Artificial Intelligence Enthusiasm, Potential for Federal Reserve Rate Cuts and Strong Growth Power Stocks to New Highs

By Matthew Gaude & Shawn McGuire

The 2023 rally continued in the first quarter of 2024 as a positive combination of stable economic growth, falling inflation, impending Fed rate cuts, and ever-growing enthusiasm toward artificial intelligence (AI) propelled stocks higher, as the S&P 500 rose above 5,000 for the first time and hit new all-time highs.

The year began with a modest uptick in volatility, as traders and investors initially booked profits following the strong 2023 gains. However, those initially small declines intensified shortly after the start of the year when the December Consumer Price Index, an important inflation indicator, declined less than expected. That reading challenged the idea that inflation was quickly falling toward the Fed's 2.0% target and caused investors to delay the expected date of the first Fed rate cut, as expectations for that first cut moved from March to June. Fears of potentially higher-than-expected rates pushed stocks temporarily into negative territory early in January. However, the declines didn't last. First, fourth-quarter corporate earnings were again better than expected and that helped stocks recover from those early declines. Then, in late January, the Federal Reserve clearly signaled that rate hikes were over and strongly hinted that rate cuts would occur in the coming months. Investors seized on that positive message and the S&P 500 hit a new all-time high late in the month and finished with a modest gain, up 1.59%.

The rally continued and accelerated in February as fears of a potential rebound in inflation subsided. Inflation metrics released in February largely met expectations and importantly did not imply that inflation was reaccelerating. As such, investor expectations for a June rate cut were strengthened and that helped stocks extend the year-to-date gains. Then, on February 21st, Nvidia, the semiconductor company at the heart of the AI boom, posted much stronger-than-expected earnings and guidance. Those results further fueled investors' AI enthusiasm and large-cap tech stocks powered the S&P 500 higher into month-end as the index hit a new record high above 5,000. The benchmark domestic index gained 5.34% in February.

The final month of the quarter saw even more gains, aided by familiar factors such as solid economic growth, generally as-expected inflation data, AI enthusiasm, and bullish Fed guidance. Broadly speaking, economic and inflation data largely met expectations in March and continued to point toward stable growth and (slowly) falling inflation. Then, in mid-March, updated Federal Reserve interest rate projections still pointed toward three rate cuts in 2024, further reinforcing investor expectations for a June rate cut. Those positive factors combined with additional strong AI-related earnings reports (this time from Micron) to push markets broadly higher as the S&P 500 crossed 5,200 for the first time late in the month and ended March with strong gains.

In sum, the 2023 rally continued and accelerated in the first quarter of 2024 thanks to positive news flow that implied stable growth (no recession), still-falling inflation, looming Fed rate cuts, and continued AI enthusiasm; and those factors propelled the S&P 500 to new all-time highs.

First Quarter Performance Review

The first quarter of 2024 reflected a much more evenly distributed rally compared to the fourth quarter of 2023, where tech and tech-aligned sectors handily outperformed the rest of the markets. Over the past three months, markets saw broad gains distributed more equitably amongst various sectors and industries.

However, while the rally in stocks did broaden out in the first quarter, that did not benefit small caps as they were some of the notable laggards over the past three months. Small caps registered a positive return for the first quarter but lagged large caps as concerns about stubbornly high interest rates weighed on small caps, as they are more sensitive to higher funding costs and slowing growth.

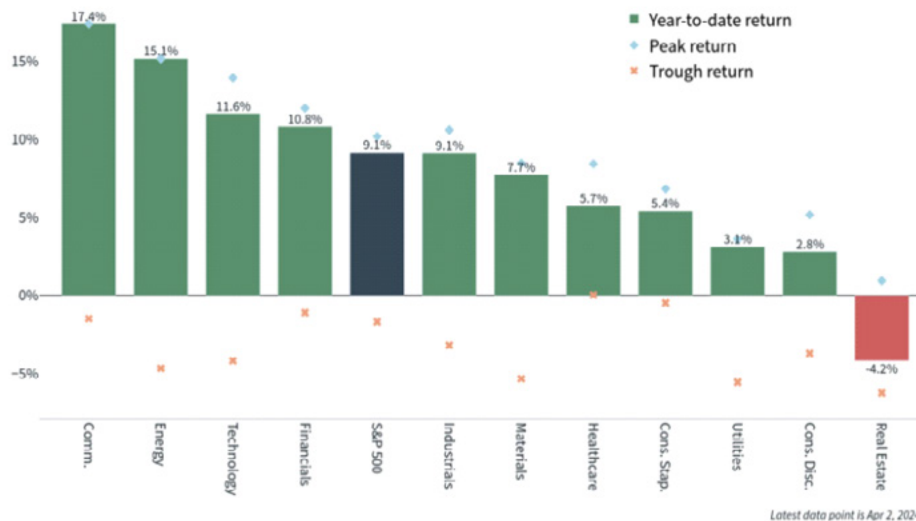
From an investment style standpoint, growth once again outperformed value in the first quarter, but the margin was much closer than last year, as both investment styles logged strong quarterly returns. Continued heightened AI enthusiasm was the main reason for the modest growth outperformance over the past three months, as large-cap tech stocks again saw strong rallies in Q1.

