VICTORIA
Capital Management, Inc.

Financial Markets Perspective

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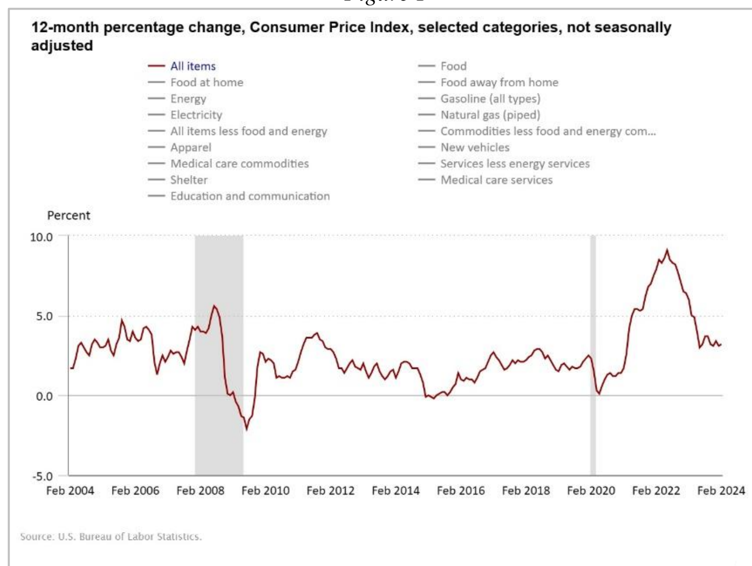
What are the Markets Telling Us?

The financial markets may be providing us with a glimpse of the future, at least the prospect up until the outcome of the 2024 elections. A turning point in equity markets came in late October of 2023 when it was evident that a decelerating rate of inflation (*Figure 1*) influenced the Federal Reserve to terminate the aggressive policy of raising rates. Over the ensuing six months, the equity market rallied with the three major measures of market health, the S&P 500, the Dow Jones Industrial Average, and the NASDAQ indices hitting record highs. The impetus to these record returns appears to have been triggered by a combination of falling inflation and the expectation that the Federal Reserve would be lowering the fed funds rate throughout 2024 and into 2025.

Figure 1



During March, economic events suggested that the Fed would not be as quick to lower interest rates. The latest read from the Fed of Atlanta's GDPNow economic forecast is for another good economic quarter with a gain of 2.8%, down slightly from the 4th quarter gain of 3.4% but nowhere near various inferences that we were in or near a recession. Other positive statistics are factory orders that were above expectations for March (up 1.4% vs an expected 1.0%) and the ISM Manufacturing (Institute for Supply Management) came in at 50.3 vs. an expected 48.3. A reading above 50 signals expansion. This unexpected strength in the economy is leading to the prospect of a delay in the Fed's plan to lower interest rates.

As equity markets rallied strongly in the first quarter, the bond market weakened slightly in the face of a better-than-expected economy. (Long-term government bonds declined 3%.) Changing expectations about Fed policy also eroded bond prices yet further economic strength portends even higher interest rates as the Fed pauses to see if inflation remains in a downtrend. Our concern is that inflation has probably bottomed in the short term as oil prices remain above our target of ($70-$80 per barrel). Oil recently closed above $85 per barrel and the influx of illegal aliens at our southern border is reaching proportions that are bound to put upward pressure on inflation. Additionally, fiscal policy remains expansive and the continued need for government bond sales could push interest rates higher.

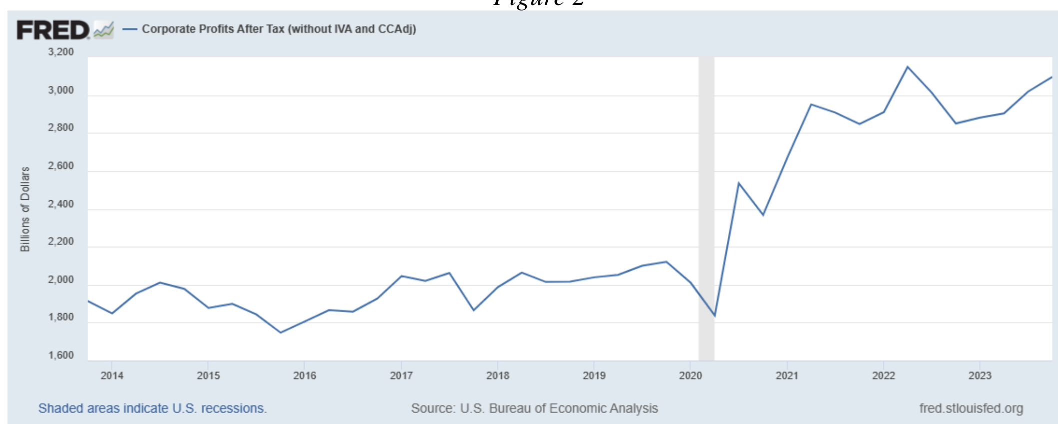
During the first two months of the quarter, the source of the advance was concentrated in a few technology companies that were labeled the "Magnificent Seven." The rapid rise in the stock prices of these companies accounted for just about all the overall stock market advance during January and February. Those stocks (Alphabet, [the old Google] Amazon, Apple, Meta [the old Facebook], Microsoft, Nvidia, and Tesla. However, by the end of the quarter, there was a broadening out in the stock market with small-and mid-cap stocks rallying with their larger-cap brethren. Even small-cap stocks that had been in the red all year finished March with a gain. The beginning of the second quarter ushered in a change from the Magnificent Seven to the "Fabulous Four" consisting of the following four stocks: Amazon, Meta Platforms, Microsoft, and Nvidia.

