Sentinel Trust
Together, families prosper℠

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

Q1 2024 Review and Outlook- Higher for longer than expected, for now

Executive Summary

- "Higher for longer than expected" was the dominant theme of Q1. Both U.S. employment and inflation data came in higher than expected in each month of Q1. This has led both the Federal Reserve and the markets to price in higher interest rates that may stay with us for longer.
- Higher interest rates led to negative results for bonds and real estate, but strong economic data and AI enthusiasm pushed U.S. equity prices and valuations higher still. While international stocks delivered solid returns, a stronger than expected U.S. dollar weighed on relative results.
- While the higher for longer theme is with us for now, markets are fickle and driven by human emotions in the short term. Sticking with a long-term plan remains paramount as themes shift.

Cash and Bonds

"Higher for longer than expected" sums up the first quarter particularly in the United States. U.S. job growth came in higher than expected in every month of Q1. While this left the U.S. consumer and economy in strong shape, it also pushed consumer price inflation above expectations in each month of the year to date. The Federal Reserve is yet again increasing both their economic growth and inflation forecasts for 2024. Jerome Powell just noted "it is likely to take longer than expected" to cool inflation. While the Fed is by no means the best or steadiest forecaster, the market has been even more mercurial this year. Whereas the Fed still thinks they can cut short-term interest rates three times or by 0.75% this year, the market has quickly moved from pricing in six cuts to under three in 2024.

This market action allowed cash and shorter-term Treasury bills to outpace longer-term bonds and the broader bond market yet again in Q1. Whereas the 3-Month Treasury bill earned a smooth 1.3% in Q1 with yields steady at 5.3%, the broad Barclays Aggregate fell -0.8% as the 10-Year Treasury Note jumped from 3.9% to 4.6% currently. This has left the yield curve inverted with short rates above long rates for a record stretch and for much longer than most expected. Many economists see this inverted yield curve as a strong recession indicator. Roughly 70% of economists saw a recession in the year ahead last year at this time. However, the most anticipated recession perhaps of all-time has been pushed off for much longer than expected and just 35% of economists see one in the year ahead now.

Bond market issuance is also coming in a lot higher than expected. At the Federal level, we continue to run deficits at roughly 7% of GDP. These are levels typically associated with wars, recessions, or both and certainly not what one would expect near record high employment levels. These deficits and the lack of political will from both sides may very well push long-term bond yields higher still. While many market gurus from Stan Druckenmiller to Ray Dalio have warned of a looming debt crisis, it too has to date been pushed off for much longer than many assumed. The overall thirst for yield has in fact vastly exceeded expectations with both U.S. government debt and high-grade corporate bond sales hitting record highs in Q1. Annuity sales are also hitting record highs, driving this thirst for yield and high yield spreads to near-record lows. Record bond supply is meeting record demand for now.

US & International Stocks

Q1 U.S. stock market returns were also likely higher than most expected with valuations pushing higher for longer as well. The S&P 500 index jumped over 10% in Q1, significantly outpacing its above-average 9.6% yearly return delivered over the past twenty years. While earnings did exceed expectations by 3%, much of the uplift came from multiples expanding from high levels to even higher levels still. For example, the S&P 500 price to earnings ratio based on forward expected earnings jumped from 19.6X to 21X in Q1 versus a 20-year average of just 15.8X. US large cap stocks continue to defy expectations and have rarely been this expensive on both an absolute basis and relative to yields on international stocks, small and mid-cap US stocks, and cash and bonds.

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

There are some reasonable explanations for these rich valuations. First, perhaps there is valid enthusiasm for artificial intelligence's potential. In 2023, Nvidia alone doubled its reported sales. Both Steve Cohen and Jamie Dimon recently predicted that AI will lead to 3–4-day work weeks. Elon Musk noted AI will be smarter than any human by next year. Next, there is supply and demand. The Fed's pandemic-driven money printing and the Federal government's record high debts have created a near record pile of cash seeking yield. This supply of cash may also remain higher for longer. The Fed just announced its plans to slow its attempts to shrink money supply. On the fiscal side, the 2024 elections are ahead and neither party has a record or campaign bent on shrinking deficits. At the same time, we've seen the supply of global equities shrink at their highest rate in at least 25 years. In 2024 to date alone, the global supply of equities shrank by $120B crushing the 25-year record set last year when $40B of equity supply was retired.

