

FIRST QUARTER 2024

Quarterly Market Insights



OFF TO A FAST START

EXECUTIVE SUMMARY

- Improved labor supply has helped slow inflation...
- ...but resilient demand could keep rates high.
- Stock market leadership broadened a bit in 1Q24.
- Election cycles often = volatility and opportunity.

A risk-on tone prevailed across markets in the first quarter despite reduced expectations for Federal Reserve rate cuts, signs inflation may have bottomed short of the central bank's 2% target, and a 15% rise in crude oil prices. Unlike during most of 2022 and 2023, investors generally embraced a "good news is good news" mindset in the first three months of the year as stronger-than-expected economic data supported higher stock prices and pushed Treasury yields higher (see Chart 1). This was enabled by a collective message from Federal Reserve officials throughout the quarter that 1) substantial progress on quelling inflation has taken further rate hikes off the table but... 2) it is still too early to embark on the 0.75% worth of rate cuts anticipated by policymakers by the end of 2024.

Against this backdrop, the S&P 500 resoundingly extended its November and December rally into the first quarter. The benchmark recorded a 10.6% total return in the period, outperforming the mega cap technology-dominant Nasdaq 100 (+8.7%) for the first quarter since 4Q22. For only the fourth time in the last forty years, the S&P 500 posted back-to-back 10%-plus quarterly gains. The index went the entire first quarter without experiencing a decline of more than 2% as dip-buyers were willing to step in on every pocket of weakness.

In addition to sufficiently dovish Fed messaging and upside economic data surprises, unexpectedly decent corporate earnings growth in the 4Q23 reporting season helped boost stock returns to begin the year. S&P 500 operating earnings per share (EPS) grew 8.2% in the fourth quarter compared to a year ago, well above the consensus expectation for just 1.2% growth in the first week of January. Index-level profit growth was very much driven by a small group of mega cap stocks that are dominant in one or more of the secular themes of cloud computing, generative artificial intelligence (AI), and digital advertising. Meta Platforms (META) added a one-day record of \$177 billion of market capitalization after reporting strong quarterly results and an optimistic outlook on January 31. Not to be outdone, NVIDIA (NVDA) shattered META's record three weeks later when its market capitalization expanded by a staggering \$277 billion the day after the AI data center chip giant delivered another impressive

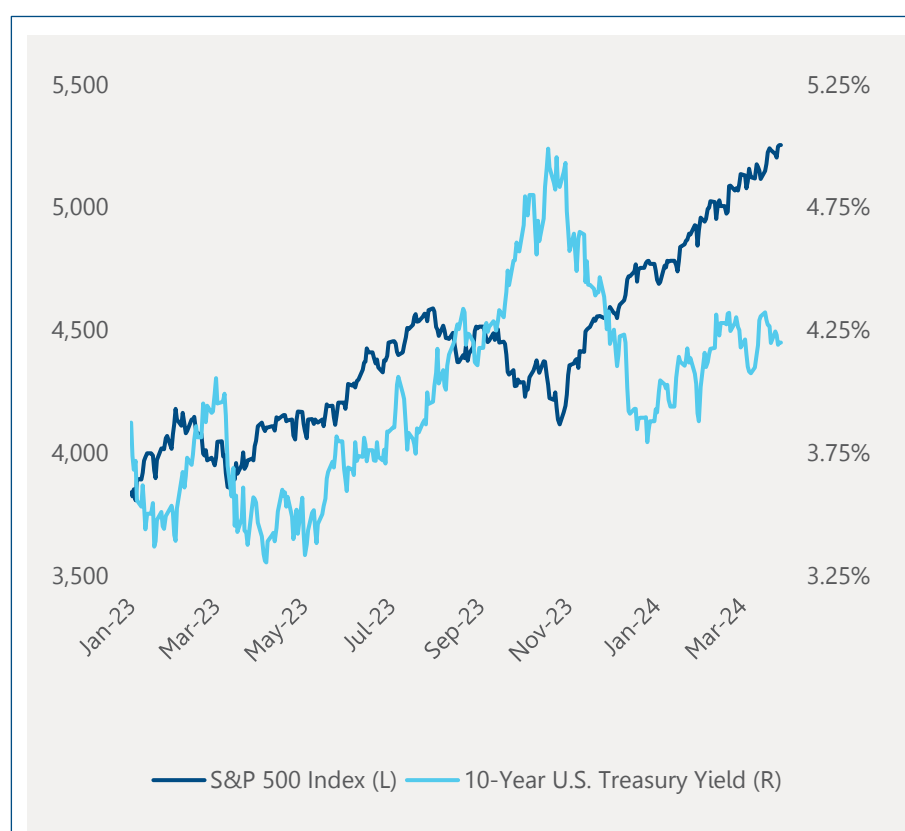
combination of results and guidance. The one-day increase in the size of NVDA's market value on February 22 was bigger than the standalone market capitalizations of Coca-Cola (K), McDonald's (MCD), and Bank of America (BAC).

