FOLLOWING THE FUNDAMENTALS

2ND QUARTER 2024: ISSUE 30

A Quarterly Market Update from The Volrath Castle Group at Morgan Stanley

SEND IT IN JEROME!

BY AARON CASTLE, *Financial Advisor & Portfolio Manager*

Every year when the calendar turns from March to April, my wife lets out a massive sigh of relief. The turning of the calendar page means she has survived another year of the NCAA Basketball tournament. March Madness has always been one of my favorite times of the year and this year was no exception. As I listened to in-game commentary from Bill Raftery, I couldn't help but think of his legendary call from 1988 as Pittsburgh's Jerome Lane slammed the ball through the hoop and shattered the glass backboard into pieces. With glass on the floor and the rim hanging by a thread, Bill emphatically yelled, "Send it in Jerome!"

While the world will always remember Jerome Lane for that dunk, many are much more interested in headlines being made by a different Jerome the past few years. As we covered in last quarter's Following the Fundamentals, the chair of the Federal Reserve, Jerome Powell, announced in November that the Federal Reserve was likely done raising interest rates and the next action would likely be to move interest rates lower. In this edition of our quarterly update, we are going to cover government deficits, immigration, and why we believe Jerome Powell's decision to pivot from rate hikes to rate cuts has eased financial conditions leading to the March Madness rally in the S&P 500 the past 6 months.

IN THIS ISSUE WE'RE COVERING

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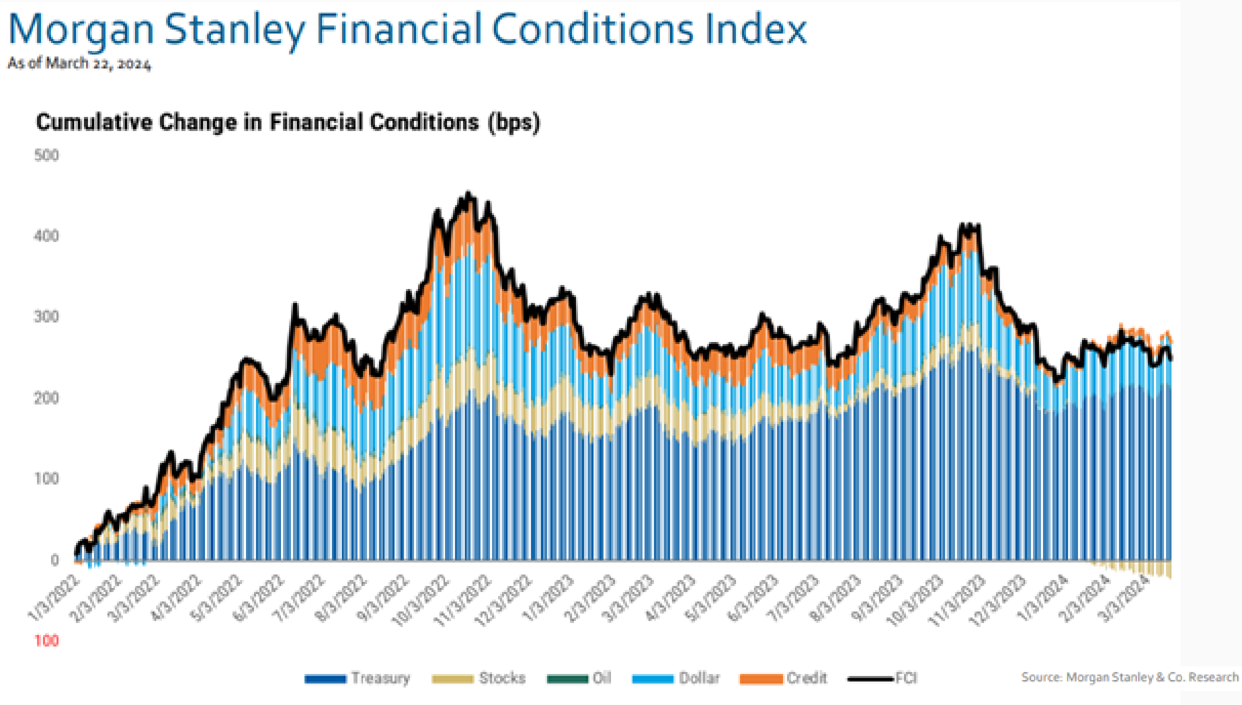
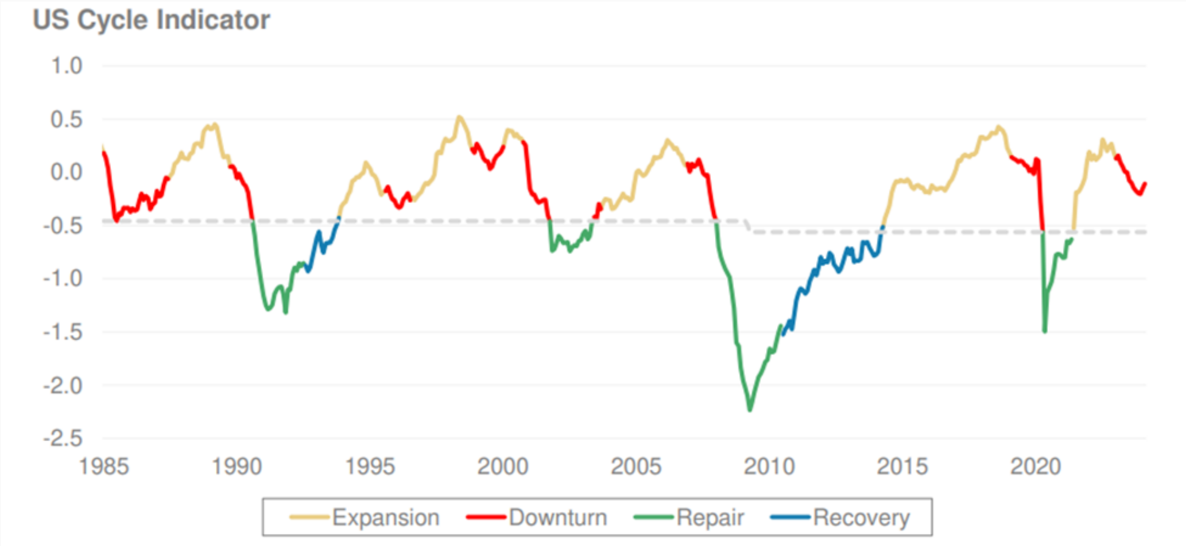
FINANCIAL CONDITIONS & ECONOMIC IMPACT

