MALVERN CAPITAL MANAGEMENT

1st Quarter 2024 Commentary and Market Outlook

April 2024

1st Quarter 2024 Review

Along with the hopes that the Federal Reserve would begin cutting interest rates later this year and with good corporate earnings, the 1st quarter of 2024 realized excellent equity returns. The S&P 500 Index jumped 10.56% for the quarter. The technology-heavy NASDAQ 100 Index still posted respectable gains of 8.72% but trailed the S&P 500 Index so far in 2024, relinquishing its leadership from 2023. Large company growth stocks outperformed large company value stocks for the quarter as they did in 2023. However, the market seemed to broaden with value stocks still exhibiting respectable gains whereas in 2023 large company value stocks trailed large company growth stocks by a wide margin.

Less impressive were the gains from overseas markets as the MSCI EAFE Index rose by just 5.78% and the FTSE All Emerging Markets Index squeezed out a relatively modest gain of 2.38%. Although valuations appear to be more reasonable with international companies versus U.S. companies based on forward price-to-earnings ratios, U.S. stocks still provided global leadership.

Despite considerable optimism for interest rate cuts this year, longer-term market-driven interest rates rose in the quarter with the Ten-year U.S. Treasury Note yield rising from 3.866% on December 31, 2023, to close the 1st quarter at 4.206%, a rise of 34 basis points. As a result, high-quality investment-grade bonds, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index fell by 0.78% in the quarter. However, lower-quality junk bonds posted a small gain of 1.47%.

The year 2024 may see the Federal Reserve cutting interest rates and corporate earnings should continue to grow (although earnings growth appears to be slowing). In addition, the economy should expand further.

Indices Performance

Category	Representative Index	1st Qtr 2024	Six Months	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	6.14	20.03	22.18	8.65	11.31	11.76
Broad US Large Companies	S&P 500 Index	10.56	23.48	29.88	11.49	15.05	12.96
US Small Cap Companies	Russell 2000 Index	5.18	19.94	19.71	-0.10	8.10	7.58
US Mid Cap Companies	Russell Mid Cap Index	8.60	22.52	22.35	6.07	11.10	9.95
Largest 100 NASDAQ Companies	NASDAQ 100 Index	8.72	24.59	39.65	12.63	20.90	18.85
Large Cap "Value" Stocks	Russell 1000 Value Index	8.99	19.34	20.27	8.11	10.32	9.01
Large Cap "Growth" Stocks	Russell 1000 Growth Index	11.41	27.19	39.00	12.50	18.52	15.98
Large Cap Stocks	Russell 1000 Index	10.30	23.49	29.87	10.45	14.76	12.68
Developed International	MSCI EAFE Index	5.78	16.81	15.32	4.78	7.33	4.80
Emerging Markets	FTSE All Emerging Markets	2.38	9.10	8.05	-3.70	2.83	3.48
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	-0.78	5.99	1.70	-2.46	0.36	1.54
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	1.47	8.74	11.15	2.19	4.21	4.44
Commodities	Bloomberg Commodity	2.19	-2.54	-0.56	9.11	6.38	-1.56
Total US Market (all cap stocks)	Russell 3000 Index	10.02	23.30	29.29	9.78	14.34	12.33
Real Estate Investment Trusts	Wilshire US REIT Index	-0.01	16.28	12.43	4.53	4.41	6.68
Cash	US T-Bill 90 Day	1.33	2.76	5.38	2.52	1.99	1.33

** 3 year, 5 year and 10 year returns are annualized. All periods ending March 31, 2024.*
All returns include the reinvestment of dividends.

Source: Morningstar Direct.

It is a Presidential election year which usually means a positive year for the equity markets regardless of which party wins the White House. As we move further into 2024, we will review the major factors that we believe will affect the markets as follows.

Will We See a Pickup in Inflation?

