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CAPITAL ADVISORS

PCA Quarterly Commentary

Q1 2024

Stock Market Continues on a Roll in 2024 while Fixed Income Takes a Pause

Stock prices pushed higher in the first quarter despite diminished expectations for Federal Reserve rate cuts in 2024 which weighed negatively on fixed income. The Russell 1000 index rose 10.3% in the first quarter. This strong performance came despite many factors that could have caused stock prices to fall. Most significant were stubbornly high readings on inflation, which pushed back and reduced expectations for Federal Reserve interest rate cuts. Bond markets started 2024 predicting six rate cuts beginning in March, but now traders are betting on three cuts or fewer, with the first potentially coming in June or later.

After stumbling in the early days of the new year, stocks officially erased all their losses from the bear market of 2022 when the US Market Index hit a new record on Jan. 24 and continued to climb through the quarter. The bull market returns were buoyed by strong earnings, an appetite for names that are seen to benefit from the nascent artificial intelligence boom, optimism for continued economic growth, and potential for waning inflation allowing the Fed to cut interest rates at some point.

The ongoing rally has continued despite fears that valuations are beginning to look frothy with the S&P 500 price to earnings (P/E) trading up to 21X and that market gains have been too narrowly concentrated in just a handful of stocks. Continued big gains at tech mega-caps like Nvidia, Microsoft, and Meta Platforms were key to the stock market's strong performance, although not all mega-caps participated with Tesla and Apple logging negative returns in the first quarter.

By industry group, gains were led by technology stocks, especially the companies seen as most likely to benefit from the artificial intelligence boom. Stock leadership for the overall rally continued to spring from the communications services and technology sectors. Communications services, which include Meta and Alphabet, gained 14.8%. The tech sector, home to Nvidia and Microsoft, rose 13.1%. The rally did broaden out as the quarter progressed and included double digit returns from financials, energy, and industrials. Energy stocks experienced a big turnaround for the quarter after being one of the worst-performing sectors in the fourth quarter of 2023. Utilities still lag well behind on a one-year basis due at least in part to higher interest rates. Real estate stocks slumped 0.7% as interest rates remained high. That marked a major reversal from the fourth quarter, when these stocks saw gains of nearly 18%. Over the past year, however, real estate stocks are still up 9.6%.

While the stock market was able to weather the diminished expectations for Fed rate cuts, the higher-for-longer landscape caused the bond market to stumble at the beginning of 2024. After a huge rally in the fourth quarter, bond prices fell, and yields rose with the 10-year US Treasury note notching a new year-to-date high of 4.33% at the end of March and have subsequently risen further.

The Core Bond Index ended the first quarter down 0.8%, while US Treasury bonds overall dropped 0.9%. The biggest losses came in long-term bonds, which tend to be most sensitive to changes in interest rates. The Long-Term Treasury Bond Index fell 3% in the first quarter, which reversed some of the index's 12% gain in the previous quarter. Meanwhile, the Long-Term Core Bond Index dropped 2.3%. Bonds with shorter maturities performed slightly better, with the Short-Term Core Bond Index eking its way into the green for the quarter with a gain of 0.2%.

But it wasn't all bad news for fixed income. Investors found pockets of price appreciation in high-yield bonds, which tend to be lower quality and riskier than government-backed or investment-grade assets or leveraged loans. The High-Yield Bond Index gained 1.5% in Q1, while the US Leveraged Loan Index ended the quarter up 2.5%.

International markets also had a positive start to the year with the global index ex-U.S. returning 4.8% in dollar terms with U.S. currency appreciation providing a head wind to returns on a local currency basis. Developed markets (+5.9%) outperformed emerging markets (2.4%) with China, the largest country component for the emerging market index, continuing to be a headwind.

Investment Outlook

Over the past few months, the biggest question mark in markets has been the path of interest rates in the wake of one of the most aggressive monetary tightening cycles in history. The current federal-funds target rate range of 5.25%-5.50% is the highest it's been since before the 2008 financial crisis. Investors have been eagerly awaiting confirmation of when rates are likely to fall, and by how much. In January, markets were confident that the Fed had all but beaten inflation and would start cutting rates in March. Traders were anticipating six cuts in 2024 that would bring the target rate range to 3.75%-4.00%. Lower rates are seen as a catalyst for economic growth and support higher valuations.

But consecutive hot Consumer Price Index reports in January and February and a more hawkish tone from the central bankers told a different story. By the end of February, bond market futures shifted dramatically to predict that the first cut would not come before June and the current forecast is down to three cuts, if not fewer. Offsetting the higher for longer state of the interest rate outlook, the economy is projected to be relatively strong with a broadening out of earnings growth projected for the rest of the year. However, the concern is ever present that higher rates and the extended period of yield curve inversion may be the precursors to a slowdown in economic growth.

A slowdown in economic growth would likely alter the current financial market performance trends. For equities, stock prices tend to follow earnings direction and cadence. A reversal lower in earnings expectations would likely result in a market pullback and rotation into defensive sectors that have lagged in the latest market cycle. For fixed income, and longer duration in particular, higher for longer interest rates will likely continue to be a headwind but be defensive in a scenario in which economic growth slows and positioned positively when rates cuts take place.

Overall, the current economic backdrop has been favorable for financial markets. Resilient growth has more than offset sticky inflation and the attendant higher level of interest rates. For the time being, this status quo in markets will likely continue, but investors should expect a more modest level of return and likely increased volatility. This follows the above long-term trend level in returns and potential for a slowdown in economic growth or sustained inflation above the Fed's target.

Sincerely,

Stephen Kylander
Senior Portfolio Manager
Pallas Capital Advisors

Mark A. Bogar, CFA®, CAIA®
Chief Investment Officer
Pallas Capital Advisors