As previously mentioned, the Federal Reserve pivoted their policy from a rate hiking cycle to a potential rate cutting cycle this past November. As seen below, the Morgan Stanley Financial Conditions Index has eased significantly since that decision was made 5-6 months ago.



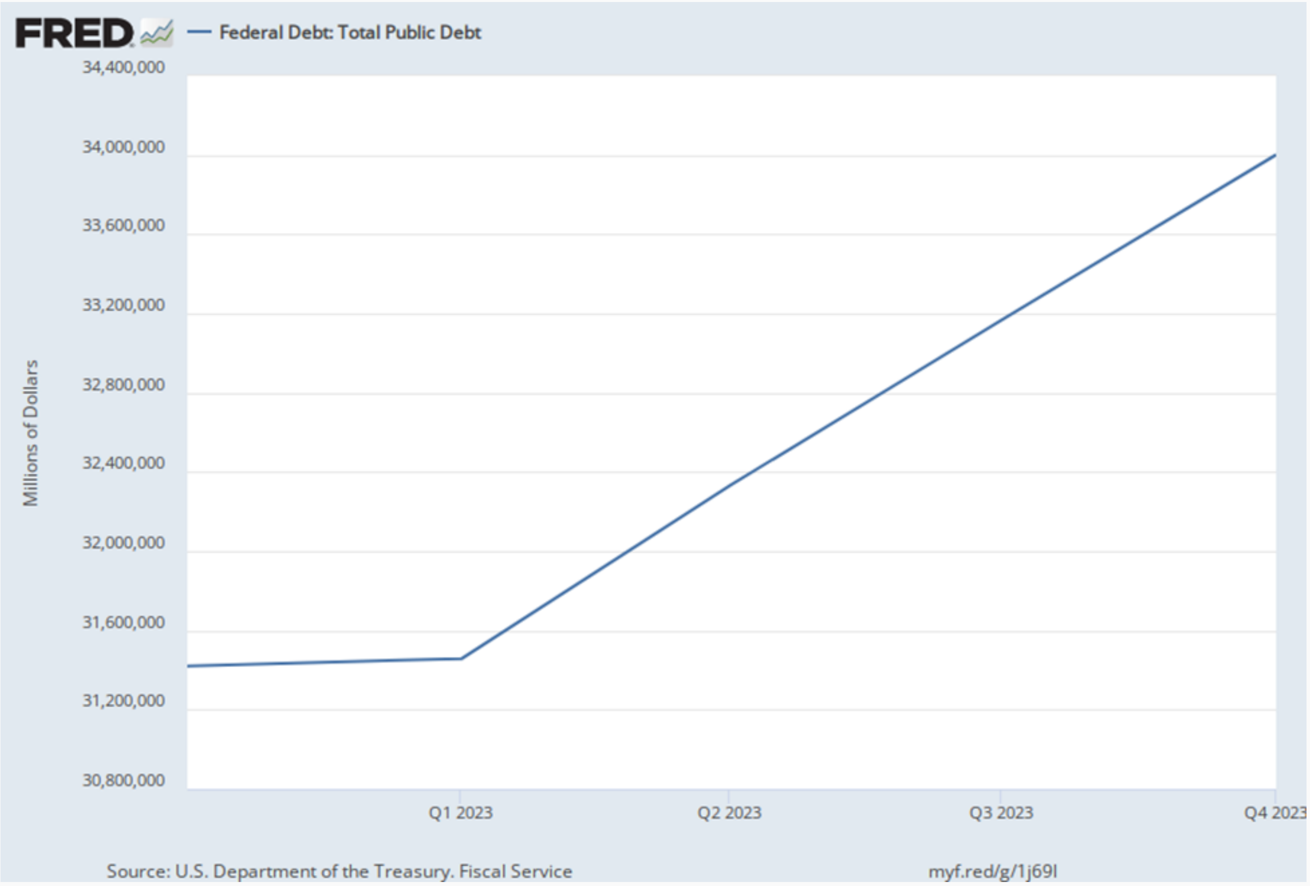
We believe the easing of financial conditions is one of the primary factors that has led to some of the high frequency economic indicators starting to turn positive over that time frame. While the Morgan Stanley US Cycle indicator is still registering in a "downturn", the indicator has started to move in a positive direction over the past 2-3 months after steadily heading downward for the previous 12-15 months.



