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MARKET REVIEW
FEBRUARY 2024

RED SEA ATTACKS

– Escalating attacks on commercial vessels in the Red Sea by Houthi militants have increased shipping costs and delivery times.

– Shipments of energy and goods from the Middle East and Asia to Europe have been most impacted by the Houthi attacks.

– Increased political instability in Egypt due to reduced Suez Canal revenues could be the biggest fallout of the Red Sea chaos.

Over the last three months, the Houthis, an Iran-backed Shia rebel group based in Yemen, have fired hundreds of drones and missiles at commercial vessels in the southern Red Sea. The attacks have disrupted global seaborne trade and led to a spike in insurance premiums paid by shipping companies who risk traversing the region. The Houthis say their campaign is motivated by solidarity with the Palestinians following Israel's invasion of Gaza in response to the Hamas attacks of October 7. Yet their attacks have targeted container ships flying under the flags of many different nations, with the notable exceptions of China, Russia, and Iran.

The Red Sea is an important part of a well-functioning global trade system because it is the only way for ships to access the Suez Canal and the Mediterranean Sea from the south. It is a critical conduit for container chips from Asia and oil tankers from the Middle East heading to the large economies of northern Europe. According to The Economist, approximately 20% of global container volumes and 8%-10% of seaborne oil and gas pass through the Red Sea and Suez Canal in northeastern Egypt. Most of the Houthi attacks have occurred near Baba-el-Mandeb (an Arabic term that roughly translates to gate of tears), a strait at the southern end of the Red Sea spanning just 20 miles from Djibouti in the east to Yemen in the west.

As of early February, Houthi attacks have diverted about 30% of the ship traffic in the Red Sea and 50%-60% of the tonnage. An escalation of attacks in January caused some oil tankers, LNG carriers and bulk vessels to join the armada of container ships opting to take the 3,500-mile detour around the Cape of Good Hope in South Africa. Most of the world's largest container ship companies have suspended Red Sea voyages and warned the security situation in the region has not improved despite U.S and UK-led efforts to stabilize shipping lanes. State-of-art U.S. Navy Arleigh Burke class guided-missile destroyers have led Operation Prosperity Guardian, an American-led defensive maneuver focused on shooting down Houthi drones and anti-ship missiles.

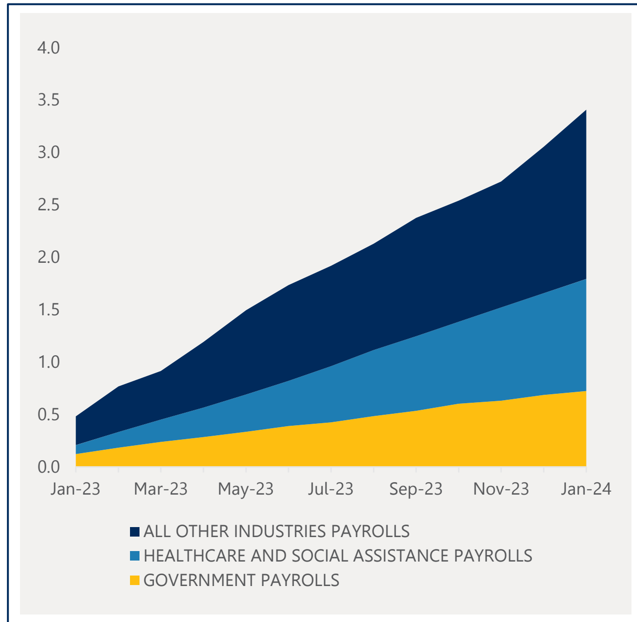
The immediate financial impact of the Houthi attacks has been a sharp increase in so-called war-risk insurance paid by shipping companies that opt to have vessels sail through the Red Sea. To account for the increased risk, spot rates to transport goods from Europe to Asia (or vice versa) through the dangerous waters of Baba-el Mandeb have risen dramatically. A potential risk in coming months is an acceleration in goods or energy inflation in Europe.

Oil supplies from Iraq and Saudi Arabia destined for Europe along with liquid natural gas (LNG) supplies from Qatar are among the types of shipments most impacted by the Red Sea attacks. Tesla and several other manufacturers in Germany have recently halted production in some facilities due to delays in receiving parts from Asian suppliers related to the Red Sea attacks. The timing of the Chinese Lunar New Year from February 10 through February 24 could further aggravate container ship delays due to slowed production, delayed transportation and other supply chain disruptions that typically occur across China during this two-week period every year. The U.S. is less likely to experience higher goods inflation solely due to the Red Sea attacks as most container ship imports from Asia cross the Pacific Ocean to west coast ports. Lower water levels in the Panama Canal, however, could exacerbate higher shipping costs and container ship delays caused by the diversion of vessels away from the Red Sea.

