On Point

INVESTMENT STRATEGY STATEMENT

April 2024

SouthState
WEALTH

Equity Markets

Stock Prices Rose in March Following Dovish FOMC Meeting

Investors spent the first half of March digesting the somewhat firmer than expected inflation reports for the first two months of the year and signs that the economy is maintaining solid forward momentum. Treasury yields rose to mid-month, with the yield on the ten-year Treasury rising 16 basis points to 4.34%, while the two-year Treasury yield rose 21 basis points to 4.74%. This led investors to focus on whether Federal Reserve officials would still project three rate cuts this year at the March FOMC meeting, or a lesser amount.

The three major large company stock indices rose to new highs following the FOMC meeting following a narrow majority of FOMC Committee members reaffirming projections to cut rates three times this year and raised their forecast for the economy's growth rate.

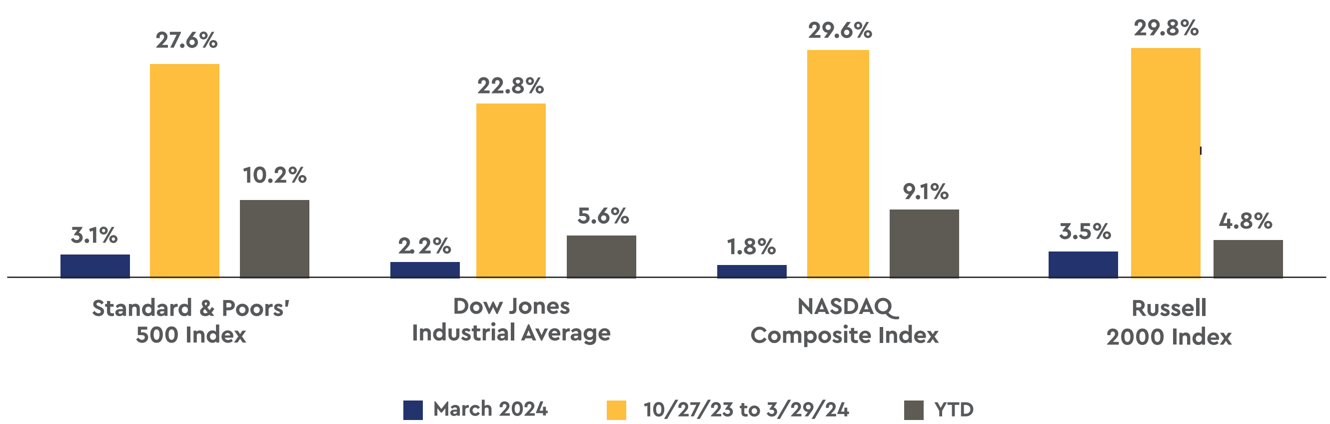
Monetary policy continues to be a key focus of investors as the stakes are high for Federal Reserve officials, who are trying to thread the needle between two risks. One is that they ease policy too soon, allowing inflation to remain sticky and entrenched at a level above the Federal Reserve's 2% inflation target. The other risk is that they move too slowly, keeping policy in restrictive territory for too long a period of time, eventually pushing the economy into an unnecessary recession under the weight of too high real rates.

▲ **S&P 500 10.2%**	▲ **NASDAQ 9.1%**
▲ **DJIA 5.6%**	▲ **Russell 2000 4.8%**

YTD Index Performance as of 3/29/24

For the month of March, the major stock market measures rose 1.8% to 3.5% with investors focusing on companies that will benefit from faster revenue growth and improved efficiency arising from the ongoing development of artificial intelligence. The S&P 500 and the NASDAQ Composite rose 10.2% and 9.1%, respectively, over the course of the first quarter, while the DJIA and the Russell 2000 index of small company stocks gained 5.6% and 4.8%, respectively. The major stock market measures are higher by 22.8% to 29.8% since the recent low for the S&P 500 on October 27.

Major Stock Market Indices – Prices Change Only



Source – Bloomberg

The Data Will Drive Federal Reserve Policy

The tone of the policy statement and Chair Powell's press conference following the March 19–20 FOMC meeting was very similar to the tone of the January FOMC meeting, namely be careful, watch, and wait. In a move that surprised no one, the FOMC Committee voted unanimously to leave the policy range for the federal funds rate unchanged at 5.25% to 5.50%. The policy statement was almost identical to the January statement save for an upgrade on its jobs growth assessment to "strong" from the January characterization that job gains had "moderated."

