Quarterly Economic Update

March 6, 2024

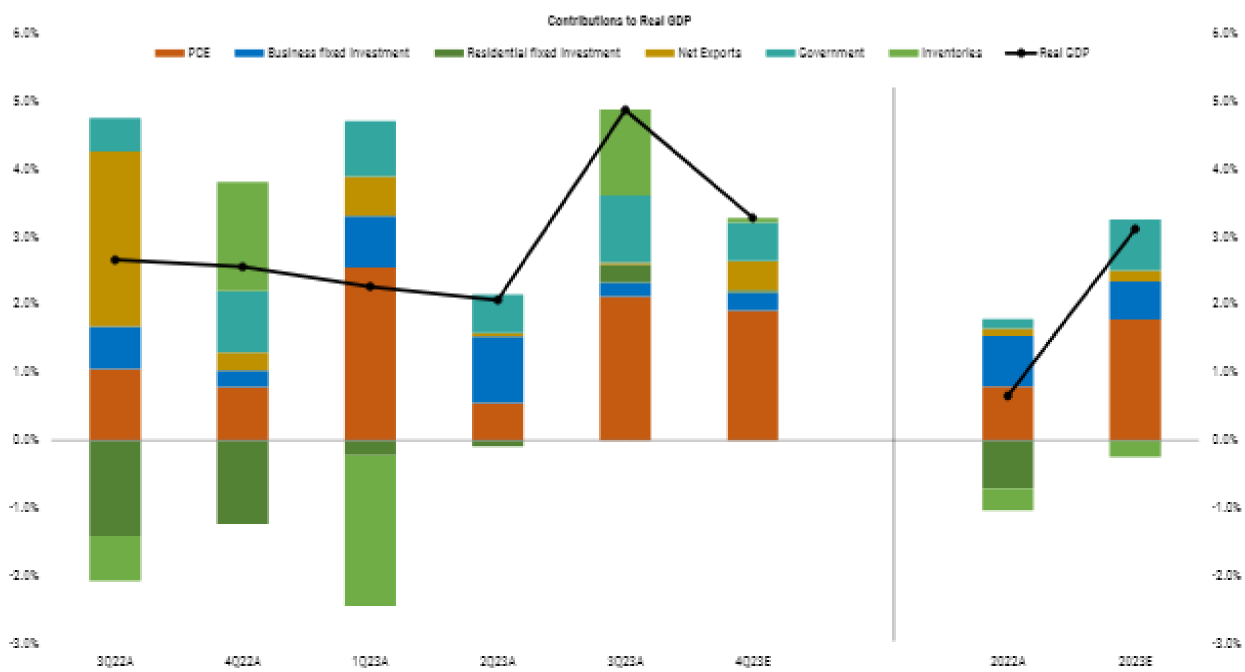
MACROECONOMIC COMMENTARY

Economic Outlook

By Bobby Long

The economy delivered stronger-than-expected growth in 2023. The year began with slower than anticipated growth, however conditions proved far more resilient, and the second half of the year produced a very healthy level of economic activity. Along with the improving activity, recession concerns faded as the year progressed. Many economists shifted their outlook from a “recession” view to a “soft landing” view. The 2024 year begins with many of these outlooks shifting from a “soft landing” view to a “no landing” scenario where economic growth can continue at a robust pace. A recent survey of economists by Bloomberg News marked recession odds down to 40% over the next year. Evercore ISI conducted a recent survey of investors that showed only 25% expected a recession. Following a series of steady increases to the federal funds rate, the Federal Reserve has held the policy rate firm at an elevated level since July. As inflation has fallen, this has further tightened policy, with real interest rates becoming more restrictive. Despite the restrictive policy, economic activity has remained strong and labor conditions healthy without widespread job losses surfacing. Employment and inflation remain the key variables to economic conditions and the path forward over the next several quarters.

Gross Domestic Product (GDP) for the fourth quarter grew at an annual rate of 3.2%. This slowed from the third quarter’s growth rate of 4.9% but was still a strong number that exceeded expectations. Most major components of the measure contributed positively to the quarter’s growth, with personal consumption continuing to carry the weight. Consumer spending on services came in slightly stronger, whereas spending on goods was modestly softer over the prior quarter.

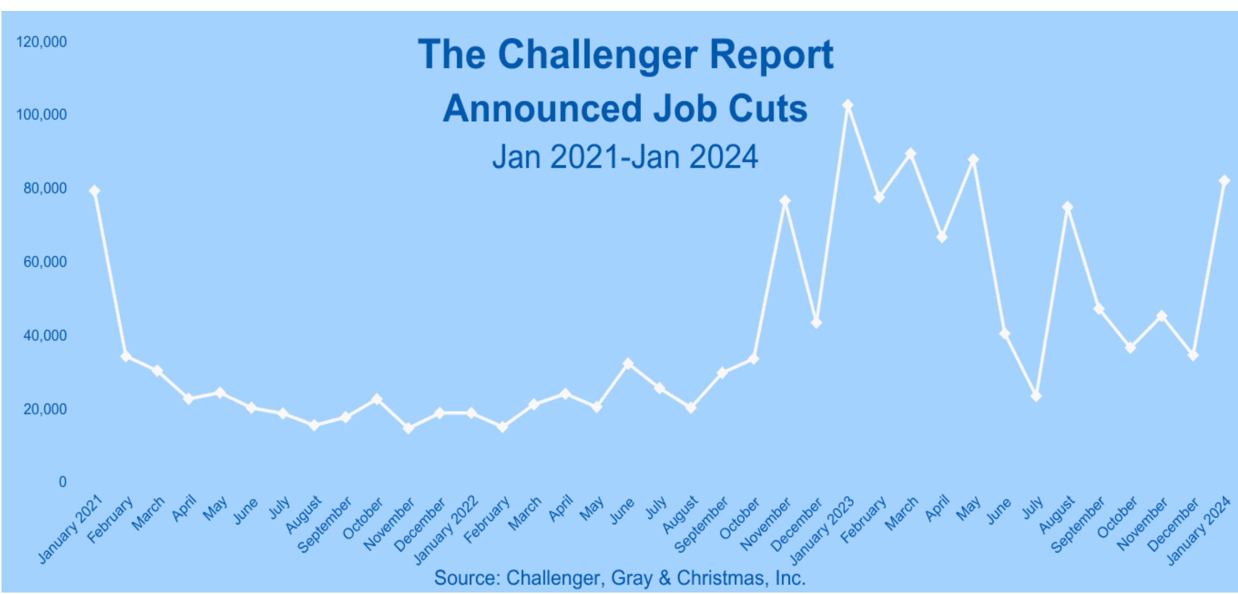


Source: Bureau of Economic Analysis, Morgan Stanley Research

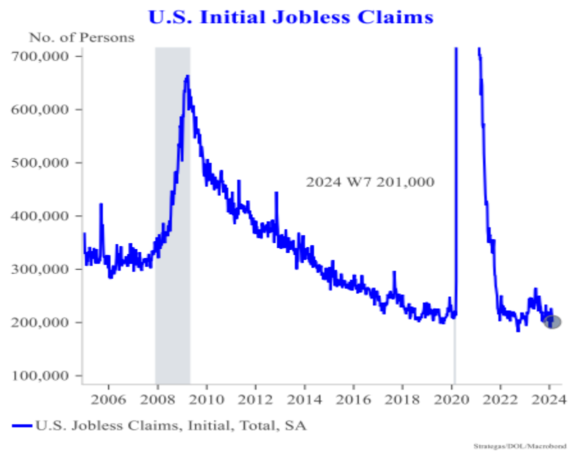
Real GDP growth for the full 2023 year was 3.1%, a much stronger rate than the prior year's growth of 0.7%. Stronger growth from personal consumption expenditures, government spending, and net exports lifted the growth rate. Business fixed investment also increased over the prior year but at a slower rate. A Bloomberg News survey of economists shows median expectations for real GDP to slow to 2.0% for 2024, with weaker consumer spending offset by stronger private investment.

The employment situation has remained strong and shows no clear signs of weakness. The January payroll report included an increase in nonfarm payrolls of 353,000. December nonfarm payrolls were revised upward to 333,000. These are strong numbers that do not indicate deteriorating conditions. The breadth of job gains across industries was also positive, with the strongest contributions coming from professional and business services, healthcare and social assistance, and retail. Labor force participation increased slightly to 62.52%, supported by a bump in prime-age participation. The participation rate had been improving through much of 2023 but has stalled over the past few months. The rate faces some natural demographic headwinds, but economic activity and immigration trends should be more supportive for prime-age participation. The unemployment rate held steady at 3.7%. The labor market imbalance has eased as labor demand decelerates and labor supply has improved. This has resulted in lower quit rates and job churn, which is relieving wage pressures. All of these factors combined paint the picture of a labor market that remains tight but is loosening some from prior extraordinary conditions.

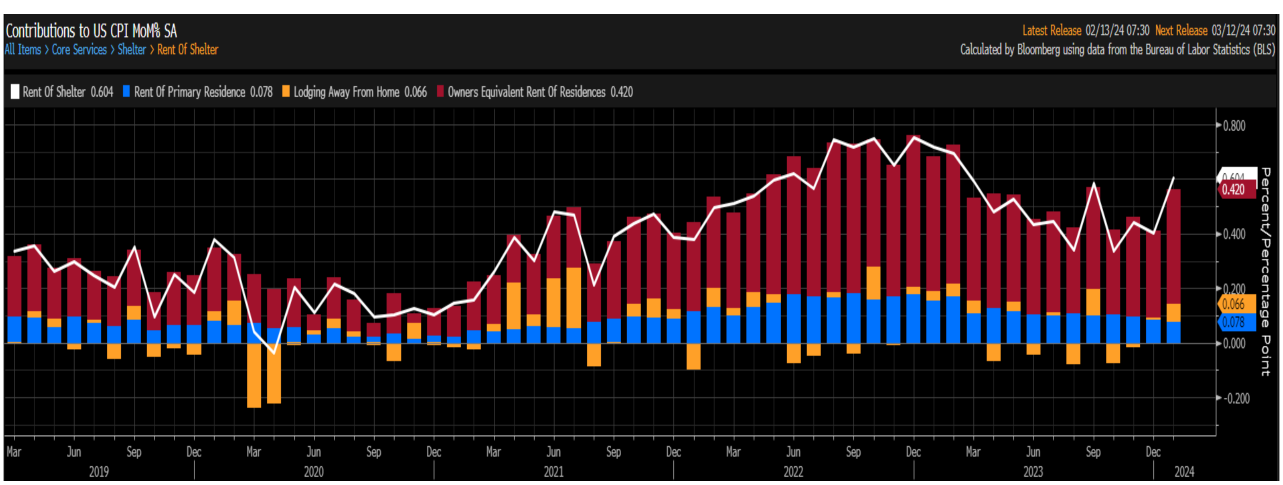
There has been an uptick in layoff announcements more recently, but not a significant enough increase to signal weakening labor conditions. The Challenger Report tracks job cut announcements by US-based employers and recorded a sharp increase of 82,307 cuts in the month of January, as shown in the chart below. These job cuts were concentrated largely in the financial and technology sectors. The report also indicated that hiring announcements were very low in both December and January.



Initial jobless claims have remained low and ticked down in recent weeks, showing no signs of widespread job losses forming. Continuing claims have also remained stable over the past few months, indicating that employees who become separated from their jobs are still able to find new employment rather quickly. We saw an increase in initial claims over the 1st half of 2023, however this faded as the year progressed, and the trend has continued its path over the first couple months of this year.

