June 3, 2024

THOUGHTS TO START YOUR WEEK

Investors Beware

Continuing our review of President Biden's Budget Proposals, consider the end of the favorable 20 percent income tax rates on **Qualified Dividends and Long-Term Capital Gains**. For taxpayers with income over $1 million, but only to the extent a joint taxpayer's income exceed $1MM, the Administration proposes to tax qualified dividends and L-T capital gains at ordinary income tax rates of 39.6% (if increased as proposed). This would not be effective until enactment, so corporations will be able to pay extraordinary dividends, and investors could accelerate sales of capital assets to take advantage of the 20% rate.

The proposal also imposes a **minimum tax of 25% on total income**, including unrealized capital gains, on taxpayers with wealth of over $100 million. This tax can be paid over five years, but this is a classic good news/bad news. Congrats on the income, but get ready to pay more in taxes.

Weekly Economic Insights From Our Investment Managers

The past couple of weeks' economic data has been generally positive, countering fears of slowing growth, which had the markets under a little pressure in late May. The positive news flow began when the May flash PMIs came in notably strong with both manufacturing and services showing significant gains. Jobless claims also stabilized back under the 220k mark, and New Orders for Non-Defense Capital Goods ex-Aircraft (NDCGXA) showed business spending plateauing but not declining, while the revised Q1 GDP showed solid growth at 1.3%. From an economic activity perspective, this was all "good news." Last week, the Core PCE Price Index met expectations at a 2.8% year-over-year increase, easing investor concerns about inflation and not altering expectations for Fed rate cuts.

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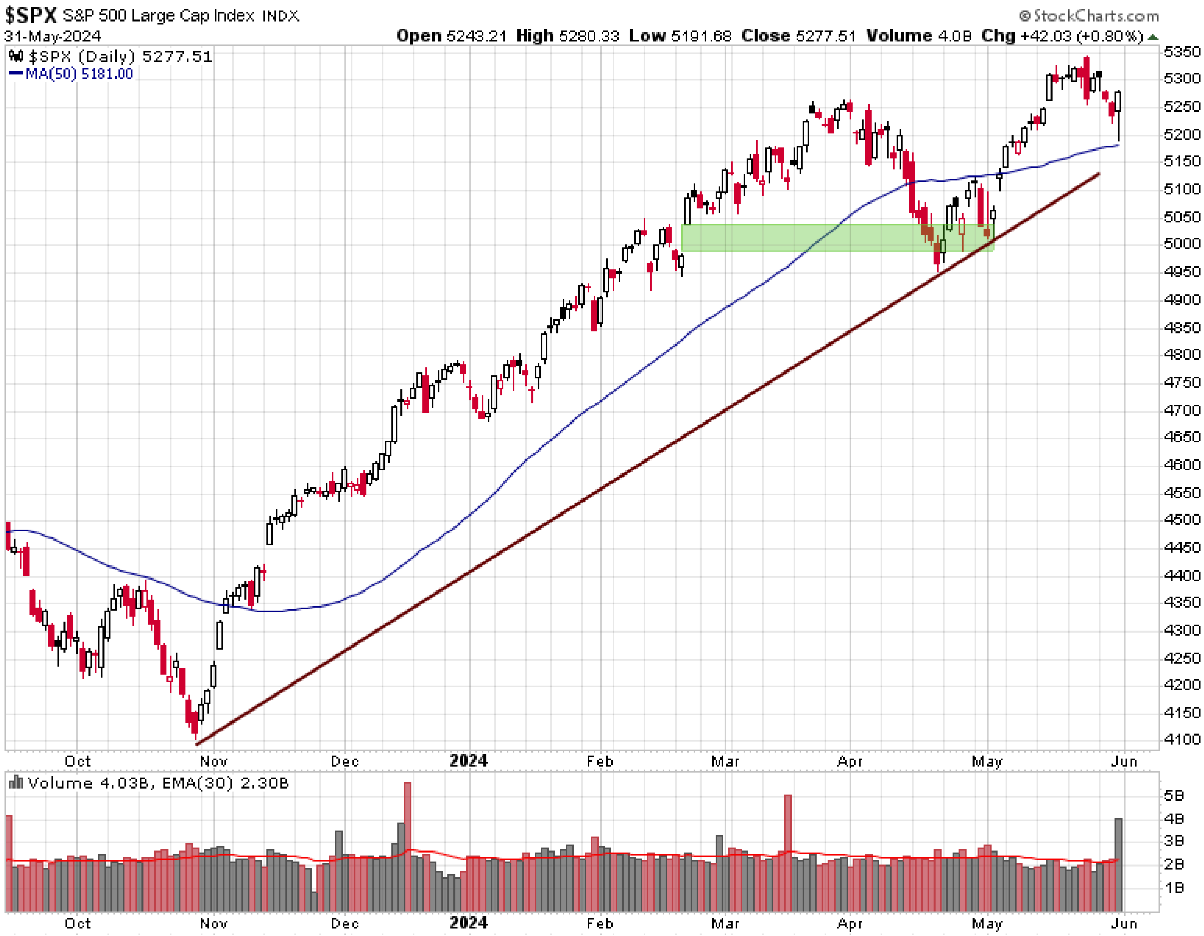