The February read for the Consumer Price Index (CPI) continued to show that the rate of the increase in inflation has been falling since it peaked at 9.1% in June 2022. For February 2024, the Consumer Price Index (CPI) was up 0.4% and it increased by 3.2% for the previous 12 months. When carving out food and energy, the increase was also 0.4% for February and the rate was up 3.8% for the previous 12 months.

While it appears that inflation is getting under control based on recent (February) CPI, can we trust this seemingly tame recent inflation data? Of concern are rising commodity prices. In the 1st quarter of 2024, gold rose 7.37% hitting all-time new highs; five new highs in March alone. Crude oil rose 16.8% or $11.52 per barrel for the quarter. Silver also rose. Cocoa nearly tripled. Commodities in general were on fire for the 1st quarter. With the rise in commodity prices, and in particular oil, could it mean that another bout of inflation is not far behind?

In the early 1970s, unusually high inflation seemed to be under control by the middle of the decade. Some economists say the inflation in the 1970s was partly caused by the oil embargo in October 1973. It was further exacerbated by the abandonment of the gold standard and the high government spending on the Great Society social programs and Vietnam War spending from the 1960s. Deficit spending was also cited as a cause for inflation. Inflation ended the year 1974 at 12.2% before trending down by 1976 (4.8% at the end of the year). However, inflation returned and went even higher from 1976 to 1980 when it peaked at almost 15% in March 1980. Will history repeat itself with inflation beginning to rise again?

The CPI readings each month have implications for the financial markets. The markets are pricing in the Federal Reserve's cutting of interest rates this year. Investors want to see the CPI in a downward trajectory supporting the belief that interest rates will be cut. CPI readings showing higher-than-expected inflation will cause investors to re-think their beliefs that interest rates will be cut and could lead to market sell-offs.

Federal Reserve & Interest Rates

The Federal Reserve's Federal Open Market Committee (FOMC) left the Fed Funds rate unchanged at its March 2024 meeting. The FOMC has now kept interest rates unchanged for five straight meetings. It is widely believed that the FOMC has reached its peak in interest rates for this rate hike cycle. Now attention is turning to when it will begin cutting interest rates.

The Federal Reserve is very concerned about inflation and committed to reaching its 2% target rate of inflation. The Fed pours over every piece of inflation data for clues as to the extent of the current inflation environment as well as the outlook for future inflation. It does not want to risk a return to inflation such as what happened in the 1980s and must then abruptly reverse course and raise interest rates again.

Our view of the timing of the first interest rate cut has changed. Due to our fears that inflation may re-emerge, we no longer see a rate cut occurring at the June 2024 FOMC meeting. Given that we are in an election year and that the Fed does not want to be seen as political, we see it as unlikely that we will now see any rate cuts before the election in November. If we are to see any rate cuts this year, we now see the earliest the Fed could cut rates is at the November meeting right after the election. We are concerned about the risk that inflation comes back and that could jeopardize the rate cuts altogether.

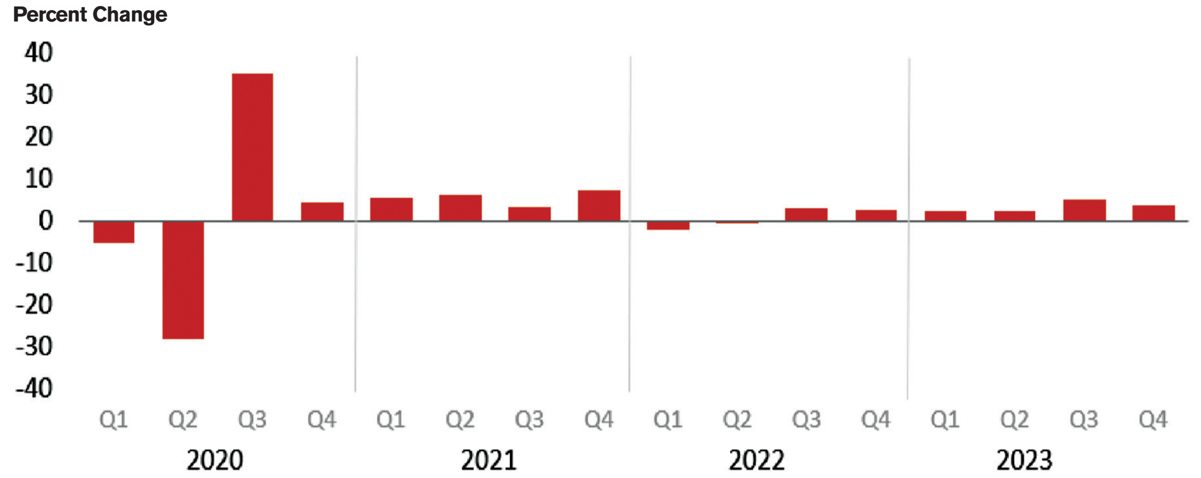
Ideally, when the Fed does begin cutting the Fed Funds rate, it will lead to a steepening of the yield curve away from the current "inverted" yield curve. If the economy is on firm footing when the rate cuts begin, we should see short-term rates fall and long-term rates rise.

