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Market Outlook & Strategy

First Quarter of 2024

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Executive Summary

- **Q1 2024.** Markets continued their impressive rally in Q1 as a positive combination of stable economic growth, falling inflation, impending Fed rate cuts and ever-growing enthusiasm towards artificial intelligence (AI) propelled stocks higher. The overall U.S. market rose by +10.0%.

- On the whole, market gains this quarter were distributed more equitably amongst various sectors and industries, a healthy sign that the rally is not only about AI.

- International developed markets also posted solid quarterly gains (+5.6%) but still underperformed the U.S. market. Gains were due in part to better-than-expected economic data and rising expectations for interest rate cuts from the European Central Bank. Emerging markets, meanwhile, logged only modestly positive returns in Q1 (+2.4%) and solidly underperformed the U.S.

- As for fixed income, the leading benchmark for bonds (Barclays U.S. Aggregate Bond Index) realized a slightly negative return (-0.8%) for the quarter. Disappointing inflation readings were the primary reason for the weakness in bonds, as the Fed delayed the expected start of rate cuts from March until June.

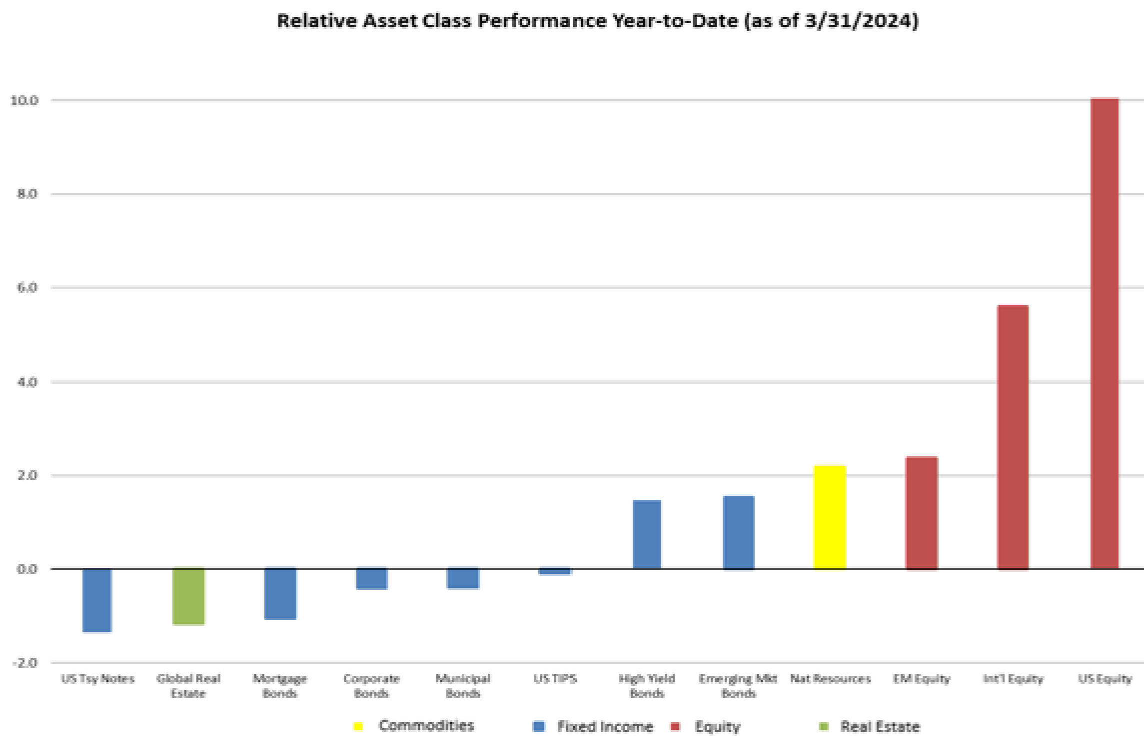
- In this report, we take a closer look at some of the reasons why the U.S. economy did not experience a recession last year in the face of the sharp rise in the cost of capital. We also explore the perennial question of whether the stock market is now overvalued due to its recent strong performance. We conclude that we are not anywhere close to the frothiness we experienced in the dot-com bubble, but that we do need to see real productivity gains from AI to be realized to keep the rally going.

