Navigating The Bull

February, 2024

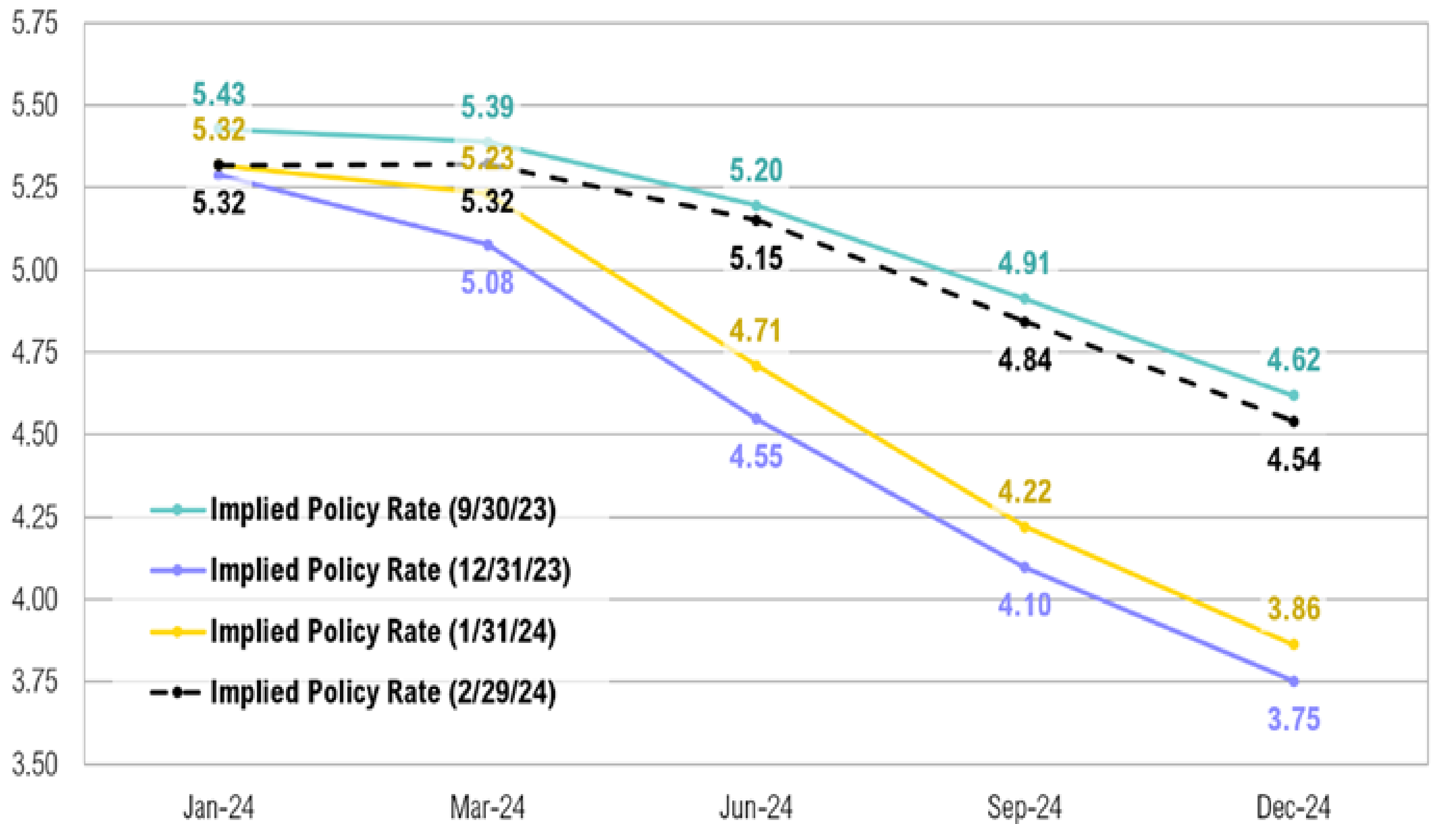
Summary

- Equity market returns were robust during the month of February. U.S. small cap stocks led the rally, up 5.7%, and the S&P 500 set new highs, marking a rare occurrence of gains in 16 of the past 18 weeks, something not achieved in more than 50 years.
- The January CPI report indicated higher-than-expected inflation. Coupled with strong economic data, this has prompted investors to scale back expectations for Federal Reserve rate cuts in 2024.
- While the U.S. economy continues to show resilience, the United Kingdom and Japan recently slipped into technical recessions, adding complexity to the global economic landscape.
- Despite the recent equity rally, its narrow scope continues to raises crucial questions. Investors are keenly watching to see if the rally will broaden further and whether current earnings and monetary policy can sustain elevated market valuations.

