William Blair

Q1 2024

Private Wealth Management
williamblair.com

Market Review and Outlook

- Economic growth in the last quarter continued to surprise to the upside, easing investor fears of a hard or even soft landing with a new narrative of no landing taking shape.
- This has not resulted in any changes to the Fed's view on forecast rate cuts, but it has caused the market to sharply scale back its expectations to now be roughly in line with the Fed's.
- Market performance in the quarter continued to be driven by a small group of mega-cap stocks known as the "Magnificent 7" (now the Fab 4), and momentum stocks more generally.
- If the economy is going through a wider structural transition away from inflation risks being heavily skewed to the downside and now more balanced, or even tilted to the upside, investors may be well-suited to review their asset allocation and the degree to which portfolios are actively managed and positioned, potentially favoring active versus passive investing.

Hard Landing, to Soft Landing, to No Landing?

Once again, this last quarter was proof that the narrative around U.S. economic growth in the post-COVID environment rarely stays stable for long and can shift in just a few months. At the start of 2023, most economic prognosticators were heavily leaning to the hard-landing/recession side of the boat. Over the course of that year, there was a steady trickle of converts to the soft-landing side, with this then becoming the overwhelming consensus by the start of this year. In just the last three months, however, doubt has started to creep in about the prospects of even a soft landing, with that camp now spilling their weight into the no-landing scenario.

In early December, for example, real GDP growth was expected to increase by 1.3% for all of 2024, with growth in the first quarter of just 0.6%. Over the last three months, that estimate has risen to 2.2% for annual growth and 2.0% for the first quarter. The Atlanta Fed's GDPNow data tracker pegs this quarter's growth at 2.5%.

With respect to inflation, however, we have not seen the same resurgence, though the pace of expected deceleration has been slightly scaled back and there are concerns among both the market and the Fed that this final mile back to 2% could still be a very bumpy one. The Fed's preferred inflation target, the PCE index, was expected to fall to a 2.2% seasonally adjusted annual rate in the final quarter of this year; the market now expects a 2.3% rate, and it currently sits at 2.8%. What's incredibly encouraging, however, has been that this softening of inflation has not—yet at least—come at the expense of employment.

Most of the heavy lifting from the disinflation came from post-COVID supply-side improvements and a reduction in goods prices. The next leg lower for inflation, however, will have to come from weaker services and shelter components, which may entail some easing in the labor market to quell still-too-high employment costs. While the labor shortage situation is improving, many companies are still reporting workers as being hard to find, and the cost of that labor remains an issue.

The combination of these pressures—coupled with higher net interest costs due to higher interest rates, higher commodity costs exacerbated by geopolitical and climate issues around the Suez and Panama canals, and the recent Baltimore bridge collapse—and reduced pricing power could start to pressure corporate profit margins, forcing companies to turn their focus to their largest input cost: labor.

For now, however, companies are reluctant to let go of workers that have been so hard to find, adjusting instead by slowing hours worked, shifting some workers to part-time, and hoping growth accelerates further or the Fed starts to lower interest rates. Meanwhile, research analysts still do not foresee any major drop in earnings, with the pace of 2024 estimated growth largely on track with the historical average trend for the last 20 years (exhibit 1).

The Shifting Sands of Interest Rate Expectations

How has this change in sentiment toward growth and inflation been reflected in expectations for Fed policy? Exhibit 2 shows that there has been no expectation that rates will rise further in the coming four years, though the amount by which they are expected to be cut has declined: at the January 2024 low, the

