Summary

Economic data for the week included the Federal Reserve keeping interest rates unchanged, coupled with a continued balanced narrative. The index of leading economic indicators ticked up for the first time in years, coupled with stronger housing data, including improved existing home sales, starts, and homebuilder sentiment.

Equities saw gains again around the world, led by strength in the U.S. and Japan. Bonds gained in the U.S. with a broad drop in yields, while foreign bonds were mixed, along with a stronger dollar. Commodities were little changed for the week with minimal price movement in crude oil.

Economic Notes

(0) The March **FOMC meeting** was uneventful in terms of no rate change, with most of the attention focused on the quarterly Summary of Economic Projections report and famous 'dot plot' graphic, which lays out future Fed funds rate estimates. The dots for 2024, 2025, and 2026 each showed a committee view of about three cuts per year, with the near-term being in line with futures markets. As in the December prior release, the longer-run (beyond 2026) expected funds rate continued to run above the 2.5% target level commonly referenced by the Fed. In fact, while eight votes hovered right around 2.5%, another nine members estimated a more hawkish long-term rate range of 2.625-3.750%. This points to opinions of either far stickier long-term inflation and/or stronger economic growth over a longer span than seen in the past few cycles. There are also some concerns over higher U.S. debt levels and deficit spending potentially creating a higher rate demanded by markets down the road.

In the post-meeting press conference, Fed Chair Powell noted that they haven't made any "decisions about future meetings," no doubt referring to rising expectations for an initial cut in June. He did note that "It's going to be a bumpy ride...it is very important...that we do get inflation sustainably down." He also noted the undesirability of starting a rate cut regime and then having to reverse course and hike rates again. The quantitative tightening process was also mentioned, in that the Fed would begin slowing the rate of balance sheet shrinkage. Not much surprising here, with conditions remaining data dependent in terms of the exact month rate cuts will happen, and how many there will be, but the Fed has been consistent in their communications about cuts happening this year.

(0/+) The Conference Board's **Index of Leading Economic Indicators** ticked up by 0.1% in February, reversing course after a two-year string of declines, and outperforming expectations of another -0.1% drop. If the current reversal continues, it will buck the signal of three recessions over the last 20 years coinciding with a trough in LEI. Over the past six months, the LEI has contracted by -2.6%, which is a relative improvement from the -3.8% drop over the earlier six-month period ending in August 2023. Per the Conference Board, recent improvement was seen in manufacturing hours, stock prices, credit, and building permits. On the other hand, consumer expectations for business conditions and ISM new orders remain negative, as is the still-inverted Treasury yield curve. Per this index, the Board now expects GDP growth to slow in Q2 and Q3, but the recession base case was no longer mentioned.

(0) The **Philadelphia Fed manufacturing index** fell by -2.0 points to a still-expansionary 3.2 reading in March, relative to expectations of a worse contractionary result of -2.5. In the report, new orders and shipments gained, further into expansion, while employment also improved, trimming the contractionary reading. Prices paid fell back sharply but remained slightly in expansion. The business conditions index six months out rose by over 7 points back into expansion. As a typically more volatile regional survey, this didn't provide a lot of useful new data.

(+) **Existing home sales** rose 9.5% in February to a seasonally-adjusted annualized rate of 4.38 mil. units, continuing gains from January, and stronger than the expected decline of -1.3%. Compared to a year ago, sales are still down over -3%, with overall activity equivalent to levels of over a decade ago. For the month, single-family sales were up 10%, exceeding the pace of condos/co-ops up 3%. Regionally, the West saw the strongest gains (16%), with upper single-digit results in the South and Midwest, offset by flat sales in the Northeast. The national median sales price gained 6% from a year ago at $384,500. In this case, the average hides a very wide divergence between regions (bookended by a median high price of $593k in the West and $278k in the Midwest). Inventory conditions tightened again from 3.0 months' supply to 2.9, slightly better than a year ago, although the reading has fairly consistently fallen between 2.5-3.5 during that time. Lack of supply remains a big problem, as are mortgage rates, although the 30-year fixed rate has fallen back from 7.8% at the peak last October to 6.9% last week (per the Federal Reserve).

(+) **Housing starts** rose 10.7% in February to a seasonally-adjusted level of 1.521 mil., above the 8.2% gain expected. This was in addition to some upward prior month revisions from steep declines. The bulk of the gains came from single-family starts rising 12%, while multi-family also gained 8%. Regionally, the Midwest saw the sharpest increase (over 50%), while the Northeast and West fell by up to -10%. For the single month, more favorable weather compared to January may have been at least a partial catalyst. Year-over-year, combined starts are up 6% nationally, which hides the wide divergence of single-family starts up 35% and multi-family starts down -35%. **Building permits** rose 1.9% to a rate of 1.518 mil., exceeding the 0.5% expected, led by gains in multi-family. Year-over-year, the same trends applied here as seen in starts, with single-family up sharply, offset by a sharp drop in multi-family. This continues to show the trend toward needed new single-family housing stock, despite the prohibitively high mortgage rates, and slow easing away from apartments, which are on the fringe of being overbuilt in some cities.

