PrivateWealth
Partners, LLC

FIRST QUARTER
2024 REVIEW

April 12, 2024

Dear Friend,

The stock market rally that started last October persisted in the first quarter of 2024. While mega-cap technology and growth stocks in general continued to outperform (save for Apple and Tesla, which fell during the quarter), positive returns were experienced more broadly across style, size, and sector. 195 companies in the S&P 500 outperformed the index's 10.6% return in Q1, with many outperforming names coming from the Energy, Financials, and Industrials sectors.

All told, the S&P 500 hit 22 new all-time highs in the first quarter alone, with just a 1.7% maximum drawdown in the first three months. In the past 50 years, any time the S&P 500 has risen 25+% in a 100-day period (as it has since last October), the index was another 15% higher a year later (on average) and positive 98% of the time. Historically, all-time highs tend to happen in clusters.

Low volatility and extremely strong returns certainly open the door for an equity market correction of some kind this year. Downside volatility following a sustained rally would be normal. But given strong economic fundamentals, earnings growth, and expectations for anchored inflation, stocks remain attractive on an intermediate-term basis.

> **Private Wealth Partners owns companies we think have a strong earnings outlooks in 2024, while also having strong balance sheets to withstand any unforeseen turbulence.**

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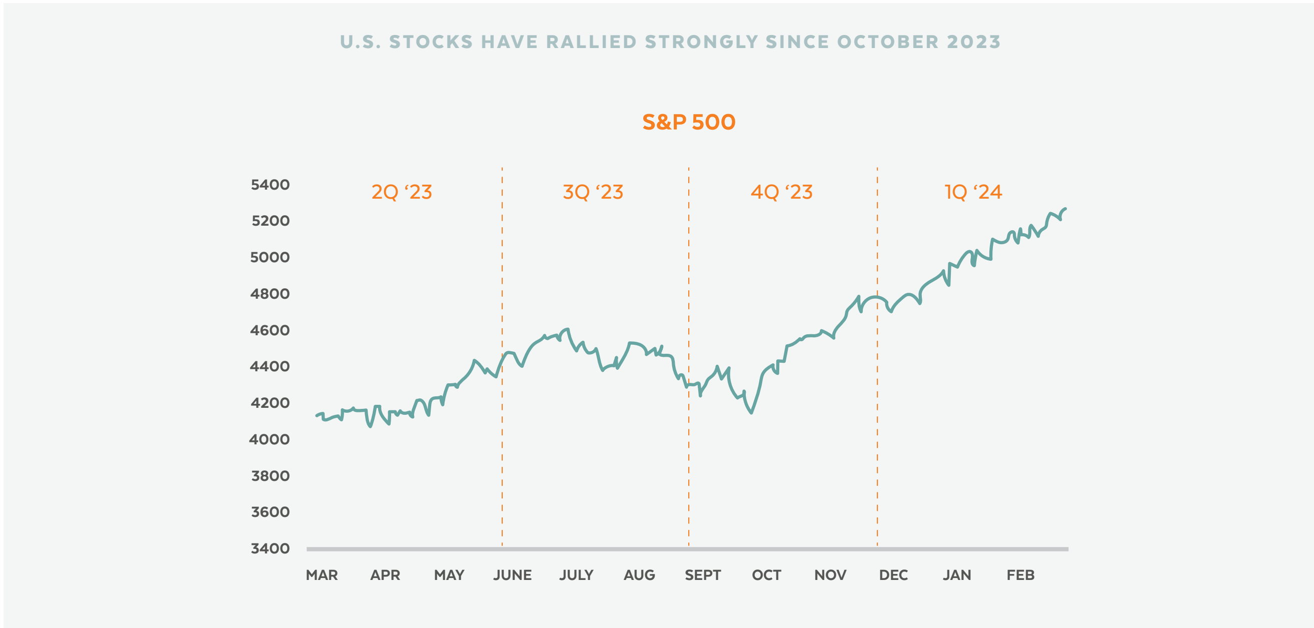
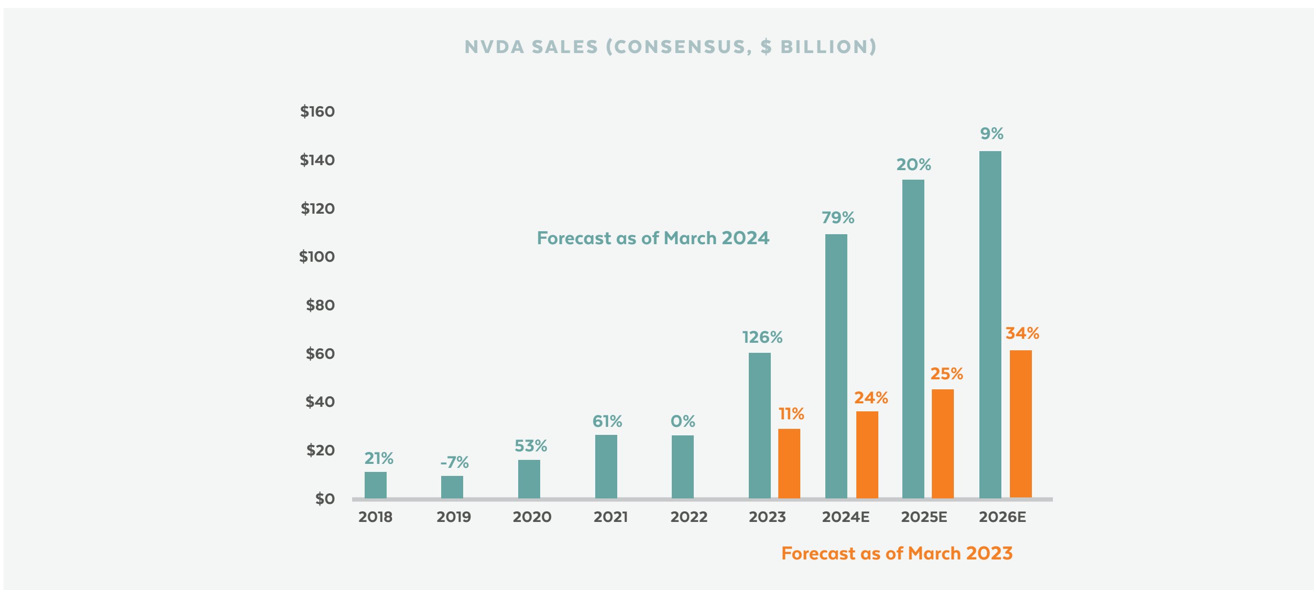


