Outlook, Q2 2024
Traub Capital Management
April 3, 2024

Introduction and Spoiler Alert

While the general economy, corporate earnings, inflation, Federal Funds rates and the stock market seem to be confounding most economists, 2024 is unfolding very much in line with the view you have seen in our Economic Outlooks for some time. There is no recession, but rather good domestic economic growth coupled with stubborn inflation not getting back to a level of 2%, no cuts in Federal Funds rates until mid to late 2024 and all the media doom and gloom is contrasting with new highs in the stock market.

We believe these trends will continue and that gradually, most economists and most market participants will start to see the picture we have outlined for 2024. (Next year, 2025, might be a bit different, but it is a bit early to tell at this point).

Year so Far

As we have projected for some time, the markets continued their upward path in the first quarter of 2024, with the S&P 500 rising a bit over 10% including dividends. The gain so far this year, however, is closer to what we were thinking for the year rather than for just one quarter. Yields on the short side of the yield curve held steady, while the interest rate on the 10-year Treasury bond increased from 3.88% to 4.22%.

There is strength in the overall domestic US economy. Unemployment is holding below 4% indicating a “full employment” condition. Housing starts have held steady at a rate of a bit over 1.4 million. There has been a modest decline in new vehicle sales of 8% compared to the very strong sales in 2023. Compared to the same period last year, consumer spending is up 1.9% with January alone increasing 0.4% - well above the consensus expectation. The overall GDP increased 2.8% after adjusting for inflation. That inflation rate itself has held steady just over 3% - pretty much where it has been since last June.

The big news is the increase in corporate earnings of 14% compared to the same period last year. Overall profit margins also remain very healthy. The other very much unheralded news is the increase in labor productivity of 2.6% compared to the same period in 2023. We believe this labor productivity improvement is understated as it more reflects the way data is collected and tabulated based on the historic manufacturing centric economy. The US economy is quite different today and the past data collection techniques simply do not fully capture the productivity increase presently being experienced.

So the US domestic economy is in pretty good shape and what we have been expecting. In Q4 of 2023, the GDP expanded at a rate of 3.3%. This strength in overall GDP is very different than expectations from the various mainstream economists and media outlets. These people are being surprised by the overall economic strength and the surprise factor of “better than expected” is part of what has driven the markets higher so far in 2024.

We believe that the overall economic picture in the US will continue to be good, but that it will lose its surprise power over the next twelve months or so as more and more market participants start to see the reality and the doom and gloom headlines continue to fade. Let's look at some of the determining factors.

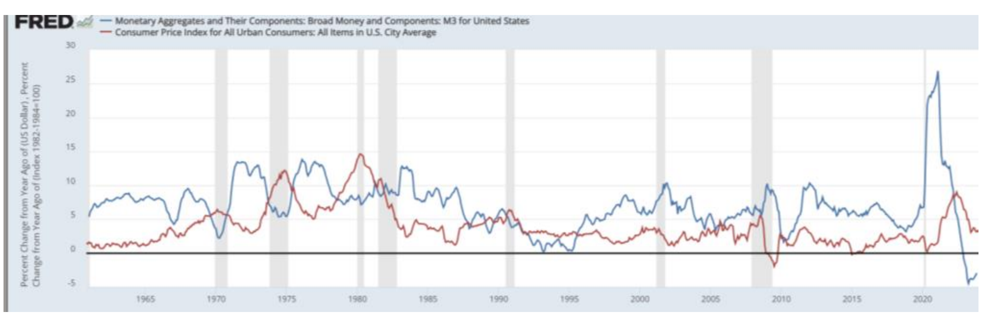
Inflation

Most everyone is focusing on when the level of inflation will get down to the Fed target of 2%. We have doubted these mainstream forecasts of inflation at 2% "pretty soon" and we continue to hold that doubt.

As a measure of inflation, we tend to focus on the Consumer Price Index, but another measure of inflation is personal consumption expenditures excluding food and energy. This is referred to as "The Federal Reserve's Preferred Gauge". The most recent two months of this measure show an increase of 0.5% and 0.3% respectively or 4.8% annualized. This is a long way from 2%.

The real question, however, is "does it matter"? The much talked about target of the Federal Reserve is 2%. However, there is no particular magic in achieving 2%. It is not like the old silk hat for Frosty the Snowman. There is no 2% inflation goal in the congressional mandate for the Fed to maintain both low unemployment and low inflation. Rather, the magic is in the overall growth of the economy and it is clear that that growth is alive and well with a Federal funds rate above 5% and inflation holding at a level of 3%, rather than 2%. Inflation may get down to 2%, but when it does, the overall economy and corporate earnings are not going to leap forward any more than we have already seen.