(+) The **NAHB housing market index** rose 3 points to an above-neutral 51 level in March, exceeding expectations calling for no change. All segments improved, but mostly in the current sales figures, while lesser gains were seen in futures sales and prospective buyer traffic. Regionally, the Midwest saw the sharpest gains (11 points to just under 50), while the South improved into expansion; the West and Northeast fell back a bit, with the former remaining in contraction, and latter still solidly in expansion. While only a single data point, this bodes well for future activity on the part of builders.

(0) **Initial jobless claims** for the Mar. 16 ending week saw a -2k decline to 210k, below the 213k median forecast. Continuing claims for the Mar. 9 week ticked up by 4k to 1.807 mil., but still below the 1.820 mil. expected. Differences among states were few, still pointing to a benign labor environment with no major layoff activity.

Question of the Week

What was the significance of the policy shift in Japan last week?

The Bank of Japan, their central bank, announced the first rate hike in 17 years. Their monetary policy has been more complicated than that of other major developed nations during the last few decades, largely due to unique country-specific concerns. Specifically, the short-term cash rate was raised from a negative -0.1% to a positive 0.1%. While a minor adjustment, it represents a critical first step in thinking away from stimulative negative interest rate policy back toward a more 'normal' yield curve.

Along with this, after being hinted at for several meetings, the long-term interest rate tool of yield curve control policy (YCC) was formally discontinued, although the 10-year 'reference rate' was kept at an 'upper bound' of around 1.0%. Keeping a less formal 'reference rate' was seen as the reason markets didn't react more strongly on the policy change announcement. The YCC program was pivotal in that it represented the original quantitative easing program, later used in the U.S. and Europe for so many years, using targeted government purchases of bonds as needed to raise prices and contain yields on the long end of the yield curve. Also, the BOJ is discontinuing stimulative purchases of ETFs and REITs, markets in which they had become significant participants and asset owners; they also announced a reduced involvement in buying corporate bonds and commercial paper. Lastly, they've agreed to abolish their commitment to increase the monetary base, which went along with the long-standing easing program.

From the fiscal side, Japan has the developed world's highest debt-to-GDP ratio, at well over 250%. This would normally be even more concerning, but much of the debt is owned domestically, which is seen as lowering the risk level somewhat compared to countries with a more globally-diverse and fickle lender base. By overall stock market cap, Japan is the largest component of the MSCI EAFE foreign developed markets index at just under 25%, and just over 5% of the world stock market basket, represented by MSCI ACWI (per Morningstar, as of 3/22/24).

Why was this stimulative monetary policy in place for so long? Despite being one of the world's largest economies, the population of Japan has been aging and shrinking at a greater rate than others. As two primary inputs to GDP growth are labor force growth and productivity, Japan doesn't have the positive labor force influence so was forced to rely increasingly on productivity as a growth engine to bridge the gap—something it has done quite well at for decades. There has also been a general cautiousness in risk-taking that started after the severe bursting after the 1989 stock market and real estate peaks. Weak demographics remain a significant long-term hurdle, and with inflation remaining extremely low (at least prior to the pandemic, when it began ticking up), a perpetually stimulative policy wasn't as disruptive as it might have been in other nations, such as the U.S., where low financing rates could and have encouraged excessive leverage and speculation in pockets. With a declining population, a legitimate policymaker fear was deflation, which creates a spiral more difficult to emerge from, and also explains the lack of more negative effects from such a long-standing period of stimulative policy.

These monetary changes come on the heels of fiscal, regulatory, and behavior changes in Japan over the past several years as well—with the benefit of encouraging the attractiveness of domestic stocks from global capital markets as well as domestic investors to help ease burdens on the retirement system. Some of these reforms were part of the late prime minister Shinzo Abe's 'three arrows' policies of: (1) fiscal stimulus, including ramped-up infrastructure; (2) easy monetary policy, of low interest rates and QE, already discussed; and (3) structural reforms to encourage global economic competitiveness and ultimately GDP growth, which included greater workforce inclusiveness (including more women workers), higher wages, regulatory reform, and changes in corporate governance. Progress towards these changes has been done fairly quickly, but time will tell how sticky they are. These include the trimming of excess cash on company balance sheets, which were initially put in place as defensive buffers from executives scarred from the late 1980s-early 1990s stock market crash, and the subsequent slower growth period. Japanese firms have been considered inherently more conservative in their operations than U.S. or European peers, so keeping a higher cash level was not considered unusual. Though, over time, excessive cash not put to work can weigh down company efficiency and profitability. This weaker profitability led to lower valuations generally (based on price/book), which became another target of government policymakers, who encouraged the use of this cash. In fact, stock exchanges threatened delisting of firms if P/B ratios could not be brought up above 1.0, unless there was a good reason for it. (Part of the Japanese stock market rally as of late has been in reaction to this effort; higher investment leading to expected higher profitability.) Also, a long-standing tradition in Japan has been the cross-investment, consisting of firms' owning each other's shares. This has been done historically to encourage a shared alignment of economic interests and protect relationship-specific investments, as it's been described in academic research of the practice. However, in a fickle modern stock market, companies with 'conglomerate' characteristics served to water down core business models, lowering profitability somewhat, and detracting from stock attractiveness—especially when banks were involved, as they commonly were. This change goes along with the encouragement of shareholder-friendly reforms generally, including more diverse boards of directors, and encouraged share buybacks.

