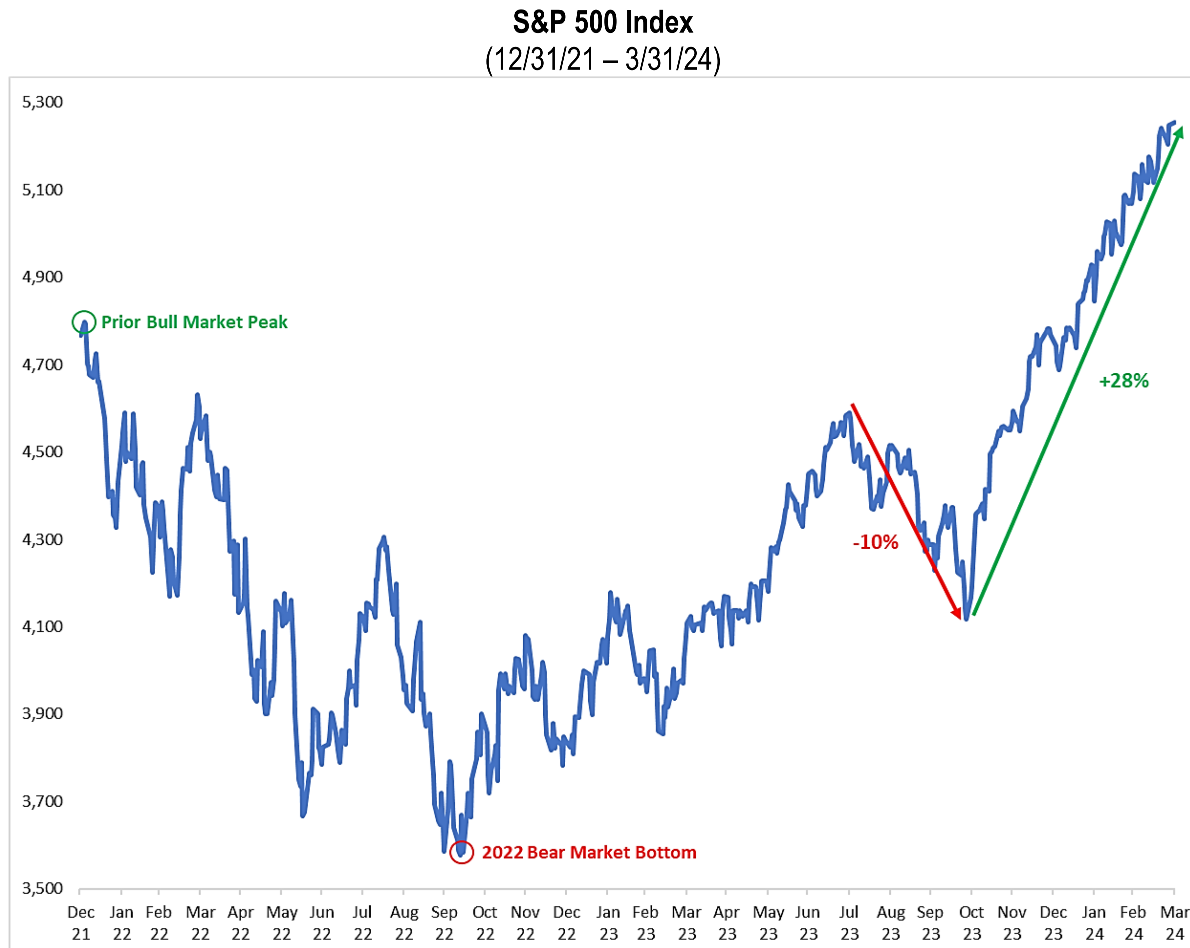
Market Review and Outlook

Global equities got off to a solid start in 2024, extending their positive year-end 2023 momentum, with each of the major indices posting another period of impressive gains during the first quarter. The S&P 500 Index returned an additional 10.6% during the first three months of the year, notching 22 new all-time highs in the process, as investor confidence continued to build around the Federal Reserves' ability to orchestrate a soft landing for the economy. International stocks followed suit, with the developed markets (EAFE) reporting a total return of 5.8% during the first quarter and emerging markets (EM) posting a quarterly gain of 2.4%.

The S&P 500 Index is now up 30% over the last 12 months, and 50% from the October 2022 bear market low, as enthusiasm around artificial intelligence (AI) technology, stronger-than-anticipated economic expansion, and looming interest rate cuts continue to drive stock prices (and valuation multiples) higher. While equities encountered a fleeting 10% correction last year from August through October when spiking interest rates weighed on investor sentiment, the S&P 500 Index has been on a relatively unabated upsurge since then (+28% over the last five months) and now sits above the previous bull market peak set in January 2022.