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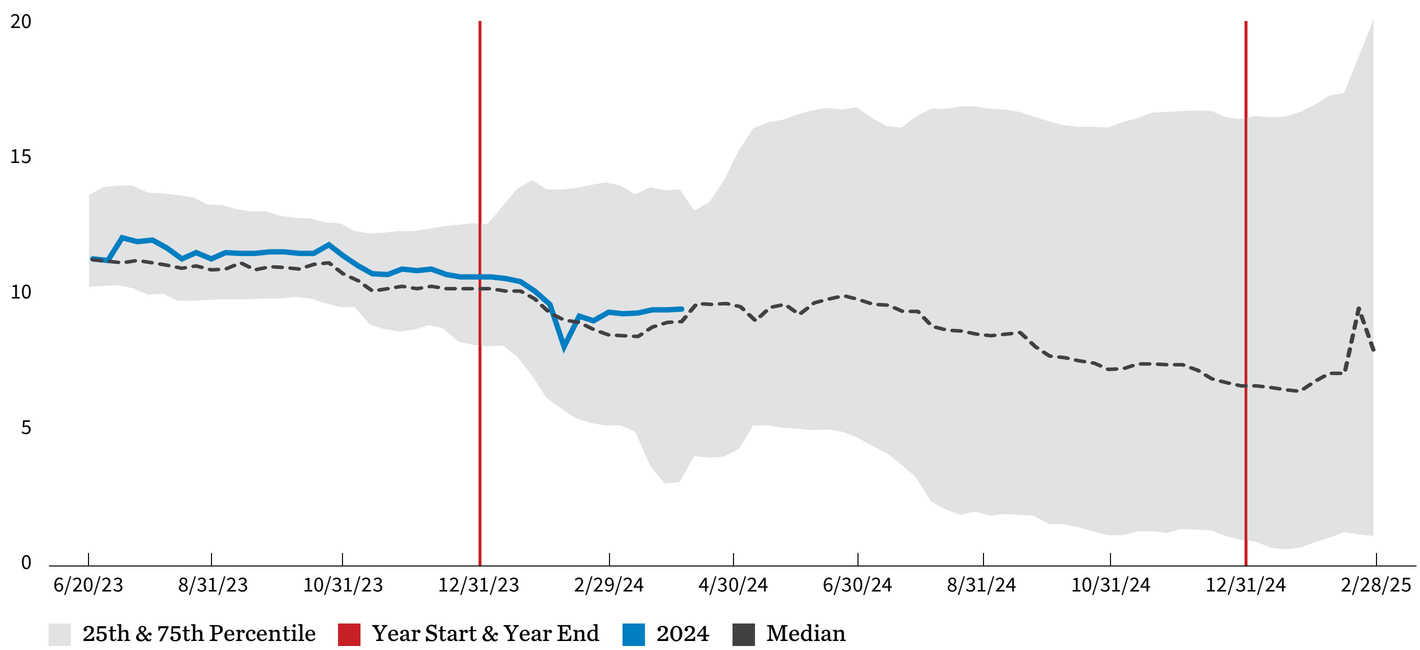
EXHIBIT 1

Progression of S&P 500 2024

EPS Growth Estimates, 2024 vs. Median Growth Rate 2003–2023



Sources: LSEG I/B/E/S, William Blair Equity Research

market felt that the Fed would end up lowering rates from the current 5.3% to 2.8%, fully 250 basis points, starting with 150 basis points in 2024. Today, the market anticipates about 150 basis points of cuts, with between 50 and 75 basis points of those cuts taking place this year. Significantly, the exhibit also shows that the trough in rates will remain well above the Fed's 2.6% estimate of the neutral interest rate (above/below which policy is deemed restrictive/accommodative), consistent with expectations for a stronger economy that does not require an accommodative monetary stance.

At the long end of the yield curve, we have also seen a material backup in 10-year U.S. Treasury yields, with the yield rising from 3.79% to 4.42% at present. This has resulted in some modest re-steepening of the yield curve, though it remains inverted. A deconstruction of the yield reveals that this rise has been less due to fears about high and rising inflation; rather, it has been more a result of stronger real growth (i.e., a real yield) and a higher term premium, reflecting concerns about increased debt issuance from the U.S. Treasury on the supply side against weaker demand from price insensitive foreign central banks on the demand side, coupled with U.S. households demanding a higher yield to participate.

Surprisingly, despite these shifts in the Treasury market and a major surge of corporate debt refinancing during the first quarter, corporate credit spreads—for both high-yield and investment-grade corporate debt—have remained incredibly compressed. Investors clearly expect strong earnings growth and solid corporate balance sheets to continue.

Perhaps the biggest anticipated risk to these spreads on the horizon is what happens in the commercial real estate space. Market jitters returned around this area during February, when we saw several banks experience significant losses. Vacant office space and higher interest rates are damaging profitability, and the concern is that some entity will be left holding the bag. However, the fact that this has been a slow-motion car crash for the last year should have given investors plenty of time to mitigate the risks, meaning that any fallout is more likely to be idiosyncratic rather than systemic.