The implications for the markets of Fed Funds rate cuts, when they eventually occur, are that we should see stocks move higher. As mentioned earlier, the hopes for lower interest rates are what has been primarily driving stock prices higher so far this year. There is certainly a risk to stock prices with a “no rate cut” scenario.

Is the Economy on Solid Ground?

Gross Domestic Product (GDP) for the 4th quarter of 2023 grew at a real rate of 3.4% (third reading). This is a good number and is indicative of a strong economy. Monthly job growth has been relatively strong since the end of the pandemic scare. In March 2024, the monthly job growth was 303,000 jobs with an unemployment rate of 3.8%. Many economists consider an unemployment rate of 5% or lower as “full employment.” Average hourly earnings have been ticking up over the past several months. In March, we also saw a pick up in the labor force participation rate suggesting that more people are becoming available to work.

Real GDP: Percent Change From Preceding Quarter



Source: U.S. Bureau of Economic Analysis

Seasonally adjusted at annual rates

Productivity has increased in four of the last five quarters (ending in the 4th quarter of 2023). Productivity is a factor looked at by the Fed in determining its inflation outlook. Higher productivity is suggestive of lower inflation.

Not everything is good. Leading economic indicators (LEI) give us an early sign of changes in the business cycle. For the first time since February 2022, the LEI increased for February 2024 by 0.1%. For the six months ending in February 2024, LEI contracted by 2.6% which was a smaller contraction than the previous six months’ 3.8% shrinkage.

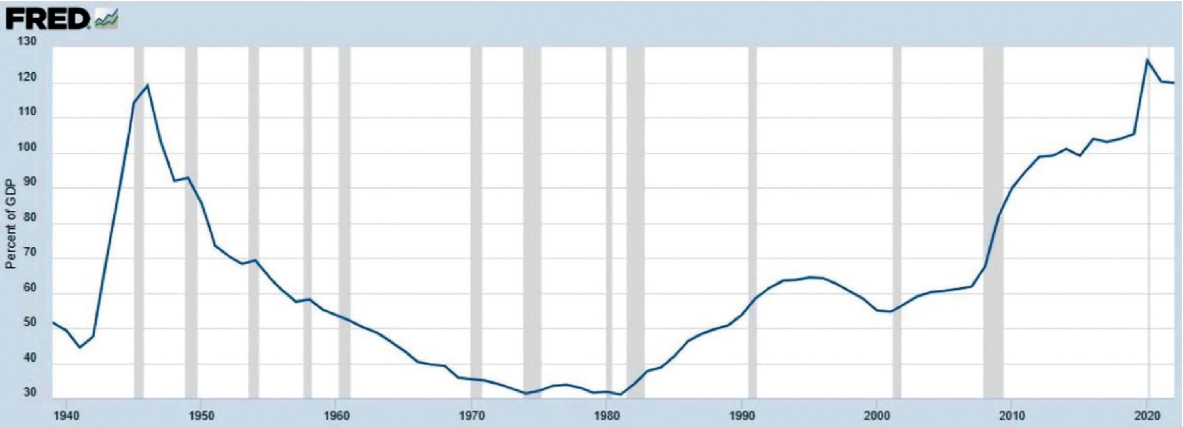
Many households are using credit to pay for the higher costs of goods and services brought on by persistent inflation. Household debt had increased by $212 billion in the 4th quarter of 2023. Outstanding credit card debt now exceeds $1.1 trillion. With the high-interest rates on credit cards, this is not a good sign for the consumer. Further, past-due payments are increasing on credit cards, auto loans, and home loans. Also, compounding matters is the low personal savings rate of Americans which stood at 3.7% in December 2023.