Stock Index Performance

Index	Week	YTD	12-mo.	2023	5-yr.
Dow Jones Industrial Avg. (39,807)	0.07%	6.14%	25.49%	16.18%	11.48%
S&P 500 (5,254)	0.26%	10.55%	34.40%	26.26%	15.17%
NASDAQ 100 (18,255)	-0.35%	8.72%	45.98%	55.13%	21.06%
S&P 500 Growth	-0.49%	12.75%	38.33%	30.02%	15.91%
S&P 500 Value	1.19%	8.05%	30.01%	22.19%	13.36%
S&P MidCap 400 Growth	0.78%	15.60%	33.23%	17.44%	12.09%
S&P MidCap 400 Value	1.59%	4.10%	21.28%	15.35%	10.87%
S&P SmallCap 600 Growth	1.16%	4.75%	22.78%	16.93%	9.15%
S&P SmallCap 600 Value	1.57%	0.13%	14.75%	14.84%	8.68%
Russell 2000	1.30%	5.17%	23.14%	16.88%	8.13%
MSCI EAFE	-0.15%	5.67%	18.24%	18.24%	7.42%
MSCI World (ex US)	-0.26%	4.53%	15.94%	15.62%	6.08%
MSCI World	0.14%	8.85%	29.19%	23.79%	12.20%
MSCI Emerging Markets	-0.67%	2.09%	10.10%	9.83%	2.42%
S&P GSCI	1.06%	10.36%	12.80%	-4.27%	7.90%

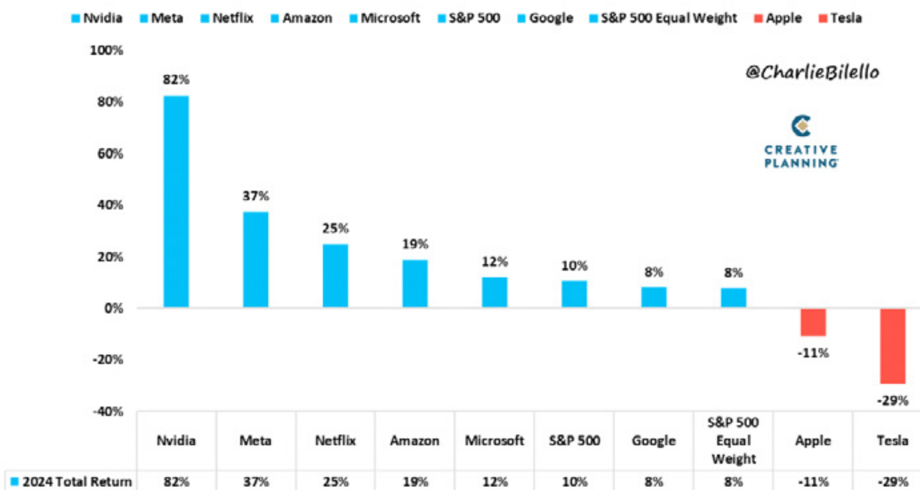
Source: Bloomberg. Returns are total returns. *5-yr. return is an average annual.* One-week, YTD, 12-mo. and 5-yr. performance returns calculated through 3/28/24. An index cannot be purchased directly by investors. Past performance is no guarantee of future results.

On a sector level, as mentioned, gains were broad as 10 of the 11 S&P 500 sectors finished the first quarter with a positive return. Unlike 2023, however, tech and tech-aligned sectors didn't substantially outperform. To that point, the best-performing sectors in the market in the first quarter were communication services, financials, energy, and industrials. That sector mix reflected the influences of AI enthusiasm, strong financial stock guidance, solid U.S. economic data, and rising optimism toward a rebound in Chinese economic growth. The diversified gains demonstrated that the Q1 rally was driven by a more varied set of influences beyond just AI enthusiasm.