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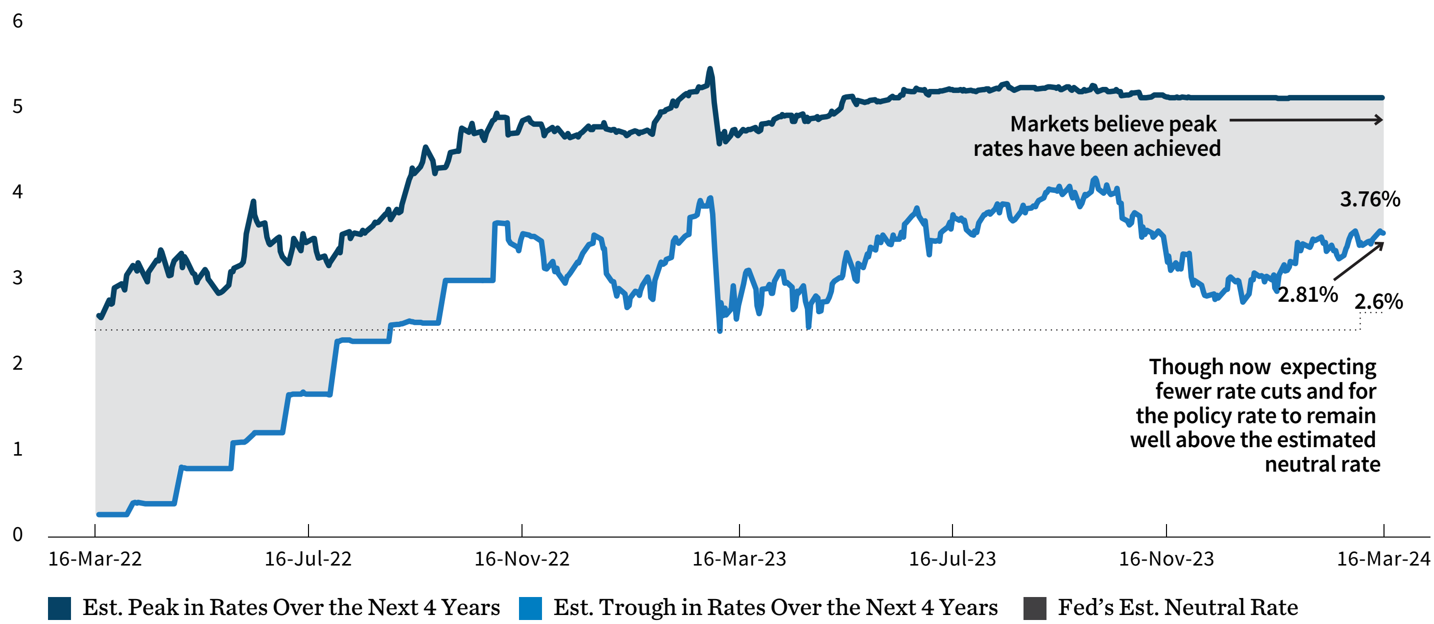
EXHIBIT 2

Progression of Expected Range for Fed Funds Rate in Next 4 Years

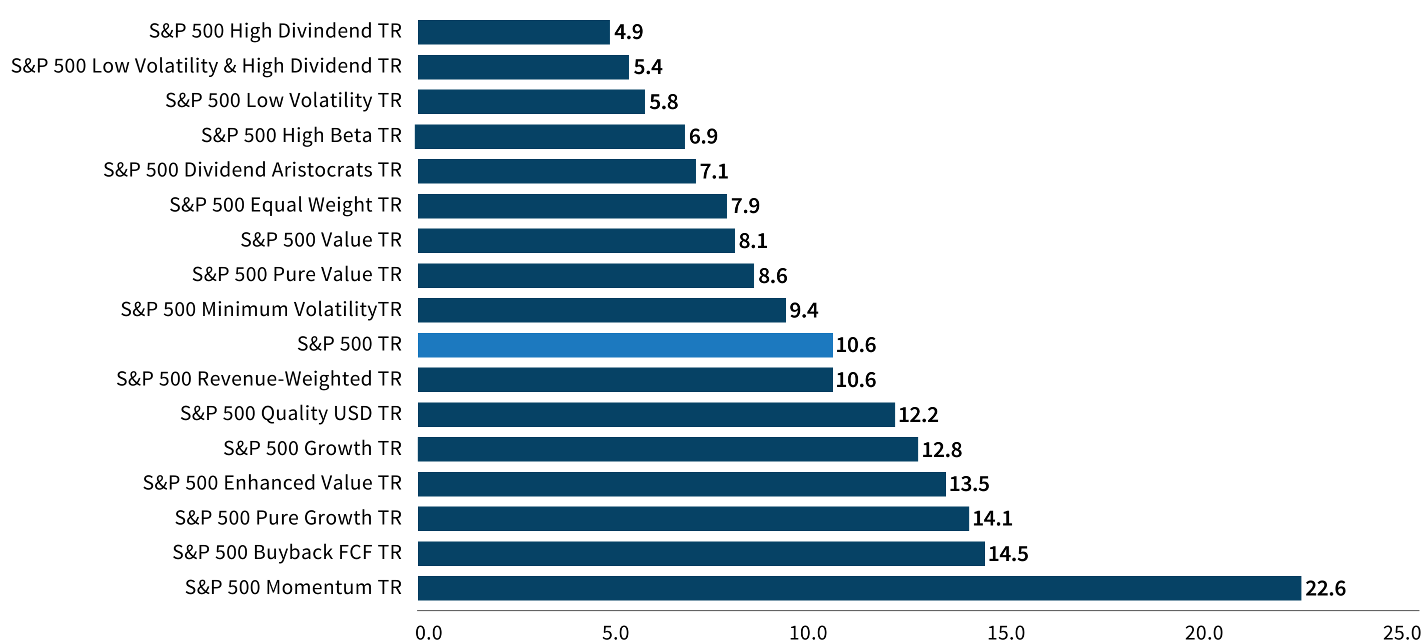
(Fed Funds Futures Pricing, %)



