First Quarter 2024 – Investment Commentary

The economy continues to surprise to the upside on several fronts including, unfortunately, inflation. This in turn has pushed back the expected date of the Federal Reserve's (Fed) first rate cut. First it was March, then May, now June, and it would not be surprising at all if the expected first rate cut gets pushed back to the second half of this year. It is also starting to put pressure on interest rates and higher rates will likely begin to put some temporary pressure on stock prices as well.

Table 1 - Fixed Income Index Total Returns – as of March 28, 2024

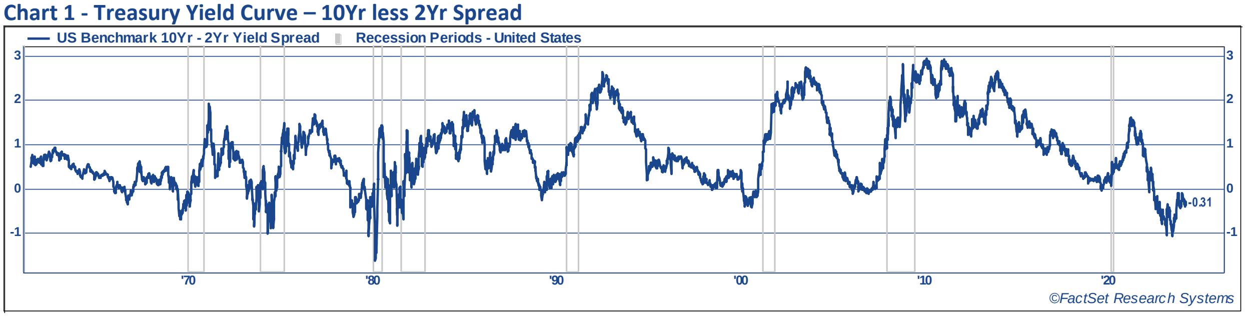
Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg High Yield	1.18	1.47	1.47	11.15	2.19	4.21	4.44
Bloomberg Inter Gov't/Credit	0.64	-0.15	-0.15	2.69	-1.06	1.09	1.61
Barclays Michigan Muni	0.08	-0.23	-0.23	3.47	-0.53	1.62	2.88
Bloomberg Municipal	0.00	-0.39	-0.39	3.13	-0.41	1.59	2.66
Bloomberg U.S. Aggregate	0.92	-0.78	-0.78	1.70	-2.46	0.36	1.54

Buckle up because the road forward near-term is going to get bumpy. Even Fed Chair Jerome Powell believes the path to price stability will be bumpy. When asked if the recent hotter-than-expected inflation numbers have dented their confidence that inflation will continue to gradually move down, he answered "It certainly hasn't improved our confidence. Now here are some bumps and the question is: are they more than bumps? And we just don't, we can't know that. I think the historical record, it's every situation is different, but the historical record is that you need to approach that question carefully and try and get it right the first time and not have to come back and raise again."

With inflation stalling in the 3.0% - 4.0% range, and the economy continuing to chug along, the Fed is prudently reluctant to cut rates. When they do decide to cut rates, the frequency and pace is likely to be terribly slow as the Fed will err on the side of caution to ensure inflation does not re-accelerate. Powell has stated numerous times they do not want to repeat the mistakes made in the 1970s which ended in stagflation, which is basically high unemployment and high inflation.

When inflation trended lower during the 1970s, then Fed Chairman Arthur Burns cut rates several times only to have to raise rates higher due to accelerating inflation. This ultimately resulted in higher unemployment and inflation, a self-fulfilling inflation sentiment bias, and a general erosion of public confidence about the economy and inflation. Unlike today, public sentiment was not considered an important measure for the Fed back in 1970s, which was a critical and costly mistake, but a valuable lesson was learned.

Chart 1 - Treasury Yield Curve – 10Yr less 2Yr Spread



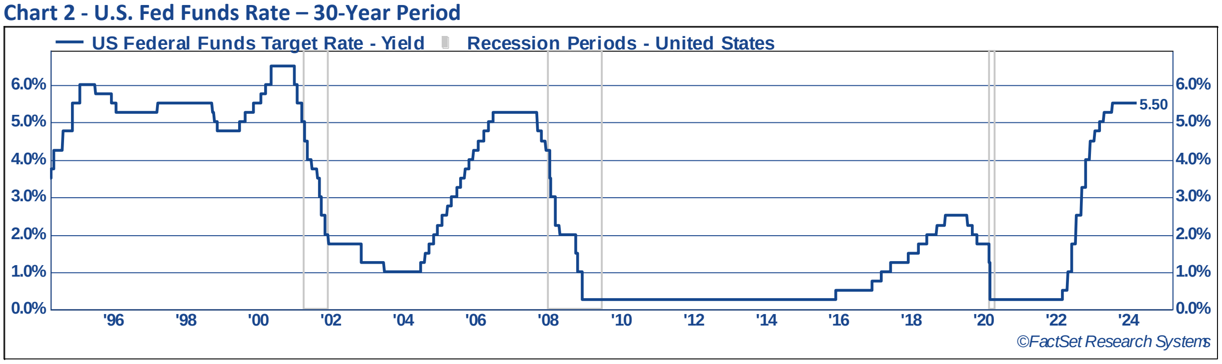
This is why rates have a good chance of staying higher for longer. Not only short-term rates but there is a good chance long-term rates could push meaningfully higher. The yield curve has been inverted (short-term rates **higher** than long-term rates) for almost two years and at some point reality may kick in that perhaps modestly higher inflation is going to stick around for a while. If this is in fact the case, it would drive the neutral rate higher and steepen the yield curve (short-rates **lower** than long-term rates). The Fed's latest projections (March) reflect a higher short-term and longer-term neutral rate.