Overview

Equity markets ended February on a strong note. U.S. small cap stocks marginally bested their larger peers, ending the month up 5.7%. The S&P 500 continued to reach new highs throughout the month, as U.S. large cap stocks gained 5.3%. As of the last week in February, the S&P 500 Index had been up in 16 of the past 18 weeks—something that hasn't occurred in more than 50 years. In contrast to strong equity markets, U.S. intermediate-term bonds continued to struggle, with the Bloomberg U.S. Aggregate Bond Index ending the month down 1.4%.

The January CPI report came in above expectations, with headline inflation easing to 3.1% year-over-year. This reading was down from 3.4% in December, but higher than the expected 2.9%. Core inflation remained unchanged year-over-year, at 3.9%. Producer prices also rose more than expected in January, increasing by 0.3% month-over-month, compared to the anticipated 0.1%. Strong economic data over the past month suggests that inflation may linger at current levels for longer than initially expected. The labor market remained extremely tight, and the unemployment rate stayed near its four-decade low. In response, Fed officials' communications throughout February consistently emphasized that rate cuts would be considered only with clear evidence that inflation is moving towards the 2% target. Interestingly, market expectations for interest rate cuts declined throughout February and ended the month in line with the Fed's expected three cuts for the year. This is a notable decline from the six cuts expected at the end of January, the result of strong economic data and stickier inflation, which pushed out hopes for imminent rate cuts.



Although the U.S. economy remained strong, the United Kingdom and Japan both unexpectedly slipped into recession. The British economy shrank by 0.3% in the fourth quarter of 2023, marking the second consecutive quarterly contraction and meeting the definition of a 'technical recession'. A slowdown in consumer and business spending caused the Japanese economy to shrink for a second consecutive quarter as consumers battled four-decade-high inflation and a weak yen. Japan's economy also dropped to the world's fourth largest, losing third place to Germany. Despite a weakening economy, Japan's stock market, the Nikkei 225 Index, hit a new all-time high on February 22, finally breaking the record set nearly 35 years ago.