On the international side, U.S. exceptionalism has continued for a lot longer than most expected. International stocks delivered a respectable and above average 4.3% return in Q1, but again failed to outpace U.S. markets despite their record relative cheapness. If this pattern holds in 2024, U.S. markets will have outpaced their international peers in 12 of the past 15 years and add to their 369% of excess returns generated in the past 14 years. Part of the disparity in performance stems from the record strength of the U.S. dollar. It just reached its highest level against the Japanese Yen in 34 years defying expectations after the Bank of Japan ended eight years of negative interest rate policy. Also impacting relative international returns, the war in Ukraine continues to drag on longer than most expected while the war in the Middle East has become hotter than expected. This has pushed oil prices higher than most anticipated. As the world's largest oil producer, the U.S. can handle and even benefit from these higher-than-expected oil prices, unlike our energy dependent peers in Europe and Japan.

Alternative and Real Assets

Outside of oil, we've seen other commodities and real assets rising higher than many expected. Coffee prices were up 20% in Q1 and are near 20-year highs. Cocoa prices jumped over 100% in Q1 touching 20-year highs. Gold recently also reached record levels. This all occurred in the face of a stronger dollar and higher interest rates, forces which often drive commodities and especially gold lower. Both China's central bank and U.S. Costco shoppers have stocked up on gold recently for similar reasons- a growing distrust in the purchasing power of a dollar. To wit, Bitcoin reclaimed its all-time high in Q1, despite some troubling issues from its ecosystem. Coinbase, the largest crypto exchange in the U.S., briefly panicked many users in Q1 by showing them erroneous zero balances. Meanwhile in Q1, Sam Bankman-Fried, the founder of FTX once the largest global crypto exchange, was sentenced to 25 years in prison for stealing $8B of customer deposits in one of the biggest financial frauds in history.

In real estate, we also saw the higher for longer theme play out. 30-Year mortgage rates pushed back above 7%. This pushed the American Dream for many would be homebuyers further off into the future. While we've seen these higher rates creating some pockets of stress and rent reductions in multi-family housing, shelter costs surprised most economists by edging higher in Q1. While government measured shelter costs often have lags, they still do not include the common person inflation which also include rising insurance costs and property taxes. No wonder Costco consumers are stocking up on gold bars.

Conclusion

Just as Sam Bankman-Fried went from the 25th richest person in America in 2021 to doing 25 years' time by 2024, we would note that all the above is fickle. Markets continue to be driven by human emotions and these emotions can change quickly. In April alone we've seen some weakness following Jerome Powell's recent comments, the latest higher than expected inflation print, and escalating tensions in the Middle East.

Longer term, market history is full of instances where long-term themes reversed in short order. The economy and inflation were running hot in 2007, before collapsing into the Great Financial Crisis and deflationary fears of 2008.

Sentinel Trust
Together, families prosper℠

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

The 10-Year Treasury yield actually rose in the first half of 2008 to 4.3% before collapsing to 2.1% just months later. While employment is strong today, it also tends to change quickly. The 20-year record low unemployment rate of 3.5% set in February of 2020 touched a record high of 14.8% two months later in April. Most economists in February 2020 saw no recession ahead (despite an inverted yield curve), but 100% thought we were in one a month later. The tech bubble enthusiasm of 1998-9 was quickly replaced by the despair by 2000-1. Whereas we noted the U.S. equity market's exceptional 369% outperformance over international markets over the past fourteen years, international markets experienced a similar 300+% outperformance over U.S. stocks in the 1980s. This was driven by Japan's exceptionalism which was then followed by a lost three decades with the Japanese equity markets just recently recovering those highs set nearly 40 years ago.

We are not predicting any of these things in the near term and it is important to remember that predicting such turns in the markets is impossible. We emphasize that in this higher for longer world, things can change quickly. It is best not to chase current themes and near-term winners. Investors will be best prepared for further surprises ahead by having a long-term plan with a diverse mix of assets so that they can ride through the unexpected shocks of the future.