Sources: Bloomberg, William Blair Equity Research

EXHIBIT 3

S&P 500 Performance by Factors, Total Return Indices Percent Change Q1 2024



Sources: Bloomberg, William Blair Equity Research

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Market Performance

The performance of the U.S. equity market has once again been turbo charged over the past quarter by generative AI on the technology side, and to a lesser extent the introduction of GLP-1s on the healthcare side. Both are already resulting in significant changes to work and health, and it may not be an exaggeration to suggest that looking back from the future will mark this period as having been a major turning point for humanity.

Whereas the market was initially placing its bets on the Magnificent 7 as the tech winners (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) through 2023, this group has subsequently dwindled to the Fab 4 as Tesla, Apple, and Alphabet's performance has disappointed and their prices have flattened or fallen. Nevertheless, in the first quarter, the Mag 7 increased by 12.9%, against 8.6% for the rest of the S&P 500 excluding those 7. The rise encompasses a one-day increase of 16.2% in the price of Nvidia—a gain of $277 billion, or roughly the size of the entire market cap of the 29th-largest stock in the S&P 500 (Netflix).

This performance is highlighted in exhibit 3, which breaks the S&P 500 down into various styles and factor drivers. By far the biggest winners over the last quarter have been the momentum stocks, with the laggards being the higher-dividend, higher-beta, and lower-volatility stocks.

