CHOATE INVESTMENT ADVISORS

2024 Q1 REVIEW

Economy Remains Resilient as Innovation Spurs Growth

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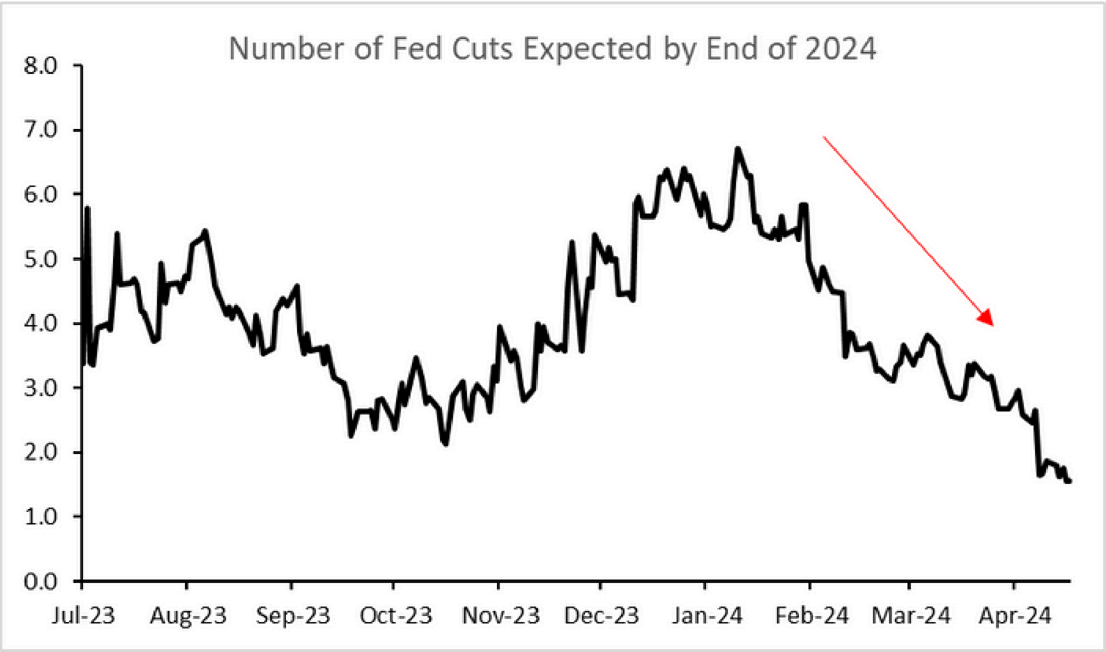
2024 First Quarter Review

Economy Remains Resilient as Innovation Spurs Growth

Taming inflation is hard, and stocks and bonds diverged last quarter as the economy remains resilient while interest rates remained higher for longer. The stock market continued to churn upward in the first quarter of 2024. The MSCI All Country World Index rose by 8.1%, and the S&P 500 Index increased by 10.6%. By contrast, bonds struggled as interest rates rose, with the Bloomberg Aggregate Bond Index down 0.8%. Equity returns drifted down in April as investors begin to digest the Federal Reserve's determination to deter inflation's stubborn crawl upward.

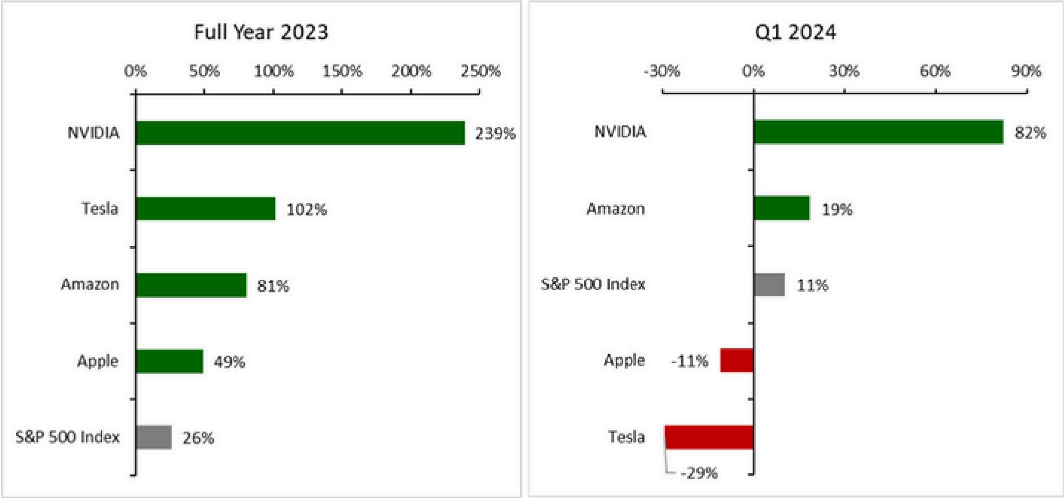
Chart 1: Forecasted interest cuts declined from 6 to 2