Foreign equity markets also rallied during the quarter with European stocks, in general, leading the way. Denmark, Germany, Italy, and the Netherlands all had double-digit returns. Asian equities were mixed but Japan's Nikkei 225 index hit an all-time high – exceeding the 39,000 level last reached in 1989! Taiwan's stock market also had double-digit returns on the back of strength in the information technology space.

Global equity markets continue to be enamored with the opportunities that artificial intelligence (AI) may offer. While numerous nay-sayers are concerned about the negative effects of this technological breakthrough, the outlook is bright for a variety of groundbreaking applications that will have a major impact on our lives. For example, AI is being given credit for advancing the ability to create a viable fusion reaction that will dramatically change how energy is produced. Specifically, fusion is a nuclear reaction that does not create any residual materials that have radioactive characteristics. In other words, fusion is clean energy! Although such a transition will cause enormous disruptions to traditional sources of energy, the result will be reducing pollutants worldwide. Maybe our enthusiasm is a little early in the adaptation of fusion technology, but it is coming.

In general, the stock market is a leading economic indicator. The stock market can impact the overall economy, as businesses and investors may adjust their spending based on its health or lack thereof. Corporations, especially non-financial companies, have been doing very well post-pandemic. According to Forbes magazine: "For the business cycle that started with the first quarter of 2020 then, before tax profits averaged 4.0% of all nonfinancial corporations' assets, the largest ratio since the business cycle that ended in the middle of 1980. After-tax profits averaged 3.4% of total corporate assets. This was the highest average since the business cycle that ended in late 1969." Looking back to the final quarter of 2023, corporate profits after taxes stood at $2.8 trillion, a $105 billion increase from the previous quarter! Forecasts for corporate profits through the end of 2024 (*Figure 2*) provide a continued rosy outlook for corporate America as companies continue to use those profits to mainly pay dividends to their shareholders and build their stockpiles of cash. American companies are very healthy!

Figure 2



In our current overall favorable economic environment, there are still some stumbling blocks to an advance. First, the commercial real estate market is in shambles with the aftermath of COVID-19 keeping workers away from office buildings. Vacancy rates are predicted to go higher, which is sobering, considering that the national rate just hit an all-time high of 19.6% in the fourth quarter. Commercial real estate experts are looking for vacancies to peak at nearly 21% later this year as demand for space stays subdued. Moreover, major real estate loans are coming due this year and there is concern that some of these loans will default.

Second, as mentioned earlier, there are likely to be negative economic consequences from the influx of illegals at the border. In addition to inflationary pressures on the supply side of the equation, the migrants are causing other economic problems. Recently, The Wall Street Journal published an editorial about these itinerants taking over empty homes (even when people are on a short vacation) and refusing to leave. This squatting has become big business for these illegals as they have learned how to work the system. On the other hand, the shortage of domestic workers may be lessened by qualified migrants who are likely motivated by the opportunities that America provides. Most Americans are in favor of allowing legal people into our country to work hard to achieve the American dream, yet the illegals including criminals are spoiling the prospects for others. From an economic standpoint, adding more workers to the workforce, even at the lowest level, provides a small boost to economic growth.

Lastly, we are in an election year. History tells us that equities generally do well in an election year no matter who wins. Yet, this year is unusual. Looking back, the only time this type of confrontation occurred was in the 19th century when Grover Cleveland ran a second time after losing to Benjamin Harrison in 1888. He won! He beat the incumbent president, Harrison! As Yogi Berra once said: “It’s déjà vu all over again.”

For the balance of 2024, we lean towards believing that the equity markets will be higher through yearend although individual stock leadership may change during the rest of the year depending on such factors as oil prices and changing government regulations. Russia’s continued assault on Ukraine and the more recent war in Gaza could have some day-to-day impact on financial markets resulting in increased volatility. The first quarter surge in stocks gives us a cushion against this potential unpredictability.