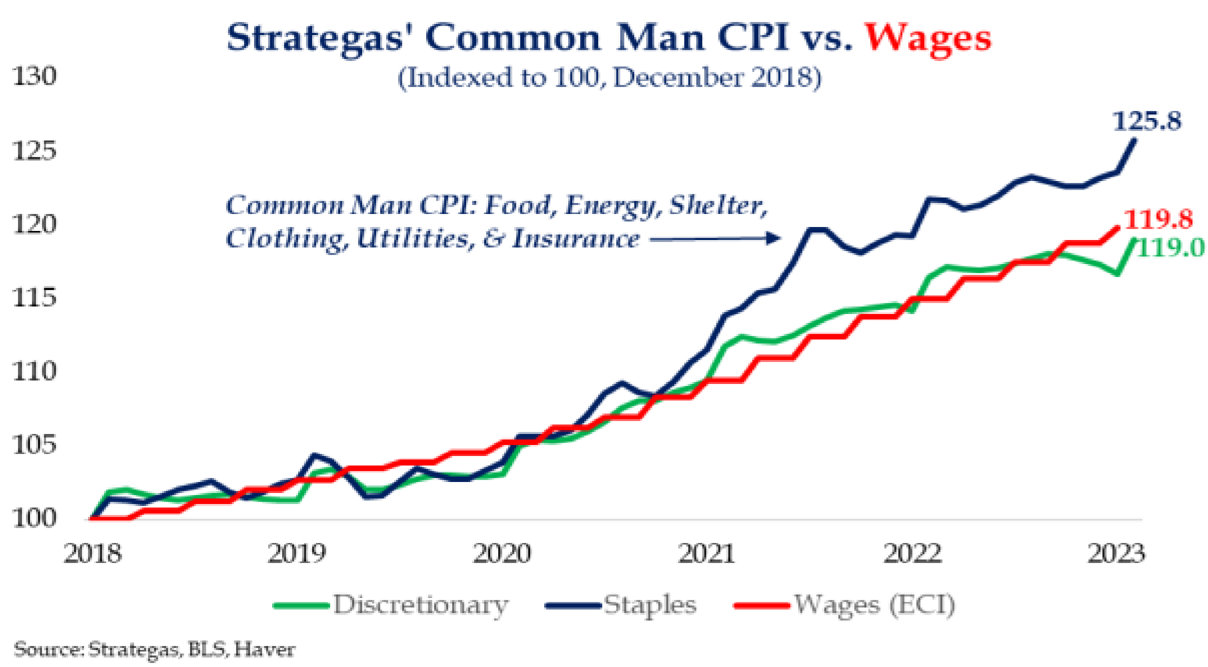


The Federal Reserve continues its battle to decrease inflation while avoiding job losses. So far, their efforts have been successful with inflation steadily falling throughout 2023. For the month of January, the Consumer Price Index (CPI) rose 3.1% y/y. Core CPI, excluding food and energy, rose 3.9% y/y. This is a substantial deceleration from its peak in mid-2022. The January report did show an increase over the prior month, indicating the threat of reaccelerating inflation pressures. January CPI rose 0.3% m/m and core CPI rose 0.4% m/m. If the monthly change continues at these levels, it may indicate that the decline in inflation has stalled and could begin to creep higher again. The recent report, combined with strong employment data, has been enough to push back expectations for the Federal Reserve to declare inflationary pressures tamed and pivot toward less aggressive policy action. There are many ways you can carve up inflation measures and different methods can paint varied pictures on overall inflation and the contributing factors. The monthly increase in January was fairly broad. Declining prices on apparel and vehicles have kept core goods inflation down. Services have seen broader inflation, with shelter inflation being especially problematic. Rents and owners' equivalent rent components have been running high. Without a deterioration in employment conditions, shelter inflation can remain elevated, with a supply imbalance supporting home prices and higher home prices pushing rents higher.

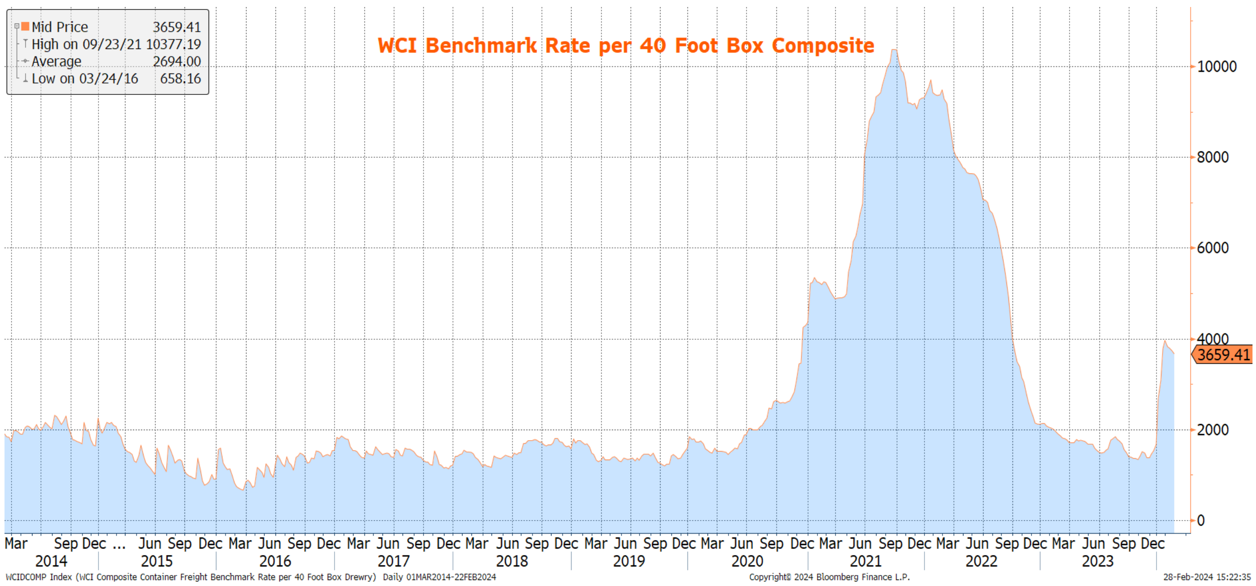


The labor market imbalance has loosened, but conditions remain tight, which is keeping pressure on wages. While wage inflation has declined, it remains elevated, and this continues to feed broader inflation pressures that are showing up in services. The Employment Cost Index has been falling but continues to run above 4%, a level that has historically preceded economic contractions. Employers need to pass these costs on to consumers through higher prices on goods and services or absorb the costs through lower profits. The broad economic strength and employment conditions have made it easy to pass this inflation on to consumers, but it may be more difficult as consumers find themselves unwilling or unable to pay the higher prices.

Consumers continue to express concern about inflation, even as inflation measures have fallen from their highs. For the average family, many have seen their basic living expenses outpace their incomes, leaving them with less discretionary income in their monthly budgets. Their household net worth has likely risen with housing and retirement account appreciation, but their monthly budgets are tighter, and a change in their employment status or a reduction in hours worked threatens to significantly disrupt their lives. Since December 2019, average hourly earnings have increased 21.8%. The median monthly mortgage payment has increased 98.1%, and the median auto payment has increased 36.7%. These are not everyday purchases but are big-ticket necessities and consume a large portion of the monthly budget. For those who need to make these purchases, the price increases have left many needing to stretch for these expenditures and has possibly pushed them out of reach. CPI food prices overall have increased 25.9%, with many basic household grocery items such as eggs, beef, chicken, cereal and bread increasing at higher rates. This inflation on non-discretionary household necessities still weighs on the average family and has left many feeling less secure despite the improving economic conditions. The chart below illustrates how these items have outpaced wages and discretionary inflation.

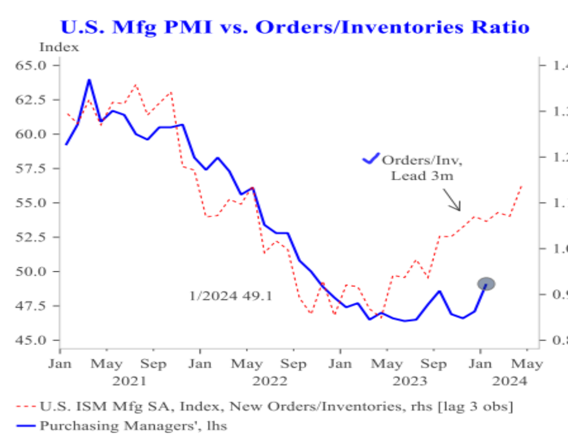


A risk to improving inflation trends is disruption in supply chain and logistics channels. Pandemic shutdowns and restrictions fueled initial inflation pressures as supply chains became broken, pushing up prices as companies struggled with shipping delays and sourcing problems. With geopolitical tensions increasing and major shipping lanes impacted, this risk is resurfacing and could lead to future inflationary pressures. Disruptions in the Red Sea have caused composite shipping prices to more than double over the past several months.

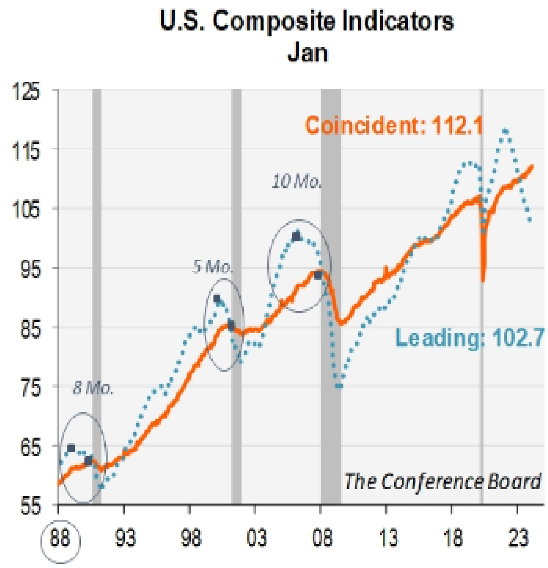


While consumer spending has been the key component driving economic strength, manufacturing activity has been broadly weak over the past year. Most measures remained in contraction territory throughout 2023. More recent data is mixed and does not necessarily indicate a change in trend, but some surveys are beginning to show improvement. The S&P Global US Manufacturing index moved into expansion territory in January for the first time since late 2022. Regional manufacturing surveys have remained weak, but the Empire State and Philadelphia Fed indexes have shown improvement recently.

The Institute of Supply Management's Manufacturing Purchasing Managers' Index moved closer to expansion territory in January. New orders have been improving for several months now and generally lead to an upturn. The chart below indicates this may be starting to improve and could be a catalyst for further economic expansion. Manufacturing employment and overtime are still in declining trends, but stabilization could be a confirming signal.



Many leading indicators continue to be weak and signal recessionary conditions. The Conference Board's Leading Economic Index has declined for the 22nd straight month. The indicator is a composite index designed to signal peaks and troughs in the business cycle and strongly correlates with retail sales. Most recently, seven of the ten components were flat to negative. The chart below shows both the leading and coincident indicators. Historically, the leading indicator peaks prior to a recession and crosses below the coincident indicator at the start of a recession.



Other economic data remains mixed. The Conference Board's CEO confidence survey has improved. A slightly lower rate of CEOs at 35% indicated they expect to expand their workforce over the next 12 months, however the number of CEOs expected to reduce headcount increased from 13% to 23%. The Conference Board's Consumer Confidence Index has been range bound, however the University of Michigan's Consumer Sentiment Index has shown some improvement. Bank loans have declined, with surveys reporting tighter lending standards and weaker demand. The January Senior Loan Officer Opinion Survey reported expectations that lending standards would remain tight for commercial, industrial, and residential real estate loans but tighten further for commercial real estate, credit card, and auto loans. Banks reported expectations that loan demand would strengthen and quality deteriorate across loan types.

Housing affordability remains an issue, and while there is still an undersupply of housing, a lot of demand has likely been pulled forward, and existing homeowners will be reluctant to take on a higher mortgage rate. A pickup in housing activity would be a boost to broader activity, but lower mortgage rates are needed to help this. Retail sales were weaker in January, but seasonal factors made for a messy number, so this should be watched for recurring weakness along with other indicators that may indicate a weaker trend forming. Consumer spending will likely slow as we move through the year, just on the elevated levels of spending over the past year and as discretionary income declines for most income brackets. An increase in business investment would be a welcome offset to support economic growth. Inflation expectations have declined, and it looks like inflation is headed in the right direction, however it does need to move further toward the Federal Reserve's two percent target. The Fed is conscious of prior inflationary cycles where policy errors led to waves of inflation and unemployment. They seem inclined to hold policy tighter for longer to ensure inflation pressures are quashed, which should serve to slow economic activity further at the risk of triggering job losses. So far, employment and economic growth have remained strong, and with the yield curve inverted, nothing has broken yet.

