FOLLOWING THE FUNDAMENTALS

1ST QUARTER 2024: ISSUE 29

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

NEW YEAR...SAME ROLLER COASTER RIDE

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As a parent with two boys under the age of eight, life can seem like a roller coaster ride with the constant emotional highs and lows around my house. It is not uncommon for my children to transition from playing nicely with each other, to attacking each other, then back to being best friends within the span of 10 minutes. While not a perfect analogy, the price action of the S&P 500 over the past couple of years has felt like an emotional roller coaster ride for many of our clients. According to FactSet, the S&P 500 returned 26.89% in 2021, declined by 19.44% in 2022, followed by a return of 24.23% for 2023.

This past year was highlighted by the Federal Reserve announcing they planned to pause the interest rate hiking cycle at their November meeting. In our view, this announcement led to the ferocious rally that ensued the last 2 months of the year as the S&P 500 rallied 16.23% (FactSet) from the recent October 27th low. In this edition of Following the Fundamentals, we are going to recap current economic signals, stock and bond market reaction to a Federal Reserve pause/pivot, and why we believe the roller coaster ride for the S&P 500 isn't quite over yet.

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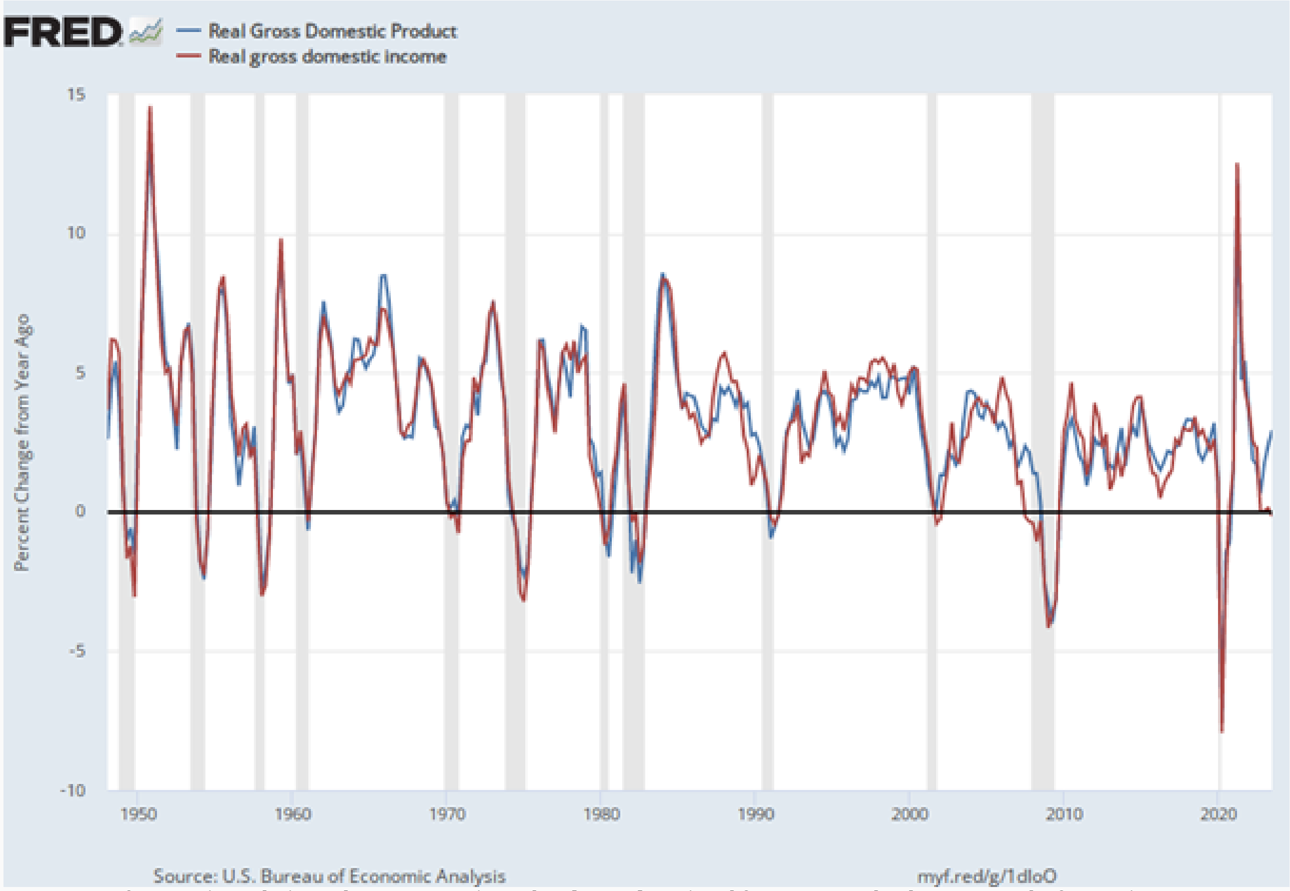
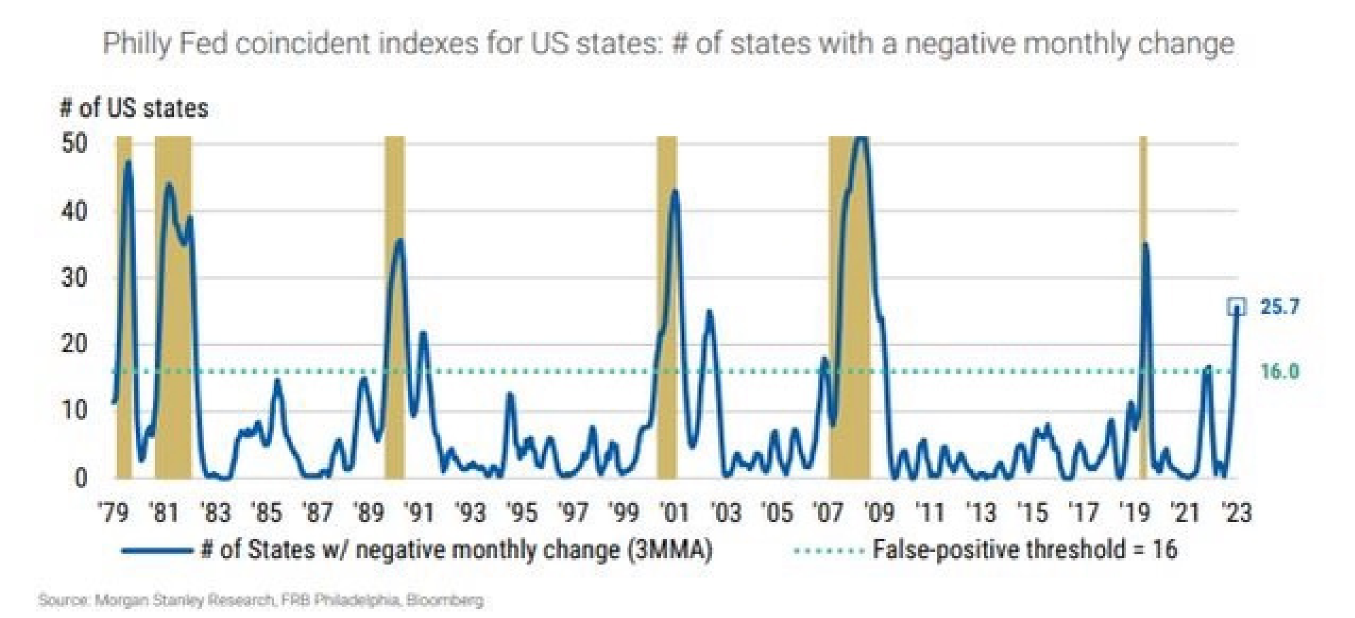
ECONOMIC SIGNALS

In last quarter's Following the Fundamentals update, we discussed the potential impacts the post Covid government stimulus packages were having on last year's Gross Domestic Product and Gross Domestic Income readings. As seen below, the measures of Real GDP and Real GDI have diverged over the past 12 months with GDP increasing year-over-year and GDI entering contractionary territory. Over the past 75 years, a contraction of GDI has correlated highly with US recessions shaded in grey below. In our view, those stimulus packages boosted GDP readings to levels they would not have been without the stimulus.