Turning to the laggards, the only S&P 500 sector to log a negative return for the first quarter was the real estate sector, as it continues to be weighed down by concerns about the health of the commercial real estate market. Specifically, terrible quarterly earnings from New York Community Bank reminded investors of the sustained weakness in the commercial real estate market, which weighed on the real estate space. Consumer discretionary also lagged and registered only a slightly positive return as numerous retailers warned about a potential slowing of consumer spending during the first quarter (this is something to monitor as we begin the second quarter).

Unlike 2023, the rising tide did not lift all boats in Q1. Nvidia continued to lead the Magnificent 7 with a gain of 82%, but Apple (-11%) and Tesla (-29%) moved in the opposite direction.



	Nvidia	Meta	Netflix	Amazon	Microsoft	S&P 500	Google	S&P 500 Equal Weight	Apple	Tesla
2024 Total Return	82%	37%	25%	19%	12%	10%	8%	8%	-11%	-29%

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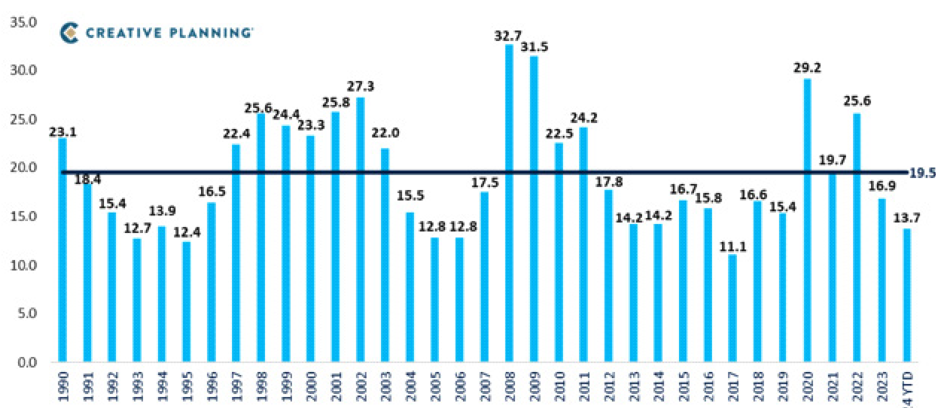
More remarkable, though, was the calmness in the market. The Volatility Index ($VIX) averaged 13.7, on pace for the least volatile year since 2017. We do not believe this calmness will continue, as we should be prepared for volatility, especially if a government shutdown is not avoided by Congress, trade tensions increase, geopolitical risks increase, or a financial incident occurs. The surge in deficit spending at a time of overall growth in the economy is likely to shape a fierce debate on Capitol Hill about the nation's fiscal policies as lawmakers face a potential government shutdown early next year and make choices over trillions of dollars in expiring tax cuts.



Commodities saw strong gains in the first quarter thanks to still-elevated geopolitical tensions, a weaker U.S. dollar, and smaller-than-expected declines in inflation. Oil rallied sharply in Q1 thanks to late-quarter optimism for an acceleration in Chinese economic growth, combined with an increase in geopolitical tensions following the continued attacks on commercial ships in the Red Sea, along with an increase in Russian attacks on Ukrainian energy infrastructure. Meanwhile, gold hit a new all-time high in the first quarter, and logged solidly positive returns thanks to the aforementioned buoyant inflation data and a weaker U.S. dollar.

Commodity Indexes	Q1 Return	YTD
S&P GSCI (Broad-Based Commodities)	10.36%	10.36%
S&P GSCI Crude Oil	15.93%	15.93%
GLD Gold Price	7.93%	7.93%

Source: YCharts/Koyfin.com

Assessing (and Ranking) Market Risks As We Start Q2

The S&P 500 increased more than 10% in Q1 and has gained more than 28% since the Oct. 27 low. That's a 28% return in five months, or an annualized return of nearly 60%. One doesn't have to have a lot of experience in the markets to think that pace is unsustainable, and it's reasonable for us all to expect an uptick in volatility sometime over the coming months. That doesn't mean the rally will end, but it does mean more volatility.

So, as we enter April, I wanted to provide a brief analysis of the current risks facing the market. To make this as practical as possible, I'm going to rank these risks by:

1) Probability

2) How much damage it could do to the bull market, so we have a reference of what is most likely to happen and how much damage they could do.

