakness in the second quarter, in our opinion. Headwinds from weakening finances in parts of the economy and pressure on inflation-adjusted incomes now are being joined by slowing job growth – previously a pillar of support for growth during the post-pandemic recovery. The more sanguine outlook for inflation and interest rates tied to slowing growth we believe now increase the odds of a mild economic slowdown later this year, responding to less ample funds in the financial market, slower job growth, eroding finances, and pressure on inflation-adjusted incomes. We look for a window of disinflation during the economy's soft patch to contribute to an equally mild recovery, restrained by limited cleansing from deleveraging, increased pent-up consumer demand, and aggressive de-stocking by businesses during the potential slowdown. These conditions could create opportune entry points for clients with side-lined cash.

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

Sincerely,

Chad E. Mickelson, CRPC®, CFP®
Managing Director – Investments
Financial Advisor

Clint A. Markin, CRPC®, CFP®
Managing Director – Investments
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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.

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.

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