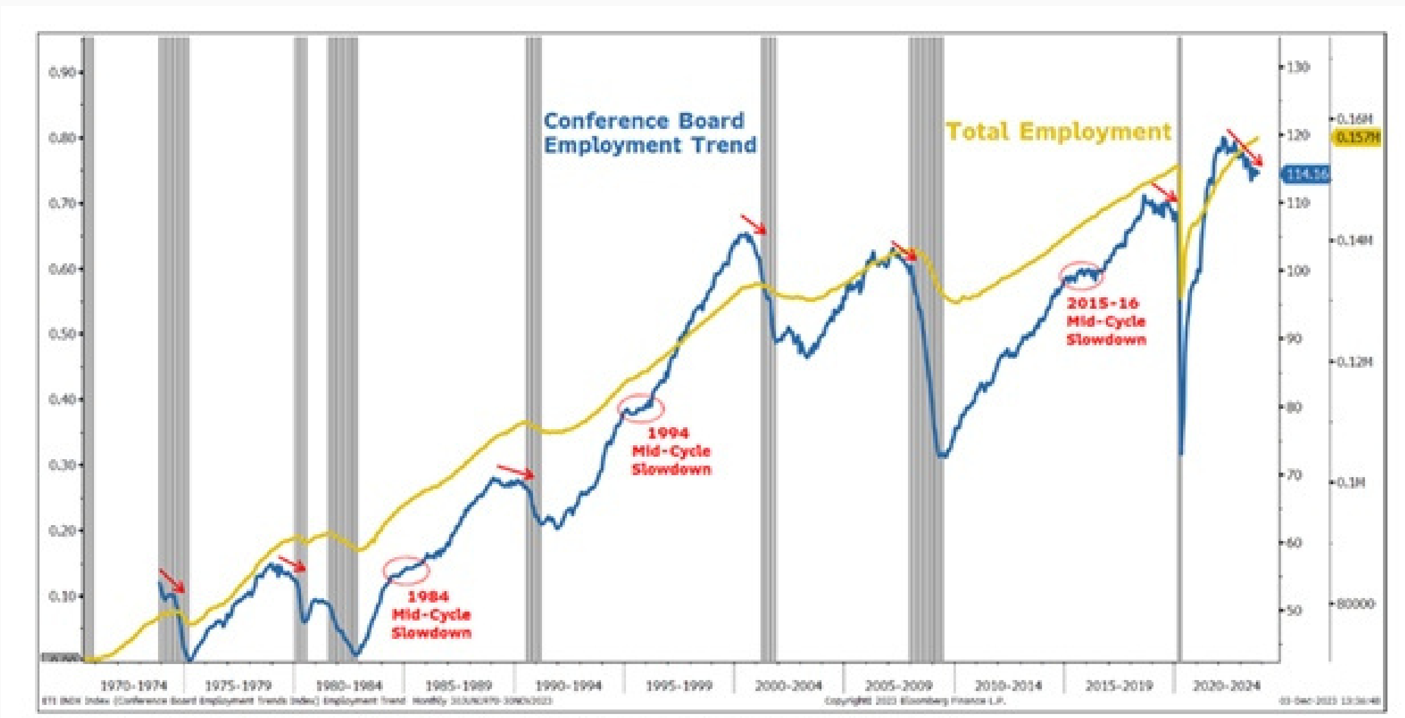


U.S. Bureau of Economic Analysis, Real Gross Domestic Product [GDPC1], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GDPC1, December 27, 2023

In additon to Real GDI entering contractionary territory, the Philidelpia Fed's coincident index for US state recently indicated that 26 of the 50 states recorded a negative monthly change. Over the past 55 years, a reading of over 16 states has correlated highly with the US recessions shaded in gold in the next chart.