The national debt is reaching unsustainable levels. The national debt-to-GDP level is currently 121.6%. At some point, financial markets will lose confidence in the management of the fiscal house in the United States. There is no doubt that annual deficit spending is contributing to inflation.

We have had an inverted yield curve (10-year U.S. Treasury Note minus the 2-year U.S. Treasury Note) since July 2022. The yield curve is considered a predictor of economic growth. An inverted yield curve usually foretells the coming of a recession generally within one year of the first signs of inversion. Since the inversion occurred well over a year ago, one would expect us to have slipped into a recession by now as many economists and investment analysts predicted would occur by the second half of last year.

Where does our assessment of the economy leave us in terms of the possibility of a recession in 2024? Many of the economists and investment analysts no longer project a recession. We were not in agreement with their negative assessment last year and did not think we would see a recession last year. We continue to believe that economic growth, wage growth, and job growth are too strong to imagine having a recession.

Gross Federal Debt as Percent of Gross Domestic Product



Shaded area indicate U.S. recessions.
Source: OMB; St. Louis Fed.
fred.stlouisfed.org

Don't Ignore the Rising Sun

The Japanese “bubble” economy began to burst at the end of 1989. The roots of the bubble formation were thought to have been caused by the 1985 “Plaza Accord” which led to the decline of the U.S. Dollar versus the Japanese Yen. Fears of an economic downturn because of the rising Yen value led to a monetary easing policy from the Bank of Japan. The monetary easing contributed greatly to the acceleration of the Japanese economy. Along with low inflation during this period, asset prices greatly appreciated including stock and land prices. The stock market peaked at the end of 1989, the economy's summit was at the end of 1990 and land prices topped out at the end of 1991. This was the start of the so-called “lost three decades” in Japan. (*Nomura, Japan's Three Lost Decades – Escaping Deflation*).

Compared to the U.S. markets and other markets around the globe, the Japanese stock market has not been a good place to invest since early 1990. After reaching a high of over 38,700 in January 1990, the Nikkei 225 Index dropped to a low of under 7,100 in March 2009 (the global markets' bottom following the

