Highland Capital
MANAGEMENT, LLC

QUARTERLY REVIEW

March 31, 2024

Q1 Economic and Market Commentary

The first quarter of 2024 started strongly with the momentum of 2023's strong returns (+26%) continuing as the S&P 500 posted a gain of 10.56% for the quarter. **This was the second consecutive quarter that the market posted a return above 10% (this has only happened 8 times since 1950), and the market has now risen in 5 of the last 6 quarters**. This was done in the face of rising interest rates as the 10-year US Treasury bond gained 32 basis points in Q1 and has stayed above 4% since early February. This is somewhat counterintuitive, as we normally expect rising rates to dampen equity prices, but in this case the rising rates have been viewed as indicative of a strengthening and resilient economy. The Fed has remained center stage and at their most recent meeting their forecasts still predict 3 rate cuts in 2024, which the market viewed as bullish, even though recent inflation data has proven to be more troublesome. They did however lower the number of anticipated cuts in 2025 from 4 to 3, while upgrading their projection for 2024 GDP growth from 1.4% to 2.1%, as well as raising both 2025 and 2026 slightly. **Their estimate for Core PCE inflation also increased from 2.4% to 2.6%, an acknowledgement that recent inflation stats have been hotter than expected**. The market has also embraced the notion that a better economy will underpin the expected solid earnings for 2024, which will support current lofty valuation levels. While it's possible that rates may remain higher for longer, it does seem as though the Fed is biased towards cutting rates and should employment or equity prices weaken to any great extent its likely the Fed would ride to the rescue. The Fed does have to be cognizant of election year optics however, and cutting rates in the fall could be problematic for the Fed. **While June has long been considered the timeframe for the first cut, recent inflation readings could push that date back**. The inflation numbers will be key to the course of the markets for the rest of the year, since markets have already discounted some degree of rate cuts, and a rebound in inflation would certainly be problematic.

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The Economy

The US economy ended the year on a solid note with 4th quarter GDP rising 3.4%. Growth of 2.5% in 2023 was better than expected, and Q1 2024 should expand at a 2.1% rate. Rate increases did little to slow the economy except for highly interest sensitive sectors such as housing and manufacturing. The economy failed to slow as much as expected due to the Treasury conducting its own stealth Quantitative Easing program at the same time the Fed was doing Quantitative Tightening. **Since October of 2022 liquidity provided primarily from the Treasury's General Account has exceeded the reduction in the Fed's balance sheet (roughly $1.4 Trillion reduction) by almost $417 billion, with half of that coming in the last five months**. Financial assets tend to do well when liquidity is rising, therefore it's no coincidence that the equity market is up 25% since November of 2023. The jobs picture has also remained solid with unemployment at 3.8% in March. Average Hourly Earnings are up 4.1% y/y, and still need to move lower for the Fed to reach their 2% inflation bogey. If wages remain high productivity will need to improve to offset the inflationary pressure of higher labor costs. **The Fed's favored Core PCE came in at +0.3% and was down from an upwardly revised +0.5% for January but was up 2.8% year over year.** The Fed described the reading as being in line with expectations, but the "stickiness" of the inflation readings has caused investors to moderate their outlook for rate cuts this year from 6 to just 3, and that number could move lower if inflation persists. The recently released Manufacturing PMI report shows manufacturing expanded for the first time after having contracted for 16 months. However, the prices paid component jumped 3.3% from February, the highest level since July 2022. As manufacturing rebounds, factories are passing on price increases to consumers. **In addition, inflation has dampened consumer confidence. The Conference Board Survey shows consumers were more negative in March as their short-term outlook for income, business, and labor market conditions fell to 73.8 from 76.3 in February.** Readings below 80 often signal an upcoming recession, but we would discount that reading in an election year. A bright spot is that inflation expectations remain anchored around 2.7 – 2.8%. There is evidence that the US consumer is tiring however as retail sales in February rose at a 0.6% rate, which was less than the 0.8% expected, but up from a 1.1% drop in January. With credit card balances also growing it's an indicator that consumers are feeling pressured. The Personal Savings Rate fell to 3.6% for February, down from 4.7% a year ago. This is below pre-Covid levels of 5%+ and the long-term average of almost 8.5%. But politicians are priming the economic pump with fiscal spending, and while it may be a near term positive for the economy, that same spending leads to deficits, which could keep pressure on interest rates well into the future. **The deficit for fiscal year 2024 will be $1.6 trillion (5.6% of GDP), growing to $1.8 trillion in 2025 (6.1% of GDP)**. Since the Great Depression deficits have exceeded that level only during and shortly after WWII, the 2009 financial crisis, and the pandemic. In fact, this level of deficit is historically associated with an unemployment rate near 7%, not the current 3.8%. As we've heard repeated many times, "this is not sustainable", yet real attention to address the issue is absent.