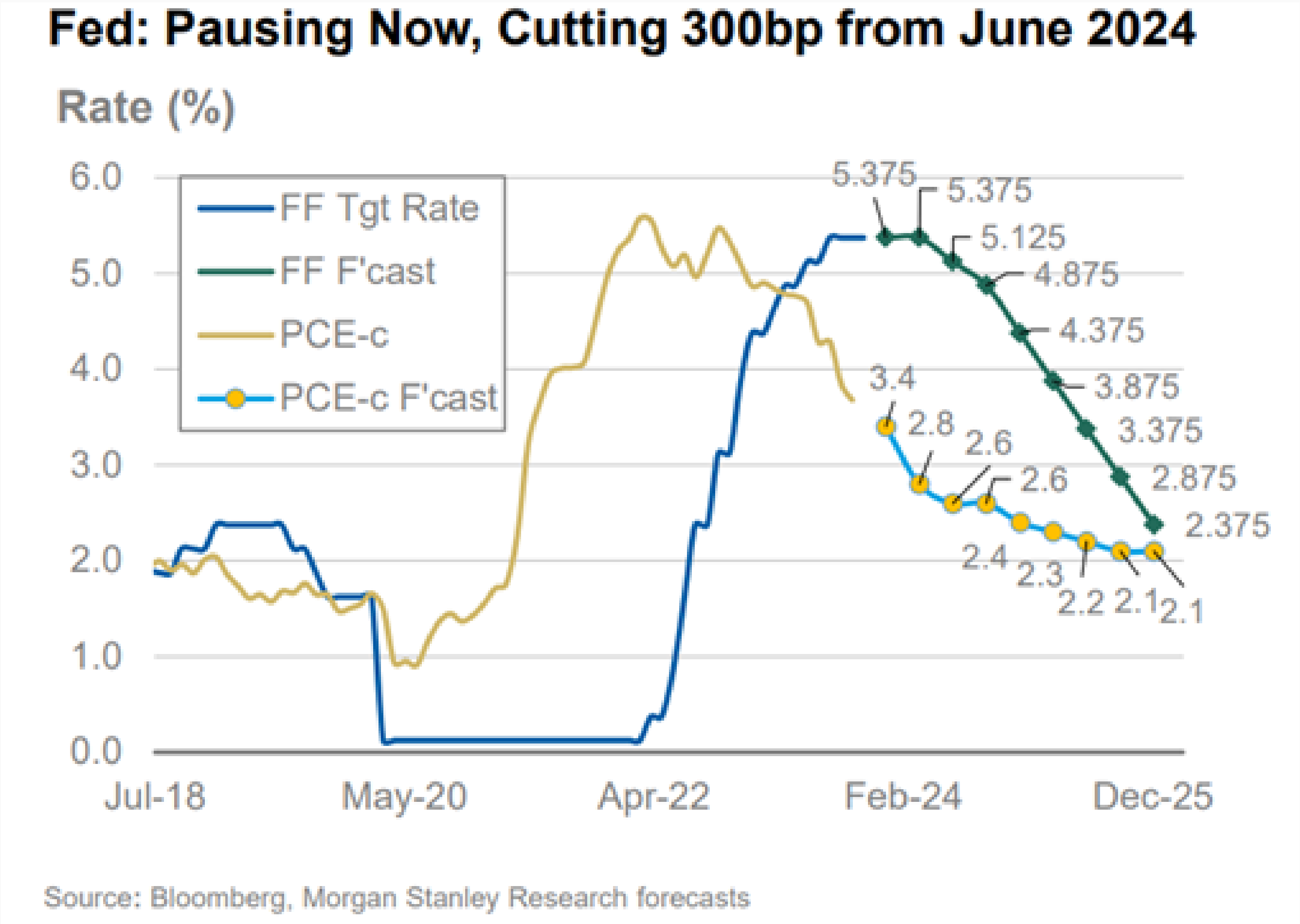
Focusing on the labor market, while the Total Employment numbers have looked fine, the trend of the labor market has been trending lower for the past 12-15 months. As seen below, the Conference Board Employment Trend turning lower has correlated highly over the past 55 years with the recessions highlighted in grey below. Notably, the three instances of a soft landing for the US economy, circled in red below, that avoided a recession did not see the Employment Trend turn downward.



