Hutchinson
CAPITAL MANAGEMENT

April 2024

INVESTMENT PERSPECTIVES

To Cut, or Not to Cut, that is the Question

"The only function of economic forecasting is to make astrology look respectable."
– John Kenneth Galbraith, Economist

Despite the Federal Reserves' attempts to pump the brakes on the U.S. economy to subdue inflation, we appear to have avoided a hard landing, with the labor market and other measures of economic activity showing continued resilience. This set the stage for another strong quarter of stock performance. The S&P 500 returned just over 10% in the first quarter of 2024, with all major U.S. equity benchmarks (the Dow Jones Industrial Average, NASDAQ, and S&P 500) reaching new all-time highs.

Market performance has remained concentrated, with some of the biggest contributors having changed. At the same time, the U.S. equity market has broadened from a performance perspective. As the table below shows, five sectors are now outperforming the total index.

YTD S&P 500 Return Attribution

Sector	Weight at start of 2024	YTD return	Basis points of S&P 500 return
Info Tech	**29 %**	**13 %**	**366 bp**
Financials	13	12	162
Comm. Services	9	16	136
Health Care	13	9	112
Industrials	9	11	97
Cons. Discretionary	11	5	54
Energy	4	14	53
Consumer Staples	6	8	46
Materials	2	9	22
Utilities	2	5	11
Real Estate	2	(1)	(3)
S&P 500	**100 %**	**11 %**	**1056 bp**

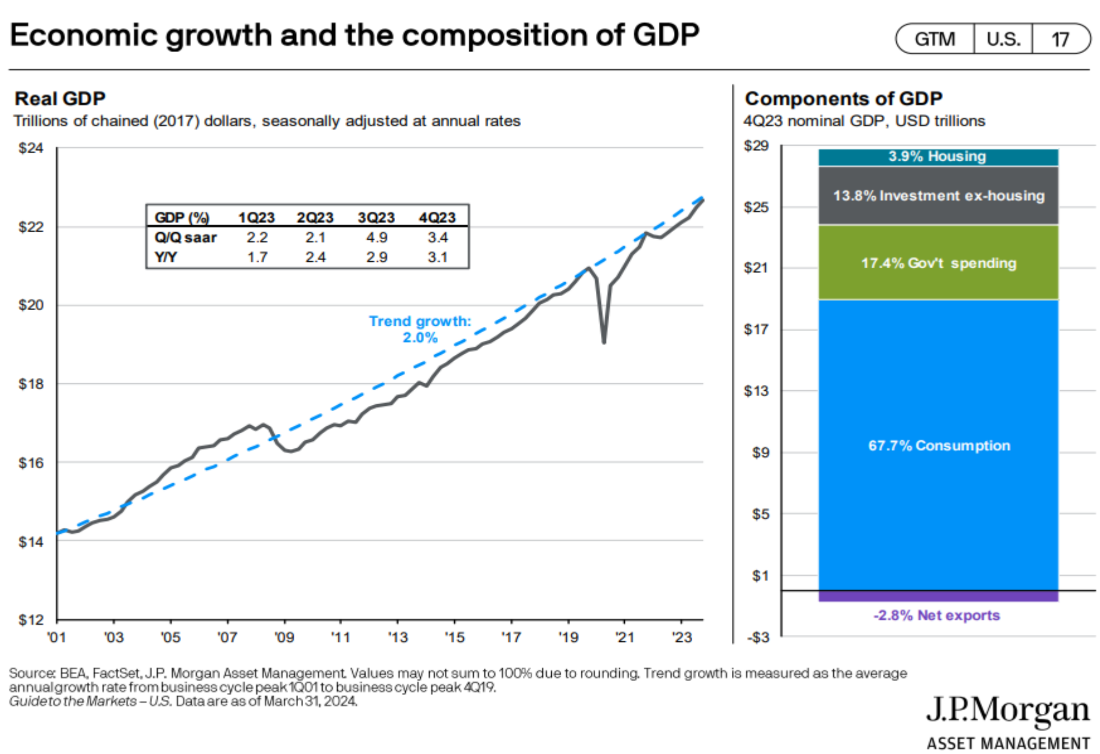
Source: FactSet, Goldman Sachs Global Investment Research

Meanwhile, inflation remains stubbornly elevated, leaving the Fed in an unenviable position. In this *Investment Perspectives*, we review what has transpired this past quarter and what may lie ahead for investors.

What Direction Now?