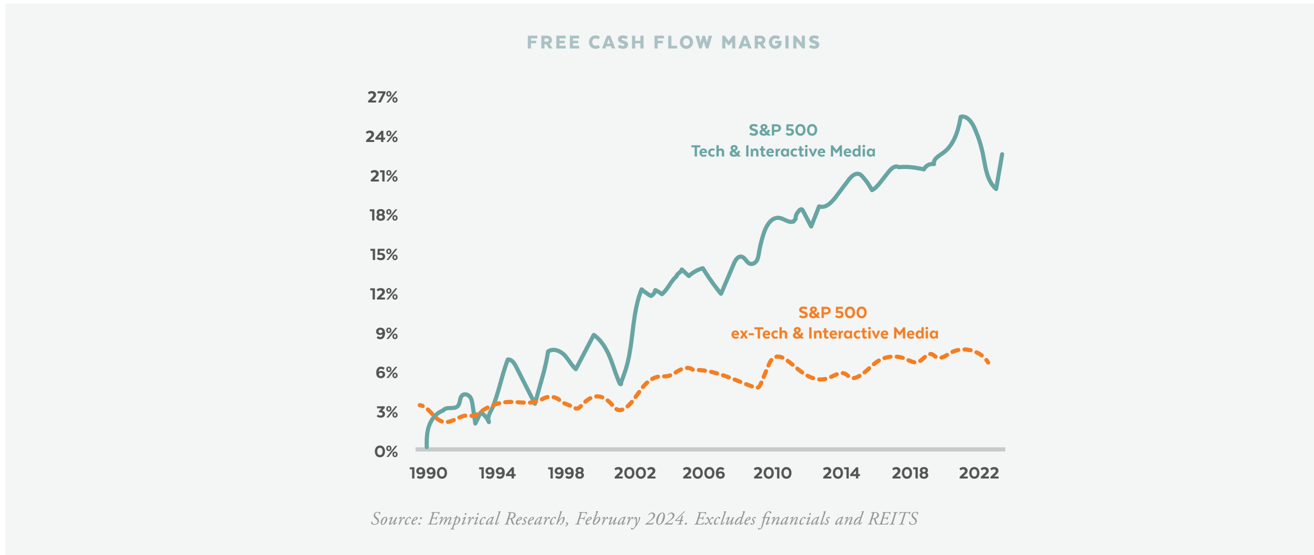
Source: Strategas Research

While market breadth notably improved in Q1 2024, Technology continues to be ripe with opportunity. As detailed in our AI white paper last October, the data center hardware theme is a big reason why. For example, in Q1 Nvidia rose +82.5% and was responsible for over 20% of the S&P 500's total return. And this sharp increase followed a 200+% return posted in 2023. Returns of this magnitude may be hard to fathom. But as research partner Goldman Sachs points out, even with the staggering price increase *"Nvidia's valuation (next-twelve-months P/E ratio) is still below its five-year average. Its earnings growth has actually outpaced its price gains."*



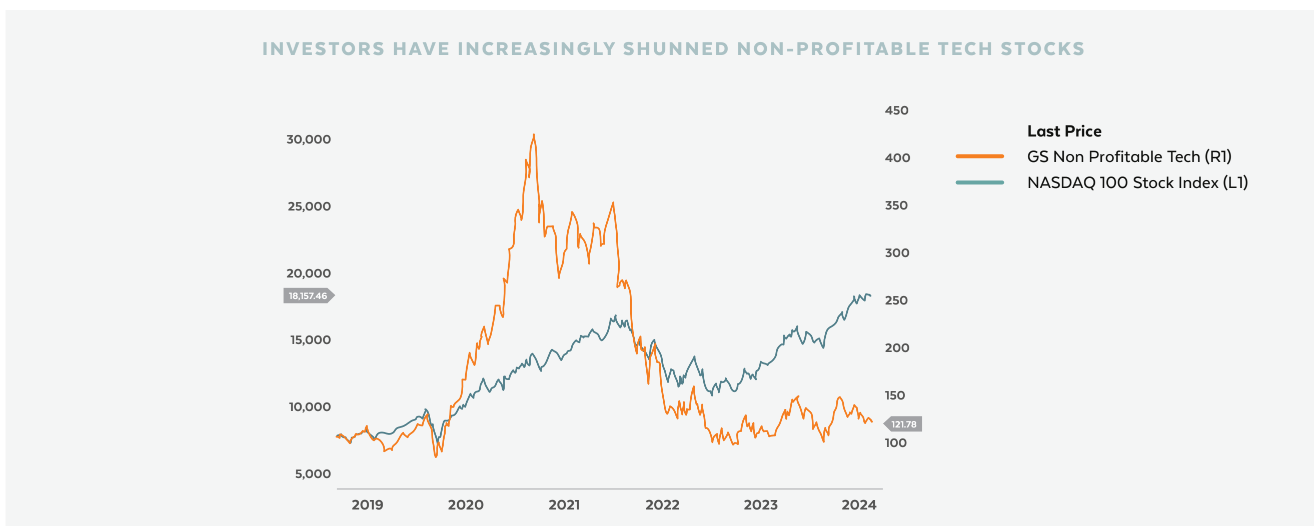
Source: Goldman Sachs

Investors can easily get over-excited about new innovations in technology, especially ones with the promise to reshape the entire economy. Readers remember the 2000 tech bubble. What's different about today, however, is that the game-changing innovation—generative artificial intelligence and machine learning—are already generating massive profits for companies producing the chips, servers, and infrastructure needed to power this nascent technology. Major AI suppliers and beneficiaries alike are seeing incredibly strong free cash flow margins, as seen on the chart below.