The policy statement repeated the statement that "The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent." This statement implies that the Federal Reserve is in no hurry to cut rates because it does not want to cut rates in the near term and later on this year be put in a position where it needs to consider raising rates again to cool down a too hot jobs market and a rekindling of inflationary pressures.

However, Chair Powell repeated that the federal funds rate is "likely at its peak for this tightening cycle." He again characterized the level of rates as "restrictive," and said that "it is likely to be appropriate to begin reducing rates this year."

He went on to say that the Committee engaged in an in depth discussion of slowing the pace of quantitative tightening – the monthly runoff of maturing Treasury and mortgage-backed securities held on its balance sheet – and that it seems "appropriate to slow the pace of runoff fairly soon," from the current pace of $95 billion per month.

The markets were also encouraged by the forecasts of the 19 members of the FOMC Committee found in the Summary of Economic Projections. The economy is now projected to grow 2.1% in 2024 from the 1.4% estimate in December, which brightens the outlook for corporate earnings.

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The majority of Committee members still expect three rate cuts this year despite Chair Powell acknowledging that reported inflation had been stickier than anticipated over the first two months of the year. Mr. Powell stated that the latest data "have not really changed the overall story, which is that of inflation moving down gradually on a sometimes bumpy road toward 2%."

The expectation for the unemployment rate shifted down to 4.0% from 4.1% and is expected to roughly hold at that level through 2026, while core inflation expectations rose slightly to 2.6% from 2.4%, but remain slightly below most recent reading of 2.8%. Inflation is expected to reach the Federal Reserve's target of 2% by 2026 same as in December. The projections suggest that the central bank does not believe that a recession is necessary for the disinflationary trends in the economy to remain in place.

In lieu of rate cuts, the Federal Reserve is currently signaling additional rate hikes are no longer on the table and that it will remain data dependent regarding both the timing and magnitude of future rate cuts. Ever since the December FOMC meeting, Chair Powell has made it clear that the Federal Reserve does not want to cut rates before it is responsible to do so, but will start the rate cutting cycle as soon as it is responsible to do so.

Rate cuts are on the table this year because the Federal Reserve is keenly aware that failing to lower the target range for the federal funds rate will bring about an inadvertent tightening of monetary policy as the real, or inflation-adjusted, policy rate increases as the pace of inflation slows. On that score, using the core PCE inflation measure, the real federal funds rate has increased to 2.6% currently from 1.2% last summer with no rate hike taking place following the July hike. The market currently has a 64% probability of a June rate cut, with two more to follow this year.

So, watch the data, just as the FOMC Committee is doing. The key is that the next policy move by the Federal Reserve will be a rate cut and that more than one cut could occur this year, the timing is not nearly as important. For the economy and the financial markets, the former headwind of Federal Reserve policy is likely to become a tailwind as rate cuts come into play. The data will determine the timing and extent of the rate cuts. As always, stay tuned!

Four Big Themes Are Driving the Markets

One thing we all know for sure today is that nothing about inflation or the economic cycle have been normal over the past couple of years. However, we viewed the backdrop as 2023 unfolded as much more positive than the 2022 backdrop of the Federal Reserve pivoting to a restrictive monetary policy stance, which required a major reset in the financial markets. While there are always risks to the outlook for the economy and the financial markets, it appears to us that the backdrop is reasonably positive for common stocks, as well as for Treasury and corporate fixed income securities, as the markets navigate the remainder of 2024 and look ahead to 2025.

