Economic and Market Outlook – First Quarter 2024

Overview

Two years after the Federal Reserve began raising short-term interest rates, U.S. economic growth has yet to slow materially; indeed, Bloomberg News' survey of economists estimates of 2024 GDP growth continue to rise, from the 0.6% expected in July 2023 to 2.2% expected in March 2024. Both consumer spending and private investment spending continue to show resilience. New job creation has been steady for the past year. Household employment has declined slightly but has not yet fallen to levels consistent with recession. Consumer price inflation has declined steadily on a year-over-year basis since its peak in June 2022, led by declines in energy, food, and core goods prices, but core services inflation has yet to subside, leaving CPI inflation at 3.15% for the past year, well above the Fed's target of 2%. Similarly, the broader personal consumer expenditure (PCE) index is still at 2.45% year-over-year, almost entirely due to services inflation, with non-durable goods contributing only a negligible amount while durable goods prices have declined. Deflation in core services is likely to be much harder to achieve without much softer labor markets, suggesting that the Fed will have difficulty reaching its inflation target.

Economists proclaim "this time is different" at their peril, but this economic resilience is puzzling. In January, the market assumed a smooth and soft landing, with softer economic data interpreted positively as reasons for the Fed to start cutting rates sooner. By March, the "no landing" scenario had gained traction: expectations of economic growth were rising, the bond market had cut its expectations of the number of Federal Funds rate cuts in 2024 from six to three, and cyclical sectors such as energy and materials began to outpace more defensive ones.

We were clearly too early in our call for recession in 2023; while 2024 seems unlikely, we cannot discount it entirely. The Conference Board's Leading Economic Index rose in February 2024 for the first time since February 2022, based on strength in hours worked, residential construction, stock prices, and the leading credit index. The distortions from Covid-related supply chain issues may have limited the usefulness the Leading Economic Indicators signals, although the Coincident Economic Indicators do not appear to be subject to the same distortions and are also at levels consistent with recessions. The unemployment rate, a lagging indicator, has risen from 3.4% in January 2023 to 3.9% in February 2024, and other labor market indicators look weak, including a decline in job openings, reductions in the average weekly hours worked, poor job growth in cyclical industries, and large discrepancies between the establishment and household measures of unemployment. While measures of manufacturing activity which have indicated contracting activity since October 2022 have recently improved slightly, measures of service sector activity have begun to decline, particularly employment and pricing.

While a recession is not clearly in view, we remain concerned that current equity market pricing reflects a very optimistic view of the Fed's ability to engineer either a simple, mid-cycle slowdown or a soft landing without reflecting the considerable current geopolitical risks. Active and deeply divisive wars continue in Ukraine and Gaza, while the Houthi rebels continue to disrupt shipping. Rising oil prices and supply

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disruptions in the U.S. from the destruction of the Francis Scott Key bridge in Baltimore could raise goods prices, interrupting the slow progress of disinflation. Geopolitical flareups carry a substantial risk of higher oil and commodity prices as well as additional trade disruption. The U.S. is in the middle of an election year, along with more than half of the world's population; the rising popularity of authoritarian and nationalist rulers raises the risk of destructive trade and rising tariff barriers. Oceanic heating appears to be much more rapid than even recent projections had indicated, while extreme rainfall and drought patterns continue to develop worldwide.

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First Quarter Performance

U.S. Treasury yields ground slowly higher during the quarter. The 10 Year Treasury yield rose from 3.88% at year end to 4.20% on March 28, while the yield curve ended the quarter at the same level of inversion as at the beginning. Despite a significant revision in the number of interest rate cuts expected during 2024 from six in early January to three by the beginning of April, equity market investors retained an unshakeable focus on expected cuts and the belief that a Fed pivot toward easier monetary policy is imminent. This change in sentiment reversed the correlation between stocks and bonds. In the second half of 2023, stock prices rose as Treasury yields fell; since December 31, 2023, rising stock prices have accompanied rising interest rates. In January and February, stock markets traded mostly risk-off, with large-cap and growth characteristics leading the market and Communications Services and Technologies posting the highest returns, while March saw a reversal and a more risk-favoring tone, with value and smaller-cap stocks leading, and the lead passing to the Energy and Utilities sectors.

