

# **CLUTINGER, WILLIAMS & VERHOYE, INC.**

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## **Economic and Market Outlook**

**March 31st, 2024**

**Don't Worry, Be Happy**

*Remember that the stock market is a manic depressive.*

*-Warren Buffett*

### **Section I. Introduction**

Mr. Buffett is referring to how the stock market tends to react to news in the short term. For any consumer of financial news, this will ring true. Equity markets swing wildly from day to day on the smallest of news, rally, and crash on sentiment, and celebrate or vilify the most inane data points. It's important not to get caught up in the madness and to stay rational.

### **Section II. The Developing Bull Market**

Just like a bear market is defined by the S&P 500 (S&P) being down by 20% or more, the most basic definition of a bull market is an upward move of 20%. Since the lows of October 2022 through March 22<sup>nd</sup>, 2024, on a closing basis, the S&P was up 46.1%. In addition, the S&P has achieved all-time highs multiple times.

Prognosticators were claiming that we were experiencing a "bear market rally". Now those same so called experts are claiming that we are in a stock market bubble.

The fact is that since 1930 the average bull market lasted 694 days. The current one is only 366 days old, implying it is about at its midpoint.

Based on historic trends, 2024 should turn out to be a positive year for equity markets. Since World War II, whenever the S&P 500 rose in price in January, The market was up an average of 16% for the entire year and was up in price 85% of the time. In addition, for the 9 election years with positive January returns, the S&P gained an average 15.6% and went up 100% of the time.

While the earlier run in the market was somewhat concentrated in a few tech stocks, we have started to witness slightly broader participation. Remember that the S&P 500 is a market capitalization weighted index influenced by seven mega-cap stocks. This is why the S&P outperformed the equal-weighted S&P by 13% during 2023.

For the first quarter, the S&P was up 9.89% quarter to date and the Equal-Weighted S&P was up 6.34%. Since the end of last month the Russell 2000, an index of mid-cap and small-cap stocks, is up 5.27%. These returns are an indication of some broader participation in the markets. This also aligns with the January barometer. Data shows that sectors with positive returns in an up January have an average full year return of 21.2% compared to 15.0% for the S&P. This lends support to maintaining our current allocation.

To be clear, in the short term we fully expect some type of correction or consolidation for the market over the next few months for reasons we will cover later in this report. Corrections of less than 10% are part of normal volatility, and is healthy for the market.

Earnings last quarter were better than feared, and estimates for next quarter have risen in each of the first two months of this quarter. This would mark the third quarter in five with earnings growing instead of shrinking.

Artificial Intelligence (AI) has only benefited a few obvious stocks to this point. But the real benefit will be for non-tech companies becoming permanently more efficient because of AI, which would coincide with a broadening out of the stock market rally. AI promises to be the next great revolution for our economy. This will not happen overnight but will provide outstanding benefits over the long term.

### **Section III. Inflation**

The readings for inflation continue to moderate. Currently the Consumer Price Index (CPI) is up 3.2% on an annual basis, and core CPI, which excludes food and energy, is up 3.8%. Both readings are for February 2024. While CPI ticked up 0.1% since our last report, core CPI continued its descent. The CPI reading has leveled off after peaking in June of last year at 9.1%. The core rate actually peaked in September at 6.6%. This is still well above the Federal Reserve's 2% target. The problem with all these measures of inflation is that they are backward looking, or lagging indicators, especially housing, rent and used cars. The recent efforts by the Federal Reserve to reduce inflation by raising the Fed Funds Rate by 5.25% will continue to have a delayed effect on the economy.

The Federal Reserve prefers to use a measure called the Personal Consumption Expenditures (PCE) Price Index to gauge inflation. The reading for PCE in January was 2.4% and the core rate was 2.8%. If you annualize the past 6 months, the core PCE is 2.4%. February data will be released March 29<sup>th</sup>. Inflation in the Euro Zone decreased to 2.6% in February, the lowest rate in 3 months.

Remember that containing inflation is not about lower prices, but about stable prices. It appears that the Fed's aggressive approach is already having some effect. The normal lag for the effect of rate hikes is 12 to 24 months or more. Our first hike was last March, 24 months ago.

