Market and Economic Review

Client Communication for the First Quarter 2024

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1Q 2024 – STRONG START TO THE YEAR

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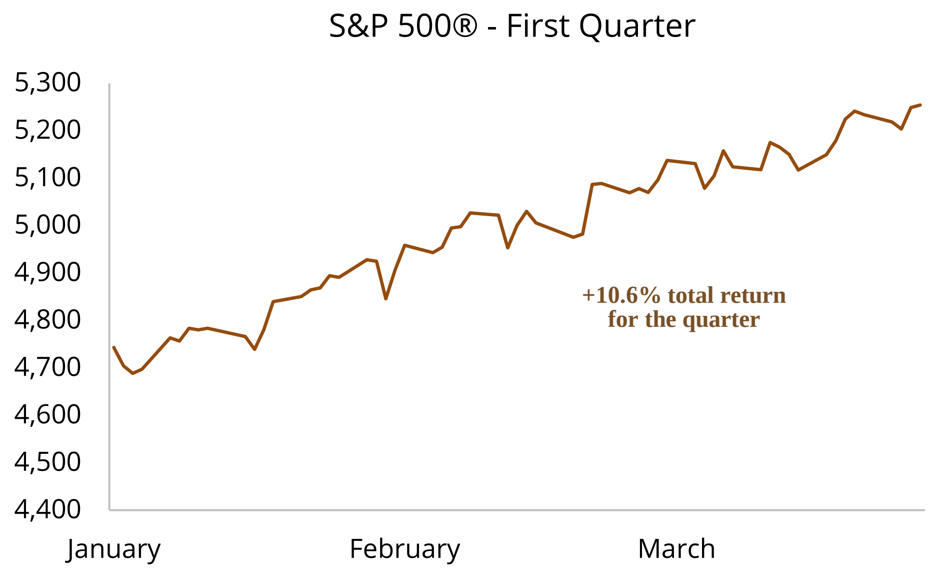
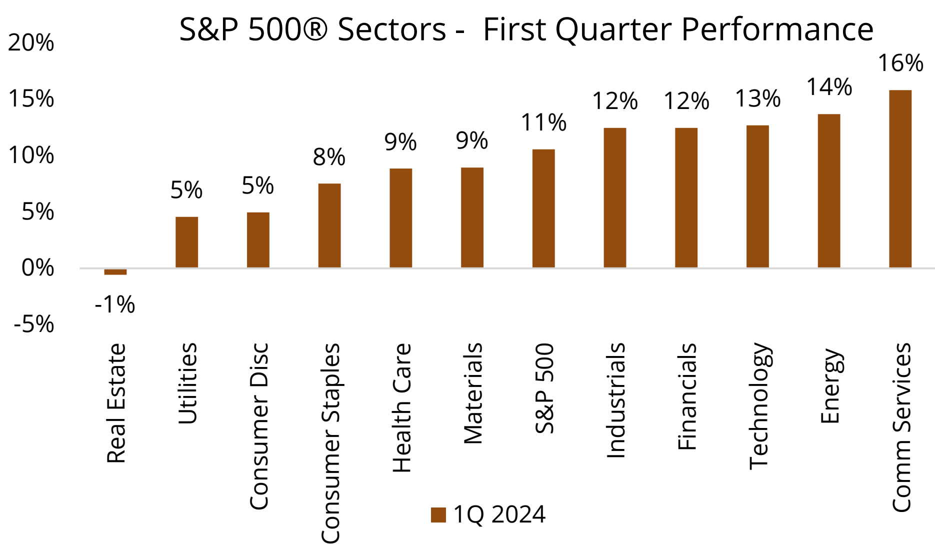
First Quarter Highlights

Equity markets kicked off the year with a strong first quarter. The S&P 500 was up 10.6%.

Inflation continues to moderate with CPI at 3.2% in the fourth quarter and is expected to remain at 3.2% for the first quarter. The market still expects that the Federal Reserve (Fed) will begin cutting interest rates in 2024. We are watching inflation data closely as it's a key determinant for when the Fed may begin to lower rates.

The US economy remains solid with real GDP growth for the fourth quarter up 3.2%, well above the 1.4% expected. GDP growth expectations in 2024 have also increased from 1.6% in January to 2.2% today.





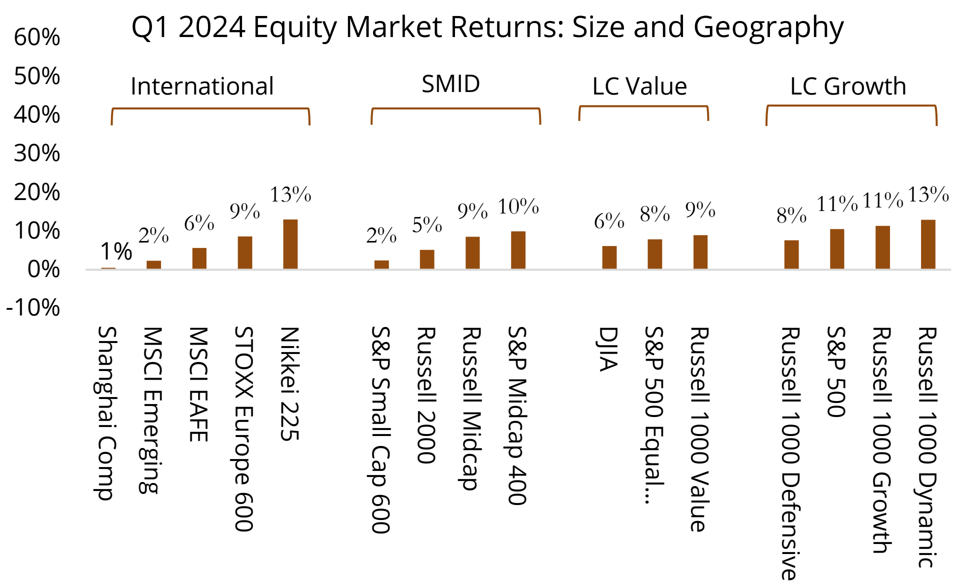
Sector Snapshot

Almost all sectors had a strong start to the year. Real Estate was the only sector with a negative return at -0.55%. Communication Services, Energy, and Technology led the market with mid-teens returns.

Although Communication Services and Technology remained strong, the market broadened beyond the Magnificent 7. Nvidia, however, did lead the market again in the first quarter.

Source: FactSet, Bloomberg

FIRST QUARTER CONTINUES HIGHER



Growth Leads Performance

Equity markets had a solid start to 2024. By both size and geography, all had positive returns. The Shanghai Comp was the weakest performer, up 0.5% in the first quarter.

