2024 SPRING INVESTMENT OUTLOOK

The economy continues to defy prognostications of impending doom from tighter monetary policy and the rise in interest rates over the past two years. Economic surprises have generally been to the upside throughout the first quarter of 2024, leading to upward revisions in economic growth expectations for this year and a decline in year-ahead recession probabilities of forecasters. Full year GDP growth estimates for the U.S. in 2024 have now risen to an average of 2.1% amongst economists regularly polled by Bloomberg (modestly higher than the economy's 1.8% potential attributed by most analysts) from the 1.0% or so expectation entering the year. The Bloomberg near term recession probability has fallen to a current 40% from 65% a year ago, a favorable trend (but still well above the 15% level historically associated with mid-cycle expansions).

The stock market has rewarded this growth surprise with a strong continuation of the rally that commenced in late October of last year. Cumulative price gains in the S&P 500 since the October 27th bottom are now nearly 27% in just five short months, adding trillions of dollars in value and supporting an acceleration in spending over the past six months by the wealthiest households, according to Bank of America data.

Investment grade corporate bond issuance in the first quarter of 2024 alone is up nearly 33% relative to last year and on pace to total an eye-popping $520 billion. High yield credit spreads have tightened to just 300 bps wider than Treasuries, the narrowest level since January 2022 (when the fed funds rate was still 0%) and barely above the 262 bps low of mid-2021 when policy was at its easiest during the height of the pandemic. Concurrently, the US dollar has generally eased against major currencies, supporting global liquidity.

Many of the above trends began when the Federal Reserve more explicitly signaled an end to the rise in interest rates at its last two meetings of 2023 and the potential for rate cuts to begin in 2024. After all, the current fed funds rate of 5.5% is well-above the 2.5%-3.5% neutral rate identified by most economists, highly restrictive amidst a falling inflation assumption. This pivot led to the interest rate derivatives markets pricing the potential for 150 bps of rate cuts this year as the calendar turned, leading to a further easing in financial conditions and supporting a positive feedback loop in equity valuations.

However, as the first quarter progressed the inflation data has proven to be quite stubborn with measures like core CPI coming in hotter than expected for both January and February alongside firmer producer and import prices. Furthermore, the so-called "sticky" components of core CPI (a basket of items that change price relatively slowly) have seen price momentum trending higher, rising at a current 5.1% annualized rate on a 3-month basis from its 3.6% late summer trough. The derivatives markets have since fallen in-line with the Fed's so-called dot plot, currently discounting only 75 bps of cuts for 2024, and pushing out the first cut to mid-summer at the earliest.

The large mega cap tech companies have led the 10% year-to-date equity rally on the heels of strong artificial intelligence (AI) enthusiasm while the average stock is tracking at essentially half that rate per the equal weight index. Small cap stocks per the Russell 2000 are up just 2.4% on the year, perhaps a signal that some parts of the capital markets are still wary of the downside risks that could emanate from the sharp rise in rates over the past two years, especially if the currently tight policy regime needed to be maintained for an

THE INFORMATION CONTAINED HEREIN IS BASED ON SOURCES BELIEVED TO BE RELIABLE BUT IS NEITHER ALL-INCLUSIVE NOR GUARANTEED BY OUR FIRM.
OPINIONS REFLECT OUR JUDGMENT AT THIS TIME AND ARE SUBJECT TO CHANGE.

even longer duration to beat inflation. Crude oil prices have risen 18% since mid-December and broad commodity prices are up 11%, complicating the inflation trajectory as the economy exits the first quarter.

