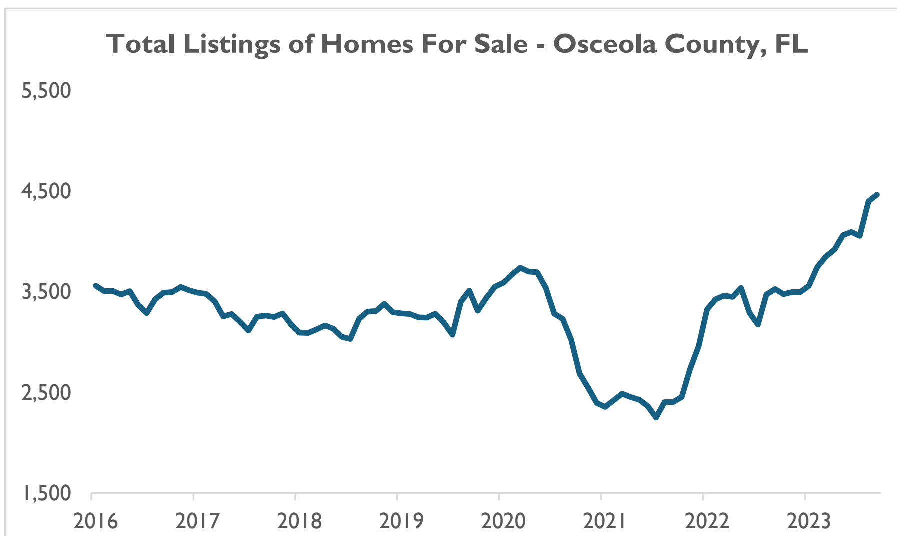
Monthly Market Review & Outlook
April 2024

An Overdue Pullback

After a five-month run, the S&P 500 peaked on March 28th. We discussed on our last webinar that the market was overdue for a pullback. Valuations and technicals were extended and sentiment could not have been more robust. The fear of missing out on the AI boom, in particular, and generally solid economic data pushed stock prices to record highs again and again. Eventually, there are fewer buyers than sellers. You could blame it on higher-than-expected inflation numbers, higher interest rates, the Israeli/Iran confrontation or a ship oddly colliding with a bridge in Baltimore. The reality is that when investors have accumulated gains over the course of five months, they do not need much of an excuse to take profits and so they have in recent weeks. The S&P 500 declined approximately -5% from its peak and the Nasdaq fell -7% from its recent high.

What Changed?

Fundamentally, nothing has really changed with the economy in the last few weeks. The labor market remains strong. Inflation is still directionally heading down. Yes, the consumer price index ticked up last month to 3.5% from 3.2%, but the core driver remains Shelter (i.e., housing prices), which in reality is showing a good deal of price weakness[1]. We have discussed this issue previously. Homes-for-sale listings nationwide are surging (up 14.4% y/y in March) and, especially in previously overheated markets like Florida[2]. This chart shows the total active listings of homes for sale in Osceola County, FL, which is where Orlando is located. This was a popular location for AirBnb owners to buy and rent homes to families visiting Disney World and other entertainment venues. Higher operating costs (i.e., property taxes and insurance) and market saturation have forced many to list these homes for sale. Active listings in March are up 86% y/y and are now 36% higher than the average listings during the 2017-2019 pre-Pandemic period.



According to Realtor.com, Osceola County is not the only county where listings are surging, other counties in Florida, Texas, South Carolina, Arizona, North Carolina and Tennessee are seeing a dramatic increase in listings. This comes at a time when there are seemingly very few buyers that can afford to purchase a home. With home prices at record levels relative to median incomes and mortgage rates still

[1] Bureau of Labor Statistics
[2] Freddie Mac

in excess of 7%, mortgage applications are at records lows[3]. Prices will likely need to decline to clear this building inventory. New home prices are already down -19.4% since their peak as homebuilders try to clear their inventory[4]. How widespread and severe existing home price declines become is anyone's guess but directionally this points to the Shelter component of inflation decreasing and, ultimately, interest rates declining.

