



FIRST QUARTER 2024 MARKET OUTLOOK

MARKET OVERVIEW ¹

At year's end, the market was expecting six or seven rate cuts from the Fed, and seemed to be implicitly assuming that inflation was on its way back to target. Even as that optimistic view eroded, equity markets posted robust nominal returns. The S&P 500® Index grew by more than 10%. Bonds struggled as interest rates rose throughout the period. Gold broke out to new all-time highs.

Economic data was generally good, although certainly not ideal, with many headline economic statistics appearing OK while there were some troubling signs beneath the surface. For instance, unemployment remained low, but revisions to prior releases showed a deterioration, and part-time jobs made up a large portion of the job growth. Inflation proved to be more sticky than expected, remaining in the 3.5% range. Corporate earnings were healthy, and renewed excitement about Artificial Intelligence fueled many of the gains in the market this quarter.

Geopolitical tensions remained a looming concern, with no end in sight for the Russia/Ukraine conflict and more fighting in the Middle East. The political divide here in the US is still pronounced, and pressure seems to be building as we head into the Presidential election cycle.

OUTLOOK

A little more than ten years ago, my wife and I bought a small ranch in the Texas Hill Country. I reckon it's a Texas thing. It's been a great place to get away from the city. My kids love being out there. During COVID, it was amazing, all five of us lived out there and had a blast.

The downside to owning a place like this is the upkeep and maintenance. The house there isn't much to speak of – It's charming, I suppose, but it's also old and small. What's amazing, is how quickly the thing deteriorates. When we aren't there, actively living in the house, things go wrong at an alarming rate. Plumbing issues and leaks, critters in the house, HVAC problems, foundation problems, roof problems, and the list goes on and on. We had a leak recently that did quite a bit of damage, and we are dealing with that now. I suppose it slowly deteriorates a little every day, and then something finally breaks, and you really notice it.

The same is true of the purchasing power of the U.S. Dollar. It deteriorates a little every day. Occasionally something "breaks" and you really notice it. The inflation spike in the last few years stands out as such an example. Our government and some pundits have been quick to claim victory as the published inflation rate has settled down. But don't be fooled back into complacency, it's still a problem. It's still deteriorating.

Larry Summers was one of the few economists who largely got it right over the last few years. He has really been the voice of reason among mainstream economists. He recently co-authored a [paper](#) proposing that borrowing costs can drive inflation higher, and that helps explain the disconnect between consumer sentiment and reported inflation and unemployment. There's a brilliant and snarky line in the introduction.

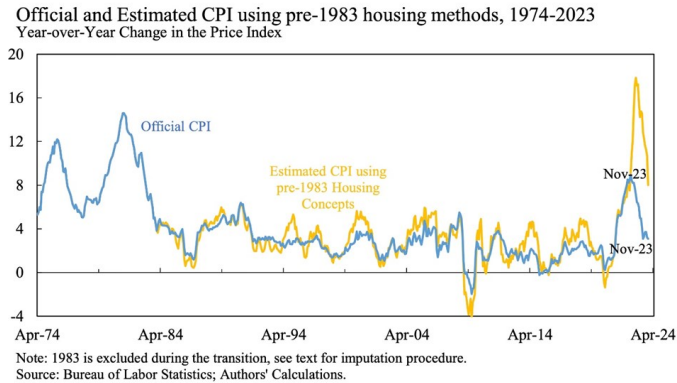
Consumers, unlike modern economists, consider the cost of money part of their cost of living.

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OUTLOOK

Summers and the co-authors point out that the BLS does not include interest rates in their CPI calculations. This has been true since 1983, when the BLS changed the calculation on housing to owner's equivalent rent. Today's methodology also excludes financing costs on automobiles. They report that 80 percent of new cars are financed, so this is a clear omission of a very real cost to most consumers. The authors then go on to develop an alternate to CPI that *does* account for these interest costs. What is labeled as Figure 7 (from their text) shows their alternative measure versus reported CPI.