Most likely but with a marginal impact: Rate-cut disappointment (the market expects fewer than three cuts). The Fed will likely cut in June (although the odds continue to decline), but if growth stays resilient and price pressures increase, they may guide to less than three cuts in 2024. So far, markets have handled rate-cut disappointment very well, which likely will continue as long as economic growth stays solid. Yet, as we've said before, the potential for inflation to be higher for longer is greater than the likelihood of inflation reaching a 2% annual rate anytime soon. For example, the trade winds for oil are shifting to the upside—a significant development for the global inflation picture. ***Likely Market Reaction: A mild pullback.***

Possible with a moderate impact: AI earnings disappointment. Artificial intelligence isn't responsible for this rally (it would have happened anyway), but it is responsible for part of the intensity. AI-related tech company earnings expectations are through the roof. If they prove too good to be true, we will see selling in mega-cap tech and tech-aligned sectors, and that will hit markets. It won't end the bull market or the rally, but it would easily give back a large portion of the YTD gains. ***Likely Market Reaction: A moderate pullback.***

Unlikely but with a significant impact: Inflation rebounds. If the Fed is wrong and inflation rebounds, it will eliminate a major reason for the October-to-present rally, because not only will it destroy rate-cut expectations, it will put rate hikes back on the table—and now we have a repeat of the mid-1970s. Higher-for-longer rates will dramatically increase the chances of an eventual recession. Higher-for-longer rates and rising hard landing chances will make this market extremely overvalued and a substantial decline is possible. ***Likely Market Reaction: 10%-15% decline in the S&P 500.***

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Least likely but with the biggest impact: An economic slowdown. We have mentioned this consistently, but if we experience a sudden, unexpected slowing of growth, this could cause a bigger decline because it negates any benefit from looming rate cuts. Positively, economic data remains resilient and that's no real signal of a looming slowdown. But if it starts to show up, that is a potentially major problem for markets. On Monday April 1, a key measure of U.S. manufacturing activity showed growth for the first time in 17 months, above Wall Street expectations and a positive signal about the industrial part of the U.S. economy. ***Likely Market Reaction: 15%-20% decline or more.***

Second Quarter Market Outlook

We begin the second quarter in the midst of a positive macroeconomic environment as growth appears stable, inflation is still falling, the Fed is likely going to deliver the first rate cut in four years, and AI enthusiasm keeps earnings estimates high. But while this is undoubtedly a favorable setup, the strong rally of the last six months has left the S&P 500 at previously historically unsustainable valuations while investor and analyst sentiment is very bullish and (potentially) complacent. So, while the outlook is currently positive, it's essential we continue to monitor the macroeconomic horizon for risks, because at current stretched valuations and with sentiment very bullish, the market is vulnerable to a negative surprise.

Specifically, while it's true that economic growth has remained resilient in the face of higher rates, some data is pointing to a loss of momentum. Retail sales missed expectations in January and February while the unemployment rate jumped to the highest level since 2022 during the first quarter. Neither number warrants concern about the economy right now, but both serve as a reminder to watch data closely as a continued economic expansion is not guaranteed.

The source of inflation, meanwhile, is still retreating, but the pace of that decline has slowed meaningfully. Core CPI, one of the Fed's preferred measures of inflation, has barely declined over the past several months as it sat at 4.0% year-over-year in October, and in February was just 3.8% year-over-year. Meanwhile, other anecdotal indicators of inflation have hinted at a rebound in prices such as energy. If inflation bounces back, that will reduce the number of Fed rate cuts in 2024, and that disappointment could pressure stocks and bonds.

To that point, markets fully expect a June rate cut from the Fed and three rate cuts in 2024, and that assumption was central to the first-quarter rally. However, those rate cuts are not guaranteed and if the Fed does not cut as aggressively as markets expect, that will result in disappointment and a potential decline in stocks and bonds.

Finally, investor enthusiasm toward the potential for artificial intelligence remains a critical part of the bull market and strong earnings from Nvidia in February furthered investors' hopes that AI integration will lead to a profitability and

earnings boom, not just for tech companies, but for the entire market. However, that's also not guaranteed, and so far, AI integration has produced a lot of flashy headlines but not a lot of profit maximization for non-tech industries. If AI fails to broadly boost profits and demand declines, that will be a significant negative for this market.

Changing Trends As We Enter the Second Quarter?