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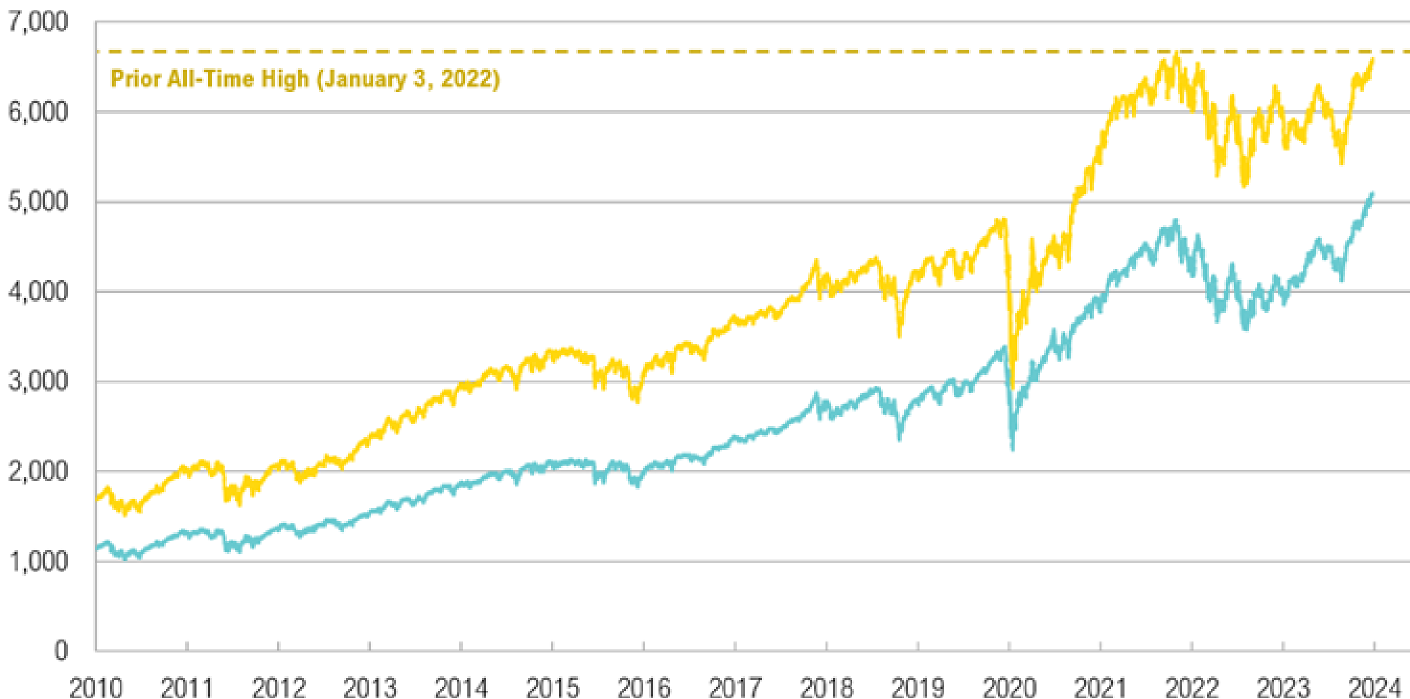
Throughout February, the S&P 500 continued to reach new highs, and bullish investor sentiment remained above average for 16 consecutive weeks while the S&P 500 rose for 16 of the past 18 weeks. With more than 80% of S&P 500 companies having reported earnings by the end of February, the fourth-quarter 2023 earnings season is nearly wrapped up. Fourth quarter earnings growth estimates have increased to 4.0% year-over-year, up from an initial 1.5% expected at the end of 2023 due mostly to gains in the communication services and consumer discretionary sectors. Looking forward, expectations for first-quarter 2024 earnings growth have been revised lower, falling to 3.6% from an earlier projection of 5.8% at the start of the year. Despite the S&P 500 continuing to reach new highs throughout February, bottom-up earnings estimates for 2024 remained largely unchanged.

Although earnings estimates have stayed relatively stagnant, the performance of several bellwether companies highlighted the continued resilience of the U.S. consumer. At Walmart, U.S. same-store sales increased by 4% year-over-year in the fourth quarter, as consumers, though more selective, "have been shopping frequently," according to CEO John Rainey during the company's earnings call. Further, Marriott, Royal Caribbean, and other travel-related companies noted that demand for travel remained elevated into 2024. A recent study by the San Francisco Federal Reserve found that the overall level of real household wealth in the U.S. remained above pre-pandemic levels, despite the drawdown in excess savings, which may suggest the potential for ongoing strength in spending at least in the near future.

Some speculate that an AI-driven "bubble" might be forming, largely due to the stellar performance of a handful of mega-cap technology companies. Despite clear signs of excitement (and, arguably, frenzy) surrounding the new technology, the current rally may be built on more solid underpinnings than the tech bubble of the early 2000s. For instance, several high-flying companies may ultimately merit their otherwise stretched valuations if they can continue to deliver the same level of strong earnings growth that they have had in recent quarters. Despite ending February up more than 65% year-to-date and adding $275 billion in market cap and 16% to its share price after announcing earnings, Nvidia's price-to-earnings (P/E) ratio declined from over 200 times trailing earnings last summer to around 75 in February. If we use earnings estimates for 2024, Nvidia trades at a P/E of around 35 times. Similarly, Amazon and Meta are not cheap stocks with trailing P/E ratios of about 60 and 33, respectively, but these multiples are among their lower valuations of the last several years as they have consistently delivered good growth. Investors have also been more discerning with their rewards: Tesla is down nearly 20% year-to-date, and Apple and Google are down 3% and 1% year-to-date, respectively, due to poorer-than-expected earnings announcements. Finally, the narrow leadership that historically has been a hallmark of toppy markets may be beginning to broaden out. The equal-weighted S&P 500 rose 3.0% over February, ending the month only 0.1% below its all-time high. Small caps rallied in the last week of February, climbing 3% to produce a solid 5.7% for the month.

