SouthState WEALTH

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On Point

INVESTMENT STRATEGY STATEMENT

The recent data supporting solid forward momentum in the economy and a stalling of the disinflationary trend of 2023 leaves the Federal Reserve in a position to remain on pause, possibly for all of 2024. As we stated last month, while Federal Reserve officials have indicated a desire to cut rates this year, they remain in no rush as additional evidence is preferred that both inflation is moving consistently toward the Fed's 2% target, and labor markets are loosening.

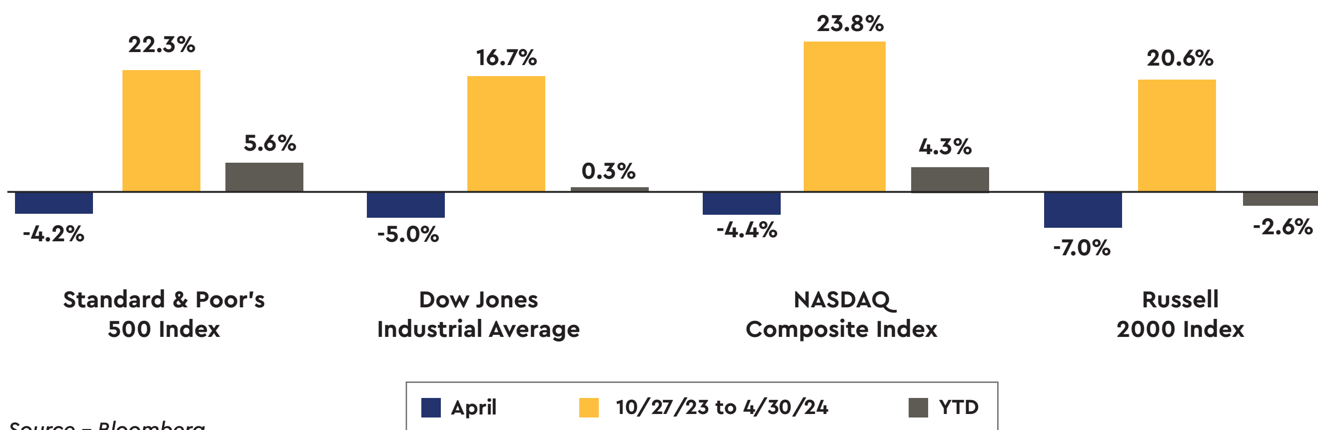
Equity Markets

Federal Reserve Resets Rate Cut Expectations.

Following five months of very strong gains, stock prices fell in April as investors were concerned about the rise in yields on Treasury securities, mounting geopolitical tensions, and the Federal Reserve's path to lowering the policy rate. The market's patience is being tested as the consumer inflation data thus far in 2024 has not followed the disinflationary trend of 2023. Both the headline and core CPI measures for March rose 0.4%, and are higher by 3.5% and 3.8% year-over-year, respectively.

With the reported inflation measures running closer to 4% compared to the Federal Reserve's 2% target, the market continues to reset its expectations for the timing and magnitude of rate cuts this year. Not long ago the markets were expecting a rate cut in

Major Stock Market Indices – Price Change Only



Source – Bloomberg

March, but that day has long passed. Then it was June, but that probability has collapsed, with July now at roughly a 25% probability and September at 49%. The expectation for the number of cuts this year has correspondingly fallen from six or seven at the beginning of the year, to the Federal Reserve's March forecast of three cuts, to a current probability in the futures market of one rate cut.

The central bank has paused rate hikes since the last hike in July, and officials at the Federal Reserve have indicated that they are looking for the data that gives them a reason to conclude that it is responsible to start the rate cutting cycle. However, they remain reluctant to start cutting rates if there are any concerns that it is not responsible to do so.

The latest update from Chair Powell came mid-month at a question and answer session in Washington. Mr. Powell confirmed that firmer inflation readings this year called into question whether the Federal Reserve would be able to cut rates this year, a clear shift in the central bank's outlook. He stated, "The recent data have clearly not given us greater confidence and instead indicate that it is likely to take longer than expected to achieve that confidence."