Bond yields moved higher over the quarter against a backdrop of solid economic data and a lack of further progress in restoring annual inflation measures to the Federal Reserve's stated target of 2%. The U.S. 10-year Treasury yield climbed 0.32% in the first three months of the year to 4.32%, reversing nearly half of its fourth quarter descent from 4.57% to 3.88%. In the first three weeks of April, 10-year yields pushed above 4.50% for the first time since mid-November. Meanwhile, gold broke out to all-time high well above \$2,200 per ounce despite higher bond yields and a stronger U.S. dollar (two factors that have historically been headwinds for the precious metal).

U.S. EXCEPTIONALISM

The resiliency of the U.S. economy in the face of the most aggressive Fed policy tightening since the late 1970s surprised most market participants last year. In the seven quarters since the Federal Reserve began hiking its policy rate in March 2022 to combat surging inflation, U.S. gross domestic product (GDP) has grown at an average annualized rate of 2.5%. There were two quarters of modestly negative gross domestic product (GDP) to begin 2022, but this was predominantly driven by inventory destocking after aggressive overstocking in 2020 and 2021 amidst global supply chain disruptions. As seen in Chart 2, real (inflation-adjusted) U.S. GDP has easily outpaced the

CHART 1
STOCKS ROSE DESPITE HIGHER BOND YIELDS

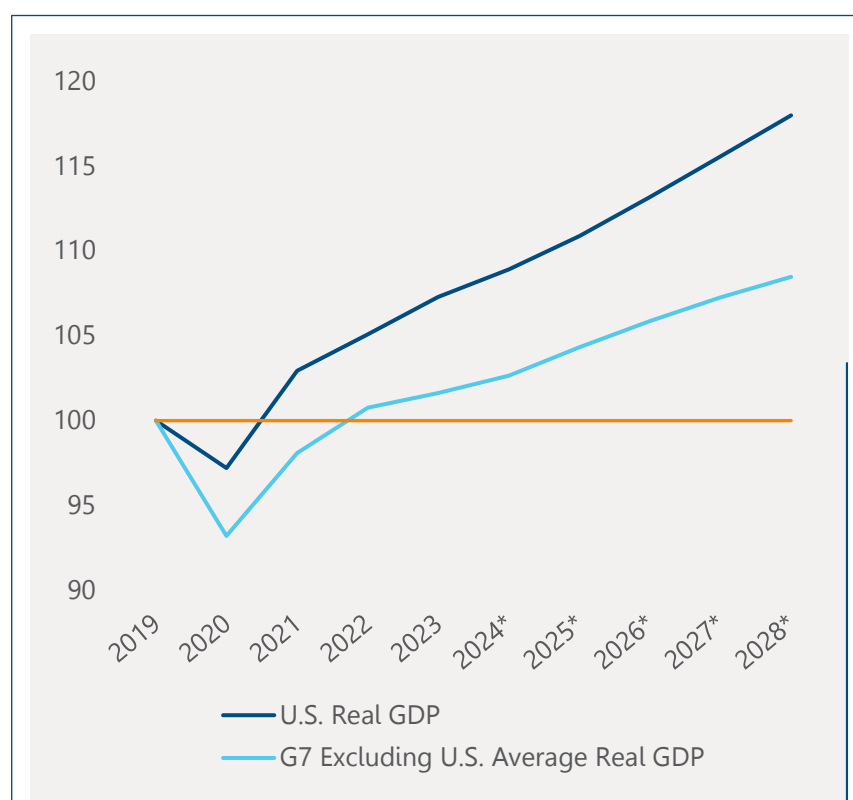


Source: Bloomberg. Data as of 3/31/24. Past Performance does not guarantee future results.

average growth rate of the other Group of 7 advanced economies over the four-year period from the end of 2019 through the end of 2023. Of all the world’s large, developed economies, the U.S. experienced the shallowest contraction in 2020 and enjoyed the quickest recovery to its 2019 level. According to the median forecast in a recent Bloomberg survey, U.S. gross domestic product (GDP) is projected to have expanded at an annualized clip of 2.3% in the first quarter.

As is usually the case with the U.S. economy, consumer spending and labor market trends have been among the most important determinants of growth. Nonfarm payrolls expanded by 829,000 in the first quarter, an acceleration from 637,000 in the fourth quarter and 640,000 in the third quarter. The unemployment rate wavered between 3.7% and 3.9% in the first three months of the year. Although this is at the high end of the 3.4%-4.0% range that has been in place since January 2022 it is still very low compared to the average of 5.8% in the thirty years prior to the onset of the COVID-19 pandemic in March 2020. Meanwhile, the annual rate of wage growth for U.S. workers has stabilized near 4% in recent months. This is a level which is too low to suggest an impending wage-cost inflation spiral, but higher than most measures of consumer inflation. Wage growth in excess of inflation can provide a boost to consumer spending because it implies workers have experienced real, or inflation-adjusted pay gains.

CHART 2
RELATIVE U.S. ECONOMIC STRENGTH



Source: IMF Data as of 12/31/23. Group of Seven (G7) nations: U.S., Japan, Germany, U.K., France, Italy, Canada. *2024-2028 are IMF projections.