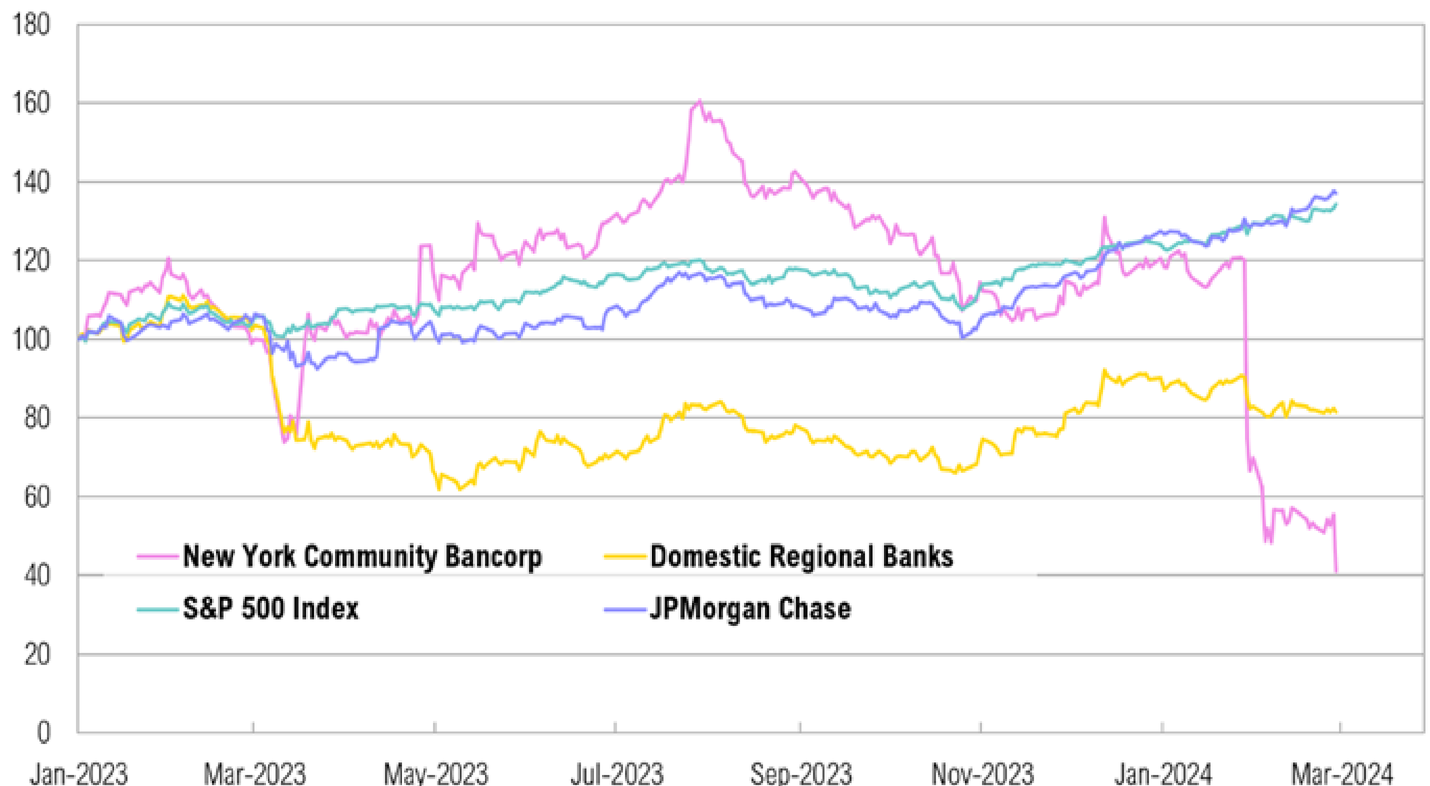


Even though more of the market is enjoying strong returns, the breadth of this rally remains a concern. Only four names (Nvidia, Microsoft, Meta, and Amazon) have driven more than 50% of the S&P 500's 7.1% gains for the year. In domestic small cap stocks, one company (Supermicro Computer; a U.S. information technology company) was responsible for nearly all of the Russell 2000's year-to-date gains of 1.5%. Supermicro Computer ended February up more than 200% year-to-date. Further, the timing and magnitude of interest rate cuts still remain uncertain. Federal Open Market Committee (FOMC) meeting minutes show that while the Fed still expects to cut interest rates in 2024, committee members are wary of cutting too soon. Three cuts have already been priced out for this year, and higher interest rates continue to affect several key areas of the market. Mortgage rates ended February back above 7% for the first time since December, and average credit card interest rates remain elevated, at 21.5%. Rising oil prices have led to average gasoline prices rising across the U.S., with the national average for regular gasoline rising by 7% over the past month.