Chair Powell went on to say that rates would be held at their current level "as long as needed" if inflation proves more difficult to subdue, allowing the current moderately restrictive policy stance further time to work. Mr. Powell's comments suggest the central bank will need to see several monthly inflation readings pointing to easing pricing pressures to gain the confidence that it is looking for, effectively delaying rate cuts until later in the year, if not into 2025. Given these developments, there is no expectation the FOMC

▲ **S&P 500 5.6%**	▲ **NASDAQ 4.3%**
▲ **DJIA 0.3%**	▼ **Russell 2000 -2.6%**

YTD Index Performance as of 4/30/24

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Committee lowers the target range for the federal funds rate at the May FOMC meeting.

Geopolitical concerns were heightened mid-month as Iran telegraphed in advance that it would attack Israel in retaliation for a suspected strike that killed senior Iranian military personnel in a diplomatic compound in Syria at the beginning of the month. After weighing its response to Iran's first ever direct attack on Israel for several days, Israel retaliated with a limited strike which appears to have been aimed at avoiding an escalation of tensions.

While the Middle East remains a dangerous situation, the reluctance of all parties involved to bring about an all out war provided hope that the disruption to markets, from oil to common stocks, would be short-lived, allowing market sentiment to shift from fear to relief. With stocks reaching a near term oversold condition, the earnings backdrop consistent with the broader story of growth remaining reasonably strong, and the March read on core consumer inflation being in line with expectations, investors bought the dip in stock prices last week, narrowing the extent of the losses on the month.

The major stock market measures fell -4.2% to -7.0% during April. On the year-to-date, the advance in the S&P 500 is now 5.6%, while the NASDAQ Composite is higher by 4.3%, the DJIA is higher by only 0.3% and the Russell 2000 is now negative on the year at -2.6%. The major stock market measures are still higher by 16.7% to 23.8% since the recent low for the S&P 500 on October 27.

The Economy Grew at a Solid Pace in 1Q 2024, No Signs of Recession on the Horizon.

Despite the reported 1.6% annualized rate of growth reported for 1Q 2024, the economy grew at solid pace to start the year. Consumer spending advanced at a healthy 2.5% rate, a touch slower than the 3.3% gain in the final quarter of 2023. The ongoing shift in household outlays from goods to services following the pandemic and the reopening of the economy continues, with spending on goods falling at a -0.4% pace while outlays for services posted a strong 4.0% gain. The tightening of monetary policy since March 2022 and the higher borrowing costs it brings is also negatively impacting the demand for goods.

Business capital spending rose at a 2.9% pace, led by a 5.4% gain in intellectual property products as the development of artificial intelligence is providing a push to literary and artistic works, designs, images, computer code, etc. Outlays on equipment grew at a 2.1% rate, led by gains of 12.2% for computers and related equipment and 17.8% for industrial equipment as the latest advances in technology are in strong demand. Spending on structures was largely flat at -0.1% as the lagged impact from tighter lending standards takes hold, the fiscal support from the Chips and Science Act is beginning to wane, and the glut of office space weighs on the commercial real estate market.

Despite housing affordability remaining near all-time lows, residential construction outlays were the strongest sector of the economy, surging at a 13.9% annual rate. The market for existing homes remains locked up as many homeowners are unwilling, or cannot afford, to give up their 2.5% to 4% mortgages. Existing home sales are running just above 4 million at an annual rate, compared to a 5 to 5.5 million run rate prior to the pandemic.

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In response, many prospective homebuyers have turned to new construction as homebuilders are helping by shrinking square footage, trimming amenities, and buying down mortgage rates. The drop in mortgages rates early in the first quarter also supported homebuilding, but that support is ebbing currently as thirty-year mortgage rates have risen above 7% again with the recent backup in Treasury yields.

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The soft headline real GDP growth rate resulted from a slower build in inventories and a further deterioration in net exports which subtracted -0.4 and -0.9 percentage points from the economy's growth rate, respectively. The negative contribution from foreign trade came from a very strong 7.2% gain in imports, while the strong dollar and slowing global growth weighed on exports which grew at only a 0.9% pace. Having both trade and inventories provide negative contributions in the same quarter is a significant drag on real GDP growth, but likely temporary.