Wages are starting to moderate as job openings drop and adjustments for increases in the minimum wage start to moderate. Wage increases trail inflation so it is not the problem that many believe. Wages tend to increase in order to keep up with inflation, as opposed to causing inflation.

### **Section IV. The Federal Reserve and Interest Rates**

Because of inflation, the financial media and the Fed have become more focused on interest rates. We have been spoiled by ultra-low rates during the pandemic.

The Federal Reserve has continued to alter their previous monetary policy path of hiking interest rates. Federal Reserve Chairman Jerome Powell held rates steady for the fifth time in a row at their last meeting earlier this month, but stated the committee is still data dependent, and appeared to open the door for possible rate cuts in the future. This probably does mean the Federal Reserve is done with the rate hiking cycle, a bullish sign. While they also will continue to let \$95 billion in bonds roll off the Fed

balance sheet each month, there was talk of reducing this amount to half as much. Slowing down the roll off will give the Fed greater flexibility to maintain ample liquidity in the system. Shrinking the Fed balance sheet will tighten money supply which once again means lessening consumer demand. This is reflected by the fact that growth in M2 money for February year over year is now -4.97% (Chart #1).

We do expect the Fed to start cutting interest rates, probably with the first cut in June. This brings us to another study that found that after the first rate cut, if no recession materializes, the market is up 24% on average over the next year. Even if a recession comes the market rose 10% on average over the following year.

One problem we have had with the Fed's path is the pace at which they had been raising rates. It takes time for interest rate hikes to have their full effect on the economy and inflation. The economy does not turn on a dime. The rapid pace and size of the rate increases have partly contributed to the gap on some bank balance sheets, causing some concern regarding the stability of the regional banks. With rates now starting to drop that concern is lessening. We view the continued pause in recent months a positive sign that the Fed is starting to let previous hikes take their full effect.

Rates in most European 10-year bonds are pulling back along with the U.S., because of a slowing global economy. The U.S. 10-year bond still remains more attractive to international investors for its yield and AA+ credit rating. The U.K. 10-year yields 3.96% (AA), German 10-year yields 2.32% (AAA), France 10-year yields 2.80% (AA), Italian 10-year yields 3.64% (BBB) and Swiss 10-year yields 0.5.9% (AAA). These compare to our 4.21% 10-year yield.

## **Section V. The Recession Model**

As we have discussed in past reports, earnings and the economy are the true long term influences on the stock market. Recessions, or fear of recessions, are the major reason we experience corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and tend to happen multiple times each year.

The official arbiter of recessions in the U.S. is the National Bureau of Economic Research (NBER). They determine when our economy enters and exits recessions. The problem is that usually by the time they declare the official start date of the recession the economy is probably coming out or already done with that recession, in other words no predictive value.

At Clutinger, Williams & Verhoye we have developed what we view as a recession indicator which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative and the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of February, the unemployment rate was 3.9% and the 12 month moving average was 3.71%. By being above the moving average this indicator has stayed negative.

Indicator number two is represented in Chart #2. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. Currently the reading is -1.62% for February, so this indicator is negative. Any reading above 0 is positive.

Indicator number three is represented in Chart #3. This shows the year over year change in Industrial Production. This indicator has turned slightly negative. It currently sits at -0.23% for February 2023. This is not surprising given the strong GDP number from the fourth quarter.

For indicator number four (Chart #4), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year over year percentage change basis. This indicator stands at 0.93%. A zero reading represents neutral therefore this indicator is positive.

Indicator number five (Chart #5) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Currently the reading is -0.49%, so this indicator is negative but is unchanged from our last report. This reflects the continued fear of the long predicted recession but also allows for an easing of inflation.

Currently four of the five indicators are negative but the S&P 500 Index has surged to be 13.33% above its 40-week moving average as of March 22<sup>nd</sup>. With the S&P 500 above its forty week moving average this model is not giving it a recession warning sign. We will be closely monitoring these indicators in the coming months.

The above indicators are only updated on a monthly basis. To offset this situation we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile so we track three month moving averages.

These two indicators are separate and independent of the first five and either one can indicate the possibility of recession on its own.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average has turned slightly negative and is at -0.19 currently. The divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average remained relative steady at -0.02.