PARTICIPATION AND IMMIGRATION

Surprisingly strong job growth without a reacceleration in wages has been a virtuous combination for the U.S. economy over the last several quarters. What explains this historically rare development? Much of the answer probably lies in the 5% expansion of the domestic labor force from a pandemic-depressed 160 million in January 2021 to 168 million in March 2024. About half of this growth came from workers returning to the labor force as the participation rate of prime-age workers in the U.S. aged 25-54 climbed to a 20-year high of 83.5% in June 2023. Notably, improving labor force participation coincided with the end of direct pandemic-era stimulus payments and widespread student debt relief, along with a booming services sector.

The other half of the 5% increase in the labor force over the last 39 months comes down to immigration. A recent Congressional Budget Office (CBO) report estimated a net 3.3 million immigrants arrived in the U.S. in 2023, including 2.4 million with a nonlegal or pending status. In 2019, the CBO estimated net U.S. immigration to the U.S. in 2023 would be just 1 million, about 70% less than its updated estimate. The authors of the CBO report project a net immigration figure above 3 million in 2024. According to the Brookings Institute, a policy think-tank, the updated CBO immigration estimates imply the U.S. economy could accommodate monthly payroll growth of between 160,000 and 200,000 in 2024 without putting upward pressure on inflation through accelerating wage growth. Prior to the pandemic, the CBO and Bureau of Labor Statistics estimated the long-term monthly rate of sustainable domestic job growth was 60,000 to 100,000. Setting the social and political implications of the immigration surge aside, it likely helps explain a good portion of how the labor market has chugged along while average hourly wage growth has slowed from an annual rate of 5.9% in March 2022 to 4.1% in March 2024.

THE DEMAND SIDE

It would be short-sighted, however, for investors to view immigration exclusively as a long-term source of disinflation (prices rising at decelerating rate). This is because immigration also produces more demand in an economy as the new arrivals generate additional spending on domestic goods and services either directly or via the government on their behalf. Moving forward, the immigration factor could shift from an inflation suppressant to a demand stimulant and lengthen the period in which the annual rate of change in consumer prices remains above the Federal Reserve’s stated 2% target. If net immigration continues at the accelerated pace seen in 2023, it could eventually lead to labor supply overtaking demand for workers and cause an increase in the unemployment rate.

Although immigration will probably become a more important factor in the trajectory of aggregate spending, the primary reasons for the surprising persistence of demand in the U.S. economy are likely to be found elsewhere. First, a significant increase in deficit spending focused on infrastructure,

the clean energy transition, and domestic semiconductor production has spurred private companies and state governments to begin investing aggressively in areas like factory construction. Together, the Infrastructure Investment and Jobs Act (November 2021), the CHIPS and Science Act (August 2022), and the Inflation Reduction Act (October 2022) authorized \$1.6 trillion of new government spending over the next 5-10 years. Investment in manufacturing is estimated to have added about 0.4% to U.S. GDP growth in 2023. All of this additional spending has been financed by a growing federal debt load. A federal budget deficit that was 7.5% of GDP in 2023 has become a concern to an increasing number of mainstream economists given this is a number that has rarely been seen outside of wars or economic recessions.

A potential second reason for stronger-than-expected demand in 2023 is that most American homeowners have been at least partially insulated from the pain of sharply higher interest rates. As shown in Chart 3, the average rate on the current stock of 30-year mortgages in the U.S. is about 3.8%, about half of the going 7.5% rate on a new mortgage. For the wealthier cohorts of homeowners with excess savings parked in money market accounts yielding close to 5%, there is a positive spread between the income earned in short-term savings accounts and their mortgage rate. A small but growing number of commentators have counterintuitively suggested the Fed's rate hike cycle may be having a stimulative effect on spending by wealthy Americans, especially in "revenge spending" areas like luxury goods and travel.

THE LAST MILE AND RATE CUTS

A string of slightly hotter-than-expected inflation readings in the first quarter forced investors to recalibrate their timeline for annual inflation to complete the "last mile" of its journey back to 2%. This has been viewed by many market participants as the final step needed for the Federal Reserve to begin cutting its policy rate. Higher crude oil prices along with sharp increases in certain services categories including auto insurance and hospital services were key drivers of the upside inflation surprises. The core consumer price index (CPI), which excludes volatile food and energy prices, registered three straight monthly increases of at least 0.35% in the first quarter for the first time since the three-month period ended February 2023. The three-month annualized rate of change in core CPI during 1Q24 was 4.5%, more than double the Federal Reserve's target of 2% average inflation over an economic cycle. Although month-to-month inflation data is noisy, the trend seems to suggest stronger-than-anticipated U.S. growth may be pushing up against the economy's supply limit and causing upward price pressure to remain uncomfortably persistent.