For 2025 and 2026, Fed fund rate projections moved from 3.6% and 2.9%, respectively, to 3.9% and 3.1%. Their longer-run rate projection went from 2.5% to 2.6%. The longer-run rate projection change doesn't seem like much, but it sends a clear message of rates being higher-for-longer and perhaps the acceptance of modestly higher inflation.

The neutral rate is defined as the short-term interest rate (Fed funds rate) that provides for full employment and stable inflation. It is neither restrictive nor accommodative. This rate is not static but dynamic, subjective, and theoretical. Put simply, the Fed's obligation is to find the neutral rate that will accomplish its mandate of full employment and price stability. The neutral rate is a moving target as monetary policy adjusts based upon current and expected economic conditions.

The Fed aggressively raised rates 11 times from March 2022 to July 2023 and then moved into wait-and-see mode to determine if higher rates were indeed restrictive enough to broadly weaken the economy, soften the labor market, and drive the inflation rate down to their stated goal of 2%. Pockets of progress has been made on each of these fronts, especially inflation, but the pace has been erratic and proven to be much slower than widely anticipated. This has prompted the question, does the neutral rate need to be higher?

Chart 2 - U.S. Fed Funds Rate – 30-Year Period



Over the last 30 years, the Fed funds rate has ranged from a high of +6.5% (May 2000 – January 2001) to a low of +0.25% (May 2020 – March 2022) and has averaged +2.6%. Moreover, the spread between the 10-year treasury and the Fed funds rate has ranged from +3.9% (steep curve) to -1.9% (inverted curve) and has averaged +1.3%. The bottom line is the longer it takes for the Fed to achieve its 2% price stability mandate, the more likely long-term rates will press higher.

Acceptance of a higher neutral rate could push the 10-year treasury yield well north of 5.0%, and a 6.0% handle is not out of the question. Bear in mind that inflation has been rather tame for the most part over the last 40 years. Up until 2021, an entire generation has not experienced a sustained period of high inflation but over the last couple of years they have learned how it affects their standard of living. Despite recent high inflation, longer-term inflation expectations appear to remain well anchored, as reflected in a broad range of surveys of households and businesses.

If rates do stay higher for longer, how will this impact stocks? An old Wall Street adage is "Don't fight the Fed." This means that when the Fed is cutting rates, the economy and the stock market typically do well and when they are raising rates, the economy and stock market typically do poorly. The last couple of years are fairly good examples. In 2022, the Fed began raising rates to quash rapidly rising inflation and stocks were crushed. In 2023, as inflation trended lower and as the Fed slowed the pace of rate increases, anticipation grew they were done raising rates and stocks performed admirably.

Table 2 - Equity Index Total Returns – as of March 28, 2024

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
S&P 500	3.22	10.56	10.56	29.88	11.49	15.05	12.96
S&P 400	5.60	9.95	9.95	23.33	6.96	11.71	9.99
NASDAQ	1.85	9.31	9.31	35.08	8.17	17.19	15.73
Dow Jones Industrial	2.21	6.14	6.14	22.18	8.65	11.31	11.76
MSCI Developed	3.29	5.78	5.78	15.32	4.78	7.33	4.80
Russell 2000	3.58	5.18	5.18	19.71	-0.10	8.10	7.58
MSCI Emerging	2.48	2.37	2.37	8.15	-5.05	2.22	2.95

Stocks have risen five of the last six months so a pullback or even a correction (a decline of more than 10 percent) should not come as a big surprise. However, we remain bullish on stocks as the fundamentals are still positive. Despite higher inflation readings, the Fed still believes the declining inflation story is still intact and forecasts three rate cuts this year. Additionally, S&P 500 earnings growth forecasts for 2024 and 2025 have held steady in the low double digits at 11.0% and 13.4%, respectively. Also, consensus forecasts for U.S. economic growth for the next couple of years are near 2%. Finally, stock markets are fairly valued as valuations are near or below historical averages.

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Sources: FactSet, The Federal Reserve, Federal Reserve History, FactSet Earnings Insight