Figure 7



As economist John Cochrane puts it, "If we measured inflation as we did in the 1970s, the recent bout of inflation would have been even higher than the worst of the 1970s!". To me, this is a shocking revelation. The most recent readings would be around 8% or 9% under this methodology – an apples to apples comparison with the 1970s. While that is sinking in, let's talk about gold.

It might surprise you to know that I'm a bit of a gold bug. I don't think that's necessarily inconsistent with being a long-only growth equity manager. Despite the modern complaints of gold being an antiquated store of value or having no yield, it's actually done a pretty good job of hedging against inflation.

Using data available on Bloomberg, I went back as far as I could to see how many ounces of gold were required to buy the median home in the US. The housing data goes back to 1963, when it took just over 500 ounces of gold to buy the median house. Today that figure is only 202. Relative to housing, it's been materially better than just a hedge, it's drastically outperformed the appreciation in home prices.



There is a similar case for wages. Paying the median worker in 1975 would have cost you \$11,800 or about 84 ounces of gold. Today it would cost you over 6 times as many dollars (\$74,580), but only 41 ounces of gold.

Some people argue that the price of gold is inversely correlated with *real* yields, and this has some logical foundation – when inflation-adjusted returns are negative, gold seems like a decent store of value. But when real yields are higher, investors are lured to the returns of bonds or other alternatives. For the last decade or so, this relationship has been pretty tight...until the last year. Keep in mind that real yields of any appreciable duration are impossible to calculate with any precision. We can get a sense of what inflation expectations are, but we can't know what inflation will be.



Source: Bloomberg

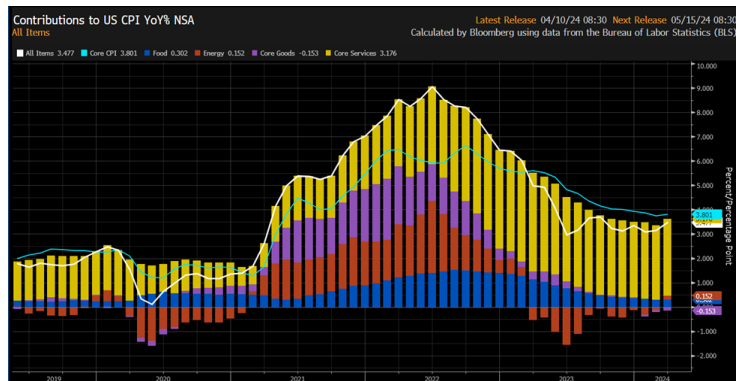
I came across a tweet that showed a chart similar to this, and the author was advocating to short gold, implying that the move in gold was “wrong.” I see it from a different perspective – the price of gold is revealing the imperfect and flawed calculation of *real yields*, and its price implies that the real yield is probably in the neighborhood of -4.5%. What a coincidence! If Summers, et alia calculate inflation at 9%, and nominal yields are 4.5% as of the time of writing this, and gold is saying real yields are -4.5%, it all adds up. How neat.

If you’ve been following my thoughts on inflation, you know that I’ve frequently made the case that actual inflation is much higher than is reported in CPI, and this is yet another data point supporting my case. So I’ll try not to belabor the point any more than is warranted by its importance, which is to say, you’ll probably hear me say it again.

Admittedly, early last year, I was worried about a potential recession. And that clearly hasn’t happened yet. Although it’s worth noting that if Summers’ 9% inflation is anywhere near right, then real GDP growth would likely be negative. The strong nominal growth and under-reported inflation have masked what might be a recession. If that is the case, it’s clearly not like other recessions - in terms of layoffs and job loss. Although I suppose to the consumer with little to no assets and increasing borrowing costs, it might feel like a recession.

In any event, my fears about a potential recession were based on the Fed doing what was required of them to cure inflation. It’s an unhappy trade-off for sure. Toward the end of last year when it looked like the cure was happening and the 10-year was above 5%, the Treasury department used a new technique to buy some time, by shifting the source of funding to the short end of the curve, drawing from a massive pool of assets in the reverse repo facility at the Fed. Then the Fed blinked at the December meeting, when they broadcast intentions to cut rates. The combination was a loosening of financial conditions which will have likely spurred additional inflation in the coming months, and provided enough stimulus to avoid a recession in the near term.

