The Davis Center for Portfolio Management

University of Dayton

U.S. Equity Outlook

Spring 2024 Outlook: Managing Market Volatility - Insights for the U.S. Equity Market

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Real GDP Growth

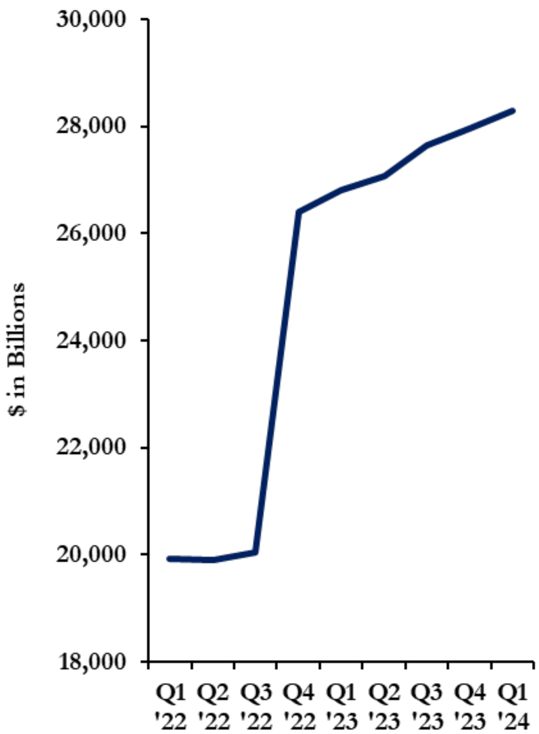

Figure 1: U.S. GDP; seasonally and inflation adjusted
Source: FRED. St. Louis Economic Data

The U.S. economy is at a crossroads coming off a better-than-expected 2023, with real GDP growing at 2.5% for the year. Real GDP growth is expected to decelerate to a below-trend pace of expansion of around 2.1% in 2024, according to data from the IMF. Tighter monetary policy initiated in previous years and the fading post-pandemic tailwinds dampen the economic outlook, especially as household debt rises. Consumer spending is forecasted to increase at a more subdued rate in the remaining three quarters of 2024, at a quarterly annualized rate of 1.4%, 1.4%, and 1.5%, respectively, reflecting the combined impact of diminished savings, plateauing wage gains, and a declining savings rate alongside less pent-up demand. Accordingly, the consumer confidence index fell to 106.7 in February, breaking a three-month streak of rising confidence. Government spending, particularly on infrastructure, grew at 4.0% in 2023, contributing to much of the headline GDP growth. This spending is expected to stabilize in 2024, back to a rate of 2.4%, though political instability regarding debt and government spending makes this number hard to forecast. Labor markets, which have been a strong suit of the economy, are showing signs of normalization, with roughly 1.32 job openings per unemployed person. Unemployment may tick slightly higher but is expected to remain low by historical standards. Tight labor markets should support employment levels, though wage gains are likely to slow down. Inflation is cooling off but is projected to remain above the Federal Reserve's 2% target through 2024. With the assumption that the hiking cycle has concluded, the Federal Funds rate may hold at the current level until mid-2024, with bond market pricing facing a cut as early as June. On the positive side, increased labor productivity, partially a product of the adaptation of AI by many companies, is expected to contribute to the growth of aggregate supply, which could help contain inflationary pressures. As food prices stabilize from pandemic and geopolitical-induced highs and energy prices fall back to more normal levels, inflation could see a more significant decrease. Globally, inflation is also falling faster than expected, with the IMF predicting the 2024 global CPI to hit 4.0%, down from 6.8% in 2023. Real GDP is forecasted to grow at 3.1% in

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2023. Real GDP is forecasted to grow at 3.1% in 2024, led by emerging markets and a more positive U.S. outlook and dragged down by a less than favorable Eruozone outlook.

With all of these factors in play, private sector forecasters, financial institutions, and the IMF are projecting a soft landing for the U.S. economy, with real GDP growth forecasted at 2.1%, unemployment hovering around 4%, and inflation trending downwards, possibly dipping below 2% by the end of the year.

Labor Market Conditions

Although interest rates have been kept relatively high with an outlook of maybe a few cuts down the line, the U.S. labor market has proved resilient, adding 275,000 jobs in February, outpacing consensus expectations. The labor market has remained strong despite high interest rates, high inflation, and slowing economic indicators. Although the jobs numbers beat expectations, other indicators suggest market activity has cooled. Payroll gains were revised downward for December and January, and the unemployment rate and wage growth were weaker than forecasted. Total nonfarm payroll employment for December was revised down by 43,000, from +333,000 to +290,000, and January was revised down by 124,000, from +353,000 to +229,000. These employment revisions in December and January were a combined 167,000 lower than previously reported.

February Report

Unemployment rose to 3.9% in February after holding out at 3.8% for the previous three months. The jobs gains were higher than expected for February, with a total gain of 275,000 (nonfarm) jobs. The consensus-estimated monthly expectation was a 200,000 job increase. In February, the job gains occurred in health care, government, food services and drinking places, social assistance, and in transportation and warehousing. Healthcare added 67,000, beating the average monthly gain of 58,000 LTM. Government employment rose by 52,000 in February, about the same as the prior 12-month average gain (+53,000). Employment in transportation and warehousing rose by 20,000 in February. Couriers and messengers added 17,000 jobs, after losing 70,000 jobs over the prior three months. In February, job growth also occurred in air transportation (+4,000), while warehousing and storage lost 7,000 jobs. Employment in food services and drinking places increased by 42,000 in February, after little change over the previous three months. Employment showed little change over the month in other major industries. With regard to wages, average hourly earnings for all employees on private nonfarm payroll creeped up by five cents to $34.57, following an increase of 18 cents in January. Average hourly earnings were up by 0.1 percent in February and 4.3 percent over the year. The jobless claims, or initial claims, for the week ending March 2 were 217,000 – the same as the previous week's revised level.

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Long-term outlook

In upcoming quarters, economic indicators suggest the pace of job growth will slow and contribute to bringing down inflation. Alongside the rise in the unemployment rate to a two-year high and a much weaker bump in wages, it is believed there is less reason now to be concerned that renewed labor market strength will drive inflation higher again. The labor market plays a key role in the Fed's interest rate decisions as it continues its battle to bring down inflation to the 2% target. In projections after the previous Federal Open Market Committee (FOMC) meetings, the

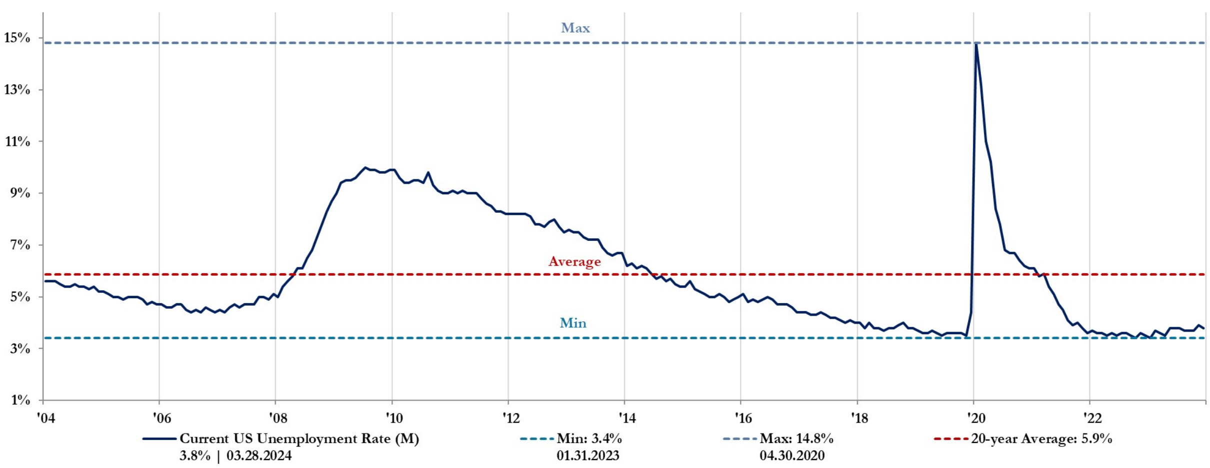

Figure 2: U.S. Unemployment Rate
Source: Bureau of Labor Statistics

Fed suggested it would cut rates in 2024. Although Jerome Powell's semi-annual monetary policy testimony indicated that the FOMC will consider cutting rates later this year, these cuts and their timing are data-dependent. The job numbers that are to be released on March 17 will provide more color on the outlook for the remainder of the year.

Inflationary Environment

Inflation in the United States surged unexpectedly in February, echoing a concerning trend from January and raising alarms about potential Federal Reserve rate cuts. The Consumer Price Index (CPI), reported by the Bureau of Labor Statistics, rose by 3.2% year-on-year in February 2024, slightly exceeding January's 3.1% increase and surpassing the 3.1% forecasts. Month-on-month, inflation accelerated to 0.4%, up from January's 0.3%.

