1st Quarter 2024 Review

In a continuation of the rally that began in the 4th quarter of last year, stock markets rose in each of the three months during the first quarter. While market gains have begun to broaden out, they are still mainly driven by the largest technology stocks by market capitalization. To that end, four stocks were responsible for about half of the S&P 500 index return in the first quarter.
The returns for the major averages for the 1st quarter of 2024 were as follows:

The Dow Jones Industrial Average gained 6.14%, the S&P 500 was up 10.53, the Russell 2000 Small Cap Index rose 5.18%, the NASDAQ gained 9.18%. International equities lagged the U.S. with emerging market stocks rising 2.10% while the MSCI EAFE Developed International Index rose by 5.68%. Bonds did not participate in the rally, with the U.S. Aggregate Bond Index down 0.78%.
From a style and size perspective, growth stocks outperformed value stocks with the Russell 1000 Growth Index gaining 11.4% while the Russell 1000 Value Index rose 8.4%, and the larger capitalization stocks outperformed the smaller ones.

The volatility of stocks as measured by the VIX index remained low during the quarter. This low volatility is also reflected in the fact that the largest drawdown for the S&P 500 so far this year has been only 1.7%. There are still three remaining quarters in the year, so time will tell if this level of volatility can be sustained. Data on stocks over the last 96 years shows the average intra-year drawdown for the S&P 500 being closer to 16%, so a period of higher volatility going forward should not be ruled out.

The improvement in economic activity in the U.S. so far this year has not deterred the Federal Reserve in their view that inflation is coming down enough to allow for them to cut interest rates at some point during this year. They acknowledge that the path to their lower inflation target may have some bumps along the way, but the general path is lower. There are risks as it relates to market complacency with the ability of the Fed to perfectly “stick their landing.” How they balance the risk of easing policy too soon or too aggressively (allowing inflation to reaccelerate) versus keeping rates higher for too long (causing the economy to contract too much) have yet to play out.

Some areas of complacency that we are alert to include the increasing valuation risk among pockets of the market, as well as an elevated level of investor optimism as it relates to market sentiment. On valuations, according to data from Ned Davis Research, the median stock in their Multi-Cap Equity Series had a P/E (Price to Earnings Ratio) of 27.9 at the end of March. This is about 26% above the median level over the last 44 years. At the same time that valuations are rising, sentiment readings are pointing to excessive levels of optimism (which are historically contrarian indicators).

While in the short run, overextended markets can continue to run higher on sentiment, flows and benign policy expectations, the lens through which we see the markets from a long-term perspective is the valuation lens. Long term valuation measures such as the price investors are paying for each dollar of company earnings or sales help frame up whether the risks are asymmetrically skewed to the upside or to the downside over the coming years. (see our 4th quarter 2023 review for more detail on this if you missed it)

As long-term equity investors in a concentrated portfolio of high-quality businesses trading at attractive valuations, we are not discouraged by short-term periods of underperformance relative to the broad market. The recent performance of our equity portfolio is reminiscent of the period of underperformance we experienced from 2018-2019. We had outsized moves lower in some key long-term holdings that dramatically underperformed the index. We viewed these declines as temporary and not reflecting any permanent loss of capital or problems with the underlying businesses. Our experience has shown that high quality businesses with durable cash flows, bought at good valuations bounce back after a fall; whereas low quality businesses with questionable finances, and overvaluation either never recover or take way too long to recover based on their excessive valuations.

This is exactly what happened the following year as these prior year laggards bounced strongly higher driving our positive returns. While these stocks were out of sync with the market in the short run, we held them and still considered them to be attractive long-term holdings capable of compounding their way back on the basis of their strong business fundamentals. We see the same set up in the names that have been detractors to our recent performance and likewise expect their business fundamentals to prevail over time.

As a proxy for investment grade bonds, the10-year treasury note yield rose in both January and February while stabilizing in March to end at 4.2% The path forward for yields will depend largely on the ultimate trajectory of inflation and the economy compared to market expectations that have been priced in. A more resilient economy and stickier inflation data has resulted in a lower number of rate cuts expected in 2024 and more uncertainty around the timing of the first rate cut. The higher supply of treasury debt that will be coming to fund increasing deficits and the source of demand for this is a factor for the bond market as well. On the corporate credit side, spreads are low implying higher valuations.

With this fixed income backdrop, we like a diversified approach to fixed income portfolios with varying maturities and a move up in quality to capture the higher yields being offered across the investment grade bond markets. We expect bouts of volatility in rates and credit as the Fed policy evolves. Our tactical managers keep some powder dry for either extending/removing duration or taking on more short-dated credit risk when volatility presents good risk-adjusted opportunities. These strategies can be good options to holding cash under the right circumstances given their flexible mandates and lower historical volatility.

In alternatives, we favor having a good mix of strategies to provide broad diversification of return streams and downside protection. A properly constructed alternatives portfolio can provide stability and diversification in periods when stock and bond volatility increases. While public high yield corporate bond spreads are very tight (richly valued), there are opportunities in privately negotiated credit markets that offer covenant protection, strong collateral, and attractive risk-adjusted yields with lower correlations to public markets. This is just one of many types of non-traditional, alternative investments that can offer lower volatility strategies aimed at a more consistent return pattern and low correlation to public equity and bond markets.

As always, we thank you for your trust and confidence.

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