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Market Review

First Quarter Equity Market Recap:

The first quarter of 2024 was the best first quarter since 2019 with the momentum of 2023 extending into the new year as the S&P gained 10.56%. **During this run the index notched 21 record closes**. To keep this return in perspective, the S&P has averaged a 10% return for the entire year over the past thirty years. The outlook for improving corporate profits, excitement around AI, and potential Fed rate cuts drove the positive returns. The market stumbled in the early days of January, but recovered to new highs, with the market erasing all the losses from the 2022 bear market before the end of January. **For the most part, the top performing sectors of 2023 were still the top performing sectors in Q1**. Communication Services gained 16.7% led by Meta (+37.4%), and Technology added another 14.1%. The Tech sector was led by semiconductors, with the semi-index up 40%. The Magnificent Seven were not all magnificent in Q1, and some are now reducing the Mag 7 to the Fab Four (Nvidia, Microsoft, Meta, and Amazon), with Apple (-11%), Tesla (-29%), and Alphabet +8% losing some momentum for the time being. **In an encouraging sign, the market returns did broaden as every sector produced a positive return in Q1 except for Real Estate (-2.9%) which was weighed down by higher interest rates**. There was an improvement in cyclicals performance as Energy (+11.2%), Financials (+10.5%), and Industrials (+10.3%) all performed much better. And while Large Value stocks (+8.98%) still did not outperform Large Growth stocks (+11.39%), the spread narrowed considerably versus what we saw in 2023. Brent crude rose over 13% in the quarter, as global growth forecasts were raised, the International Energy Agency hiked its oil demand forecast, and geopolitical tensions heightened. In a strong "risk on" market the defensive categories once again lagged, with Utilities gaining just 1.7%, Consumer Staples up 6.5%, and Healthcare +7.1%. In another indication that the US consumer is feeling some duress, Consumer Discretionary was up just +4.2% in Q1.

Stock Market Indexes

Market/Index	2023 Close	March 31 Close	March Return	YTD Return
DJIA	37,689.54	39,807.37	2.21%	6.14%
Nasdaq	15011.35	13,219.32	1.85%	9.32%
S&P 500	4,769.83	4,288.05	3.22%	10.55%
Russell 2000	2,027.07	1,785.10	3.58%	5.17%
IEFA	70.35	64.35	3.37%	5.50%

What to Expect Going Forward:

At the start of the year the market consensus was expecting 6 rate cuts and a soft landing. **Within a matter of weeks consensus has trimmed the number of rate cuts expected to 3 or less (first cut no sooner than June and likely later), and economic data is coming in stronger than expected, perhaps indicating that the economy will do better than a soft landing**. The market gains in Q1 were largely predicated on that positive outlook. Now the inflation picture is cloudier, rate cuts look less supportive, yet the market has for now shrugged off this deterioration in the macro picture. Whether or not these gains can be maintained will be determined by earnings. **It seems the market is encouraged that the earnings picture in 2024 is substantially better than 2023**. Q4 earnings came in at +4.2% versus the estimate of just 1.5%. The first quarter of 2024 is expected to see earnings growth of +3.6%, which will be the third consecutive quarter of earnings growth. Given that 2023 had earnings growth of just 1%, the improvement is necessary given the valuation of the market. The market gains in 2023 were driven by valuation expansion, and at some point, the earnings must materialize. **While Q1 earning growth of 3.6% is not flashy, the pace of acceleration over the next two quarters is better with Q2 estimated at +9.4% and Q3 at +8.5%, ultimately leading to full year eps growth of 11%**. Analysts start a new year more optimistic about their earnings forecast, only to trim estimates as the year progresses. This year, however, the rate of reduction is lower than normal. For Q1 analysts reduced their estimates by 2.5% versus the 5-year average of a 3.7% cut. Full calendar year estimates also get reduced in the first quarter on average by 2%, yet the 2024 earnings estimate was only reduced by 0.4%. So, analysts have a higher confidence level in their 2024 estimates, and if those earnings materialize, then valuation levels are justified. And 2025 earnings estimates currently project another increase of 13.4%. But plenty of pitfalls could lie ahead. **The escalation of geopolitical events is having an impact on oil prices, shipping logistics, and subsequently inflation**. The most recent manufacturing data shows prices paid increasing and being passed along to consumers. If consumers balk at higher prices or simply become tapped out, companies will have to absorb the higher costs and the negative impact to profitability. **It now appears that interest rates will stay higher for longer**. Will this have a detrimental impact on the economy? Many Commercial Real Estate projects will need to be refinanced over the next few years. Some of those projects will go into default if more amenable rates and terms don't exist. This would cause some distress for smaller banks, but not the larger banks. Nevertheless, unexpected events can cause outcomes that could change the current outlook. **But we remain constructive on the equity market and expect the strength of the political year spending to carry the day**. The last time the S&P fell in a presidential re-election year was 1940. The average return in re-election years since 1944 has averaged +15.8%. While valuations are not cheap, they also do not appear excessive given that the median P/E is 19X when excluding the Magnificent 7. The market has supported a P/E of 19.5X when the 10-year US Treasury has been between 4 – 6%, and a 17.5X P/E with inflation between 2 – 4%. We are within those ranges, and with good earnings growth upcoming we believe current price levels can be supported.