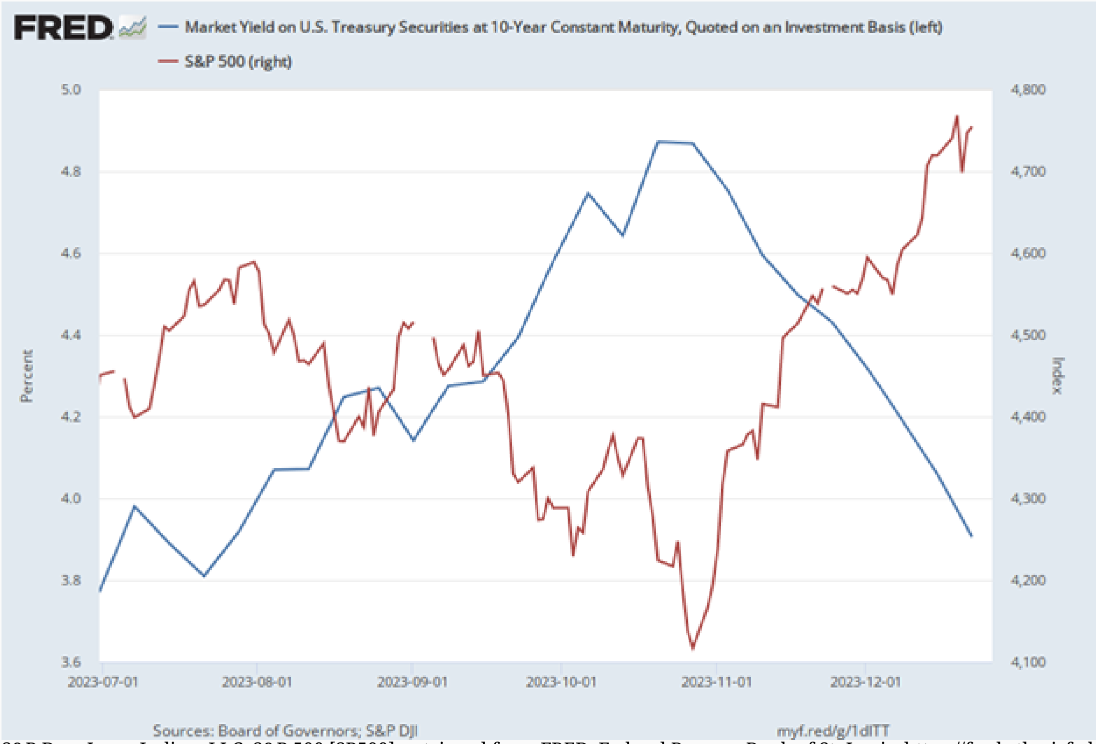
Source: Bloomberg, Morgan Stanley Research, Date: 12/8/2023

FED PAUSE/PIVOT

With economic and inflation readings slowing, the Federal Reserve made a dramatic pivot during their November meeting by formally announcing a near term pause from raising rates as well as increasing their expectations for rate cuts in 2024. The below chart shows Morgan Stanley's post-meeting updated forecasts for future levels of the Federal Funds rate and the Fed's preferred inflation gage, the Core Personal Consumption Expenditures Price Index.



The pivot from the Federal reserve at their November meeting took the market by surprise as the decision to pivot did not match the rhetoric from recent Federal Reserve member's public speeches. In our view, this surprise had immediate effects on the stock and bond markets. In the following chart, you can see the move the S&P 500 and 10-year Treasury Yield made after the November meeting. Over the last 60 days of the year, the 10-year Treasury yield dropped from roughly 5% to below 4% as the S&P 500 rallied into year end.



S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SP500, December 27, 2023.

While investors are cheering the rally that stocks and bonds experienced the last two months of the year post the Federal Reserve pivot, a look back at what has historically happened after a rate hiking cycle pause leads us to a less optimistic view of those markets near term. As seen below, when inflation is not elevated, the S&P 500 has experienced positive returns the last four times the Federal Reserve has paused a rate hiking cycle dating back to 1984. However, when inflation was elevated from 1969-1981, as we believe it is today, the short-term returns of the S&P 500 were not as favorable over the next 12 months after Federal Reserve pivot.