Performance broadened out beyond the Magnificent 7 with the Russell 1000 Growth up 11% and the Russell 1000 Value up 9%. The Dow Jones returned 6% and the equal-weighted S&P 500 was up 8% for the quarter.

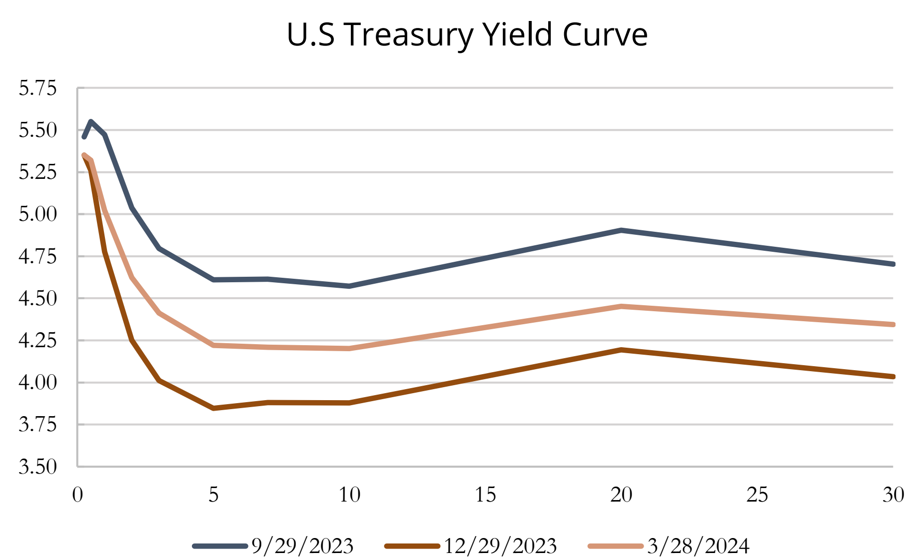
The Russell Midcap was up 9% and the Russell 2000 (small stocks) was up 5%. International stocks were up 6% while Emerging Markets were up just 2%.

Fixed Income was Volatile

Coming into the year, fixed income markets expected the Federal Reserve to begin cutting interest rates in March. However, as economic growth remained strong and disinflationary pressures receded, the anticipation for the initial rate cut was pushed out.

The yield curve shifted higher throughout the first quarter after the strong move lower in the fourth quarter, yet remains below the previous highs of last October.

As interest rates rose, bond prices fell with the Bloomberg Aggregate Bond index falling -0.8% in the first quarter.



Source: FactSet, Bloomberg

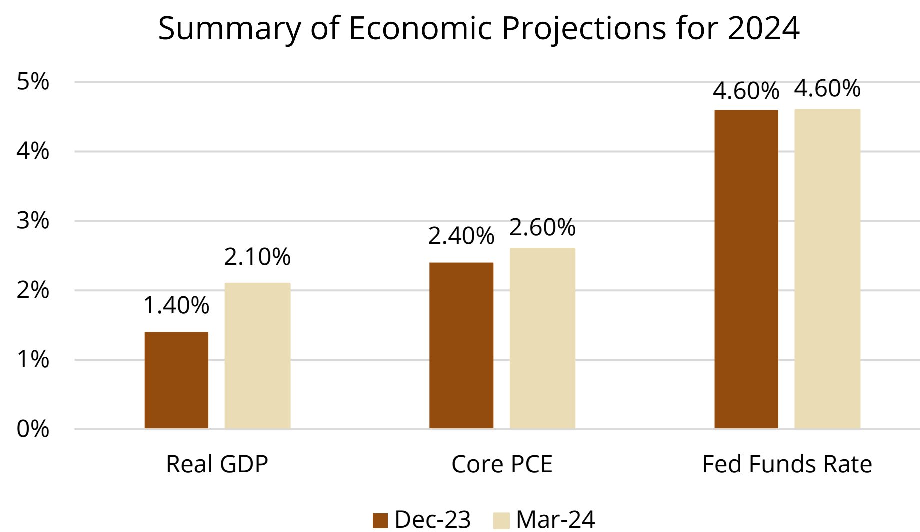
WHAT TO EXPECT FROM THE FED IN 2024?

Anticipating Lower Rates

March passed without any changes to the Federal Funds Rate. However, the Federal Reserve provided updated thinking in the latest Series of Economic Projections (SEP).

Their real GDP estimate for 2024 moved higher to 2.1% from 1.4%, and their core PCE (inflation) estimate also ticked higher to 2.6% from 2.4%.

Despite increasing both their growth and inflation estimates for the year, the Fed continues to believe they will need to cut interest rates three times by the end of this year.

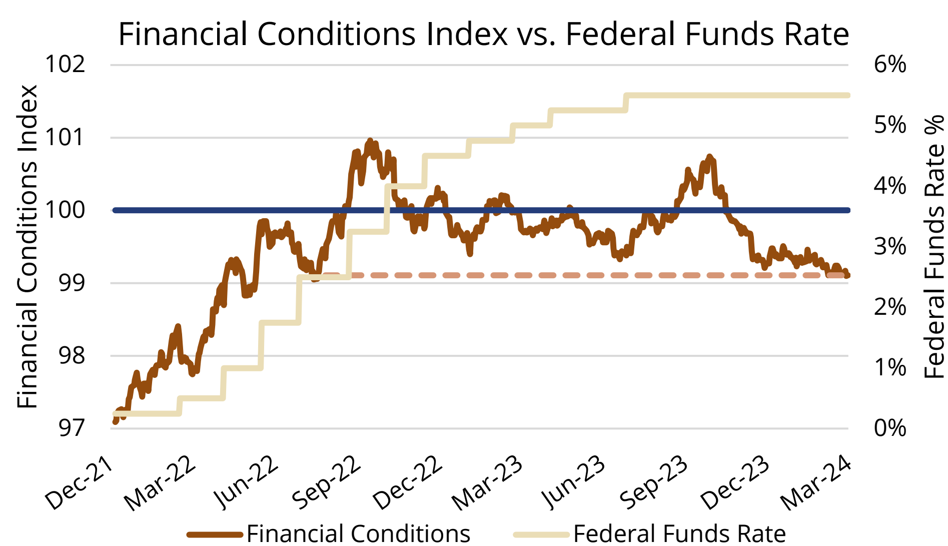


Accommodative Conditions Remain

The Fed Funds Rate remains elevated at 5.5% and interest rates moved higher throughout the first quarter.