If there were one word to describe the U.S. economy over the recent past it would be "resilient." At the beginning of 2023, the consensus view amongst macroeconomists was that the U.S. was on the brink of a slowdown and would experience a mild recession by the end of the year. Instead, the U.S. economy defied the pessimistic forecasts and delivered real gross domestic product (GDP) of 3.4% in the fourth quarter of 2023 and is the envy of other major economies around the world. Since the start of the pandemic in 2020, GDP has grown by 8% adjusted for inflation; during the same time the Euro area has expanded by only 3%, Japan by 1% and the UK not at all.[i]

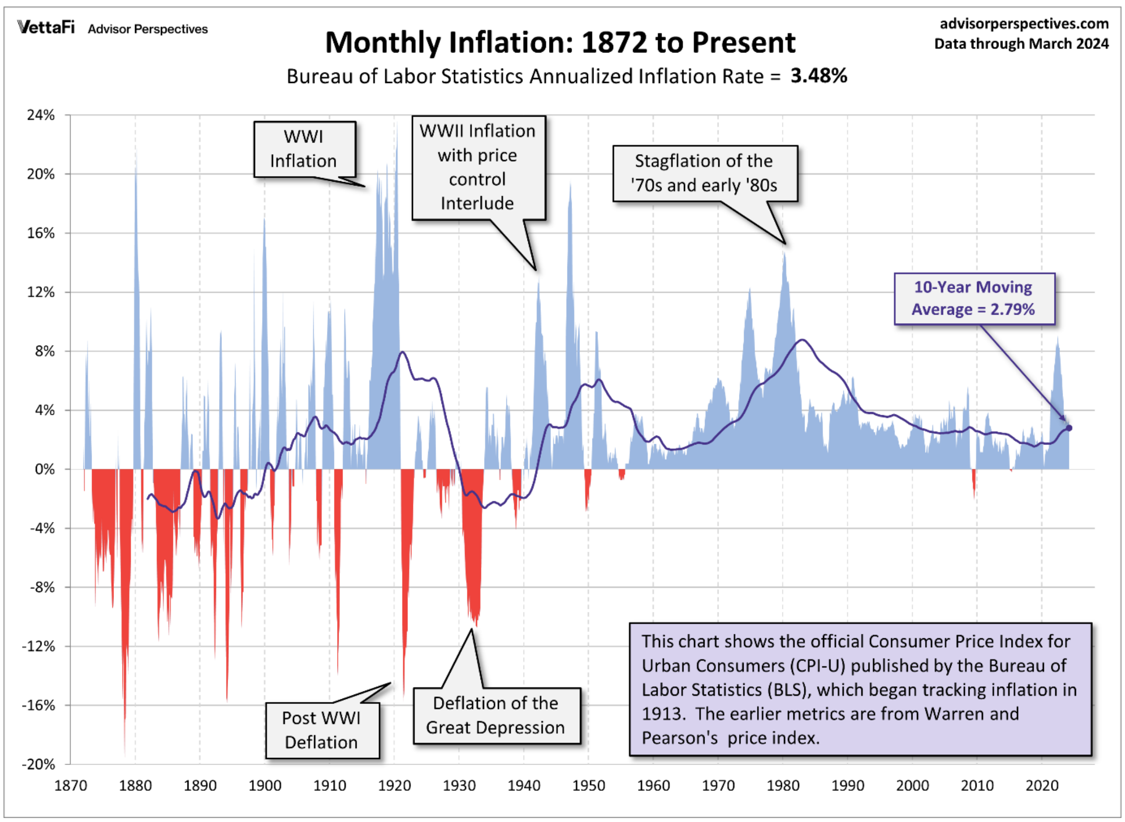
The unemployment rate has been below 4.0% for over two years and remains at 50-year lows. Can this solid performance continue as the Federal Reserve attempts to engineer the proverbial "soft landing" by keeping interest rates at a level that reduces inflation but also avoids a recession? Time will tell, but headwinds include intense geopolitical tensions, uncertainty regarding the Presidential election, and the increased likelihood that the Fed will take a "higher for longer" stance before reducing interest rates. Furthermore, recent economic data is more mixed, suggesting the economy is finally cooling. GDP growth in the first quarter was 1.6%, lagging the 2.4% consensus projection. The business cycle is not dead, and the U.S. economy will eventually experience an economic downturn but at this stage, 2024 looks to be on a path for continued growth and "resilience" remains an appropriate description.