As expected, on March 20, the Federal Open Market Committee (FOMC) voted unanimously to keep its target policy rate unchanged at 5.25%-5.50% for the fifth consecutive meeting. The quarterly Summary of Economic

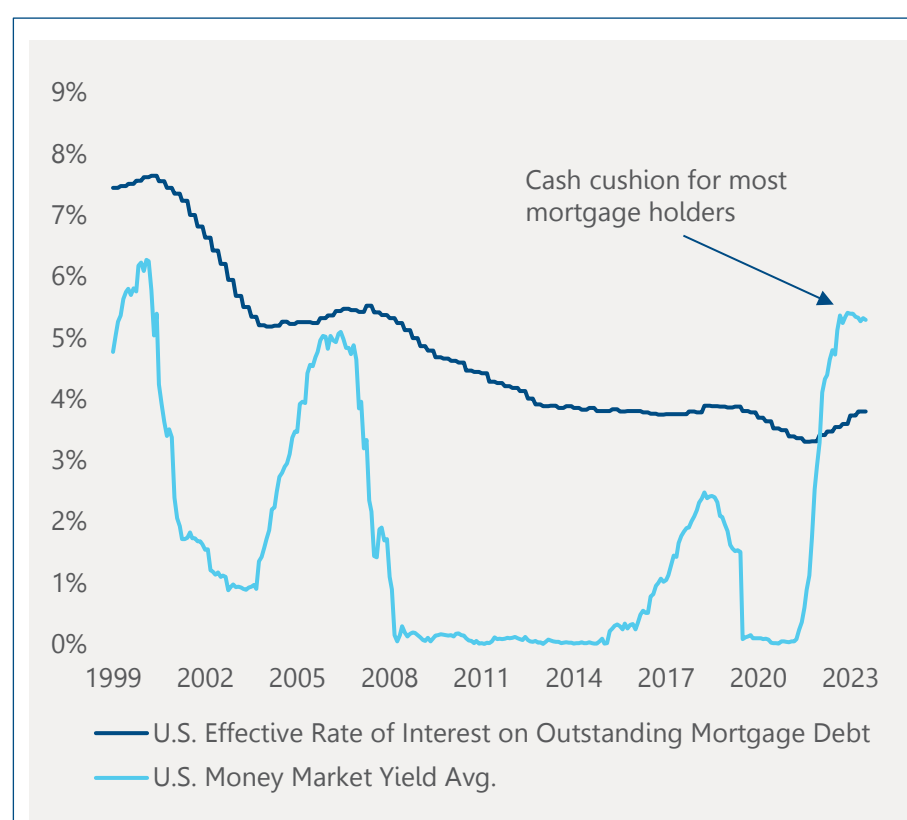
Projections (SEP) was released at the meeting, with the median estimate for the 2024 year-end fed funds rate remaining at 4.6%. This implied a total of 0.75% worth of rate cuts over the next eight months. Notably, the SEP's median estimate for the policy rate at year-end 2025 moved up to 3.9% from 3.6% previously. The year-end estimate for 2026 ticked higher to 3.1% from the prior 2.9%. The median FOMC participant now expects core personal consumption expenditures (PCE) inflation in 2024 of 2.6% up from 2.4% in December and GDP growth of 2.1% this year vs. just 1.4% three months ago. Collectively, these updated estimates suggest Fed policymakers now expect a shallower trajectory of rate cuts over the next two years (i.e., "Higher for Longer") than several months ago. As of April 19, fed funds futures pricing indicated market expectations for between 0.25% and 0.50% of rate cuts by the end of 2024. This is a stark change from expectations for 1.75% worth of policy easing priced by markets in mid-January.

OIL AND GASOLINE

Historically, energy prices have been one of the most direct links between inflation and the activity and psychology of U.S. consumers. A 15% increase in West Texas Intermediate (WTI) crude oil in the first quarter to near \$85 per barrel was driven in large part by escalating tensions in the Middle East and an extension of production quota cuts by the Saudi Arabian-led Organization of Petroleum Exporting Countries (OPEC). The upward move in oil prices in the first three months of the year drove a commensurate 15% increase in the AAA national average retail price for a gallon of gasoline to above \$3.50 per gallon for the first time since late October. Investors should keep an eye on fuel prices heading into the summer driving season given the potentially negative effect further gains

CHART 3

HAVE HIGHER RATES BEEN PARTIALLY STIMULATIVE?



Source: Bloomberg. Data as of 3/31/24. Past Performance does not guarantee future results.

would have on consumer sentiment, consumer spending, and inflation expectations. As shown in Chart 4, there was a sharp drop-off in consumer confidence in the summer of 2022 when the national average retail price for a gallon of gasoline pushed above \$4.00 per gallon.

IMPROVING MARKET BREADTH

One beneficiary of higher oil prices has been U.S. energy stocks, which climbed near the top of the sector leaderboard in the first quarter. The S&P 500 energy sector’s 13.7% total return in the period trailed only the communication services sector (+15.8%). In addition to energy, the financials (+12.5%) and industrials (+11.0%) sectors were other laggards from 2023 that modestly outpaced the broad index in 1Q24. We view solid performance from the cyclical energy, financials, and industrials sectors as an encouraging sign of a potential broadening of returns away from the heavily concentrated stock market leadership of 2023. The S&P 500 industrials sector exhibited notably improved breadth with 42 of the 78 stocks in the sub-index outperforming the broad index’s 10.55% quarterly return. Not surprisingly, the interest-rate sensitive utilities (+4.7%) and real estate (-0.6%) sectors were the weakest performers of the S&P 500’s eleven major groups.

