Birch Hill
INVESTMENT ADVISORS

Market View

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CONTINUED OPTIMISM IN MARKETS

Upward momentum continued in the US and other markets, such as Japan, during the first quarter of 2024. The market capitalization-weighted S&P 500 Index returned a solid +10.6%, aided partly by continued strong performance by the Magnificent Seven stocks (Apple, Microsoft, Google parent Alphabet, Amazon, Nvidia, Facebook parent Meta Platforms and Tesla), which returned +17.1% on an equal-weighted basis. The equal-weighted S&P 500 Index's returns were positive (+7.9%), but it still underperformed its capitalization-weighted counterpart, reflecting the disproportionate influence of the mega-cap Magnificent Seven. The Dow Jones Industrial Average returned +6.1%. Smaller capitalization stocks continued to underperform with more modest returns of +5.2%.

US ECONOMIC STRENGTH

The US economy was a bright spot among advanced economies in 2023. US real gross domestic product (GDP) grew at an average annual rate of 2.5%, outperforming the eurozone and the United Kingdom, both growing at 0.5%, and Japan, growing at 1.9%, according to the International Monetary Fund. The US should continue to grow at a solid pace in 2024.

Supported by a strong but normalizing labor market, the US consumer has continued to spend despite inflationary cost pressures and high interest rates relative to recent history. Spending by the US government has also boosted economic growth. Lastly, immigration has helped economic growth, with an increasing supply of workers entering the labor market.

INFLATION AND RATE CUTS

The rate of inflation continues to decline on a yearly basis but remains above the Federal Reserve's 2% target. Meanwhile, economic growth and the labor market remain strong. Therefore, the Fed will likely take a measured approach to reducing interest rates, with only modest short-term interest rate cuts this year. The strong economy and continued above-target inflation led longer-term bond yields to rise in the first quarter. The 10-year US Treasury Bond yielded 4.20% at the end of March, up from 3.88% to start the year.

Market Indicators		3/31/2024
TOTAL RETURN		
US Stock Markets	12 Mos	1st Qtr 2024
S&P 500 Index	29.9%	10.6%
DJ Industrial Avg.	22.2%	6.1%
S&P 400 Mid Cap	23.3%	9.9%
Russell 2000 Small Cap	19.7%	5.2%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australia, Asia, Far East)	15.2%	6.0%
Japan (MSCI Index)	24.2%	11.2%
China (FTSE 50)	-15.9%	0.2%
Emerging Mkts Index	7.0%	2.2%
US Fixed Income Yields	12/31/2023	3/31/2024
6 Mo US T-Bill	5.26%	5.38%
2 Yr US T-Note	4.23%	4.59%
10 Yr US T-Note	3.88%	4.20%

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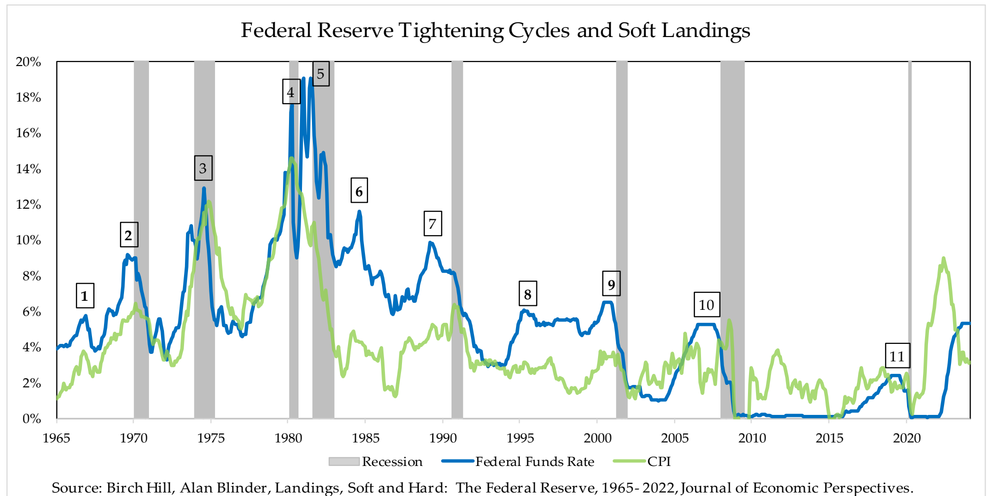
SOFT LANDINGS IN US HISTORY

With the US economy on a solid footing, inflation declining, stocks near record highs and rate cuts potentially on the horizon, is an economic soft landing a foregone conclusion? Alan Blinder, former vice chairman of the Federal Reserve, says it may be more likely than widely thought. According to his research paper, the US has experienced many "softish" landings and situations in which softish landings would've been likely had some unexpected event not occurred. The paper defines a softish landing as a period following a Federal Reserve interest rate hiking cycle that has no recession (as designated by the National Bureau of Economic Research) or a period in which GDP falls less than 1%.

In the chart to the right, Blinder identifies 11 interest rate hiking cycles between 1965 and 2022. He argues that six of the 11 were—or would've likely been—softish landings (1, 2, 6, 7, 8, 9). Further, Blinder argues that some hiking cycles should be discarded from the analysis because the Fed was not trying to achieve a soft landing in 4 and 5, and in other cases (3, 10, 11), an unexpected event outside the Fed's control, like the COVID-19 pandemic, caused a recession. Therefore, he believes the odds that the Fed can achieve a soft landing are much higher than many investors think—despite the argument that there have been eight recessions following 11 interest rate hiking cycles, whether the recession was caused by the Fed or not. In any case, a soft landing is possible but not guaranteed.



Source: Birch Hill, Alan Blinder, Landings, Soft and Hard: The Federal Reserve, 1965- 2022, Journal of Economic Perspectives.

US EQUITY VALUATIONS

US stocks may be pricing in good times for far longer than justified. The S&P 500 Index's current price-earnings (P/E) ratio of 21x is well above its 30-year average of nearly 17x. However, other factors suggest that stocks are not overvalued. A big one is that a substantial percentage of the S&P 500 Index today consists of fast-growing, highly profitable technology companies with powerful long-term tailwinds. Technology stocks made up only 6% of the S&P 500 Index in 1990, but they comprise nearly 30% today. If one also counts Amazon.com, Alphabet, Meta Platforms and Tesla—all of which have technological roots but technically fall into different sectors—as tech stocks, the S&P 500 Index technology weighting would be above 40%. Therefore, it is hard to know whether the historical average P/E multiple of 17x is a good measure of fair value today. Investors should always be mindful of the price they pay for stocks and how they measure that price.

CONCLUSION: DESPITE UNCERTAINTY, A MOSTLY POSITIVE US OUTLOOK

The stock market and the economy both have strong momentum in 2024. While the path of inflation remains lower, the Federal Reserve is likely to reduce short-term rates only modestly this year. An economic soft landing is achievable but is not a given. US equities are expensive relative to history, but today's higher mix of technology stocks could justify valuations. Investors should continue holding high-quality companies at portfolio target asset allocation levels.

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