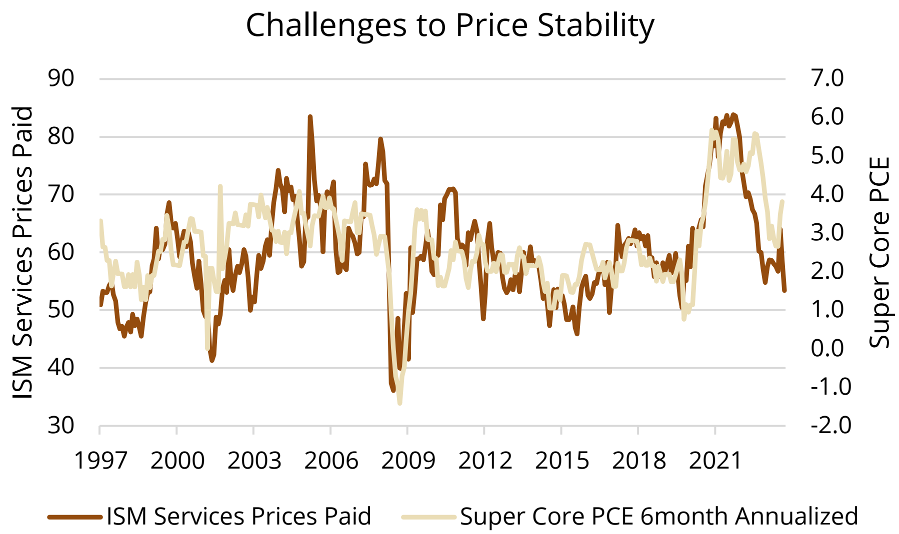
Despite this increase in longer term interest rates as well as a stronger US dollar, broader financial conditions were largely unchanged from where we entered the year and remain accommodative.

Investment grade rated companies took advantage of the accommodative financial conditions by issuing nearly $200 billion of bonds in the month of February, making it the highest amount issued during the second month of any year.



Sources: FactSet, Federal Reserve

INFLATION IS SLOWING BUT REMAINS ELEVATED

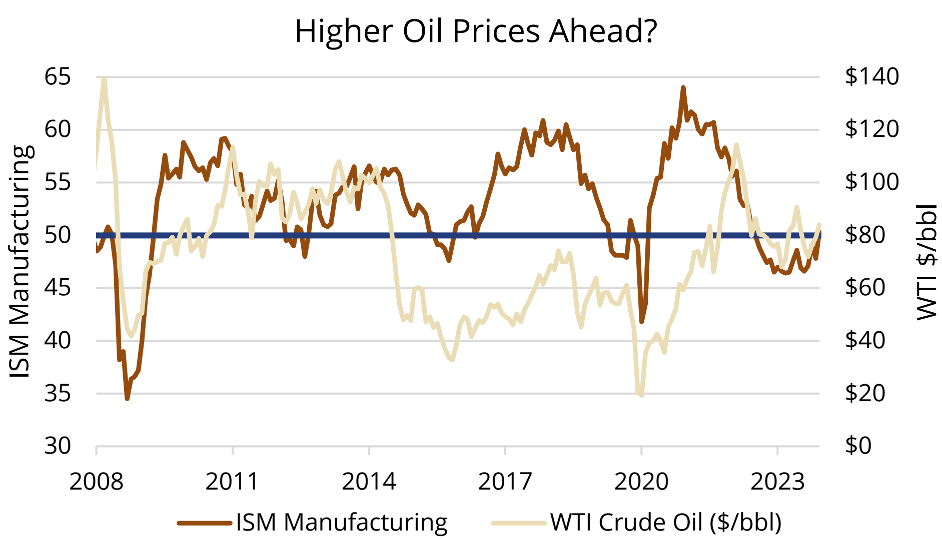


Disinflation

Based on the Federal Reserve projections, the inflation rate won't reach 2% until 2026. Getting to 2% PCE will not likely take a linear path.

Super Core PCE, which measures service inflation ex-shelter, has moved higher recently after falling towards 2% in 2023.

The ISM Services paid index, which tracks prices paid in the service sector, has fallen markedly, yet remains in expansionary territory and moved higher throughout the first quarter.



Manufacturing Activity Picking Up

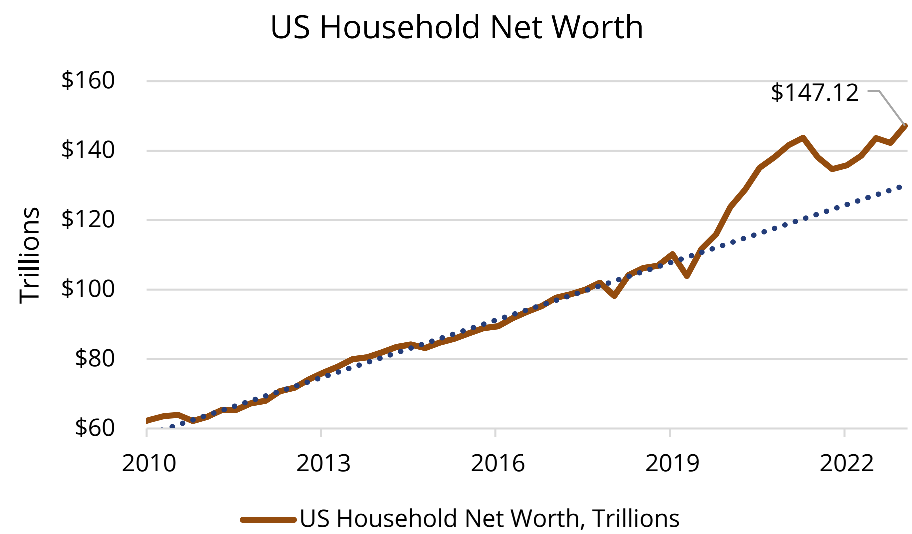
Stuck in contraction (below 50) since November of 2022, manufacturing activity is now starting to show signs of improvement, expanding in March to 50.3. While encouraging from an economic perspective, as manufacturing activity improves it has historically led to higher oil prices.

In addition to potentially stronger demand for oil from increased economic activity, the uncertainty regarding supply is elevated as geopolitical tensions in the Middle East continue to smolder.

As energy prices move higher, we believe it will push inflation higher as well, potentially requiring the Fed Funds Rate to remain higher for longer.