"APPROXIMATELY 20% OF GLOBAL CONTAINER VOLUMES AND 8%-10% OF SEABORNE OIL AND GAS PASS THROUGH THE RED SEA AND SUEZ CANAL."

The biggest risk posed to the global economy by the current Red Sea instability is an escalation that fuels a broadening of the Israel-Hamas war to include Iran and Saudi Arabia. Currently, this seems unlikely given 1) Saudi Arabia's stated desire to strike a deal with the Houthis to end the civil war in Yemen and 2) the influence China could exert on Iran to pressure its Houthi proxies to dial back their attacks. The potential for the Red Sea attacks to enflame political instability and civil strife in Egypt is another risk of the current situation. The fees paid by shipping companies to the Egyptian government for their vessels to pass through the Suez Canal ($9.4 billion in the country's fiscal year ended June 30) are one of the most important sources of revenue and foreign exchange for the third most populous country in Africa. The Israel-Hamas war on Egypt's northeastern border has dramatically reduced its trade and tourism revenues. The country's central bank has devalued its currency three times since early 2022, while annual inflation has surged to 30%. Any sort of political breakdown in Egypt could further destabilize a region with active wars in Gaza to the north and Sudan to south, along with a simmering civil conflict in Libya to the east.

JOB GAINS BOOSTED BY NON-CYCLICAL HIRING
NONFARM PAYROLLS GROWTH COMPOSITION (MILLIONS)



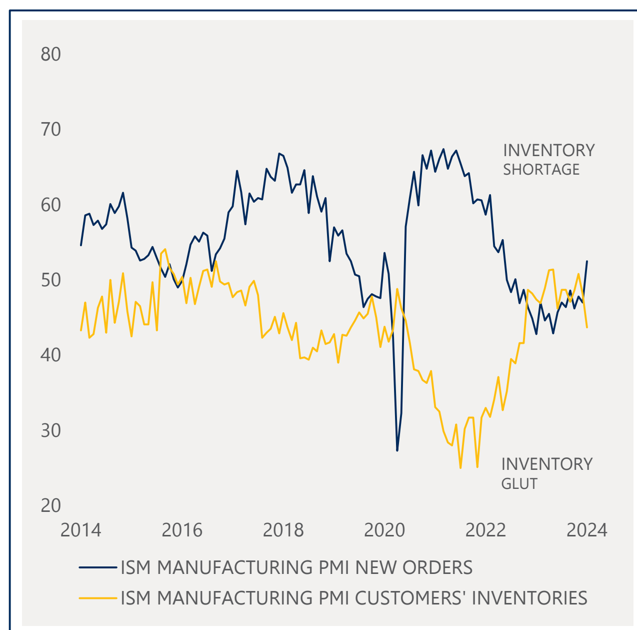
Source: Bloomberg. Past performance does not guarantee future results.

U.S. nonfarm payrolls expanded by a much stronger-than-expected 353,000 in January, which was comfortably above the high end of economists' 100,000 – 300,000 forecast range. Payroll additions in November and December were upwardly revised by a combined 126,000. The upside surprise in January and positive revisions will probably make the Fed less likely to cut its policy rate at their March 19-20 meeting.

The strength in payroll gains could be overstating the underlying momentum in the economy, however, as a larger-than-usual proportion of the net job additions over the last 13 months have been in the government and healthcare/social assistance industries. Combined payroll gains of 1.79 million in these two non-cyclical industries (which account for 29% of total jobs in the U.S.) were responsible for 52% of the total 3.41 million jobs added from January 2023 through January 2024.

There were other conflicting data in January's payrolls report. Average hours worked dipped to a 46-month low of 34.1 from 34.3 in December (typically a sign of potential labor market weakness). Meanwhile, average hourly wages rose 4.5% from a year ago, an acceleration from the 4.3% reading in December.

U.S. MANUFACTURING SHOWING SIGNS OF LIFE
NEW ORDERS-TO-INVENTORIES RATIO TURNS POSITIVE



Source: Bloomberg. Past performance does not guarantee future results.