The best gauge of the underlying momentum in the economy last quarter was found in the 3.1% annualized gain in real domestic private final sales which is the sum of consumer spending, business capital spending, and residential construction outlays. This core measure of the economy strips out the short term volatility that can arise from inventories, international trade, and government spending. The 3.1% pace is about one percentage

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point higher than the economy's long run growth rate, but slightly below the 3.3% growth rate in 4Q 2023.

Without a doubt, the inflation data was the most concerning news in the report as the Gross Domestic Purchases price index rose at a 3.1% rate last quarter, almost double the 1.6% rate in 4Q 2023. On a year-over-year basis, however, the price index was higher by only 2.3%. Moving to the Federal Reserve's preferred inflation measure, the core PCE price index rose at a 3.7% rate, quite a bit above the 2.0% readings of the previous two quarters.

However, on a year-over-year basis core PCE inflation did drop to 2.9% in 1Q 2024 compared to 3.2% in 4Q 2023. Turning to the monthly data, the March pace for core PCE inflation was 2.8%, the lowest year-over-year monthly read for inflation since March 2021. A detailed look at the monthly data also showed that the jump in pricing pressures in 1Q 2024 stemmed mostly from an upward revision to January's inflation reading, which was likely due to difficulty in seasonally adjusting "start of the year" price adjustments.

An in-depth review of the inflation data does not point to a widespread pickup in pricing pressures. Prices on consumer goods actually fell at a -0.5% pace, while residential construction and business capital spending saw price gains at rates of only 0.6% and 1.4%, respectively. All of the inflationary pressures in the private economy were found in consumer spending on services, which rose at a 5.4% rate.

Wages are the culprit, as wages and salaries in services producing industries rose at a 6.1% annual rate last quarter. With spending on services strong, businesses were able to pass along the higher labor costs to customers. Some easing of demand for services, along with some cooling of demand for labor will be necessary to ease pricing pressures in the services sector. Rising prices and wages in the service sector support a Federal Reserve policy outlook of fewer than previously expected rate cuts arriving later than previously expected.

Last quarter's report on the economy is broadly consistent with the Federal Reserve bringing the economy in on a soft landing with the private domestic economy continuing to grow, but with few signs of a further acceleration requiring additional rate hikes or the threat of recession requiring rate cuts in the near term. The data points to the Federal Reserve keeping policy moderately restrictive for the foreseeable future, which will continue to weigh on domestic demand, particularly for middle and lower income households.

We look for the economy's growth rate to be in the range of 1.5% to 2% over the next couple quarters, a bit slower that the 3.1% advance in the core economy last quarter and the 2.5% growth rate in 2023. Look for outlays on services to slow as discretionary spending will increasingly get squeezed as the cost of necessities has far outpaced wage gains over the past two years, along with mounting non-mortgage interest payments and the personal savings rate falling to 3.2% in March compared to 5.2% a year ago. We expect job gains to ease from the 276,000 average monthly gain so far this year.

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The Backdrop Remains Reasonably Positive for Common Stocks.

We have held the position for several months that the mix of inflation trending toward the 2% target, the economy slowing but not falling into recession, the Federal Reserve following through on its December policy pivot to cut rates, and earnings continuing to grow would support higher common stock prices in 2024. In light of the recent data releases and the expectation that rate cuts will be fewer and later, have we changed our position? The answer is no, although the outlook may be a little less rosy than it was at the start of the year and the trends may just take a little longer to play out.

First on inflation, the distortions from the pandemic continue to impact the pattern of economic growth and the disinflationary trend from the peak in inflation in mid-2022. The shelter component (5.7% higher year-over-year) of the CPI continues to distort the inflation data to the high side, and now motor vehicle insurance (22.2% year-over-year gain) is adding to the upward bias. These are the two most backward-looking components of the CPI.

The New Tenant Rent Index – which uses a subset of the rent data the Bureau of Labor Statistics uses in the official CPI to measure prices renters would face if they changed housing units each quarter – was higher by only 0.4% year-over-year in 1Q 2024, a much more benign read on shelter costs. The roughly 18 month lag with which real time rent prices factor into the CPI is a well-documented distortion of reported inflation to the high side currently. Over time, reported shelter inflation is expected to come in line with cooling real-time market rents.