It's noted that while the Consumer Price Index (CPI) is utilized as an input for the PCE, Federal Reserve officials prioritize the latter due to its adjustments for consumer substitutions in response

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to changing prices. The PCE is regarded as more reflective of actual consumer purchasing behavior compared to the CPI, which is considered a simpler, more volatile price measure.

The Commerce Department's Bureau of Economic Analysis reported that the Personal Consumption Expenditures (PCE) price index increased by 0.3% in February. This uptick followed a revised lower figure of 0.1% for December, down from the previously reported 0.2%. The rise in the PCE price index was primarily driven by a 0.5% increase in food prices, while goods prices fell by 0.2%, largely due to a 1.4% drop in energy costs.

Additionally, the Core PCE price index, which excludes volatile food and energy prices, rose by 0.4% in January, marking a 2.8% year-on-year increase. Consumer spending increased by 0.2% while personal income saw a substantial jump of 1.0%. In contrast, weekly jobless claims rose by 13,000 to 215,000, reflecting a slight increase in unemployment filings.

Core inflation, excluding volatile components like energy and food, reached 3.8% annually in February, slightly lower than January's 3.9% but exceeding the expected 3.7%. On a monthly basis, core inflation remained steady at 0.4%, consistent with January's figure and above the 0.3% forecast. The rise in inflation was driven by a 0.4% increase in the shelter index and a 3.8% surge in gasoline prices, collectively contributing to over 60% of the total monthly increase in the headline index.

Key sectors experiencing significant annual growth included transport services at 9.9%, shelter at 5.7%, and food consumed outside the home at 4.5%. Conversely, the utility gas service sector witnessed an annual decline of 8.8%, although it showed two consecutive months of acceleration, suggesting a revival of price pressures in energy services.

The sustained elevation of the U.S. annual inflation rate above the Federal Reserve's 2% target for three years, coupled with robust employment conditions, has intensified speculation about potential rate cuts. Despite the February inflation report, market predictions indicate a nearly 70% chance of a rate cut by June 2024, with traders pricing in a full percentage point of cuts by year-end. The Federal Reserve's upcoming FOMC meeting will be closely monitored for insights into the central bank's economic projections.

In December 2023, the Fed projected inflation averaging 2.4% in 2023, gradually declining to 2% by 2026. However, the latest inflation reports, which surpass expectations, pose a challenge to these projections, potentially necessitating upward adjustments to interest rate forecasts to meet the 2% target.

Despite improvements in consumer optimism about the economy, inflation continues to impact financial stability. While real wages are rising, inflation has increased by 20% since before the

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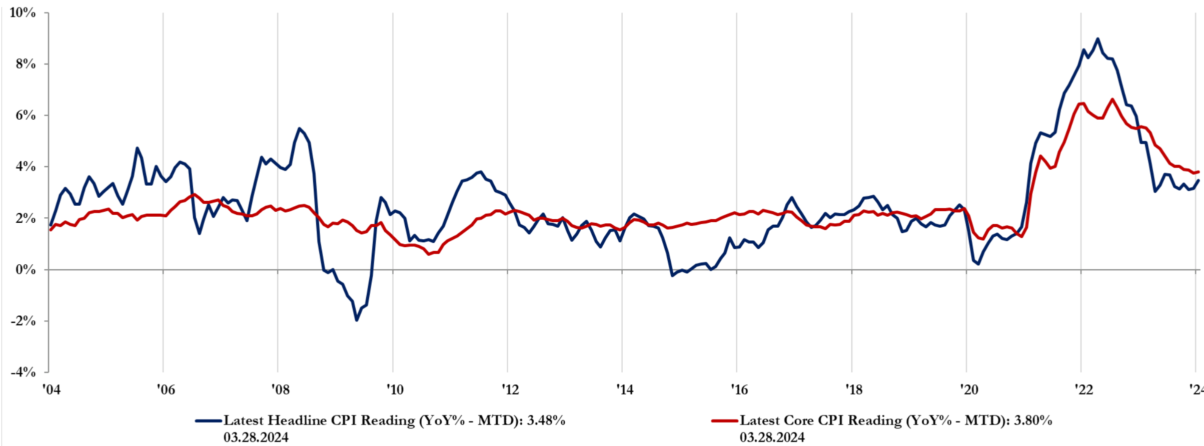

Figure 3: Headline vs. Core Consumer Price Index
Source: FactSet

pandemic, eroding purchasing power. Certain items, such as juices and drinks, and motor vehicle insurance, witnessed double-digit price hikes year over year, contributing to financial strain for many Americans

The outlook suggests a gradual cooling of economic conditions, with inflation reverting to the Fed's 2% target. However, risks persist, including geopolitical tensions and overly restrictive monetary policies against slower growth, potentially leading to tighter financial conditions.

In conclusion, while the U.S. economy is expected to grow by 2.2% in 2024, the trajectory of inflation and Federal Reserve policies will significantly influence economic stability and consumer welfare in the coming months.

Federal Reserve Actions

The Federal Reserve concluded its last meeting in January with another pause on the target overnight lending rate. This holds the rate in the range of 5.25%-5.50% and marks the sixth consecutive FOMC meeting in a row where the rate remained unchanged. In the December 2023 FOMC meeting, there had been notable updates compared to the Summary of Economic Projections (SEP) at the September 2023 meeting. The December projections anticipated a slightly higher growth in real GDP for 2023 at 2.6%, up from the September projection of 2.1%. However, for 2024, the GDP growth expectations was slightly reduced to 1.4% from the previous 1.5%. The projections for 2025 and 2026, as well as the longer run, remained consistent at 1.8%. The unemployment rate projections stayed stable across the two meetings, with an expected gradual increase to 4.1% through 2024 and maintaining this level through 2026. In terms of inflation, measured by the PCE index, there's a noticeable decrease in the forecast for 2023 from 3.3% in September to

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2.8% in December, reflecting an improvement in inflationary pressures. The projections for the following years show a convergence towards the Federal Reserve's target of 2.0%, with 2024's projection at 2.4% and 2025's at 2.1%, both slightly improved from the September projections. Core PCE inflation, which excludes volatile food and energy prices, is also expected to follow a declining trend. The December projection for 2023 was 3.2%, down from 3.7% in September, with further decreases anticipated in the subsequent years, aligning with the overall PCE inflation projections towards the 2.0% target. These adjustments reflect the Federal Reserve's ongoing assessments of economic conditions and its commitment to achieving its dual mandate of promoting maximum employment and stable prices. The changes in projections indicate the Fed's re-

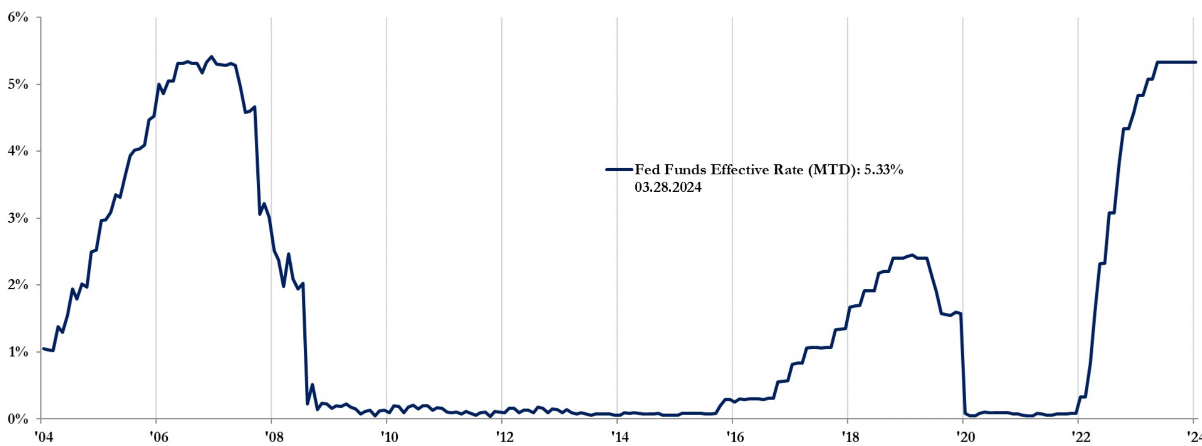

Figure 4: Effective Federal Funds Rate
Source: FactSet

sponsiveness to evolving economic data and its readiness to adjust monetary policy as necessary to support sustainable economic growth and price stability. The Federal Reserve's "dot plot," a visual representation of the interest rate outlook among FOMC members, showed significant shifts in the December 2023 projections compared to earlier ones. In December, the consensus among FOMC members indicated a more dovish stance, with 16 out of 19 members projecting the year-end 2024 fed funds target rate to be below 5.00%, a notable change from the September 2023 dot plot where opinions were more divided. The December plot also highlighted a tighter target range for 2025, with the majority of dots between 3.00-4.00%, suggesting a gradual move towards easing monetary policy in the future. Regarding the Federal Reserve's balance sheet, the focus in recent years has shifted towards quantitative tightening, a reversal from the quantitative easing policies implemented in the aftermath of the financial crisis and during the COVID-19 pandemic. Quantitative tightening involves the reduction of the Federal Reserve's balance sheet