Commercial loan delinquency rates are also worrying. Commercial real estate coverage ratios (or loss reserves to delinquent loans) declined to the lowest levels in more than seven years as the value of delinquent loans has more than doubled over the past year, from $11.2 billion to $24.3 billion. Banks may lose as much as $60 billion on bad commercial real estate loans in the next five years, almost double the $31 billion currently held in loan loss reserves. For instance, New York Community Bank (NYCB) is down more than 70% this year and just received a one-billion-dollar cash infusion. The bank announced in late January that it was anticipating significantly higher loan losses due in part to its exposure to commercial real estate. The story worsened at the end of February when the company disclosed weaknesses in its internal controls and a tenfold increase in its fourth-quarter loss, hitting $2.7 billion. Before its precipitous fall, NYCB was a top-ten position in the SPDR S&P Regional Banking ETF (KRE) and had a market cap of $7.5 billion. NYCB now has a market cap of $2.5 billion.

'Higher-for-Longer' Remains A Concern for Regional Banks With Bad CRE Loans

Growth of 100



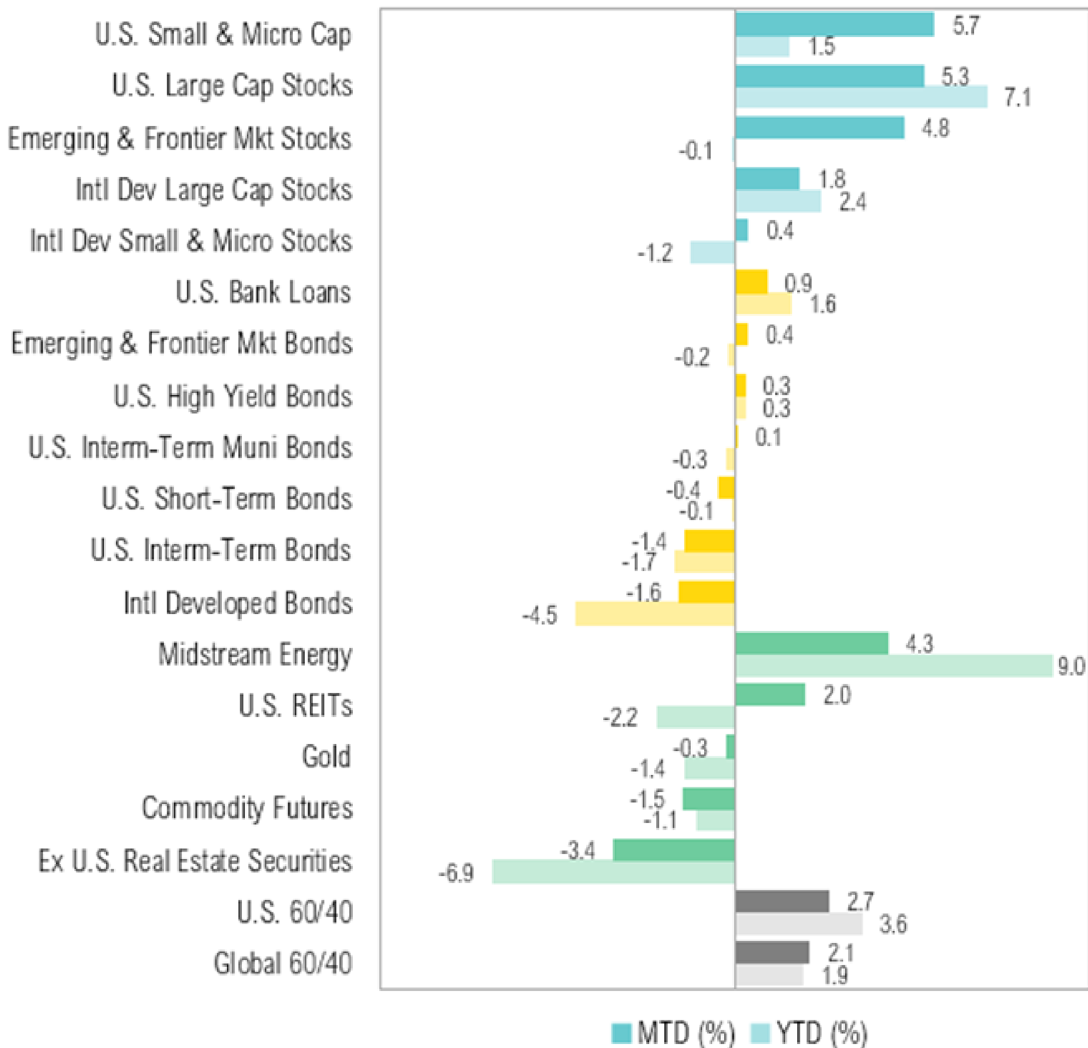
Source: Bloomberg. Domestic regional banks proxied by the SPDR S&P Regional Banking ETF.