Motor vehicle insurance rates lag new and used vehicle prices by 12 to 18 months. The two reasons for higher motor vehicle insurance costs currently are that new and used prices for cars, SUV's, and trucks are nearly 30% higher than in June 2020 and vehicle repairs are increasingly more expensive due to advanced technologies in vehicles such as microprocessors, cameras, and other sensors. Shelter and motor vehicle insurance accounted for 89% of the 3.8% year-over-year rise in the core CPI reported for March.

The economy remains resilient with growth exceeding expectations which bodes well for earnings. With the recent rebound in stock prices toward the end of April, it appears common stock investors prefer a better outlook for the economy and earnings over rate cuts arising from a weakening economy. So far, with 51% of companies reporting, operating earnings for the S&P 500 companies are projected to grow 5.6% year-over-year in 1Q 2024, following the 8.4% gain over the four quarters of 2023.

For anyone fearing that a recession is on the horizon, we suggest taking a look at the messaging being sent from the credit markets regarding the outlook for the economy. Once fixed income investors sense a serious downturn in the economy is approaching, they require additional yield on both investment grade and non-investment grade corporate debt compared to Treasury yields to be compensated for the greater default risk.

Currently, the yield spread on both investment grade and non-investment grade corporate debt is below the average yield spread. Namely, the current yield spread on investment grade corporate debt is 90 basis points, while the average yield spread since December 1996 is 152 basis points. Likewise, the yield spread on non-investment grade corporate debt is 312 points, compared to the average yield spread since December 1996 of 542 basis points.

We would be far more worried about the path ahead for the economy if credit yield spreads were running above their averages, but that is not the case currently. In our view, the narrow credit spreads and the low level of initial unemployment insurance claims are the key soft landing gauges to monitor.

While earnings growth is largely dependent upon continued growth in the economy, it is also true that earnings growth bodes well for a continuation of the economic expansion because the economy tends not to fall into recession during a positive earnings cycle. Companies that are growing earnings are not under pressure to cut jobs, so the jobs market stays healthy, households maintain their incomes, and are not forced to pull back on spending.

This leaves us with the outlook for monetary policy. We continue to expect that the next policy move by the Federal Reserve will be a rate cut, and that the direction of policy is much more important than the timing of the first rate cut. With the distortions in the reported inflation data, an inadvertent tightening of monetary policy is taking place as the real, or inflation-adjusted, policy rate increases with the underlying pace of inflation slowing with the federal funds rate unchanged since July.

This is the primary reason keeping rate cuts on the table this year and into 2025 for the Federal Reserve and other central banks around the globe that are trying to bring their economies in on a soft landing – inflation returning to target without pushing the economy into recession. The ongoing passive tightening of monetary policy should slow the pace of economic growth further and reinforce the trend toward disinflation, but risks pushing the economy into recession if maintained too long.

The recent data showing solid forward momentum in the economy and a stalling of the disinflationary trend of 2023 leaves the Federal Reserve in a position to remain on pause, possibly for all of 2024. As we stated last month, while Federal Reserve officials have indicated a desire to cut rates this year, they are in no rush as they want more evidence that inflation is moving consistently toward their 2% target and the data will drive the timing and magnitude of any rate cuts. Currently there is even less urgency to cut rates because the jobs market continues to run strong.

Some analysts have even raised the question of whether the current target range of 5.25% to 5.50% for the federal funds rate will turn out to be the terminal rate for this hiking cycle, i.e., is there another rate hike or two in the offing? We think the bar for another rate hike is high at the present time, however, holding the current moderately restrictive target rate for a longer period of time should reinforce the disinflationary trend. We still describe the backdrop as a "high for longer" scenario, rather than a "higher for longer" scenario.

Despite the market pricing out the aggressive rate cutting cycle expected at the beginning of the year and a good portion of the three rate cuts found in the FOMC Committee's Summary of Economic Projection for 2024 released in March, the S&P 500 is still higher by 5.6% through April. We would cite two reasons for the higher stock prices. One is the expectation that earnings will support those higher stock prices as the economy remains resilient despite rate cuts being pushed out.

