Investment Perspective

Patience is necessary considering the strong upward thrust in stock prices over the last six months

Investor enthusiasm improved in the first quarter with the S&P 500 (SPX) return above 10%. This has happened only 12 times since 1957. The other 11 instances generated a median return of 8.2% over the subsequent nine months, with only one negative return. History suggests the current momentum will continue. Interestingly, this marks just the third time since 1957 that the index produced a fourth quarter double-digit return followed by another 10% plus return in the subsequent quarter. On a fundamental basis, the improving economy and favorable earnings outlook are supporting equities. However, the Iran/Israel military conflict, sticky inflation, and rising long-term yields are causing near-term market turbulence. Patience is necessary considering the strong upward thrust in stock prices over the last six months. A summary of year-to-date index returns for the period ending March 31, 2024 is as follows:

Dow Jones Industrials	6.1%	Russell 2500	6.9%
MSCI EAFE	5.9%	S&P 500	10.6%
NASDAQ Composite	9.3%	Wilshire 5000	10.0%

GLOBAL ECONOMY

The global outlook is improving moderately with recent economic indicators coming in better than expected. World economic growth is expected to increase 2.6% this year after 2.7% in 2023. Europe remains sluggish, Japan has overcome deflation, but growth remains low, and China is muddling through its own challenges with deflation. Purchasing manager surveys suggest China is accelerating to start the year and export activity is picking up. Chinese exports bring lower inflation to the rest of the world but raise protectionist responses from Europe and the U.S. China's property development and housing sectors are weak, further adding to subpar growth and deflation. Positively, the Federal Reserve, European Central Bank (ECB), and the Bank of England are preparing to ease monetary policy this year.

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The U.S. economy is expected to grow approximately 2.4% in 2024, almost equal to last year's growth of 2.5%. Although the fourth quarter closed on a strong note with 3.4% annualized growth despite prior predictions of "recessionary" conditions, the first quarter was reported at 1.6% -- lower than expected due to a decrease in inventories and an increase in imports. Still, the U.S. is benefitting from a balanced economy. For example, consumer and government spending, non-residential and residential investment are all expected to positively contribute this year. Consumer spending has remained resilient due to a strong job market. The unemployment rate is historically low at 3.8%, the labor participation rate is gently increasing to 62.7% and payroll growth is 1.9% -- these indicators reflect a healthy labor market. The mixture of non-residential construction, capital spending and technology investments continues to be a source of growth for the

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overall economy. The manufacturing sector is emerging from a downturn, which is evident in the improving purchasing managers index (PMI) for manufacturing, which registered 50.3 in March after remaining below 50 for each month last year. Residential investment is beginning to improve after dragging on overall growth the last few years. New housing starts continue at a relatively high level (1.4 million annualized) due to the shortage of new housing stock around the country. Higher mortgage rates (7.1% for a 30-year fixed mortgage) have curtailed activity, but the housing sector is demonstrating more resilience than expected because supply is tight and turnover has decreased. For example, the Case-Shiller Home Price Index is up 6.1% y/y, which reflects demand/supply imbalance. In general, moderate economic growth is the current trend with balanced contributions from various sectors. Early last year, the forecast was for a "Hard Landing", then a "Soft Landing" and now it is "No Landing. "

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INFLATION & INTEREST RATES

We expect the Federal Reserve to reduce interest rates twice this year. The Fed has been on hold since July 2023 as it watches inflation indicators moderately improve. Recent messaging around monetary policy suggests an inflection point is near, but the Fed may move more cautiously than expected given the stubbornness of inflation to retreat to the targeted 2% range. Market based pricing of intermediate and long-term bonds implies that short-term interest rates will decline and the risk of hyper-inflation is low. For example, the Philadelphia Fed's Survey of Inflationary Expectations expects an average rate of inflation of 2.53% for the next two years. Currently, Treasury rates across the maturity spectrum yield more than inflation, which suggests we have positive real interest rates again after a decade of negative real interest rates.

The Fed remains data dependent and the monthly inflation report continues to play a dominant role in its evaluation of the outlook. Recently, the improvement in inflation has stalled. The consumer price index (CPI) in March was 3.5% y/y and core inflation (CPI excluding food and energy) rose 3.8% y/y. The Fed's preferred measure of inflation, the core personal consumption expenditure (PCE) price index, which excludes the impact of food and energy prices, rose 2.8% y/y in March. We expect further relief over the intermediate term that will support Fed easing, especially as the long lags of softer housing rents work their way into the CPI shelter statistics. The shelter component of CPI comprises 35% of the index and was up 5.7% y/y in March -- this is holding back further progress in the headline indicators. Overall, bond investors have a constructive view that inflation will eventually decline to reasonable levels as the 10-year Treasury yield is 4.70%.