[1] The Economist, March 14, 2024

Rate Cuts and Inflation

The disruption of the progress around inflation is one of the most significant risks to the markets in the short-term. Since the start of 2024, economic activity has outpaced expectations, and economic growth projections have reaccelerated. GDP growth forecasts for 2024 have spiked alongside inflation expectations. This begs the question of whether the data is too strong to support a continued downward trend in inflation. There is no doubt that the market is banking on the Fed easing interest rate policy this year. The expectation for rate cuts remains in place but the magnitude of the expected cuts has shifted sharply downward. The futures market had factored in over six interest rate cuts of 25 basis points each for 2024 but has since reassessed the number of cuts needed given the strong economic growth and inflation data. The futures market is now reflecting just over two cuts this year.

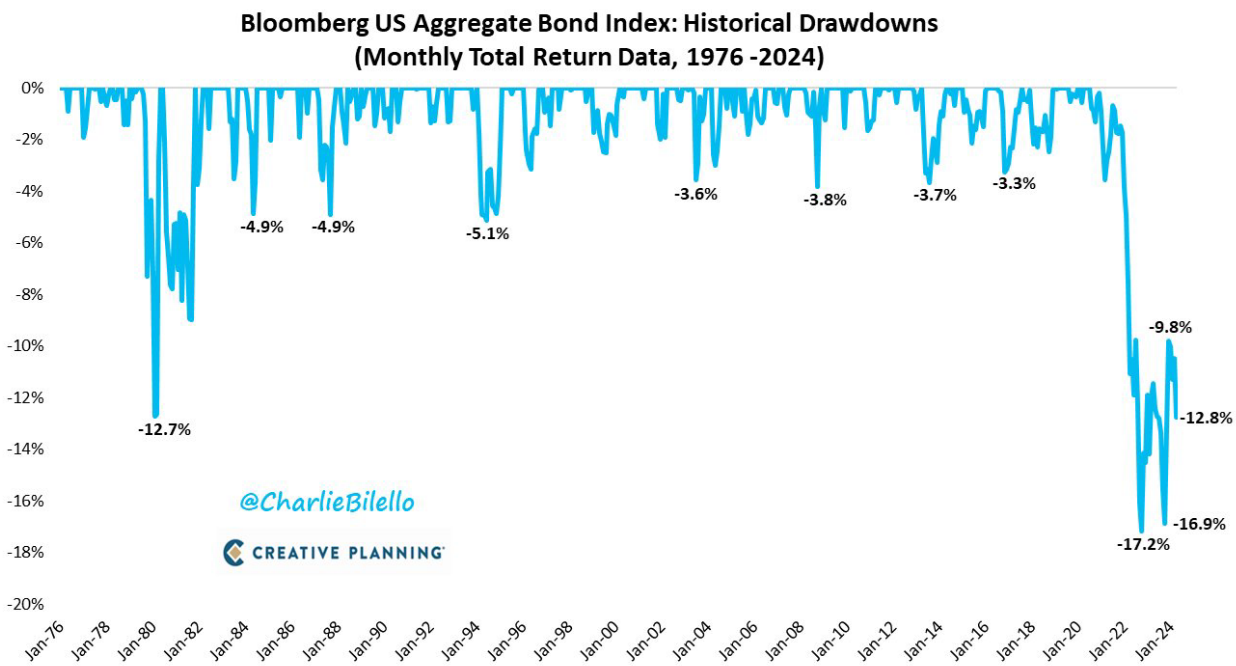


The past decade of zero interest rates has changed how the consensus views interest rates. While we used to think 5% was "normal", we now believe that 2 or 3% for longer term interest rates is the "right" number and inflation should reside in the low single digits. Lower long-term interest rates have benefitted the consumer and businesses broadly: low mortgage rates and cheap capital acted as a significant tailwind. They led to sizable gains in both real estate and stocks. It's no wonder market watchers want to get back there as quickly as possible. Unfortunately, our concern at HCM is that inflation and normalized interest rates will land on the higher side of market forecasts.

Impact on Bond Portfolios?

