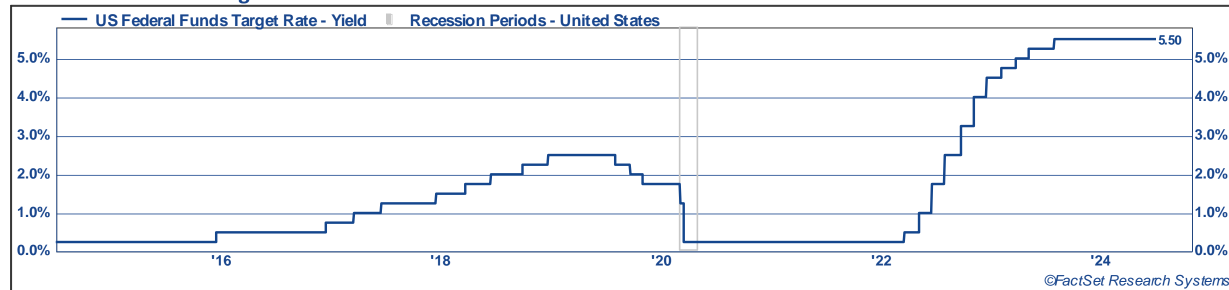
Second Quarter 2024 – Investment Commentary

After aggressively raising rates 11 times since March 2022, the Fed, along with most economists, believed this policy would be restrictive enough to broadly weaken the economy, soften the labor market, and bring inflation down to target in a timely fashion. With the resiliency of the consumer and labor market, it's proven to be a marathon, not a race. That phrase is befitting to explain how Federal Reserve (Fed) policy is taking much longer than expected to bring inflation under control and down to their 2% target. The Fed has held the target rate steady since July 2023.

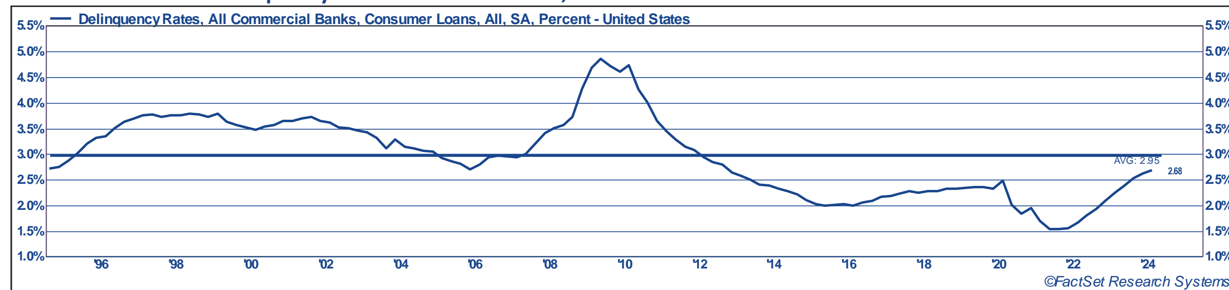
Chart 1 - Fed Funds Target Rate



Consumer spending comprises roughly two-thirds of U.S. GDP and has held up rather well since the onslaught of higher inflation in 2021. There are several reasons why the consumer has held up so well. First, is wage growth which has increased household disposable income and helped to somewhat soften the blow of inflation more so in the past year than at the onset of inflation which peaked at 9.2% in June 2022. Annual wage growth has averaged 4.8% over the past three years but has been trending lower this year.

Second is the solid rise in household wealth as stock market and home price gains may have given consumers more confidence and room to increase their level of borrowing. Indeed, according to the Federal Reserve Bank of New York's 1Q24 Household Debt and Credit report, credit card debt breached the $1 trillion mark back in 2Q23 and is up $230 billion from the onset of COVID in 1Q20. Some economists contend a good portion of increased credit card use is to cope with higher inflation which may now be pressuring delinquencies.