Key Takeaway:

The past two weeks' data has been generally positive. Although yields rallied on the positive data as investors initially priced in the "Higher for Longer" interest rate narrative and pressured stocks, Friday's Core PCE (the Federal Reserves preferred inflation metric) seems to have calmed investors' nerves.

The Week Ahead:

Once again, it's Jobs week, but before we get to Friday's all-important employment reports, we will see ISM Manufacturing PMI today and the ISM Services PMI on Wednesday.

Investors will cheer "Goldilocks" data (not too hot, not too cold), as that will keep the two-rate cut thesis for this year on the table without destroying growth. In this fickle market, soft data has been received rather well of late, so one would expect lower rates and a rally in equities so long as the data isn't too strong.

Tidbits & Technicals: (New developments will be denoted in *italics*)

Current Headwinds:

- Valuations seem frothy given the current rate environment, leaving the markets subject to a potential swift pullback
- “Higher for Longer” – Risk that the Federal Reserve waits too long to begin lowering rates and threatens economic growth
- 10-year Treasury yields recently broke out to new highs for the year, signaling that bond investors may be beginning to believe in the “Higher for Longer” thesis, but have retreated more than 25 basis points (.25%) in May

Current Tailwinds:

- Optimism surrounding Artificial Intelligence (AI)
- Fed pivoting from raising rates to potentially cutting in the future
- Strong labor market
- Solid economic growth
- Continued earnings growth (the pace of which may be slowing)
- Momentum
- Participation is broadening with cyclicals taking a leadership role while the tech-trade begins to fade

Sentiment:

- Credit spreads remain tight, hitting their lowest levels since peaking in 2022, signaling the bond market (aka “smart money”) is not worries about a recession in the near future.
- The VIX (CBOE Volatility Index) has completely reversed its tone and is back to the lower levels of the complacency zone.
- *The CNN FEAR & Greed Index has returned to Neutral, signifying a balanced sense of investor optimism.*

Intermarket Trends:

- The major indices (Dow Jones Industrial Average, S&P 500, and NASDAQ) recently posted new highs, signifying a positive trend.
- *Interest rates crept back up recently, as investors perceived the recent bout of strong economic data to keep rates higher for longer. Rates were somewhat cooled by last week’s inline Core PCE but remain volatile.*
- The US Dollar is trading near the upper end of this year’s trading range due to foreign central banks being the first to cut rates and others taking further rate hikes off the table while the Fed continues its campaign of tough rhetoric.
- Gold is trading near record highs.
- Industrial metals have raced higher recently, and copper recently broke out of a multi-month trading range.

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- Oil futures have pulled back from recent highs and are trading in the middle of their one-year trading band.

Tying it all together:

The economy and the market are stable for now. Four factors have driven the market since October: strong growth, falling inflation, expectations of Fed rate cuts, and tech stock strength. These factors remain intact despite some of the alarming headlines that surfaced a few weeks ago.

In April, stocks fell when it seemed the Fed might not cut rates in 2024. Now, markets expect two rate cuts in 2024, starting in September. Coming into the year, I heard expectations for seven rate cuts. These shifts could cause short-term volatility, but we're not generally focused on the short term. Whether the Fed cuts rates in September or December isn't crucial, as long as a cut is coming. If the market drops soon due to rate-cut worries, it's likely a buying opportunity rather than a long-term problem.

In the long term, the key concern is economic growth. It's strong now, but we need to watch for signs of a slowdown, as that could be detrimental to the markets. High interest rates aren't as much of a major concern so long as growth remains solid.

For now, this is all “to be watched,” as the positives (full employment, declining inflation, economic growth, strong earnings, etc.) currently far outweigh the negatives, and until those change, conditions are favorable for risk assets. Environments like this have best been navigated in the past by making certain one’s overall portfolio is in line with their risk tolerance and focused on achieving long term goals.

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