- **Artemis Strategy.** We modestly increased our overweight exposure to the U.S. relative to the rest of the world, but, within the U.S. allocation we remain with a balanced exposure to both large value and growth stocks and a modest tilt toward quality. We continue to encourage investors to move away from cash.

Markets in Review – Q1 2024

Markets continued their impressive rally in Q1 as a positive combination of stable economic growth, impending Fed rate cuts and ever-growing enthusiasm towards artificial intelligence (AI) propelled stocks higher. The overall U.S. market rose by +10.0%. See Figure 1. Growth stocks once again outperformed value, but the margin was much closer than last year as both investment styles logged strong quarterly returns. On the whole, market gains this quarter were distributed more equitably amongst various sectors and industries, a healthy sign that the rally is not only about AI.

Figure 1. Asset Class Returns in USD for Q1 2024(%)



International developed markets also posted solid quarterly gains (+5.6%) but still underperformed the U.S. market. Gains were due in part to better-than-expected economic data and rising expectations for interest rate cuts from the European Central Bank. Emerging markets, meanwhile, logged only modestly positive returns in Q1 (+2.4%) and solidly underperformed the U.S. market due to mixed Chinese economic data and a lack of substantial Chinese economic stimulus early in the quarter.

In terms of real assets, commodities saw strong gains thanks to still-elevated geopolitical tensions and a weaker U.S. dollar. Real estate had a tough quarter, in part due to continued concerns about the health of the sector, although many pundits are starting to believe that pricing may be at or near a floor outside of the office sector, presenting a compelling entry point for new investors.

As for fixed income, the leading benchmark for bonds (Barclays U.S. Aggregate Bond Index) realized a slightly negative return (-0.8%) for the quarter. Disappointing inflation readings were the primary reason for the weakness in bonds as the Fed delayed the expected start of rate cuts from March until June and caused bond investors to consider that rates may be higher than previously expected over the medium and longer term.

Why is the U.S. Economy So Strong?

For those of you who haven't noticed, it's pretty good out there from an economic perspective:

- Inflation is down from 9% to 3%.
- Jobs are plentiful, and the unemployment rate has been less than 4% for over two years now, the longest such stretch for over 50 years.
- Economic growth has been above trend – the U.S. economy expanded by 2.5% in real terms last year and looks like it might do the same again this year. (The pre-Covid trend was 2.0%.)
- Productivity is finally up after falling during and immediately after Covid.

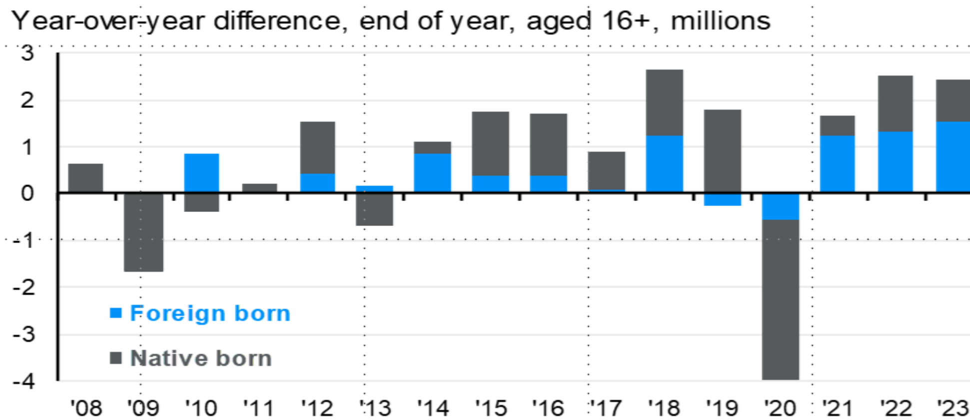
To put things in context, the overall U.S. economy has grown by about 8% in real terms since the end of 2019. During the same time, the euro area has expanded by only 3%, Japan by 1% and Britain not at all. The U.S. is the only big economy that is back to its pre-pandemic growth trend.