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primarily through the non-reinvestment of the proceeds from maturing securities. This policy aims to normalize the size of the Fed's balance sheet and can lead to higher long-term interest rates, influencing borrowing costs and economic activity. Since a March 2022 high of nearly $9 trillion, the balance sheet has shrunk 16% to $7.56 trillion. The Fed announced in its most recent meeting that it will continue the process of quantitative tightening by allowing the current portfolio of bonds to engage in a "run-off." The current outlook on the Fed's overnight borrowing rate reflects a delicate balancing act. The interest rate futures market is predicting the FOMC to continue holding rates steady in the upcoming March meeting, which will also include the next release of the Summary of Economic Projections, while traders place 10.3% odds on a cut in May, followed by a June prediction of a 54.2% chance of a 25bps reduction. In general, the futures market is expecting a total of three to four 25bps cuts by the end of 2024. The Bank Term Funding Program (BTFP), initiated by the Federal Reserve in March 2023, in the wake of three bank failures, was designed to provide additional liquidity to eligible depository institutions like banks, savings associations, and credit unions. Through the BTFP, these institutions could receive loans of up to one year by pledging high-quality securities such as U.S. Treasuries, agency debt, and mortgage-backed securities as collateral, with these assets being valued at par. This program aimed to support American businesses and households by ensuring that banks could meet the needs of all their depositors, especially during times of financial stress. The BTFP proved to be an essential liquidity source, helping institutions avoid the need to sell securities quickly in challenging market conditions. As planned, the program ceased making new loans on March 11, 2024, marking the end of its operation. The Fed will have to carefully monitor the precarious situation in the Financials sector now that regional banks will again feel the negative implications of their decisions in 2022 to buy large amounts of U.S government bonds at low yields right before one of the quickest rate hiking cycles in Fed history in 2022. Looking forward, the Fed will continue to keep its sights on incoming data releases, especially those related to inflation, which needs to show conclusive evidence that it is returning to the 2% target rate before the Fed will consider rate cuts. The FOMC is in a difficult spot right now, for if it eases by cutting rates too early, inflation will rise and remain a concern in the minds of U.S. consumers. If the FOMC leaves rates too high, they may push unemployment up and cause a recession. It is important to note that rate hikes have a laggard effect on the economy, and many economists believe that we have yet to see the full effects of the fastest pace of hikes since the 80s. Fed Chairman Jerome Powell has continued to face questions on whether the current rate is restrictive enough relative to the neutral rate, which ideally reflects an equilibrium in economic supply and demand. During his March 7th semi-annual monetary policy report to Congress, Powell emphasized his belief that the current rate is well into restrictive territory, thus indicating rate cuts will be necessary this year. Only time will tell if his statements are correct in this time of uncertainty within the U.S. economy. Another important

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event is the upcoming U.S. presidential election, as the make-up of the Board of Governors can change significantly based on which political party emerges victorious. The likely-selected Republican candidate, Donald Trump, has mentioned that if he were to win re-election, he would replace Jerome Powell as he is unhappy with his suggestion of rate cuts this year, which Trump believes would be a political act designed to curry favor with voters and give the Democrats an electoral advantage.

Treasury Markets

The Treasury and bond markets experienced significant fluctuations in 2023, reflecting broader shifts in the global economy and financial markets. The year began with the 10-year U.S. Treasury note yield at 3.84%, escalating to 5% by mid-October before retracting to under 4% by mid-December, amid changing economic conditions and waning investor sentiment. The Bloomberg U.S. Aggregate Index's performance, with a return of 9.29% from October 19 to December 31, underscored the missed opportunities for investors who maintained cash positions, illustrating the rewards of navigating the bond market effectively during volatile periods. It was a year marked by transitions, as initial concerns over extreme inflation gave way to anticipations of slowing growth and prospective rate cuts, leading to a rollercoaster of bond yield movements, particularly noted by the temporary spike of the 10-year U.S. Treasury yield to 5%. The bond market's trajectory altered in February 2024 following a more hawkish stance from the Federal Reserve's January FOMC meeting, resulting in elevated yields due to revised rate cut expectations. This adjustment saw the 10-year Treasury yield climb to 4.23% from 3.88% at the beginning of the month, with significant movements across other maturities and a narrowing, yet still inverted, yield curve. However, a recent pullback in Treasury yields, prompted by economic data suggesting slowing inflation, offers a nuanced view. A drop of over 8bps in the 10-year yield and over 5bps in the two-year yield reflects ongoing market recalibrations in response to economic indicators.

Looking forward, the global financial environment remains poised on a knife’s edge, with central bank rates and bond yields expected to stay high well into 2024, gradually declining as the year progresses. The U.S. faces continued inflationary pressures although the rate is decelerating, leading to anticipation that the Federal Reserve may maintain elevated rates into the second half of 2024. Yet, there is optimism that, with inflation moving closer to the 2% target, the Fed may halt its rate hikes, allowing for a potential easing in response to cooling growth. For bond investors, this landscape presents a unique set of opportunities and challenges. The current high yields, assuming a forthcoming decline in rates, suggest the potential for price appreciation. Investors might consider extending the duration of their portfolios to leverage this environment, especially as most bond returns over time accrue from yields. However, the uncertainty surrounding rate cut timelines and mixed economic signals calls for cautious optimism and strategic navigation through these turbulent waters.

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Manufacturing and Service Activities

The leading economic indicator of manufacturing and services activities is the Purchasing Managers' Index as it draws on data from a survey given to supply chain managers at over 400 companies across 19 industries. New orders, inventory levels, production, supplier deliveries, and employment are the five areas surveyed. Each of these subindexes is scored from 0 to 100, depending on respondents' answers to the questionnaire. In compiling the overall headline score, each survey area is weighted equally while industries are weighted according to their contribution to GDP. In either instance, scoring above 50 indicates expansion and scoring below 50 represents contraction.

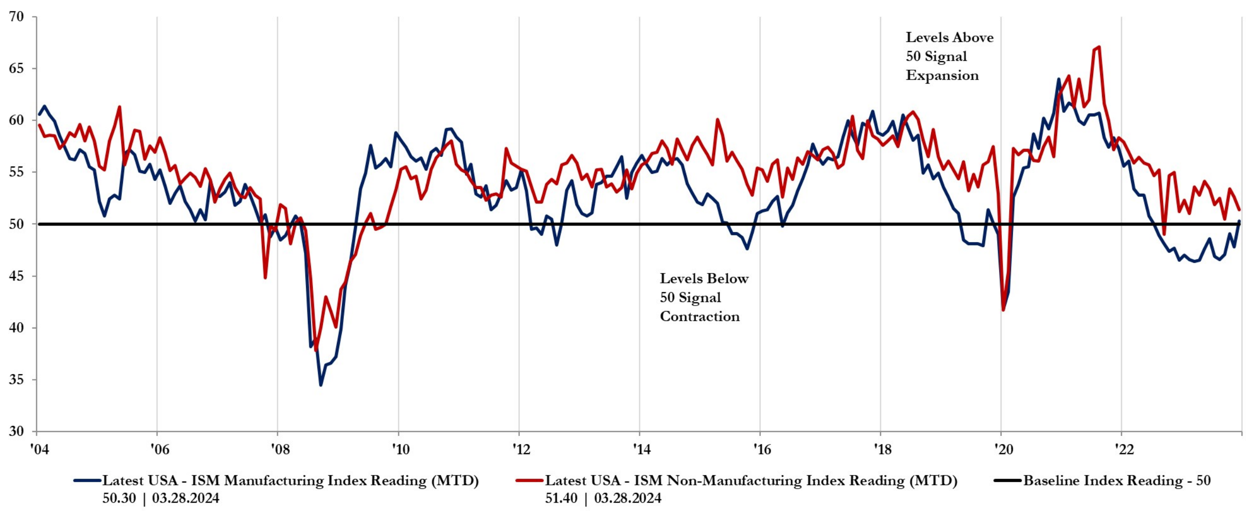

Figure 5: ISM Manufacturing PMI vs. Non-Manufacturing PMI

The PMI is not only a measure of the prevailing direction of economic trends, but a guide used by manufacturers to forecast future cash flows and budgets and by economists to view where consumers are spending their money.

The February Manufacturing PMI, which registered 47.8 vs. 49.1 in January, suggests the manufacturing sector continues to contract (and at faster rate compared to January), even with the overall economy continuing its expansion for the 46th month in a row. A Manufacturing PMI above 42.5, over a period of time, indicates the overall economy, or GDP, is generally expanding. The New Orders, Production, Prices, and Employment subindexes all reported numbers below that of January's readings at 49.2, 48.4, 52.5, and 45.9, respectively. The New Export Orders subindex, 51.6, and the Backlog of Orders subindex, 46.3, both grew from January but at a moderate rate adding to the indication that demand is slowing. Eight of the 15 manufacturing industries reported growth in February: Apparel, Leather and Allied Products; Nonmetallic Mineral Products; Primary Metals; Plastics and Rubber Products; Fabricated Metal Products; Chemical Products; Miscellaneous

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Manufacturing; and Transportation Equipment. Companies steadied their production month over month but could not do the same for employees as layoffs persisted. Many manufacturing industries blamed the contraction on seasonal headwinds and are optimistic regarding the latter half of the year, with heavy orders already scheduled and a stable overall business outlook.