Source: Bloomberg as of 4/30/2024

There is a broadening out of stock returns this year beyond the largest companies in the index. The gap between the market cap-weighted index (up 10.6%) and the equal-weighted index (up 8%) is much smaller than last year, and some of the largest firms such as Tesla and Apple are struggling, while NVIDIA and Amazon continue to outperform.

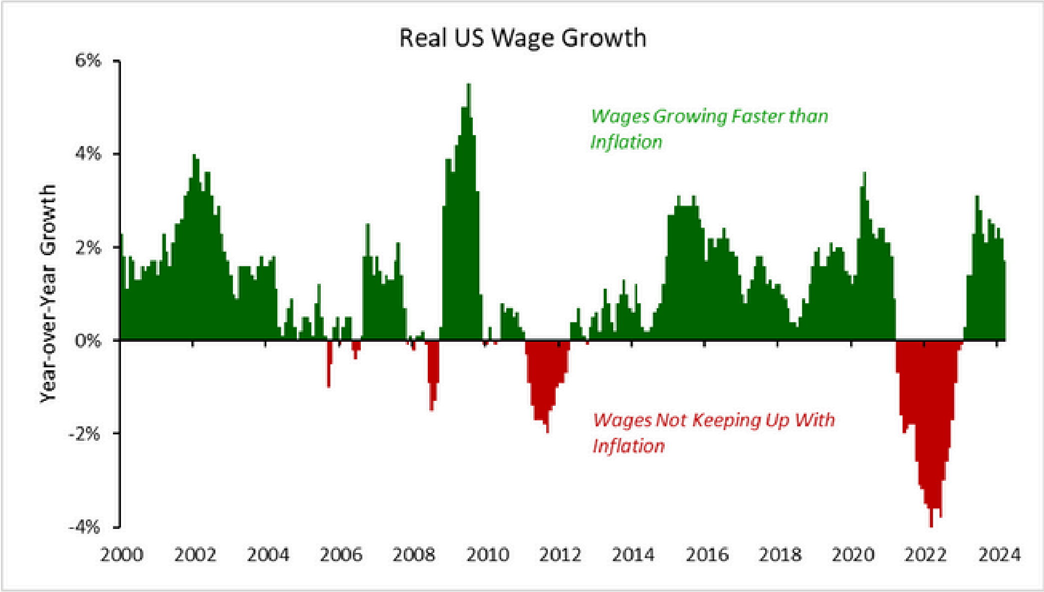
Chart 2: Total Return – Mega Caps diverging



Source: FactSet as of 3/31/24

Why are stocks continuing to climb higher? Economic spending is beating nearly all the pundits' predictions. Unemployment remains low and wage growth now exceeds the inflation rate, increasing household purchasing power.