Source: J.P. Morgan

Another key is that unlike 1999 (and 2020), unprofitable tech companies are not seeing the same kind of valuation surge that accompanied more speculative technology bull markets of the past. While many of the highest-quality tech company valuations are back up near the 2020/2021 highs, investors are clearly favoring companies with strong and rising earnings—signaling a 'healthier' rally in the sector. The bust of non-profitable technology stocks in 2021 and 2022 created a much different positioning set-up, with scared investors fleeing the sector just as Artificial Intelligence emerged.

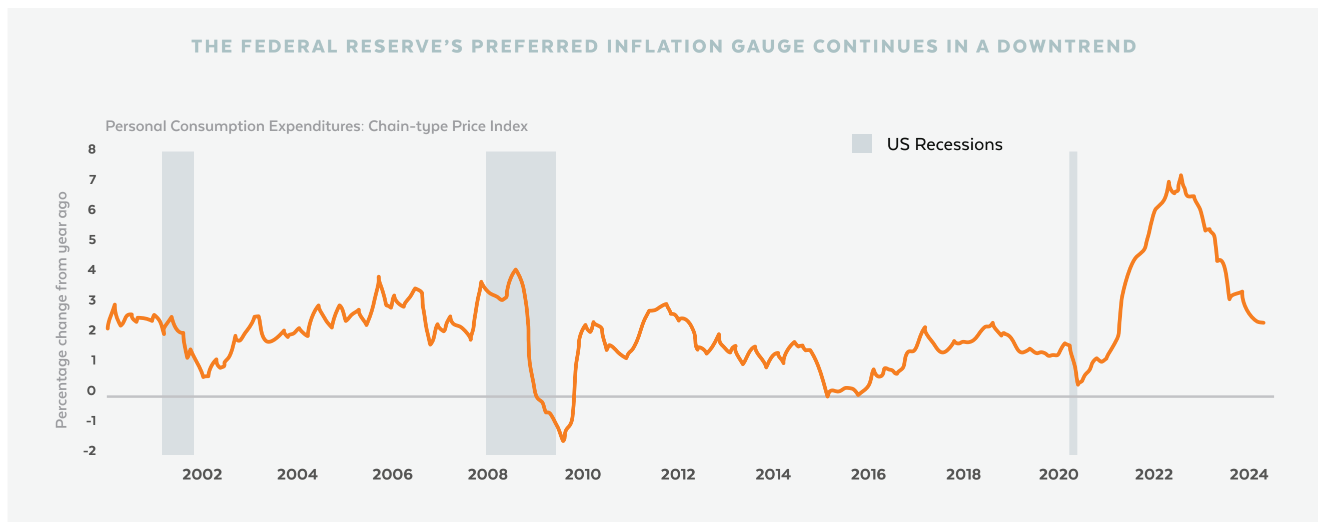


Source: Bloomberg

THE U.S. ECONOMY

In our first quarter review last year, we wrote that *"the table is set for a peak in the interest rate cycle, likely this summer. We've also made the case [in Q1 2023] and in previous quarters that inflation should continue in a downtrend."*