This wasn't supposed to happen. Rising interest rates were meant to slow economic growth and increase unemployment and, via this suppression of demand, reduce inflation over time. Why inflation came down and growth did not is the subject of a lot of research currently, but here are some leading theories:

- Supportive fiscal policy. While the Federal Reserve has been trying to suppress demand via raising the cost of capital, the federal government has been stoking demand via increased spending. This started with a very generous set of pandemic stimulus bills, followed more recently by several large fiscal government spending bills, including the Chips and Science Act, the Inflation Reduction Act and the Infrastructure Investment and Jobs Act.

- Mending of the supply chain. We all know how much the pandemic disrupted global supply chains (remember waiting a year to get a new sofa?) and led to a concentration in demand for goods we could enjoy during a pandemic (e.g., home office furniture) and away from things (e.g., travel) we couldn't. This concentration in demand with a challenged supply capacity due to Covid undoubtedly drove up prices, and so it's reasonable to believe that now that supply chains are largely repaired, inflation would moderate.
- Surge in productivity. While we can't be sure whether the U.S. is in the middle of another major productivity boom, recent data suggest a major uptick in output per hour – from -2.4% in late 2022 to +2.7% in the last quarter of 2023. As long as productivity is rising faster than wages, corporations don't have to raise prices to preserve their margins.
- Liberal immigration. Less well known and appreciated is that under the Biden administration, immigration is way up, helping to both boost economic growth and temper wage inflation. See Figure 2.

Figure 2. U.S. Labor Force Growth – Native and Immigrant Contribution



Source: JP Morgan

More research will undoubtedly turn up additional reasons why the recent performance of the U.S. economy has not followed traditional economic orthodoxy. I look forward to learning more.

In the meantime, it's worth pointing out that the U.S. economy has actually been doing very well for the last 15 years. One way to see this is by looking at the growth of the U.S. equity

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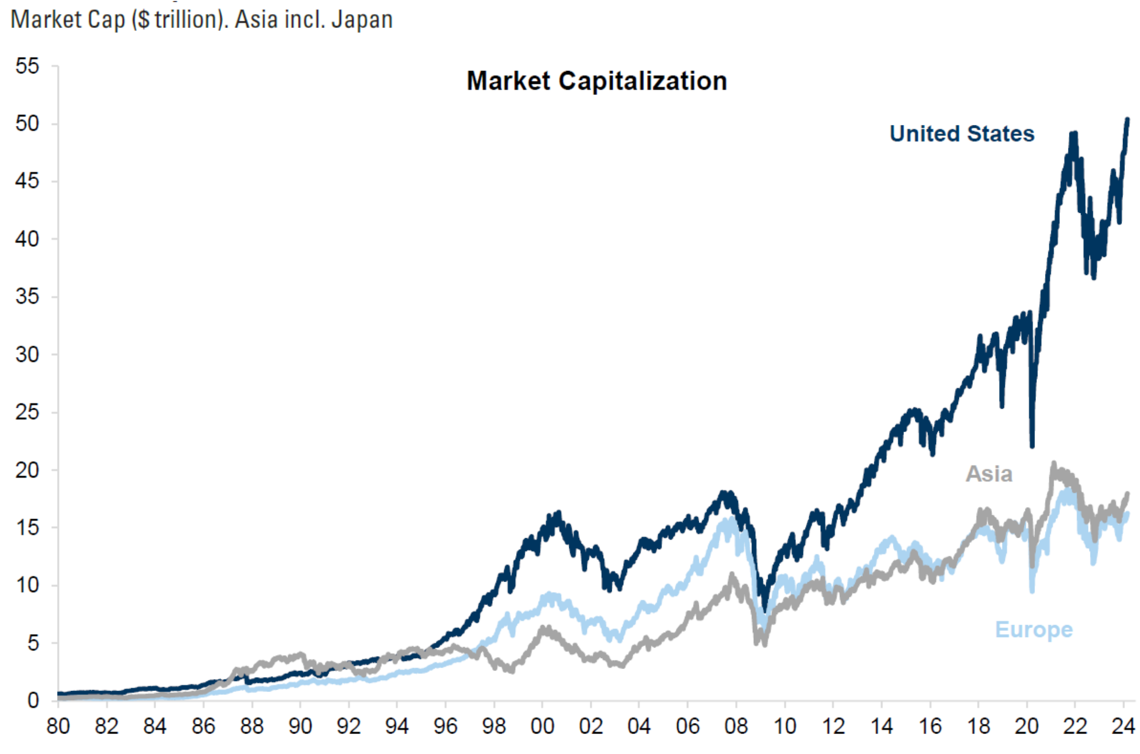
market relative to the rest of the world. See Figure 3. This change is due in large part to the earnings growth from U.S. companies outstripping those in the rest of the world.

