

ECONOMIC OUTLOOK

Summary

The tone of nearly all incoming economic data shifted during May. The overall weakness in April's data (released in May) contributed to volatility in the major asset classes, partly because investors were caught off guard after several quarters of economic strength. Following the disappointing data, GDP expectations throughout the second quarter (according to Atlanta Fed's GDPNow model) dropped substantially from 3.9% to 1.8% as of June 3, 2024.

The month started with ISM manufacturing (a diffusion index where values above 50 represent expansion and values below 50 indicate contraction) slipping back into contractionary territory after having crossed above 50 for the first time in 17 months during March. A few days later, ISM services also fell into contractionary territory for the first time in 16 months. Most of the economic growth experienced during the past two years has come from the service side of the economy, so the possibility both services and manufacturing were contracting at the same time caused market participants to worry. That same day, non-farm payrolls surprised to the downside with its second-smallest gain in the last three years (including revisions), accelerating further economic concern.

Fortunately, the following week the Consumer Price Index (CPI) values came in slightly lower than expected. This provided market participants with some relief after four consecutive months of hot inflation prints. However, the monthly values in isolation were still much higher than the Federal Reserve (or any individual) would care to see.

The disappointments continued later in the month. Retail sales data showed no monthly gains, we saw continued weakness in the housing market and material revisions lowering first-quarter GDP and personal consumption.

The question now becomes this: Was April data an outlier or the start of a new trend? It is possible that seasonal factors caused the weak data and it will be a blip on the radar as we move forward with solid economic growth. On the other hand, it's also possible that we are now just starting to experience some of the lagged effects of the Fed's aggressive rate-hiking cycle. FCI still believes that a slowdown will not be possible without weakness in the job market, so we will be closely monitoring May's payroll report.

Positives

Year-over-year Core PCE remains under 3% for the fifth consecutive month

Factory orders were positive and surprised to the upside (0.7% vs. 0.6% est.)

Durable goods orders beat expectations by 1.5% (0.7% vs. -0.8% est.)

Negatives

First-quarter GDP was revised lower by 0.3% to 1.3%

Retail sales missed expectations by 0.4% (0.0% vs 0.4% est.)

Month-over-month pending home sales declined by 7.7%

EQUITY OUTLOOK

Summary

Equity markets recovered in May following the declines in April. The S&P 500 Index rose 5.0% during the month and hit a new all-time closing high mid month. The stock market's strength was fairly broad with the Russell 1000 Growth Index increase of 6.0% outpacing the 3.2% gain in the Russell 1000 Value Index. The developed international MSCI EAFE Index added 4.0% while the MSCI Emerging Markets Index eked out a 0.6% gain.

With earnings season all but wrapped up, releases were largely in line to positive with forward looking guidance more conservative. A few high-profile companies (such as Nvidia) delivered impressive results that helped to aid the stock market's recovery for the month. Still, stock leadership remains fairly narrow with no clear thematic trends evident in the near term.

There is an old market adage that stock investors should sell in May and go away. It suggests equity investors can step away in the summer months when returns tend to moderate and return to the markets in the fall. Like many strategies, sometimes that works and other times it does not. However, it would not surprise us if that trend holds true in 2024 given current market sentiment.

The next few months may be more indicative of a range-bound market with stocks trending sideways in a volatile

fashion. We maintain our focus as long-term investors. Most corporations are operating with clean balance sheets and solid fundamentals. The regulatory environment still looks favorable for many industries and advancing innovation should lead to productivity gains.

Positives

Artificial intelligence and related technology ushering in a new industrial revolution

Labor markets cooling in recent weeks an improved signal for inflation

Negatives

Geopolitical tensions remain elevated

Both major presidential candidates have challenges

Unknowns

Forward corporate earnings visibility mixed

FIXED INCOME OUTLOOK

Summary

The bond market continues to move lockstep with an oscillating outlook for Fed rate cuts. For the first four months of the year, as inflation data came in hotter than economists and Fed officials expected, yields moved generally higher. Coming into May, investor expectations had already changed from forecasting six rate cuts this year to just one. Yields for the 10-year Treasury note moved up accordingly and formed a “triple-top” in late April. Importantly, it was unable to move materially above 4.70% which made it unlikely there would be a full retest of last October’s 5% level.

Then following the Fed’s May 1 meeting of the Federal Reserve’s Open Market Committee (FOMC), yields began to turn back lower again. While there was no change in policy, at the post-meeting press conference Chairman Powell emphasized even though rate cuts would be delayed, rate increases were not being considered. By mid month, aided by softer economic data, the 10-year had staged a 34 basis points (bps) rally back down to 4.34%. But this too was short-lived as rates bounced back above 4.60% and closed May at 4.50%, down 18 bps for the month. The 2-year note closed the month of May 16 bps lower at 4.87%. The longest inversion in history, of the 2 to 10-year yield curve, is nearing the 2-year mark with no signs of returning to its usual relationship anytime soon.

Year-to-date corporate bond issuance has been nearly 20% greater than the previous three-year average. Even with the massive supply and economic uncertainties, credit spreads narrowed a few more bps in May to the tightest level in more than two years and about 30 bps lower than the post-pandemic three-year average. Given their incremental carry, slightly longer duration and modest spread compression, corporate bonds once again outpaced Treasury notes for the month. From a sector perspective, finance company bond spreads narrowed more than those of the industrial sector and were the strongest duration-adjusted returning sector. Following one of the worst months for most broad bond market indexes, May’s performance was in the top quartile of monthly returns since their inception almost 50 years ago.

Barring an unlikely rapid reacceleration of inflationary pressures, the Fed hit their terminal point of this tightening monetary policy cycle last July. They believe the overnight rate is restrictive enough to eventually slow demand and move inflation toward their target. The time it will take remains an uncertainty. Relative to past tightening cycles, at about 210 trading days, this period is shorter than the 246-day average of the past four rate-hike cycles. If the current rate is maintained until the December FOMC meeting, the duration will still be more than two months shorter than the 1997 to 1998 top when for 379 trading days rates were held at 5.50%, coincidentally. We continue to believe a retest of 5% on the 10-year is unlikely and therefore are sticking with our policy of modestly more duration exposure than benchmark indexes (5%). With no recession on the horizon, we are also maintaining an overweight to high-quality corporate bonds.

Positives

Increasing retail interest should attract net new flows into bond funds and ETFs

Record equity market levels could create bond demand through rebalancing

Negatives

Timing of Fed rate cuts as uncertain as ever

Federal budget deficit and heavy Treasury debt issuance

Unknowns

Escalation of Middle East conflict with Iranian proxies.
Domestic protests.

Resolution of Russia/Ukraine war and impact on global trade