



**WALKER, HIGGINS & ASSOCIATES**  
WEALTH MANAGEMENT, LLC

## Quarterly Market Review and Outlook

### 2024 Q1 Market Re-Cap

The U.S. stock market is up in the 1<sup>st</sup> Quarter of 2024. The DOW Jones Industrial average gained 3.72% year to date.<sup>i</sup> U.S. growth companies were up more, while small cap stocks returned about 5%.<sup>ii</sup> Finally, non-U.S. stocks earned a little less than 5% during the 1<sup>st</sup> Quarter.<sup>iii</sup>

So far this year the trend of mega-sized, technology-focused U.S. stocks (the “magnificent 7” and others) are significantly running ahead of most other asset classes. Will this continue? Should we dramatically shift asset allocations to these stocks? Or are these stocks overvalued and due for a pullback? More on that later.

The overall U.S. bond market, sensitive to changes in interest rates, struggled at times in the 1<sup>st</sup> Quarter. We would attribute this primarily to changes in expectations, rather than changes in the actual rates. We are quite happy that the overwhelming majority of our bond allocation experienced a positive return so far this year.

### 2024 Q2 Economic Outlook & Beyond

#### **Interest Rate Update**

As we have said before, the Federal Reserve Board’s interest rate policy is perhaps one of the most important contributors to our country’s economic direction.

Interest rates are in the process of finding equilibrium after two material external shocks over the last 15 years. The first was the Great Financial Crisis of 2008 caused by the collapse of the U.S. residential housing market and the second, a mere 12 years later, was the Covid-19 pandemic. In both cases, the Fed’s response was to effectively set rates at 0% and to flood the economy with liquidity. This isn’t sustainable over long periods of time as evidenced by the inflation rate topping 9.1% in June 2022.

As we have written before, the Fed’s response to this was to raise interest rates to the present 5.25%. Because of that, the inflation rate has declined—the most recent number came in at 3.5%. This is far from the Fed’s 2% target but a substantial improvement over the peak.

Over the last four months, economic sentiment has greatly improved as recession fears have receded. Because of this, and because of positive statements put out by the Fed, many expect interest rate cuts this year.

Late last year, several financial institutions predicted 6 or 7 rate cuts this year. We thought this was overly optimistic and too aggressive. If the Fed cuts rates too much and too soon, inflation can come back—not good. Our best guess is that the Fed will have 2 or 3 rate cuts this year starting later this year. We would caution, however, that a “normalized” rate won’t go back to 0%. The Fed is signaling that it may settle around 2.5% over the next three or so years.

The key metric to watch over the next few to 6 months is inflation. As of this writing, the March inflation numbers came in higher than expected. If it continues to trend up, a rate cut should be off the table. If it moderates, a rate cut should be in the mix.

Currently, it looks like the Federal Reserve has accomplished the historic impossibility of dramatically increasing interest rates while not causing a recession. We now believe this is the likely scenario, but a recession is still a possibility.

## **Market Valuation**

So, if it seems like a recession is off the table, we should back the truck to the stock market and load up, right? We think not so fast, because valuation matters. Is the U.S. stock market currently expensive or not? This question matters a lot to us as we think of ourselves as value investors.

One simple measure of value is the ratio of price to earnings of a stock or of a market (the P/E ratio). Currently, the S&P500 index P/E ratio is 21—the 30-year average has been 16.6. The current number being higher than the average is one indication of overvaluation—27% overvalued if you do the math.

However, as we have written in the past, the S&P500 index is flawed in its construction. The top 10 stocks of the S&P500 make up 33.5% of the value of the index. The remaining 490 stocks make up 66.5%. The top 10 stocks are 40% overvalued while the remaining 490 are only 17% overvalued.

So, that simple measure of value indicates that some aspects of the market may be quite overvalued, while others may be fairly valued. As we like to say, it's not the stock market we are interested in investing in, but rather, it's a market of stocks.

So, if the portion of the stock market that has been performing the best is expensive, where should we go for opportunities? We aren't hockey fans specifically, but as we understand it, great hockey players focus on where the puck is going as opposed to where it has been.

