Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update

First Quarter, 2024

ASSESSING THE MARKET'S BIG RALLY

An unexpected rally. It may be hard to believe, but the S&P 500 dropped to 4,100—albeit briefly—just five months ago. A major catalyst for the 28% rally since late October, in our view, was the Treasury Department's decision to change its quarterly refunding schedule to favor short-term bills, limiting the supply of longer-term notes. This short-circuited a bear market in bond prices and brought 10-year yields from roughly 5.0% to less than 4.0% by the end of 2023. The move in yields was the single spark that lit a prairie fire in risk assets that was further fueled in mid-December when Federal Reserve Chairman Jay Powell signaled a pivot to a more dovish monetary policy. The hunt for momentum had commenced in earnest.

Looking for cuts. At the start of the year, futures markets implied that the Fed would cut rates by 0.25 percentage points up to six times by the end of the year. We have yet to see the Fed's first rate cut, and higher-than-expected inflation numbers in Q1 whittled the market's expectations to three cuts in 2024. Still, the market has powered on. Earnings for the S&P 500 were up just ~1% in 2023 over 2022, but Q4 earnings showed upward momentum, rising 7.5% from the year prior. Despite signs of growing animal spirits and speculation, none of the nine items on our Bull Market Top checklist can be checked off today (See page 2 for the checklist). The labor market remains strong and credit spreads are tight.

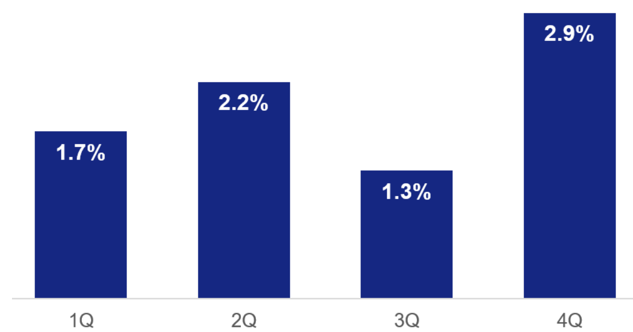
A broadening rally. With the equal-weighted S&P 500 index up 7.9% in Q1 (versus +10.6% for the cap-weighted S&P), there are hopeful signs that the rally is broadening out beyond the heavyweight Magnificent Seven stocks that enthralled investors last year. Further, the macro environment is starting to provide excitement beyond geopolitical risks and tragedy. Japan's Nikkei 225 index reached a new all-time high (its previous all-time high was back in 1989). Gold and Bitcoin also reached new highs, perhaps suggesting that policymakers may try to control interest rates, inflation, and the currency but they can't control all three at once. We are monitoring the price of gasoline and the Strategas Common Man CPI (see page 2) for a sense of how voters are feeling about the economy ahead of the November election.

Bullish until. Given today's heightened stock valuations and relatively low 10-year Treasury yields, it's hard to say how much additional performance can be achieved from here. Stock prices, credit spreads, and the price of gold and Bitcoin suggest that monetary conditions are far from restrictive. History has shown that market conditions often remain overbought for far longer than they can remain oversold. We continue to be "bullish until the bill comes due." We consider "the bill" to be higher long-term Treasury yields—something to keep a close eye on.

S&P 500

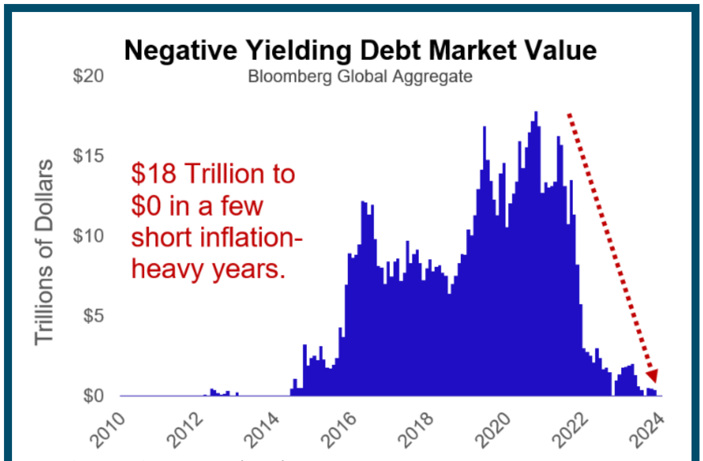
Asset Class	Representative Benchmark	Q1 Return
US Large Cap	S&P 500	10.6%
US Small Cap	Russell 2000	5.2%
International	MSCI AC World ex-USA (USD)	4.8%
Commodities	Bloomberg Commodity	2.2%
Municipal Bonds	Bloomberg Municipal Bond	-0.4%
Taxable Bonds	Bloomberg US Aggregate	-0.8%
Cash	Bloomberg 3-Month T-Bill	1.3%