S&P 500 Index
(12/31/21 – 3/31/24)



Source: FactSet

As shown in the table below, it has historically taken two to three years for the S&P 500 Index to reclaim its prior highs after the start of a bear market (which this bull market did in December 2023). Once the prior peak has been surpassed, stocks typically continue to rise for another three to four years until another bear market ensues.

Bull Market and Bear Market Trends
(12/31/55 – 3/31/24)

Bull market peak	High revisited	Months to recover	Months until next bear market
8/2/1956	9/29/1958	26	38
12/12/1961	9/5/1963	21	63
11/29/1968	3/6/1972	39	10
1/11/1973	7/21/1980	90	4
11/28/1980	11/3/1982	23	58
8/25/1987	7/27/1989	23	128
3/24/2000	6/4/2007	86	4
10/9/2007	3/28/2013	65	83
2/19/2020	8/18/2020	6	16
1/3/2022	*12/31/2023*	*24*	***???***
	Average	42	45
	Median	25	38

Source: Edward Jones, Bloomberg, S&P 500 Index

Although past results do not guarantee future performance, the historical bull market data above suggests that this market rally could still have plenty of life remaining to extend its run.

That said, amid the latest equity market upsurge, investors appear to be pricing in near-ideal economic conditions over the coming quarters that may leave stocks vulnerable to a temporary correction. The now consensus “Goldilocks” economic outlook assumes the labor market remains sufficiently strong to support ongoing growth in gross domestic product, consumer spending and corporate profits—while inflation simultaneously moderates further to support interest rate cuts from the Fed later this year. The strong GDP growth (+3.4%) and above consensus earnings expansion (+4.0%) generated during the fourth quarter last year bolstered the argument that conditions remain supportive for stocks, but forward-looking economic indicators (like the inverted yield curve—which has a perfect track record of forecasting recession), continue to suggest a level of caution is still warranted. Just as the lack of a recession surprised the bearish consensus last year, current bullish forecasts could just as easily be upended by an economic downturn later this year.

Even if the economic backdrop remains positive, elevated equity valuations may limit upside advancement from here. At 21.1 times forward earnings, the S&P 500 Index’s P/E multiple looks stretched at a 33% premium to the 25-year average (15.8x). The massive runup in the technology-oriented (i.e., artificial intelligence) companies like Nvidia are pushing up the index’s valuation multiple, as the outsized concentration of these high-flying names in the index continues to expand.

Based on the rapid price appreciation of specific technology stocks, the frenzy around artificial intelligence is displaying attributes of euphoria. It’s quite common for technological advancements to be accompanied by initial overexuberance that can fuel pockets of market bubbles, as investors incorporate the technology’s long-term growth potential immediately into current market prices. AI certainly has the potential to be a transformative revolution, with capability of drive efficiency improvements across an expansive range of applications, but investors may be overestimating the speed and profitability at which these market-altering AI advancements will be deployed.

Technology isn’t the only expensive sector of the market though. With price/earnings ratios for nine of the 11 individual S&P 500 industry groups above their respective historical average since 1999, equity valuations in aggregate are extended.

Sector Valuation Multiples
(as of 3/31/24)

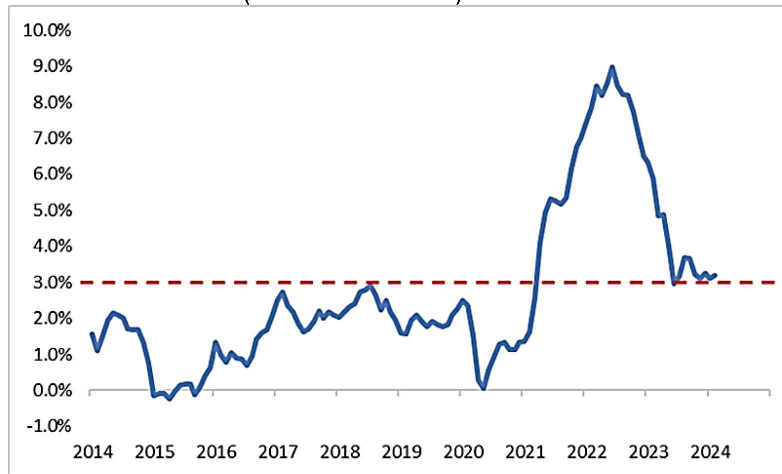
	Forward P/E	25-yr Avg. Forward P/E	Premium/ (Discount)
S&P 500	**21.1**	**15.8**	**33%**
Information Technology	28.2	17.1	65%
Materials	21.4	15.1	42%
Industrials	21.7	16.7	30%
Health Care	19.5	15.0	29%
Consumer Discretionary	26.2	20.9	25%
Consumer Staples	20.4	17.6	16%
Communication Services	19.0	17.4	9%
Utilities	16.1	15.5	4%
Financials	15.8	15.6	1%
Real Estate	17.6	18.7	-6%
Energy	13.0	15.0	-13%