The February Services PMI registered at 52.6, down from 53.4 in January. The Services PMI has been expanding for 14 consecutive months and 44 out of the last 45 months, the last contraction occurring in December of 2022. The Business Activity, New Orders, and Supplier Deliveries subindexes expanded at 57.2, 56.1, and 48.9, respectively, with the Employment subindex contracting at 48. The Supplier Deliveries subindex is inversed because a reading below 50 indicates supplier delivery performance being faster as customer demand decreases. The Prices subindex registered 58.6, showing slower expansion from January, and the Inventories subindex contracted for the third consecutive month at 47.1. The Backlog of Orders subindex expanded for the second consecutive month at 50.3 after two consecutive months in contraction. Fourteen service industries reported growth in February but at a slower rate than in January. Services typically make up around 70% of consumer spending in a given year, implying an expanding U.S. economy based on February's report. The Chair of the Institute of Supply Management concluded that respondents are "mostly positive" about their business conditions, but they are still wary of inflation, employment, and geopolitical conflicts down the road.

The U.S. Consumer

Consumer Spending

Consumer spending drives the United States' economy more than any other factor. In 2023, consumer spending maintained an upward trajectory, serving as a vital pillar of economic momentum amidst various global uncertainties. Bolstered by a confluence of factors, including income gains, healthy household finances, and moderate inflation, consumer sentiment remained buoyant throughout the year. Olu Sonola, Head of Fitch U.S. Economic Research, emphasized the strength of the U.S. economy, attributing it to renewed fiscal easing, consumers' continued utilization of excess savings, solid household balance sheets, and a tight labor market. Notably, household nominal disposable income surged by 6.9% year-over-year, propelled by robust employment figures and nominal wage growth. Furthermore, consumer net worth increased by 5.1% YTD 3Q23, primarily attributed to rebounds in both equity markets and real estate equity. These positive trends underscored the resilience of consumer spending, which continued to play a pivotal role, representing nearly 68% of the nation's GDP according to U.S. Bank.

Consumer spending remained a crucial driver of the U.S. economy in the past year, coinciding with a notable surge in debt attributed to various factors including mortgage debt and credit card borrowing. The increasing popularity of home equity lines of credit has enabled consumers to leverage

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the appreciation in real estate values to meet their financial needs. As highlighted in the Federal Reserve Bank of New York's Quarterly Report on Household Debt and Credit, credit card debt in the nation experienced a substantial increase in 2023, with a $45 billion surge recorded in just one quarter that culminated in a total outstanding debt of $1.03 trillion by the end of the year, an average of $5,733 per cardholder. Especially concerning is the observation that individuals aged 30 to 64, particularly those between 40 to 49 years-old, are surpassing the national average in credit card debt, with an average of $7,600. Members of this age group, often in their peak earning years, face significant financial obligations such as supporting families, funding education, and making substantial purchases like homes and vehicles, which contribute to the accumulation of credit card debt. Further exacerbating this issue, credit card interest rates have surged over the past decade, nearly doubling from late 2013 to reach an average annual percentage rate (APR) of 22.8% by the close of 2023, according to the Federal Reserve Consumer Credit report.

Transitioning from the discussion of credit card debt, the outlook for consumer spending in 2024 is influenced by various other factors, including unemployment rates and interest rate fluctuations. According to Peter Ganong from the American Economic Association, spending tends to decline sharply following the exhaustion of unemployment insurance benefits, indicating the significant impact of unemployment on consumer behavior. The unemployment rate has remained low and stable, fluctuating between 3.4% and 3.9% since December 2021. However, the Organization of Economic Co-Operation and Development (OECD) forecasts a slight uptick in unemployment to 4.1% in 2024, signaling potential challenges ahead. Jobless claims have already begun to rise, with claims up by 7,000 to 218,000 in 2024, reaching their highest levels since November 2021 and suggesting underlying issues in the job market. Despite these headwinds, consumer spending is anticipated to grow, albeit at a slower pace, in the coming year. Bill Conerly, Senior Contributor at Forbes, highlights expectations for tempered consumer spending as the result of higher interest rates, which typically lead to reduced purchases of big-ticket items and contractions in interest-sensitive sectors. Moreover, Conerly suggests that the full effects of higher interest rates may not be immediate, with lagged effects likely to materialize in the first half of the year. Overall, while increased consumer spending is expected to persist, economic growth may experience a slowdown early in the year due to past interest rate hikes and their repercussions on various sectors of the economy.

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Consumer Sentiment

Consumer sentiment also proved to be resilient, holding steady with minor fluctuations and demonstrating an underlying assuredness in the economic landscape. The economic sentiment is reflected in the tenacity of the U.S. economy, which continues to expand at an above-average pace. Factors such as stable hiring, low unemployment, and a robust stock market contribute to this resilience, instilling confidence among consumers to maintain their spending habits. The prospect of the Federal Reserve cutting interest rates later this year could further support economic growth.

President Biden optimistically asserted in his March State of the Union address that consumer confidence is soaring. However, this claim has been challenged by experts and is clearly contradicted by the data, as recent consumer confidence releases have raised concerns. The University of Michigan's consumer sentiment survey for February climbed to a 32-month high at 76.9. This optimism is echoed in the survey's findings from January to February, where short-run business conditions expectations rose by 63% and long-run expectations by 46% compared to November 2023, highlighting a recent improvement in consumer outlook. However, there still was an intra-month drop in sentiment in February, the most significant since March 2020, signaling increased caution among consumers. The Conference Board Consumer Confidence Index dipped to 106.7 in February from January's 110.9 after three months of consecutive gains, suggesting a possible pause in the upward trend of consumer confidence as well. The Present Situation Index also took a hit, dropping to 147.2 as consumers felt less favorable toward current business and labor market conditions

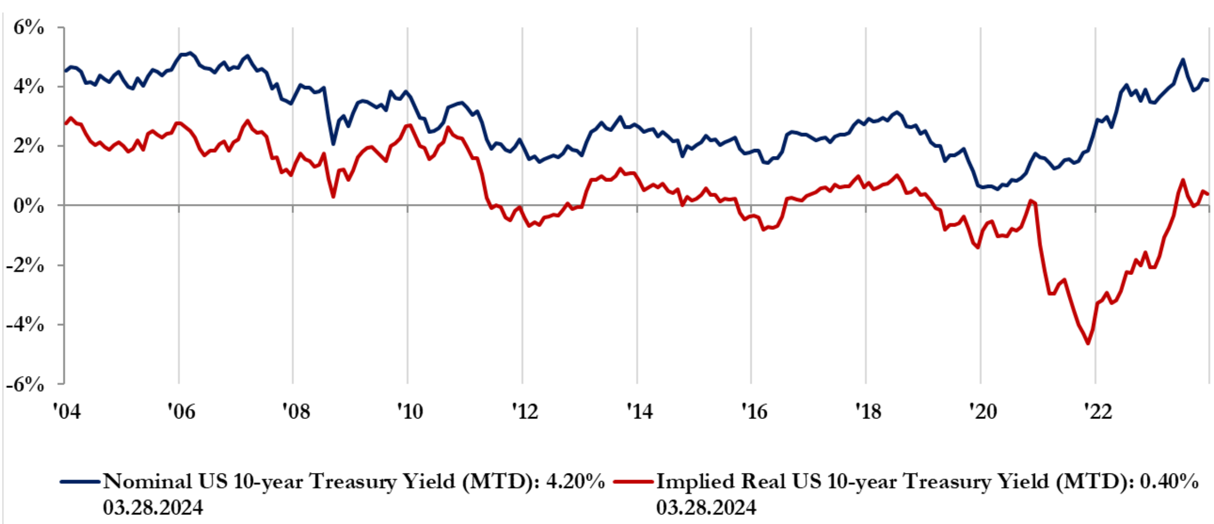

Figure 6: Nominal vs. Real U.S. 10-Year Treasury Yield
Source: FactSet

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while the Expectations Index, reflecting short-term outlooks for income, business, and labor, slipped below the 80-point mark to 76.3, often seen as an indicator of a looming recession. Dana Peterson of The Conference Board noted this broad-based decline in confidence occurred across most income and age groups, with inflation being of particular concern to the labor market situation and the political landscape. February showed that political affiliations also play a role in shaping consumer sentiment as perspectives differed between Republicans and Democrats. Republican views improved significantly as Donald Trump looked to be leading the race for the upcoming 2024 presidential election, reaching their best level since mid-2021. Democrat views worsened considerably for the same reason, although remaining elevated compared to their Republican counterparts. Overall, current sentiment is cautiously optimistic, supported by the economy's resilience and receding inflation but tempered by anticipation of a tougher job market, reduced wage growth, and high interest rates. This further emphasizes the complexity of the current economic environment.

