OAK ASSOCIATES

Market Update

1st Quarter 2024

When Bad news is Good News

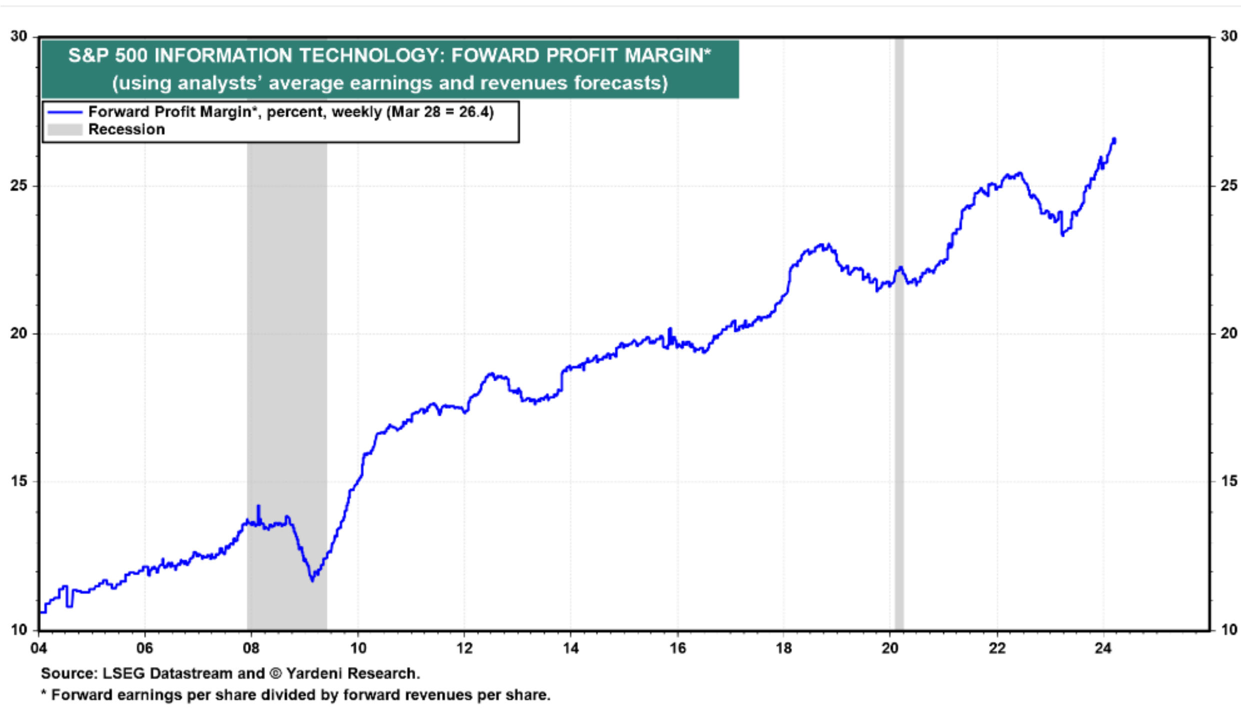
For U.S. equity investors, bad economic news is typically a negative sign for forward market returns and sustainable Gross Domestic Product (GDP) growth. Yet, occasionally, an economic paradox occurs where faltering economic data is actually viewed as positive for equities. This situation has developed as weakening data essentially confirms the Federal Reserve's progress towards slowing the economy to suppress inflation. More importantly, the softer economic news should enable the Fed to unwind the tight monetary environment it enacted over the past two years. The prospects of lower interest rates have underscored the market's solid gains over the past year. For the first quarter of 2024, the S&P 500 rose over 10% and the broad-based market index is now up over 29% for the past 12 months.

In reality, the softer economic series which could allow the Fed to lower interest rates has really just been more mixed data. On the one hand, the S&P Global US Services PMI, an index of the prevailing direction of economic trends in the U.S. service sector, fell to a three-month low of 51.7 in March 2024. The US unemployment rate, though still low, rose slightly in the first quarter to 3.7%. On the other hand, existing home sales jumped 9.5% in February 2024, the highest level since February 2023 and above consensus expectations. Wages increased; the labor market remained strong; and business confidence improved. The economic preeminent concern, US inflation, is down dramatically from the more than 9% annualized growth rate seen in the summer of 2022 to a 3.2% annual rate, although it has yet to reach the Fed's stated 2% preferred level.

The mixed economic news supports a scenario where economists feel comfortable rescinding the restrictive rate environment while investors still find that the economy is healthy and that the risk of a severe recession has been avoided.

All that said, perspective is important. We believe the market has been overly optimistic about its rate cut expectations. Back in January 2024, market participants were anticipating seven or more interest rate cuts by the Fed and starting in the first quarter of the year. On the heels of Fed Chair Powell's comments in late March, the onset of the interest rate unwinding has again shifted to the Fed's June meeting and could still be delayed. The U.S. equity market has nonetheless responded by moving to a new all-time high. It has been our view all along that it was more likely the Fed would cut two or three times in 2024, beginning in the second half of the year. Fed Chair Powell's March comments went a long way toward bringing market expectations more realistically in line with the Fed's view. Failure to obtain the rate cuts priced into the market could spark a correction if the Fed does not deliver.

A key driver of equity market returns this year has been the focus on Artificial Intelligence (AI) stocks. The AI frenzy remains in full effect, yet the valuation ratios for the AI leaders and other semiconductor companies, while up sharply over the past 15 months, are not in the extreme "bubble" territory seen in the late 1990s. One important difference between the dot-com era and today's technology sector is the significantly stronger level of profitability. With profit margins far higher compared to 25 years ago, in our view, the sector deserves the higher valuation.



As we enter the second quarter of 2024, we believe conditions remain good for U.S. equities. Valuations are up, but not extreme. Market strength had broadened beyond the "Magnificent Seven," i.e., the narrow group of high-performing and influential companies in the U.S. stock market that dominated in 2023. U.S. corporate earnings were widely expected to exceed those of 2023, potentially improving at a stronger clip in 2024 as inflation and interest rates come down—despite lingering economic worries. So, for now, bad news is good news.

With the increase in valuations for Large-Cap stocks and the hype surrounding AI stocks, an opportunity may have developed within the small-cap segment of the market. Plagued with lower quality balance sheets and higher interest burdens, small-caps are seen as riskier and less attractive. However, the valuations spread between smaller companies relative to large-cap companies has widened to extreme levels. Should interest rates decline as expected, within the small-cap universe, higher quality smaller companies could present an attractive asset class for the active investors.

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