S&P 500 Average Quarterly Return (since 1928)



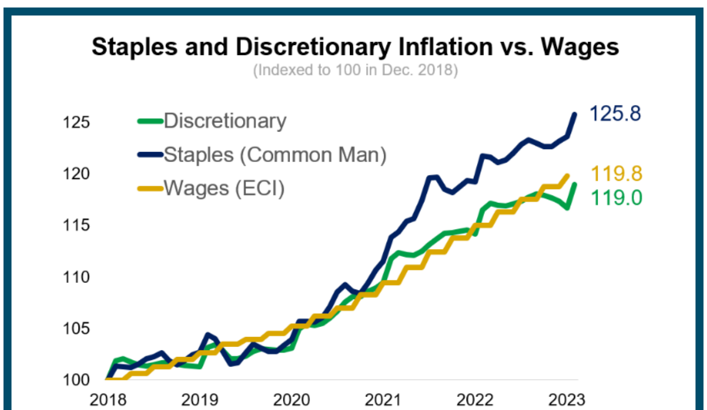
Strategas' Bull Market Top Checklist

Indicator	2000	2007	Now	Comments
Blow-off top	✓	✓	X	While investors are paying elevated multiples with an underwhelming risk/reward profile, December's euphoria has cooled.
Heavy inflows into equity market funds	✓	✓	X	Net inflows into equity funds are underwhelming compared to money market funds. There still appears to be cash on the sidelines
Big pick-up in M&A activity	✓	✓	X	M&A activity has seen a pickup recently, especially in the energy sector. There will likely need to be a significant increase to feel frothy.
IPO activity	✓	✓	X	IPO activity has been rather lackluster thus far and there are few signs it will turn euphoric in the near-term.
Rising real interest rates	✓	✓	X	The more inflation comes down, the more restrictive real rates become. For now, they are below levels seen at the start of recessions.
Weakening upward earnings revisions	✓	✓	X	Earnings revisions have begun to turn higher. Based on figures reported by S&P, operating and reported earnings have bottomed.
Erosion in # of stocks making new highs	✓	✓	X	Breadth has expanded significantly during the current rally.
Shift towards defensive leadership	✓	✓	X	There have been no durable signs of a shift towards defensive leadership.
Widening credit spreads	✓	✓	X	High-yield and investment grade credit spreads remain tight by any historical standard.



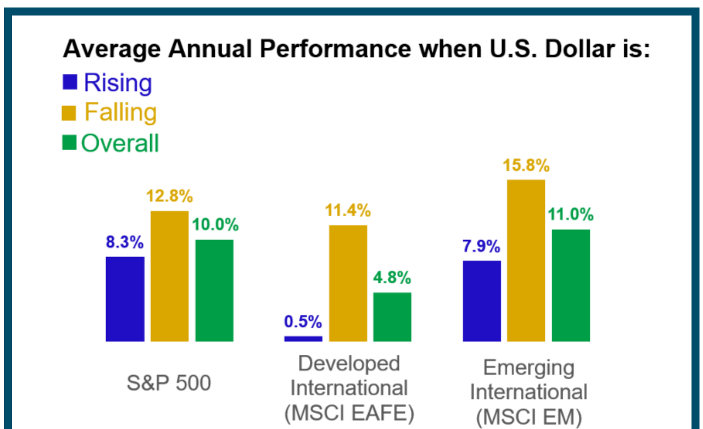
Source: Strategas, Bloomberg

Last month ended a period in which the amount of negative yielding debt got as high as $18 trillion. We've been critics of sustained periods of financial repression because we believe that removing the price mechanism from economic decisions leads to huge misallocations of capital, rewards financial engineering over capital spending, and creates a moral hazard for policymakers. Going forward, we think the bar for using controversial policies like negative rates will be much higher given the stickiness of inflation. At the margin, this means that the "everyone gets a trophy" cost of capital era that defined the post-2008 period is over.