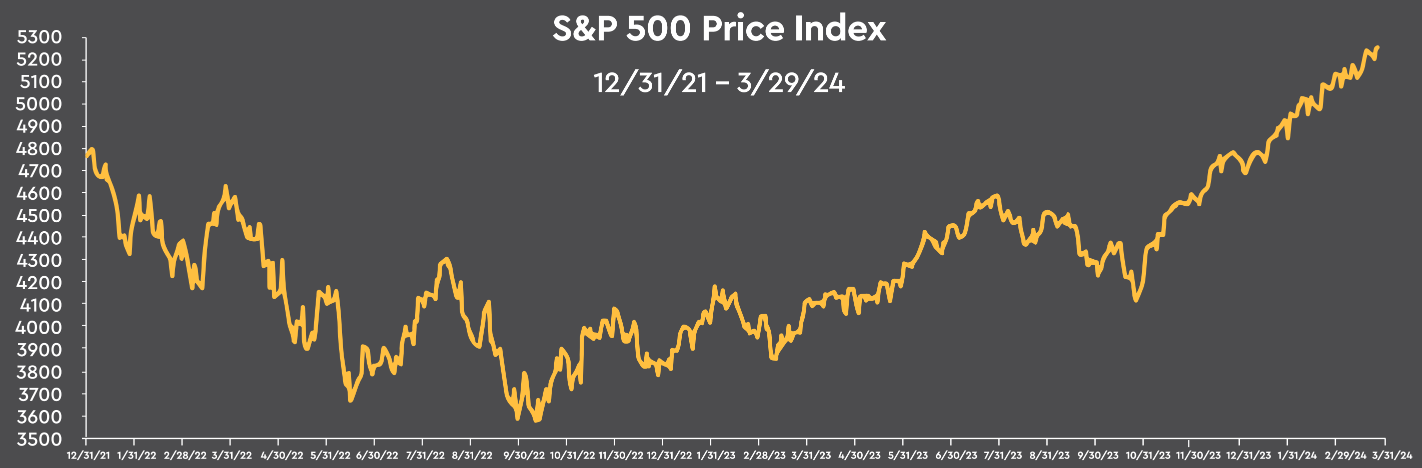
Consider four big themes that are currently driving the markets. The economy's inflation rate has fallen sharply from the surge in pricing pressures to the peak in 2022. Much of the inflation surge was transitory in nature – over roughly 18 months, not 2 to 3 months – and dissipated as supply chain disruptions and bottlenecks were repaired, while a rebound in labor supply from rising immigration and higher workforce participation has eased the upward pressure on wages.

The shelter component of the consumer price index continues to distort the inflation data to the high side. The shelter component is higher by 5.7% year-on-year, contributing 68% of the reported 3.8% increase in the core CPI. However, rent prices fell for six months in a row before rising 0.2% in February according to the Apartment List National Rent Report, and are lower by -1% over the past twelve months. The good news is that further downward pressure on the inflation data is in the pipeline as falling rents will eventually show up in the data with a well documented lag. With the core CPI ex-shelter higher by 1.2% year-on-year, it appears the disinflation narrative in the economy is in full effect.

The resiliency of the jobs market in 2022 and 2023 – where a decline in open positions rather than actual jobs losses supported household incomes and consumer spending – was a major factor why the economy avoided the widely anticipated recession in 2023, following the aggressive tightening of monetary policy by the Federal Reserve to combat the surge in inflationary pressures. Additionally, the economy turned out to be not nearly as interest rate sensitive as it was during previous business cycles as households and businesses locked in very low financing rates following the Financial Crisis through the end of the pandemic.

While the overall economy did not fall into recession last year, the economy did experience a series of sector specific recessions and recoveries over the past two years that were not coordinated – such as auto production, homebuilding, and business capital spending on structures – leading to rebounds in certain sectors offsetting downturns in other sectors. Currently, the economy's growth rate is slowing to a range of 1.5% to 2.0% following a gain of 2.5% in 2023 as job gains slow and high borrowing costs cut into discretionary purchases.

The progress on easing inflationary pressures and a slower pace of economic growth led to the policy pivot by the Federal Reserve at the December FOMC meeting. By most accounts, the Federal Reserve is succeeding in bringing the economy in on a soft landing. As mentioned previously, Federal Reserve officials are signaling that they are in no



Source – Bloomberg

hurry to lower rates as they want greater assurances that inflation is moving sustainably toward 2%.

It is pretty clear that rate cuts are ahead, but the timing is unclear, as they will be driven by the data. What is important is not the exact date of the first rate cut, but the direction the Federal Reserve is moving. To the extent that fewer rate cuts rather than more take place this year and the first rate cut gets pushed out further than the June FOMC meeting as the markets currently expect, that means the economy did not need as much support as was anticipated at the beginning of the year.

Finally, with the economy not tumbling into a recession last year, operating earnings on the S&P 500 rebounded 8.4% in 2023 after declining -5.4% in 2022. The analysts at Standard & Poor's are looking for operating earnings to grow close to 13% over the four quarters of 2024. A growing economy with easing wage pressures and ongoing productivity gains should be positive for profit margins. Aggregate demand should continue to grow as households are supported by a healthy jobs market, just at a slower pace.

