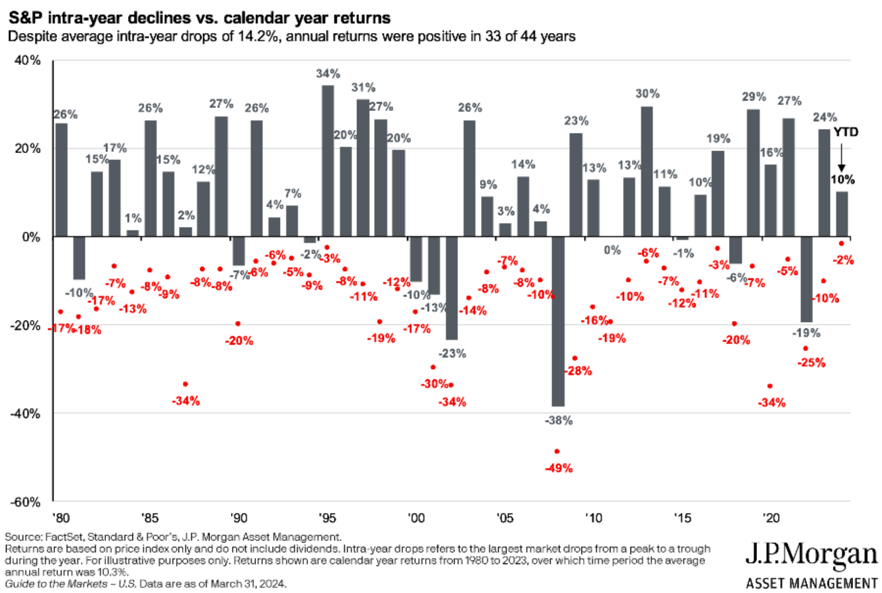
Pavlic Investment Advisors

Client Review & Outlook

1st Quarter, 2024

Dear Client,

Our core portfolio of stocks continued its strong performance in the first quarter driven by four main factors, which we will discuss in greater detail throughout this letter: economic growth, inflation, Fed rate cut expectations, and enthusiasm towards technology and more specifically artificial intelligence (AI). The S&P 500 had its best first three months of the year since 2019. Since 1961, the market has gained at least 9% in the first quarter only 13 of 63 times. Of those 13 times, it went on to rise again in the second quarter nine times, and finished the year higher in every instance but one. Economic data continues to be strong as evidenced by the latest jobs report released in early April. Despite continued elevated prices, inflation growth is slowing, and consumers have shown that they are still willing to spend. These factors have kept both investor sentiment elevated and the Federal Reserve hesitant to cut interest rates.



The chart (left) shows each year's annual return for the S&P 500 in gray and its intra-year max drawdown (i.e., the biggest sell-off from its peak during the year) in red. In the last 44 years, the S&P has seen an average annual max drawdown of 14% compared to the 2% drawdown we witnessed in the first quarter. As such, we should be prepared for more volatility for the balance of the year. The other important takeaway from this chart is that the market has ended the year in positive territory in 33 of the 44 years measured (75% hit rate) with an average return of +9%/year. In summary, despite average drawdowns of -14%/year, the market has finished up +9%/year, on average. Volatility isn't a "bug", it is simply a "feature" of the market that delivers solid long term returns for investors.

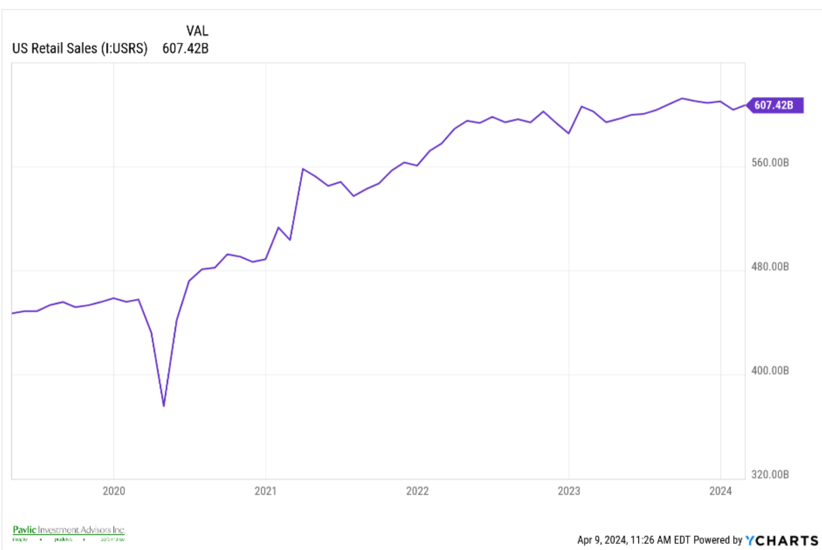
Continuing the theme of general market stats, one could ask a follow up question, "With a historically modest 2% drawdown in the first quarter, does this mean we are due for a crash?" Not necessarily. In looking at the 13 times that the market has gained upwards of 10% in 1Q, the average max drawdown during the remainder of the year was only 11%. That's below average, but no drawdown ever feels comfortable. That is why we have investment plans in place based on individual client risk tolerance. We will continue to take advantage of market volatility.