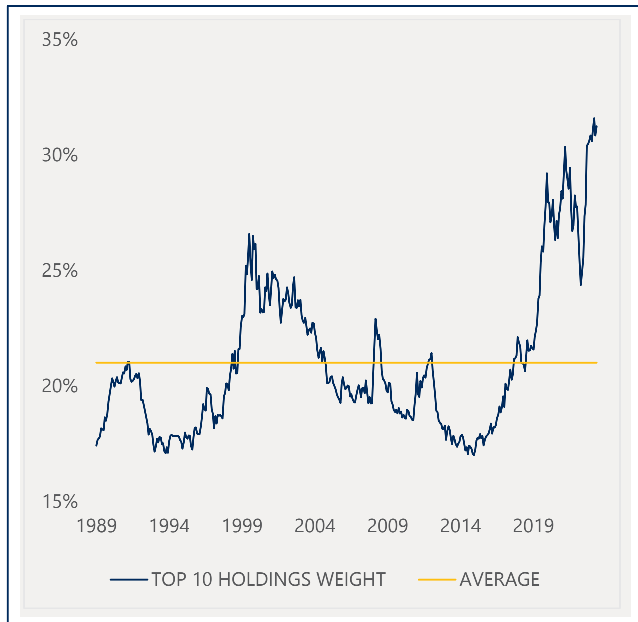
The new orders component of the U.S. ISM Manufacturing Purchasing Managers Index (PMI) increased in January at the fastest monthly clip since June 2020, boosted by stronger-than-expected aggregate demand in recent months. This contrasts with a trio of regional Federal Reserve surveys that showed aggregate business activity likely contracted during January in the New York, Philadelphia, and Texas regions.

According to ISM, "Of the six largest manufacturing sectors, three (Chemical Products, Transportation Equipment, and Fabricated Metal Products) reported an expansion in new orders in January."

Survey respondents indicated customer inventory levels have declined after staying elevated for most of 2023. This mix of increasing new orders and easing inventories could bode well for factory activity and domestic economic growth in the first half of 2024. Of the six largest industries in the ISM survey, only Transportation Equipment increased manufacturing inventories in January.

S&P 500 HIGH CONCENTRATION

S&P 500 TOP 10 HOLDINGS WEIGHT



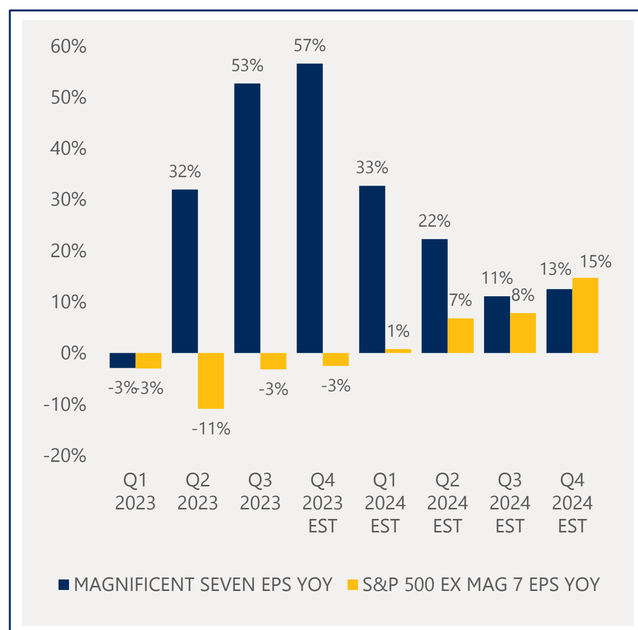
Source: Morningstar. Past performance does not guarantee future results.

Equity market performance was mixed in January following strong returns in most areas of the market last quarter. The S&P 500 rose for a third straight month and reached a new record high, while mid-cap and small-cap stocks declined. Mega-cap technology and technology adjacent stocks returned to market leadership to start the year. Nvidia (NVDA), Meta Platforms (META), and Microsoft (MSFT) January returns of 24.24%, 10.22%, and 5.73% accounted for around 80% of the S&P 500's 1.68% monthly return. The S&P 500 Equal Weight index declined 0.82% in the month.

Magnificent Seven stocks' outperformance over the last year led to the S&P 500's concentration reaching the highest level in more than 30 years. The index's top 10 holdings weight was 31.26% at the end of January, compared to the 21.02% average weight since 1989 and 26.60% weight at the peak of the late 1990s technology bubble. Unlike the technology bubble, many of the largest technology stocks today are among the most profitable companies with robust cash flow and durable earning growth potential. Analysts' projections for slowing earnings growth for the Magnificent Seven stocks in the coming quarters might help to improve the stock market's breadth.

PROJECTED IMPROVED EARNINGS BREADTH

EARNINGS GROWTH YEAR OVER YEAR



Source: Bloomberg. Past performance does not guarantee future results.