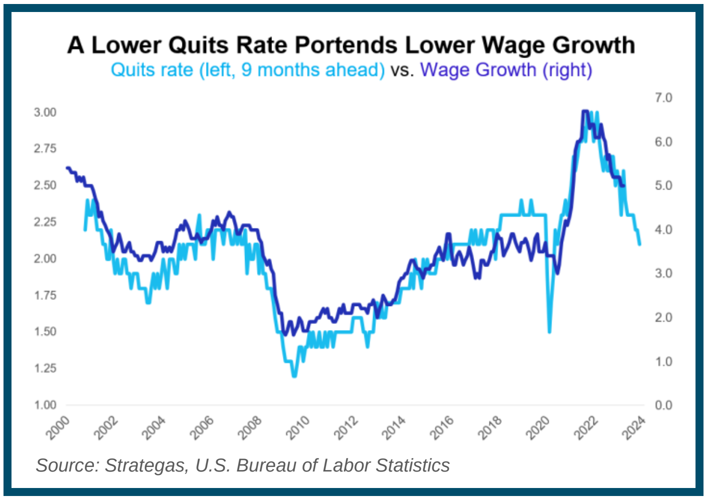
Source: Strategas, BLS, Haver

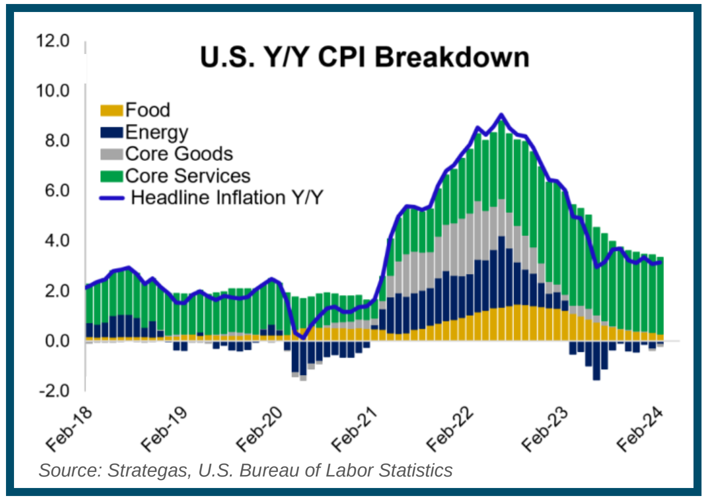
A recent article on the rising cost of auto insurance spurred us to look at inflation beyond the "Core" and "Headline" numbers. We put all items we believe people *must* buy in one category (Staples) and everything else in another (Discretionary). We call our measure of the Staples category the Common Man CPI. Intriguingly, the data show a greater spike in the rate of inflation in 2022 and a greater decline in 2023 (though it's reaccelerated more recently). Our Common Man measure has grown faster than wages of late—one potential explanation for weakness in the Biden administration's polling despite full employment and high asset prices.



