Maclura Investments

1Q24 Review - Momentum Continues, But Uncertainties Persist

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During the first quarter of 2024, the market continued its upward momentum and returned 10.24% (Morningstar US Market benchmark). The market saw a broadening of its performance from the 2023 Magnificent 7 driven market to all market cap segments (small to large capitalization) performing well as illustrated in the table below. Fixed income benchmark returns for the first quarter were in the low single digits, with the short duration bills fairing best as the yield curve continues to be inverted with higher yields on the shorter maturing bonds.

Exhibit 1. Investment-Style Returns

	Morningstar Index Market Returns	2016	2017	2018	2019	2020	2021	2022	2023	2024 1st Qtr.
Growth	U.S. Growth	3.16%	29.52%	0.78%	35.90%	44.65%	24.79%	-36.70%	38.48%	8.32%
	Large Growth	1.79%	31.15%	2.94%	33.81%	38.86%	21.47%	-40.36%	47.26%	9.59%
	Mid Growth	6.46%	25.67%	-3.16%	36.01%	46.17%	14.97%	-32.37%	25.38%	10.56%
	Small Growth	9.61%	23.77%	-5.67%	27.60%	43.52%	-1.00%	-33.13%	26.65%	5.29%
	US Market	12.44%	21.47%	-5.05%	31.22%	20.99%	25.78%	-19.43%	26.44%	10.24%
Value	U.S. Value	20.79%	14.23%	-7.51%	25.09%	-1.31%	23.98%	-0.72%	11.98%	9.46%
	Large Value	18.91%	15.09%	-5.90%	25.70%	-0.62%	21.49%	0.26%	11.82%	8.89%
	Mid Value	25.21%	13.02%	-10.63%	24.81%	-3.76%	29.02%	-2.39%	10.94%	9.17%
	Small Value	27.96%	8.40%	-16.61%	19.96%	1.01%	31.79%	-6.60%	14.58%	4.64%

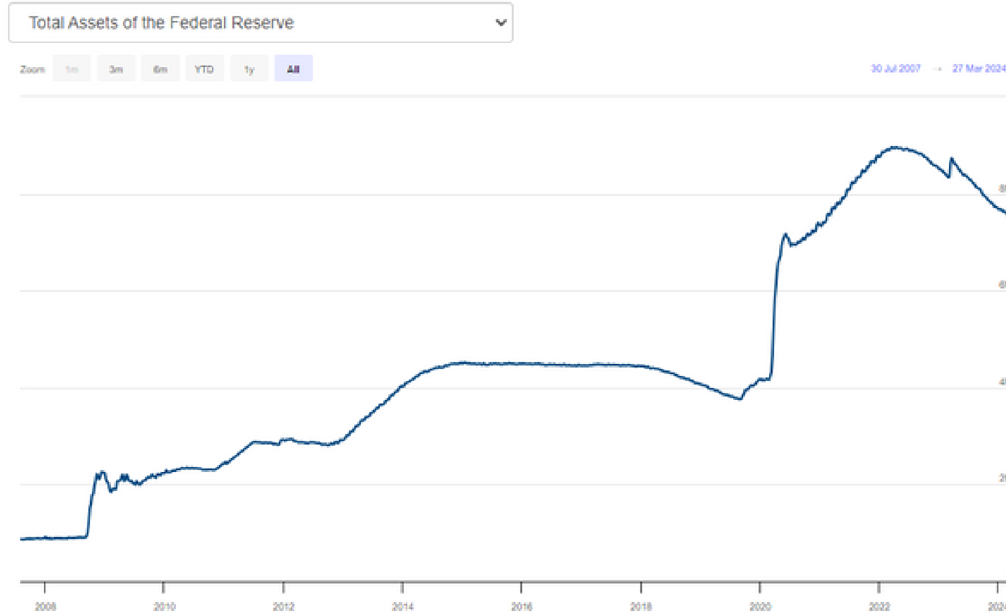
Source: Morningstar

The resiliency of the economy continued to drive the resiliency of the market, making the first quarter the strongest since 2019. At the start of the year, the markets were anticipating that the Federal Reserve would implement multiple cuts to the Federal Funds rate throughout the year starting with the March meeting, but an uptick in inflation in January and February, along with a lingering hawkish bias by the Fed, ruled out the March cut.