In summary, the two “early warning signs” are not predicting recession at this time. We still believe that in February 2023, when our indicators predicted recession, we may have already experienced the mild recession everyone keeps predicting.

## **Section VI. Market Psychology**

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently, all 12 of our price/volume indicators are positive, which sounds good on the surface but indicates to us that the market may be a bit ahead of itself. This is the reason we would expect some sort of short term correction or consolidation. The S&P has reached 5260 and keeps making all-time highs. But that doesn't necessarily mean the end of the rally. The market needs corrections from time to time in the short term to stay healthy and growing over the long term.

Our advance/decline line has been positive for the last several weeks and sits at 57.5%, and is reflecting a slight overheating of enthusiasm.

Our technical model measures the first and second derivative of price and volume for the market. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data. This model is providing neutral signs and our proprietary charting is reflecting a pattern seen during past consolidations in the market.

## **Section VII. The Economy**

Indexes that measure manufacturing data are mixed. The Philly Fed Manufacturing Index, after being negative showing contraction for months, popped back to 5.2 in February of 2024. But The Empire State Manufacturing Index dropped to -20.9 in March. The national ISM manufacturing index was 47.8% in March and the ISM services index was 52.6% (above 50 is considered growth, above 55 is considered exceptional growth). All these readings reflect a softening economy and the fact that the Fed may just pull off the goldilocks soft landing scenario.

Multiple Wall Street and Federal Reserve predictions for GDP have been lowered because of elevated interest rates. GDPNow correctly predicted GDP at 3.2% annualized for the fourth quarter. Their estimate for the first quarter of 2024 is currently 2.1%. This shows the economy is normalizing even with the headwind of higher rates and strengthens the argument for at least one or two rate cuts.

## **Section VIII. Conclusion**

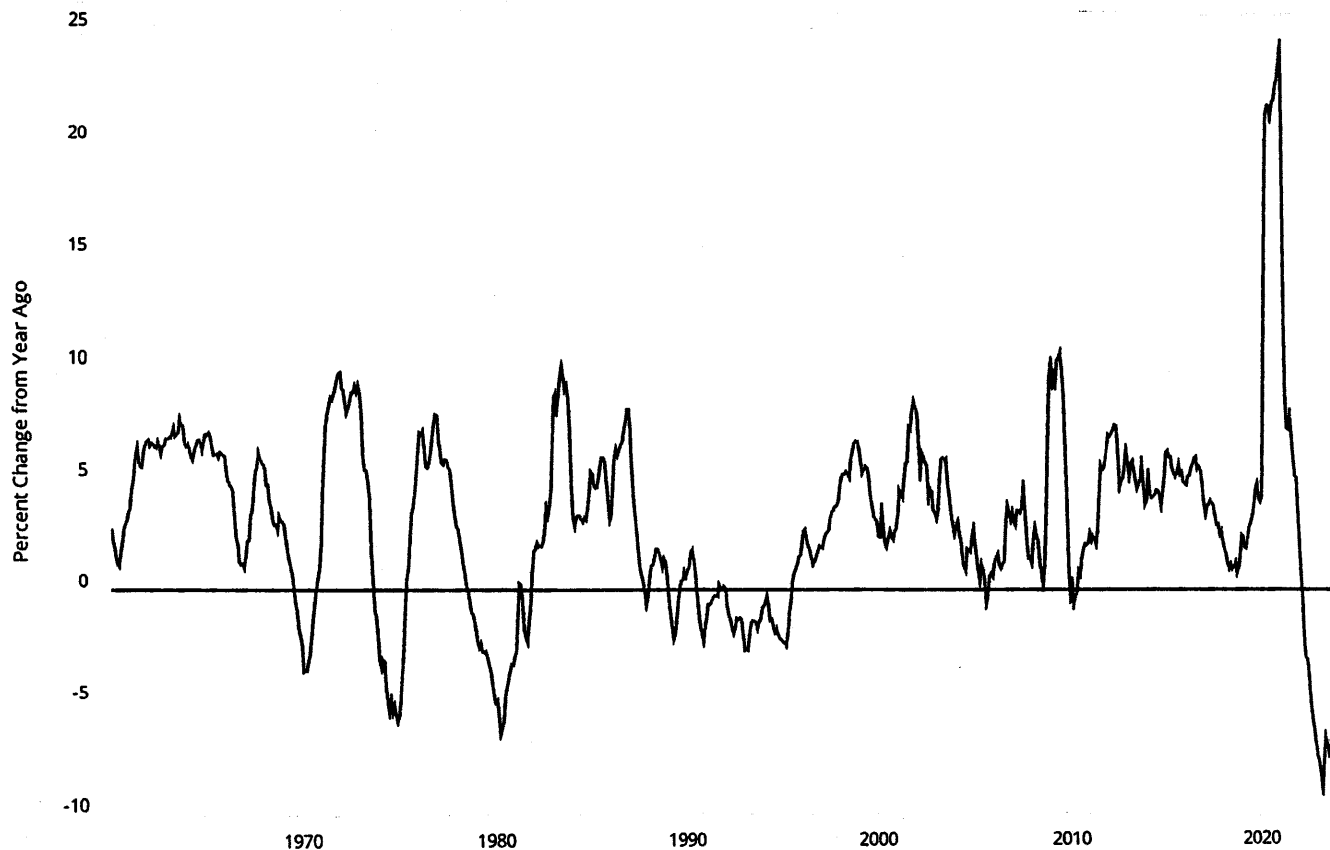
The first quarter has seen a continuation of the market rally that started last year. We have sighted many reasons why we believe this will continue in the long run.