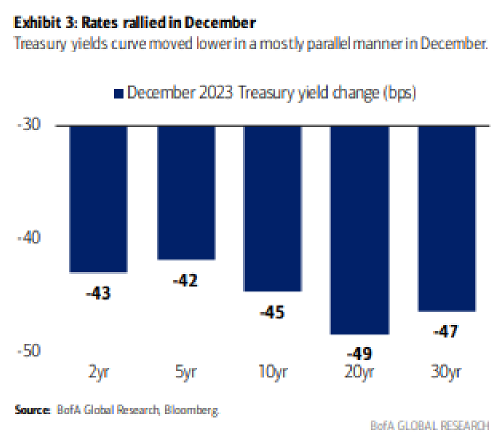
RSA PORTFOLIO STRATEGY

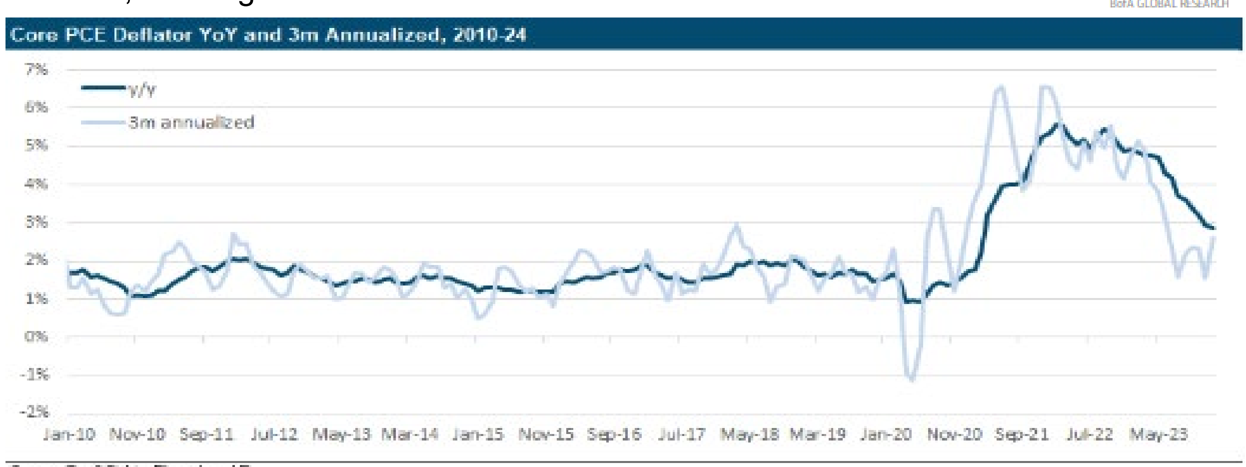
Fixed Income Strategy

By Lance Lachney

At the time of our last meeting in December, interest rates continued to plummet after a substantial drop in treasury yields during the previous month. The biggest impact on the direction of rates came from the Federal Open Market Committee in what has now been deemed as the “dovish pivot.” Policymakers held rates steady for a third consecutive meeting and indicated three potential rate cuts in 2024, a view that the market had already snuffed out. In his press conference, Chairman Jay Powell relayed the committee’s discussions on its progress regarding inflation and its outlook for a soft landing. Inflation data for November came in line with market expectations with core PCE climbing .10% from the previous month. The resiliency of the economy provided additional hope, leading to a massive rally in risk assets and a further decline in interest rates. Investment grade and high yield spreads tightened during the month of December and finished with yearly returns of approximately 8.40% and 13.45%, respectively.

Coming into January, financial markets were pricing in a total of six interest rate cuts for the year, with the first move arriving at the March FOMC meeting. A better-than-expected December payroll number and a near half percent monthly increase in average hourly earnings helped slow the rapid decline in treasury yields. Spreads within the high-grade and high-yield sectors also widened after considerable strength in the previous month. This move was short-lived despite a slightly higher December CPI reading. When viewed on a 3-month basis, the headline CPI number was running at a sub-2% annualized pace. The Producer Price Index also came in well below its estimate, and treasury yields resumed their downward descent. However, a strong retail sales number for the month



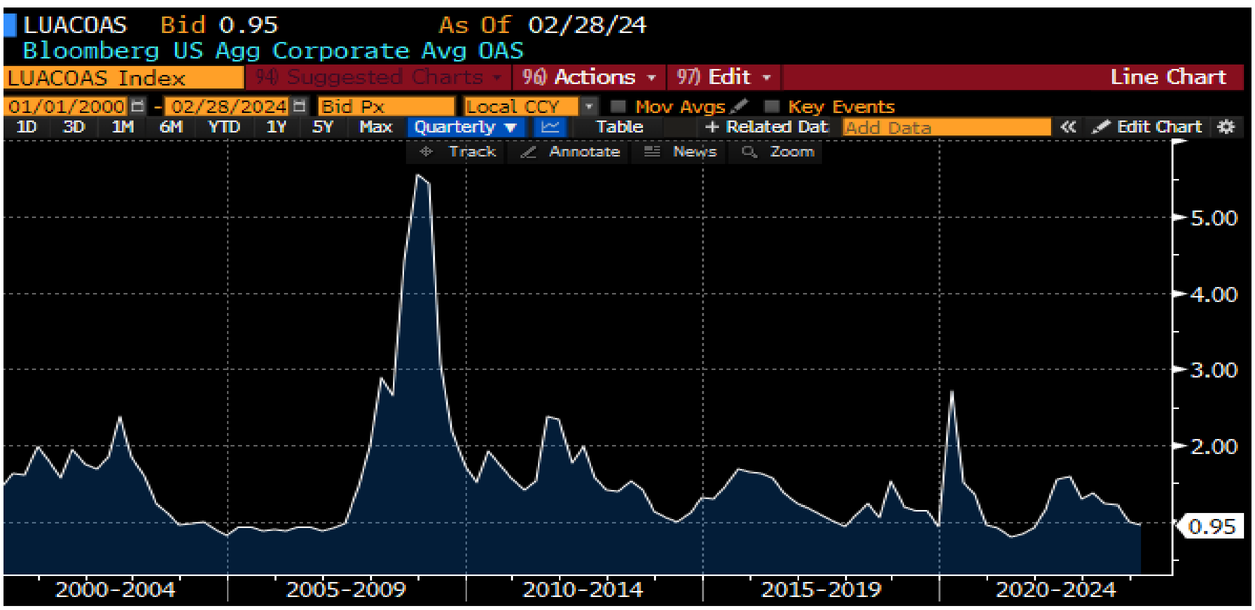


of December led to an abrupt selloff in risk-free assets, with the treasury curve bear flattening in response. A few Fed officials also pushed back on the poised-to-cut narrative, with one anticipating the first move to come in the third quarter of this year and the other highlighting strong economic activity and a tight labor market. GDP growth for 4Q23 exceeded economists' forecasts, coming in at 3.3% due to strength in consumer spending. On the last day of the month, the FOMC implied that further rate hikes were likely off the table, but it needed to be more confident that "inflation is moving sustainably to 2 percent." Chairman Powell essentially threw cold water on a potential cut at the March meeting. He stated that a discussion about the future path of its Quantitative Tightening program will soon begin.

The once-forgotten "higher for longer" narrative began to rear its head in the first week of February. The nonfarm payroll report for January revealed that 353,000 jobs were added, nearly twice the consensus estimate. The revisions to the two previous months added another 126,000 jobs to boot. Average hourly earnings also grew .60% mom and 4.5% yoy, while the unemployment rate held steady at 3.7%. Treasury yields rose across the curve while credit spreads tightened at the margin. High-yield bonds outperformed due to their short-duration composition. Led by the front end, interest rates continued to push higher as the headline CPI number for January came in hotter than expected on a monthly basis. While the increase declined from December, headline inflation still grew 3.1% from the previous year. Credit spreads have been resilient during this time as balance sheets remain relatively stable, and corporate yields are fairly valued from a historical perspective.

Source: Bloomberg

Trading within fixed income has been somewhat muted and selective. Within mortgages, the fund purchased a couple of lower coupon 30yr securities during this time as spreads were relatively healthy and to lengthen duration as insurance against an economic downturn. Over the last month or so, the fund has been swapping a portion of its short-term treasury securities into longer-dated ones across the curve to tighten the duration mismatch relative to the index. The fund's short-duration positioning has proven to outperform amid interest rate increases, so it is in our best interest to provide a little protection should a soft landing not occur. Within corporates, the fund has purchased a couple of high-quality issues locking in 5.00-5.50% over 3 to 10 years. The fund has placed orders on a couple of new issues recently, though ultimately dropping out after pricing was lowered by 30-35bps from the original guidance. Investment grade corporate supply is approaching $400bn year-to-date, with virtually every deal heavily oversubscribed and offering little to no concession over outstanding debt. Over the last week, investors have pushed back as newer issues have struggled to perform, and spreads have leaked marginally wider. One can make the argument that corporate spread levels may have little room to tighten despite the dramatic drop from the regional banking crisis a year ago. The most recent tights(~86bps) happened in mid-2021, however overall corporate yields were substantially lower due to the zero-interest rate policy during the COVID era. The fund is currently, historically, and will remain overweight corporate credit going forward, but will be prudent in terms of quality and timing.



Source: Bloomberg

In summary, the market appears to have gotten a little ahead of itself, as growth has held up better than expected, and inflation remains sticky for the time being. The rise in prices to start the calendar year has core PCE inflation running at 2.5% on a 6-month annualized basis. The market's expectations for interest rate cuts for the year have fallen to three from the six projected moves several weeks back. The steepening trade has faltered early in 2024, with the spread differential between 2yr and 10yr treasury notes lingering around -40bps. The unemployment rate remains roughly in the same position as it was when the hiking cycle commenced two years ago. Further deceleration in inflation is likely to require further slowing in economic activity. There appears to be some strain in consumer credit at the lower end with card and auto loan delinquencies rising. However, there is a considerable amount of uncertainty on when and how much the economy will weaken as long as Americans have a job awaiting them each morning.

Domestic Equity Strategy

By Allan Carr

Since our last update in December, equities have continued to deliver, with the S&P 500 up another 8%. After a rough month in October to start, the market is now up 19% just five months into our fiscal year. It's been a powerful rally with the S&P up 15 out of the last 17 weeks, and on February 23, the S&P500, Nasdaq, and Dow all closed at record highs.

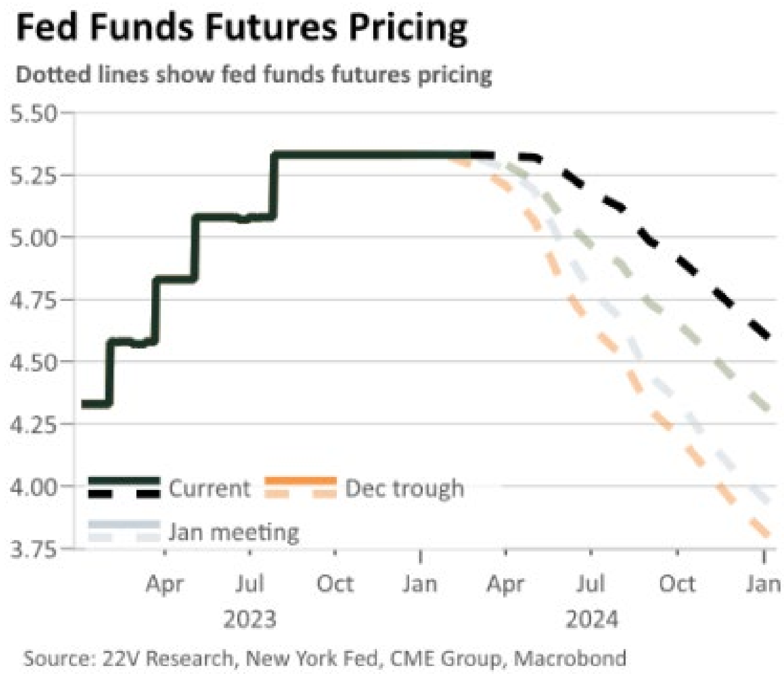
The rally has been fueled by a steady stream of strong data. Refer to the economic portion of this update for detailed information, but the economy has remained quite resilient: growth has surprised to the upside, inflation has steadily declined, and employment data remains remarkably strong. In conjunction with that, earnings have been robust, with roughly 80% of S&P companies beating estimates in 4Q. Artificial Intelligence (AI) excitement has been a tailwind, which encouragingly was validated by NVIDIA's blowout 4Q earnings report a week ago. Lastly, the biggest underpinning of the recent rally has been optimism that the Fed is going to stick a soft landing.

There were three noteable blips that spooked markets in recent weeks, but they ended up being short-lived. Two occurred on January 31 which resulted in the Nasdaq closing down -2.2% and the S&P down -1.6%. Tech bellwhether Google had a disappointing earnings report, and New York Community Bank (NYCB) unexpectedly cut their dividend and took a large one-time loss due to regulators' concerns over their commercial real estate (CRE) exposure. The third came on February 13 with the release of the January CPI, which surprised to the upside, causing the market to trade down over -2% intraday before rallying back into the close to finish down -1.37%.

So, as markets sit at all-time highs after a remarkable run, where do things stand? Atop the worry list continues to be the unknowns around the world and the Fed. Geopolitical and political risks seem to get worse by the day, and there's been little reason for optimism on either getting markedly better.