Figure 3. Relative Size of the U.S. Equity Market



But why has this happened? Goldman Sachs just published an interesting report on the topic, and they point to the undisputed fact that the U.S. has more exposure to faster-growing industries (e.g., technology) than in the rest of the world and less exposure to slower-growing companies[1]. They attribute this to the U.S. having a more robust support system to grow successful companies, including a large domestic market, a well-developed and well-funded system for collaborating with universities and the government, and the greater availability of venture capital and private equity to fund start-ups and growth acceleration. Cultural differences may also play a role as it is often said that Americans are

[1] "The Concentration Conundrum – What to Do About Market Dominance". Global Strategy Paper No 66. Goldman Sachs, March 11, 2024.

more comfortable taking risk and attach less stigma to business failure than people in other countries.

Is the Stock Market Overvalued?

For whatever set of reasons, there is no question that American stocks have outperformed over the last decade or more. This excellent relative performance, particularly of late, has led to a big valuation gap with the rest of the world (and the gap persists even if one equalizes the sector weights across all regions). See Figure 4.

Figure 4. Forward Price/Earnings Ratios of Various Indices

But as Goldman Sachs points out, the U.S. valuation premium is not extreme once one adjusts for the higher rates of return on capital of U.S. companies. In other words, the U.S. market is more expensive, but it's worth it. In addition, the report's authors point out that the U.S. is structurally very attractive. Reasons cited include the fact that the U.S. is the only very large country with high per-capita GDP and deep, liquid capital markets. It also has a huge domestic market that insulates it from global turbulence, the best demographic outlook of any large economy except for India and the highest labor productivity in the

world. It's also the world's largest producer of oil and gas and is the undisputed technological leader.

So there are lots of reasons why U.S. company earnings growth and return on capital has outpaced the rest of the world and will likely continue to do so. Of course, not everyone agrees. One perennial and well-respected contrarian – Jeremy Grantham from GMO – thinks the U.S. market is severely overvalued currently, with a Shiller P/E of 34 for the S&P 500.[2][3] He points out that for the U.S. market in general, "there has never been a sustained rally starting from a 34 Shiller P/E. The only bull markets that continued up from similar levels happened in Japan in the late 1980s, and the U.S. technology bubble of 1998-1999, both of which ended very badly." In short, in his view, "the long-run prospects for the broad U.S. stock market look as poor as almost any other time in history."

It's always difficult to parse these arguments and different perspectives, and not everyone agrees with the Shiller P/E methodology. But to gain some perspective, during the peak of the dot-com bubble in 2000, Nasdaq (i.e., technology) stocks traded at a P/E of 200 at their highest point, or more than six times today's level, while the S&P 500 traded at a P/E of close to 45, more than twice today's level of 21. We are nowhere near where we were in 2000.