Chart 3: Wages growing faster than inflation supports household spending

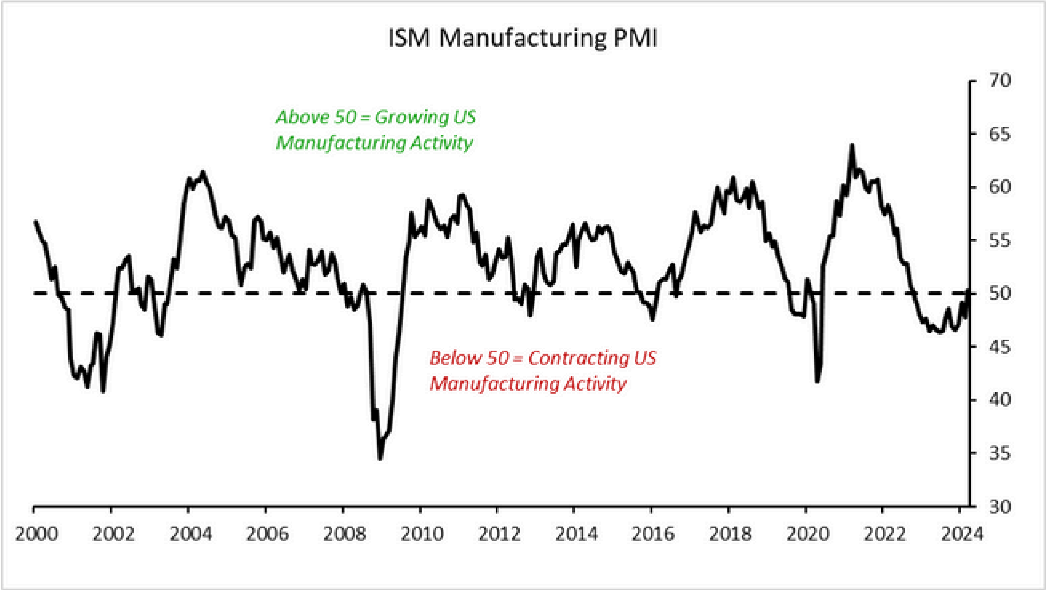


Source: Bloomberg as of 3/31/24

In addition, survey data point to expansion in the manufacturing sector and continued growth in services. This economy continues to support higher corporate earnings and stock prices.

Inflation is now a lesser concern but remains a lingering issue, since its deceleration has stalled above the Federal Reserve's 2% target. To date, the economy has weathered the steep movement to higher interest rates without showing any real widespread stress or a slowdown in company profits and the stock market.

Chart 4: Manufacturing activity expanding

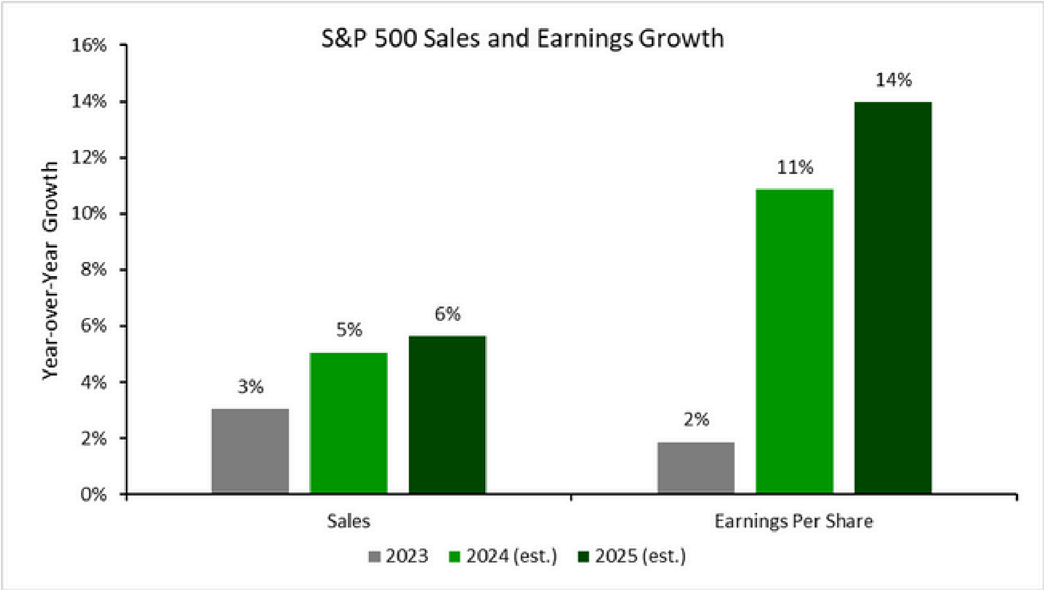


Source: Bloomberg, Institute for Supply Management (ISM), Purchasers' Manager Index (PMI) as of 3/31/24

Let's take a closer look at corporate trends in growth, profitability and valuation for the S&P 500 index in aggregate.

Growth tailwinds persist: 2024 corporate sales growth is expected to be above 4%, which is in line with the 15-year average top line increase and better than the slowdown predicted a year ago. Furthermore, investors expect sales growth to continue into 2025.