Source: Bloomberg, Datastream, Haver Analytics, Morgan Stanley Research (see Cross-Asset Strategy: Global In the Flow – February Recap (1 Mar 2024)).

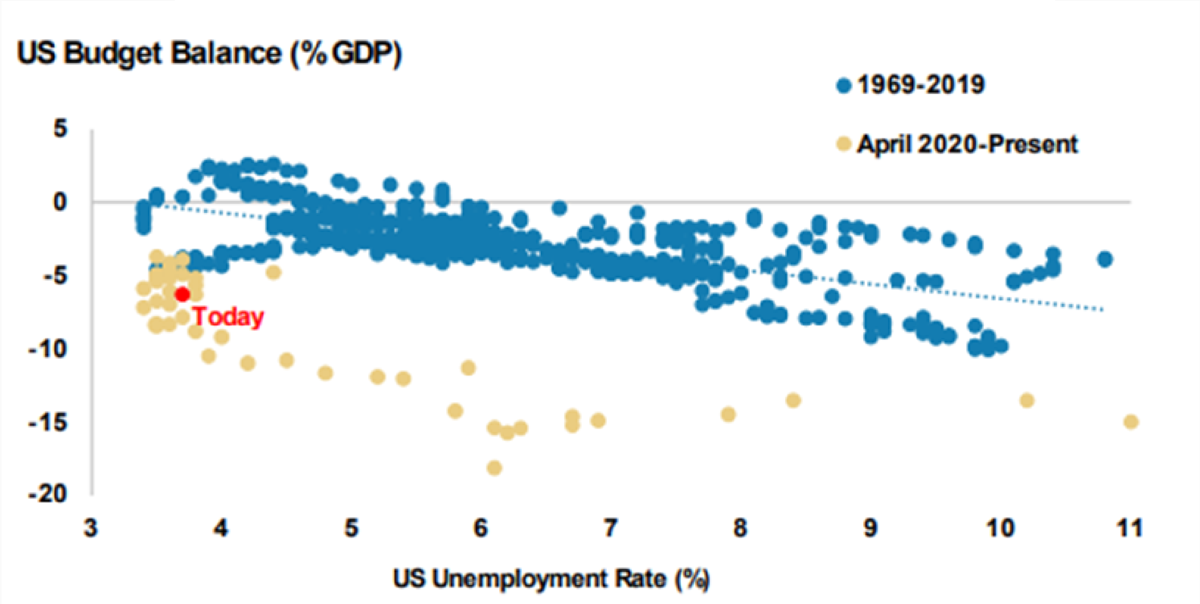
GOVERNMENT DEFICITS & IMMIGRATION

We also believe that the lifting of the debt ceiling last summer has played a role in the easing of financial conditions. As seen below, US debt plateaued in the 1st half of 2023 and then reaccelerated in the 2nd half of the year after the debt ceiling was raised. Since the debt ceiling was raised, US debt has gone higher by approximately 10% or an additional $3 trillion.