While the Federal Reserve has kept its restrictive stance of monetary policy and maintained the target range for the federal funds rate at 5¼ to 5½%, the Committee did reiterate that if the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint later this year. Most of the Committee members are forecasting three cuts before year-end. Additionally, the Fed's March meeting was the first meeting at which the committee discussed slowing the pace of decreasing the Federal Reserve's balance sheet (quantitative tightening). Since the Federal Reserve started reducing their balance sheet last year, it has declined by nearly $1.5 trillion.

During the press conference after the FOMC meeting, Chairman Powell stated that the intent of slowing the pace of monthly decrease of the Federal Reserve balance sheet was to maximize the lowering of debt held by the Federal Reserve. Additionally, he indicated that the bank's eventual goal would be to only hold US Treasury Securities. With the current balance of the balance sheet just over $7 trillion, and nearly $2.3 trillion of that being in mortgage-backed securities, there is a long runway to get the Fed's balance sheet back to pre-covid levels.

Exhibit 2. Federal Reserve Historical balance sheet trends



Source: Federal Reserve Bank of St. Louis

Before any reductions in the range of the Federal Funds rate takes place, the committee first must be confident that inflation is moving sustainably down towards 2%. During the last week of the quarter, the Federal Reserve's preferred measure of inflation, the Core Personal Consumption Expenditures Price Index (PCE), was released for February and reported to show year-over-year growth of 2.8%. Chairman Powell mentioned in his comments during the press conference that the committee expected that the road to 2% would be bumpy.

With most of the Federal Reserve committee members forecasting three cuts to the Federal Reserve Rate totaling 75 basis points during 2024, the market is currently estimating that the first cut would likely come at the conclusion of the FOMC June meeting (June 12). While a 25-basis point reduction to the Federal Reserve rate will likely have minimal to zero impact on most Americans, the stock market will likely react positively to the start of a more "dovish" monetary policy with the anticipation of more cuts being realized in the future.

Inflation vs the 1934 $50 Bill

From an economics perspective, inflation is the general increase in price of a basket of goods and services measured over a period. Otherwise referred to as the decreasing purchasing power of money, the US dollar. While currency (cash) is an efficient means for transacting commerce in a society, it is a horrendous investment as illustrated in the following example. During college, I worked as a teller at a local bank, and whenever "unusual" bills or coins were made in deposits, I would purchase them out of my drawer. A particular 1934 $50 dollar bill caught my eye one day and, after much consideration (particularly because of what $50 meant to a college student in 1990!), I splurged and acquired the bill.

The bill was minted five years after the stock market crash of 1929 and two years after President Roosevelt took office, but the Great Depression still had seven more years until it ended in 1941. Stories from that generation would often refer to hiding cash under mattresses because they didn't trust the banks. Wondering how much this bill could be worth, a quick search on EBAY concluded that it could fetch $70 from a collector, but worst-case scenario the bank would credit our checking account at least $50.

Being an investor, my real curiosity was what it would have been worth if the bearer of the bill had invested it in 1934. According to the IRS, the average net income on tax returns filed during 1934 was $3,125. The $50 bill represented 1.6% of household income during that year. While I admit that there is some survival bias regarding the limited number of public companies from that period that are still public today, it would be obvious back then that railroads were a relatively safe investment. Union Pacific Railroad had 2.2 million shares outstanding during 1934 and traded between $99.75 to $133.88 a share during that year. If it were possible to purchase $50 worth of Union Pacific in 1934 at the mid-point of the trading range, it would be worth $33,626 at the end of March 2024. In addition to price appreciation and stock splits over the past 90 years, the company also paid annual dividends. Assuming that the dividends were just put under the mattress, that $50 bill would have generated an additional $7,592, for a total appreciation of $41,218! If the dividends were invested to yield a conservative compound annual growth rate of 5%, the total return would have been $53,404! Instead, all I have is a lousy $50 bill. While it is often touted that "Cash is King," it seems a better reference would be from Hans Christian Andersen's book The Emperor's New Clothes where a small boy finally stated the obvious that, "The Emperor has no clothes!"