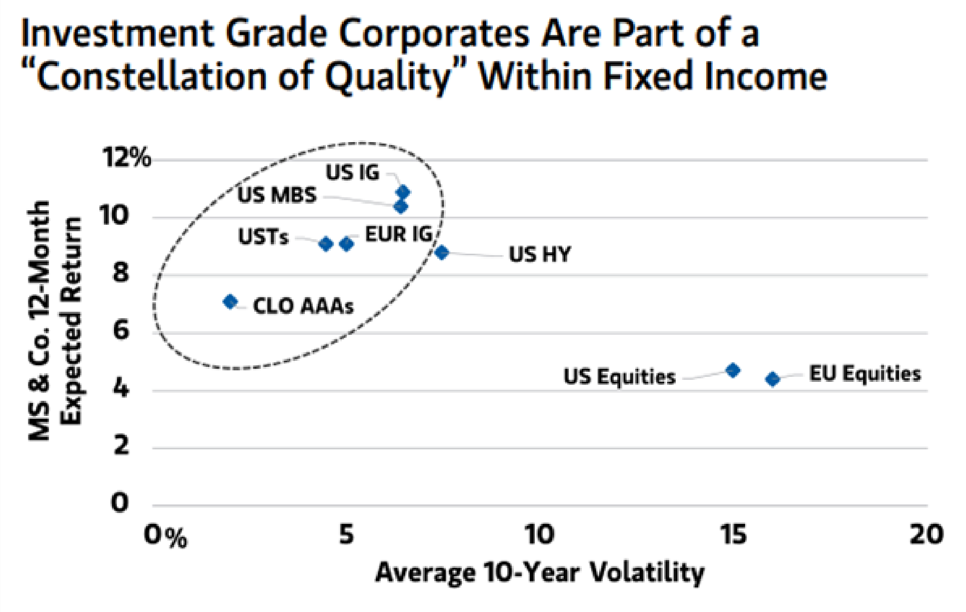
S&P 500 Returns Post Cycle Peak in Front-End Interest Rates

Peak Rate Year	Elevated Inflation?	Fwd. P/E at Peak Rate	3M Return	6M Return	9M Return	12M Return
1969	Yes	NA	-4.6%	-18.4%	-13.1%	-7.0%
1973	Yes	NA	-8.0%	-7.7%	-16.3%	-30.8%
1981	Yes	*7.5x*	-7.4%	-4.7%	-14.7%	-15.6%
1984	No	*7.6x*	8.4%	9.2%	17.9%	25.2%
1994	No	*12.2x*	9.0%	18.6%	27.2%	34.1%
2006	No	*14.0x*	7.9%	12.7%	16.1%	14.0%
2018	No	*15.9x*	0.9%	-0.3%	6.0%	13.8%
Avg.: Inflation Elevated			**-6.6%**	**-10.3%**	**-14.7%**	**-17.8%**
Avg.: Inflation Not Elevated			**6.6%**	**10.0%**	**16.8%**	**21.8%**

Source: Haver Analytics, Bloomberg, Morgan Stanley Research. 1-year Treasury yield used for front-end rates. Elevated inflation is top 20% of historical CPI Y/Y levels. 1980 peak omitted due to the close proximity of the 2 early 1980s cycles and the fact that front-end rates made a secondary high shortly thereafter.

CONCLUSION

Over the past 18-24 months we have expressed our concerns about the short-term returns of the S&P 500 and have remained cautious in the portfolios that we manage. As seen in the chart below, we believe that the risk/reward skew currently favors the fixed income market where Morgan Stanley expects higher returns and less volatility over the next 12 months compared to US Equities. Until these expectations flip, we expect we will continue to be overweight bonds vs stocks in the portfolios we manage.



Source: Morgan Stanley & Co. Research as of Nov. 12, 2023

As we have stated before, while we are still cautious on stocks short term, we are bullish in the medium to long term as the Millennial & Gen Z generations mature. As these generations gain employment, form families, and build homes, we believe the economy of the US will see significant growth leading to growth of earnings for the companies we invest in. 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.

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Enjoy this content? We'll be hosting our quarterly webinar on January 16th 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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Investors should carefully consider the investment objectives and risks as well as charges and expenses of a mutual fund before investing. To obtain a prospectus, contact your Financial Advisor or visit the fund company's website. The prospectus contains this and other important information about the mutual fund. Read the prospectus carefully before investing.

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You could lose money by investing in a Money Market Fund. Because the share price of the Fund will fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. The Fund may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

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