Source: FactSet, Bloomberg, Edward Jones

While valuation multiples are bad at pinpointing when markets will inflect in the short term (as 3- to 12-month returns are driven more by sentiment and/or surprise), they are pretty good at predicting the magnitude of long-term returns. According to Strategas Research, when the S&P 500 is trading at a P/E of more than 20x, the historic average annualized returns for the index over the subsequent 1-, 3-, 5-, and 10-year periods has been a relatively lackluster 3.9%, 4.4%, 5.0% and 3.0%, respectively. Thus, a period of more measured equity market returns may be in store over the coming years given current valuations.

It's true that P/E multiples have been elevated for the last decade (18x average) and returns over that period have still been above average (12.0% total annualized return for the S&P 500 from 2014-2023). However, interest rates over much of the last decade were suppressed (10-year Treasury yield averaged 2.3% from 2014-2023 vs. the 40-year historical average of 5.0%) due to low inflationary pressures, justifying sustainably higher valuation multiples. If we speculate that the 3.0% inflation ceiling during the last decade (as measured by CPI) is now the base rate for inflation over the coming decade (on par with the 40-year median CPI of 3.0%), interest rates are likely to stabilize well above the levels observed the last 10 years. This could put downward pressure on valuation multiples moving forward and create a drag on equity returns.

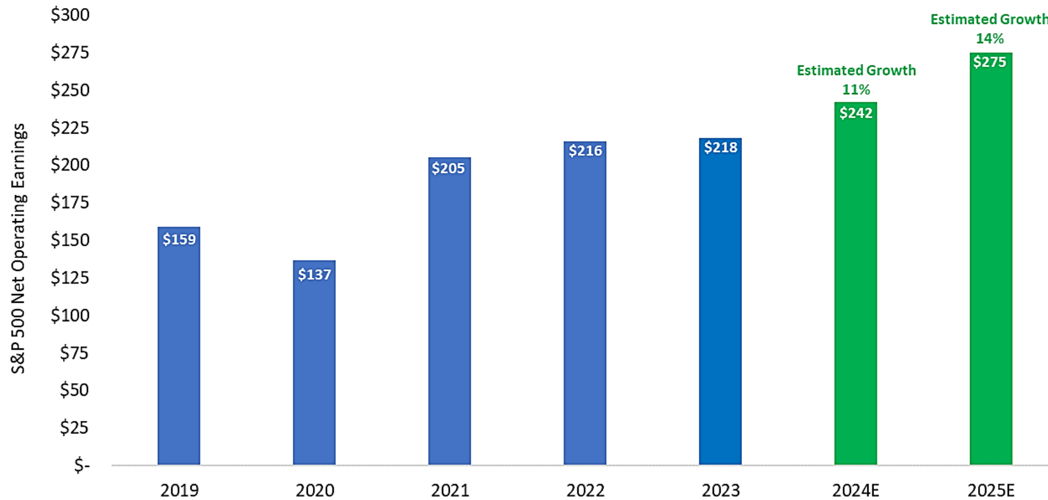
Consumer Price Index (CPI)
(1/31/14 – 3/31/24)



Source: U.S. Bureau of Labor Statistics

Assuming valuation multiples begin to regress back toward more normalized levels, corporate earnings will play a pivotal role in the trajectory of equity returns in the coming quarters. Consensus expectations are that earnings will reaccelerate both in 2024 (+11%) and in 2025 (+14%), which should be supportive of equities—even if valuation multiples moderately contract.

S&P 500 Index EPS
(2019 – 2025)



Source: FactSet

The risk of deteriorating economic conditions and corporate earnings falling short of investors' double-digit growth expectations, however, pose the biggest threats to sustained upward market momentum. Even a mild recession would likely derail earnings expansion, which could have significant implications on the stock market given how high valuations are relative to historical norms. Thus, a cautious approach toward the equity market seems prudent over the near term as temporary pullbacks could ensue. It seems unlikely a potential correction would devolve into a more punishing bear market (a 20% or more pullback) over the next few quarters given the still solid economic backdrop though. As a result, we would likely view increased levels of market volatility during the balance of the year as opportunities—especially ahead of a multi-year rate-cutting cycle that the Fed looks poised to commence later this year.