Stock Market Review

We focus our stock market review on the four largest drivers of the market: Fed rate cut expectations, economic growth, inflation, and the continued outperformance of technology stocks.

Fed vs. Market rate cut expectations. Coming into the year, the market was forecasting that the Fed would cut rates *six* times from its current level of 5.25%-5.50%. Fast forward to April, and the market now has met the Fed in its expectations for only *three* rate cuts, with the first rate cut occurring (currently a 50%/50% chance) at the June meeting. Rate cut expectations have come down for two reasons: economic growth has remained strong. and inflation has remained stubbornly high (above the Fed's long-term target of 2.0%). What are the implications for investors? First, the money market fund rate we can earn for clients has remained high and is currently 5.17%/year. Investors should note however that this is a variable rate, and as the Fed eventually cuts interest rates, this rate will fall. By year-end, we expect the rate to be between 4.5%-4.75%.

Secondly, a higher Federal funds rate means upward pressure on the rest of the yield curve. The Federal Funds rate controls the shortest end of the yield curve, while longer rates are freely floating. If an investor can earn more money investing short term (buying short term duration products such as the money market mutual fund), they have little incentive to buy longer term US treasuries and corporate bonds (and receive *lower* rates). The only motivation, in this scenario, would be reinvestment rate risk—or the risk an investor is unable to realize a comparable return in the future when their capital has to be reinvested. This dynamic has kept us in a "higher for longer" interest rate environment, with the 10-year US treasury rate increasing almost a full 1.0% over the last year from ~3.3% to ~4.4% as of early April. In the short term, we believe the market will be focused on the 50/50 chance of a June rate cut. If expectations of a cut are pushed further out (say to July or later), we would expect market volatility to pick up—something we've seen very little of in the last six months.



Economic growth continues to move along. For most of the last two years, economic prognosticators and market forecasters have been calling for a recession. While we have been cautious, we haven't been nearly as bearish as many market forecasters (although many forecasters capitulated in early 2024 with now lofty expectations for the market to continue to rise in 2024). The largest issue with the bear case is that stocks generally follow corporate earnings, and corporate earnings follow economic growth. Both have held steady.

Growth metrics such as retail sales (3-year US Retail Sales Chart left), Empire manufacturing index, and ISM manufacturing index have all been stable while non-tech corporate commentary has been what we would consider "cautiously optimistic." We focus on growth metrics because growth could be the potential rally killer that will cause a 10% correction if it rolls over. With market valuations at historically high levels, it doesn't take a recession for a 10% pullback. However, in light of this backdrop, we expect the rally to continue to broaden into other sectors outside of just technology, as we started to see in 1Q24. Therefore, we are leaning into the more discounted yet high quality sectors of the market.

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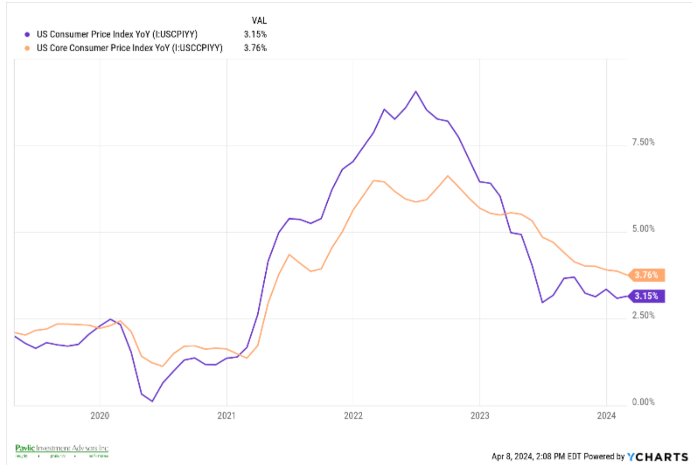
Inflation stable at elevated levels. Just like economic growth, we would consider inflation to be "stable." Unfortunately, consumer prices have been stable above 3.0%, which is a full 1.0% above the Federal Reserve's long term 2.0% target. It is as if we have marched down the football field and are in the red zone, however the last 10 yards are proving to be the most difficult (and we need a touchdown to win, not a field goal!). The chart (right) shows two measures of inflation, the Core Consumer Price Index (CPI) and the Headline CPI. Both remain in a downward, albeit slowing, trend. Interestingly, we have noticed that commodity prices are picking up. This will put upward pressure on inflation. We expect that any businesses that use commodities as a cost input (e.g. airlines, homebuilders, etc.) will pass those higher input costs along in the form of higher prices to consumers.