Chart 5: S&P 500 growth estimates accelerating

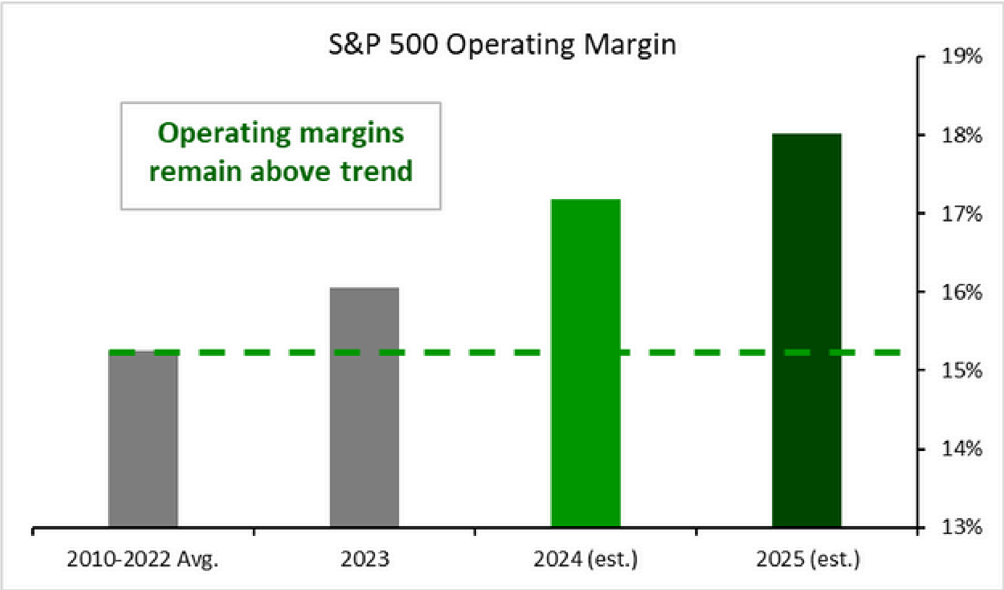


Source: FactSet and S&P as of 4/30/24

In addition, earnings growth expectations remain stable at 11% above last year, which provides support for current stock prices. However, investors may need faster growth to drive equity returns significantly higher. We would rate this as a neutral factor for now.

Profitability remains high: The current margin trends point to a relatively optimistic picture. Operating margin for the S&P is expected to increase from 2023 and remains above the historical average since 2010.

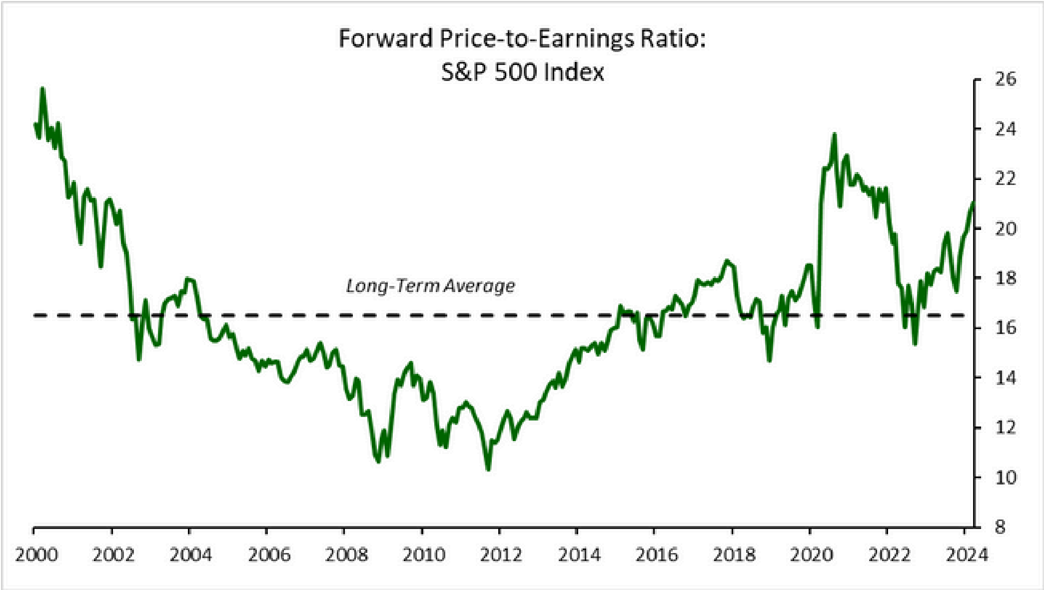
Chart 6: Profitability is robust



Source: FactSet and S&P as of 4/30/24

Valuation: Valuation is often the best prism for investors to interpret market sentiment. Stock investors are usually optimists, in the aggregate, and have already imbedded the positive revenue and earnings growth into equity valuations. For stocks to move higher, we would need to see persistence or acceleration in expected growth and profitability.