Energy Outlook

U.S crude oil futures have trended upward since the beginning of the year, opening the year at $71.65 a barrel versus $77.98 as of March 13, 2024. Despite these gains, U.S crude oil futures are still well below their October 2023 highs of $90.30. The price fluctuations at the beginning of the year are mostly attributable to OPEC leaving its estimates for global oil demand growth unchanged since last July. OPEC did, however, raise its economic forecast for this year in consideration of falling inflation and anticipated interest rate cuts. The latest report comes as crude futures continue to sell within a small trading range due to conflicting market forces. The two main conflicts on investors' minds are the slowing demand in Chinese markets versus the United States signaling impending rate cuts. Because of this, OPEC and its allies have agreed to extend their voluntary output cuts of around 2.2 million barrels a day through the second quarter to avoid a global surplus and keep prices high. The cartel cut its non-OPEC supply growth forecast earlier this year from 1.2 million barrels a day to 1.1 million barrels a day.

As of 2023, the Unites States had produced more crude oil than any other nation at any time for six years in a row. Crude oil production in the United States averaged 12.9 million barrels a day in 2023. In December 2023, United States crude oil production reached a monthly high of 13.3 million barrels a day, according to International Energy Statistics. Collectively, the United States, Russia, and Saudi Arabia accounted for 40% of global oil production in 2023. President Biden has quietly been helping increase the production of U.S crude oil, recently expediting the construction of an oil pipeline in West Virginia and approving the Willow Oil Project in Alaska, despite his public stance against fossil fuels.

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Due to an extended outage at Freeport LNG's liquefaction train 3, U.S. natural gas experienced losses toward $1.7/MMbtu in early April, making it the lowest price in two weeks. As planned, U.S. gas output decreased by 6% in late February due to natural gas firms like EQT and Chesapeake purposely cutting production. EQT Corporation agreed to an all-stock deal valued at $5.5 billion to reacquire its former unit, Equitrans Midstream. This merger is expected to create a company value of over $35 billion, including debt, and aims to create a vertically integrated natural gas provider with expected annual synergies of $250 million from the integration of upstream and midstream businesses. The anticipated development of El Niño conditions forecasts a significant winter impact on the U.S. energy landscape. Higher winter temperatures are predicted throughout the northern United States, potentially reducing natural gas consumption. Despite diminished gas inventories, market traders are keeping prices low given the expectation of weak winter demand.

Global Economic Outlook

The International Monetary Fund's January 2024 World Economic Outlook projects a somewhat bullish fiscal 2024 and beyond. The IMF estimates 3.1 percent growth globally in 2024, slightly improving to 3.2 percent growth in 2025. (The Former is up from 2.9 percent compared to the IMF's previous report while the latter remains unchanged). This growth is to be derived from strong expected resiliency, largely concentrated in the United States and a number of emerging market economies, and is slightly lower than the 20 year average from 2000 to 2019 of 3.8 percent, suggesting continued slow recovery from COVID restrictions. Inflation is projected to fall from 5.8 percent in 2024 to 4.4 percent in 2025, which is faster than initially thought. This projection is predicated on restrictive monetary policy as well as more breathing room on the supply side following bottleneck issues largely related to COVID. However, the IMF lists some serious risk factors, including geopolitical tensions such as the Russo-Ukraine War as well as the expanding conflict in the Middle East with its derivative supply disruptions in the Red Sea. A slower than expected Chinese recovery would also affect the IMF's forecasts given that the IMF is bullish on China's economic growth.

The IMF's assessment of more resilient growth in America and abroad is miscalculated for the following reasons. The fact that consumer spending has increased, along with the net worth of the average consumer over the last five years, does not necessarily imply economic growth. The IMF fails to factor in unsustainable consumer spending habits. According to CNBC, the percent of disposable income saved has decreased over the last decade from 8% to 4%, and Millennials and Gen Z are spending over 400% more on non-essentials than their elder counterparts. This, combined with increasingly unaffordable housing and essential goods such as groceries, creates an unsustainable economic environment on which to base long-term growth. Thus, while the economy may appear to be improving from a purely statistical perspective, growth is inorganic and consumer sentiment continues to worsen.

Macro Conditions

As cited above, geopolitical risk factors identified by the IMF include the Russo-Ukraine War as well as the expanding conflict in the Middle East, which has created a supply chain crisis in the Red Sea. Ukraine's prospect of victory continues to grow slimmer as President Zelensky is losing in polls to one of his generals. The United States has been funding Ukraine, and this support will probably continue, at least for as long as the Biden administration remains in power. This means that Western sanctions against Russia will persist and Europe will have to continue securing long-term energy solutions that don't involve Russia, creating positive demand for American energy exports. The Israeli-Hamas conflict is especially unfortunate because neither side appears interested in de-escalation, and this war will likely continue indefinitely, even if Iran escalates further. However, the situation has been worsened by Houthi rebels in the Red Sea area, who have recently sabotaged undersea Internet cables in the Red Sea and have launched over 40 attacks on commercial ships there since November. The threat of Iranian intervention looms large, especially given that Iran just attacked Israel after Israel destroyed an Iranian diplomatic facility in Damascus. The Houthi rebels are also funded by Iran, and their actions will likely persist for the duration of the conflict, despite countermeasures. That would cause a major supply shock to OPEC+ commodities and throw a monkey wrench into global trade as 12 percent of commercial maritime shipping passes through the Red Sea. Overall, the threat of a geopolitical disruption looms large in the near future, and these situations need to be carefully monitored.

The IMF anticipates a slower recovery for China, projecting 4.6% growth in 2024 and 4.1% growth in 2025. While this growth is higher than the global average, it is considerably lower than China's growth from 2000-2019, which was roughly 9% annually. China has massive upside, with the world's largest population and an advanced technological base but also is subject to an incredible amount of economic vulnerability. As China has a planned economy, a lot of statistical economic growth is inorganic and will produce no fruits. An example of this is the infrastructure construction industry. China's GDP boom was largely derived from its population growth and construction to support said growth. The problem is that China's population is no longer increasing. In fact, due to the coercive one-child policy that remained in effect all the way until 2016, China's population is now declining, and many worry that the CCP is overstating the country's population in order to try and avoid the chaos inevitably caused by acknowledging such an important demographic shift. This subterfuge is partially to blame for the current real estate crisis, as many construction companies overestimated demand and overbuilt, but with low demand, the renters just aren't coming rendering any economic output moot. As a result, over 50 property developers have defaulted on their debt, eroding the balance sheets of the nation's largest state-run banks. Looking on the positive side, China has a large competitive advantage in the AI sector as the CCP is able to take advantage of weak to non-existent privacy laws in order to extract as much data as possible from its citizen base and beyond. Overall though, China is facing issues that raise some serious

Macro Conditions

questions, including those surrounding the accuracy of its own data. How China responds over the next few quarters will determine whether it returns to global dominance or needs to sort out internal issues before long-term economic investment is sustainable.

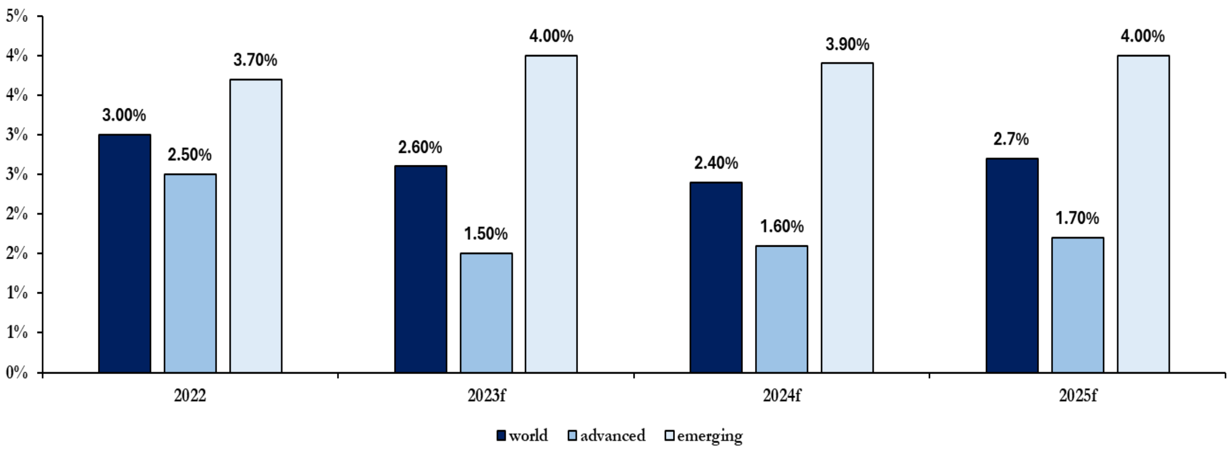

Figure 7: Real GDP Growth
Source: IMF

S&P 500 Outlook & Fundamentals

S&P 500 Outlook

The S&P 500 Index was up 29.2% last year, after a very rocky 2022 and early 2023 for the markets as a whole. It was an eventful 12 months in the American macroeconomy that drove a mob of investors into a frenzy across several sectors. At the end of March 2023, the collapse of Silicon Valley Bank briefly rattled the markets, and holes in banking regulation were swiftly brought to light by Financials sector portfolio managers. This headline news was quickly replaced by the artificial intelligence boom in the summer of 2023. The prospect of tech companies with exponential growth possibilities both puzzled and excited the markets. From July to November 2023, the Index saw a brief downturn of 9.8% as buy-side and sell-side analysts alike scrambled to identify and allocate to long-term winners exposed to artificial intelligence. Since November, the Index has returned 23.7%, driven mainly by NVDA and the other "Magnificent Seven" stocks as many investors have placed their bets on the so-called long-term winners. Between the prospect of a soft landing given the string of strong economic data releases versus the Fed's "higher for longer" stance on interest rates, macro investors are puzzled as to where the economy will head in 2024. High borrowing costs combined with the hype surrounding technology companies have led to a capital markets freeze in several non-cyclical sectors, most notably Utilities. The S&P 500's forward price-to-earnings ratio is at 20.7x, far exceeding the long-term average of 15.7x, as a result of the squeezed bottom line of non-cyclical companies contrasted against the huge earnings call surprises for Big Tech. Based on the forecasts of continuing earnings surprises and high valuations, polled strategists expect the S&P 500 Index to finish the year at or above 5,100.