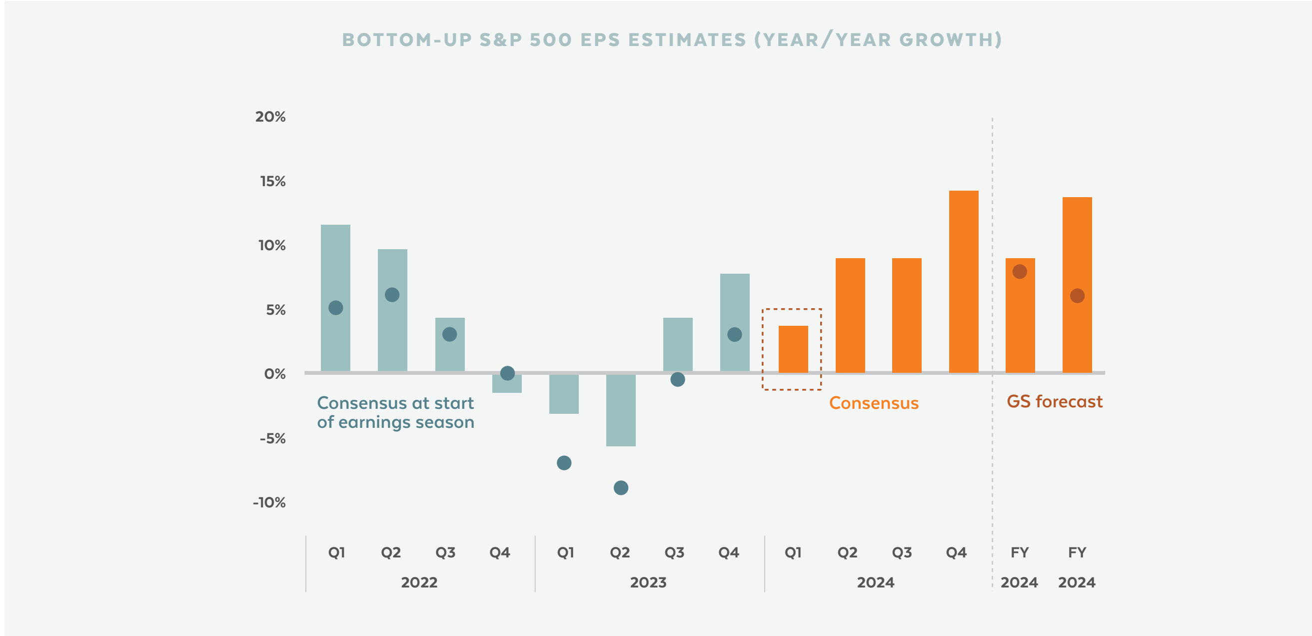
Both of these outcomes occurred, with the Fed last raising rates in July 2023 and inflation falling steadily from its peak in June 2022. The pain of 2022's very sharp interest rate increases creates a much more favorable backdrop, as that scenario is extremely unlikely to repeat—and could in fact become a tailwind.



Source: Federal Reserve Bank of St. Louis

Earnings were a bigger driver of positive returns. S&P 500 earnings entered a weak patch in 2023, with three consecutive quarters of negative year-over-year growth. The Energy sector was a major drag during this period of weakness, which obfuscated reasonably good performance in other areas of the economy. The 'earnings recession' ended in the second half of last year, and solid earnings growth is expected in 2024.

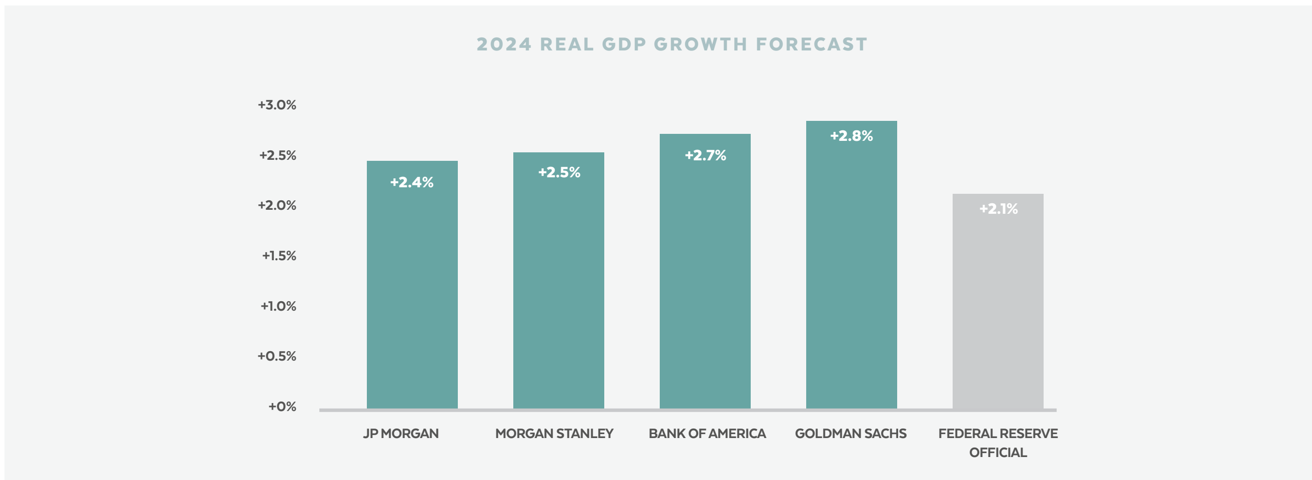
> This 2024 earnings recovery is "likely the key reason why the rally has marched on even with less Fed rate cuts in the cards."
>
> – GOLDMAN SACHS