With the Fed, the soft landing has become the overwhelming base case after most economists and strategists assigned slim odds to it in late 2022 and well into mid-2023. The hot January CPI print being a one-off remains to be seen, but markets seem to thus far agree with economists that it was an aberration due to seasonality. The CPI print and other factors have caused the timing and amount of rate cuts to be pushed out substantially in recent weeks (Exhibit 1).

Exhibit 1



At the end of 2023, Fed Fund futures were pricing in over 150bps rate cuts, and the consensus was forming that the Fed would start cutting in March. Now futures indicate the Fed won't cut until June at the earliest and by only 75bps for the year. Recent Fedspeak has backed this up with Philly Fed President Harker saying the biggest risk for the Fed "comes from acting to lower the rate too early." Additionally, Fed Governor Waller said he is "going to need to see at least another couple more months of inflation data before I can judge whether January was a speed bump or a pothole." While the strength in the economy has given the Fed some wiggle room, this is a drastic shift in how markets saw the Fed's policy developing and is going to be a major focal point for investors in the upcoming months.

Not surprisingly, there are internals within the market giving investors angst as based on ferocious the market rally has been. Sentiment is stretched (Exhibit 2, Strategas), and momentum is crowded (Exhibit 3).

Exhibit 2

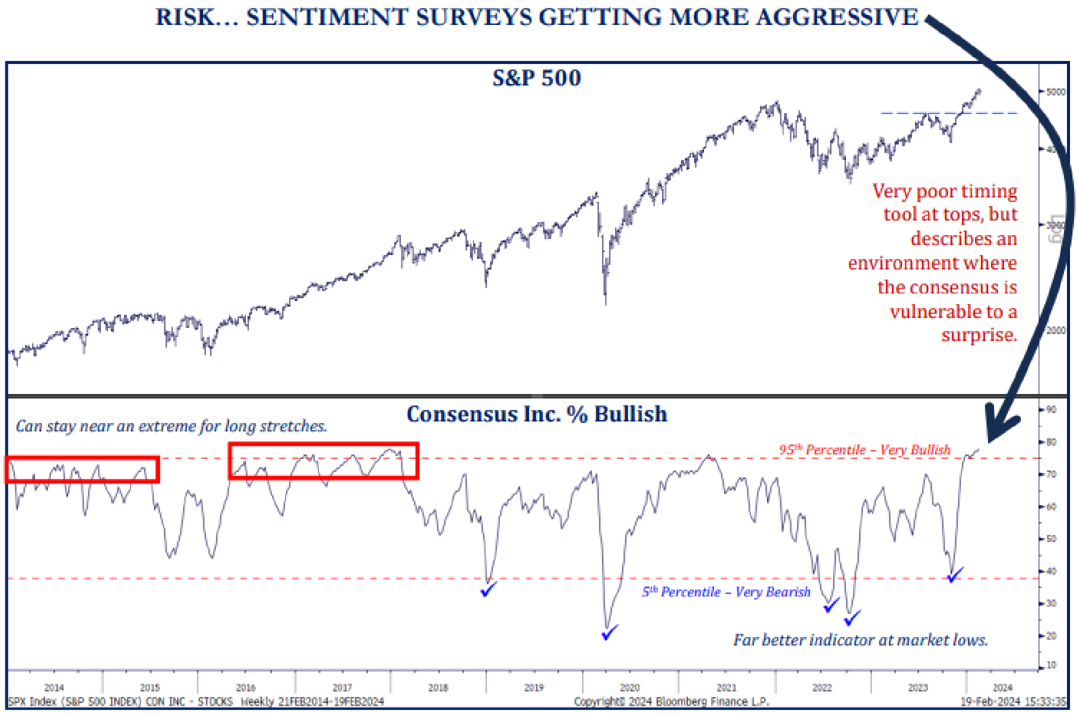
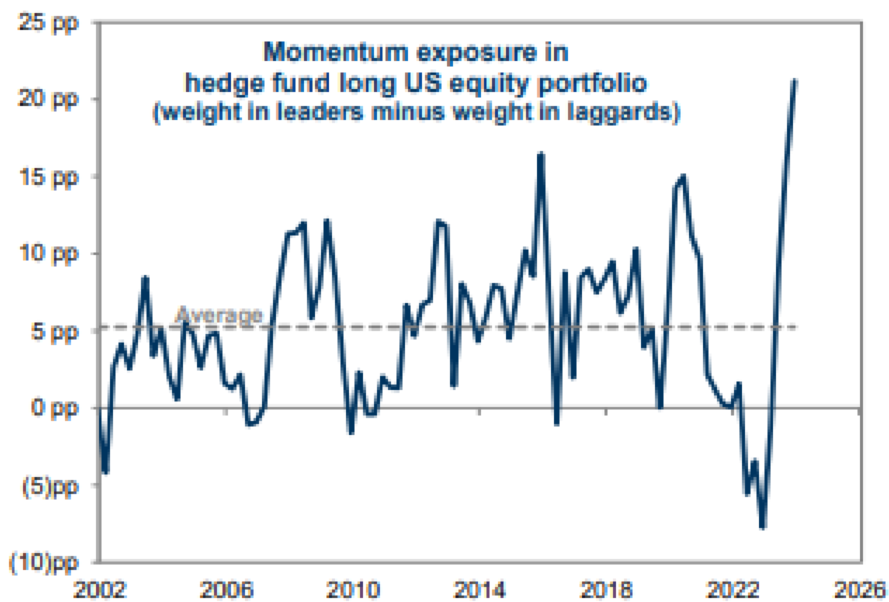


Exhibit 3



Source: Goldman Sachs Global Investment Research

Valuation is also becoming an obstacle as multiple expansion has been responsible for roughly 75% of the rally in 2023 (Exhibit 4, Cornerstone) and similarly in 2024 YTD.

<u>Exhibit 4</u>

P/E Multiple

P/E & Earnings Attribution

Year	% Attribution	
	EPS %	PE %
2023	5.9	18.3
2022	3.2	-22.6
2021	33.6	-6.6
2020	-5.9	22.2
2019	2.2	26.7
2018	18.0	-24.2
2017	10.7	8.7

Valuation segues into another hot debate topic around the top-heaviness of the market and the outsized reliance on a handful of names dubbed the Magnificent-7 (Microsoft, Apple, Google, Meta, NVIDIA, Amazon, and Tesla). There's no debate that they have been the overwhelming drivers of market returns over the last 15 months.

However, some of the rhetoric around them seems misguided by bears, as if these are dot-com stocks that trade on the hope of future profitability. Five of the Mag-7 have free cash flow margins north of 20%. They have incredibly strong balance sheets. For 4Q 2023, the Mag-7 grew earnings 60% year over year versus the rest of the S&P500, down roughly -2%, per Goldman. In 2023, NVDA had revenues of $27B. A year later, they had over $27B in free cash flow on revenues of $61B and 70% plus gross margins. NVDA added over $1.5Tln in market cap in just over a year, yet the P/E ratio barely budged.

Valuing the Mag-7 is admittedly tough, but the rate at which most of them have compounded is remarkable, especially given their enormous size. Along those lines, they do not look as crazy expensive as bears make it seem when accounting for their incredible growth profiles (Exhibit 5, Strategas).

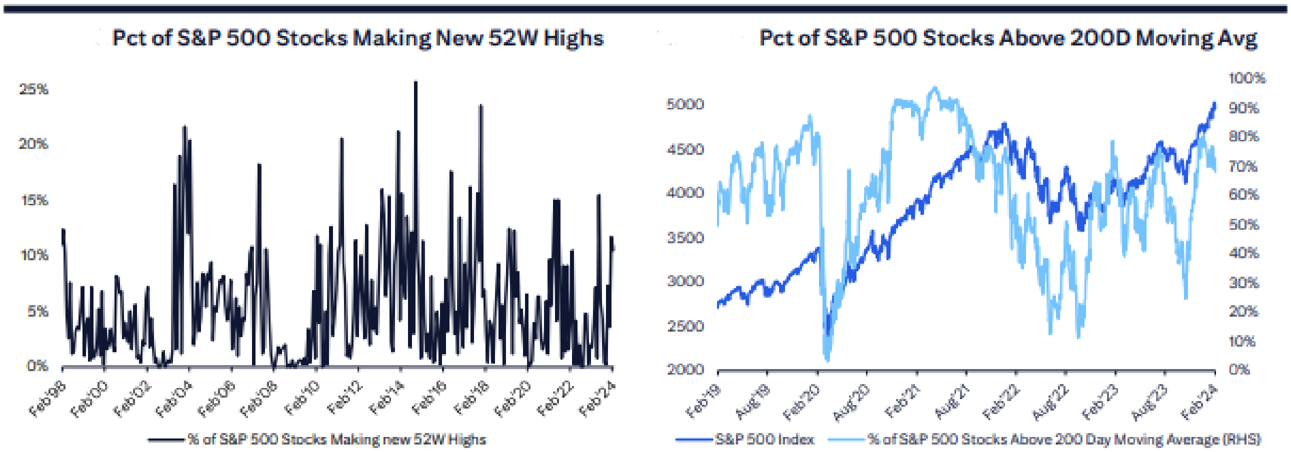
Exhibit 5

FOUR OF MAG 7 ARE CHEAPER THAN BROADER MARKET ON A PEG RATIO BASIS

	LTM PEG	NTM PEG
TSLA	12.91x	12.38x
AAPL	3.22x	2.99x
MSFT	2.68x	2.31x
S&P 500	1.64x	1.59x
AMZN	2.17x	1.55x
GOOG	1.51x	1.29x
NVDA	2.14x	1.18x
META	1.23x	0.94x

Discussion of the Mag-7 has gone hand in hand with breadth and the lack of participation. However, the latest move higher has broadened (Exhibit 6), and in the last three months, Financials, Healthcare, and Industrials have all outperformed the overall market and the Mag-7 (Exhibit 7).

Exhibit 6



Source: Citi Research, Bloomberg

Source: Citi Research, Bloomberg

Exhibit 7

Range 11/28/2023 - 02/28/2024	Period Daily	No. of Period 92 Day(s)	Table	
Security	Currency	Price Change	Total Return	Difference
1) SPX Index	USD	11.35%	11.77%	.60%
2) UBXXMAG7 Index	USD	11.07%	11.16%	--
3) S5INDU Index	USD	14.58%	15.03%	3.87%
4) S5HLTH Index	USD	12.34%	12.81%	1.65%
5) S5FINL Index	USD	14.77%	15.30%	4.13%
6)				

Over that same three-month timeframe, there has been quite a divergence within the Mag-7, with several of them down and NVDA carrying the load following their 4Q earnings print (Exhibit 8). Separating the haves and have-nots of the group versus them all trading in tandem is a positive.

Exhibit 8

Range 11/28/2023 - 02/28/2024	Period Daily	No. of Period 92 Day(s)	
Security	Currency	Price Change	Total Return
1) SPX Index	USD	11.38%	11.80%
2) UBXXMAG7 Index	USD	11.11%	11.20%
3) NVDA US Equity	USD	63.99%	64.00%
4) TSLA US Equity	USD	-17.92%	-17.92%
5) AAPL US Equity	USD	-5.15%	-5.03%
6) GOOG US Equity	USD	-.90%	-.90%

The impact AI ultimately has on productivity and innovation will not be known for quite some time. The outsized moves in tech names, NVDA especially, have people using terms like “bubble” and comparing it to the dot-com tech blowup in 2000. It’s hard not to be at least somewhat skittish about the size and importance of these big names, but painting with a broad brush can be dangerous. There’s definitely speculative activity creeping back into markets, as evidenced by Bitcoin crossing $60K for the first time since late 2021. There are also some names and areas that have gotten ahead of themselves, at a minimum.

However, the usual warning signs of an impending bull market crash are not sounding the alarm bell right now. M&A remains muted, credit remains tight, breadth has improved, earnings are strong and being revised upward, and money has been plowed into safe assets by multiples versus that of risky assets since COVID (Exhibit 9), and over the last year (Exhibit 10, GS).