Source: FactSet, Federal Reserve Bank of St. Louis

US CONSUMER REMAINS SOLID

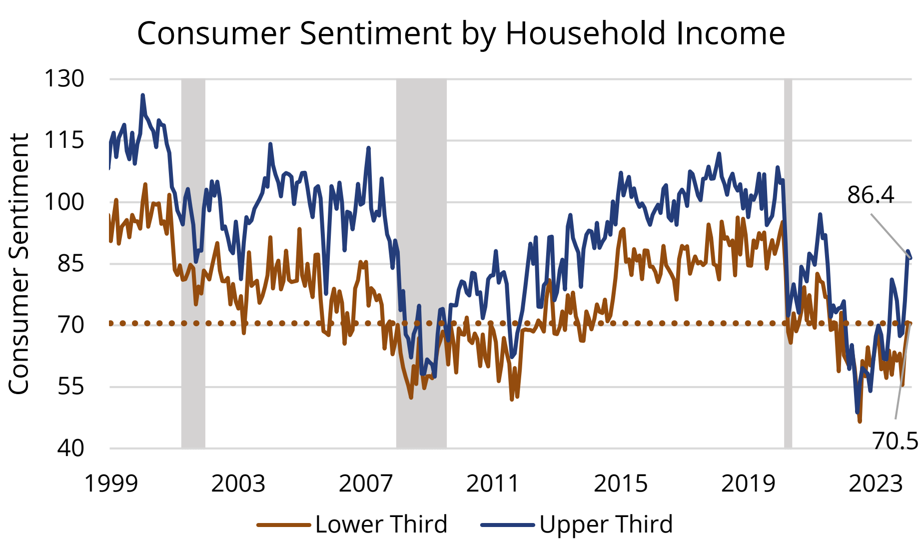


Wealth Effect Supporting Spending

Outside of fiscal spending, another core piece driving the economy has been the resilience of the consumer and their continued willingness to spend.

By most measures, the excess savings that accumulated through the pandemic has been depleted.

As equity markets pushed higher, existing home prices have risen in tandem, putting consumer net worth at an all time high and well above the pre-pandemic trend. This supports the broader economy but mainly among the upper income tiers.



Sentiment - Two Different Stories

Consumer sentiment amongst the top third of income earners has rebounded markedly since hitting its lowest level since the 1980s in June of 2022. However, sentiment amongst the lowest third of income earners remains at levels historically associated with recessions.

This bifurcation in consumer sentiment has been exacerbated by the increased cost of living (inflation) over the past few years, disproportionately weighing on lower income households.

Source: FactSet, University of Michigan

ANOTHER SOLID QUARTER FOR MARKETS, VALUATION REMAINS ABOVE AVERAGE

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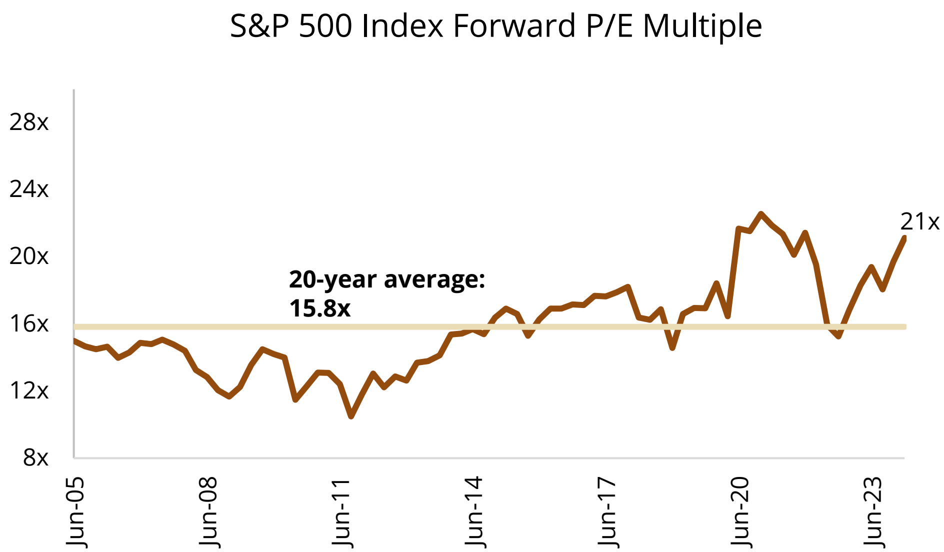


(Top Left) After another solid market move in the first quarter, valuations again moved higher to reach 21x forward earnings, well above the 20-year average of 15.8x. The equal-weighted S&P 500 forward P/E multiple, however, is just above its long-term average, implying that there are a handful of stocks with very high earnings multiples.

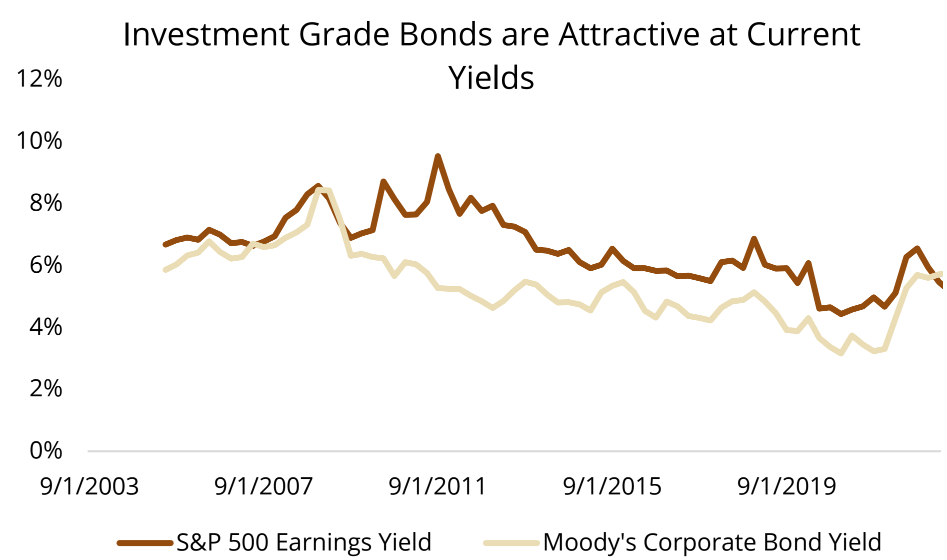
(Bottom Left) Earnings estimates for the S&P 500 in both 2024 and 2025 show solid growth of approximately 12% in each year. We're more cautious on earnings in 2024. Although GDP growth has exceeded expectations, we expect economic growth to moderate through the year while Street estimates show an acceleration in earnings. Near-term this has us more guarded on equities given the recent strength, but we are constructive for the long-term as the high-quality companies we own will adjust to the environment and return to growth.

(Bottom Right) Comparing the S&P 500 Earnings Yield with the Moody's Corporate Bond Yield, stocks and bonds look equally attractive. The yield curve pushed higher in the first quarter and the resulting higher yields are attractive and warrant a positive outlook for investment grade fixed income.