2024 YTD Total Returns

	3/20/24	% Change
Dow 30 Industrials	39,512	+5.3%
S&P 500	5,225	+9.9%
NASDAQ Composite	16,369	+9.2%
MSCI ACWI ex-USA	326	+3.6%

Outlook

The economy and capital market backdrop is entering the spring season already in full bloom. Financial conditions are the easiest since late 2021; credit is flowing freely in corporate America; unemployment is low at just 3.9%; investor positioning and sentiment is stretched near prior bullish extremes; earnings growth appears to be in the early stages of recovering off the bottom of its subpar trend of the past year or so; and equity valuations are the most expensive relative to bond yields in 22 years. Inflation remains stubborn, however, with core measures stalling well above the Fed's threshold on a sequential basis to start the year. Thus, all of the above together are not an appropriate formula for easier monetary policy and lower interest rates at the moment.

The key questions entering the second quarter are whether or not the pick-up in growth will be strong enough to substantiate the equity market's sharp advance to start the year and whether the central bank needs to push back more forcefully against the easing of broad financial conditions to ultimately win the inflation fight. The latest Federal Reserve meeting shows a tolerance for marginally higher inflation by the central bank in the short run to avoid damaging the labor market and to give the economy a chance to thread the needle for a potential soft landing. Participants raised their projections for both economic growth and inflation this year while still barely maintaining an expectation of three rate cuts on a median basis.

Lead indicators of manufacturing activity point to an imminent recovery in the global industrial economy, which has been in its own recession for the better part of 18 months. Customer de-stocking has subsided and inventories are being depleted across many industries like electronics and goods manufacturing while order books are finally starting to grow again. China exports are up 7.1% year-to-date following a dismal 2023 and industrial production is growing at the fastest pace in two years albeit producer prices are still deflationary due to excess capacity and oversupply. The property crisis in China continues its slow-roll while the high level of excess household savings is impeding a recovery in consumption in the country. Nonetheless, the recovery in China industrial activity has the potential to impart a spark in global economic activity through the middle of the year. The price of copper is up 10% since mid-February as this possibility became more visible with the release of positive data (alongside the rise in crude oil prices), demonstrating the potential for a global manufacturing recovery to be a hinderance to pushing inflation permanently lower.

Other parts of the economy that were initially the most sensitive to rate hikes appear to be steadying. While buying conditions for existing homes are not on the side of those looking to become homeowners, residential investment is once again contributing to economic activity following a dismal 2 ½ years. Single family housing permit activity has accelerated the past three months and is up nearly 30% from year ago levels, a solid 1-2 quarter lead indicator for additional starts.

Bank lending standards for business loans have also eased the past two quarters, a solid lead indicator for future business loan growth (which has been stagnant for about 18 months). Such a trend could eventually help spur some additional capital investment in the economy, which has been modestly declining on an inflation-adjusted basis. The Conference Board's Index of Leading Economic Indicators is also rising once again on a 3-month annualized basis (but still slightly in negative territory). While this metric has historically been a reliable signal of an impending recession following sharp declines, its most recent plunge into

negative territory over the past two years since the Fed commenced its tightening cycle has not been confirmed by an overall contraction in economic activity. The components that comprise the so-called “hard” government economic data in the index failed to decline in magnitude commensurate with the “soft” economic survey components (which simply asks respondents whether certain measures of activity are growing or contracting) during this indicator’s most recent decline.

Although economic projections for the year have been revised higher, the economy is still showing some signs of slowing. Real GDP grew at a 4.0% annualized rate in the second half of last year driven by strong consumption and deficit spending by the federal government. Core retail sales have declined fractionally the past three months, however, and overall consumption is forecasted to grow just 1.4% on an annualized basis during the middle of this year compared to the 3.0% rate during the second half of 2023. While there are pockets of layoffs in some industries, initial weekly jobless claims are averaging just 208,000 and showing no signs of trending higher like in a recession (when claims often spike into the 500-600k range). Labor market fundamentals have been solid in the aggregate with monthly payroll additions averaging about 265k over the past three months (above consensus estimates) and labor supply still trending higher as folks come back into the workforce post-pandemic. Such trends are supportive of consumption growth in the ensuing quarters.