We've started the second quarter of the year with a move up in global government bond yields, up in commodities prices, and down in stocks.

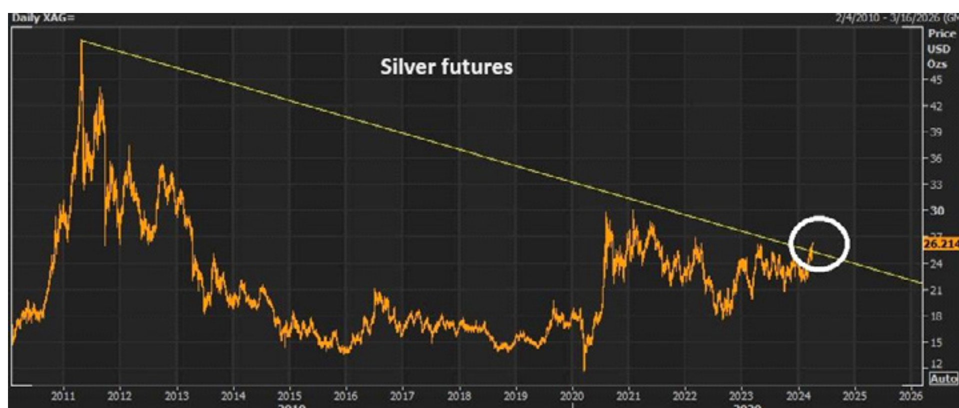
Higher rates: This absolutely contributed as the 10-year yield hit a multi-month high of 4.40% and appears to be trying to break out of the "stock positive" 3.75%-4.25% trading range. The higher rates were driven by markets reducing expectations for a June rate cut (now just above 60%). Following is a chart of the 10-year Government Bond Yield. Since the start of the year, interest rates have slowly increased from a low of 3.80% to the current 4.35%.

Meanwhile, commodities are making new price highs after years of sideways price action.

Is it demand driven, given the outlook on the technology revolution? Or are commodities (finally) repricing against the global central bank money printing era, which has delivered record (and unsustainable) global government debt?

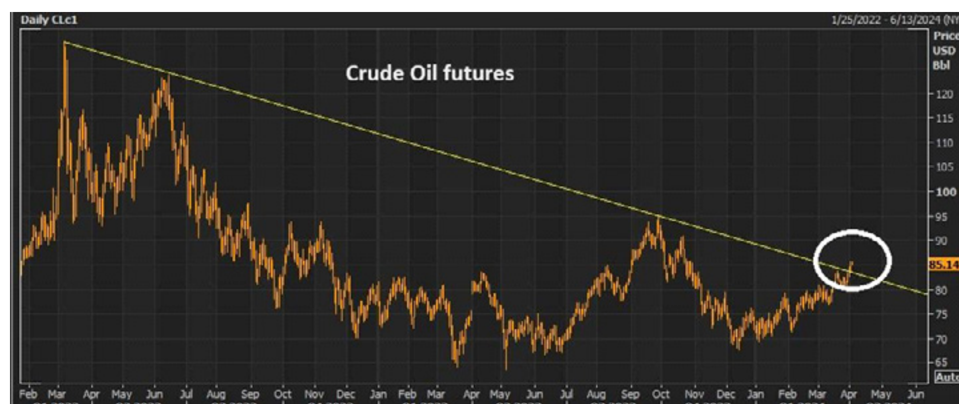
Maybe a bit of both.

The chart below is silver. We have a technical breakout.



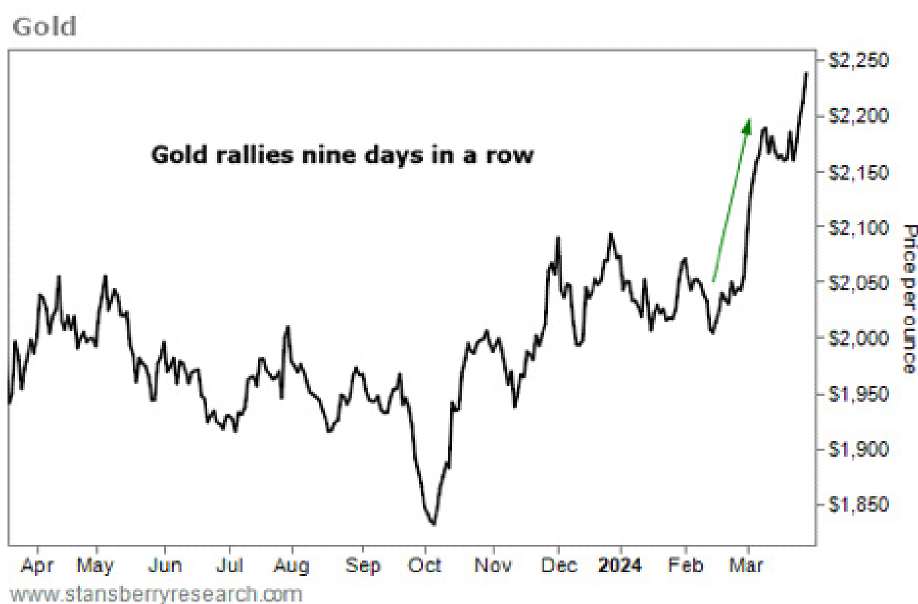
We have a breakout in Copper prices.