Source: Goldman Sachs

The Bureau of Economic Analysis revised Q4-2023 U.S. GDP higher in their "third" estimate, from 3.2% to 3.4%. The upward revision was attributed to stronger consumer spending and business investment, partially offset by a downward revision to private inventory investment. The jobs market remains stable, with March payrolls showing a 303,000 increase and the unemployment rate ticking lower to 3.8%—which marks 25 consecutive months below 4.0%.

A healthy jobs market and rising real wages continue to support the U.S. consumer—the lifeblood of the U.S. economy. Strong levels of spending almost always result in positive economic growth, which is what we see in the year ahead. As seen in the chart below, many major banks are also more optimistic about growth in 2024 than the Federal Reserve.



Source: Bloomberg as of March 2024

RISKS TO CONSIDER

There are always many risks to weigh, but here are four prominent ones on our watchlist.

1. Geopolitics

Markets have largely priced-in the impact of the two ongoing wars in Gaza and Ukraine, but an escalation or an expanded war (Iran's more direct involvement for example) could not only cause human toll and increase uncertainty, it could also directly create oil supply shocks and/or more supply chain disruptions in the Red Sea and possibly elsewhere. These sorts of developments could complicate the inflation picture (see risk #3 below).

In the realm of geopolitical uncertainty, there's also Taiwan. All of AI's promise and potential relies heavily on the most advanced, highest-performance semiconductors. Losing access to this critical supply would be a major setback for the U.S. and global economy. It would also directly impact earnings growth for key technology companies in the AI business, like Nvidia. According to a recent analysis by the U.S. International Trade Commission, *90% of advanced chips designed by Nvidia, Apple, and Broadcom are reportedly made by one company: Taiwan Semiconductor.*

In short, a Chinese invasion of Taiwan would be calamitous.

The U.S. is pushing to accelerate domestic manufacturing of advanced semiconductors with major investment incentives coming from the recent CHIPS and Science Act, but the road is long. The goal is for at least 20% of the world's most advanced chips to be made in the U.S. by 2030—up from 0% today. While China knows the U.S. would defend Taiwan for this reason, the threat of this possibility—even without actual incident—could be a reason for a market volatility.

2. Regulatory headwinds for Technology

Overseas, the European Union began enforcement of the Digital Markets Act on major tech companies, which is likely to raise costs in the form of adjusted business practices, strategies, and compliance.

Here in the U.S., the Justice Department sued Apple, accusing the company of monopolizing smartphone markets. These legal fights and forced adjustments to business practices are likely to stretch out over many years, and may result in some level of drag on earnings. But the bigger risk is that a major company is forced to be broken up, or that regulations target major revenue sources. We do not foresee either of these latter outcomes, but it's worth noting that the appetite for regulation is high and rising.