FANTASTIC FOUR

Although there was a more diverse group of stocks that provided leadership in the first quarter, market gains were still relatively concentrated. A quartet of mega cap growth names, NVIDIA (NVDA), Meta Platforms (META), Microsoft (MSFT), and Amazon (AMZN), accounted for about 45% of the S&P 500’s first quarter return. Noticeably absent from this foursome were the remaining three members of the vaunted Magnificent 7 stocks from 2023: Apple (AAPL), Alphabet (GOOGL), and Tesla (TSLA). The shares of these three companies have been weighed down by some combination of stagnating growth in China and the perception that their management teams have fallen behind in the race to monetize the power of generative artificial intelligence. Chart 5 depicts the bifurcation in returns in the first three months of 2024 across the Magnificent 7, with the Fantastic Four (NVDA, META, MSFT, and AMZN) in a clear leadership position. According to the median analyst estimate aggregated by Bloomberg, NVDA, AMZN, and META are expected to grow their adjusted earnings per share (EPS) by 106%, 42%, and 35%, respectively, in calendar year 2024. GOOGL and MSFT are projected to achieve more modest EPS growth rates between 10% and 20%, whereas profits at AAPL and TSLA are anticipated to grow at a low-single-digit clip or even contract.

WHAT ABOUT SMALL CAPS?

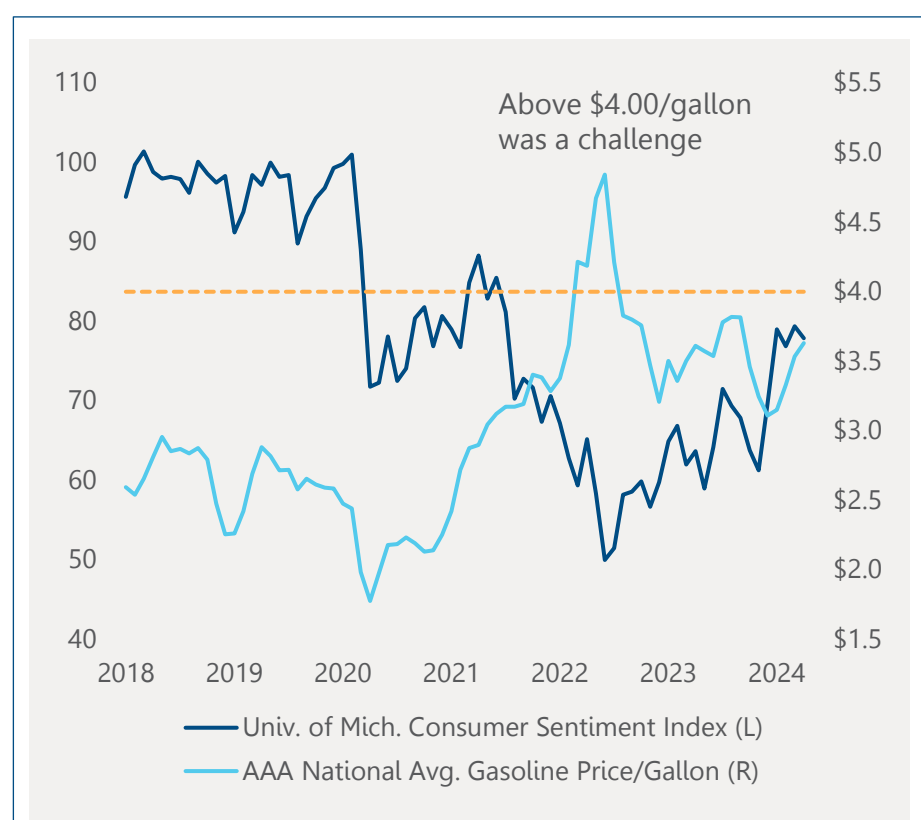
Shares of small cap U.S. stocks (those with market capitalizations between \$250 million and \$2 billion) again struggled to keep up with the broad market last quarter. The Russell 2000 Index and S&P 600 Index returned

5.2% and 2.5%, respectively, in the opening quarter of 2024. This was the fourth quarter in the last five that both small cap indexes trailed the large cap S&P 500 Index. Since the failure of Silicon Valley Bank on March 9, 2023, the two small cap indexes have trailed the S&P 500 by roughly 20% through the end of the first quarter. The starting point of this time period is instructive for the drivers of small cap underperformance given the types of companies that came under the most pressure during the regional banking turmoil last spring. Smaller companies tend to be less profitable and more dependent on external financing than their larger brethren. This generally makes small cap stocks more volatile and sensitive to changes in interest rates than those in the S&P 500. Meanwhile, banks and real estate investment trusts (REITS) account for about 15% of the Russell 2000 and S&P 600, more than double the two industries’ weighting in the S&P 500. As long as interest rates stay elevated and banks’ net interest margins (the spread between interest earned on loans and interest paid on deposits) remain compressed, small cap stocks seem unlikely to achieve a durable stretch of outperformance. More than most areas of the market, small cap stocks would benefit from a proper soft landing in which the Federal Reserve cuts rates, the economy stays strong, and annual inflation meanders back down to an annual rate of 2%.