Fixed Income Recap and Outlook

In the first quarter of 2024, the Federal Reserve maintained the fed funds rate target range at 5.25%-5.50%, in line with market expectations. Despite this decision, subtle shifts in the finer points of the Fed's communication suggest a hawkish undertone compared to the December Summary of Economic Projections (SEP) and recent Fed communication. Notably, the outlook for inflation has been revised higher, with some FOMC participants adjusting their rate projections upward. Additionally, the Fed's balance sheet will continue to progress according to previously announced plans. Changes to the Fed's statement were minimal, with a continued emphasis on the need for "greater confidence" before considering rate cuts. The statement reiterated the commitment to balance sheet runoff.

Key highlights from the FOMC meeting include:

- The median projection for 2024 still indicates a likelihood of three rate cuts this year, despite some upward movement in rate projections within this measure.
- Projections for the out years showed a general upward trend, with the median 2025 fed funds estimate increasing from 3.625% to 3.875%. Moreover, the median longer-run projection for fed funds increased from 2.5% to 2.625%, signaling a subtle but noteworthy shift within the Committee.
- The end-2024 core Personal Consumption Expenditures (PCE) projection shifted upward from 2.4% in the December SEP to 2.6%, aligning with previous projections. Additionally, GDP growth estimates for 2024-2026 were revised upward, implying a more patient approach by the Fed towards initiating rate cuts.

The Bloomberg Barclays Aggregate decreased -0.78% during the quarter. The Bloomberg Barclays Intermediate US Government/Credit index decreased only -0.15% during the quarter. The general theme for the first quarter is that ultra-defensive (i.e. shorter duration) bonds performed the best, a reversal from the fourth quarter of 2023. The 10-year Treasury ended 2023 yielding 3.88% and increased 32 basis points during the first three months of the year to reach 4.2%.

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The large overhang in the bond market continues to be the fiscal concerns facing the United States government. Outside of the pandemic years, last year marked the highest federal deficit in United States history. According to the Congressional Budget Office (CBO) for fiscal year 2023 indicated to grow the deficit by $2 trillion dollars, nearly $1.1 trillion larger than the prior year. Federal spending on interest payments is forecast to hit $870 billion this year, exceeding the $822 billion that the nation will spend on defense in 2024, according to a recent analysis by the Congressional Budget Office. The outlays for interest payments increased 32% during the last fiscal year for the United States.

Fortunately, the concerns hanging over the Treasury market have not impacted the red hot issuance in the Investment Grade corporate bond market. The first three months saw the busiest first quarter on record with $529 billion of issuance. Issuance has benefited from rich valuations in the corporate bond market, as issuer spreads have contracted in line with the strong bid in the stock market. The corporate bond market has also benefited from investor demand. High grade bond mutual funds have experienced twelve consecutive weeks of inflows this year and 21 weeks in total.

In terms of the ongoing risk of inflationary pressures, inflation growth rates continue to decline, according to key measures such as the Consumer Price Index-CPI and Core CPI-ex food and fuel. The rate of decline has slowed, however the rate of inflation is still well above the Fed's target rate of 2%. As we start the second quarter, recent inflation readings should give the Fed ample reasons to not cut rates in 2024. Wages, compensation, consumer spending and accelerating prices in the commodities market could spell another wave of inflation. Investors should be cognizant to not hang onto every single word from the FOMC, as they predicted inflation to be transitory in 2020/2021. At the start of the year, the market was anticipating the Fed to lower rates by approximately 150 basis points. Recent developments have caused the market to recalibrate expectations for 2024. The shift in sentiment is casting a doubt on bets that the first rate cute will take place in June. The probability of a quarter-point reduction in June is basically a coin flip. Markets and investors are always micro focused on the path of interest rates. However as long term investors, we believe the key to success is simply focusing on asset class valuations and deploying capital in areas that offer the best outcome regardless of what the Federal Reserve decides to do in the future.

As always are here to assist you in any way and to answer your questions. We appreciate the opportunity to serve you and value the trust and confidence that you have placed in us.

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