There are a lot of moving parts here, and an economy of that size cannot evolve quickly overnight. In the near-term, currency impacts may be the most immediate. The Japanese yen's performance has been complicated, but rising rate regimes are normally considered bullish for a currency, especially if other competing currencies (dollar, euro) begin to cut rates. For example, over the past cycle, the yen 'carry trade' was quite popular. This includes borrowing in Japan at a very low interest rate (tied to low policy rates) and lending/investing in countries with far higher policy rates, such as in Latin America. Naturally, this comes with a variety of risks as well, but the 'carry,' or spread between the two rates, has been more significant than you usually find in such currency pairs. All else equal, a more expensive yen makes such carry trades less attractive. At the same time, a stronger yen (and correspondingly weaker U.S. dollar, if looked at head-to-head) could be a benefit to stocks from the standpoint of U.S. investors.

Market Notes

Period ending 3/22/2024	**1 Week %**	**YTD %**
DJIA	1.97	5.25
S&P 500	2.31	10.12
NASDAQ	2.86	9.63
Russell 2000	1.61	2.52
MSCI-EAFE	1.21	5.64
MSCI-EM	0.51	1.90
Bloomberg U.S. Aggregate	0.73	-1.00

U.S. Treasury Yields	**3 Mo.**	**2 Yr.**	**5 Yr.**	**10 Yr.**	**30 Yr.**
12/31/2023	5.40	4.23	3.84	3.88	4.03
3/15/2024	5.48	4.72	4.33	4.31	4.43
3/22/2024	5.46	4.59	4.20	4.22	4.39

U.S. stocks continued a run of positivity, with the mid-week FOMC decision of leaving rates unchanged being far from a surprise, but the dovish press conference commentary boosted market sentiment, relative to the more hawkish tone that had been expected. Nearly all sectors saw gains last week, led by communications and consumer discretionary, up several percent each, while defensives health care rose a fraction of a percent. Real estate fell a fraction of a percent as well, despite improvements in interest rates. Sentiment in tech remained high, specifically with AI and trend leader Nvidia, as well as rumors of a possible Google-Apple AI-related partnership. Apple, however, was also held back by the U.S. government's new lawsuit on anticompetitive grounds, with the claim that the iPhone prevented other firms from offering competitive services (via apps). This is not overly surprising, in a string of suits, including Google last year and separate investigations by the FTC against Amazon and Meta. Over the weekend, the President signed a $1.2 tril. government funding package, which avoids the possibility and uncertainty of a partial government shutdown.

Foreign stocks saw positive returns, along with dovish central bank rhetoric, but lagged domestic stocks generally. This was largely due to underperformance in Europe and the U.K., while Japan outperformed. Emerging markets were also little changed, as strength in Korea and Taiwan was offset by weakness in China. Interest rate policy has turned into the key pieces of news in global markets as well. The Bank of England kept interest rates steady, as expected, while providing a dovish narrative. However, the Swiss National Bank became the first central bank in the developed group to cut rates, by -0.25% to 1.50%—a bit of a surprise, even though their inflation rates have been below those elsewhere, and other considerations are often at play (such as their focus on the currency value of the franc relative to the euro). The Bank of Japan raised rates as noted earlier, as did Taiwan, which was also a surprise. Granted, smaller nations don't have the complexities in policy that the Fed or ECB do. Chinese stocks were held back by more concerns over property markets, with investments and sales falling sharply so far this year. On the brighter side, industrial production and investment in other sectors has shown improvement. The central banks of Brazil and Mexico each cut rates, with improvement in the expected inflation path, while the Turkish central bank raised short-term rates by 5% to a level of 50%, hoping to put a dent in the inflation problem (67% year-over-year) ahead of local elections, and show a return to more conventional monetary policy.

Bonds gained last week, corresponding to a drop in yields across the curve, led by the Fed's more dovish commentary, with similar results for governments and corporates. Foreign bonds gained in local terms, but declined by a fraction of a percent along with a stronger dollar.

Commodities were mixed, with gains in agriculture, declines in metals, and little change in energy on net. Crude oil prices barely ticked higher last week, ending at still under $81/barrel.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, Univ. of Michigan, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.