For the quarter, the S&P 500 returned +10.6%. The S&P 1000 rose +7.6%; the S&P Mid Cap increased by +10.0%, and the S&P Small Cap Index rose +2.5%. International stocks rose as well, with the quarterly returns for the MSCI All Country World Index at +8.2% and the MSCI Europe, Asia, and Far East Index at +4.7%. All S&P 500 sectors except the interest-rate sensitive Real Estate sector rose in the quarter. The Communications Services sector rose +15.8%; the Energy sector rose +13.7%, as oil prices increased by +16.1% during the quarter. Information Technology returned +12.7%, and Financial Services rose +12.5%. Real Estate fell by -0.6%, and Utilities increased just +4.6%. The Russell 3000 Growth index returned +11.2% in the quarter while the Russell 3000 Value Index rose +8.6%. Rising interest rates led to losses for the Bloomberg Government/Credit Intermediate Index, which returned -0.2% for the quarter and the Bloomberg Intermediate 1-10 Year Municipal Bond Index which lost -0.4% for the quarter.

Valuation and Positioning

As in most high-return quarters, the strong first quarter results were primarily driven by P/E expansion, which contributed 7.4 percentage points, or 70%, of the quarter's return while S&P 500 earnings growth contributed only 2.4 percentage points, or 20%, of the S&P 500's 10.6% return. At the current P/E level, we view markets as fully priced, with limited further upside until economic growth and corporate earnings reach stronger growth rates. At quarter-end, the S&P 500 was valued at 21.0 times expected earnings for the next twelve months, up from 19.5 times on December 31, 2023, and 1.3 standard deviations above its 30-year average of 16.6 times. In the past, one-year returns from a P/E at this level have ranged between -25% to 45%, consistent with a wide range of economic outcomes. The earnings yield of the S&P 500 decreased to 4.77%, while the 10 Year Treasury Inflation Protected Security yield rose to 1.88%. This suggests that stocks will return about 2.9% more than bonds over the next year, or -0.5% less than last quarter's expectation of 3.4%.

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For a longer-term perspective, we turn to Economist Robert Shiller's concept of the cyclically adjusted price-to-earnings (CAPE) ratio, which references 10 years of inflation-adjusted earnings. The CAPE ratio is currently at 34.4 times, 1.2 standard deviations above its 30-year average of 27.7 times. Robert Shiller's calculation of the excess CAPE yield, or the difference between the CAPE P/E and the 10 Year Treasury yield adjusted for the prior 10 years inflation, was 1.48% as of March 31. Based on Shiller's data going back to 1871, an excess CAPE yield between 1.37% and 1.63% has been consistent with a ten-year expected return of just 3.81%. Elevated price/earnings ratios, modest expectations for earnings growth, higher oil prices, and geopolitical risk do not necessarily forecast either a recession or a bear market. Nor do they provide much cushion or comfort against these outcomes. We remain watchful for signs of economic deterioration.

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Conclusion

With a broad range of potential economic outcomes, and at best modest expected upside, we continue to seek quality and financial flexibility in our holdings. As companies face refinancing existing debt at significantly higher costs, we favor companies with strong balance sheets, particularly those with low net debt. We also favor companies with demonstrated profitability and steadier revenue flows. While weare mindful of having been too early in our positioning for an expected recession, we also need to protect against market overexuberance with current expectations of a soft landing. The sharp runup in both stock and bond prices in the past six months leaves very little room for error in valuation.

As a baseline for individual portfolio decisions, we continue to slightly favor stocks over bonds as a strategic allocation, even as the +23.5% return for the S&P 500 over the past six months has extended valuations. We recognize that stocks may have considerable additional risk over the immediate horizon, and that bonds frequently provide a diversification benefit to portfolio construction. Nonetheless, the continued resilience of the U.S. economy in the face of both significant rate hikes over the past two years and the continuing runoff of Central Bank balance sheets suggests caution in reducing equity holdings below strategic neutral targets. Ultimately, the earnings growth capabilities of stocks are expected to support their valuation in both inflationary and deflationary environments. For certain of our domestic-oriented strategies, we prefer to position for equity market downside by adjusting portfolio composition to reflect our cautious stance rather than moving below an appropriate strategic allocation.

Whatever the outcome of the U.S. election in November 2024, we believe that companies that manage ESG risks will be positioned to benefit from the continued importance of diversity, climate change, and workplace satisfaction to company financial performance. Despite the "ESG backlash," these issues continue to be important and smart management will not be any less committed to managing these risks.

About Trillium Asset Management

Trillium Asset Management, LLC (Trillium) offers investment strategies and services that advance humankind towards a global sustainable economy, a just society, and a better world. For over 40 years, the firm has been at the forefront of ESG thought leadership and draws from decades of experience focused exclusively on responsible investing. Trillium uses a holistic, fully integrated fundamental investment process to uncover compelling long-term investment opportunities. Devoted to aligning stakeholders' values and objectives, Trillium combines impactful investment solutions with active ownership. The firm delivers equity, fixed income, and alternative investments to institutions, intermediaries, high net worth individuals, and other charitable and non-profit organizations with the goal to provide positive impact, long-term value, and 'social dividends™.'

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