Source: Strategas, Bloomberg, Factset

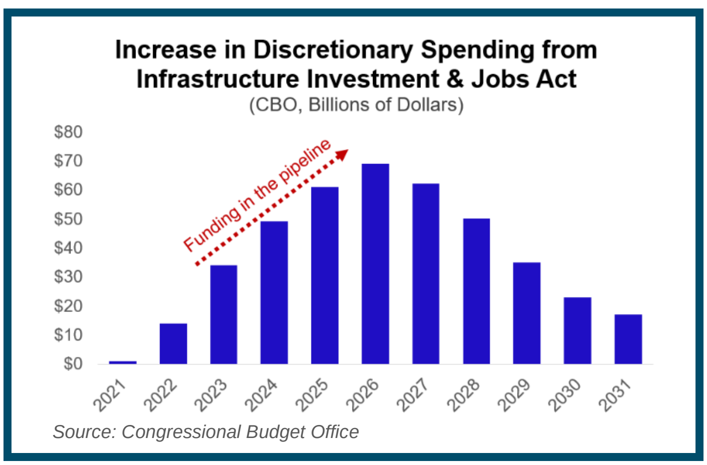
Entering 2024, consensus forecast a weaker U.S. Dollar on the back of expectations for 6+ rate cuts from the Federal Reserve. Instead, sticky inflation and a strong economy shifted the market's outlook for the Fed and the dollar rallied over 3% in Q1. That said, the Fed is still expecting to cut rates three times in 2024 – and if other central banks globally find it more difficult to ease policy given inflation woes, a weaker dollar may yet be on the horizon. Historically, a weaker U.S. dollar has boded well for stocks, with Emerging Markets and U.S. multinationals the biggest beneficiaries (the two sectors with the most foreign sales exposure are Tech and Materials).

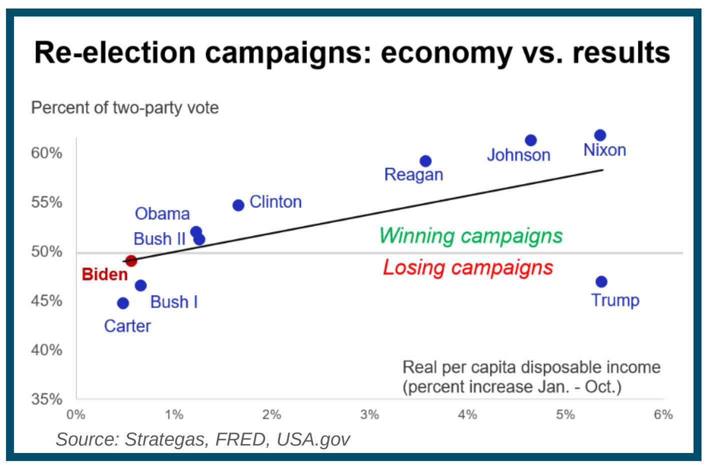




The U.S. economy has been resilient in large part due to a tight labor market. This has kept consumers spending but has been a thorn in the Fed's side (fears of strong wage growth leading to price inflation). The quits rate, displayed above, is worth keeping an eye on both as a future wage growth indicator and a sign of normalization in the labor market. This metric (the percent of people quitting their jobs vs. overall employment) is back to pre-Covid levels after hitting a multi-decade high in 2022, and sure enough, wage growth is following. Normalizing wages without large-scale unemployment is needed for a soft landing; so far so good.

When inflation first spiked in 2022, it was a story of broad-based pressure – energy and food prices were rising amid war in Ukraine, core goods prices were rising amid pandemic-related supply chain woes, and core services were rising amid labor and housing shortages. As of today, inflation is a narrower issue – the last mile to the Fed's 2% target is almost entirely about core services, which is driven by wage growth and shelter costs. Both are moderating somewhat, but have remained sticky above their pre-pandemic trend. The Fed's comfort level with inflation at 2-point-something instead of 2.0% will determine the odds of a soft landing from here.





US net interest costs are above 14% of tax revenue, a key inflection point that historically has forced austerity on policy-makers. But for fiscal stimulus that has already passed, the allocation of stimulus is shifting from subsidizing consumers and discretionary spending towards subsidizing investment. While pandemic aid programs are wearing off (e.g., student loan deferral, enhanced unemployment), investment-led stimulus (infrastructure, clean energy, CHIPs) is about to be unleashed. The push for more investment puts a cushion under commodity prices as more raw materials are needed. It also reinforces trends like deglobalization and onshoring.

Income after tax and after inflation has been a great predictor of the percentage a president garners in a re-election vote. The chart shows that recent first-term incumbents that avoided a recession two years before the next presidential election won another term. Incumbents that presided over a recession in that period went on to lose. Presidents tend to try to mitigate the odds of a recession ahead of the election with things like student loan cuts or encouraging U.S. oil production to keep gas prices down. With a bipartisan tax bill languishing in the Senate, we expect to see more stimulative actions on the margin to boost the economy.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equities of small capitalization. ● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US and Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Composed of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990, and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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