Japan vs U.S. Markets

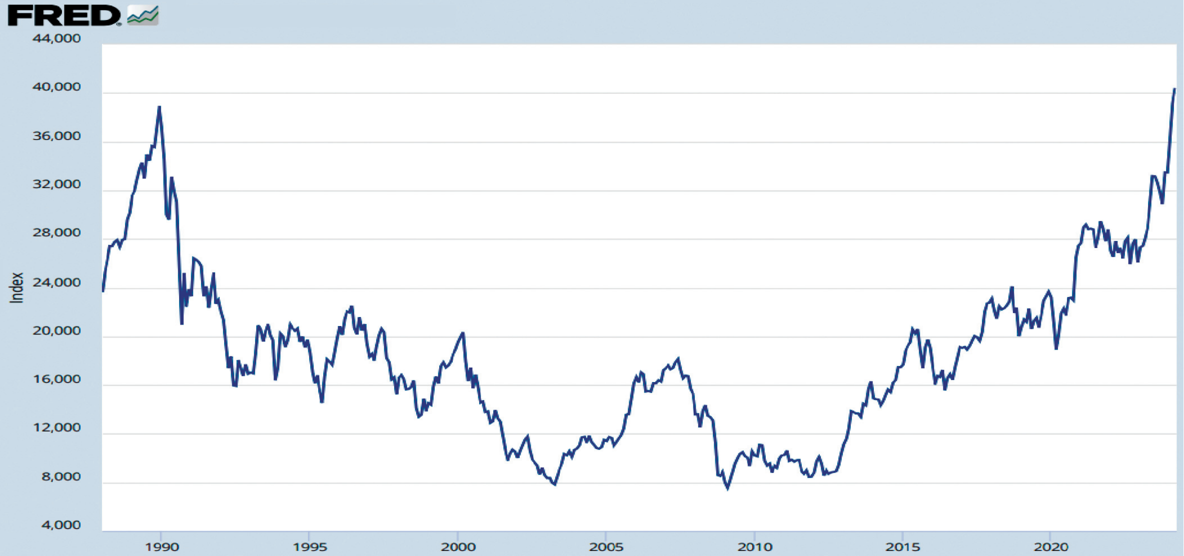
Index	1st Qtr 2024	12 Months*	2023	3 Year Annualized	5 Year Annualized	10 Year Annualized
S&P 500 TR USD	10.56	29.88	26.29	11.49	15.05	12.96
NASDAQ 100 TR USD	8.72	39.65	55.13	12.63	20.90	18.85
Nikkei 225 Average TR JPY	13.21	28.96	22.56	2.38	8.97	8.42

** Periods ending March 31, 2024.*
All returns indude the reinvestment of dividends.

financial crisis). Over the past decade, the Nikkei 225 Index has a 10-year annualized return of 8.42% versus the S&P 500 Index's 10-year annualized return of 12.96%.

But have the fortunes of the Japanese market changed? Since the start of 2024 (through the end of the 1st quarter of 2024), the Nikkei 225 Index has advanced 13.21% versus the S&P 500 Index rising 10.56%. One quarter does not make a new trend, but there may be reasons to be optimistic for Japanese stocks. The Nikkei 225 exceeded 40000 in March 2024. The index has reached levels not seen since 1990. After years of deflation, the Japanese economy is shifting toward an inflationary economy. Japan's central bank is the last globally to finally end negative interest rates. Also, corporate governance reforms have been implemented. There is a strong outlook for Japan's technology sector as well as strong corporate earnings. A weakening Japanese Yen versus the U.S. Dollar has helped propel stocks higher. Despite the strong growth in corporate earnings, Japan's economy is in a technical recession. Even so, we expect Japanese stocks to continue to rise.

Nikkei Stock Average, Nikkei 225



Source: Nikkei Industry Research Institute.
fred.stlouisfed.org

Corporate Earnings

At the end of December 2023, analysts at the S&P Corporation projected earnings for the 1st quarter of 2024 at $217.22 per share. Those analysts now project earnings for the 1st quarter of 2024 at $215.24, a decline in their projection of nearly $2.00 per share. Downward adjustments in earnings estimates are seen for the full-year 2024 earnings as well. In December 2023, the S&P Corporation analysts projected full-year 2024 earnings at $242.44. They now project earnings for the full year of 2024 at $240.30, a modest decline of $2.14 per share. It is not so much the magnitude of the decline which is of concern, it is the direction of the adjustment.

On a positive note, for the 4th quarter of 2023, 73.95% of companies reported earnings that beat their estimates while only 21.24% missed their estimates. 4.81% of the companies were in line with their estimates. Also, despite the downward revision to estimates, earnings are still growing. Operating margins are still impressive at an estimate of 11.0% for the 4th quarter of 2023. The average quarterly operating margin since 1993 is 8.39%. Companies can be more profitable with each dollar of revenue.

We expect earnings estimates to come down a little further in 2024 for the full year, but still show growth over 2023's earnings.