The Federal Reserve cutting rates and operating earnings growing is a somewhat rare combination, but a potentially potent one, and that possibility in the backdrop supporting common stock prices so far in 2024. Typically, when the central bank lowers rates, the economy was weak or actually in recession and earnings were under pressure. The so-called soft landing that occurred in 1995 was a notable exception, when the Federal Reserve cut the federal funds rate even as earnings for the S&P 500 companies grew. The S&P 500 gained 34.1% that year, which remains its single best annual return going back to 1958.

Looking at 1995 does not necessarily mean stock prices will post further gains this year. Inflation could rebound as financial conditions are eased, or the economy could trip into recession as the lagged effects of the aggressive tightening of monetary policy come into play. Additionally, stock prices could be running ahead of the fundamentals following the strong gains since late October.

While the decline in yields from late October to the end of 2023 and expectations for lower policy rates this year provided stocks with a push higher over the past five months, earnings will largely determine the path forward over the remainder of 2024. Fortunately, with the economy avoiding a recession last year, operating earnings have some positive momentum as 2024 unfolds.

Should the economy be more challenged this year than we expect, the Federal Reserve will likely make a quick course correction to a much more accommodative policy stance rather than following a gradually less restrictive path to kick the economy back into expansion. Artificial intelligence advancements will benefit the economy and many companies in a variety of ways, even if we do not precisely know all the ways at the moment. The innovators are working on it and the benefits will include lower costs and enhanced productivity, a greater supply of services, and improved quality of many services.

Treasury Market

Treasury Yields Rose in March on Firmer Inflation Report and Resilient Economy

Treasury yields rose modestly across the yield curve last month following another slightly firmer than expected read on consumer price inflation, with the yield on the ten-year Treasury note reaching a high of 4.34% midmonth, while the two-year Treasury yield peaked at 4.74%. However, yields eased a bit over the back half of the month, with the ten-year Treasury yield settling at 4.21% and the two-year Treasury yield at 4.63% following a fairly dovish March FOMC meeting that still pointed to three rate cuts this year and a further easing of core inflationary pressures.

With implied ten-year inflation expectations embodied in Treasury securities largely unchanged during March, largely all of the rise in Treasury yields can be attributed to better than expected growth in the economy. This has forced investors to accept that the Federal Reserve will likely hold rates "high for longer" than expected at the end of 2023 as the economy is maintaining solid forward momentum despite the federal funds rate remaining at a 17 year high and real rates rising as inflation cools.

Two other factors contributed to the rise in Treasury yields last month. First is the outsized supply of Treasury securities being issued given the massive federal budget deficits. The other is the "quantitative tightening" program the Federal Reserve kicked off in June 2022 whereby the central bank shrinks the size of its bond portfolio by $95 billion each month.

We continue to hold the position that the main message from the inversion of the Treasury yield curve is that the current level of interest rates and bond yields cannot hold as the economy and inflation cool further. As such, it looks to us that

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Treasury Market Talks to Federal Reserve

	Ten-Year Treasury Yield	(minus)	Two-Year Treasury Yield	(equals)	Yield Spread
9/30/21	1.49%		0.28%		121bp
3/07/23	3.98%		5.07%		-109bp
10/31/23	4.93%		5.04%		-11bp
12/29/23	3.87%		4.25%		-38bp
2/29/24	4.18%		4.53%		-35bp
3/29/24	4.21%		4.63%		-42bp

Source – Bloomberg

the Treasury market is poised to take a run at 4% over the course of the year for several reasons. The ongoing disinflationary forces in the economy and a further slowing in the economy's growth rate from the 2.5% pace in 2023 should provide Treasury yields with some room to fall.

The Federal Reserve should also help by eventually cutting rates – if only to push back against the passive tightening of policy as inflationary pressures continue to ease. Additionally, Chair Powell said at the press conference following the March FOMC meeting that it seemed appropriate to slow the current monthly runoff of $95 billion of maturing Treasury and mortgage-backed securities "fairly soon."

The path to lower Treasury yields is unclear, but will be driven by the economic data, just as the pace of easing monetary policy by the Federal Reserve will be.

We expect more significant declines in yields on two-year to five-year (4.22%) Treasury yields over the next 12 to 24 months as the Federal Reserve follows through on a series of rate cuts. We look for a normal, positive slope of the Treasury yield curve to return by late 2024 or early 2025 as the rate cutting cycle gets underway.

The backup in Treasury yields so far this year is providing investors with another opportunity to add to their fixed income portfolios, or initiate a fixed income allocation, at attractive yields. The path to lower Treasury yields is unclear, but will be driven by the economic data, just as the pace of easing monetary policy by the Federal Reserve will be.

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