Exhibit 9

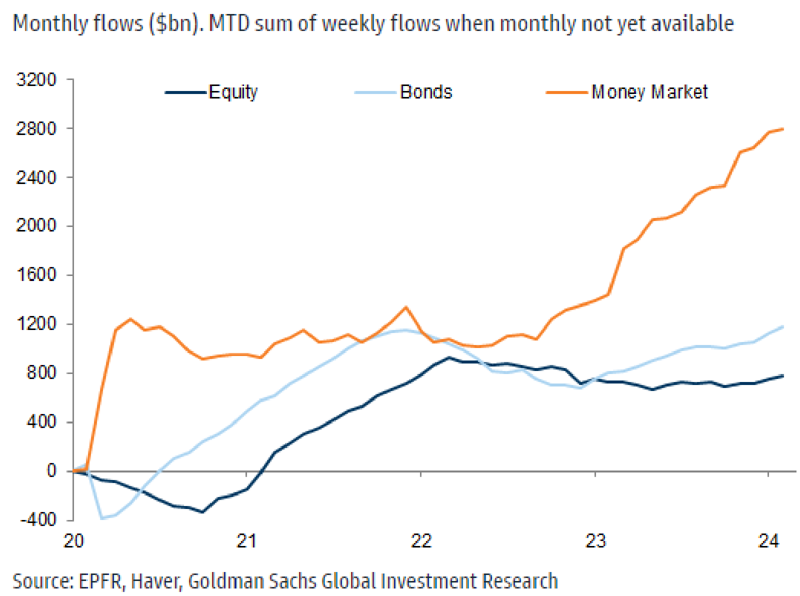
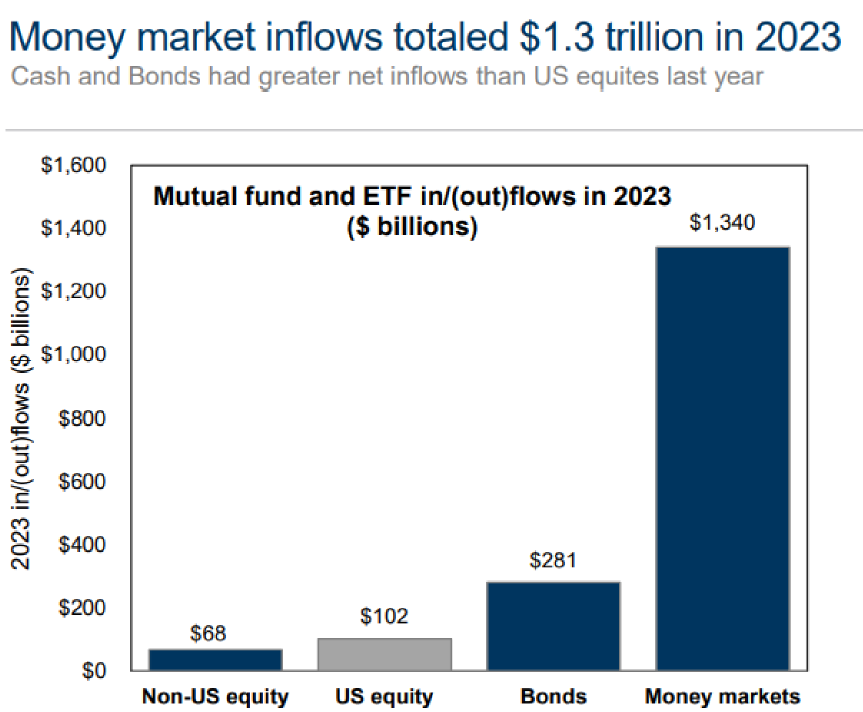
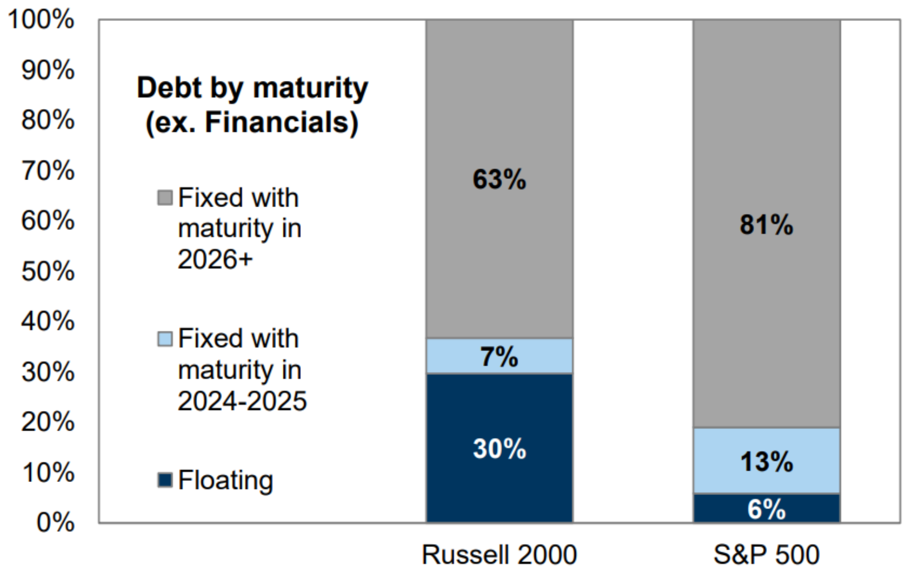


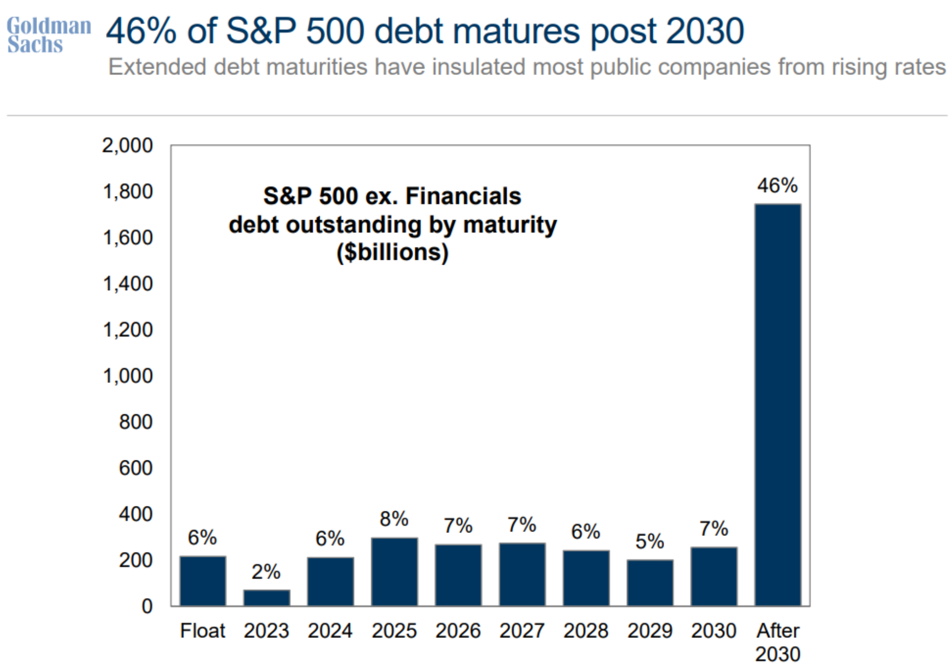
Exhibit 10



Lastly, and unlike the US Government, corporate executives (especially at largecap companies) did a prudent job in terming out fixed-rate debt when rates were low, which should better protect profitability if rates stay higher for longer (Exhibit 11).

Exhibit 11





To tie everything together, despite all the uncertainty geopolitically and politically, the economy and Corporate America have forged ahead and continued to surprise to the upside. Importantly, this has bought the Fed some extra time to assess the “last mile” of inflation. Sentiment and positioning suggest the “easy money” has been made. Further upside from here would likely come in the form of a more broad-based earnings recovery outside the Mag-7 and/or bond yields moving lower. Earnings season just wrapped up, so that potential catalyst is several months away. Bond yields moving lower would come with confirmation of inflation being tamed, but Fed officials do not appear eager to sound the all-clear signal without sufficient evidence. Given the strong move in stocks on what has been a solid news cycle, the market feels due for at least a digestion/consolidation phase as investors wait to see how a host of important topics ultimately play out.

International Equity Strategy

By Steve Lambdin

The global equity markets finished 2023 in spectacular fashion as most major central banks signaled an end to the hiking cycle. This provided the “soft landing” narrative investors were looking for and the necessary fuel for a significant rally in risk assets. As we have experienced in the past, any pivots in major central bank policies can lead to aggressive changes in equity prices, and this pivot was no different. European and US 10-year bond yields fell precipitously through the fourth quarter. In addition, the International Monetary Fund (IMF) raised its projection for 2024 global growth to +3.1% from +2.9%, as growth expectations were raised in the US as well as a few of the larger emerging market economies. However, projected growth is still well below the twenty average of +3.8% global growth. In general, economic data points continued to be a mixed bag in late 2023 across most of the major regions around the world. For example, inflation has fallen drastically in the US and the Eurozone, while less so in the UK. We expect this mixed trend to continue as we move through 2024. Global employment statistics remained surprisingly strong over the last several months in most major regions around the globe.

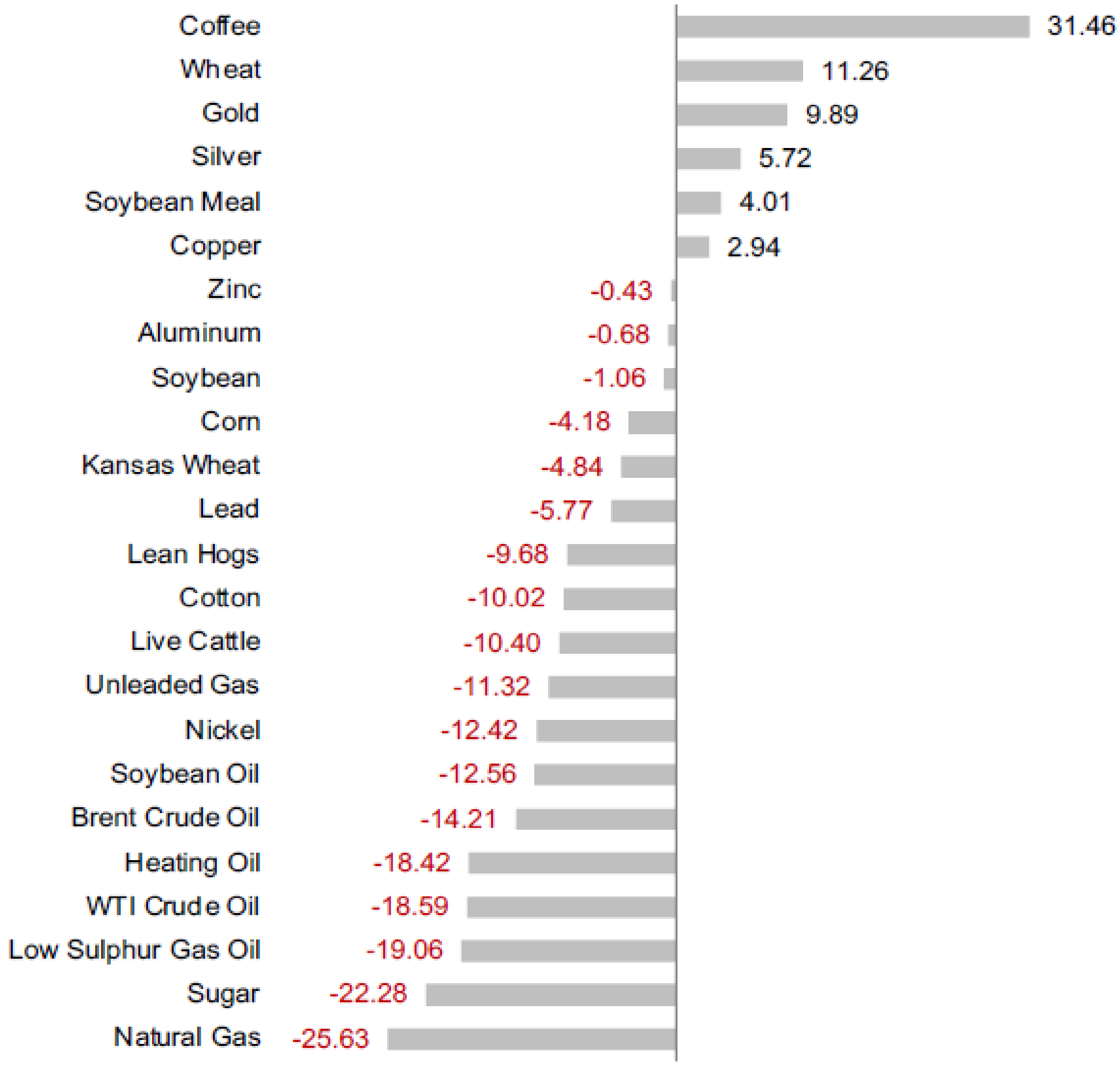
Recent corporate earnings have also been more resilient than expected, leading to increased conviction among investors that most regions will avoid an outright recession in 2024. The geopolitical front continued to deteriorate during this period as continued attacks in the Red Sea threatened 11% of global trade flows, of which a large part was oil exports. This will raise shipping costs for businesses that have to re-route supply lines to avoid this area, which is likely to be inflationary. The conflict between Israel and Hamas continued to worsen in the quarter as Israel moved further into the Gaza Strip and the humanitarian damage escalated. China/US relations over Taiwan saw no relief, as China reiterated its stance on the unification of the island with the Chinese mainland. Ukraine’s 2023 counter-offensive was basically a complete failure as Russia withstood this and has taken several key cities over the last several weeks, now controlling approximately 20% of Ukraine. Ukraine is running dangerously low on munitions, equipment, and personnel necessary to resist the size of the Russian military effort. In addition, Western support for Ukraine is waning as politics come into play in the US and Europe. Unfortunately, at this point, an undesirable outcome for Ukraine is a very real possibility.