We continue to be optimistic for 2024. Please remember that in the short term there is always volatility and we would not be surprised by some profit taking or a healthy consolidation in the market. But, in the long run, portfolios should continue to grow and provide for your long term goals.

Best Regards,

Scott B. Williams, CFA, CFP  
Kent Edwin Stone

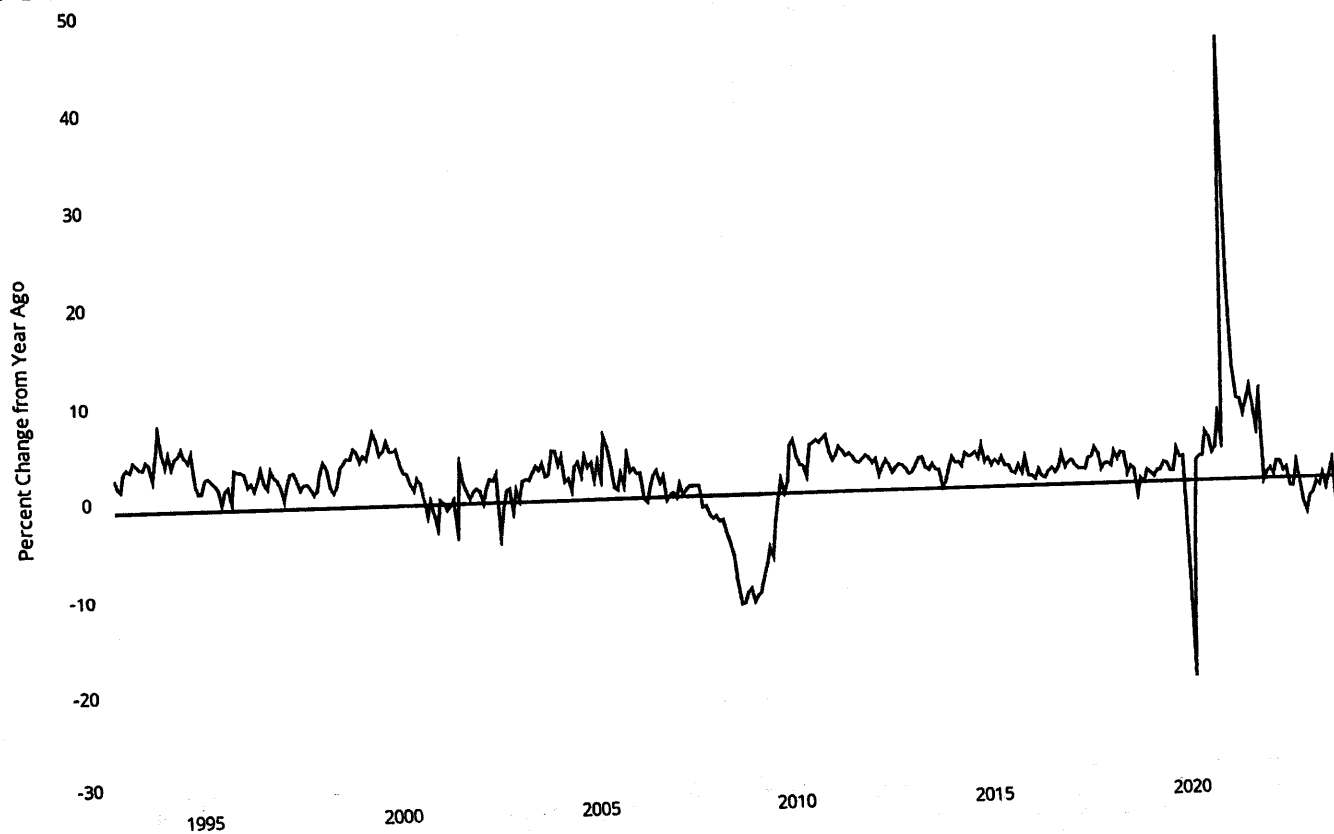
Chart 1

**FRED** — Real M2 Money Stock

Source: Federal Reserve Bank of St. Louis

fred.stlouisfed.org

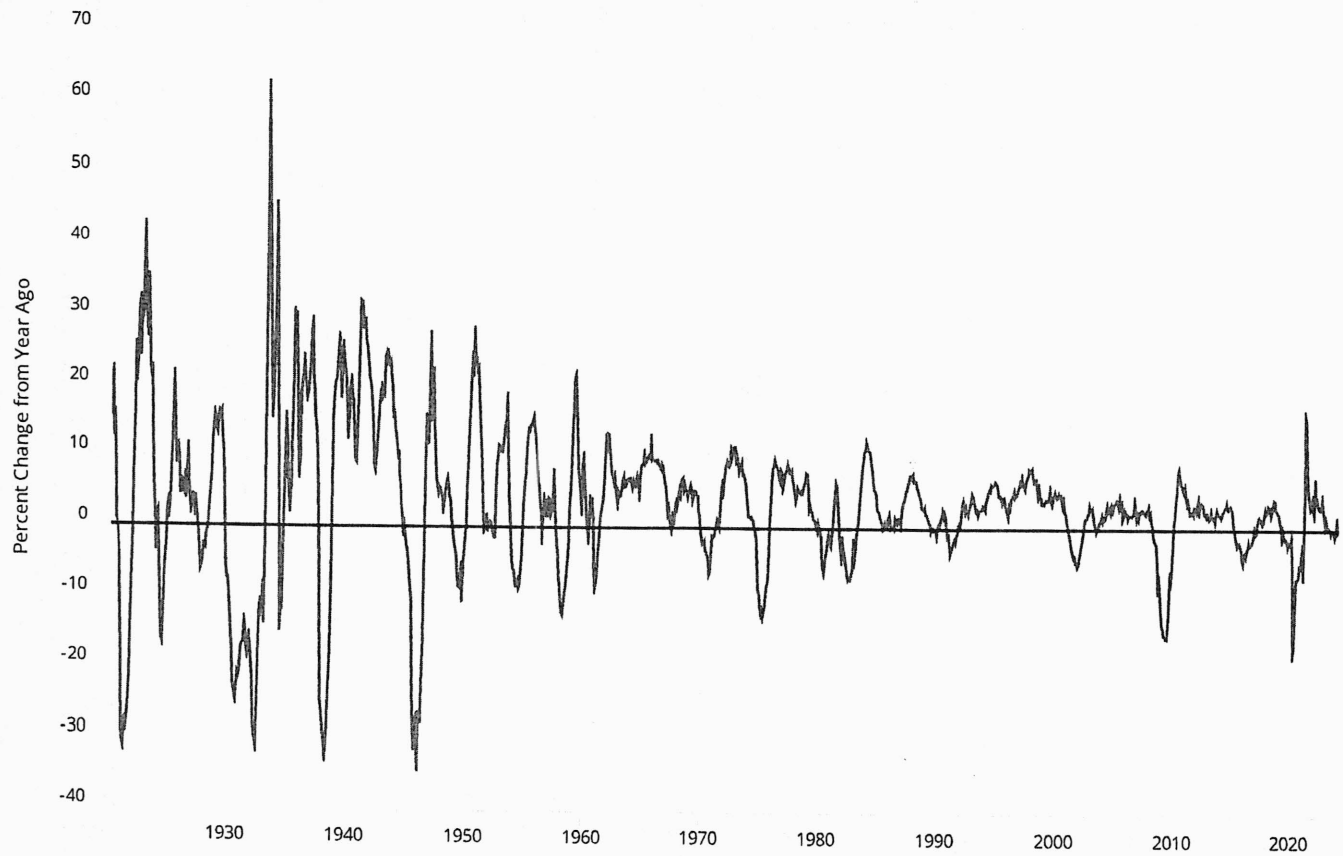
Chart 2

**FRED** — Advance Real Retail and Food Services Sales

fred.stlouisfed.org