Chart 7: Investor optimism reflected in elevated S&P 500 valuation

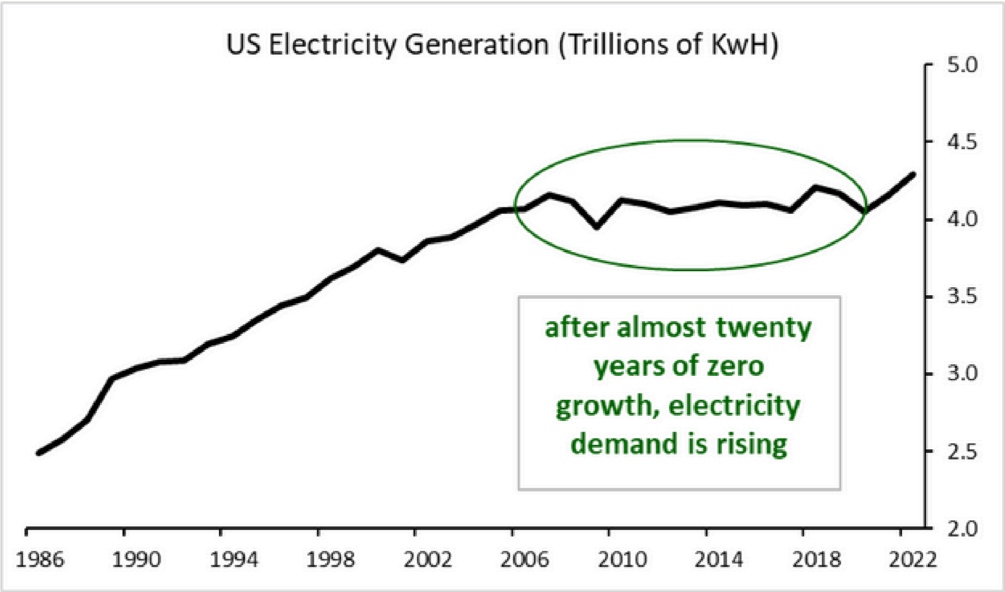


Source: FactSet and S&P as of 4/30/24

Thus, the stock market is vulnerable to any adverse changes in these expectations. We would rate valuation as challenging.

Seismic innovative transitions: There are several significant innovation trends driving our domestic economic engine -- including biotech discovery, electrification of our energy usage, and general Artificial Intelligence (AI). We will dig into AI here and look for opportunities beyond the primary semiconductor beneficiary, NVIDIA. One opportunity is the tremendous energy demand to power massive AI data centers and the additional infrastructure to support this demand. According to research from Bernstein, data center power consumption is expected to grow 9% per year through 2030, and the data center share of overall electricity demand is expected to triple, growing from 2.5% to 7.5%. This is because AI server racks use much more energy than non-AI server racks. Our current electricity grid has not grown in decades and is not capable of supporting this demand surge (See chart 8 below).

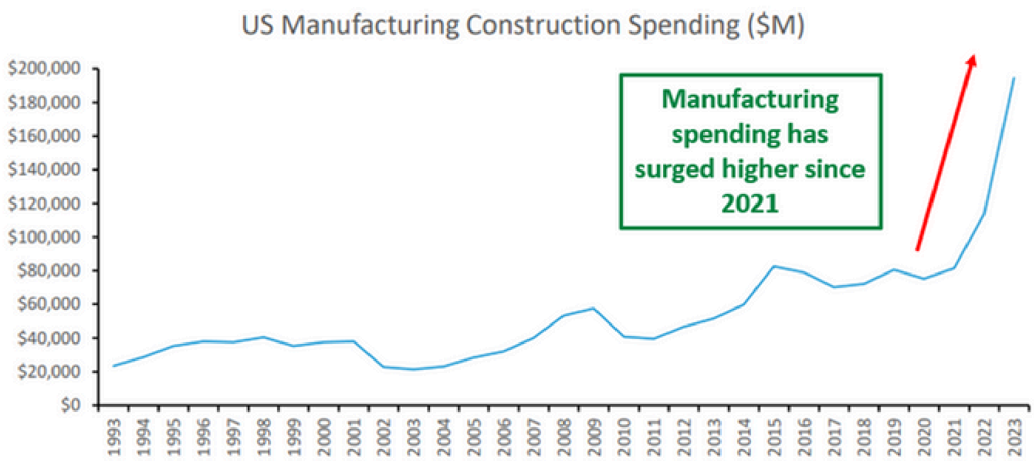
Chart 8: US electricity demand set to grow for first time in nearly twenty years



Source: Bloomberg and EIA as of 3/31/24

In addition, companies are taking advantage of the Inflation Protection Act to rebuild and expand American factories, which is accelerating the manufacturing capital expenditures that will drive more robust and diversified supply chains.