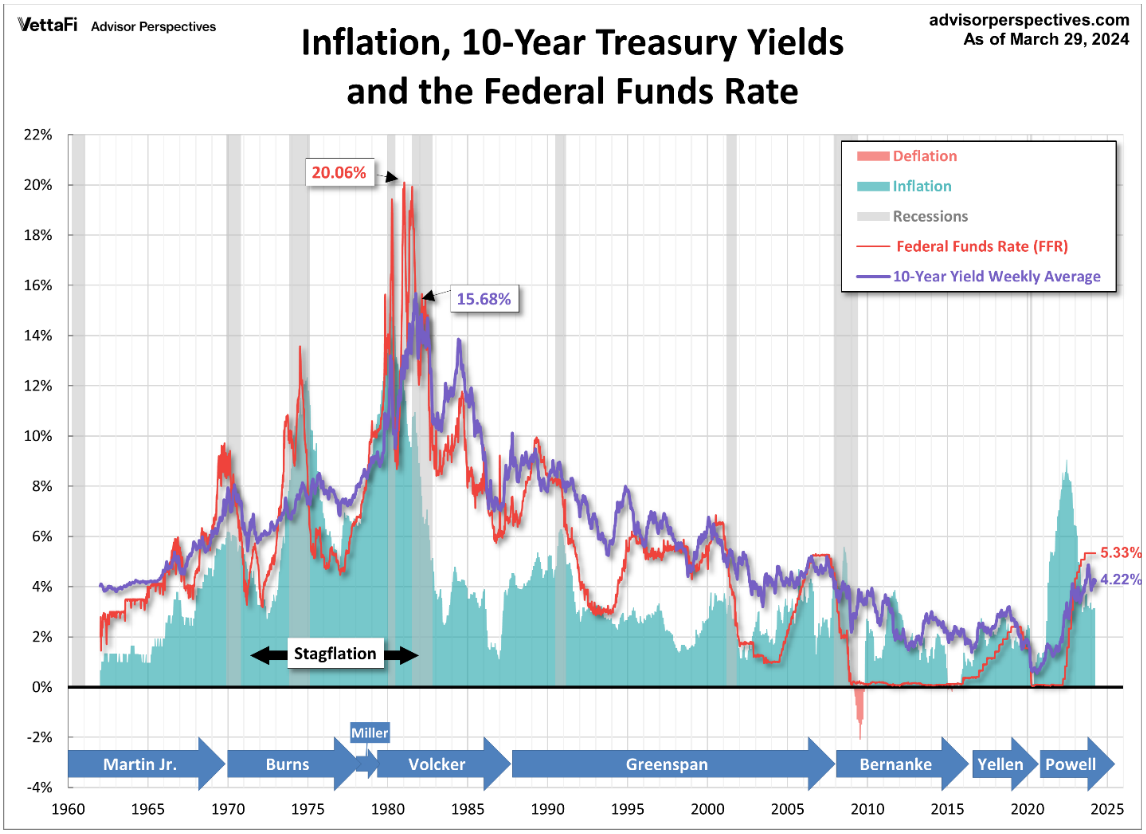
Bond market weakness in the first quarter can be explained by the increase in interest rates across the yield curve since the beginning of 2024. Interest rates have responded to higher-than-expected levels of both economic growth and inflation.

In the previous period of low interest rates, we did not see a lot of value in buying longer-term maturity bonds since you were not being adequately compensated for bearing the interest rate risk. In response, we kept the maturities of our bond ladder shorter than what we would consider typical. We watched as the duration (a measure of sensitivity to interest rates) of the US Aggregate Bond Index expanded to 6+ years. At HCM, your bond portfolios were closer to 2-3 years, which has provided a substantial benefit as interest rates rapidly moved higher.



The well-known US Aggregate Bond Index is currently in a significant period of negative performance, as viewed in the chart above. A similar period has not seen since the inflation spike of the early 1980's and the recent performance has been considerably worse. We believe owning individual bonds, versus owning a perpetual maturity index makes a lot more sense. In the event where our bonds experience a short-term decline, holding to maturity, gives us the opportunity to earn the original yield-to-maturity. Our bond portfolios have outperformed during this recent period due to a shorter duration than the index (represented above).