Frankly, I think I would have preferred the recession, because what comes next is potentially very dangerous. Back in 2021, we were told that the inflationary pressures were transitory. My take was always that *some* of the inflationary issues were indeed transitory, but some were more structural and long-term in nature. Specifically, the inflation for goods was transitory. People were flush with cash and stimulus, while production and logistics struggled – demand went up and supply went down. See the CPI breakdown below, where goods are in purple.



Source: Bloomberg

OUTLOOK

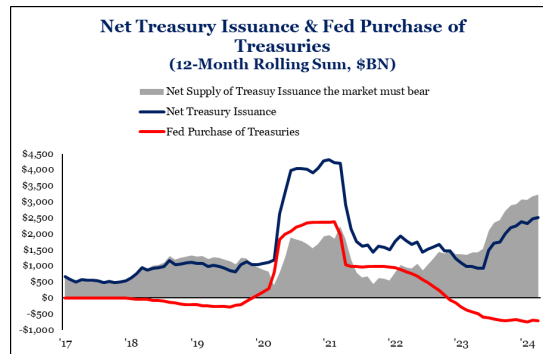
Energy also spiked during that period, but lately it has been a negative contributor to inflation. The Fed and some economists like to focus on Core inflation, excluding food and energy. But there are two issues with doing that. First, food and energy costs are very real, and consumers can't avoid them. Second, while they can be more volatile, that also makes them more predictable. Here are some more thoughts from John Cochrane of the Hoover Institute:

There is a supposition that food and energy prices are “volatile.” Volatile really means predictable — a rise in price today can reliably forecast a decline in that price in the future. Then core is a better forecast of future inflation than headline inflation.

With food and energy prices having recently declined, the more reliable forecast would assume that they may revert, and potentially drive inflation even higher.

For some reason, the Fed really seems to want to cut rates. Maybe it's just me, but I would think the proper approach to being a policy maker at the Fed would be to have a completely unbiased stance — neither wanting nor hoping that policy rates would need to move one way or the other, but instead methodically executing in a disciplined framework. The [Taylor Rule](#) was a famous effort to provide that framework, and the current interpretation of the original Taylor Rule would lead to Fed Funds rates being 88 basis points **higher** than where they are today.

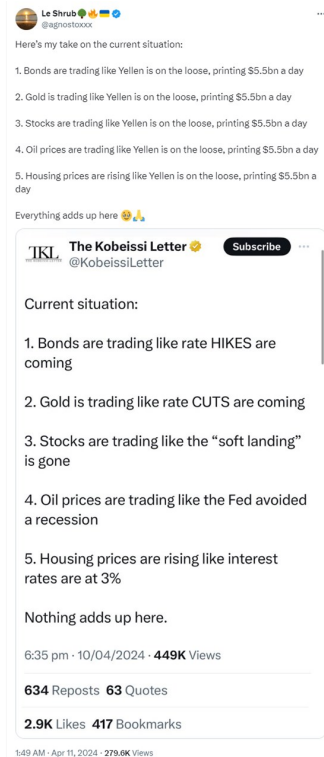
While the Fed has broadcast their intentions to cut rates as soon as the data allows them, they have also recently indicated that they intend to slow the pace of the balance sheet runoff, aka Quantitative Tightening or QT. Refer back to my comments last quarter for a deeper discussion of this. Recent Fed minutes confirm our suspicions. The net effect is that the Fed will start reinvesting proceeds from government bonds into new issues. I suppose the takeaway is that the Fed doesn't think the market can deal with the mountain of debt the Treasury has to issue to keep the government spending at the pace they're on. With the Treasury ramping up issuance to cover the pace of spending, and the Fed trying to get away from QE, it's just too much for the market to bear.



Source: Strategas

It's very possible that what really drives inflation isn't short term rates, but expectations about government debt. If we assume that it has to be repaid at some time, and significantly raising taxes to do so isn't feasible, and neither is cutting spending to the point of running a budget surplus, then the only remaining option is to inflate our way out of the debt. There was a tweet that beautifully summed up the whole confusing situation of what we are witnessing across markets.