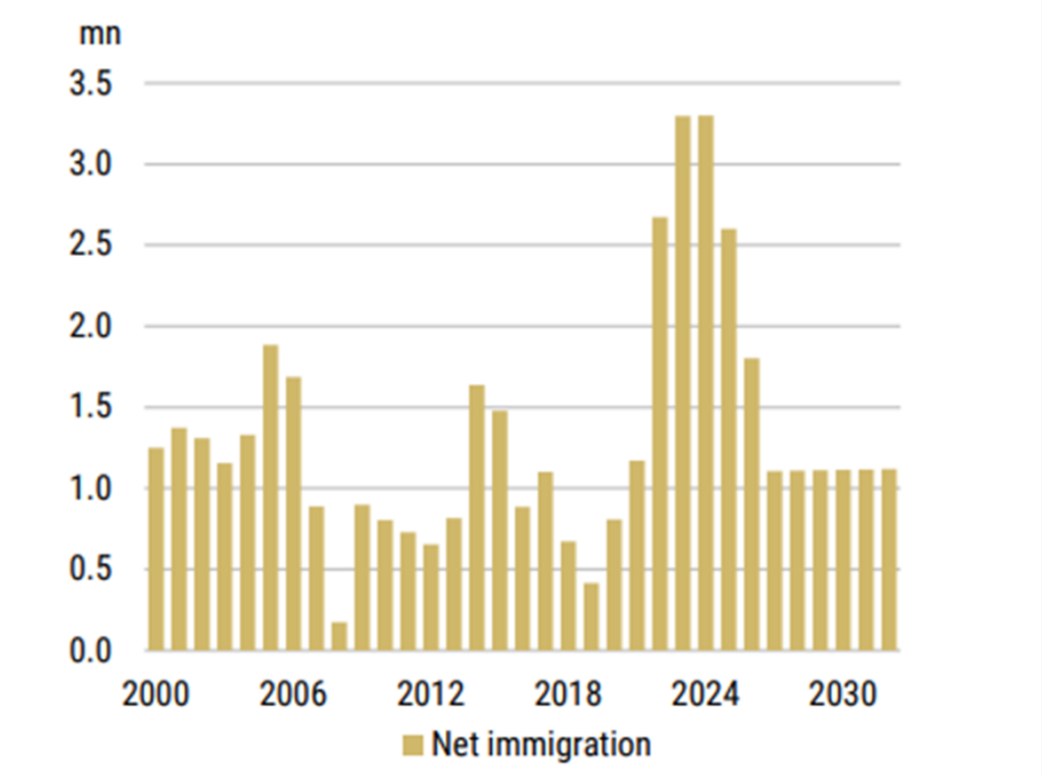
This level of government spending has led to an annual deficit that is unprecedented when looking back the past 55 years. Historically, the level of deficit or surplus ran by the US government has lined up nicely with the level of the unemployment rate. When the unemployment rate was high, the government would increase spending and run a deficit. When the unemployment rate was low, the government would let the economy do the heavy lifting and would often run a budget surplus. That is not the case today, as the government is running a large deficit while the unemployment rate is at historically low levels.

Fiscal Spending is Historically Elevated



Source: Haver, Morgan Stanley Research.