S&P 500 Level Implied by Price to Earnings Combinations

		Price/Earnings Multiple				
		14x	16x	18x	20x	22x
	$312	4,368	4,992	5,616	6,240	6,864
	$300	4,200	4,800	5,400	6,000	6,600
	$275	3,850	4,400	4,950	5,500	6,050
S&P 500	$260	3,640	4,160	4,680	5,200	5,720
Earnings	$248	3,472	3,968	4,464	4,960	5,456
per Share	$240	3,360	3,840	4,320	4,800	5,280
	$230	3,220	3,680	4,140	4,600	5,060

S&P 500 Top Down Estimates		
	Mean	Growth
2022A	$ 219.19	5%
2023A	$ 220.17	0%
2024E	$ 243.61	11%
2025E	$ 276.07	13%
2026E	$ 311.32	13%



Source: FactSet, Bloomberg, Moody's

FIXED INCOME EXECUTIVE SUMMARY

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Market Summary (1Q24)

- Uncertainties surrounding the path of inflation escalated during the quarter causing interest rates to move 30 to 40 basis points (bps) higher. Investors reduced the number of expected Fed rate cuts this year from six (-1.50%) to three (-0.75%).
- Economic growth during the fourth quarter 2023 surprised investors by expanding at a higher than anticipated annualized rate of 3.4%.
- The resilient labor market continues to support household spending, although some consumers have increased the use of debt to finance purchases.
- The Treasury curve remains inverted by –0.42% with the 10-year yielding 4.20% versus the 2-year at 4.62%.
- High-quality corporate bond spreads decreased 10 bps during the quarter to 83 bps. AA, A, and BBB spreads ended the quarter at 28 bps, 70 bps, and 102 bps, respectively.

Matters Madison Fixed Income is Monitoring

- The timing and magnitude of potential Fed rates cuts has become increasing ambiguous as recession concerns recede and inflation reports indicate it may take longer to reach the Fed's 2% target. Investor expectations for a March rate cut were pushed into the future with the likelihood of a June cut now standing at 50%. Inflation remains a key determinate.
- Economic growth should slow in the coming quarters as the effects of restrictive monetary policy become more apparent. Signs of a slowdown include softer employment conditions, lower consumer spending, and reduced business investment. A potential slowdown doesn't imply a recession, although short-term interest rates would likely move lower.
- Corporate bonds remain a viable alternative for many investors, although risk premiums appear low given the potential for spread volatility should the economy slow. Asset-backed spreads could adjust higher should defaults continue to rise. We believe mortgage-backed securities trading at discount dollar prices currently offer the best relative value.

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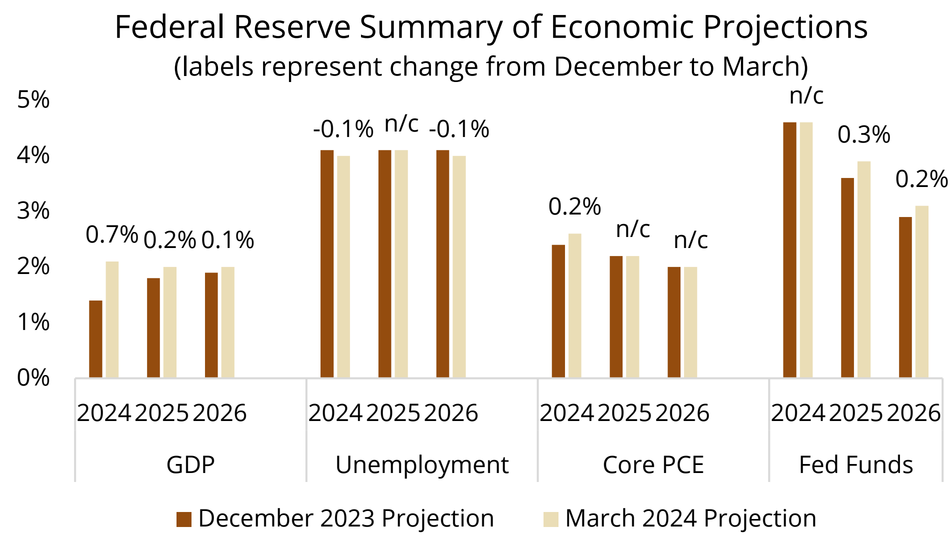
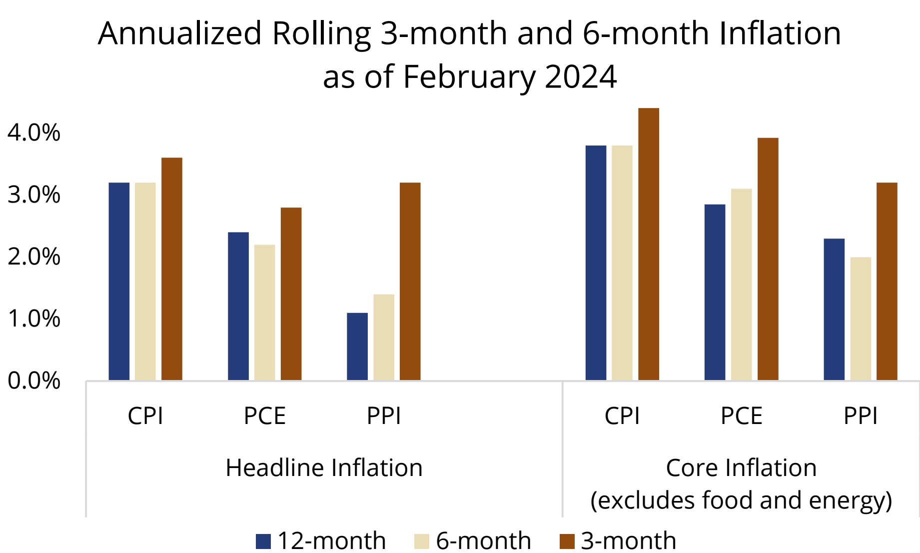
The Fed Upholds Its Wait and See Approach

In March, Federal Reserve policymakers left their policy rate unchanged and repeated the central bank's intention to await additional evidence that inflation was abating prior to lowering the federal funds rate. The Fed has held its policy rate at 5.50% since July 2023.

The timing of a potential rate cut could be pushed further into the future given the Fed's recent Summary of Economic Projections. Fed members increased their estimates for economic growth, inflation, and the federal funds rates while decreasing their expectation for unemployment.





The Level of Inflation Depends upon Both the Guage and Measurement Horizon

Recent inflation reports suggest future price increases may remain above 2% for the foreseeable future. The most cited inflation measure, CPI1, remains above 3% while the Fed's preferred measure PCE2 is nearing 2%. Troubling is the annualized 3-month rolling rate of inflation which is higher than both the 6– and 12-month periods. PPI is a particular concern should producers pass along higher production costs to consumers.