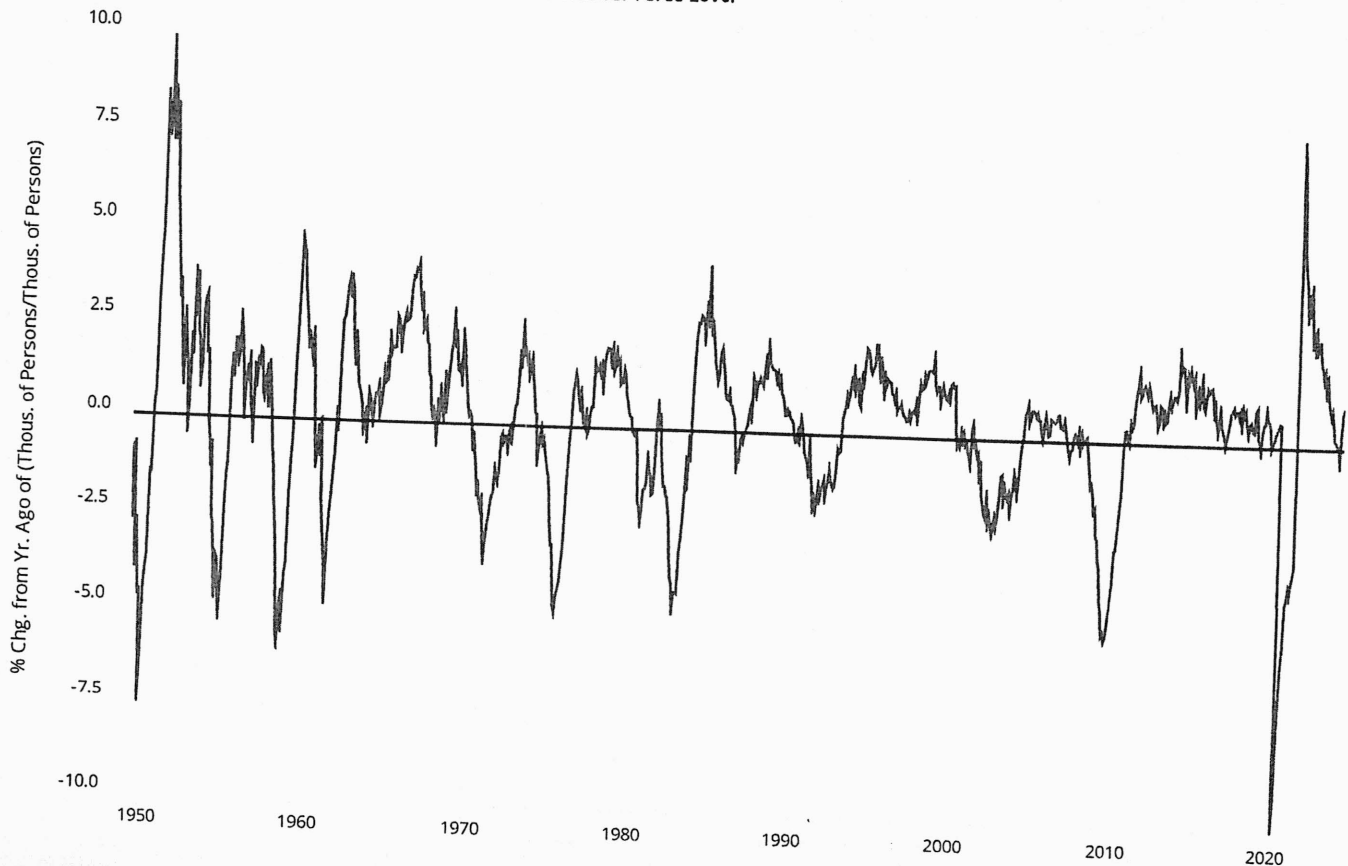
Chart 3

**FRED** — Industrial Production: Total Index

Source: Board of Governors of the Federal Reserve System (US)

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Chart 4

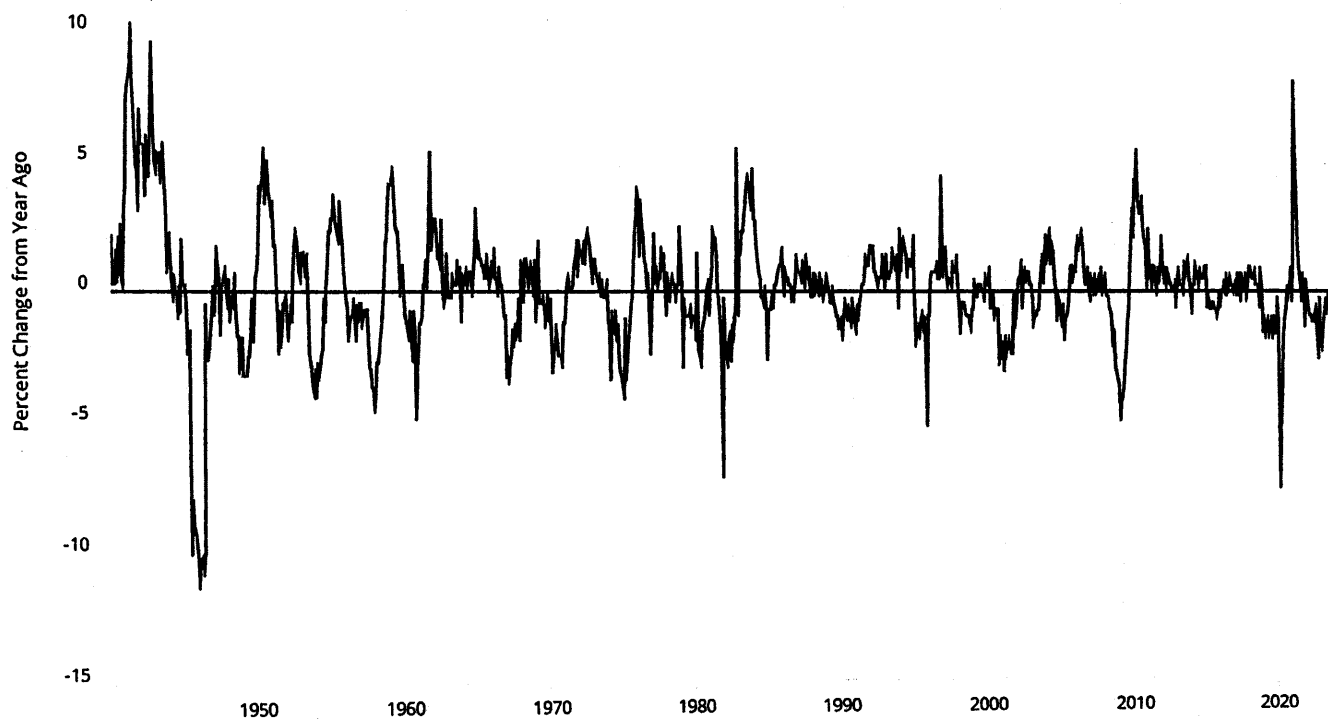
**FRED** — All Employees, Total Nonfarm/Civilian Labor Force Level

Source: U.S. Bureau of Labor Statistics

fred.stlouisfed.org

**FRED** — Average Weekly Hours of Production and Nonsupervisory Employees, Manufacturing

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Source: U.S. Bureau of Labor Statistics

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