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Talking Markets with Chuck.

Our Portfolio Manager, Tucker Donahue, sat down with Chales Schwab Netowrk last Friday to touch on all things markets, economy, and the Fed. Follow [this link] to check out the full interview, and take a look at some of his expanded responses here!

The latest GDP report shows slowing growth is likely the impact of the tightening liquidity in the economy amidst higher rates…

The recent GDP report initially appeared disappointing, but a closer look reveals consumer spending and demand have remained relatively stable at the start of the year. Trade and Inventories trimmed 1.2% of the Q1 GDP print[1]. These two categories are among the most volatile variables in the GDP equation.

The US economy, though potentially slowing, remains robust by various indicators. While we don’t subscribe to the notion that liquidity hindered growth in the quarter, we think it’s clear that net exports did. The Dollar's strength in Q1 likely contributed to below-consensus growth. Note, revisions to this report are expected at the end of the month.

We wouldn’t run to sound any alarms following the initial Q1 GDP print. If we were to try and extrapolate any of the data from the print into forward growth expectations for the remainder of the year, we would point to Consumer Final Sales and Consumer Demand. Final sales to domestic purchasers, which excludes inventories and trade increased by 2.8% and final sales to domestic private purchasers which excludes government, inventories, and trade advanced by 3.1%. Real final sales increased 2%[2]. This implies private sector activity remains strong to robust even as overall growth slows.

Let’s not forget where we are coming from, either. The growth rate reported for the quarter is slowing sequentially following a surge of growth in the second half of last year. Zooming out, the US economy has now been in an expansion for 48 months (4 years) with annualized real GDP growth of 4.6% over that time. This post-pandemic growth rate has exceeded the post GFC decade long growth rate of 2.4%[3]. As we distance ourselves from the pandemic era fiscal policy, we would expect the U.S. economy to return to a post-GFC expansion rate, barring any major uptick in productivity

Inflation reports have again begun to show hotter price growth than anticipated, which will impact potential rate cuts from the Fed that equity markets have highly anticipated this year…

We would argue the current trend in CPI began back in June of 2023, which is when the YoY change for the basket stopped moving lower and began its gradual ticks higher. But when you take a look at Core PCE, the trend in this report has not stopped moving lower since February of 2022[4].

The MoM trend for Core PCE has been sticker as of late, but we see little in the data that would make us concerned about an uptick in inflation this year that would cause the Fed to pivot from its pivot last year. You can’t triple stamp a double stamp.

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1 Data provided by U.S. BEA.

2 Data provided by U.S. BEA.

3 Data provided by Bloomberg database.

4 Data provided by Bloomberg database.

As for the expectation of rate cuts, we've seen the market price in 7 cuts at the start of the year, just to have less than 2 priced in by the time April ended[5]. We think the swing from one extreme to the next is on par for market participants, but for now we view the current market sentiment to no longer act as a headwind.

Looking ahead, we can monitor commodity prices, real-time rents, spring equity market behavior, and the Fed's Nowcast forecasts to gauge future inflation.

The U.S. commodity price index has remained flat for 16 months, contrasting sharply with the inflation spikes of 2020 and 2022. Financial Services inflation correlates with stock market returns, and the April reversal in the S&P 500 is likely to lower this volatile inflation component. New rents have declined year-over-year for 11 consecutive months, as noted by Chair Powell in his recent press conference. The CPI Nowcast for May anticipates a decline in CPI and no change in PCE as of last Friday. If PCE prints remain between 0.2% and 0.3% month-over-month in the coming months, we anticipate the Fed will maintain its stance that the battle against inflation is largely resolved.

On top of these data points, we'd also point to real wage compensation growth vs the growth in productivity. Over the last year, productivity has outpaced the growth in earnings for workers. The long-feared wage spiral seems to be avoided.

Slowing growth against a backdrop of stubborn inflation could pose a dilemma for the Fed as it balances the delicate act of reducing its balance sheet but not keeping rates too high for too long…

We think growth will remain more than acceptable for investors on a forward-looking basis (2.25% – 3% GDP) while inflation should begin to come in more in line with what we saw on the back half of last year given the metrics we've already pointed to.

So, with this in mind, we ask the question, what is wrong with 3% real GDP growth and flattish commodity prices? Sounds like healthy real growth without inflationary pressures to us.

It's important to not become a prisoner of the moment. While some of the inflation and growth-related data to start the year has come in hotter and more sluggish than expected- we believe the data that helps us try to forecast what's to come does not reflect a continuation of this pattern.

Equity markets could see continued volatility in the second half of the year…

Numerous factors could contribute to market uncertainty in the second half of the year, with the upcoming election in November potentially adding more catalysts than usual. However, we believe the divergence in global monetary policy is a more probable cause of volatility, impacting not only the equity market but also currency and interest rates.

Despite this, the year has largely continued the low-volatility trend of the past year. We shouldn't underestimate the market's potential to remain calmer than anticipated. The VIX sits around 10% above its one-year low and 40% below its one-year high, suggesting a subdued market environment may persist[6].

We often rely on historical market trends to anticipate future developments. The four-year Presidential Cycle is particularly insightful. However, this year has seen the market behave differently than expected for the fourth year

[5] CME Group FedWatch tool, as of 4/30/2024.

[6] Data provided by Bloomberg database.

of the cycle. The year began strongly with less spring weakness than historical patterns suggest, partly due to Super Tuesday having little impact, given the long-known leading candidates.

As Election Day nears, we anticipate this aspect will become more significant. With both candidates having prior presidential experience, this election cycle holds few unknowns for investors. It's worth confirming, but to my knowledge, there has never been a U.S. election where both candidates were former Presidents. This clarity should simplify game theory strategies as we approach fall.

We think this puts the fate of the market on the shoulders of earnings. At a forward multiple hovering near 20x for 2024’s expected earnings; U.S. corporations have a heavy burden on their shoulders to deliver. And in fact, they’ve done just that in Q1. We’re seeing more revisions higher for the next three quarters of earnings from Wall Street analysts as well. If we do in fact find ourselves in a modest real GDP growth environment, with tame inflation, and relenting monetary policy by the end of the year, there might be room for multiple expansion in the second half of this year.

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