Bangor
WEALTH MANAGEMENT

Wealth Management Newsletter

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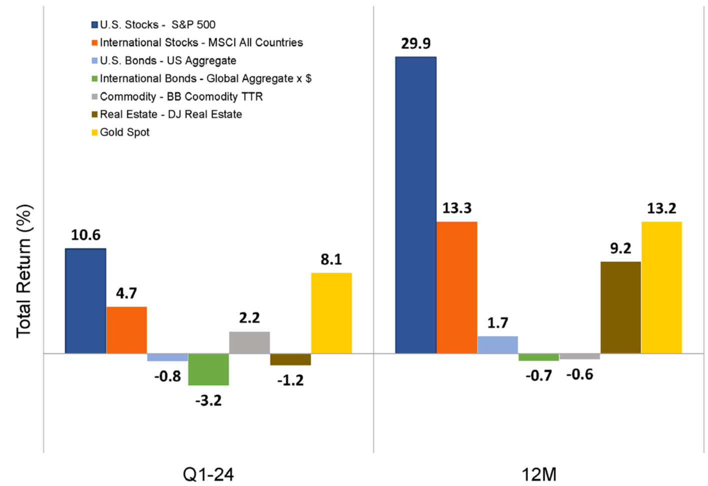
KEY POINTS

- Forecasts of an economic soft landing have become more widespread as above-trend economic growth and robust labor markets persist
- Disinflationary pressures have subsided and prices have begun to resume an upward trend
- Equity markets had a strong start to the year with broader market participation, potentially pulling forward full-year returns
- Bond markets retraced a sizable portion of their late 2023 rally, and are now priced in alignment with the Federal Reserve's forecast of three rate cuts in 2024



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

2024 Q1: BY THE NUMBERS

Despite lingering investor concerns about high inflation, increasing government debt, and global geopolitical tensions, the S&P 500 had the strongest first-quarter return since 2019. Progress towards achieving 2% core inflation coupled with supportive Federal Reserve rhetoric was sufficient to support market sentiment, bolstered by better-than-expected economic indicators. U.S. Gross Domestic Product (GDP) continued to expand, unemployment rates remained low, and market participants fully embraced a soft economic landing scenario.

Investor optimism propelled the S&P 500 to a 10.6% (see figure 1) gain during the quarter. While mega-cap technology stocks like NVIDIA remained strong performers, the equity market rally broadened across sectors, with 10 out of 11 S&P 500 sectors ending the quarter in positive territory. This shift included a rotation into cyclical value stocks that had been overlooked during the narrow Artificial Intelligence induced rally for most of 2023. However, Mid-Cap and Small-Cap stocks continued to trail behind the S&P 500, posting returns of 9.9% and 5.2%, respectively, for the quarter. International equities saw a broad return of 4.7% during the quarter, with developed markets posting a return of 5.2% and emerging markets at 2.4%. Investors were drawn to the low valuations in developed markets like Japan and Europe, while showing more caution towards emerging markets, especially given the challenges faced by China's economy. Fixed income markets experienced slightly negative returns during the quarter as investors grappled with predicting the extent and timing of Federal Reserve interest rate cuts this year. Overall, U.S. bonds returned -0.8% for the quarter. Real estate also saw a decline, with the DJ Real Estate Index returning -1.2%. On the other hand, gold surged by 8.1% to reach an all-time high, reflecting concerns about funding record levels of government debt and global geopolitical tensions. Broadly, commodities posted a 2.2% increase for the quarter, rebounding from a -7.9% return in 2023.

THE ECONOMY – RESILIENCY DESPITE CONTINUED UNCERTAINTY

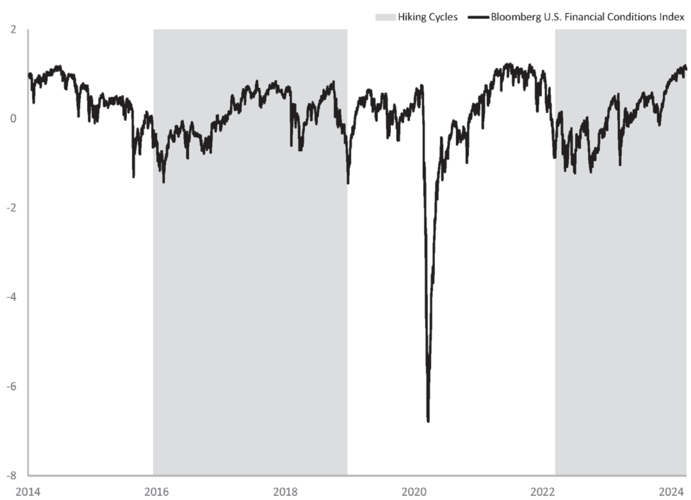
The U.S. economy continued its above-trend growth, surpassing expectations as concerns about a recession faded and optimism for ongoing expansion prevailed. GDP closed 2023 at 3.4% and is projected to maintain a level around 3% in Q1 2024. The labor market remained robust, with unemployment staying below 4% and jobless claims at historically low levels, although some labor indicators hinted at a slowdown. Disinflationary pressures lost steam during the quarter, and inflation data showed a sideways to slightly higher trend. Surprisingly, the lack of disinflation did not alter the Federal Reserve's outlook, which still anticipates 75 basis points of rate cuts in 2024. However, their rhetoric has shifted marginally towards seeking more evidence of sustained easing in price pressures.