Perhaps inflation can get to 2%. Lowering the supply of money will lower inflation, but there is no direct, much less immediate, connection as you can see from the graph below. Here, a broad measure of the supply of money is shown in blue and the consumer price index is shown in red. Both variables are graphed as percent change from last year[1]. The massive increase in the supply of money following the pandemic was followed by a large increase in inflation about a year later, but getting the inflation genie back into the bottle is more difficult than just decreasing the supply of money.



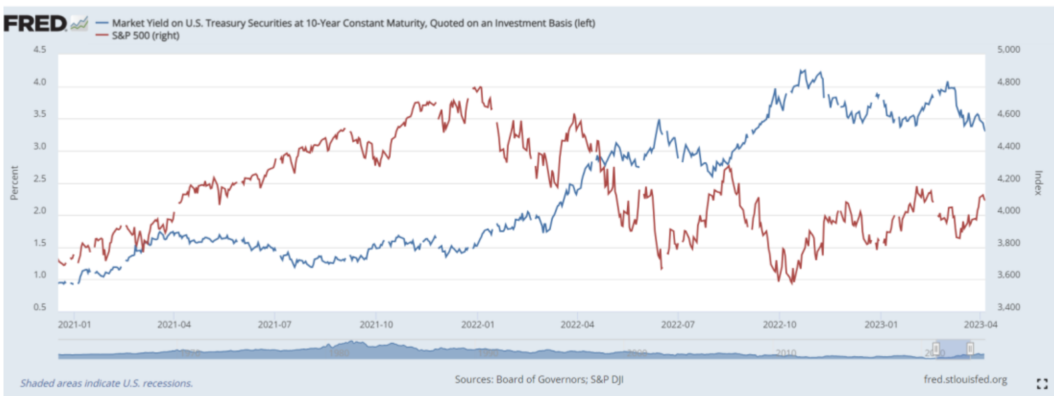
The Federal Reserve made a mistake late in 2021 calling inflation "transient" and letting it spiral upwards out of control. They are not going to make that mistake again.

[1] Federal Reserve Bank of St. Louis

However, inflation under 3% coupled with very low unemployment and a large increase in both consumer spending and corporate earnings is not a bad environment in spite of the somewhat high Federal Funds rate that we will explore below. Increasingly, the stock market will accept this picture. It will get accustomed to inflation at 3% instead of 2% and the market will lose its focus on the intricate movements of the Fed.

Federal Funds Rate

From the pandemic to the end of 2023, there was a very distinct inverse relationship between the interest rate paid on a 10-year note and the S&P 500. See graph below, again from the database at the Federal Reserve of St Louis.



This inverse relationship ended at the end of 2023. So far in 2024, both the stock market and the 10-year treasury rate have risen together. Clearly, by the end of 2023, the market began to see that increasing corporate earnings were not predicated on low interest rates. In fact, looking back at the 10-year treasury rate for a forty-five year period from 1979 to the present, a 10-year treasury interest rate of 4% is about the average for that period. In that time, the S&P 500 has grown from less than 100 to over 5,200 – an increase of fifty-two times. The unmistakable conclusion is that you simply do not need unusually low interest rates to realize good stock market gains. The market is getting this message.

That said, we continue to believe that the Fed will bow to political pressure and lower the Federal Funds rate twice this year to get it down below 5% by year-end. But we also believe that the Federal Funds rate will cease to be a driver of stock market performance as the market determinants pivot to other variables, namely corporate earnings. In a similar vein, we believe that inflation will hold well over 2%, but that inflation at over 2% will also cease to be a singular focal point of the market.

Bubble?

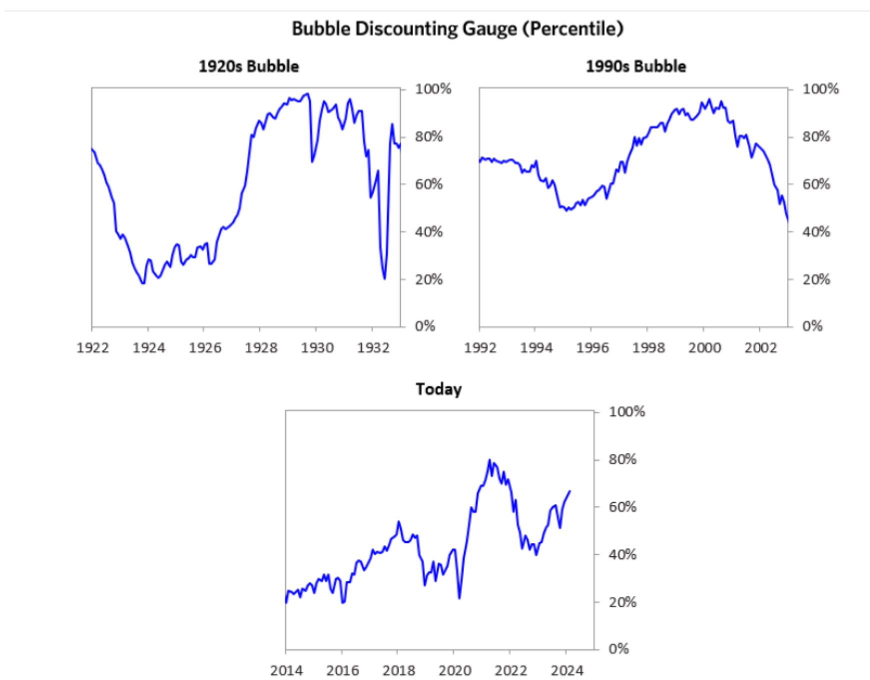
The S&P500 closed the first quarter at a record high after setting a number of new record highs during the quarter. Whenever the market reaches a new high, there is always media talk about a "bubble". Bubble headlines are part of the wall-of-worry that the market loves to climb. To support the bubble theory, news stories always trot out the CAPE ratio. This index averages the market's earnings for the past ten years and uses that average earnings in a P/E calculation. The media also quickly points out that a very high level of the CAPE ratio preceded the dot-com bubble of the late '90's.