The other reason is that investors are encouraged by the steadfast commitment by Chair Powell and the other members of the FOMC Committee to bring inflation down to the 2% inflation target.

In the near term, the backup in Treasury yields since the beginning of the year and the possibility that yields could rise further pose the biggest risk to stock prices.

The other reason is that investors are encouraged by the steadfast commitment by Chair Powell and the other members of the FOMC Committee to bring inflation down to the 2% inflation target. Note that the inflation forecast embedded in ten-year Treasury securities was 2.4% on October 27 at the recent low for the S&P 500, 2.2% at year end 2023, and remains at 2.4% at the end of April.

We all know there is nothing more detrimental to the efficient functioning of the economy and the financial markets than high and rising inflationary pressures. While the Federal Reserve waiting to gain greater confidence that inflation is on a steady path to 2% pushes out the likely start of the rate cutting cycle, the long run positives of returning inflation to a 2% trajectory outweighs any short run considerations of a further easing of financial conditions.

In the near term, the backup in Treasury yields since the beginning of the year and the possibility that yields could rise further pose the biggest risk to stock prices. While we do not view the firmer reported inflation data in 1Q 2024 as a reacceleration of inflationary pressures, if indeed that turns out to be the case, additional rate hikes and even higher Treasury yields should reset common stock prices lower.

Treasury Market

Treasury Yields Rose Further in April as Rate Cuts Are Pushed Out.

Yields across the Treasury yield curve were volatile last month but largely rose on the back of the somewhat misleading, but still hotter than expected CPI report, and a soft pivot by Chair Powell and the other Federal Reserve officials that reset expectations for the timing and magnitude of rate cuts this year. Tensions in the Middle East generated some safe-haven demand for Treasury securities, but it did not last.

Treasury yields finished April very close to their highs for the year, with the ten-year Treasury yield ending the month at 4.68% compared to 4.21% at the end of March, while the two-year Treasury yield closed the month at 5.04%, up from 4.63%. Yields across the Treasury curve are the highest since mid-October. Of the 47 basis point rise in ten-year Treasury yields, 10 basis points was accounted for by a rise in ten year inflation expectations to 2.41%, with real yields rising 37 basis points.

The rise in real yields can be attributed to the strong forward momentum in the economy,

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which taken with the reported "sticky" inflation will combine to force the Federal Reserve to hold rates "high for longer" than expected just a couple months ago. Additionally, the U.S. government is selling new debt at a record clip given the massive federal budget deficits, and the "quantitative tightening" program the Federal Reserve started in June 2022 – whereby the central bank shrinks the size of its bond portfolio by $95 billion each month – is placing upward pressure on yields across the Treasury yield curve.

Higher Treasury yields will feed through to higher borrowing costs for car loans to mortgages, helping to slow the forward momentum in the economy, which will undermine the strength in the jobs market and help ease inflationary pressures.

Treasury yields have now risen for four consecutive months, and the consensus is that Treasury yields can only move higher. A higher cost of capital does have consequences, however, and sets the stage for a reversal and a retracement of some portion of rise in yields as the forward momentum in the economy and inflationary pressures ease under the weight of tighter financial conditions.

Higher Treasury yields will feed through to higher borrowing costs for car loans to mortgages, helping to slow the forward momentum in the economy, which will undermine the strength in the jobs market and help ease inflationary pressures. While Treasury yields could always move higher in the near term, we think the market is poised for yields to drop if we look out toward the end of the year.

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 cannot hold as the economy and inflation cool further. At some point over the next 12–18 months the Treasury market should make a run at 4% once again, helped along by the Federal Reserve eventually cutting rates.

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
4/30/24	4.68%		5.04%		-36bp

Source – Bloomberg

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 FOMC Committee could address the possibility of tapering the pace of quantitative tightening at the conclusion of today's FOMC meeting.

We expect more significant declines in yields on five-year (4.72%) Treasury securities than longer dated Treasury securities 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 in 2025 as the rate cutting cycle takes hold.

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