1 - Consumer Price Index

2 - Personal Consumption Expenditures Index

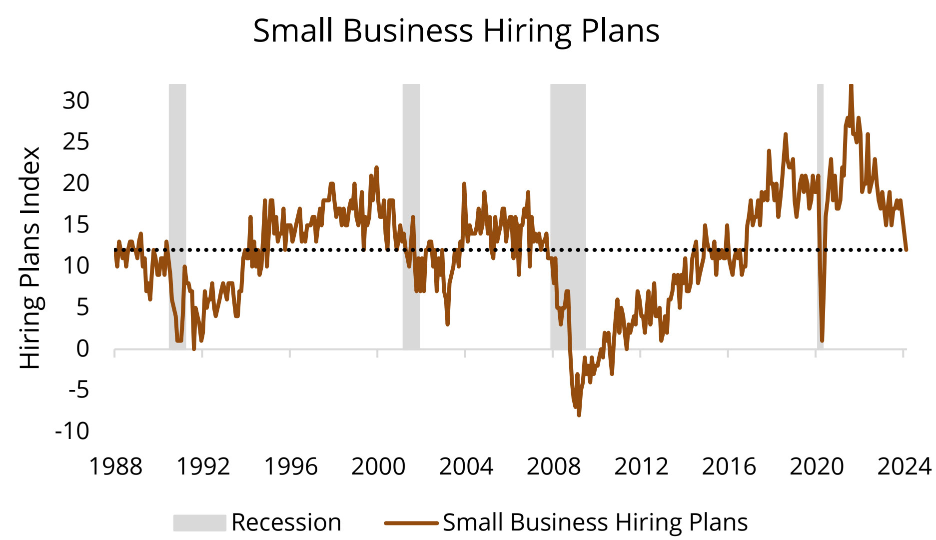
3 - Producers Price Index

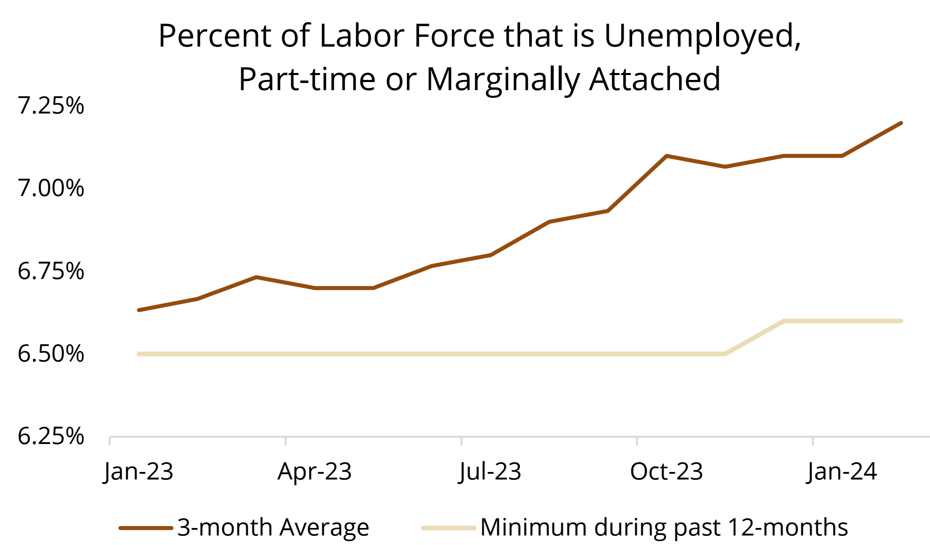
Source: Bloomberg

Employment Conditions Remain Positive, Although Small Businesses Have Reduced Hiring Plans

Employment conditions remain positive even though the unemployment rate rose to 3.9%. Currently, there are 1.4 job openings for each unemployed worker and over 200,000 jobs have been added to payrolls during each of the past few months.

A weaker job market is possible given small businesses have scaled back hiring plans. Over 50% of job openings are from firms with less than 50 employees. This number swells to nearly 80% when including firms with 50 to 249 employees.





Signs the Labor Force is Not Fully Employed

In addition to the 3.9% unemployed labor force, another 3.4% of potential full-time workers are classified as either underemployed or discouraged (e.g. cannot find full-time positions which match their skills). Since 2022, the percentage of part-time and marginally attached workers has increased by nearly double that of the unemployed labor force. This could be signaling a softer labor market lies ahead.

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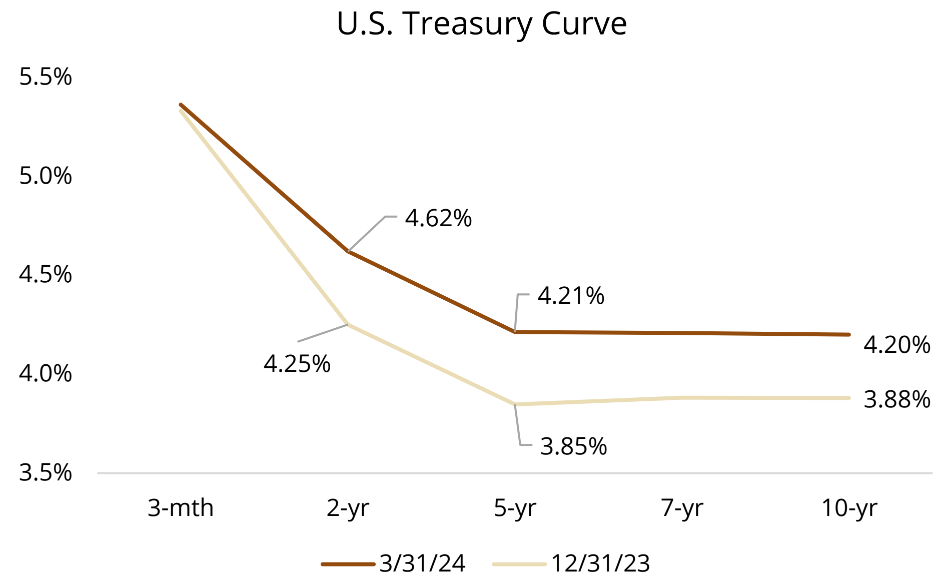
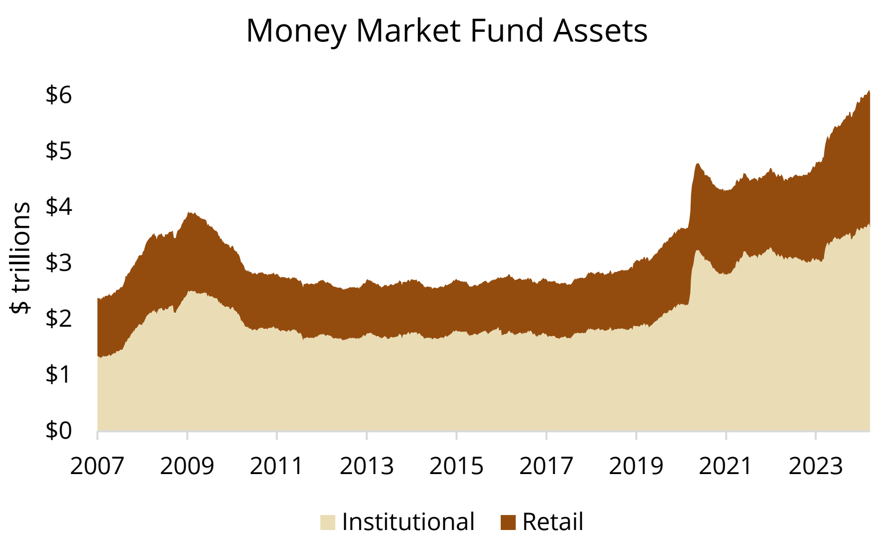
Rate Volatility Sparked by Economic Reports and Fed Comments