In 2022, the median household income was $92,750 in the United States, meaning that the $50 equivalent of the 1.6% household income from 1934 would be $1,848 in today's dollars. While often in the past the argument would be made that investing was only for the wealthy, there has never been a time like the present where investing is available to all in an inexpensive way. Cash can certainly be used as a short-term tactical strategy, but the only true way that individuals can get ahead of inflation over the long-term is to invest into assets.

Market Outlook:
It has been over a year since the artificial intelligence (A.I.) revolution took the market by storm and generated excitement within the technology industry that was suffering from identifying a new "stair-step" jump in technological innovation that would take the industry to the next level. The market is now starting to transition to a very pivotal moment of how A.I. will move forward and that is the acceptance and commercialization of A.I. products. For the past several months, companies have been rolling out A.I. products to their customer base, and the jury is still out whether companies will entice their customers to pay for the additional value-added services provided by the A.I. products. This is a crucial crossroad, particularly when considering the level of valuations currently being demanded by the market for some of the companies exposed to the A.I. buildout.

Early in my investment career, one of my Research Directors made the comment that valuations are not necessarily what an asset is worth but rather the amount of risk you are willing to bear in buying the assets. With the current high valuations in certain areas of the market, any minor change in growth trajectories could have significant negative consequences to stock prices. With the resiliency of the economy over the past several quarters, this is one of the risks that should be monitored closely.

The likely winners of the A.I. rollout are companies that have proprietary data, but validating the successfulness of their A.I. product offerings probably won't be likely until late 2024 or early 2025. Nonetheless, with the buildout of data centers dedicated to run artificial intelligence software still booming and showing no signs of slowing down, eventually A.I. product offerings will need to be commercialized to provide a return on investment. At quarter end, it was reported that Microsoft and OpenAI were planning to build a gigantic data center to run A.I. software that could require an investment of as much as $100 billion, approximately 200 times more than the spending required for current cutting-edge data centers.

As mentioned in previous commentaries, crude oil and copper are major influencers of an economy, and their price movements are of the utmost importance in gauging the future health of an economy. Although the United States is the largest producer of oil in the world, crude oil prices have increased 20% to $84 a barrel since the end of 2023 because of the Middle East unrest. While copper prices ($4.05 per pound) have increased at a smaller increment (5%), it is currently at its highest level in the past 14 months. While current levels of commodity prices likely won't hinder economic activity, another 20% price increase in crude oil would break the $100 a barrel level, which would be concerning on its potential negative impact on the economy

Other potential headwinds worth monitoring are the ongoing geopolitical and logistical issues, with the recent Baltimore Key Bridge collapse adding to the global transportation woes. One potential headwind that hasn't been a negative factor for a while is the unemployment rate, which is currently 3.9%. The labor market has been incredibly strong over the past several years, but depending on the rollout of A.I. products and their acceptance in the workplace, there is a real possibility of white-collar jobs deteriorating, particularly at entry level, to the same magnitude of how industrial automation impacted the blue-collar workforce. This is already starting to be felt in the legal and financial industries.

Though there are several headwinds always worth monitoring, there are an equal number of tailwinds positively impacting the market. Fiscal spending is just starting to pick up on the bills passed previously: the Infrastructure Investments and Jobs Act of 2021, the Inflation Reduction Act of 2022, and the CHIPS and Science Act of 2022. The IPO market is slowly starting to pick up, and the potential of lower interest rates later this year could potentially provide a spike in merger and acquisition activity.

The massive buildout of the data center network to handle the A.I. revolution is injecting capital into multiple industries and has been more stimulus to companies' actual fundamentals than the coming fiscal programs. In our previous quarterly market commentary, our outlook included that the market would likely achieve double-digit returns for the year. Even after a strong first quarter, that expectation looks easily achievable, but we wouldn't be surprised to see a market pullback in the summer months (3rd quarter) as some of the headwinds mentioned above might start to weigh on the market. Regardless of short-term fluctuations in the market, as the $50 bill illustrated, the key to successful investing is not to be consumed by the short-sightedness of the present but to keep focused on the long-term opportunities and work towards your investment goals.

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