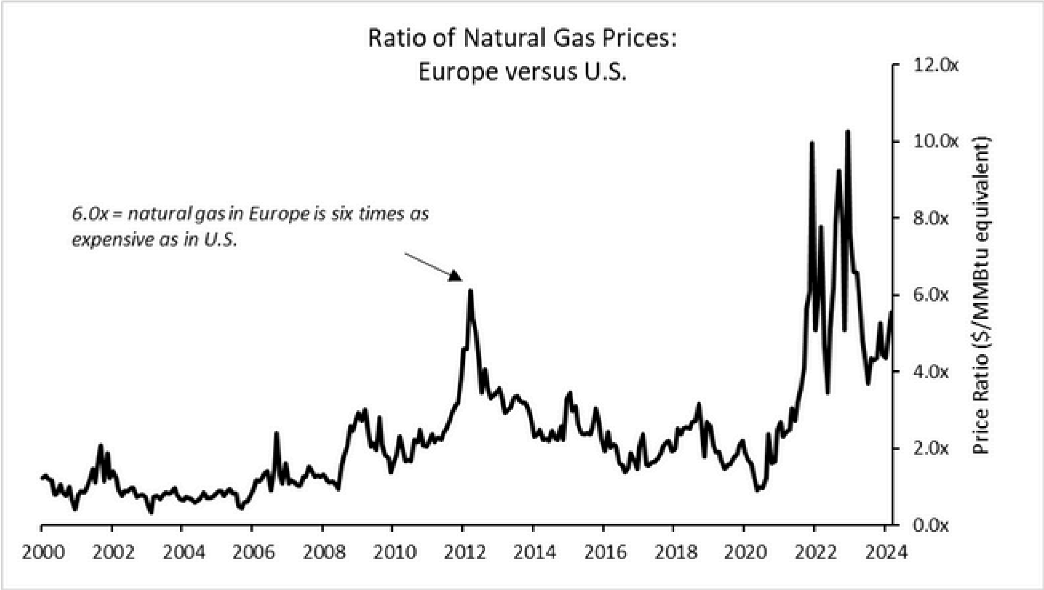
Chart 9: Annual manufacturing spend within the US



Source: Census bureau, Bernstein as of 12/31/23

Investment in AI and manufacturing provides massive support to the industrial economy. Industry in the US is also supported by our cost advantage for energy in comparison to Europe and Asia. Currently, the cost of natural gas in Europe and Asia is five times more expensive than US domestic prices. This creates a significant competitive advantage to reshoring heavy, energy intensive industrial processes. As an aside, both Europe and the US have seen a normalization of natural gas prices after the significant increase post-COVID and after the onset of the war in Ukraine.

Chart 10: European natural gas is 5.0X more expensive than US prices



Source: FactSet as of 4/30/24

In summary, the economy is adapting to the significant challenges and obstacles that surface during these innovative transitions. We seek to listen and learn to better position our clients for this changing environment. We see the current situation as neutral for stocks, with positive profitability tailwinds and valuation as a slight headwind. The strong returns in Q1 came from investors bidding up stocks on the expectation that current growth will be higher and persist for longer.

We remain optimists, but the above average GDP growth will eventually recede. Importantly, since 1926, the S&P has posted positive calendar year returns 73% of the time, so owning stocks in line with your strategic target is an appropriate baseline. We will be monitoring unemployment, inflation, and key leading economic indicators to watch for future signs of weakness.

We look forward to hearing from you, and please reach out with any questions. We look forward to updating you on your portfolio and on our outlook for the next year.

Best regards,
The ChoateIA Investment Team

For More Information

Providing objective, independent, institutional-quality investment management tailored to the needs of each client, Choate Investment Advisors offers comprehensive, integrated wealth management to high net worth individuals and families, providing a range of well-diversified investment strategies across the risk spectrum. Our open-architecture approach and substantial assets allow us to select from a wide array of asset classes and to work with the highest quality investment vehicles. As a subsidiary of Choate Hall & Stewart, our clients receive world-class estate tax planning and other family office services.

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The Bloomberg US Aggregate Bond Index is an unmanaged index that covers the investment grade fixed rate bond market index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.