Market Valuation

The current trailing price-to-earnings (P/E) ratio on the S&P 500 Index is 24.41 times earnings. The 30-year historical P/E ratio is 19.78 times earnings (the quarter-end average of the last 30 years of trailing P/E ratios). The current trailing P/E ratio suggests a market that is over-valued at present. The 12-month forward P/E ratio is 21.09 times earnings (based on S&P Corporation's earnings estimates). The 30-year average forward P/E ratio is 16.62 times earnings (*Source: JP Morgan, "Guide to the Markets" April 1, 2024*). This again suggests a market that may be over-valued.

The Fed Model currently shows that the earnings yield on stocks is less than the 10-year U.S. Treasury Note yield, but it is very close. The Earnings yield on stocks is currently 4.10% while the yield on the 10-year U.S. Treasury Note is 4.206% (March 31, 2024). The Fed Model says that when the earnings yield on stocks is less than the yield on the 10-year U.S. Treasury Note (as it is now), stocks are over-valued.

These over-valued readings on the S&P 500 Index may suggest that the market needs a "correction" or a sell-off of these stocks to bring the P/E ratio down more in line with historical averages. Or we need an increase in earnings estimates which we do not see as likely.

However, we cannot overlook the broader market. The 2024 Forward P/E Ratio on the S&P 400 Index (mid-cap stock index) is currently 16.87 times. Further, the 2024 forward P/E ratio on the S&P 600 Index (small-cap stock index) is 15.67 times. Both indices represent reasonable valuations and suggest the market may go through a rotation out of large-cap stocks to the mid-cap and small-cap stock spaces.

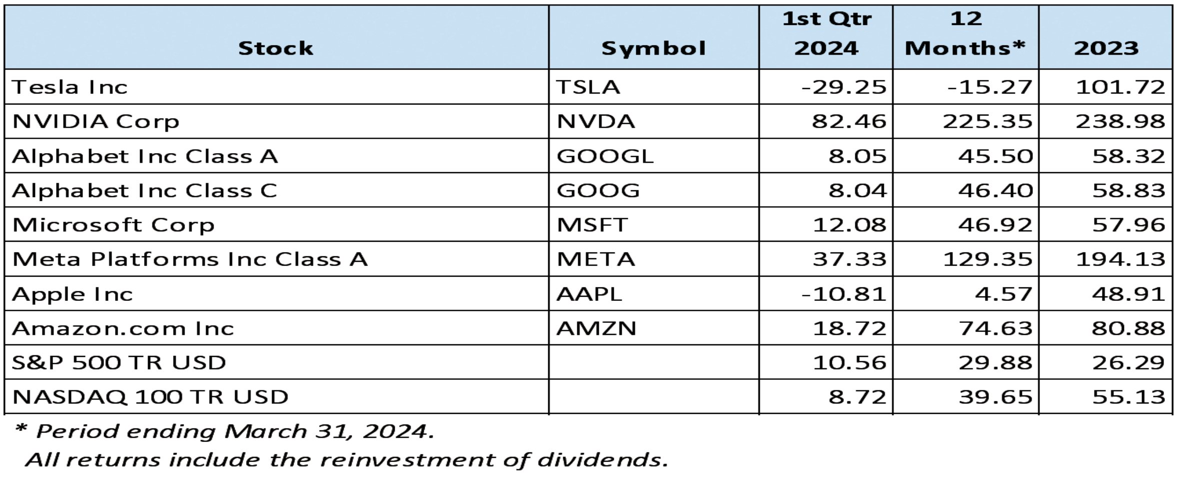
Nevertheless, markets can become more over-valued especially when the market seems to be trading on the hopes of lower interest rates. If the yield on the 10-year U.S. Treasury Note were to fall along with a decline in the Fed Funds rate, the Fed Model may say that stocks are under-valued.

We are not market timers and do not suggest pulling money off to the sidelines. Rather we are long-term investors and any sell-offs are an opportunity to put new cash to work.

What Has Happened to the "Magnificent Seven"?

