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summaries

SIGMA INVESTMENT COUNSELORS

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MARKET COMMENTARY

The first quarter of 2024 was a continuation of the strong equity performance we saw in 2023, with the S&P 500 ending the quarter near record highs. Large US corporations are still leading the way in terms of performance, but we've recently seen greater upside participation from US Small Cap, US Mid Cap and International companies during the month of March, leading to a wider market rally. As of the end of Q1 2024, the S&P 500 has returned approximately +10.6%, already surpassing its long term (1926 – 2023) average annual return of +10.2%. US Mid Cap stocks are up nearly 10.0% and US Small Cap stocks have traded up nearly +2.5%.

Foreign equities have continued to underperform their domestic counterparts as geopolitical tensions in Europe and the Middle East remain along with weakness in the Chinese economy. International Developed equities are up approximately +5.8% through the first quarter with the majority of these returns realized in March. In similar fashion, Emerging Market equities had strong performance in March and are up approximately +2.4% through Q1.

Fixed income markets have cooled off to start 2024 as rate cut expectations for this year have moderated. Given the uncertainty revolving around the US Federal Reserve's plans for interest rates, fixed income assets have lacked direction with the Bloomberg Barclays Aggregate Index trading down (0.8%) through the first quarter of 2024. Non-equity risk assets like gold have seen strong performance in 2024, supported by global central bank purchases even as real interest rates have risen this year, de-coupling from its traditional inverse relationship. And after a more than 10-year approval process, spot Bitcoin ETFs were approved by the SEC in the first quarter, leading to a resurgence in highly speculative cryptocurrencies.

In our last Market Commentary in January 2024, we outlined various risks that we had our eyes on heading into 2024. These risks included the impact on the US economy from higher interest rates, an upcoming contentious presidential election, numerous military conflicts (Russia/Ukraine & Israel/Hamas) and the impact of a weaker Chinese economy on global growth. In addition to these risks, new risks have appeared including the impact of Houthi attacks on shipping corridors, escalating tensions between Israel and Iran, excessive concentration risk in the S&P 500 (Magnificent 7) and the recent artificial intelligence frenzy potentially creating a bubble. Given the growing myriad of risks that could derail the stock market, why is the S&P 500 up more than 10% through the first quarter?

The first aspect to consider is that financial markets are forward-looking and continuously reassess asset prices based on investors' expectations for the future economy. This implies that current beliefs regarding the aforementioned risks have already been factored into financial assets to some extent. However, investors have multiple roles. Firstly, they must determine the risks currently priced into financial assets. Secondly, they need to hold different views on those risks, and these views must be accurate. Lastly, these divergent yet accurate views must generate acceptable returns.

Adopting a forward-looking perspective to gauge current investor sentiment, the recent strong performance of the stock market and low volatility, as measured by equity volatility metrics like the VIX, suggest that stock investors anticipate a relatively favorable economic environment ahead. This aligns with expectations for corporate earnings, which are expected to grow over +9% for S&P 500 constituents in 2024. Furthermore, investors are pricing in multiple interest rate cuts in 2024, which should bode well for financial assets. Measures of credit risk, such as investment grade and high yield credit spreads, are at historically low levels, indicating subdued concerns about credit risk. Therefore, a forward-looking approach suggests optimism about the near future. What underlies this optimism?

It is likely driven by the underlying fundamentals of the economy and the stock market, another facet to consider. Despite facing higher inflation and interest rates, both consumers and corporations have exhibited resilience. While certain segments of consumers (lower income & younger age groups) and corporations (highly indebted corporations & companies with excessive floating rate debt exposure) face challenges, overall, they have remained healthy in a higher rate environment, contributing to economic growth. Additionally, the US Federal Reserve seems to have inflation trending in the right direction following one of the swiftest rate hike cycles in recent history. These fundamental factors bolster current investor confidence and justify the recent equity rally.

Interestingly, by examining the fundamentals, investors can draw conclusions about some of the seemingly irrational factors in the current market environment. The recent surge in artificial intelligence has generated significant hype, with Nvidia emerging as a prominent example. From January 2023 to January 2024, NVDA stock surged by nearly +215%. While this may initially seem irrational for one of the world's largest publicly traded companies, during this period, Nvidia's earnings per share increased by close to +400%, and its free cash flow surged by over +600%. Similarly, the concentration of the Magnificent 7 (Microsoft, Apple, Nvidia, Amazon, Alphabet, Meta & Tesla) stocks in the S&P 500 raises concerns, accounting for 29% of the index's holdings and boasting a collective market capitalization greater than that of the entire Chinese stock market. However, delving into the fundamentals reveals that these companies are forecasted to contribute 26% of the total economic profit for US Large Cap stocks in 2024. Moreover, the Magnificent 7 are heavily investing in research and development and capital expenditures, indicating potential for further economic profit growth.

By employing a forward-looking approach and examining fundamentals, the recent strong equity performance and investor optimism can be rationalized by the positive outlook for the economy. The current scenario and risks priced into financial markets appear balanced and reasonable. As professional investors, Sigma will continue to monitor market pricing and make adjustments if the markets view on risk differs from our own.

We appreciate the opportunity to serve as your investment advisors.

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