Unfortunately the predictive value of the CAPE ratio is uncertain at best. This ratio index is backward looking as it takes an average of the last ten years as its base. It is supposed to average out a market cycle, but there is no historical data to support a 10 year base. This 10 year base selection is pretty arbitrary. The market is also forward looking and in every case when the market is assessing increasing forward earnings, those forward earnings increases, by definition, are going to exceed the past history.

No one can pinpoint a market bubble for certain, but a far better indicator than the CAPE ratio has been developed by Ray Dalio of Bridgewater, a well-known and successful hedge fund. Ray's bubble index considers six sub- indicators. These are:

Market prices relative to cash flow
Unsustainable extrapolations of earnings and revenue projections
Market entrants of new and naïve buyers
Broad bullish sentiment (euphoria)
Stock purchases financed by debt
High levels of inventories betting on price gains

Charts of Ray's bubble indicators for the 1920's, the dot-com period and today are shown below:



In the late 1920's, the bubble gauge was reaching 100% as it was in the dot-com era. The bubble gauge today stands at a level of 65. The poster child for the dot-com era bubble was Cisco, a company that made equipment necessary for internet communications. Cisco sold for over 100 times its forward P/E in 2000. The poster child for the AI boom today is Nvidia. It is selling for about 40 times its forward earnings projections. Nvidia also has a strong balance sheet with virtually no debt. At 40 times forward earnings, Nvidia is not cheap, but it has real, actual earnings. The earnings per share increased 400% in 2023 and should double again in 2024. These earnings have advanced significantly every single quarter for the past six. And, importantly, Nvidia has had a track record of beating the earnings projections. With this financial track record, Nvidia is not cheap, but it does not look like a bubble valuation either.

Bull markets die on euphoria and we are not at that sentiment point today.

Stock Market Impact

Hard as it may seem, the US economy and the stock market today are in a very good position – no recession, increasing earnings, no frothy bubble and a market coming to terms with interest rates exceeding 4%. Equally important is that these factors are not well appreciated, so there will continue to be positive surprises going forward this year.

Please do not interpret the positive outlook to mean that we should see a nice steady upward movement in market values. Generally market t increases happen suddenly with fairly large movements, frequently more than 1% happening in a single day. There will also be market corrections which can happen at any time and which can and will be gut wrenching and of magnitude of 10% or more. The market is up a good bit so far in the year, so it is not completely out of the realm of possibility to see it take a breather or a correction. These can happen at any time. That said, the overall trend however should be positive and the market should finish 2024 higher than it is today.

Bond Market Impact

We continue to believe that, while we may see small decreases in the Federal funds rates and on other rates near the short-term end of the yield curve, rates on the longer end should be increasing, although not enormously. The 10-year treasury is currently yielding about 4.35%. With inflation not going down to 2% anytime soon, we believe the 10-year rate should in the 4.5% range. The 30-year rate currently is 4.5% and we see this rate increasing to about 4.6%.

QLAC

With the bond market projections noted above, we continue to watch the projected payouts from QLAC annuities. The return on these annuities are currently running about 10% less than we saw last fall when the 10-year treasury rate briefly reached a level of 5%. We think that "still watching" is the right approach yet on this investment option.

Conclusion

The economy is stronger than the consensus expectation. Corporate earnings are stronger than the consensus expectation. Inflation is higher than the expected consensus and the stock market is higher than the expected consensus. However, the health of the economy, the gains in corporate earnings, the sticky inflation and the gains in the stock market are roughly in line with our expectations. We expect all of theses trends to continue through 2024 when the general consensus will catch up to the reality. The markets will continue to climb the wall-of-worry. Already in just the first quarter, the stock market is higher than the consensus forecast for all of 2024. Our forecast for the markets was on the high end and we expect for 2024 to finish up at a level higher than we see today.

As always, we hope these outlooks are helpful and we thank you for your continued confidence in Traub Capital Management.