	December 2023		4Q 2023		YTD 2023	
Equity index returns (%)	U.S. dollar	Local currency	U.S. dollar	Local currency	U.S. dollar	Local currency
S&P 500	4.5	4.5	11.7	11.7	26.3	26.3
MSCI ACWI	4.8	4.1	11.0	9.4	22.2	21.6
MSCI ACWI ex USA	5.0	3.0	9.8	5.4	15.6	14.1
MSCI World	4.9	4.2	11.4	9.8	23.8	23.1
MSCI Emerging Markets	3.9	3.1	7.9	5.6	9.8	9.9
MSCI EAFE	5.3	2.9	10.4	5.0	18.2	16.2
MSCI Europe	5.0	3.3	11.1	5.6	19.9	14.3
MSCI Pacific	5.9	1.9	9.3	3.7	15.3	20.1

Source: RIMES; Capital Group

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +10.4% and +7.9%, respectively, during the fourth quarter of 2023 vs. +11.7% for the S&P 500 Index. US stocks outperformed in the period due to the strength of mega-cap technology stocks, as investor demand for these companies was very heavy during that period. The U.S. dollar proved to be a tailwind for returns outside of the U.S., falling -5.2% in the period, helping the returns for unhedged U.S. investors in the MSCI EAFE Index and, to a lesser extent, investors in the emerging markets. For the calendar year 2023, the MSCI EAFE Index and the MSCI Emerging Markets Index finished up +18.2% and +9.8%, which we believe was a surprisingly good return in a seesaw year of market activity. For the fourth quarter, the European region was stronger than the Asian region given strong returns in Sweden, Netherlands, and Germany. All eleven sectors of the MSCI EAFE Index posted positive returns, with technology, basic materials, and real estate generating the largest returns in the quarter. The Bloomberg Commodity Index fell -4.63% in the quarter, led by declines in natural gas, crude oil, and heating oil.

Ranked Returns (%)



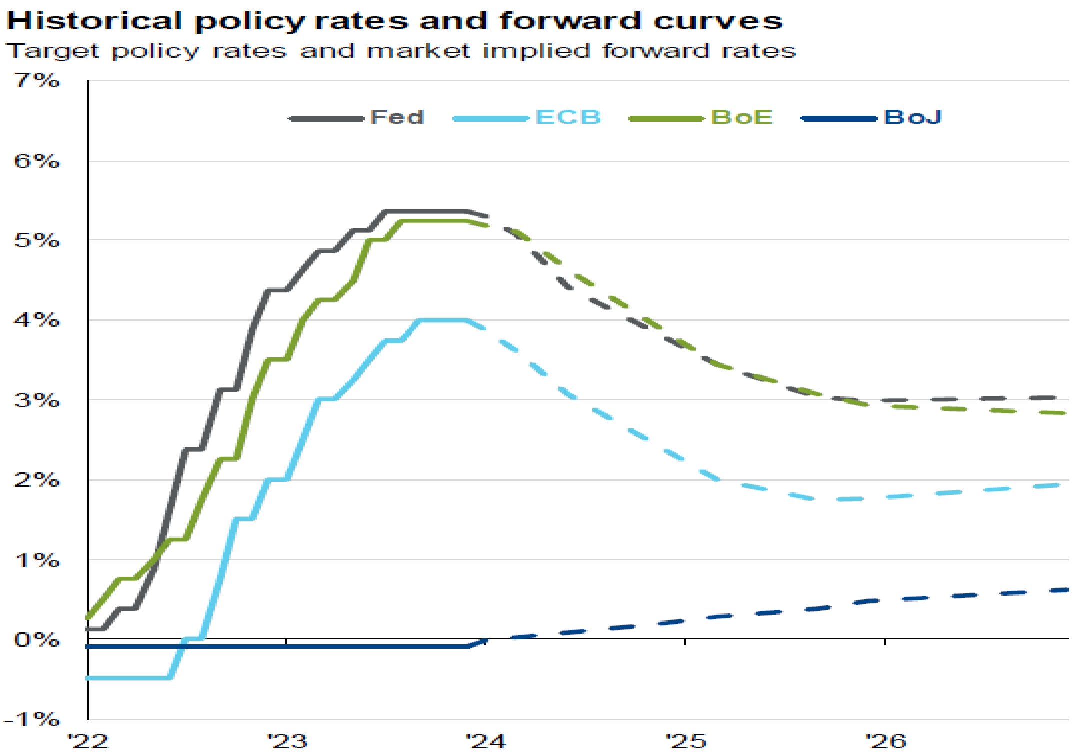
Sources: Arcadia Wealth Management

The global equity markets continued to see strength to start 2024 as the “soft landing” narrative gained more momentum with investors. Inflation readings continued to fall in most parts of the world, the global composite PMI is at the lowest levels since June of 2023, and the prospects for interest rate cuts in mid/late 2024 are increasing each month. This has provided a nice backdrop for investors to have at the current time. So far in the first quarter, the MSCI EAFE Index and the MSCI Emerging Markets Index are up +2.3% and flat, respectively, while the S&P 500 Index is up +6.5% nearing the end of February. Many equity markets are at or very near all-time highs. We will see if this strength continues.

The following pages provide an update to what we see as the current issues in the marketplace, which could set the direction of equity markets over the next few months.

Issues/Points:

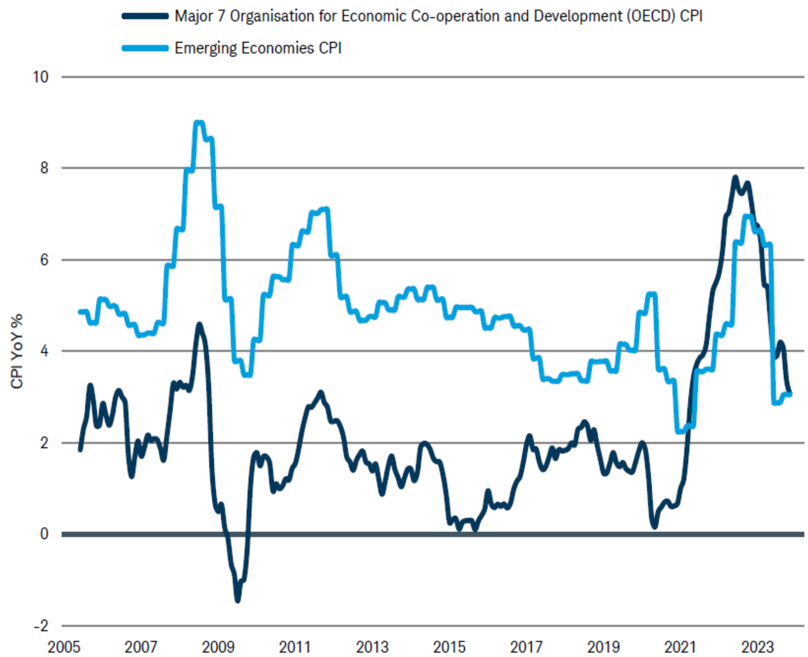
Soft Landing Narrative – One of the single biggest issues facing investors has been the notion of a "soft landing" in the U.S. and European economies. This is in stark contrast to the 2024 recession talk just a few months back. This shift of investor sentiment has been a huge driver of higher equity markets over the last several months. At this point, it would seem the U.S. Federal Reserve (FED) will be the first of the major central banks to cut interest rates sometime in the May – August timeframe, followed by the European Central Bank (ECB) later in 2024. With this new thesis in play, we would expect interest rates to fall as we move through 2024 in many parts of the world. How much of an easing cycle is anybody's guess, and this could be a huge driver of equity market performance going forward.



Source: BIS, Bloomberg, FactSet, JPM Asset Management, BOE, BOJ, FED

Inflation – Global inflation continues to be a key driver of global equity market performance. According to the IMF, advanced economies should see inflation falling even faster in 2024 to +2.6%. Overall, the IMF expects 80% of the world's economies to see lower headline and core inflation in 2024. Inflation falling faster than expected can lead to better equity market performance, while any unexpected stalling of declining inflation is likely to be a headwind for the equity markets.

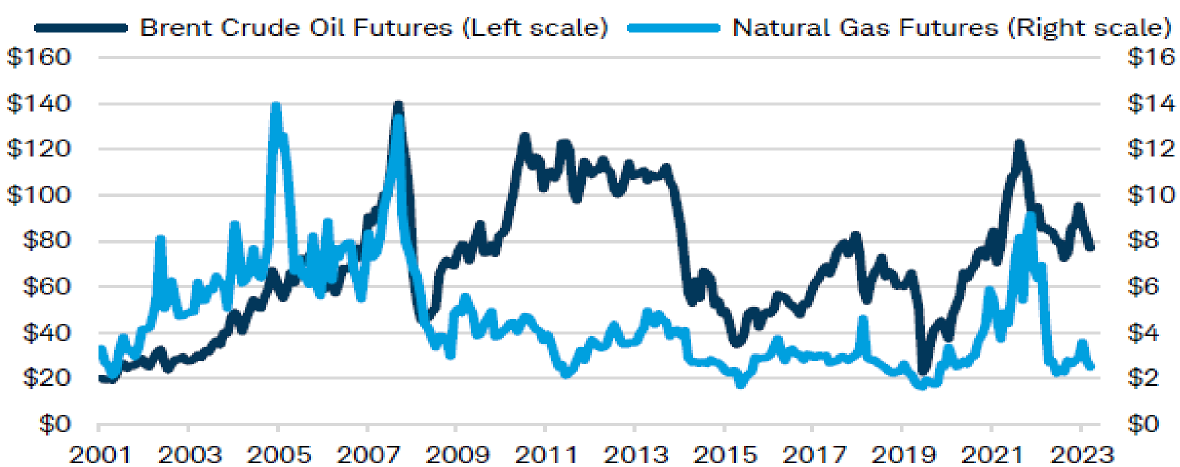
Global Inflation



Consumer Price Index year-over-year %	
Russia	7.5
India	5.6
Brazil	4.7
United Kingdom	3.9
France	3.5
South Korea	3.3
Germany	3.2
United States	3.1
Canada	3.1
Japan	2.8
Eurozone	2.4
Italy	0.7
China	-0.5

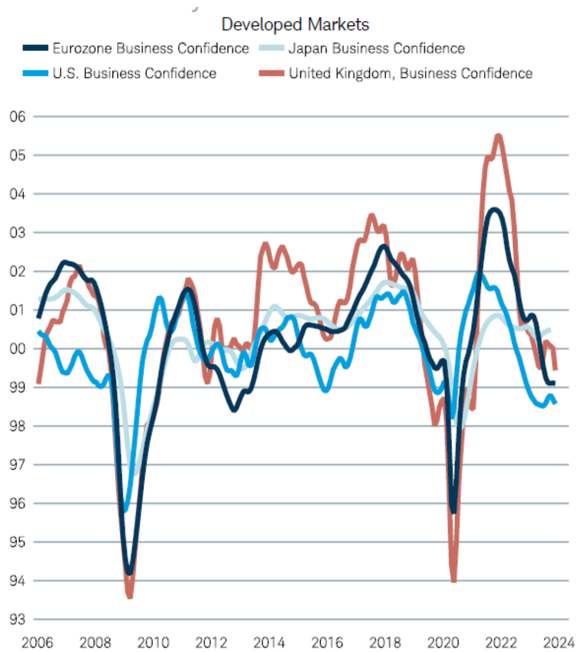
Source: Charles Schwab 1Q 2024 Chartbook

Oil Disruptions or Not? – Investors need to be on watch for sudden changes in the price of oil and gas as continuing attacks in the Red Sea could play havoc on oil exports. The area produces approximately 35% of the world's oil exports and 14% of gas exports. We could see price volatility in crude, in addition to other commodities, as well as further price hikes in shipping costs. This could quickly alter the lower inflation story in the marketplace and turn equity markets southward.