## **How We Select What We Invest In**

Over the years, we have mostly drifted away from mutual funds in favor of exchange traded funds (ETFs) and individual securities. There are several reasons for this shift.

ETFs are generally less expensive when compared to mutual funds. All things being equal, lower costs translate into higher net returns. ETFs also have a higher degree of transparency than mutual funds. This means that we have a much clearer picture of the underlying holdings in an ETFs. Finally, ETFs are more tax efficient when compared to mutual funds. Higher tax efficiency translates into clients keeping more of their money instead of it going to Uncle Sam. Think of ETFs as being the more updated and improved version of mutual funds.

As for which ETFs, we use several systems to search parameters on what type of exposure we want to hold. We can hold specific ETFs that invest only in technology companies, blue chip dividend payers, or small companies. The idea is we can be very targeted in what sector, style, or metric we are trying to gain exposure. For example, in our 1<sup>st</sup> Quarter newsletter, we mentioned the desire to increase exposure to the technology sector. However, we had concerns about valuation levels within that sector. Ultimately, we added an ETF to accounts where appropriate with a technology focus, but with some risk-mitigation features should a significant correction occur.

As for which individual stocks, we look at numerous data points to find the companies that meet the criteria we are looking for. For a growth stock, we want a high rate of projected earnings growth. Ideally, we also want a growth name that is inexpensive by various metrics. We call this “growth at a reasonable price”.

Earlier this year, we reviewed all the “magnificent 7” stocks. All but two look very expensive to us. Alphabet (GOOG/GOGL) looked attractive to us. Specifically, we set a price target of less than \$135 per share—if the stock hit that price, we would be buyers. The stock hit that price for only two trading days, and we were able to buy some shares in various client accounts. As of this writing, GOOG is trading at \$158. We feel good about this purchase and believe shareholders will be rewarded over the next 5 years.

Around the same time, we identified PepsiCo, Inc. (PEP) as a blue-chip stock that is a good contrast to GOOG. A diversified business with some recession resistance (people drink Pepsi whether the economy is good or bad), an iconic name, a good dividend yield (approximately 3%), and a reasonable valuation where all attractive data points for us. We bought it in many client accounts with the idea that it was a good counterbalance to the GOOG trade. Diversification is a beautiful thing!

We are firm believers that data, research, and patience combine for successful, long-term investing. A disciplined, systematic process is what we believe in and what we practice.

## Summary

Even though a recession is still very much a possibility, it seems like the “soft landing” scenario is in play. Stock valuations, however, are frothy and we think a short-term pullback in stocks can be expected. Over the last 25 years, the S&P500 index has had a 7% pullback in 88% of those years, a 10% pullback in 50% of those years, and a 15%+ pullback every other year. Keep in mind these are averages, but the point is pullbacks are not uncommon.

Our thought is a dollar cost averaging strategy makes sense for most investors to gradually increase their exposure to stocks and risk assets. This requires time and patience, but we are holding cash at a 5%+ rate, and we continue to feel good about the bond market moving forward. The point is we are still overallocated to cash and bonds while gradually increasing allocation to the stock market.

We encourage clients to focus on their financial, retirement, and estate planning. These objectives should guide how and where they spend money, how their assets are managed, and how they are disposed of when they die. No two clients are alike, so an individual, customized approach is what we specialize in.

We are a growing business, so we always appreciate it when clients refer us to family members, friends, and colleagues. Thanks to those of you who have sent people our way.

As always, we welcome an opportunity to have additional, deeper conversations with you. If you have questions regarding financial markets and their impact upon your financial goals, please let us know. We would like nothing more than to have a conversation with you about your specific goals.

Thank you for your continued trust!

We hope that you have a wonderful Spring!

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<sup>i</sup> <https://www.morningstar.com/etfs/arcx/spy/performance>

<sup>ii</sup> <https://www.morningstar.com/etfs/arcx/iwm/performance>

<sup>iii</sup> <https://www.morningstar.com/etfs/xnas/acwx/performance>