Sabal Trust

Investment Environment & Outlook

March 2024

Volume 11, Issue 3

Market & Economic Environment

Stronger than expected corporate earnings fueled equity market returns in February. Investors pushed markets higher even though the Federal Reserve remained hawkish in their stance on future interest rate cuts. The markets are begrudgingly accepting fewer rate cuts in 2024. Technology stocks surged in the latter half of the month on the back of earnings and the promise of Artificial Intelligence. Looking ahead, inflation will remain the focal point as Federal Reserve rate policy will shape stock and bond market volatility. We remain focused on companies that generate robust cash flows and are willing to return capital to their shareholders in the form of growing dividends.

ECONOMIC "SOFT LANDING"

In the last half century after inflation peaked above 5%, the Federal Reserve engineered three "soft landings", while recessions occurred on five separate occasions. The last "soft landing" was in 1995 when globalization trends, demographics and labor markets were deflationary. Today, these same influences are inflationary creating challenges for the Federal Reserve. Investors should be aware of the difficulties that current policy makers face and their capacity to steer the economy to a "soft landing".

CYCLICAL SIGNS?

The manufacturing sector accounts for 11% of the total economy. After contracting for 13th months in a row, the ISM Purchasing Managers Index signaled signs of bottoming. Why does this matter? A cyclical rebound could fuel economic growth and support a "soft landing" argument. However, it could also add cyclical-related input costs to the system when the Federal Reserve is working hard to reduce inflation.

GOVERNMENT SHUTDOWN

Politicians averted a government shutdown by pushing the deadline into the middle of March. Partisan politics continues to impede the development of a long-term, sustainable plan to operate our government. The unchecked growth of Federal debt and the mounting servicing costs could hinder economic growth. At some point investors might not shrug off political brinksmanship.

RE-SHORING IMPACT

Policy issues will shape the outcome of November's Presidential election and the trajectory of the markets. In addition to the economy, foreign policy, immigration and health care, trade policy will take center stage. The U.S. has become more inwardly focused through bipartisan legislation. The re-shoring of manufacturing is being done in the name of securing supply chains for national security reasons. The higher cost of producing goods domestically will be passed on to consumers, which could pressure inflation.

CORPORATE PROFITS

Investors carefully monitor a company's profit margins. Over the last few years, companies supported their profit margins by increasing the selling prices of their goods and services. Pepsi, Coke and McDonald's successfully passed on higher input costs to their consumers. The ability to absorb higher costs by additional price increases appears to be limited. Companies must rely on productivity measures to reduce costs and support earnings.

FISCAL SPENDING

Government spending and legislative initiatives could support a "soft landing". The $53B Chips Act, passed in 2022, will see +$10B of grants flowing into the economy this year. Spending from the Inflation Reduction Act will support clean energy and infrastructure projects. Congress is debating a business tax cut of $136B. Finally, the student loan forgiveness of $138B could increase consumer spending by freeing up income for discretionary purchases.

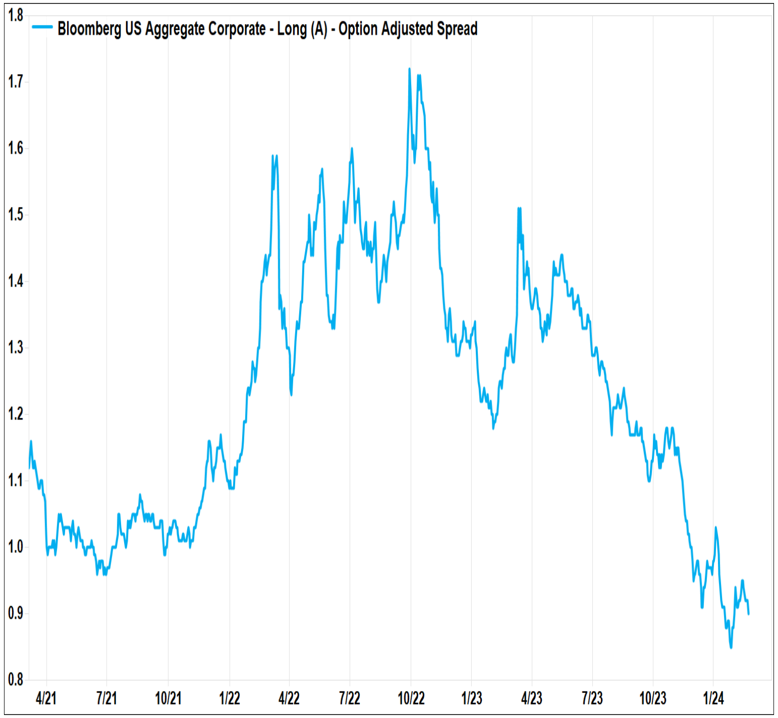
Interest Rate Observations

Since the start of 2024, bond yields steadily increased. The second month in a row with higher yields comes on the heels of the massive bond rally that marked the end of 2023. The rise in yields illustrates the tough question in bond markets as investors navigate inflation, economic and monetary uncertainty. The bond market will look for clarity during the Federal Reserve's March FOMC meeting where policy makers will release a new summary of economic projections (SEP).

Included in their quarterly SEP will be updated dot plots that show where policy makers believe interest rates should be going forward. In February, investment-grade bond issuers taped the bond market setting record volumes for the month. Issuers are taking advantage of tight credit spreads which allow companies to reduce the cost of financing to offset the increase in interest rates. Tight credit spreads are an indicator of low default risk. The tighter they are, the less risk investors perceive for a company that is issuing bonds. The huge demand from investors for investment-grade credit has tightened credit spreads as investors look to lock in attractive yields in high quality companies.

YIELD CURVE

- During the month of February, the 10-year Treasury yield increased +33.6bps to 4.25%.
- In the chart on the right, you can see the trend in investment-grade credit spreads. The chart is a good illustration of supply and demand for investment grade bonds.
- Although we do not invest in high-yield bonds due to the heightened risk of losses, it is important to note that high-yield spreads have also tightened.
- In times of stress, credit spreads will widen. We only invest in investment grade bonds which widen less compared to their high-yield counter parts.
- It is important to maintain bond ladders in client accounts as it is not wise to forecast where interest rates are going to be in the future. As such we create bond ladders that will benefit client portfolios whether interest rates are falling, rising or flat.
- As we approach the end of the rate hiking cycle, we continue reviewing cash balances to identify opportunities to purchase high quality bonds before rate cuts take place.



Sabal Trust

SABALTRUST.COM