The so-called "magnificent seven" stocks are all in the technology sector and include the following: Tesla, Nvidia, Alphabet (Google), Microsoft, Meta (Facebook), Apple, and Amazon. In 2023, the group of seven stocks had a total return of 76% while the S&P 500 Index excluding the magnificent seven had a total return of 8%. For the 1st quarter of 2024, the magnificent seven have had a total return of 13% while the remaining S&P 500 Index had a total return of 6%. As a group, the Magnificent Seven are still leading the market in 2024. However, perhaps it will need to be re-labeled the "Magnificent Four"? In the 1st quarter of

Magnificent Seven Performance



Stock	Symbol	1st Qtr 2024	12 Months*	2023
Tesla Inc	TSLA	-29.25	-15.27	101.72
NVIDIA Corp	NVDA	82.46	225.35	238.98
Alphabet Inc Class A	GOOGL	8.05	45.50	58.32
Alphabet Inc Class C	GOOG	8.04	46.40	58.83
Microsoft Corp	MSFT	12.08	46.92	57.96
Meta Platforms Inc Class A	META	37.33	129.35	194.13
Apple Inc	AAPL	-10.81	4.57	48.91
Amazon.com Inc	AMZN	18.72	74.63	80.88
S&P 500 TR USD		10.56	29.88	26.29
NASDAQ 100 TR USD		8.72	39.65	55.13

** Period ending March 31, 2024.*

All returns include the reinvestment of dividends.

2024, Tesla's and Apple's returns were negative while Alphabet failed to outperform both the S&P 500 Index and the NASDAQ 100 Index.

From an earnings-per-share standpoint, the magnificent seven are expected to grow by 37% in the 1st quarter of 2024 while the remaining S&P 500 Index companies are expected to decline by 3%. For the full year of 2024, year-over-year earnings-per-share are expected to grow 25% for the magnificent seven and 8% for the remainder of the Index. In comparison, the expected year-over-year earnings growth of the magnificent seven for 2023 is 31% while the rest of the Index 500 is projected to be a decline of 4%.

We expect some broadening out of the stock market performance as the year goes by. For the 4th quarter of 2024, the consensus analyst expected earnings per share growth of the magnificent seven companies is expected to be 15% while the rest of the Index is expected to surpass the magnificent seven at 18%. If earnings do improve for the remainder of the Index versus the magnificent seven, that will probably be reflected in stock price gains for the broader market.

Summary

Hopes of Federal Reserve interest rate cuts this year fueled an impressive rally in the equity markets for the 1st quarter of 2024. There is certainly a risk that inflation can return and we understand that risk exists like it did some 44 years ago. Higher inflation could dash our hopes for interest rate cuts this year. The Federal Reserve did seem committed to lowering rates this year and had signaled that it plans to do so. But those rate cuts appear to be in jeopardy at least until the November FOMC meeting.

Otherwise, the economy is solid with a strong jobs market, wage growth, and an increase in the labor force participation rate. However, there are some things to be concerned about with the economy such as weakening Leading Economic Indicators. Another economy across the globe to be aware of is the improvement in the Japanese economy. Japan has had lackluster stock market returns since the early 1980s and now may be poised to move higher given corporate reforms, strong earnings in the technology sector, a weakening Yen versus the Dollar, and an end to deflation.

Although estimates for earnings have come down since last quarter, earnings are still pretty good. Current market valuations suggest the S&P 500 Index is over-valued in the short term. However, we are not going to attempt to time the markets as that is not an effective investment strategy. Further, mid-cap and small-cap stocks may offer reasonable value right now and this may suggest a rotation into these stocks out of large-cap stocks.

Although as a group the magnificent seven are still performing well, Apple, Alphabet, and Tesla are not keeping up with the other four stocks. Forward earnings projections suggest that the broader market will see increased earnings estimates compared to the earnings estimates for the magnificent seven later in 2024 further suggesting a broadening out of the market.

As such, we are here to listen, counsel, and provide direction to all our clients.

James L. Olsen, CFA, CFP®
President & Chief Investment Officer

Michael P. Czajka
Chief Executive Officer

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