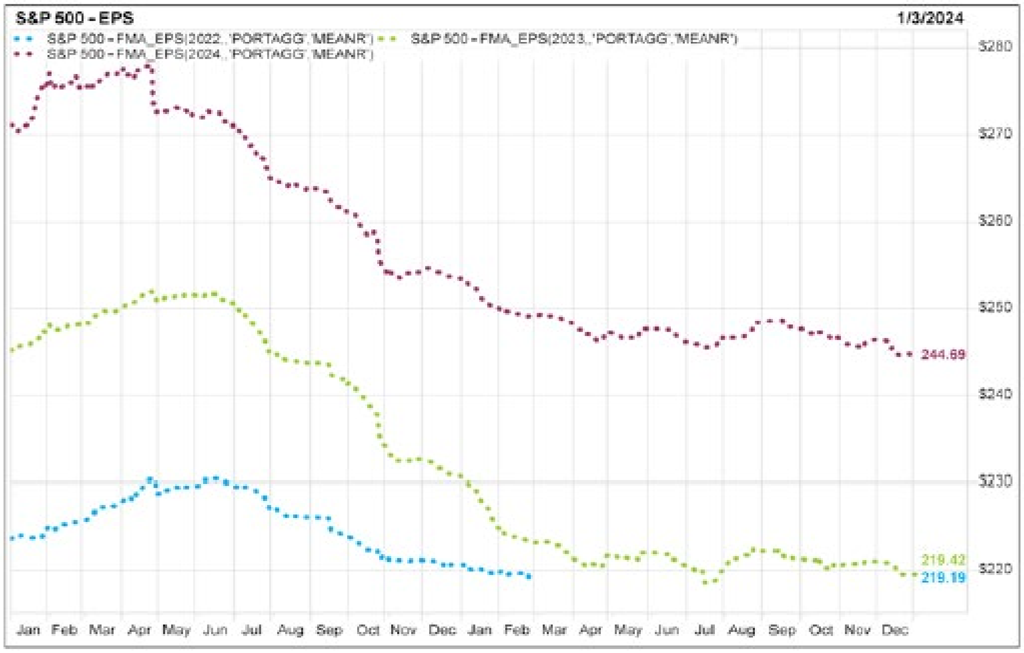


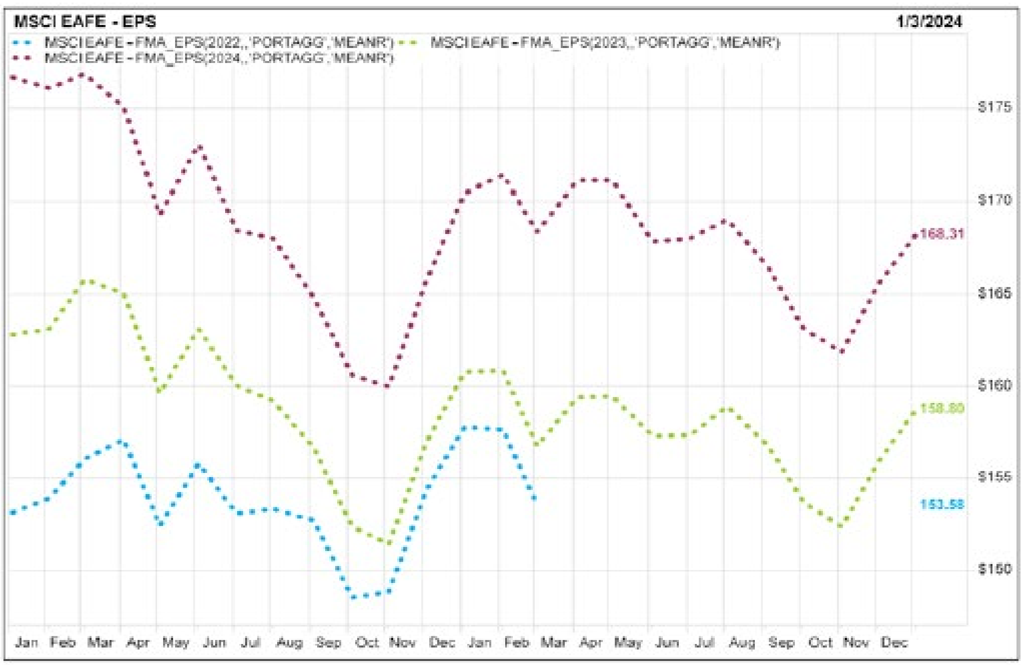
Source: Charles Schwab 1Q 2024 Chartbook; US Energy Information Administration

Economic Growth – Recent growth estimates seem to be indicating a bit more resilient outlook than just a few months back. The main reason for the better 2024 global growth outlook has been the performance of the U.S. economy. Economic data points and corporate earnings in the U.S. and the Eurozone have been better than expected in late 2023. We now expect the Eurozone to post better economic growth in 2024 as well and narrowly avoid a recession. We would expect business sentiment indicators to increase or at least stabilize at current levels in most parts of the world.



Source: OECD; Charles Schwab 1Q 2024 Chartbook; Macrobond





Source: Eagle Global Advisors; Factset

Global Elections – This could be a source of risk as we move through 2024. There are elections in over 50 countries which account for nearly half of the global population over the next year. Whether most elections finish with a "market and business-friendly" winner remains to be seen. Highlighting these elections will be the U.S. Presidential election. While equity markets generally fare well during election years, this could be a source of investor anxiety post-elections, depending on the winners. We will see how this transpires.

Emerging Themes – The continued exuberance of new themes in the marketplace has gained further momentum with investors over the last several months. Some secular themes right now are artificial intelligence (AI), electrification, obesity drugs, automation/robotics, clean energy, and re-shoring. Companies exposed to these themes have vastly outperformed most other companies and have pushed indexes that contain these companies to fresh highs. The market has not figured out the right valuation to put on many of these companies at present and, in many cases, has bid these to valuation levels well above almost anything we have seen in recent years. Earnings growth at these companies have been phenomenal. At this point, it's hard to tell how far these themes will go or if they continue to push equity markets higher.

Geopolitical? – We still believe the geopolitical arena is an area where investors could see a lot of risk and perhaps some reward. If any of these areas take a turn for the worst, then we could see some level of risk for the equity markets. However, if any of these danger zones move toward some type of a softening stance or non-military solution, then global equity markets could rally on this news.

- The Red Sea
- Russia/Ukraine
- Israel/Hames
- China/U.S./Taiwan
- Iran/U.S.
- North Korea/U.S.

Final Thoughts/Summary

As we move into the Spring, investors are clearly very bullish on global equities as a “soft landing” scenario in many of the advanced economies around the world has become more accepted. Monetary policy has shifted to expect interest rate cuts over the next few months in the U.S. and later in 2024 in Europe. Inflation is expected to continue to fall over the next couple of quarters. Global corporate earnings expectations in 2024 are clearly not as bad as feared, as operating margins remain near record levels. Most equity markets remain at or very near all-time highs, which has pushed valuation levels in some markets well above historical averages. Investors still seem enamored with the potential of AI for businesses, which is a hot theme in the equity markets at present. However, we still worry about structural problems in the Chinese economy and a Eurozone economy, which will remain closer to a potential recession. In addition, the global debt problem can become much more of an issue at any moment, which would be negative for the equity markets. We would not be surprised if global equities cooled off a bit from the torrid start to our fiscal year.

We recently liquidated our International Active Fund ($255 million) in January to take advantage of the move in European cyclical shares over the last year. In addition, we continued to sell a few out of the money calls on the Emerging Markets Index to bring in some income, as well as sell just a bit of exposure in a decent short-term rally if this happens. Premiums remain attractive in the current equity market. Emerging market equities remain an asset class that looks attractive to us going forward over the long-term. Our current allocation to Emerging Market equities is approximately 3.0% of total assets and approximately 11.4% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios for a total international equity exposure of approximately 14.7%. This is nearly at our target allocation within our investment policy statement. *(Credit is given to the following entities for charts provided: BIS, JPM Asset Mgmt., US Energy Information Administration, Macrobond, Charles Schwab & Co, UBS, Haver Analytics, Factset, MSCI, Bloomberg, Fidelity Investments, National Bureau of Statistics, PBOC, LSEG, DataStream, Russell Investments, CLSA, China National Bureau of Statistic, Oxford Economics, Eagle Asset Mgmt. and Advisors, OECD, Destatis, Markit, JP Morgan, Tradingeconomimcs.com, FED, ECB, BOJ, BOE, Arcadia Wealth Management, RIMES, Capital Group)*

Fiscal Policy

By Michael McNair

The recent economic upturn has been accompanied by growing concerns about the role of fiscal policy in sustaining this growth and ensuring long-term fiscal health. This report analyzes the impact of recent fiscal policy decisions on the U.S. economy in the fourth quarter of 2023 and explores potential future scenarios. By examining these trends, we aim to gain a clearer understanding of the challenges and opportunities surrounding fiscal policy in the current economic climate.

Impact of Fiscal Policy in 2023

Following the significant fiscal stimulus provided during the COVID-19 pandemic, 2023 saw a continued, though lessened, positive impact of fiscal policy on the economy. The Hutchins Center Fiscal Impact Measure (FIM) estimates that fiscal policy contributed to an additional 0.2 percentage points of GDP growth in the fourth quarter of 2023 when the U.S. economy grew at an annual rate of 3.3%.

This impact stems from a combination of factors. First, a decline in tax collections since 2022 boosted the FIM by 0.8 percentage points. Second, increased federal and state spending added another 0.3 percentage points to the FIM. However, the waning effects of pandemic-era programs, such as stimulus checks and unemployment benefits, partially offset these gains, reducing the FIM by 0.9 percentage points.

It's important to note that for fiscal policy to have a sustained stimulative effect, the budget deficit needs to not only increase but must do so at an accelerating rate. Think of it like pressing the gas pedal on a car – to keep speeding up, you need to keep pressing the pedal harder.

The U.S. federal budget deficit widened substantially in 2023, reaching 7.5% of GDP. Several factors contributed to this increase. Revenues in FY 2023 were 16.5% of GDP—a bit above the recent historical average but below the exceptionally strong revenue gains of FY 2022, bolstered by robust capital gains realizations and delays in tax bracket adjustments due to inflation. One-time or temporary factors further depressed revenues in FY 2023. These include delays in corporate and individual income tax filing deadlines for Californians affected by severe winter storms and a surge in refunds from the pandemic-era Employee Retention Tax Credit (ERTC). Without these special factors, receipts would have been higher, resulting in a smaller deficit.

On the spending side, outlays on the major mandatory programs—Social Security, Medicare, and Medicaid—rose by 0.3% of GDP. Spending reductions in other pandemic-era programs were largely offset by increased spending by the Federal Deposit Insurance Corporation and Pension Benefit Guaranty Corporation, as well as low spectrum auction receipts. Additionally, higher interest rates pushed up the cost of debt service, increasing total outlays by 0.5% of GDP in FY 2023 relative to FY 2022.

Comparing the FY2022 and FY2023 Deficits (%GDP)

	FY 2022	*FY 2023*	*Change*
Official Deficit	**−5.4**	**−6.3**	**−0.8**
Deficit Adjusted for Student Loans	**−3.9**	**−7.5**	**−3.6**
Revenues	19.4	16.5	−2.9
Non-Interest Outlays (adjusted)	21.2	21.3	0.2
Major Mandatory Programs	10.1	10.4	0.3
Pandemic-Era Spending	1.9	0.7	−1.2
One-Time Outlays	−0.4	0.5	0.9
Other Non-Interest Spending (adjusted for student loans)	9.6	9.7	0.1
Interest on the Debt	2.1	2.6	0.5

Source: Congressional Budget Office and Authors' Calculations

Hutchins Center on Fiscal & Monetary Policy at BROOKINGS

While deficit expansion played a role in economic growth in 2023, the situation in 2024 appears significantly different. As highlighted earlier, for fiscal policy to have a sustained stimulative effect, the budget deficit needs to expand not only in absolute terms but also at an accelerating rate. This translates to requiring a positive second derivative of the budget deficit.