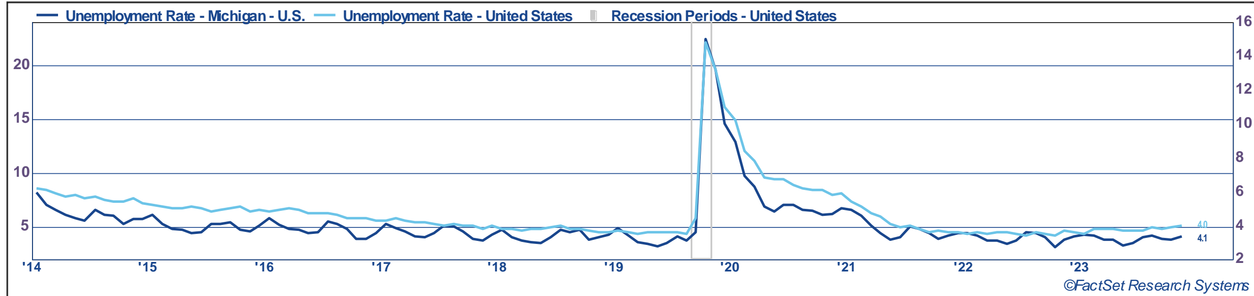
Chart 2 - Consumer Delinquency Rates – as of March 29, 2024



The third support item for consumer spending comes from the plethora of COVID fiscal spending programs but most economists contend these programs have or will be winding down soon. Finally, the millions of illegal immigrants who have entered the U.S. since 2021 and their need for goods, services, and housing has had an impact. This certainly lends support to the resilient consumer spending narrative.

Turning to the labor market, in addition to the restrictive monetary policy of higher interest rates, immigration is considered a major factor in the softening of the labor market by the Fed. When questioned about the labor market during his latest FOMC press conference Chair Jerome Powell noted how the labor market was overheated two years ago and that, while still considered tight, it has gradually moved back into better balance between supply and demand. More specifically, labor force supply has moved significantly higher because of immigration.

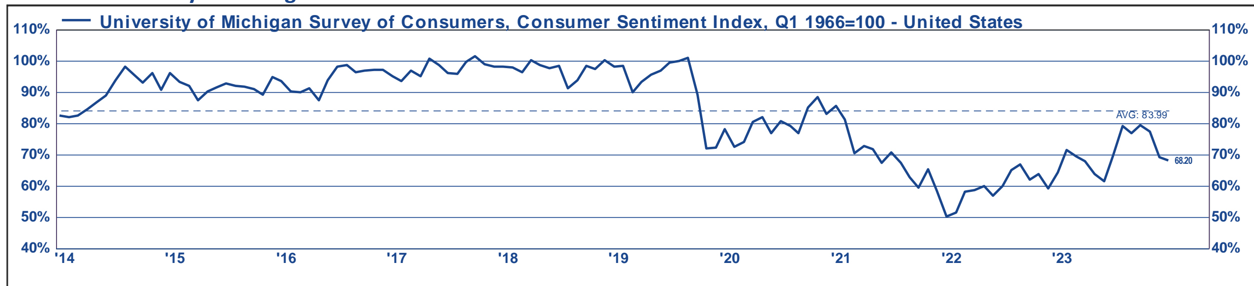
Chart 3- Michigan Unemployment Rate – as of May 31, 2024



Other labor force measures indicate more balance as well including the aforementioned average wage growth which has slowed to a 3% annualized pace; the number of available jobs, while still elevated, has declined by 33% from its peak of 12.1 million in March 2022 to 8.1 million in April 2024; and initial weekly jobless claims have been gradually moving higher over the past couple of months. It is important to note that the number of available jobs still outpaces the number of unemployed (6.6 million) by a ratio of 1.2 to 1, and that the unemployment rate remains well below historical average.

There are signs consumers are starting to feel the higher inflation and interest-rate environment pinch. Retail sales came in lower than expected in April and May, are flat from the end of last year, and are only up 2.3% over the last 12 months. The University of Michigan Consumer Sentiment survey shows consumer sentiment remains dormant and in May fell 10 percentage points to 67.4%, its lowest reading since last November and largest decline in three years. Additionally, consumer delinquencies are on the rise for both revolving credit cards and auto loans. Lastly, economic data released in June showed the demand tide may be turning and the pace of weakening could be broadly accelerating.