And we have a breakout in crude oil. Crude oil has risen to multi-month highs on a combination of optimism toward Chinese growth and rising geopolitical tensions (Iran may execute a retaliatory strike on Israel following the Israeli strike in Syria, which killed a high-ranking Iranian official).



And gold is making record highs by the day.

Gold recently moved higher for nine straight days. That's darn rare. This kind of winning streak has happened just seven times over the past 50 years. Take a look...



Other commodity prices, such as cocoa and coffee, are rising rapidly.

Bottom line, this historic rally is currently supported by positive fundamentals. But we cannot let the currently positive setup blind us to risks. And that's why, while we are pleased with the market performance, we are also focused on managing both reward and risk in portfolios, because despite the strong performance, this market remains vulnerable to negative news.

Equity Strategy for Q2 2024

As the market continues higher, so do the expectations of most investors, as well as their desire to place more money into the stock market. And that is something that has always amazed me about the stock market. In most aspects of our purchasing lives, we are in search of "The Deal." We look for the best price in just about anything we acquire. We will spend days comparing prices on our car purchases to get the best possible price. We will spend hours and hours to find the best possible price on that HD 50-inch television we so desire. Yet we do not bridge that same mentality over to the stock market. What is even worse is that we actually apply just the opposite thinking. When we see prices significantly rise, we then feel compelled to buy. What is it about the stock market that seemingly makes us put our wise buying perspective on the sideline?

We are clearly seeing this now in the stock market, wherein many investors want to push more of their money into this market due to how strong it seems, with expectation that it will continue to increase in value as it has over the past five months. I cannot tell you how many people I have heard from outside of my professional life who are now wanting to pour their money into stocks like Nvidia.

In addition, I am also seeing many analysts suggest that the market has much higher to go after updating their year-end S&P 500 forecasts just three months ago. So, of late, I am seeing a number of people who are turning quite bullish, with many calling for 6000+ on the S&P 500. And, of course, while this is certainly "possible," I do not believe that to be highly probable.

While everyone is getting bullish for various reasons, I am seeing some potential cracks in the bullish armor, which may cause me to move to a very cautionary stance. So, it's time to be on our toes.

Therefore, should I see further evidence over the coming weeks, then the probabilities rise quite dramatically that we could see a 25%+ market decline in 2024, just when everyone is now convinced that the bull market has returned and has much further to run. And should that setup develop, we may sell some equity to raise cash and reinvest the proceeds into short-term bonds yielding between 5.10%-6.45%.

How will we know? As long as the market remains over 5091SPX, we still have a path to the 5350 region on the S&P 500. So, now we have to balance further potential bullishness with an appropriate dose of risk management. As long as we remain over 5091 on the S&P 500, we will let the market continue the current trend higher. We would need to break support of 5091 on the S&P 500 with a strong breakdown and follow through below 4946SPX, which would make it likely that a major top has potentially been struck.

In the meantime, we are running on all cylinders in our portfolios. Large-Cap Growth, Energy, Precious Metals, our core bond funds, and short-term bond ETFs continue to perform very well.

We're Here for You

At Live Oak Wealth Management, we are committed to helping you effectively navigate this challenging investment environment. Successful investing is a marathon, not a sprint, and even through both bull and bear markets, we will remain focused on the diversified approach setup to meet your long-term investment goals.

Therefore, it's critical to remain patient and stick to your plan, as we've worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

We remain vigilant toward risks to portfolios and the economy, and we thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review by clicking here.

Sincerely,

Matthew Gaude
J. Shawn McGuire

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