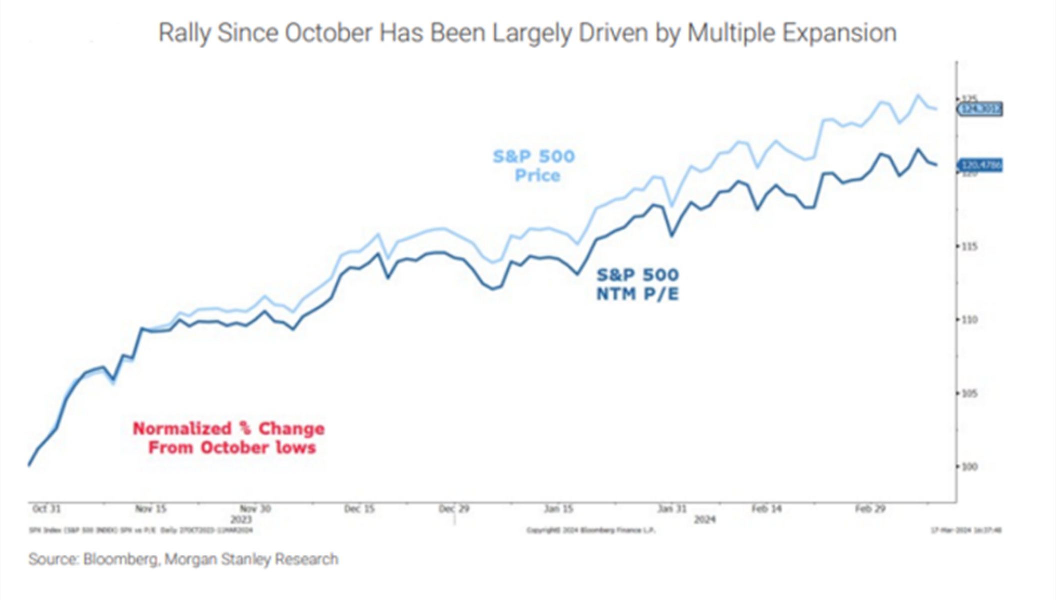
A third factor we believe is attributing to the economy starting to turn positive is the recent spike in immigration. Historically, spikes in the level of immigration have historically increased the level of economic activity in the short term as a higher population increases demand and production. Recently, the Congressional Budget Office estimated that immigration has risen to levels 2-3 times the levels of previous years. If these numbers prove to be accurate, the US has added approximately 5-6 million immigrants the past two years.



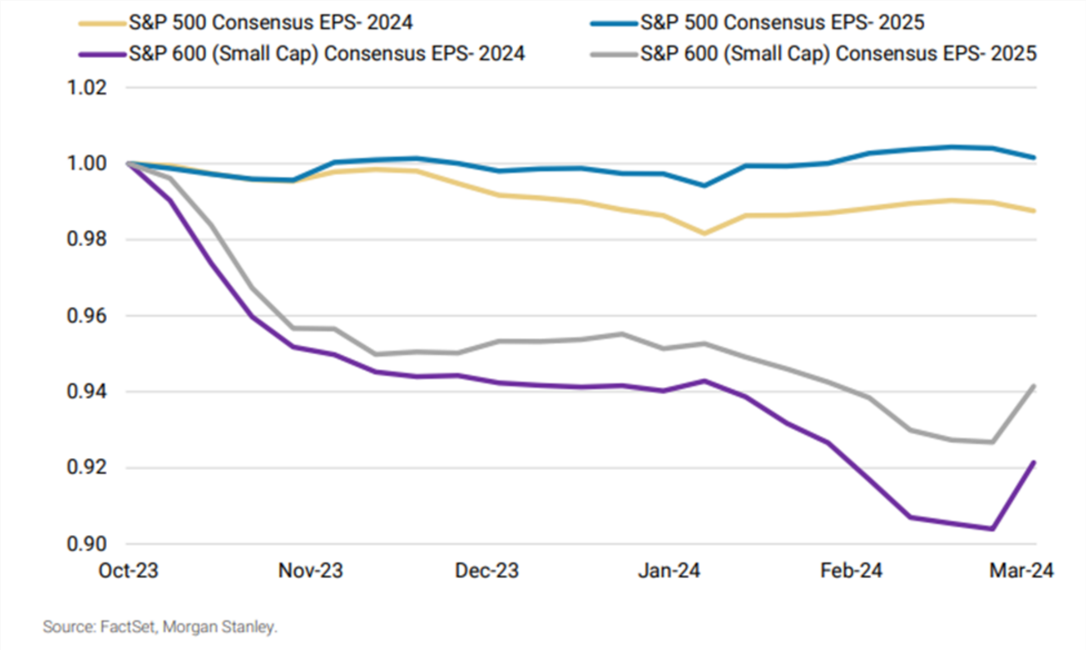
Source: CBO, Morgan Stanley Research

MARKET IMPLICATIONS

With financial conditions easing and the economic data starting to turn, the S&P 500 staged a significant rally over the past 6 months. Just days before the November Federal Reserve meeting, the S&P 500 hit a low of 4,103 on October 27th. (Source: FactSet) On March 17th, the S&P 500 closed at 5,117 near all-time highs. As seen below, that rally has been largely driven by multiple expansion or a rising Price/Earnings ratio for the index. We believe this expansion of valuation is mostly attributed to the easing of financial conditions.