ELECTION THOUGHTS

In the coming months, the attention of most investors will turn to the presidential and congressional elections this fall. Even though strong voter turnout and emotions are expected, elections have typically had a muted impact on market returns outside of the window of elevated volatility during August

CHART 4
HIGHER GAS PRICES CAN WEIGH ON CONSUMER



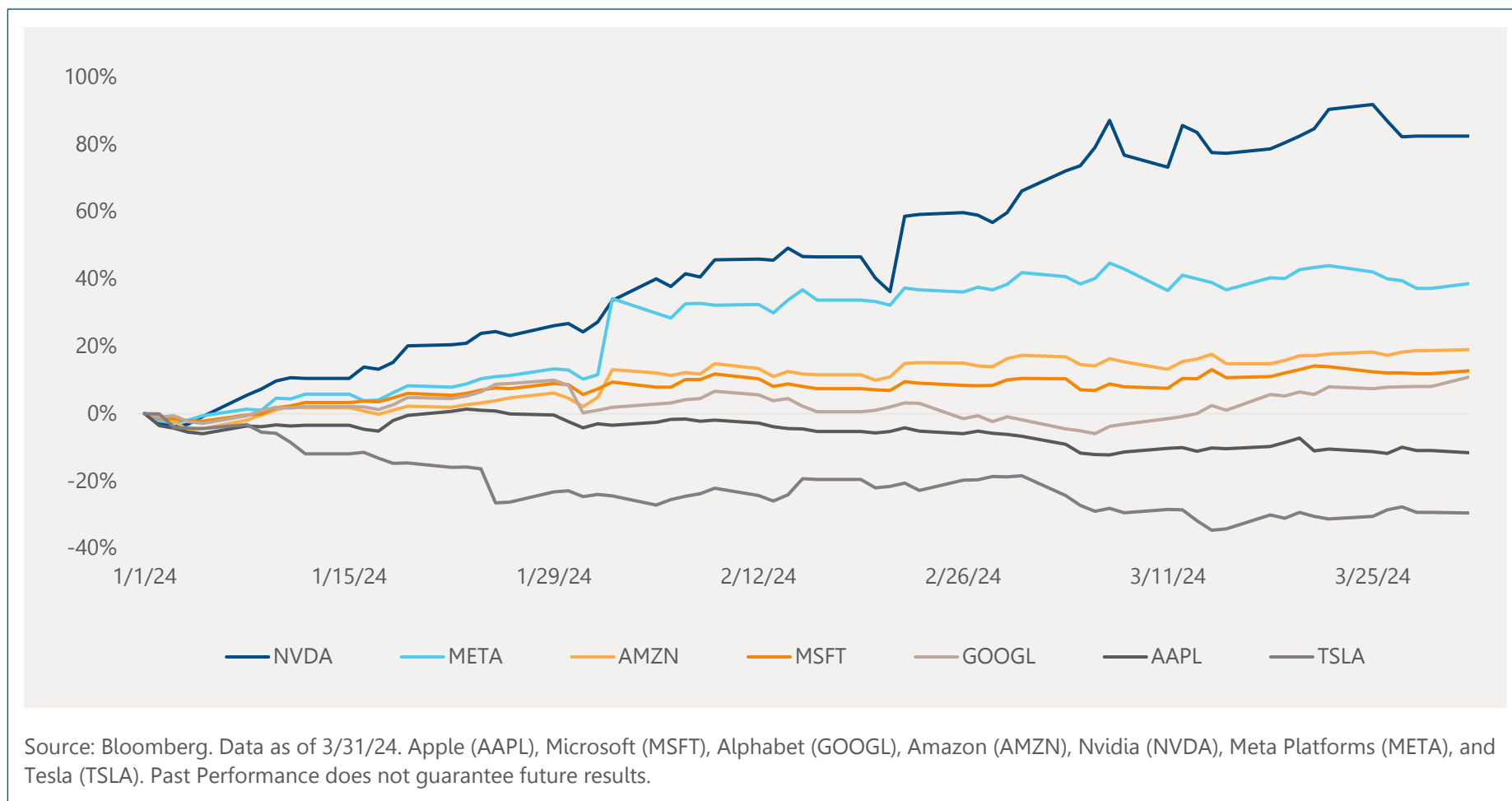
Source: Bloomberg. Data as of 3/31/24. Past Performance does not guarantee future results.

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CHART 5

DISPERSION OF MAGNIFICENT 7 STOCK RETURNS IN 1Q24



through October leading up to the first Tuesday in November. In large part, this is because 1) elections often lead to split governments which reduce the probability of largescale policy changes and 2) markets usually do a good job of discounting the policy preferences of the new government within several days or weeks following the election outcome. The S&P 500 has generally delivered a return between 10% and 15% in the 12 election years since 1968 excluding the recession years of 2000 and 2008 (see Chart 6).

Notably, in each of the last two election years, a disproportionate amount of the S&P 500's calendar year gains occurred in the final eight weeks of the year following the election in early November. Since the end of World War II, there have been five instances of a Democratic incumbent running for re-election: Harry S. Truman in 1948, Lyndon Johnson in 1964, Jimmy Carter in 1980, Bill Clinton in 1996 and Barack Obama in 2012. The S&P 500's average total return in those presidential election years was 18.4%, compared to its average of 12.3% for all years from 1948 through 2023. The index's total average return in the five years immediately following those election years (1949, 1965, 1981, 1997, and 2013) was 19.1%. While investors should not automatically extrapolate the past into the future, history suggests the U.S. stock market can withstand (and perhaps even thrive) during a presidential election year and the first year of a new administration.