Magnificent Seven

Navigating the intricacies of the financial landscape, particularly with regards to the group often referred to as the "Magnificent Seven" (Apple, NVIDIA, Microsoft, Amazon, Tesla, Meta, and Alphabet) presents a fascinating study in market dynamics. This group, celebrated for their outperformance of the broader S&P 500 Index, has been at the center of focus for many. In 2023, a notable uptick was observed in the stock values of these entities, with NVIDIA, Meta, and Amazon experiencing substantial rises. This trend seems to stem from the perceived room for growth and development within these organizations, especially in the area of artificial intelligence. Yet, despite this success, there are many doubters. The valuation of these companies, when compared with others in the market, trades on the higher side, sparking debates about their actual worth. This skepticism is prompting investors to consider shifting to small cap companies or other market sectors that might offer more tangible value. Nevertheless, it's hard to overlook the consistent financial performance of these companies, which often exceeds market expectations. The collective market cap of these tech giants would make the Magnificent Seven the second-largest country stock exchange in the world! Factors like international economic collaborations and expansions have helped buoy their prominence. Specific events, such as China's integration into the World Trade

S&P 500 Outlook & Fundamentals

Organization, have boosted these companies, providing them with expansive labor pools and market access.

The road ahead, however, is unclear. With the Magnificent Seven's growth heavily anchored to the recent interest in AI, forecasting their trajectory in the upcoming year is difficult. The economic uncertainty throughout the U.S. and the world add complexity to this prediction. The majority of these companies are categorized under the Consumer Discretionary sector, a segment traditionally sensitive to interest rate fluctuations. Despite the current elevated rates, these companies have shown remarkable resilience, a testament to their innovative approaches and compelling product and service offerings. Their valuations, nonetheless, are a subject of intense scrutiny. Trading at premium multiples, there's an ongoing debate about the sustainability of such high valuations. Additionally, the market's concentrated focus on a select few stocks raises the question of overlooked opportunities in other areas. In summary, while the immediate outlook for these titans of technology and innovation seems strong, the long-term perspective is tethered in market trends, economic policies, and technological evolutions.

Artificial Intelligence

In 2023, artificial intelligence (AI) saw an unprecedented surge in popularity and adoption, marking it as a watershed year for the technology. This surge can be attributed to several key developments and trends that have made AI more accessible, powerful, and integral to both business and daily life. The reasons for AI's growing popularity are manifold, including significant advancements in machine learning algorithms, the availability of large datasets for training these algorithms, and the increase in computing power, particularly through cloud computing and specialized hardware like GPUs. Moreover, the global pandemic accelerated digital transformation across sectors, pushing companies to innovate and adopt AI-driven solutions to stay competitive and meet evolving consumer demands.

Companies across various industries are now leveraging AI to optimize operations, enhance customer experiences, and innovate products and services. In retail, AI is used for personalized shopping experiences and inventory management through predictive analytics. Financial services employ AI for fraud detection, algorithmic trading, and personalized financial advice. In healthcare, AI aids in diagnostic processes, patient care personalization, and drug discovery. Furthermore, AI's role in automating repetitive tasks has led to increased efficiency and cost savings for businesses while also opening up new opportunities for growth and innovation. The adaptability of AI applications, from chatbots and virtual assistants to advanced analytics and autonomous vehicles, showcases the technology's broad appeal and utility.

S&P 500 Outlook & Fundamentals

NVIDIA, a company traditionally known for its graphics processing units (GPUs), has emerged as a powerhouse in the AI revolution, largely due to its strategic pivot towards AI and deep learning technologies. The stock is up over 300bps in the last twelve months. NVIDIA's success can be attributed to its early recognition of the potential for GPUs to accelerate AI computations. By optimizing its hardware to support the intensive computational needs of machine learning models, NVIDIA has become indispensable to AI research and deployment. The company's CUDA platform, a parallel computing architecture that allows developers to use NVIDIA GPUs for general purpose processing (an approach known as GPGPU, General-Purpose computing on Graphics Processing Units), has been instrumental in this regard.

NVIDIA has also expanded its product lineup to include AI-specific hardware such as the Tesla and DGX series, which are designed to handle the most demanding AI workloads, making the company a go-to choice for organizations looking to deploy sophisticated AI applications. Moreover, NVIDIA's foray into AI software and frameworks, with contributions to open-source projects and development of proprietary solutions like NVIDIA AI Enterprise, has further solidified its position in the AI ecosystem. By providing end-to-end AI hardware and software solutions, NVIDIA has enabled companies of all sizes to accelerate their AI initiatives, leading to rapid innovation and adoption across industries.

In 2023, AI's rise to prominence was unmistakable, driven by technological advancements, broad applicability, and significant investments by companies like NVIDIA. As AI continues to evolve, it will redefine industries, revolutionize how we work and live, and potentially address some of the most pressing challenges facing society today. As we move forward, the integration of AI into our daily lives and business operations will only deepen, heralding a new era of digital transformation powered by intelligent technology.

Earnings

As of March 8, 2024, 99% of S&P 500 companies had reported actual results for Q4 2023. Seventy-three percent of companies within the Index reported a positive EPS surprise and 64% reported a positive revenue surprise. The blended YoY revenue growth rate for the S&P 500 Index in Q4 2023 came in at 4%, below the five-year average of 6.9% and the ten-year average of 5.0%. However, it is important to consider that this marks positive YoY revenue growth for the 13th consecutive quarter. Growth was led by the Real Estate and Communication Services sectors, but eight total sectors reported YoY growth. Conversely, three sectors had negative revenue growth YoY, led by Energy and Materials. As a result, Energy and Materials have seen the largest decreases in EPS estimates in Q1 2024. Additionally, out of every company in the Index, only 47 mentioned recession in their Q4 earnings calls. This falls significantly below the one-year average of 85.

S&P 500 Outlook & Fundamentals

The Q1 2024 revenue growth estimate for the Index was 4.3% on December 31, but has since been decreased to 3.5% due to the release of negative EPS guidance. Out of the 106 companies that have released guidance for Q1, 74 have issued negative guidance. This number is above both the five-year average of 58 and ten-year average of 62. Regardless, seven out of the eleven sectors are projected to report YoY earnings growth this quarter, led by the Utilities, Communication Services, Information Technology, and Consumer Discretionary. Looking to the rest of 2024, YoY growth rates are estimated to be 9.0%, 8.2%, and 17.2% for Q2 2024, Q3 2024, and Q4 2024, respectively. At this time, only six companies have reported Q1 2024 earnings, but that number is set to reach 24 by April 12.