In as much as that it is government largess creating the problem, it's hard to see any improvement on the horizon. Whether it's spending on foreign wars or the flood of immigrants coming to the country, it doesn't really matter other than we simply can't afford to continue at this pace.



What does all this mean for US equities? It depends on a lot of yet unresolved issues. Here's my personal conclusion. Our policy makers and government can celebrate all they want about headline CPI readings being down versus where they were at the peak. But every consumer isn't celebrating yet. We all have to deal with the much higher *price level*, and now the compound growth on top of it. When individuals begin believing that inflation is a persistent problem, they change their behavior. They wake up to the idea that their hard earned cash is a lot like my ranch house – it deteriorates every day. We can complain to one another that the price of x is going up; or how expensive y has become. But that's not what inflation really is. Inflation is the loss of purchasing power in your currency. It's not that prices are going up, **it's that the value of your dollars is going down.**

Many of us have been excited to earn some yield in cash equivalent securities lately; we've been starved of yield for a decade! Given everything I've presented here, I think there's reason to believe that even 5% rates on cash might not be keeping up with the deterioration in purchasing power, despite what CPI indicates. If that's the case, then holding on to cash in the long term isn't such a great idea. For myself, I am certain that the after-tax returns of a T-bill or a money market account are absolutely not keeping up with the cost of living.

I worry that we might be about to enter another phase in our tangle with inflation - one where the average consumer begins to change their purchasing and investing preferences in response to what is becoming unmitigated loss of purchasing power. If you accept the condition of persistently high inflation, then common sense dictates that you pull forward purchases. Buy it now, before the price goes up. In countries with hyper-inflation, people try to spend their paychecks as soon as they get them. This has the impact of exacerbating inflation.

The other logical response is wariness about the dollar. We've seen the ramp in the price of gold, and the same is true for Bitcoin. I'm not advocating for either, but I think it's reasonable to assume that some of the increase in demand for these two things is that their holders believe they are better stores of value.

From a historical perspective, one would expect bonds to underperform if we get continued inflation and higher interest rates. It's quite possible that asset allocators, or even individual investors, change their investment portfolios substantially, shying away from cash and fixed income. Some of that money could move into equities.

Equities generally live in the nominal world, making them less sensitive to inflation. When the first bout of inflation hit, and the Fed responded with higher rates, equities didn't deliver the inflation-resistant performance people had hoped for. The burden of relatively expensive multiples in a rising rate environment was too much to overcome.

While equities might be superior to fixed income (in dealing with inflation), let's be clear: not all equities will handle inflation similarly – there will be winners and losers in both a relative and absolute sense. We've been watching this unfold over the last two years, and it seems like we aren't done yet. What matters is: each company's ability to pass through price increases, to manage costs, and to handle their capital needs.

Inflation is also causing dispersion in the market indirectly as well; it disproportionately hurts people at the lower end of the socio-economic spectrum. If you have investable assets and no debt, inflation is an annoyance, but maybe not much more. If you have significant amounts of debt, and wages that are slow to match the pace of inflation, it's a terrible problem.

Inflation and higher rates aren't the only factor causing dispersion across the market. We are still excited about the innovation and opportunities brought about by advancements in generative AI. These opportunities are not only limited to the technology space. Armed with lessons learned during the early days of Internet adoption, we believe that some of the big winners won't be AI companies per se, but more traditional businesses that adopt and use AI to gain a competitive advantage or expand their end market. Again, how each company addresses AI will cause differentiation and dispersion.

As I've said before, our view is that we are in uncharted economic territory, at a time that a new technology has been unleashed, with the potential for exponential and self-reinforcing improvements. It's a complicated and rapidly changing world. Despite the complexity and challenges, I'm as excited to be a portfolio manager as I've ever been. Change is the fuel for our investment decision making engine. And there's more of it than ever before. I don't know what the rest of the year holds, but I'm willing to bet it will be a very different place by the end of 2024. The one thing I know for sure is that my ranch house will have become a bit more dilapidated, maybe to the point of being beyond repair. Will the same be true for the dollar?

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