While the contest between Joe Biden and Donald Trump will likely dominate the news cycle, competitive congressional races could be just as important as the main event. This is because the contests for House and Senate seats will determine whether 2025 and 2026 are spent under a divided or unified government. The stock market tends to prefer a dividend government because major legislation with significant economic impact is less likely when the White House and Congress are controlled by different parties. A unified Republican government would likely prioritize extending the 2017 Trump tax cuts (which are set to expire in 2025) and seek to roll back large parts of the 2022 Inflation Reduction Act, while looking to support industrial activity outside of the clean energy sector. A government under unified Democratic control (a much less likely scenario due to the congressional map in 2024) would probably focus on raising the corporate tax rate closer to the pre-2017 level of 35% and resurrecting parts of the Build Back Better plan that did not make their way into more focused bills in 2021 and 2022.

OUTLOOK

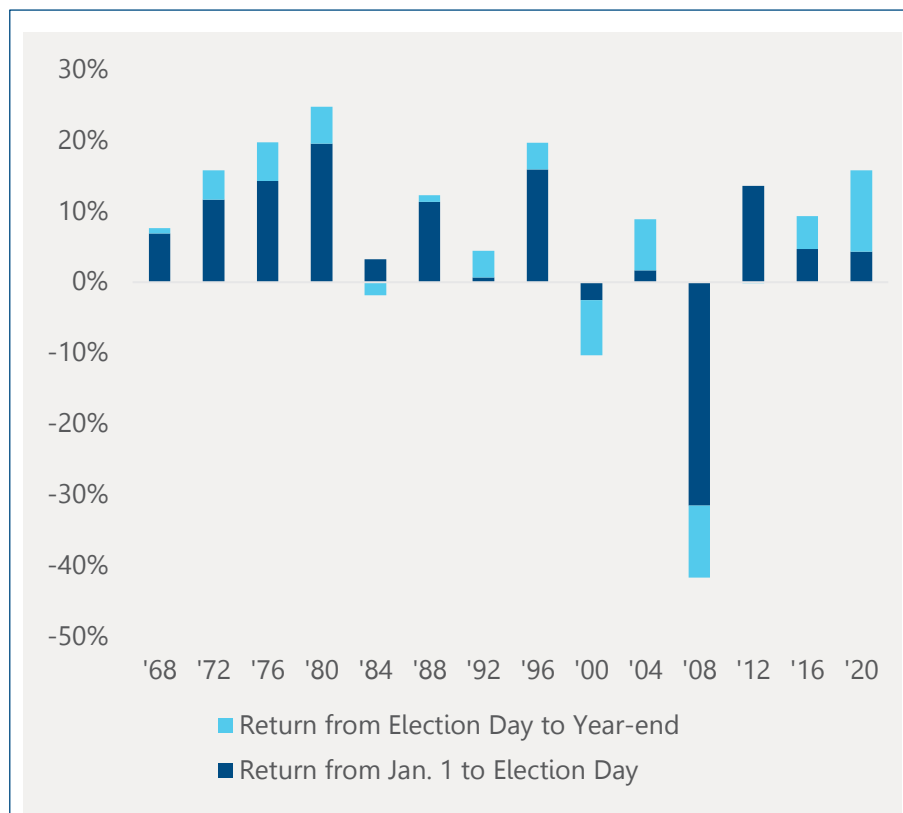
Investors came into 2024 expecting cooling inflation and a slowing but stable jobs market would allow the Federal Reserve to begin rate cuts early in the year. However, inflation and economic data trends have not fully cooperated as there are growing signs the domestic economy may be running too hot to justify lower interest rates over a short-term horizon. In our view, these developments will likely cause the Fed to extend, but not abandon its timeline for policy easing. The election

cycle could complicate the order of events as policymakers would probably prefer to avoid cutting rates in the 2-3 months preceding the election at the risk of appearing overtly political. There is a small but growing possibility the first Fed rate cut does not materialize until November 7 or December 18, the FOMC's first two meetings after the election.

We do not see any significant signs of a downward inflection in the U.S. business cycle. Elevated auto loan delinquencies, rising credit card delinquencies, and weakness in commercial real estate loan books should be monitored, but strike us more as manageable issues than systemic threats. Although not perfect, the most important underlying components of the U.S. economy (aggregate job growth, wages, consumer spending) do not appear on the cusp of an imminent contraction. This is important because most extended periods of U.S. equity market declines (i.e., bear markets) over the last 70 years coincided with recessions. Meanwhile, corporate earnings growth is expected to pick up in 2024, as U.S. companies attempt to find the right mix of growth-driving investments and expense reductions. S&P 500 operating EPS are projected to expand 10% for the full year, driven by 11%-18% growth in the communication services, technology, healthcare, and consumer discretionary sectors. These four groups accounted for about 60% of the index's market capitalization as of March 31.

