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# First Quarter 2024 Commentary

Dear Clients,

Please find enclosed your First Quarter 2024 Investment Reports.

U.S. Stocks started off the year with strong performance. U.S. Large Cap Stocks produced a 10.9% total return for the first quarter, with U.S. Mid Cap Stocks and U.S. Small Cap Stocks producing a robust 7.9% and 7.5% respectively over the same period. Developed International Stocks were up 5.8% for the quarter, with Emerging Market Stocks lagging at 2.4%.

**Benchmark Returns**

| | Last Quarter | Last Twelve Months | Last Five Years (annualized) |
|---|---|---|---|
| U.S. Large Cap Stocks | 10.9% | 32.5% | 15.7% |
| U.S. Mid Cap Stocks | 7.9% | 20.4% | 10.9% |
| U.S. Small Cap Stocks | 7.5% | 22.4% | 9.9% |
| Developed International Stocks | 5.8% | 15.3% | 7.3% |
| Emerging Market Stocks | 2.4% | 8.2% | 2.2% |
| U.S. Bonds | -0.8% | 1.7% | 0.4% |
| Global Bonds | -2.1% | 0.5% | -1.2% |

Data source: YCharts. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Indexes in table are:
US Large Cap Stocks: CRSP US Mega Cap TR
US Mid Cap Stocks: CRSP US Mid Cap TR
US Small Cap Stocks: CRSP US Small Cap TR
Developed International Stocks: MSCI EAFE NTR
Emerging Market Stocks: MSCI Emerging Markets NTR
US Bonds: Bloomberg US Aggregate TR
Global Bonds: Bloomberg Global Aggregate TR

The quarter featured a reverse in the recent strong returns for broad bond indexes, with U.S. Bonds down 0.8% for the quarter. Global Bonds trailed ever further, down 2.1%, as the dollar broadly strengthened against other currencies during the quarter. For the quarter, the 10-year U.S. Treasury rate moved upward from about 3.9% to 4.3% (recall that bond prices move inversely to interest rates). This upward trend in interest rates (and negative returns in bonds) reflected the bond market's view that the Federal Reserve may take longer to cut rates than expected at the beginning of the quarter.

There is essentially a balancing act taking place in the U.S. bond and stock markets right now. The "soft landing" that you hear about in the financial news refers to a situation where inflation expectations recede, but growth expectations do not. The Federal Reserve will presumably cut rates if growth expectations fall too far, but they will presumably keep rates higher if economic growth proves more resilient than expected. This means it is difficult for the market "to have its cake and eat it too." (i.e., it will be unlikely that the markets receive Federal Reserve interest rates cuts and simultaneously enjoy vigorous economic growth.)

Consider that from 2001 to 2022, the average annual growth rate in earnings per share of U.S. Large Cap Stocks was about 7.5%. For the 2023 calendar year, that earnings growth rate was less than 0.5%. The stock market is always looking forward to the future, and the stock market has rallied in large part because the future looks better than many expected it might. As you can see in the table to the left, over the last twelve months, U.S. Large Cap Stocks are up 32.5%. The vast majority of this return appreciation has not come from actual profits earned (which have been roughly flat), but from the expectation of *future* profits to be earned. The U.S. stock market's returns presume, and increasingly the Federal Reserve agrees, that the U.S. economy will be stronger and more resilient than expected going forward.

Indeed, despite the Federal Reserve's rate increases (designed ostensibly to cool the economy) beginning two

years ago in March 2022, the U.S. unemployment rate remains near generational lows at 3.9%, and wage growth remains above generational highs at 4.2%. Headline CPI just printed at 3.5% for March 2024. How much incentive does the Federal Reserve have to cut short-term interest rates with inflation still warmer than desired, and employment still stronger than expected?

This discourse is reasonably short-term in nature. We produce a quarterly letter to keep our clients informed of recent market movements, yet we frequently try to reserve a portion of the letter to encourage clients to take a longer-term view of their circumstances and market conditions.

For example, as noted, the 10-year U.S. Treasury rate was approximately 4.3% at the end of the quarter (and 4.5% at the writing of this letter). That rate is the best offer an investor could earn from this asset in the past 15 years. If we told you that flights to Paris were the cheapest they had been in 15 years, you would probably look into a European vacation. Could you find a better deal if you waited till next year to take that trip? Possibly, but that is unknown. Similarly, the interest rates available to clients on money market assets are the best they have been in almost 25 years. Perhaps that is a vacation destination worth looking into as well?

Do we mean investors should abandon stocks? No, yet we also want to caution against looking at recent returns in the stock market and extrapolating those forward.

Again, U.S. Large Cap Stock earnings have grown over the past twenty plus years at about 7.5% per year on average. Those are reasonable expectations of annual returns. However, U.S. Large Cap Stocks returns were 10.9% for the past *quarter*. We strongly caution clients against changing their asset allocation based on such short-term performance. There will undoubtedly be tough times ahead (as there always are) in the stock market, and we will issue similar words of caution not to abandon stocks during such periods (as we do now for bonds). There is a reason to own safe assets like bonds with lower expected returns (for example: known future cash flow and liquidity needs, and reduced portfolio volatility). There is a reason to own high performing assets like stocks (for example: a long-time horizon to retirement or with assets you intend to pass on to another generation). In either case, last year's or last quarter's performance is not a particularly compelling reason to own or sell an asset class.

We say the same thing about the benefits of diversification within asset classes. For example, do you think the earnings of U.S. companies grew faster or slower than Japanese companies over the past 15 years? You would likely be in the majority of respondents if you said U.S. company earnings grew more quickly, but you would also be wrong. Despite the total return (investment performance) to U.S. investors being higher in U.S. stocks than in Japanese stocks over the past 15 years, earnings here grew more slowly. The difference in investment performance was largely due to an appreciating U.S. dollar (and to a lesser degree expanding earnings multiples in the U.S. versus declining multiples in Japan). The decline in Japanese earnings multiples has started to reverse, and Japanese stocks outperformed U.S. stocks over the past quarter. Many commentators have noted that the Japanese Yen is meaningfully undervalued to where economic forces suggest it should be, and that may also prove a tail wind to Japanese stocks going forward.

Returns in bond markets and stock markets fluctuate based on the complex interaction of multi-factor future expectations. We have not provided the Japan example to be prescriptive of an investment one should make (we could have just as easily talked about energy stocks and technology stocks). Rather we have provided the example as evidence of something not to do in a portfolio: namely abandon diversification based solely on historical returns.

There are many different seasons in financial markets, and we encourage clients to maintain a long-term view towards portfolio diversification.

As always, we remain grateful for your trust.

**Leavell Investment Management, Inc.**

*Please advise us if you would like copies of our annual Securities & Exchange Commission Disclosure Brochure (Form ADV), a Prospectus for The Government Street Funds or a record of how your proxy statements were voted.*