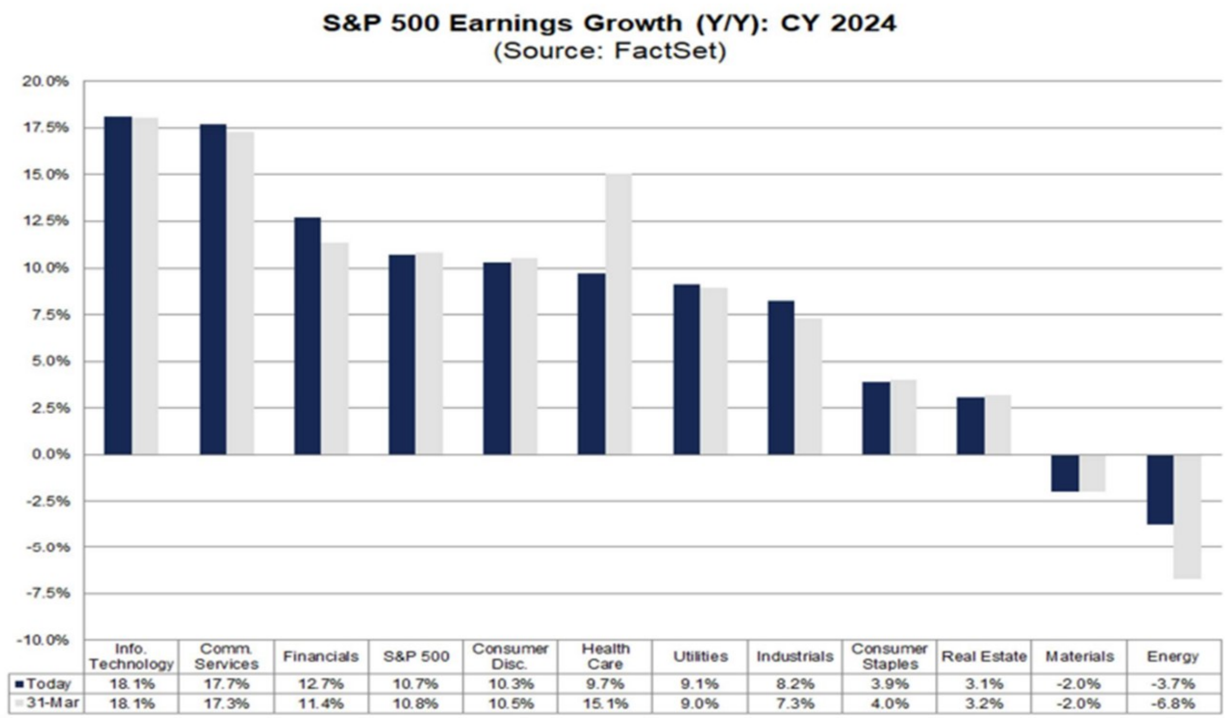

Figure 8: S&P 500 CY 2023 Earnings Estimates
Source: FactSet

Valuation

With higher-than-expected January CPI reports, 2023 Q3 GDP growth surpassing expectations, and over 67% of companies within the S&P 500 reporting higher positive numbers, fears of a recession in the near future appear unlikely. J.P. Morgan research forecasts an end to global expansion by mid-2025. The forward 12-month P/E ratio for the S&P 500 is 20.7, which is above the five-year and ten-year averages of 19.0 and 17.7, respectively. It is also above the forward 12-month P/E ratio of 19.5 recorded at the end of the fourth quarter (December 31). Since the end of the fourth quarter, the price of the Index has increased by 8.1%, while the forward 12-month EPS estimate has increased by 2.4%. At the sector level, the Information Technology (28.9) and Consumer Discretionary (24.9) sectors have the highest forward 12-month P/E ratios, while the Energy (12.2) sector has the lowest forward 12-month P/E ratio. The trailing 12-month P/E ratio is 25.6, which is above the five-year average of 23.0 and the ten-year average of 21.2. Valuation

Valuation Matrix	March 31, 2024	3 Month Median	5-Year Median	10-Year Median	20-Year Median	Current vs 10-Year Median Difference	Premium (Discount) vs 10-Year Median
S&P 500 (LTM)							
P/E	**25.4x**	24.7x	21.6x	19.8x	17.3x	5.6x	28.0%
P/B	**4.8x**	4.7x	4.1x	3.4x	2.9x	1.4x	39.9%
EV/Sales	**3.4x**	3.3x	3.0x	2.6x	1.9x	0.8x	31.7%
EV/EBITDA	**17.1x**	16.7x	14.8x	13.2x	10.7x	3.9x	29.4%
S&P 500 Sectors (Forward P/E)							
Energy	**13.0x**	12.0x	11.9x	16.8x	12.1x	(3.7x)	(22.1%)
Materials	**21.4x**	20.3x	17.1x	16.4x	15.0x	5.0x	30.8%
Industrials	**21.7x**	20.8x	19.7x	17.9x	16.0x	3.8x	21.0%
Consumer Discretionary	**26.2x**	25.8x	26.8x	23.7x	19.1x	2.5x	10.5%
Consumer Staples	**20.4x**	19.9x	20.1x	19.7x	17.5x	0.7x	3.6%
Healthcare	**19.5x**	19.2x	16.7x	16.4x	15.9x	3.1x	18.9%
Financials	**15.8x**	15.2x	14.6x	13.7x	12.6x	2.1x	15.2%
Technology	**28.2x**	28.1x	24.1x	17.5x	16.4x	10.7x	61.2%
Communication Services	**19.0x**	18.5x	18.4x	18.5x	17.7x	0.5x	2.6%
Utilities	**16.1x**	15.4x	18.4x	17.5x	15.5x	(1.3x)	(7.6%)
Real Estate	**17.6x**	17.2x	20.1x	18.3x	18.4x	(0.7x)	(4.0%)
Macroeconomic Enviroment							
10-Year US Treasury Yield (Nominal)	**4.33%**	4.19%	1.84%	2.34%	2.76%	2.0%	85.0%
Effective Federal Funds Rate	**5.33%**	5.33%	1.55%	0.66%	0.40%	4.7%	707.6%
Core CPI (YoY)*	**3.76%**	3.78%	3.91%	2.17%	2.11%	1.6%	73.7%

Data as of 03.31.2024 | Source: FactSet

Figure 9: S&P 500 Price Valuation Matrix
Source: FactSet

projections indicate that the fears of a recession in 2024 have once again been postponed to 2025 by many economists. The Flyer Investments Team is committed to tracking valuation metrics and their changes over time to adequately prepare for any market movements throughout the year.

Valuation

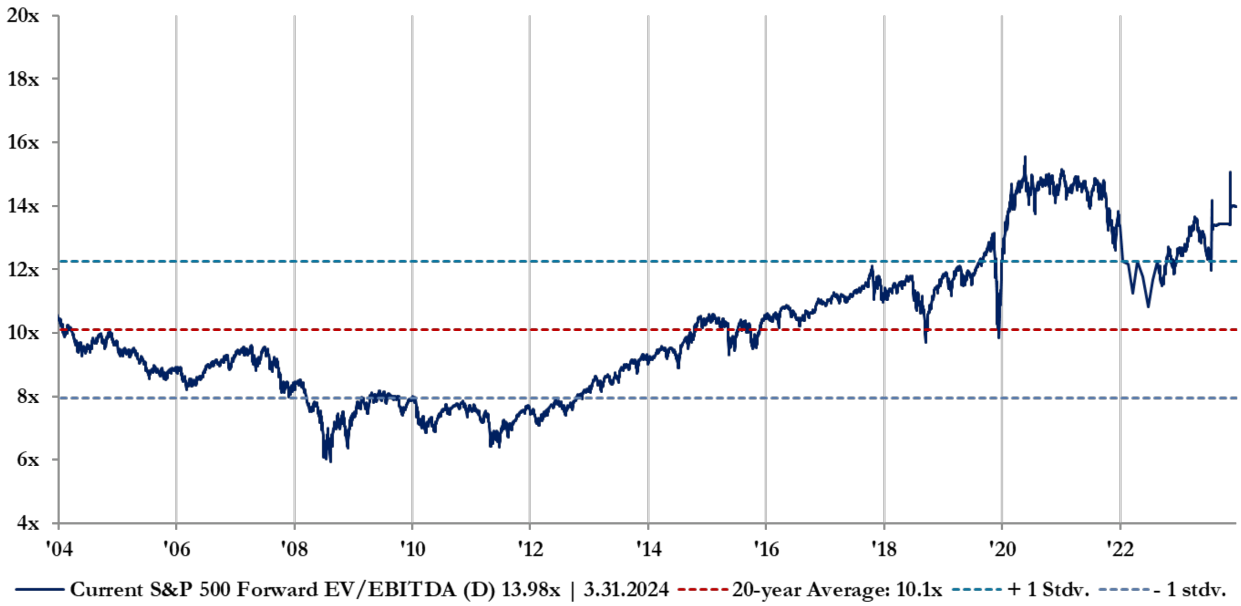

Figure 10: S&P 500 Forward EV/EBITDA
Source: FactSet

Figure 11: S&P 500 Forward P/E
Source: FactSet

Sector Positioning

Information Technology

The Economic Analysis Team recommends a neutral position in the Information Technology sector relative to the S&P 500 Index for the upcoming semester. Spurred by a significant surge in AI advancements and a shifting macroeconomic landscape, the sector has demonstrated remarkable resilience, robustly outpacing the broader market. Valuations have soared to all-time highs, propelled by a sustained rally in the sector and fueling exceedingly lofty expectations. However, failing to meet these ambitious expectations could pose significant challenges for the sector. The specter of higher-for-longer interest rates, with the central bank's target rate now at 5.5%, looms large, potentially straining valuations. Notably, the sector's forward P/E ratio stands at ~29x, a considerable leap from previous rate hike periods. The last time rates were above 5% in 2007, Tech traded ~19x. Despite this, optimism prevails, especially within Semiconductor & Semiconductor Equipment industries, which have counterbalanced the trend of Technology Hardware underperformance. Despite U.S.-China trade tensions and interest rate uncertainties, positive sentiment endures, buoyed by hopes of receding recessionary risk and a robust domestic economy. This optimism bodes well for technology companies, particularly in software and IT services, as increased spending that will further bolster the sector's performance is anticipated.