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ESCALATING CONFLICTS

The conflict in Gaza is leading to increased tension between Iran and Israel, which adds uncertainty to the investment outlook as this combativeness may escalate in an uncontrolled manner. On April 1, Israel bombed Iran's consulate in Syria killing seven officers, including two senior Iranian generals from the Islamic Revolutionary Guard (IRGC), a terrorist organization with links to Iran's Supreme Leader. Typically, a consulate or embassy is protected by war convention, but Israel justified their action citing significant military and

terrorist threats. Iran called for "punishment and revenge" and attacked Israeli on April 13th with over 300 drones and missiles. Most were intercepted. In response, Israel launched retaliatory drone and missile strikes on April 19th in Iran that produced minimal impact and no expected response from Iran. The situation is de-escalating as these actions were deemed proportional responses. However, a major escalation could involve the U.S. during a time when tensions are increasing between Russia/U.S., China/U.S., and China/Taiwan. Geopolitical tensions continue to pose a significant threat to equity prices, which warrants close attention. However, to date, investors seem to be sanguine about these additional challenges as the SPX is up 16.8% since Russian's invasion of Ukraine on February 24, 2022 and 16.3% since Hamas attacked Israel on October 7, 2023. These events increase fear, decrease confidence and delay decision-making by business leaders.

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The Russia/Ukraine war continues with Russia advancing. Congress just approved a $61 billion aid package of various weapons to strengthen Ukraine's defense. Other countries are also providing more aid. Russia is planning a summer offensive and Ukraine needs more help for its defense. This is an important geopolitical problem that indirectly impacts NATO, Taiwan, and the South China Sea problems.

INVESTMENT OUTLOOK

The equity markets have advanced based upon an outlook that includes low-to-moderate GDP growth, improving inflation, monetary easing later this year and double-digit earnings growth. As the outlook evolves, we are witnessing moderate stock market volatility as these important issues are debated. The most debated item is the pace of improvement in the inflation outlook and the timing of monetary easing. Expectations for the Fed's first interest rate cut have been delayed. Fortunately, the outlook for earnings is healthy due to a strengthening economy.

The current environment supporting above-average valuations remains dependent upon moderating inflation and long-term interest rates in the 3.50-5.00% range

We expect SPX operating earnings per share to grow 11% this year to $245 with 10% growth in 2025 to $270. For context, earnings grew slightly last year to $221 compared to $219 in 2022. However, last year finished stronger than expected as prior expectations of an earnings recession proved pessimistic. The current strength in earnings is based upon revenue growth coupled with margin expansion to produce double-digit earnings growth. Some operating leverage should be available as businesses progress through their pricing initiatives during this inflationary period and find savings after the supply chain disruptions of 2020-2022. Currently, the SPX is valued at 20.4x earnings versus its long-term average of 16.6x. The top 10 stocks in the SPX are trading at 28.4x earnings, which is 40% above the average of the index. The remaining 490 are trading at 18.3x earnings, which is just 10% above the long-term average. The market cap weighting of the top 10 stocks in the SPX is 33.5%, yet their earnings contribution is 25.5%. The current environment supporting above-average valuations remains dependent upon moderating inflation and long-term interest rates in the 3.50-5.00% range. These issues warrant close attention with the 10-year Treasury yield at 4.70% and inflation stickier than expected.

Positively, the capital markets are improving this year after a weak period in 2022-2023

Positively, the capital markets are improving this year after a weak period in 2022-2023. Global IPO activity fell to a six-year low in 2023 with the value of IPOs declining 30% last year. With the Fed on pause since last July and interest rates stabilizing, new IPO issuance will be driven by the growing pressure on private equity managers to liquify their backlog of unsold portfolio companies. According to Bain & Co., buyout funds have $2.8 trillion of unsold companies on their books. In the first quarter, approximately 10 private equity backed IPOs came to market, five of which were among the top 10 global IPOs, a testament to their growing market presence. In the first quarter, the number of U.S. IPO and deal proceeds were up 21% and 178%, respectively.

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From a technical perspective, the broad U.S. stock market continues to be powered by a small group of popular stocks. The Magnificent Seven (29% of the market value of the SPX) accounted for 37% of the YTD return, but a new Gang of Four (18% of the SPX) has emerged (Amazon, Meta, Microsoft and Nvidia), with their gains accounting for 47% of the YTD return. Despite these factors, there are indications of greater breadth developing as 86% of SPX companies were trading above their 200-day moving average at the end of the first quarter, the highest level in the past three years. We expect the narrowness of the stock market to eventually broaden and benefit small and medium-sized companies.

The fundamentals supporting the investment outlook are improving. Recession fears have faded as employment has remained strong and credit conditions are stable. We may experience a period of consolidation in stock prices as we await the monetary easing cycle. It is important to remain alert for a re-ignition of inflation as that would change the market's outlook on interest rates and valuations. The key risks include China's slowdown, cyber-attacks, disappointing earnings, geo-political conflicts, higher inflation, Iran/Israel, recession, and an unexpected credit crisis. In our opinion, quality small and medium-sized growth companies are likely to achieve above-average annual returns over the next few years. We are cautiously optimistic.