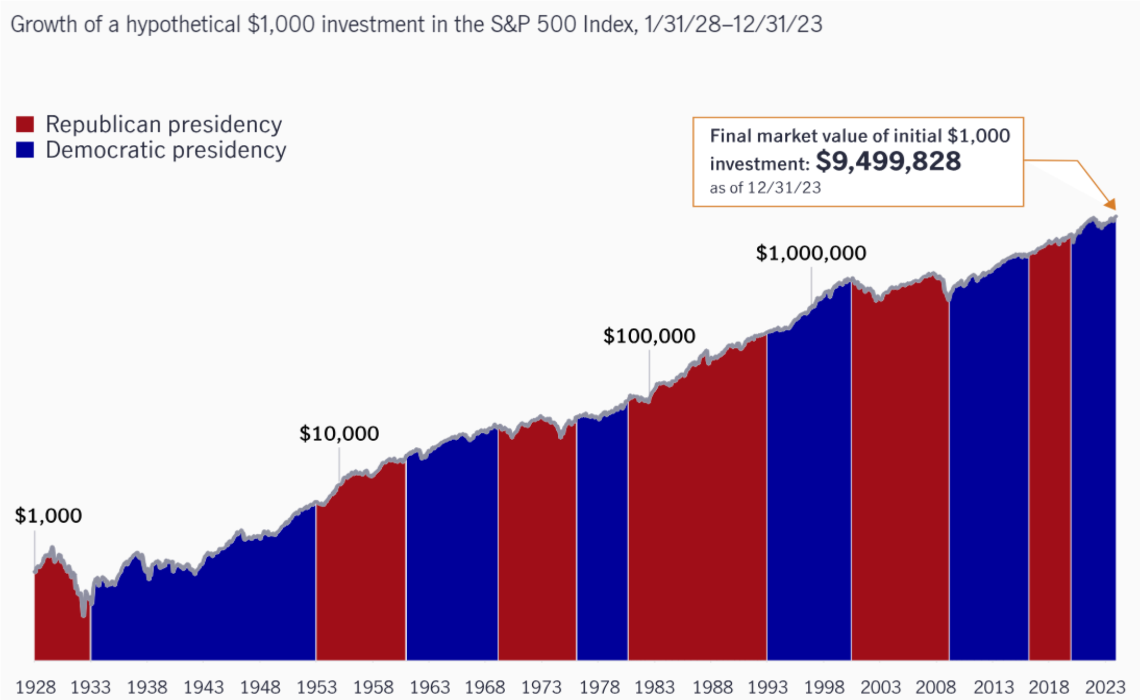
Now with long-term rates inching closer to 5%, we are starting to add to longer term bonds with higher coupons. In our opinion, the current risk-return dynamic is far more attractive. We have continued to favor higher quality bonds, such as Treasuries and Municipals, which have historically held up better in downturns than corporate bonds. They also come with tax advantages for taxable investors.



While the prospect of higher interest rates provides short-term pain for bonds, higher interest rates also come with increased return expectations. For example, if you buy a bond yielding 1% to maturity, you can expect it to return just that, 1%. However, if we buy bonds yielding 5% to maturity, we can expect them to return 5% annually over the life of the bond.

The Market and Presidential Elections

It is natural for investors to look for a connection between who wins the White House and which way stocks will go. But regardless of who wins, nearly a century of returns shows that stocks have trended upward. US presidents may have an impact on market returns, but so do many other factors—the actions of foreign leaders, interest rate changes, changing oil prices, and technological advances, just to name a few.



Source: Morningstar, 2024. A logarithmic scale has been applied to the growth of $1,000 in order to more clearly show changing values during the early decades of the 1928–2023 time span. Dates of political party control of the White House correspond with presidential inauguration months. The S&P 500 Index tracks the performance of 500 of the largest companies in the United States. It is not possible to invest directly in an index. This figure is for illustrative purposes only and does not represent any specific investment or imply any guaranteed rate of return.

Shareholders are investing in companies, which focus on serving their customers and growing their businesses, regardless of who is in the White House. While policy changes can surely influence industries and markets in the near term, they are just one piece of a complex system. With some election years witnessing stock market gains and others ending in losses, the lack of uniformity shows the unpredictable nature of markets.

As investors, this unpredictability leads us to temper our expectations that a certain election outcome will have a knowable impact on the direction of the markets. We have remained committed to the belief that this a not a game worth playing. Simply stated, history shows that stocks have rewarded disciplined investors for decades, through both Democratic and Republican presidencies.

In Conclusion

At HCM, our crystal ball is as cloudy as the next person's. As we have looked over the past several issues of our *Investment Perspectives*, the pages are littered with reports of consensus expectations (name almost any financial topic) going woefully unmet or wildly outperforming. The subsequent market reaction to these events is newsworthy and tend to dominate the financial press. We anticipate these continually changing expectations will continue to drive volatility as we move through the rest of the year. In our view, trying to guess the outcome of the economy or presidential elections can be a recipe for disaster. At HCM, we will continue to stay disciplined in our approach and focused on the things that we can control.

We have found that over time, owning high quality businesses blended with high quality bonds have led to portfolios that grow with acceptable levels risk, while maintaining liquidity for client withdrawals.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time. Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.
Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.
Nothing herein should be construed as a solicitation or offer, or recommendation to buy or sell any security, or as an offer to provide advisory services in any jurisdiction in which such solicitation or offer would be unlawful under the securities laws of such jurisdiction. The material provided herein is for informational purposes only. Before engaging HCM, prospective clients are strongly urged to perform additional due diligence, to ask additional questions of HCM as they deem appropriate, and to discuss any prospective investment with their legal and tax advisers.