Core Portfolio

During the quarter, we initiated a position in the First Trust RBA American Industrial Renaissance ETF (AIRR). The fund holds equity positions in U.S. small and mid-cap industrial companies (and a 10%-capped stake in community banks near manufacturing hubs), which are positioned to be prime beneficiaries from the bourgeoning re-industrialization of America. While the global economy became increasingly interconnected over the last century (with rapid globalization trends starting in the 1990s), there has been notable shift toward more nationalistic policies (i.e., deglobalization) around world over the last decade. As U.S. corporations re-evaluate the rising labor/energy/transportation costs and geopolitical/supply chain risks of manufacturing overseas, an increasing number of companies are expected to re-shore a portion of their operations back stateside. This secular trend will require tremendous commercial and infrastructure investment domestically over the next decade, which is likely to boost the earnings of small and mid-cap industrial companies that are participating in the development and buildout of these new economic centers.

We sold our position in Texas Pacific Land Trust (TPL) during the quarter. TPL owns the most expansive oil and natural gas acreage portfolio in the country (concentrated in the highly productive Permian Basin), but costly and time-consuming legal battles waged by two large investors/board members against the company have created uncertainties about its strategic direction and shareholder stewardship. We believe our other energy investments will more directly benefit from the sector's tightening supply/demand balance, without the overhang of the boardroom drama at TPL.

Our other portfolio moves were focused on reallocating our investments within the Technology sector to more diversified and/or more reasonably valued holdings. During the quarter we sold our position in Cisco Systems (CSCO) and trimmed our position in Advanced Micro Devices (AMD), redeploying the proceeds into Microsoft (MSFT) and the Technology Select Sector SPDR Fund (XLK). Microsoft enjoys a broad portfolio of strategic products, sits at the intersection of cloud adoption, and has emerged as a leader in artificial intelligence based on its investment in OpenAI. The company is viewed as the most critical and indispensable IT mega-vendor, which when coupled with its expanding recurring revenue model, should generate more stable profits throughout the business cycle than most of its peers. The Technology Select Sector SPDR Fund, which holds 65 individual technology stock holdings, offered another compelling solution to diversify our exposure more appropriately within the technology sector.

Tactical Portfolio

We initiated a tactical position in the VanEck Agribusiness ETF (MOO), which is invested in 60 publicly traded companies that operate in the agriculture sector, including farm equipment, seed and fertilizer, and animal health. Global population growth and an expanding middle class (consuming more calories/protein) is spurring sustained demand for food production, which has the potential to drive substantial long-term value for agribusiness companies. We sold our holding in the Vanguard Ultra Short Bond ETF (VUSB) to fund this attractive total-return investment.

We also added to our existing stake in the iShares Mortgaged Back Bond ETF (MBB) in the quarter, which was funded by selling our position in the iShares 7-10 Year Treasury Bond ETF (IEF). With the average 30-year mortgage rate still hovering at a wider-than-normal gap to the 10-year Treasury yield (2.6% spread vs. 1.7% historical average spread), we view agency mortgage bonds as a more compelling investment opportunity given both their higher yields and better capital appreciation potential as interest rates decline and/or spreads compress.

Fixed Income

The fixed income market started the year by surrendering back a portion of its healthy late-2023 gains. The aggregate bond index posted a -0.8% total return during the first quarter, as a modest rebound in U.S. Treasury yields put downward pressure on bond prices. Resilient labor market data, still-elevated inflation, and a reduction in the number of investor-forecasted Fed rate cuts this year have been key drivers of the latest upward move in Treasury yields. Longer-term interest rates remained well below their 5% October 2023 peak, but the 10-year yield repriced back above the 4% mark during the quarter—ending March at 4.20% (vs. 3.86% at the end 2023).

It's likely that the trend toward lower interest rates will remain bumpy, as the downward momentum has been interrupted by the surprising economic strength and stickier inflation trends of late. As was widely expected, the Fed left the federal funds rate at 5.25-5.50% during its March meeting—the fifth consecutive meeting during which rates were held steady. While the meeting maintained a dovish tone with the median

Federal Open Market Committee (FOMC) member projection continuing to anticipate three rate cuts in 2024, the median rate forecast for 2025, 2026 and the "longer run" all edged slightly higher. That suggests the Fed members don't think they will need to cut rates as aggressively in the coming years, given how well the economy has weathered the higher-rate environment thus far.

Despite a lackluster start to 2024 in the fixed income markets, we continue to see compelling opportunities. Investors can generate attractive yields for less than five years in duration with limited risk of that portion of the yield curve shifting dramatically higher.

Final Thoughts

As always, thank you for your continued trust and confidence. We value the responsibility you have placed in us to preserve and grow your capital alongside our own. Please do not hesitate to reach out with questions or comments, or just to catch up. We welcome your calls and e-mails.

Have a warm, healthy, and prosperous spring!

Parkside Investments, LLC

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