Some argue that the real issue is the overvaluation of the so-called Magnificent 7 stocks (Google, Microsoft, Tesla, Apple, Nividia, Amazon and Meta) as they are currently trading at a 30%+ premium to the rest of the index. But unlike the dot-com mania, the Mag 7 companies are large, extremely well-capitalized, and enjoy increasing returns, barriers to entry and a lot of momentum. In my view, the only key risk is if AI doesn't turn out to be a productivity or profitability game changer for industry. If this happens, we can expect the market to reprice downward.

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[2] Grantham, Jeremy. "The Great Paradox of the U.S. Market." GMO Viewpoint, March 2024.

[3] The Shiller P/E ratio is share price divided by the average of the last 10 years' earnings. In contrast, a forward P/E divides price by the next 12 months' *forecasted* earnings. The Shiller P/E has come under increasing criticism because it has been indicating that the U.S. stock market has been overvalued for a decade, yet we've had one of the greatest bull markets in history during this period.

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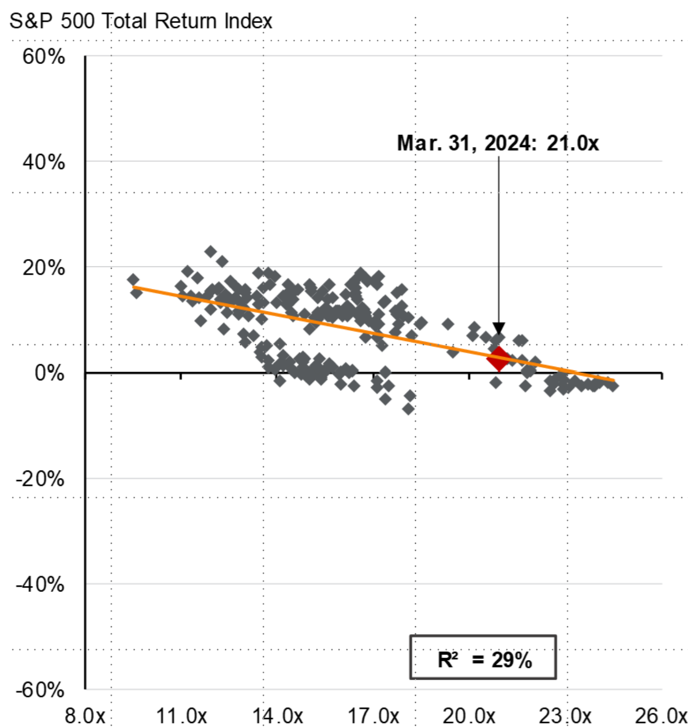
Artemis Strategy

Reading this piece might lead you to conclude that we should have all of our money in the U.S. We have recently increased our overweight to U.S. stocks relative to the all-country benchmark we use, but with over 30% of the S&P's value concentrated in just 10 stocks we also believe that it is important to be diversified and hedge some of this concentration. We do so by also investing in more mature high-quality companies that generate cash and are able to buy back shares and pay dividends, and smaller companies that should do better as interest rates decline.

Furthermore, we still believe in international diversification.[4] As we have been discussing, most of the outperformance of U.S. equities mainly reflects rising relative valuations -- and valuations do eventually revert to the mean. See Figure 5.

Figure 5. Forward P/E and Subsequent Five-Year Returns



[4] For a summary of the arguments in favor of international diversification, see Assness Cliff, Anitti Ilmanen, and Dan Villalon. "International Diversification – Still Not Crazy After All These Years." Journal of Portfolio Management. Volume 49, number 6. June 2023.

We also remain diversified in fixed income. Fixed income returns have not been great so far this year (see Figure 1 again). This is due to the Federal Reserve delaying its plans to begin pivoting to lower rates because the economy is doing so well. The market now believes that the Fed will only reduce rates three times this year (versus the six predicted a few months ago), hence we are not yet getting the hoped for appreciation bump in fixed income. But this may well still happen soon and if the Middle East war broadens out, we might all be glad indeed to have some safe fixed income in our portfolio.