As impressive as the rally has been the last 6 months, one thing that has been missing is the fundamental improvement of the S&P 500 companies' earnings. The expected earnings estimate of the S&P 500 for 2024 and 2025 have seen little or no improvement from that October 27th low in the S&P 500. As seen in the chart below, the S&P 500 earnings estimates for 2024 (Yellow Line) have decreased since the stock market rally started in October.

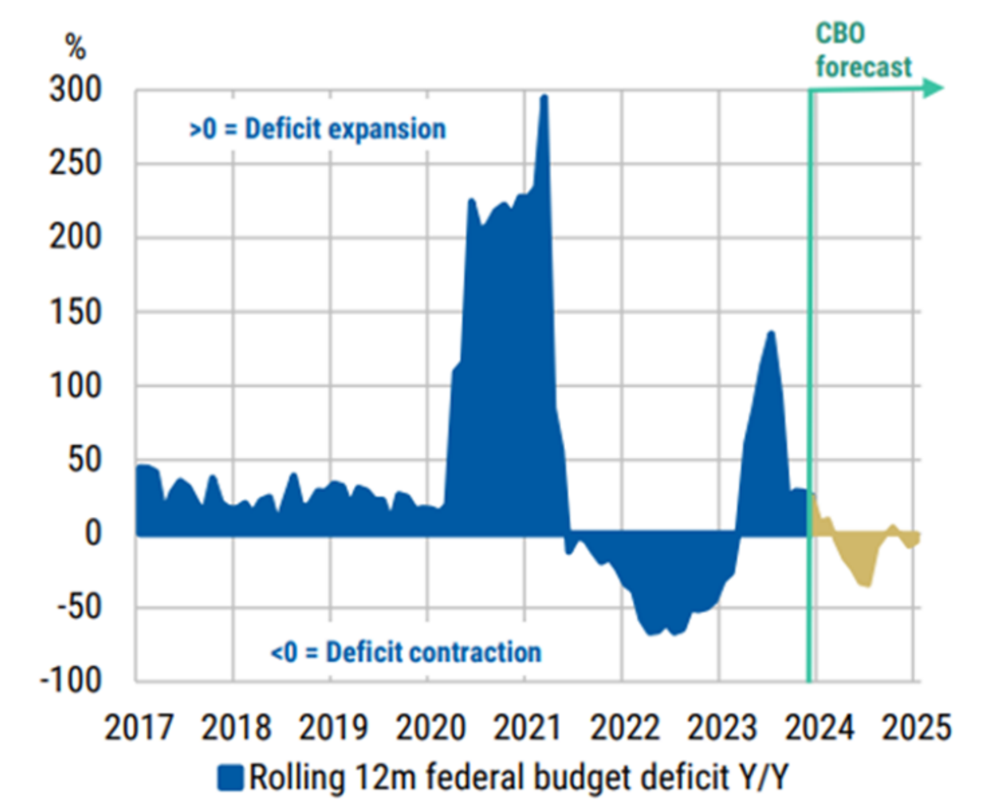


CONCLUSION

Over the past 18-24 months we have expressed our concerns about a potential downturn in economic activity and short-term returns of the S&P 500 leading us to remain cautious in the portfolios that we manage. With the Federal Reserve implying potential rate cuts soon and the easing of financial conditions, we believe the likelihood of an imminent downturn in the economy has decreased since the Federal Reserve announced their intentions at the November meeting.

We believe the conditions created from the Federal Reserve pivot, US Government deficit spending, and unexpected levels of immigration created an environment that has aided the recent rally in the S&P 500 driven primarily by valuation expansion. For this rally to continue, our view is that the earnings of S&P 500 companies must start improving at a similar rate.

We also believe that Government spending will continue to play a role in economic activity. As seen below, the Congressional Budget Office is forecasting the US will no longer be expanding the budget deficit over the next 12-18 months. We plan to monitor this forecast closely in the coming months as it could impact the level of economic activity in the US if correct. It is key to remember that the market will move based on short term headlines, but ultimately, the direction of the stock market is guided by economic and corporate earnings expansion or contraction.



Source: Morgan Stanley Research, Bloomberg

JOIN OUR WEBINAR

Enjoy this content? We'll be hosting our quarterly webinar on April 23rd at 6:00PM CST. We won't ask you to turn your camera on, but you'll be able to see us! Your name will also be hidden for complete client confidentiality.

Email allie.girardin@morganstanley.com for the Invitation and Registration Link

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