Financials

The Economic Analysis Team recommends a neutral weight in the Financials sector relative to the S&P 500 Index for the upcoming semester. Further troubles in regional banking and inflation woes have weighed on investor sentiment, leading to modest underperformance to the benchmark. Tighter capital requirements under Basel III standards could have adverse effects on banking profits; however, economic data is suggesting that the sector may have reached a peak in delinquencies, meaning credit losses are likely to subside. The insurance industry is facing a number of challenges ranging from cost pressures to regulatory scrutiny, offset by strong demand and higher premiums. Increases in disposable income and housing starts make homeowners insurance a bright spot. All of these factors, along with a resilient economy and waning inflation, have caused the Financials sector to currently trade at an 11% premium versus its ten-year P/E median. Furthermore, within the 11 S&P 500 GICS sectors, Financials distinguishes itself with more extensive positive earnings revisions, positioning it in the top 25 percentile. This signifies a notable upward shift in revision sentiment and suggests a particularly promising outlook for the sector. Top of Form A younger workforce, guided by senior professionals, will be tasked with navigating the rapidly changing economic environment to which the Financials sector is highly sensitive.

Sector Positioning

Health Care

The Economic Analysis Team recommends a neutral weight position in the Health Care sector relative to the S&P 500 Index for the upcoming semester. While the sector has generally lagged behind the broader market, there have been notable pockets of growth, particularly in pharmaceuticals where much excitement surrounds weight loss drugs and obesity treatments offered by companies like Eli Lilly and Novo Nordisk. Many of these drugs were originally approved for use in controlling diabetes, however, and their popularity and effectiveness in that area have come at a cost to diabetes equipment manufacturers. Despite the challenges encountered in 2023, with investor sentiment favoring Information Technology and Communication Services, there's anticipation of a fundamental turnaround in Health Care earnings growth that will potentially bolster optimism in the sector as 2024 unfolds. Analyst estimates suggest that the second quarter might mark the first time in two years that the sector surpasses the broader index's earnings growth. Although recent trends have not fully demonstrated the sector's defensive characteristics overall, the diversification in growth and defensive properties across its sub-sectors could help mitigate certain headwinds.

Consumer Discretionary

The Economic Analysis Team recommends an underweight position in the Consumer Discretionary sector relative to the S&P 500 Index for the upcoming semester. In 2024, sector growth has stabilized after a robust 2023 that was driven by unexpected consumer spending trends. The sector has entered underperformance territory, particularly in Automobiles & Automobile Components and Textiles, Apparel & Luxury Goods, where companies are grappling with reduced consumer purchasing power. Discretionary sub-sectors like apparel, represented by companies such as lululemon and Nike, have already experienced significant underperformance that has lowered guidance amidst a constrained consumer environment and macroeconomic uncertainties. The sector's sensitivity to the broader economy and recent indications from the Federal Reserve that suggest fewer anticipated rate cuts potentially exacerbate pressures on consumer purchasing power alongside rising interest rates. Although sentiment numbers have recently improved, they remain below pre-pandemic levels, and any surprises in inflation or further hawkishness from the Fed could quickly dampen sentiment once again.

Sector Positioning

Industrials

The Economic Analysis Team recommends a neutral position in the Industrials sector relative to the S&P 500 Index for the upcoming semester. The sector has experienced slight outperformance thus far in 2024, led by strong execution in the Construction & Engineering, Trading Companies & Distribution, and Electrical Equipment sub-industries. In the Aerospace sub-sector, supply chain challenges continue to hamper the efforts of aircraft manufacturers to ramp up production rates, impacting Boeing's recovery trajectory and causing Airbus to struggle in meeting demand targets. Likewise, despite heightened demand driven by geopolitical tensions, defense companies are confronted with supply chain complexities and prolonged lead times. Nevertheless, the sector remains buoyed by long-term themes such as nearshoring initiatives, federal funding support, and the imperative to address historical underinvestment in the U.S. industrial base. In the short term, there's a positive signal with the ISM Purchasing Managers Index (PMI) entering expansionary territory for the first time since late 2022. However, the sector's valuation appeal has slightly diminished, trading at a 21% premium to its ten-year P/E multiple, currently positioning it as the third most expensive sector.

Communication Services

The Economic Analysis Team recommends a neutral position in the Communication Services sector relative to the S&P 500 Index for the upcoming semester. The sector sustained its impressive momentum from 2023 into Q1 of this year, fueled by exceptional Q4 earnings and upward revisions in EPS and sales projections for key players like Meta, Alphabet, and Netflix. This growth trajectory owes much to heightened investments in generative AI, which has bolstered efficiencies in digital content and advertising operations. Nevertheless, concerns loom over a potential deceleration in digital advertising expenditure for 2024 amidst a backdrop of slowing economic expansion. Such conditions might prompt industry giants like Alphabet and Meta to experience a dip in advertising revenue following a period of robust demand. Despite these apprehensions, valuations remain relatively sound, with the sector trading at a mere 4.6% premium to its ten-year P/E multiple, despite strong performance. Excluding the mega caps from consideration reveals even more enticing valuations, indicating a broad array of discounts within the sector.

Sector Positioning

Consumer Staples

The Economic Analysis Team recommends a neutral position in the Consumer Staples sector relative to the S&P 500 Index for the upcoming semester. The sector's significant underperformance has persisted from the previous year, as it lost favor amidst ongoing market and economic expansion. This shift has diminished its defensive allure, with investors increasingly choosing cyclical sectors aligned with consensus expectations for earnings growth. The sector has also faced headwinds from higher yields as investors have shed dividend-paying shares for less risky investments in U.S. Treasuries. Despite headwinds, there's potential for momentum in higher traffic volumes in grocery stores, particularly as food-at-home prices rise at a slower pace than food-away-from-home, as indicated by CPI data. Additionally, the sector stands to benefit if economic growth falls short of expectations and inflation persists, potentially causing market momentum to wane.

Energy

The Economic Analysis Team recommends an overweight position in the Energy sector relative to the S&P 500 Index for the upcoming semester. In 2024, the Energy sector has staged a substantial rebound, marking its strongest first quarter performance in five years and outpacing both the overall market and the Technology sector. This resurgence is attributed to a confluence of factors, including optimism stemming from interest rate cuts, anticipated economic growth, and escalating geopolitical tensions, all of which have contributed to a surge in oil prices. Despite this impressive turnaround, Wall Street anticipates negative earnings for the sector this year. However, with the rise in oil prices experienced in Q1, analysts have since revised earnings projections upward on expectations of continued elevated oil pricing. Regardless, the sector exhibits the cheapest valuation out of all of the sectors, trading at around a 20% discount to its ten-year P/E multiple despite the aforementioned drivers surrounding global economic growth, interest rates, and geopolitics. Furthermore, continued output cuts by OPEC+ members act as positive catalysts for WTI Crude Oil prices and the broader sector, countering some of the dampening effects of demand uncertainties demonstrated by investor sentiment. In addition, Russian’s voluntary production cuts of 500,000 bbl/d also serve as a catalyst to enhance sector earnings. These factors, assuming no dramatic changes to policy, supply, or demand, should keep oil prices elevated and protect against certain headwinds.

Sector Positioning

Materials

The Economic Analysis Team recommends a neutral weight in the Materials sector relative to the S&P 500 Index for the upcoming semester. Given the sector's cyclical nature, it could be at risk as the result of worldwide recessionary concerns and declining global growth prospects. Additionally, analysts have started to trim 2024 estimates while the sector deals with a U.S. manufacturing slump and China's ongoing issues. Our current resilient economy could combat these risks, however, should factors such as unemployment remain strong. However, valuations continue to cloud the overall sector as it now trades at about a 30% premium to its ten-year P/E multiple. While growth for 2024 looks uncertain, the longer-term outlook for lithium, as well as the overall sector, appears more attractive.

Real Estate

The Economic Analysis Team recommends a neutral weight in the Real Estate sector relative to the S&P 500 Index for the upcoming semester. Numerous REIT properties, especially industrial and office, are feeling the impact of higher-for-longer interest rates. This sensitivity has been illustrated since 2022 as the Federal Reserve's long string of rate increases caused the sector to be the worst underperformer in the overall market. However, data center REITs, driven by the expansive surge in technology and AI, stand out as noticeable exceptions. Senior housing REITs could also be a bright spot in the sector as overall demand for these properties increases with the aging demographic. Additionally, valuations appear compelling, given that the sector is currently trading at about a 6% discount to its ten-year P/E multiple.

Utilities

The Economic Analysis Team recommends an underweight position in the Utilities sector relative to the S&P 500 Index for the upcoming semester. High bond yields have thus far persistently exerted pressure on utility stocks again this year, making the sector one of the worst performers in the S&P 500. The continuance of higher bond yields has led to a negative yield spread between utility dividends and U.S. Treasuries for the first time in 14 years. As a result, the sector has lost its defensive allure, evident by investors' growing pessimism and the subsequent sharp decline in its performance. With the Federal Reserve's commitment to maintaining elevated interest rates for an extended period, it appears that the negative yield will persist in the near to medium term.