Nevertheless, in the short run, the market has shifted to a "higher for longer" stance on interest rates. Interest rates have increased since this market sell-off began. The 2 Year U.S. T-Bill yield is now nearly 5% up from 4.6%. The 10 Year U.S. Treasury bond yield has also risen from 4.2% to 4.6%. Surging interest rates are generally anathema for stock and bond prices. In fact, the market has removed many rate cuts from its forecast with the Fed Futures curve reflecting just one 25 basis point interest rate cut by year end, which is more hawkish than even the Fed's projections. However, as fast as these interest rates have risen, they could also fall and the potential catalyst for this may be the release of the March Core PCE inflation report on April 26th. This report will likely determine if this pullback is one to be bought or not. For now, the inflation story remains the most important driver of both the stock and bond markets.

Market Outlook

Putting aside the potential near-term impact of the upcoming inflation report, pullbacks often offer excellent opportunities to add exposure to stocks or bonds that fall victim to overselling. During selloffs, market participants often overreact and this creates excellent risk-adjusted buying opportunities. In addition, when markets rally, as they have, we frequently do not get full positions on in the stocks we really like. Pullbacks give us another bite at the apple. So, for the past week, we have been combing through portfolios and adding exposure in our favorite themes.

A critical element of our investment approach is to invest in long-term secular themes, such as artificial intelligence, medical device innovation, cloud computing and the need to grow the electricity grid – to name a few. One of the benefits of investing in stocks that participate in a strong secular theme is that their earnings generation can often become uncorrelated to the broader economy and, therefore, these stocks may perform differently from the rest of the market. In market parlance, these stocks have higher amounts of idiosyncratic risk. This is good risk because this means that these stocks are more dependent on how they individually execute on their business opportunities as opposed to moving with the overall market. In other words, secular themes create a degree of market independence.

That said, the stock market is really a tale of two markets. The expected earnings growth of the S&P 500 is almost entirely driven by technology names. To be sure, artificial intelligence and other technology trends are creating unique opportunities to boost earnings growth in related stocks. But this also means that very little growth is expected to come from non-technology names. Low earnings growth expectations for non-technology sectors creates investment opportunities. Overlooked value is often fertile ground for finding the next big winner. The key point here is that regardless of the direction of the overall market indices, there are attractive investment opportunities to be found.

Returning to the question of where are the stock and bond markets headed, the main market driver remains inflation, and, therefore, the direction of interest rates. Given the recent backup in rates, it seems that interest rates are more likely to fall than rise from here, but one cannot be certain and we have reduced the interest rate sensitivity of our portfolios until a more definitive trend is established. In the meantime, the first quarter earnings season is underway and so far so good. The financial services sector has largely reported and their earnings, general business trends and guidance is overall better than

[3] Mortgage Bankers Association
[4] U.S. Census Bureau

expected. We are now moving into the Technology sector's earnings reports and, given their heavy composition in the S&P 500, they could have a material impact on the direction of the markets. Stay tuned.

Conclusion

Temporary pullbacks during a bull market, such as the one we are experiencing, are welcomed. People often do not believe us when we say this, but it is true. One of the best ways to make money is to invest in inefficient markets. Inefficient markets create a disconnection between fundamentals and sentiment. Fundamentals eventually win. As a tactical manager, we have the nimbleness to capitalized on these inefficiencies. And that is exactly what we are doing now.

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Definitions

The **S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The **Nasdaq Composite Index** is a market cap-weighted index, representing the value of all stocks listed on the Nasdaq Stock Market. The composition of the Nasdaq Composite is a mix of long-established companies that have been on the exchange since inception, to IPO newcomers, companies that grew from OTC exchanges or switched from other exchanges.

The **Dow Jones Industrial Average** is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

The **Bloomberg US Aggregate Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-dominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate pass throughs), asset-backed securities and commercial mortgage-backed securities.

The **S&P 500 Equal Weighted Index** is the equal-weight version of the S&P 500. The index includes the same constituents as the capitalization weighted S&P 500 index, but each company is allocated the same fixed weight at each quarterly rebalance.

The **Russell 2000 Index** is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 Index total market capitalization.