Technology continued to advance in 1Q24, but the rally is broadening. From an investment style standpoint, Growth, once again, outperformed Value in the first quarter but the margin was much smaller than we saw last year. Both investment styles had strong quarterly returns. Continued heightened AI enthusiasm was the main reason for the modest Growth outperformance over the past three months, as large-cap tech stocks, again, saw strong rallies in Q1.

On a sector level, gains were broad as 10 of the 11 S&P 500 sectors finished the first quarter with positive returns. Unlike 2023, however, tech and tech-aligned sectors didn't substantially outperform. To that point, the best-performing sectors, in the market, in the first quarter, were communication services, financials, energy and industrials—a mix of Growth and Value sectors. That sector mix reflected the influences of AI enthusiasm, strong financial stock guidance, solid U.S. economic data and rising optimism towards a rebound in China's economic growth. The diversified gains demonstrated that the Q1 rally was driven by a more varied set of influences beyond just AI enthusiasm.

Bond Market Review

"Higher for Longer": Dead or here to stay? After the US 10-year Treasury Yield hit almost 5.0% on October 16th, yields fell over 1.0% through the end of the year, sending the 10-year US Treasury yield down to 3.9%. Since then, the 10-year US Treasury Yield has moved up 0.5%, settling in at 4.4% at the time of this report. Disappointing inflation readings were the primary reason for the weakness in bonds as they delayed the expected start of Fed rate cuts from March until June and caused bond investors to consider that rates may be higher than previously expected over the medium to long term. As expected, longer dated bonds faced more pricing pressure while shorter term bonds saw little impact. Importantly, as bonds mature, we are able to redeploy the capital at higher rates of return. While it has been a tough two years in the investment grade bond market, we are sticking to our strategy of holding bonds to maturity provided they have investment grade credit rating from either S&P or Moody's. New bond purchases today average ~5.75% annualized yields.

2024 Market Outlook and Commentary

We begin the second quarter amid a positive macroeconomic environment as growth appears stable, inflation growth is falling, albeit slowly, the Fed is likely going to deliver the first rate cut in four years, and AI enthusiasm keeps earnings estimates high. But while this is undoubtedly a favorable backdrop, the strong rally of the last six months has left the S&P 500 at historically elevated valuations leaving investor sentiment very bullish (see last quarter's report on what excessive investor sentiment means for forward returns). While the outlook is currently positive, it's essential we continue to monitor the macroeconomic horizon for risks. Specifically, while it's true that economic growth has remained resilient in the face of higher rates, some data is pointing to a loss of momentum. Retail sales, while buoyant, are not growing, and the unemployment rate has ticked very modestly higher to 3.8%. Neither number warrants concern about the economy right now, but both serve as a reminder to watch data closely as continued economic expansion is not guaranteed.

Inflation, meanwhile, is still retreating but the pace of that retreat has slowed meaningfully. Core CPI (one of the Fed's preferred measures of inflation) has barely declined over the past several months. It was 4.0% year-over-year in October and had only fallen to 3.8% by February. If inflation bounces back that will reduce the number of Fed rate cuts in 2024 and that disappointment could pressure stocks. To that point, markets today expect the first Fed rate cut in June and two more rate cuts before the end of 2024. These assumptions were central to the first-quarter rally. However, if the Fed does not cut as aggressively as the market expects, market volatility will reignite.

Finally, investor enthusiasm towards the potential for artificial intelligence remains a critical part of the bull market and strong earnings from Nvidia in February furthered investors' hopes that AI integration will lead to profitability and earnings, not just for tech companies, but for the many businesses. However, as we see it today, AI integration has produced a lot of flashy headlines but not a lot of profit maximization for non-tech industries (at least not yet). If AI fails to broadly boost profits and demand declines, that will be a significant negative for the market.

In summary, this rally is currently supported by positive fundamentals, but we are aware of the risks and that's why, while we are very pleased with the performance so far, we are also focused on managing both risk and return in a diversified approach.

Please do not hesitate to contact us with any questions, comments, or to schedule a review meeting.

"The most important quality for an investor is temperament, and not intellect." – Albert Einstein