Corporate earnings are generally coming out of a trough overall although results vary substantially by industry and company. The latest FactSet estimates project 3.3% earnings growth in the first quarter for the S&P 500. Corporations will begin reporting results in just a few weeks. This follows a better than expected 4.1% advance in the fourth quarter of last year and modest 0.9% growth for the full year of 2023. Second quarter and full year 2024 estimates show an expected acceleration in growth of 9% and 11%, respectively.

It will be interesting to examine corporate reports as the year unfolds. Financial reporting obviously occurs on a nominal basis. Some companies will probably continue to benefit from a higher inflation regime, especially businesses with strong pricing power. Others could be hurt by it, especially those more dependent on a recovery in volume growth and businesses where end demand is more sensitive to pricing. Stubborn inflation is also likely to continue to impact profit margins in some industries where costs are still growing faster than revenues. Thus, we see a wide range of possibilities as the year unfolds around the Street’s projection of double-digit profit growth.

While the economy seems to be growing unimpeded at the moment there are plenty of risks that could interrupt the cycle. Election uncertainty and geopolitics are known variables with unknown impacts. More fundamentally, there is the potential that the longer the Federal Reserve maintains such tight monetary policy to beat inflation then the more likely the parts of the capital markets where risk has been egregiously mispriced eventually emerge in distressed fashion. It will take years to resolve commercial real estate issues in the banking system, for example, but the timing of some other unknown variable arriving on the scene could potentially accelerate and magnify its distress, such as potential credit or refinancing challenges in private equity or private credit.

As noted earlier, credit markets have been bullishly re-priced under the assumption that the economic expansion continues in a strong fashion. However, refinancing challenges will persist over the coming years and maturing debt at many companies will undoubtedly be replaced with higher coupon new issues, pressuring cash flows. The federal budget deficit also continues to grow in an unsustainable fashion and could pose a liquidity challenge to capital markets in the back half of the year when Treasury issuance will need to accelerate once again following tax season. The Bank of Japan recently ended its negative interest rate regime and raised interest rates for the first time since 2007. Thus, the strong appetite of foreign investors (like Japanese insurance companies) for U.S. debt and credit could begin to wane on the margin. In the meantime, equity markets are likely to continue to party until something nefarious arrives on the scene.

Investment Conclusion

We continue to be diligent as usual with new investment in an economy that is still growing amidst a higher interest rate regime that currently poses valuation challenges for some asset classes like equities and where fundamental challenges could eventually emerge if high inflation persists. Our bottoms-up equity research is still uncovering opportunities on the margin where above average growth is mispriced. We are also allocating some cash to high-grade corporate bonds yielding above 5% and extending maturities out to four or so years in some cases. With the Federal Reserve poised to cut interest rates at some point this year, money market yields have likely peaked for this cycle and we find it prudent to extend duration somewhat in fixed income.

March 20, 2024

Privacy Notice

Securities and Exchange Commission regulations require that the Firm present all new clients and then annually thereafter to inform all its clients of its rules regarding their privacy, a key element in the investment counsel relationship. Our policy is as follows:

Wilkins Investment Counsel, Inc. Privacy Notice

Our Firm collects nonpublic personal information about you from the following sources: information we receive from you on applications or other forms, information about your transactions with us or others.

We do not disclose any public or nonpublic personal information about you to anyone, except as permitted by law.

Should you decide to close your account(s), we will adhere to the privacy policies and practices as described in this notice.

Our Firm restricts access to your personal and account information to those employees who need to know that information to provide services to you. We maintain physical, electronic, and procedural safeguards to guard your nonpublic personal information.

ADV Notice

Securities and Exchange Commission regulations also require that the Firm deliver annually to clients a summary of material changes to our ADV Part 2 filing which is a narrative brochure written in plain English that contains information such as the types of advisory services we offer, our fee schedule, any disciplinary information, conflicts of interest, and the educational and business background of certain advisory personnel of the Firm. There were no material changes to the information in our ADV Part 2 filing this year. Please contact David Gately, Chief Compliance Officer, at (617) 951-9969 if you would like to receive a copy of our most recent ADV Part 2 filing.