As the second quarter begins, we think this backdrop justifies an optimistic but realistic outlook. We would not be surprised if the major U.S. stock averages end the year at higher levels, but the path toward this favorable outcome is likely to be marked by elevated volatility over the next six to nine months. An acceleration in consumer inflation, a spike in gasoline prices above \$4 per gallon, or a backup in 10-year U.S. Treasury yields above 5% could amplify market volatility as markets reassess the prospects for Fed policy, consumer spending and corporate profits. A run-of-the-mill 10% correction in the broad U.S. stock market could present an opportunity to increase equity targets in client portfolios with long-term time horizons as long as the fundamental backdrop remains constructive. We expect U.S. government bonds and high-quality corporate bonds will play an increasingly important role in dampening the volatility of diversified portfolios due to the improved coupon cushion they offer after a two-year period of interest rate normalization.

CHART 6
PRESIDENTIAL ELECTION YEARS: S&P 500 RETURNS



Source: Bloomberg. Data as of 12/31/23. Past performance does not guarantee future results.

ECONOMIC OUTLOOK AND INVESTMENT POLICY

ECONOMIC FACTORS

CURRENT OUTLOOK

U.S. GDP Growth	We expect the U.S. economy to generate real growth of 2.0%-2.5% in 1H24 before decelerating to a 1.5% clip in the second half of the year.
Federal Funds Rate	If we do not see more progress on inflation in coming months, the Fed might not start cutting rates until November or December.
Inflation	Higher energy prices and sticky services prices are likely to keep annual U.S. consumer inflation above the Fed's stated 2% target in 2Q24.
Employment	Accelerating job growth seen in 1Q24 will probably dissipate this quarter, however, there are no clear signs of major labor market cracks.
Consumer Confidence	Consumer sentiment would probably come under temporary pressure if gasoline prices push above \$4.00 per gallon this summer.
Oil	Although a direct Israel/Iran confrontation has so far been contained, elevated tensions could keep WTI crude oil above \$80 per barrel.
Housing	Housing market activity will probably remain suppressed until 30-year fixed mortgage rates drop another 200 basis points to below 6%.
International Economies	Above-trend GDP growth in India and Indonesia in 2024 is likely to be offset by weakness in China, the euro zone, and the UK.

FIXED INCOME



CURRENT OUTLOOK

Core Bonds		We expect U.S. government bonds and high-quality corporate bonds will play an increasingly important role in dampening the volatility of diversified portfolios in due to the improved coupon cushion they offer after a two-year period of interest rate normalization.
TIPS		
Non-Investment Grade		Unlike during most of the zero-to-low interest rate period from 2009 through 2021, core bonds now offer a substantial amount coupon income in addition to the stability and potential for price return they can provide in deflationary risk-off environments. If longer-term Treasury yields push above 5% (like we almost saw in October 2023), we would likely consider recommending extending duration in client portfolios.
International		

U.S. high yield corporate bond spreads have narrowed by about 200 basis points over the last 12 months, supported by resilient economic data and less issuance. Although not our base case, if signs of a weakening labor market and consumer spending begin to emerge, we will likely recommend reducing exposure to credit and reallocating to government bonds in the core sleeve of portfolios.

EQUITIES



CURRENT OUTLOOK

Large Cap		We think a neutral equity allocation remains appropriate for client portfolios given the current economic and market conditions. The U.S. economy is probably in an extended late-cycle environment following more than 500 basis points of Fed rate hikes from March 2022 through July 2023. Slightly hotter-than-expected inflation readings in 1Q24 have pushed out the timeline for a so-called Fed soft landing. However, a significant reacceleration in price pressures seems unlikely to develop.
Mid Cap		
Small Cap		
Developed International		
Emerging Markets		

With the most important underlying components of the U.S. economy (aggregate job growth, wages, and consumer spending) looking solid, we would likely recommend adding to equity positions in the event of a broad market correction in the neighborhood of 10%. Such an opportunity could present itself this summer and fall as volatility is likely to pick up around the election cycle.

Given the balance of risks and opportunities, we think it makes sense to keep equity allocations focused on areas of the market that exhibit quality characteristics in terms of leverage, earnings volatility, and return on capital.

ALTERNATIVES*



CURRENT OUTLOOK

Gold		We recommend most portfolios maintain a moderate allocation to gold given our assessment that the economic, policy, and geopolitical backdrops appear well suited for the precious metal. The likely conclusion of the Fed's rate hike cycle, potentially volatile inflation, and elevated geopolitical tensions should allow gold to improve the risk-adjusted returns of portfolios in coming quarters. Our alternatives allocations, as seen in the table to the left, are designed to decrease the overall risk profile of our five investment objective-based portfolios (CAP PRES, IWSG, BAL, GWSI, and GROWTH.)
Hedged Equity		
Arbitrage		

The above minimum/neutral/maximum recommendations represent MainStreet Advisors' current positions relative to our Strategic Asset Allocation ranges. Views expressed have a 6-12 month horizon and are those of the MSA Investment Committee.

*Cap Pres: Capital Preservation, IWSG: Income with some growth, Bal: Balanced, GWSI: Growth with some income

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