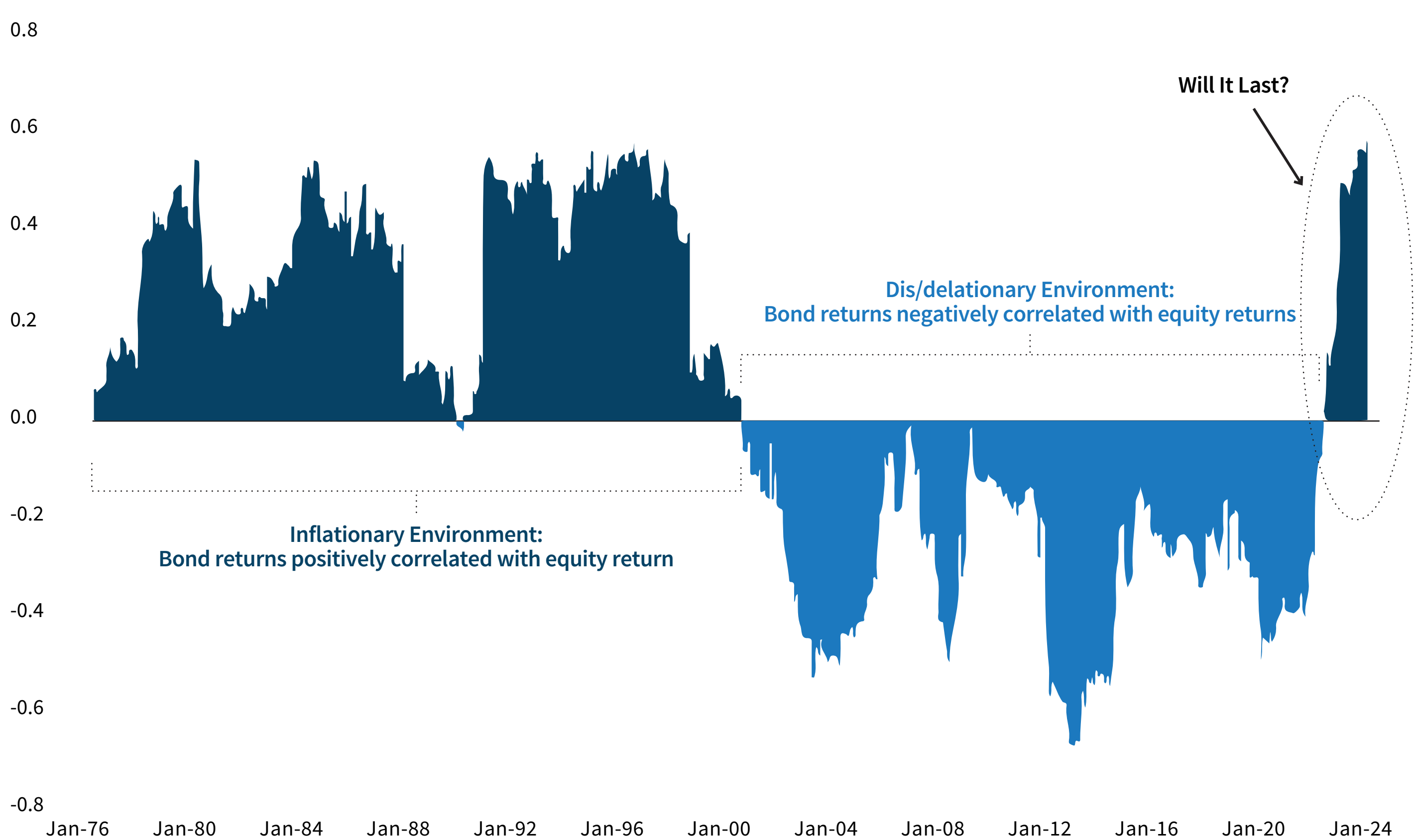
Structural Changes and Asset Allocation

It is tough enough trying to spot cyclical changes in financial markets and the economy, let alone major structural turning points; however, looking at the performance of the equity

EXHIBIT 4

Stocks to Bonds Return Correlation

3–Year Trailing Correlation of Monthly Changes in S&P 500 TR & Treasurys* TR



Sources: Bloomberg, Robert Shiller, William Blair Equity Research, *Bloomberg US Treasury Index = Notes & Bonds

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market relative to the bond market in the last two years, the clear message seems to be that something structural has changed (exhibit 4).

We attribute the shifting tailwinds and headwinds within 60/40 portfolios—where bond returns may provide a less effective counterbalance to equity portfolios—to a change in the economy's inflation bias. That is to say that while the Fed may still achieve its 2% inflation target on average, the risks are no longer as heavily skewed to the downside as they were from 2000 to 2020. Rather, there have been a number of structural changes unfolding (including climate change, increased fiscal spending, geopolitical pressures, reduced globalization, and increased labor cost pressures) to suggest we should expect to see more upside volatility around this inflation mean.

This means that investors will likely need to take a wider and more active approach to portfolio construction. While this might encompass greater exposure to global markets, fixed income, and private markets and alternative investments, it may also entail seeking greater diversification across the equity market in terms of sectors, sizes, and styles where returns may be less correlated.

Wealth Planning TIP:
Clients establishing or revitalizing their philanthropy or wealth plan or those anticipating a liquidity event turn to William Blair's professionals for guidance and strategic solutions. Did you know that our capabilities include *philanthropy strategy*, *wealth planning*, and *pre-liquidity planning*?

Index		YTD	Q1	1Y
S&P 500	US Large Cap	10.56	10.56	29.88
DJIA	US Large Cap	6.14	6.14	22.18
Russell 3000	US All Cap	10.02	10.02	29.29
Russell 2000	US Small Cap	5.18	5.18	19.71
MSCI EAFE	Developed International	5.78	5.78	15.32
MSCI EM	Emerging Markets	2.37	2.37	8.15
Bloomberg Barclays US HY	US High Yield	1.48	1.48	11.15
Bloomberg Barclays US Agg	US Core Bond	-0.78	-0.78	1.70
Bloomberg Barclays Muni	US Muni Bond	-0.39	-0.39	3.13
MSCI US REIT GR	US Real Estate	-0.32	-0.32	10.37

Total Returns

Source: Factset