Despite the positive economic environment, business confidence surveys continued to reflect a pessimistic outlook. Geopolitical uncertainties, including ongoing conflicts on multiple continents and the upcoming U.S. election, remain potential sources of market volatility.

FIXED INCOME MARKETS – PRICING OUT FED CUTS

Throughout the first quarter, U.S. Treasury yields steadily increased while the yield curve remained inverted. Strong economic data, two months of higher-than-expected inflation, and equity markets reaching all-time highs prompted the Federal Reserve to maintain its stance, causing fixed income markets to recalibrate rate cut expectations. Only high yield and emerging market bonds managed to achieve positive returns for the quarter. Tight credit spreads persisted due to robust inflows, reduced volatility, and favorable underlying fundamentals. Treasury yields transitioned from overbought levels to closer to fair values in line with Fed expectations. Notably, the rise in yields and reduced Fed accommodation did not dampen equity markets.

Looking ahead, fixed income markets have retraced approximately half of the rate rally seen in late 2023. Bond markets had initially priced in more aggressive rate cuts than what the Fed signaled, leading to an overshoot in yields to the downside. However, as disinflationary pressures eased and the Fed's tone shifted to a less dovish stance, fixed income markets adjusted to higher yields. More specifically, U.S. Treasury yields have transitioned from expensive levels earlier this year to a more balanced state, aligning with the Fed's projections of three rate cuts in 2024. Nonetheless, it remains uncertain if current economic conditions justify rate cuts given accommodative financial conditions (See figure 2) which have been underpinning robust economic activity. Additionally, credit spreads remain historically narrow, offering investors limited additional yield for taking on credit risk.



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

MARKET VIEW AND PORTFOLIO CHANGES

As we mentioned last quarter, we believe that last year's excessive skepticism has turned into growing confidence that an economic soft landing and higher asset prices are assured. Indeed, equity markets carried this positive momentum into the first quarter of 2024, witnessing a 10.6% rise in the S&P 500. Notably, the S&P 500 achieved 25 new highs during the quarter and has surged over 25% since late October 2023 without experiencing a correction of 5%. Despite this fact, investor optimism remains bolstered by the surprisingly resilient U.S. economy and the anticipation of the elusive soft landing, potentially bringing along lower interest rates.

The Magnificent 7 collectively continued to lead the market, returning 13% during the quarter compared to the S&P 500 ex-Mag 7, which returned 6%. However, the group's performance began to fracture, with Apple and Tesla posting negative returns in the first three months of the year. Although encouraged by early signs of broadening market participation, the top four performers within the Mag 7 – NVIDIA, Meta, Amazon, and Microsoft – still contributed approximately half of the Large-Cap index's return for the quarter. Market concentration within Large-Cap stocks remains near all-time highs, which cannot be overlooked as it is historically unsustainable. If economic growth remains resilient and earnings are delivered as expected, it is anticipated that the remaining 493 companies will outpace the earnings growth of the Mag 7 as we progress through 2024. This could lead to a continuation of the broadening market participation witnessed during the first quarter and would be a welcome reduction in index concentration.

The consensus bottom-up EPS forecast for the S&P 500 has remained stable this year, hovering near $244, implying 11% earnings growth for 2024. However, the forward 12-month P/E ratio remains elevated at 21x earnings, surpassing the 5-year average of ~19x and the 10-year average of ~18x. While Artificial Intelligence shows promising developments and the economy continues to display impressive momentum, we believe these fundamentals are fully reflected in current valuations. Additionally, while we expect modest investment returns for 2024 if economic momentum persists, some of the expected returns for the full year have been pulled forward.

Moreover, the BWM Investment Team remains skeptical about the possibility of the Fed beginning to cut rates with the economy performing so well, inflation stubbornly remaining above their 2% target, and asset prices continuing to climb. The potential for disappointment from the Fed, excessive bullish sentiment, and some markets appearing priced to perfection could result in a mild correction. This could, in some ways, serve as a healthy reset for markets. Dating back to 1980, the S&P 500 has on average, experienced intra-year declines of -14%, despite annual returns finishing positive in 33 of those 44 years. Anything more detrimental than that would likely require a recession and a significant decline in corporate profits, which, as of now, seems unlikely barring any unforeseen events. Accordingly, we remain attentive to investment market risks as well as opportunities.

As always, we remain focused on investing in high-quality companies with reasonable valuations, clear earnings visibility, and durable cash flows. We also continue to maintain a domestic bias relative to developed and emerging markets, given the U.S.'s economic resilience, stronger earnings, and greater exposure to near-term technological advancements such as AI. With a slightly defensive portfolio construction buttressed by additional cash reserves for opportunistic deployment in the event of a market pullback, we believe managing high-quality, diversified portfolios allows for ongoing participation in the current bull market while offering downside protection should bouts of market volatility arise. Additionally, high quality fixed income markets are now more fairly priced and offer important portfolio diversification attributes, as well as the potential for capital appreciation as the Fed ultimately eases monetary policy.

As always, please do not hesitate to reach out to our wealth management team to review your financial goals and ensure that your investment portfolio is properly aligned with your risk tolerance and time horizon.