Chart 4 - University of Michigan Consumer Sentiment – June 2024



While one month of weak economic data does not affirm a concrete trend, it certainly was welcome news from a Fed rate cut perspective, as expectations for the Fed's first rate cut accelerated to a 60% chance in September up from 45% one month ago. Because of mixed economic readings, Fed rate cut expectations have been bouncing all over the place so far this year and to a lesser extent so have stock prices and bond yields.

After a strong start to the year, stocks posted mixed results last quarter with large-cap tech stocks leading the way pushing both the S&P 500 and Nasdaq to new all-time highs. Artificial Intelligence (AI) euphoria pushed the NASDAQ and S&P 500 to solid quarterly gains of +8.5% and +4.3%, respectively. Once again, the gains were concentrated within a handful of large-cap tech companies with only five of the S&P 500 sectors posting positive total returns.

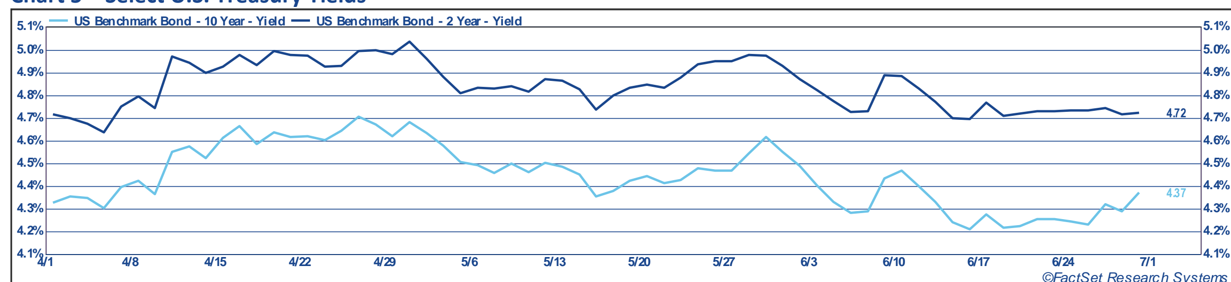
Table 1 – Equity Index Total Returns – as of June 28, 2024

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	6.03	8.47	18.57	29.61	7.78	18.21	16.07
S&P 500	3.59	4.28	15.29	24.56	10.01	15.05	12.86
MSCI Emerging	3.94	5.00	7.49	12.55	-5.07	3.10	2.79
S&P 400	-1.58	-3.45	6.17	13.57	4.47	10.27	9.14
MSCI Developed	-1.61	-0.42	5.34	11.54	2.89	6.46	4.33
Dow Jones Industrial	1.23	-1.27	4.79	16.02	6.42	10.33	11.30
Russell 2000	-0.93	-3.28	1.73	10.06	-2.58	6.94	7.00

The lack of depth and breadth in the market's advance underscores concerns about recent soft economic data and its potential impact on earnings estimates. Indeed, other domestic stock markets moved lower last quarter with the small-cap Russell 2000 and mid-cap S&P 400 posting negative total returns of -3.3% and -3.5% respectively. Going forward, earnings will be key to sustaining and expanding market valuations as much of the anticipated Fed rate cuts are already baked into the market. The good news is that earnings expectations for 2024 and 2025 moved modestly higher over the course of the first quarter earnings season and stand at 11.3% and 14.4%, respectively.

Just as Fed rate cut expectations have waxed and waned, so have treasury yields. Chart 5 below shows the wide swings in 2-year and 10-year bond yields last quarter even though they ended up pretty much where they started. The swings, however, show how sensitive markets are to the presumed course of Fed policy.