In February, rates moved upward as reports of persistent inflation, a healthy labor market, and favorable economic growth convinced bond investors the Fed would leave short term rates unchanged while awaiting signs of economic weakness. In early March, rates drifted lower as Fed officials and some market participants opined about the dangers of leaving rates too high for an extended period. Ultimately, interest rates along the maturity curve ended the quarter 30 bps to 40 bps higher than year end.





An Eventual Repositioning of Money Market Assets Could Push Rates Lower

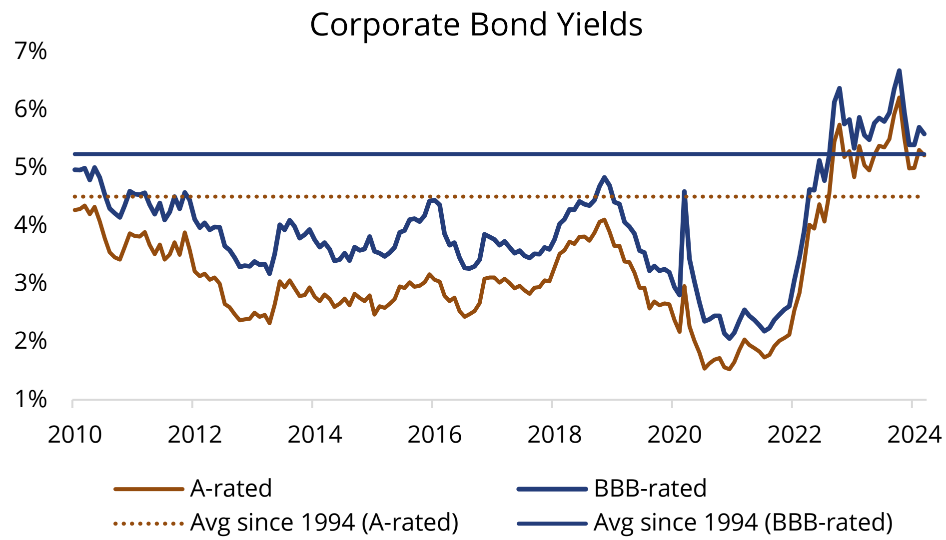
Investors have contributed $1.3 trillion into money market funds since the end of 2022 with retail investors accounting for over 40% of the increase. The historically attractive yields currently offered by many money funds is apt to end once the Fed transitions its policy stance towards lower rates. At some point, we believe a portion of the money market assets will be reallocated into bonds, thereby supporting bond prices with the potential to push yields lower.

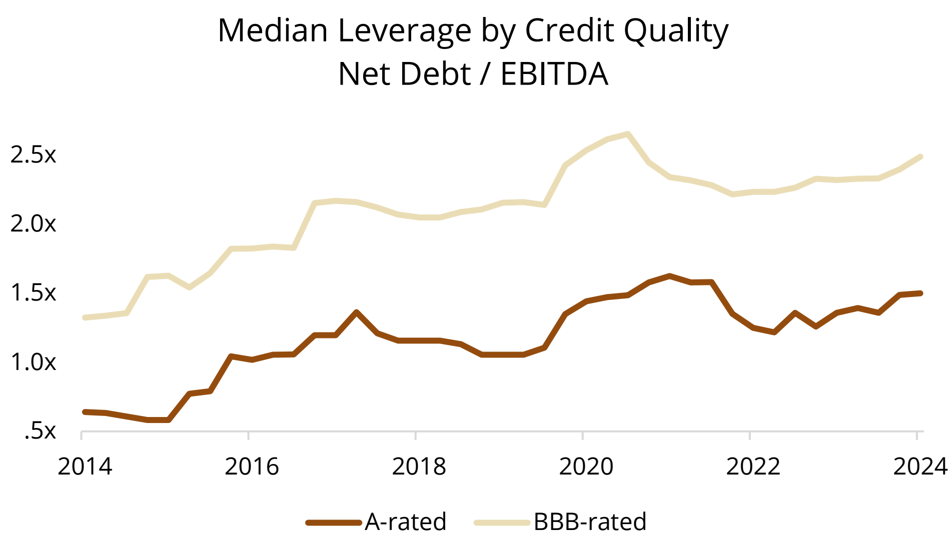
Source: Bloomberg

ASSET CLASS (CORPORATES)

Corporate Bond Yields Appear Attractive Despite Tight Credit Spreads

Higher interest rates have kept corporate bond yields above long-term averages even though risk premiums continue to trend towards historical lows. Demand for corporate bonds remains robust as investors position yield in advance of an expectation for lower rates in the near future. We believe the Financial sector continues to offer the best relative value given the low spreads available on Industrial paper.





Balance Sheets Remain Healthy Even Though Leverage Has Increased

Thus far, the increase in leverage during the past several years has not negatively impacted overall corporate health. Corporate balance sheets and cashflows remain sound, even as higher interest rates have affected some lower quality borrowers.