Fiscal Policy Outlook for 2024

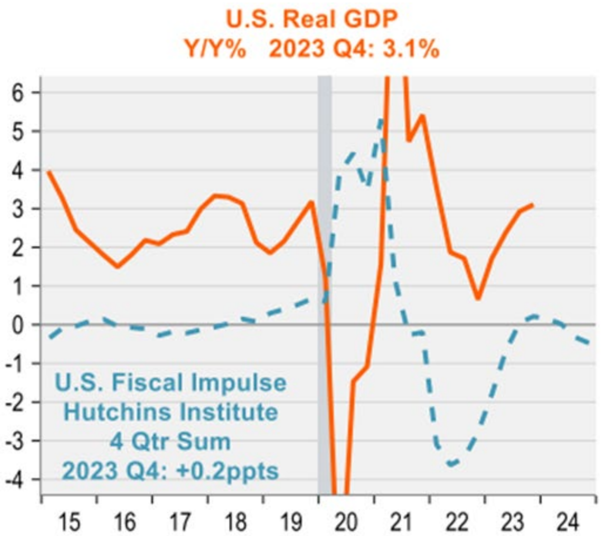
Unfortunately, achieving further stimulus in 2024 proves challenging due to the large deficit expansion witnessed in 2023. Under current legislation, the budget deficit is expected to shrink significantly, with the Congressional Budget Office (CBO) projecting a $500 billion reduction over the next eight months. This substantial decrease would effectively render fiscal policy highly contractionary (dampening economic activity).

Factors Contributing to Deficit Reduction:

- The CBO attributes roughly 80% of the projected deficit reduction to tax revenue, specifically a surge in capital gains tax revenue anticipated in April 2024. However, it is crucial to acknowledge the uncertainty surrounding these estimates. If these projected revenue gains are not realized, the Treasury Department will face two options:

- Issuing more debt than currently planned, potentially leading to higher interest rates in the future.

- Spending down the Treasury's general account below the targeted range of $750 billion could raise concerns about the government's ability to meet its financial obligations.



Fiscal Impulse*
<u>(Hutchins Institute)</u>
2020:4Q +3.5ppts
2021:4Q +0.2ppts
2022:4Q: -2.8ppts
2023:4Q: +0.2 ppts
2024:4Q: -0.5ppts e

While the current outlook suggests a contractionary fiscal policy in 2024 due to the projected deficit reduction, several potential sources of additional fiscal stimulus are under consideration. These could collectively add 1.5% to GDP in 2024, albeit with varying degrees of certainty and potential economic impact.

1. <u>Student Loan Forgiveness:</u>

   Despite the recent Supreme Court ruling, the Biden administration has continued to cancel student loan debt, totaling $138 billion so far. This trend may continue in 2024, further stimulating the economy as borrowers gain more disposable income.

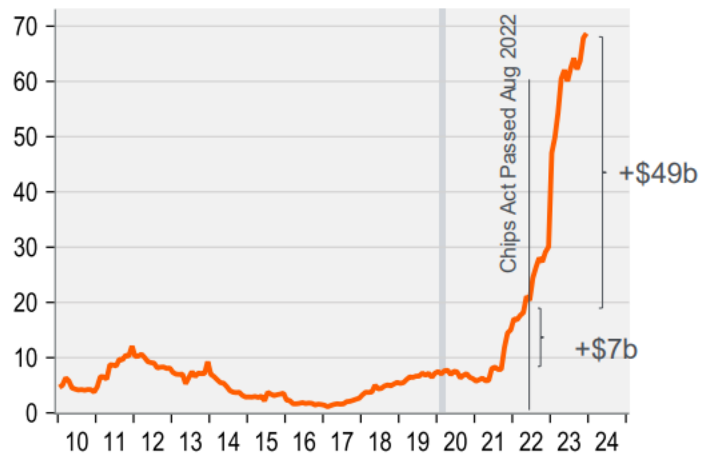
2. <u>CHIPS Act:</u>

   The CHIPS Act aims to reinforce domestic chip production by providing grants to semiconductor manufacturers. While the CHIPS Act was signed into law in 2022, the distributions of payments are just starting to hit the economy.

   According to the Wall Street Journal, “The U.S. government is giving chip maker Global Foundries $1.5b in grants to build and expand facilities in New York and Vermont, the first major award in a program meant to reinvigorate domestic chip production. The award kicks off what is expected to be a series of cash injections into semiconductor manufacturing projects. Intel, Taiwan Semi, Samsung Electronics and Micron Technology have all submitted applications to the government. The grants, under negotiation for months, are expected to be a cornerstone of the $53b Chips Act … with $39b specifically for manufacturing subsidies. Grants could total $7.5b this year, if $1.5b were also allotted to the other 4 companies that submitted applications.”

Grants could total $7.5b this year if $1.5b were also allotted to the other four companies that submitted applications. All of the funds won't be spent right away, but at the margin, they'll boost business confidence, and in turn, incremental spending on capex and jobs.

U.S. Real Mfg Construction
Computer & Electronic
Dec $69 billion

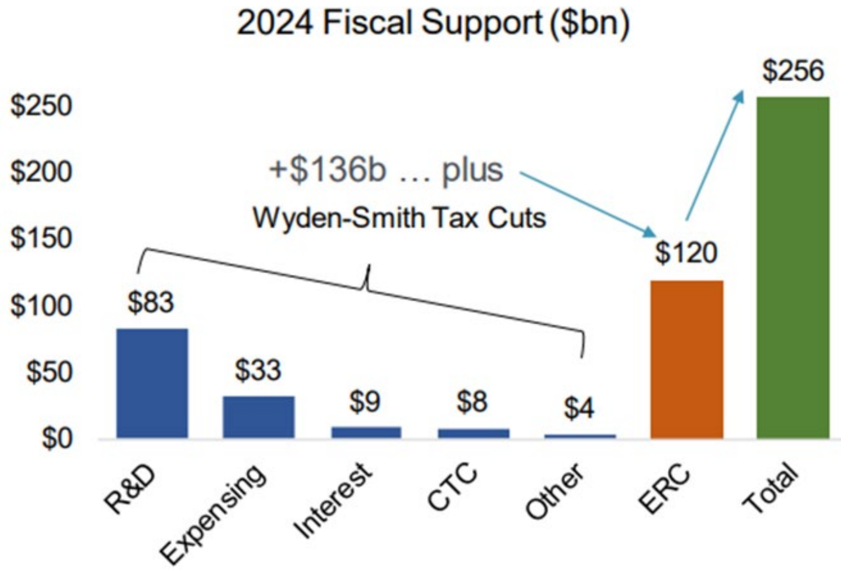


Source: PSC Macro

3. Wyden-Smith Tax Cuts:

   There is a growing likelihood that Congress will pass a tax bill in the coming weeks in order to prevent fiscal policy from being overly restrictive during an election year.

   This $136 billion tax cut proposal, primarily aimed at businesses but also including a child tax credit extension, has passed the House but faces an uncertain future in the Senate. The various paths towards a deal are starting to become clearer, but it's going to be a tough road. We give the legislation a 50% chance of final passage.



Source: PSC Macro

4. <u>ERTC Restart:</u>

   The Employee Retention Tax Credit (ERTC), which provided significant financial support to businesses during the pandemic, could be restarted in 2024. Restarting the program, with an estimated $150 billion in funding, is projected to boost small business hiring and potentially the housing market. However, the presence of over 1 million pending ERTC applications at the IRS raises concerns about potential delays and fraud.

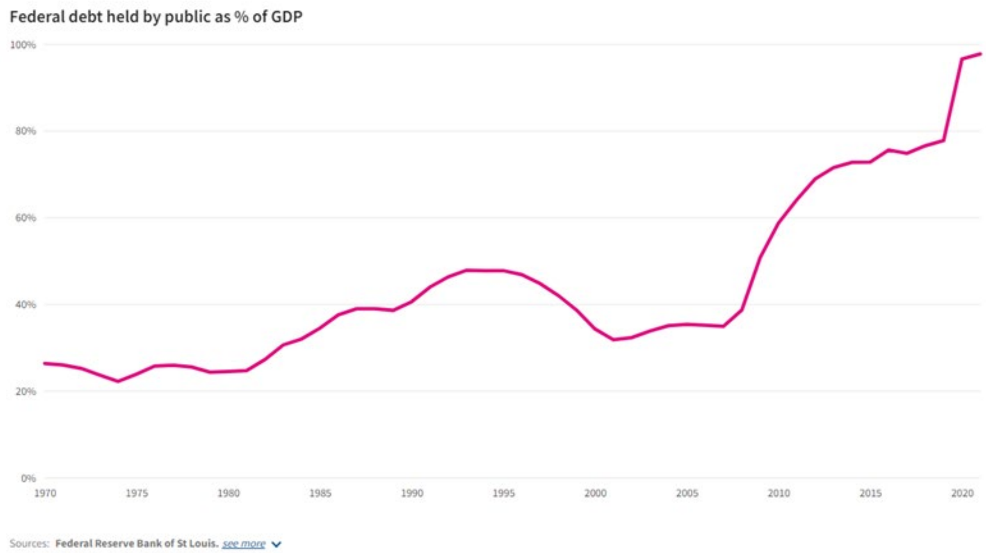
5. <u>Defense Spending:</u>

   Multiple wars are good for defense spending. The Senate's proposed $95 billion increase in defense spending, if enacted, is estimated to contribute an additional 0.3% to GDP.

6. <u>Interest Rates Impact on Fiscal Policy</u>

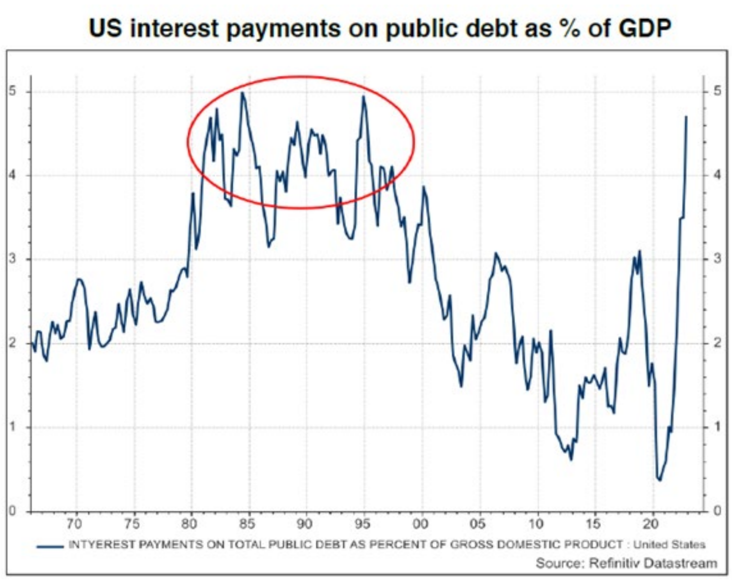
   One of the biggest variables determining the prospects for fiscal policy in 2024 is monetary. If the Fed cuts interest rates than it will reduce the governments net interest payments to the public, and vice versa if they increase rates.

Historically, the government budget deficit has exhibited countercyclical behavior, shrinking during economic expansions and growing during recessions. However, this pattern seems to be changing due to the dramatic rise in federal debt held by the public – from less than 40% of GDP a decade ago to nearly 100% of GDP today.



Despite the robust economic growth over the past three years, the federal budget deficit has remained high, currently standing at around $1.4 trillion. While countercyclical natural stabilizers in the budget deficit still exist – such as tax receipts increasing as incomes and capital gains rise and federal outlays decreasing as unemployment falls – the surge in net interest payments due to the rising stock of debt relative to GDP and the Fed's rapid interest rate hiking cycle is overwhelming these components and created a procyclical budget deficit.

Federal net interest payments are now annualizing at $1.3 trillion, representing over 20% of total federal outlays, which easily surpasses the size of the military budget. The Fed Funds Rate is currently 5.25%, but federal net interest payments as a percent of GDP are at the level it was when the Fed Funds Rate was 20%.



Long-Term Fiscal Policy Outlook

The fiscal outlook has deteriorated over the past year due to rising structural deficits and growing interest costs. Recent legislation, increased defense appropriations, and higher projected interest rates have raised the 10-year projected budget deficit by about $3.1 trillion through 2032 under current law. Notably, rising net interest accounts for around half of this increased 10-year deficit.

Major contributors to expanding deficits include insufficient revenue collection and rising mandatory spending on healthcare and retirement programs. Tax revenues as a share of the economy have lagged historical averages over the past decade. Meanwhile, spending on Social Security, Medicare, Medicaid, and the Affordable Care Act's premium tax credits is expected to grow steadily in the coming years with the aging population.

As rising primary deficits combine with already elevated debt levels, net interest is projected to soar. Despite an economic expansion, net interest payments have exceeded spending on national defense to become the largest category of federal spending. Under current CBO projections, which assume gradually increasing interest rates, net interest costs will reach a record-high 3.6% of GDP by 2033.

Together, these underlying primary deficit and interest cost trends paint a sobering long-term fiscal picture. Both the unified budget deficit and the cyclically adjusted deficit are projected to top 7% of GDP by 2033, with public debt exceeding the size of the entire U.S. economy. Avoiding such an outcome would require substantial adjustments in taxes and spending that depart markedly from current law.