Chart 5 – Select U.S. Treasury Yields



What a difference one quarter makes. At end of last quarter, inflation readings were consistently coming in hotter than expected, yields were rising, and the projected date of the first rate cut was being pushed back significantly. In fact, rate cut expectations deteriorated so badly, that in mid-April the Wall Street Journal published an article titled "Fed Rate Cuts Are Now a Matter of If, Not Just When," highlighting that rate hikes may not be off the table and the prospect that the first rate cut may not occur until 2025. Lest I remind you, both stocks and bonds finished sharply lower in April.

That was back in March and April, which seems so long ago, and since then inflation readings released in May and June showed inflation slowing and bond yields moving lower to end the quarter. As Table 2 reflects, bond returns were basically flat last quarter.

Table 2 - Fixed Income Index Total Returns – as of June 28, 2024

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg High Yield	0.94	1.09	2.58	10.44	1.64	3.92	4.31
Bloomberg Inter Gov't/Credit	0.80	0.64	0.49	4.19	-1.18	0.71	1.55
Barclays Michigan Muni	1.60	0.32	0.08	3.69	-0.87	1.27	2.64
Bloomberg Municipal	1.53	-0.02	-0.40	3.21	-0.88	1.16	2.39
Bloomberg U.S. Aggregate	0.95	0.07	-0.71	2.63	-3.02	-0.23	1.35

Last quarter we wrote that the 10-year treasury would likely breach the 5.0% yield mark over the next 6-12 months, and we continue to believe so for several reasons. First, in June, and for the second consecutive time, the Fed raised its long-run neutral rate projection from 2.6% to 2.8% and we expect the yield curve to steepen accordingly upon the first rate cut. Second, when the Fed does decide to cut rates, it will do so cautiously and at a measured pace. Finally, the consistent deluge of treasury bond issuance to fund government spending will put pressure on rates.

As we enter the third quarter, stock market bulls continue to point to forecasts for further disinflation, solid corporate earnings, a healthy labor market, and a still solid spending consumer. It may take a while for the Fed to gain enough confidence to cut, but expectations remain that those cuts are coming most likely in either in September or November. Market bears have been pointing to widespread hawkish (higher rates) Fed commentary and continued Treasury supply worries as placing upward pressure on rates. Additionally, there is a rising concern about the degree to which stubborn inflation and a stretched consumer may lower demand, constrain companies pricing power, and in turn, negatively impact earnings prospects. We remain cautiously optimistic on the stock market but will be closely watching for earnings estimate deterioration for the remainder of this year and next year.

Prepared by Perry Adams – SVP & Director – West Shore Bank Wealth Management – July 3, 2024

Sources: FactSet, The Federal Reserve, FactSet Earnings Insight, Federal Reserve Bank of New York, U.S. Bureau of Labor Statistics, University of Michigan, U.S. Census Bureau, CBOE, and the Wall Street Journal

This publication is for informational purposes only and reflects the current opinions of West Shore Bank. Information contained herein is believed to be accurate but cannot be guaranteed. Opinions represented are not intended as an offer or solicitation with respect to the purchase or sale of any security and are subject to change without notice. Statements in this material should not be considered investment advice, a forecast or guarantee of future results. To the extent specific securities are referenced herein, they have been selected by the author on an objective basis to illustrate the views expressed in the commentary. Such references do not include all material information about such securities, including risks, and are not intended to be recommendations to take any action with respect to such securities. Indices are unmanaged, do not reflect the deduction of any fees normally associated with an investment management account, including investment advisory fees. Indices are not available for direct investment. This publication has been prepared without considering your objectives, financial situation, or needs. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation, or needs. **Past performance is no guarantee of future results.** This publication is the property of West Shore Bank and is intended for the sole use of its clients, consultants, and other intended recipients. It should not be forwarded to any other person. Contents herein should be treated as proprietary information. This material may not be reproduced or used in any form or medium without express written permission. **INVESTMENTS: NOT FDIC INSURED - NO BANK OR FEDERAL GOVERNMENT GUARANTEE – MAY LOSE VALUE**