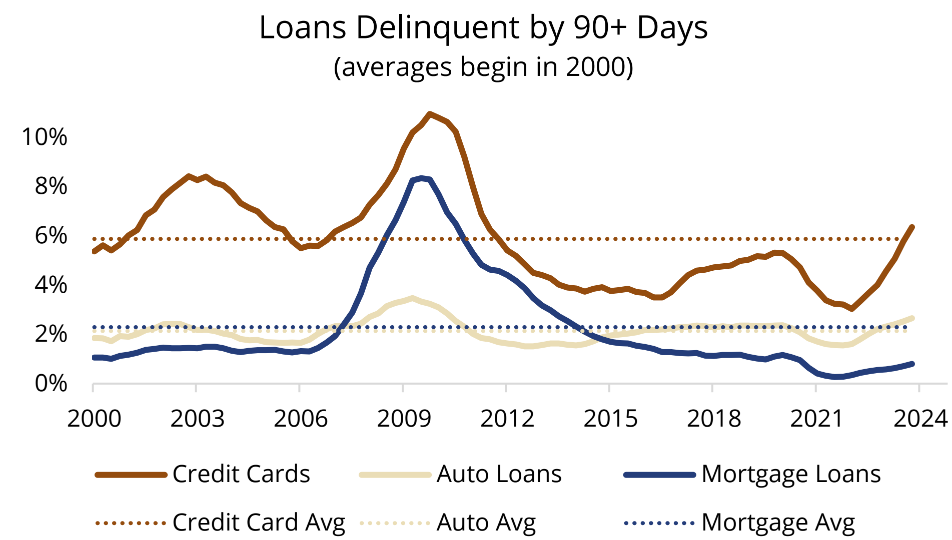
Most recent debt issuance has been absorbed by adequate investor demand, a sign investors are not overly concerned about credit deterioration. We view credit spreads as too low given where we're at in the credit cycle which makes credit selection vitally important.

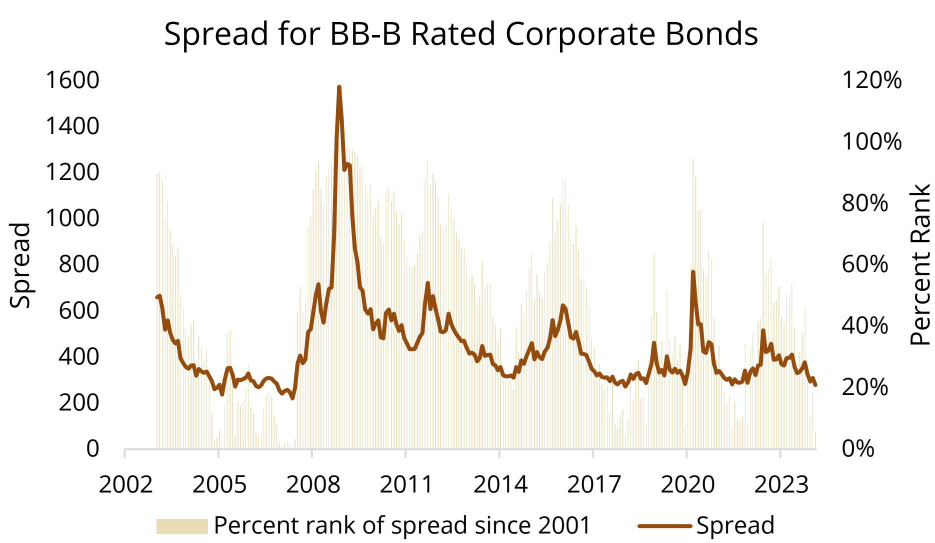
Source: FactSet, Bloomberg, ICE Global Indices

Delinquency Rates Suggest Consumers May Be Struggling

Even though wage gains have outpaced inflation since mid-2023, some consumers are struggling as evidenced by higher delinquency rates for credit cards, auto loans, and home mortgages. Spending has depleted bank balances of lower income consumers while access to credit has also diminished.

Valuations for high quality tranches of asset-backed securities remain attractive due to the protection (e.g. overcollateralization) inherent within most deal structures. Similarly, agency mortgage-backed securities remain attractive, especially issues trading at a discount dollar price.





Below Investment Grade Valuations Suggest Caution

At quarter-end, the credit spread for non-investment grade corporate bonds rated single-B or higher was 279 bps. The compensation for risk was only 160 bps above BBB-rated paper in contrast to a historical spread difference of 250 bps on average.

In our view, high yield valuations currently assume very few entities will experience credit difficulties in the coming quarters should the economy slow or access to credit weaken. We maintain our cautionary stance given high yield spreads have been higher than current levels 95% of the time since 2001.

Source: FactSet, Bloomberg

FIXED INCOME SCORECARD

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	Potential Impact on Bond Returns						
	-			-0-			+
U.S. Macroeconomics							
Economic Growth				n/c			
Employment				n/c			
Inflation				n/c			
U.S. Policy							
Monetary (Fed)				n/c			
Fiscal (Congress)				n/c			
Regulatory			n/c				
Global							
Foreign Economics			n/c				
Geopolitical Tensions			n/c				
Central Bank Policies			n/c				
U.S. Corporates							
Credit Fundamentals				n/c			
Risk Premiums			n/c				
Liquidity				n/c			
U.S. Treasury Market							
Interest Rates			n/c				
Sentiment			n/c				

– Negative for Bonds
+ Positive for Bonds

Current
Prior

n/c No Change

Economists continue to forecast slower economic growth, although growth during 2024 is projected to be above 2%. Employment conditions are favorable given low unemployment, payroll expansion and wage gains. Inflation could remain near current levels should commodity prices continue to creep upward.

The Fed has kept its policy rate at 5.50% since July 2023 and remains on-hold while awaiting evidence inflation is in fact retreating towards 2%. Since this is an election year, there's little chance fiscal spending and regulatory reform will change much. Longer term Treasury issuance is expected to increase given budget shortfalls.

Global growth is predicted to slow, although expanding at a faster rate than the U.S. Inflation is forecast to linger above 3% during the next 12-18 months. Global tensions and rising regulatory uncertainty have the potential to elevate commodity prices such as oil, copper, and gold.

Profitability and coverage ratios indicate the creditworthiness of most corporations has not been impaired by higher interest rates. Credit spreads have endured at low levels and thus far unaffected by debt issuance. An unforeseen substantial decline in U.S. economic conditions could hasten defaults and spur spread volatility.

Interest rates across the Treasury curve are apt to trade within a 25 bps to 50 bps trading range until the Fed's first rate cut. It's impossible to perfectly time the change in monetary policy, although bond investors can currently lock-in historically attractive yields.

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All investments contain risk and may lose value. Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in foreign-denominated and/or -domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets.

In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond’s maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Upon request, Madison may furnish to the client or institution a list of all security recommendations made within the past year.

A basis point is one hundredth of a percent.

Yield Curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward sloping curve), inverted (downward sloping curve) and flat.