Further, more than $480 billion has been added to total government debt since the start of 2024, compared to the $108 billion in the first two months of 2023. In early February, the Congressional Budget Office projected that the U.S. budget deficit would likely rise from $1.6 trillion to $2.6 trillion over the next decade. Unrestrained government spending is counteracting the Fed's efforts to tighten monetary policy, which may force the Fed to keep interest rates higher for longer.

Markets

Returns were mixed across asset classes in February. As discussed above, U.S. small cap stocks marginally outperformed U.S. large cap stocks. The former rose 5.7%, and the latter gained 5.3% over the month. Emerging and frontier market stocks also had a good month, ending February up 4.8%. U.S. intermediate-term bonds ended the month down 1.4%, while the 10-year Treasury yield ended the month up 40 basis points, rising to 4.25%. Gold remained above $2,000 per ounce throughout February, yet ended the month roughly flat, down 0.3%. West Texas Intermediate (WTI) crude oil rose by 6% over February, closing the month at $78.3 per barrel, its highest price since November 2023. Midstream energy ended the month up 4.3%. After climbing by 42% over the month, bitcoin ended February only 7% away from its all-time high.

February 2024 Key Market Total Returns



Source: Bloomberg

Looking Forward

Inflation and policy dynamics are becoming increasingly intricate. Stickier inflation challenges the economic outlook by potentially leading to fewer rate cuts, higher bond yields, lower equity multiples, and subdued real growth. It also places further stress on regional banks, who have come under scrutiny as commercial real estate loan portfolios struggle under the higher interest rate environment. Further, while the Fed may be forced to keep rates high for longer, rampant fiscal spending is overriding their attempts to rein in inflation.

Fiscal spending appears to be on an unsustainable trend. The reality of continued elevated Treasury issuance and the resulting increase in net interest outlays suggests a looming challenge for bond markets and underscores the risks of a "higher-for-longer" interest rate environment. As policymakers grapple with the dual objectives of managing national liabilities and sustaining government spending, the importance of diversifying investment portfolios, including allocations to traditional "safe havens," becomes ever more important.

As always, if you have any questions or need anything at all, please don't hesitate to call our investment team at 508-693-8850.

Sincerely,

Luke Murphy
Managing Director,
Martha's Vineyard Investment Advisors

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Martha's Vineyard Investment Advisors

496 State Road
West Tisbury, MA 02575
(508) 693-8850
www.mvinvestmentadvisors.com

Performance Disclosures

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