3. Inflation shock

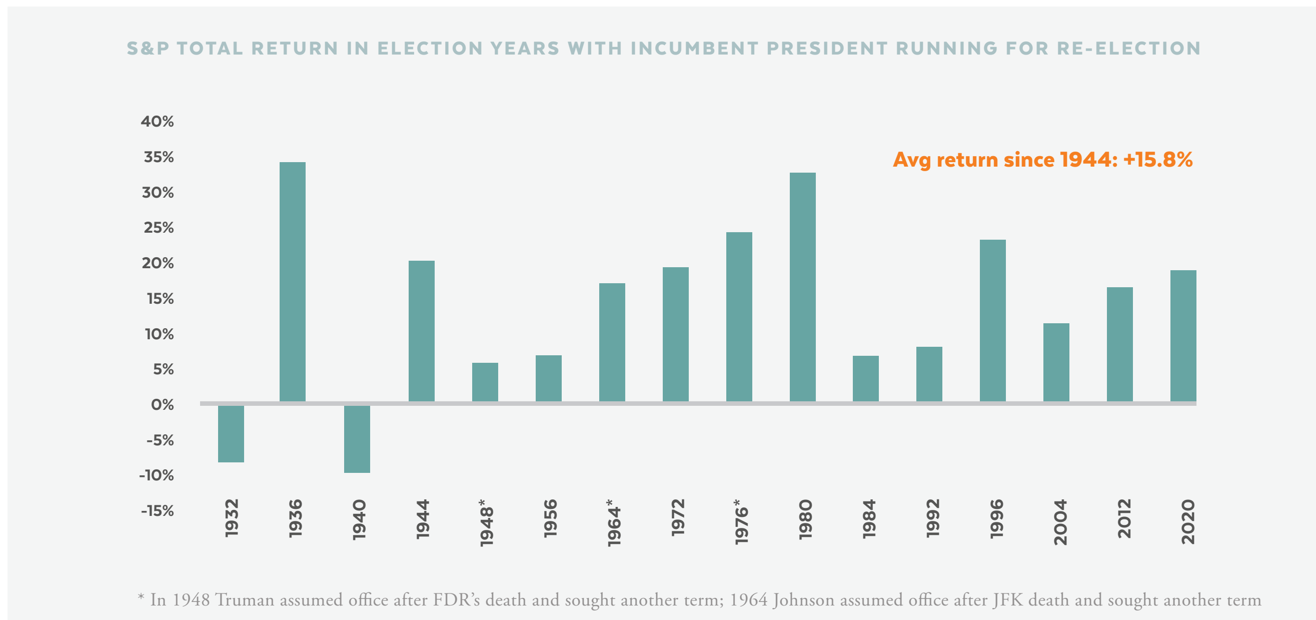
Federal Reserve Chairman Jerome Powell has indicated that policymakers are not necessarily looking for dramatically better inflation readings in the months ahead. Rather, they just want to see progress continue toward their goal, which is really not even projected to be hit until the end of 2025. The consensus has been for three rate cuts in 2024, with the Fed's longer-term projections showing the benchmark fed funds rate settling just under 4% by the end of 2025 and slightly north of 3% in 2026.

In our view, the risk of a large inflation shock is quite low, especially given that the fed funds rate is already positioned well above their long-term target. But with the economy turning up and inflation still above target, we do need to see continued progress or else investors could get frustrated. What would really hurt markets is if inflation becomes un-anchored from its current 2.5% to 3.5% level, perhaps because of some unforeseen shock in geopolitics or the global economy. If the Fed is forced to go in the other direction—raising rates instead of cutting them—the negative surprise would likely impact risk assets adversely.

4. U.S. presidential election

There isn't much we can say about the upcoming election that readers do not already know. The uncertainty is high, and markets don't like uncertainty.

But if history offers a consolation, the S&P 500 has been positive in all but two elections since 1932 when an incumbent is running for re-election. We would expect volatility in the months leading into November, but would hope for a decisive result to eradicate uncertainty and allow markets to refocus on positive core fundamentals.



Source: Strategas Research

CONCLUSION

U.S. stocks experienced an inflation and interest rate shock in 2022, driving a bear market that lasted nearly 10 months. But since then, inflation and expectations for future inflation have trended steadily downward, and we believe significant progress has been made toward the Fed's long-term target. This positive development has led to optimism that interest rates have peaked, and will likely be lower in the future than they are today—a tailwind for risk assets.

As the inflation picture improved, the U.S. economy continued to grow, defying many market participants' expectations for a recession. U.S. corporate earnings experienced a soft patch in the first half of 2023, but the Energy sector drag was a major factor and the outlook for earnings growth flipped back to positive by Q3 2023. All the while, investor enthusiasm for massive earnings and productivity growth potential has accompanied the revelation and rapid development of artificial intelligence. This has ushered-in staggering new revenue and profit growth for 'AI suppliers' – which more specifically means companies that enable high-end data centers to deliver AI services to private businesses as well as the public internet.

The U.S. presidential election will become more of a distraction as the year progresses, and history suggests volatility could increase alongside uncertainty in the months leading up to Election Day. But history also tells us that a post-election rally is common, regardless of who wins. Time in the market will matter more than timing the market in 2024.

If you have any questions about this review, our strategy, or your portfolio, please do not hesitate to reach out to us. We wish you bright and colorful spring season.

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