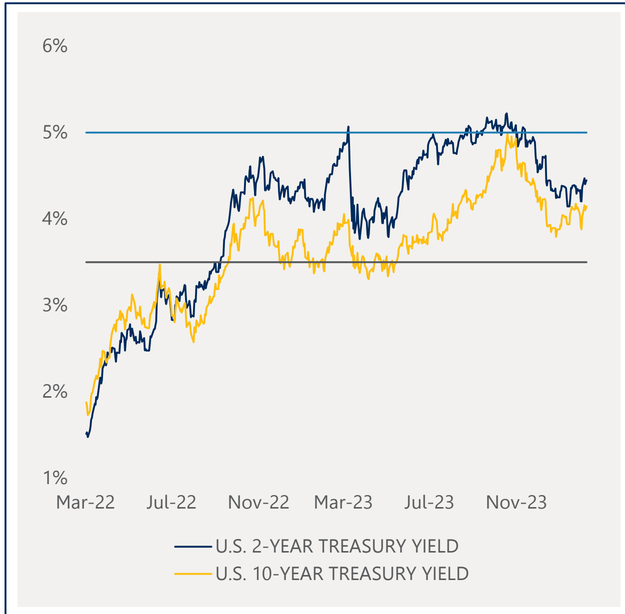
Magnificent Seven: Apple (AAPL), Microsoft (MSFT), Alphabet (GOOGL), Amazon (AMZN), Nvidia (NVDA), Meta Platforms (META), and Tesla (TSLA)

As of February 9, approximately 66% of S&P 500 companies have reported fourth quarter earnings. S&P 500 earnings are on track for 6.5% growth versus analysts' projection for 1.2% growth at the start of the reporting season. The Magnificent Seven stocks' 56.6% earnings growth provided a significant boost to the index's overall earnings. Excluding the Magnificent Seven, S&P 500 earnings are on pace to be down 2.5%, the fourth straight quarter with negative growth due to margin pressures. Analysts project slowing Magnificent Seven earnings growth this year as their year over year comparisons get tougher.

S&P 500 operating margin is on track for 14.5%, in line with analysts' forecast and below the 14.9% margin a year ago. This will be the sixth consecutive quarterly operating margin contraction year over year. Analyst project modest margin expansion in the first quarter as easing inflation pressures and cost cutting help to stabilize margins.

S&P 500 revenue growth is also on pace to exceed analysts' projection with 3.8% growth versus the 2.7% forecast. Sales growth is being led by the technology, communications, health care, and real estate sectors each posting growth over 6%.

HAVE YIELDS FOUND A HOME AROUND 4.25%?
2-YEAR AND 10-YEAR TREASURY YIELDS



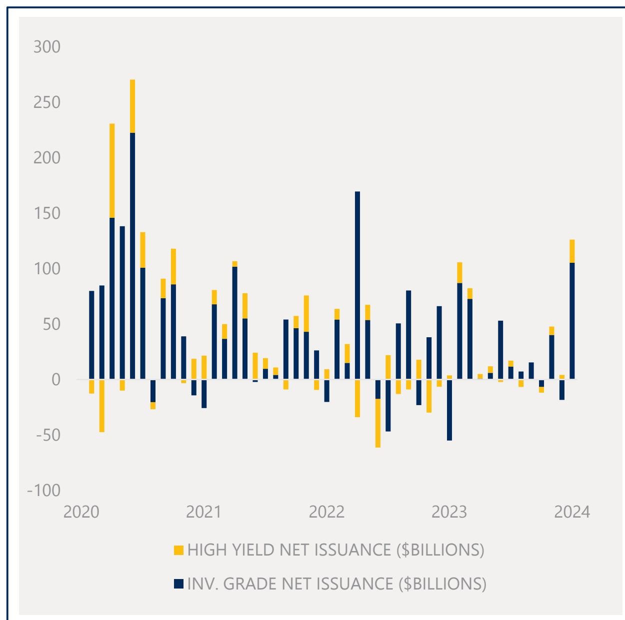
Source: Bloomberg. Past performance does not guarantee future results

U.S. Treasury yields declined sharply in November and December to levels last seen in June amid a string of cooler-than-expected inflation data and market enthusiasm for a Fed policy pivot in early 2024. In the first seven weeks of 2024, yields climbed roughly 25 basis points across the yield curve as positive economic data surprises and messaging from Federal Reserve officials led investors to push back their timeline for the beginning of rate cuts to May or June.

As shown in the accompanying chart, the 10-year yield has traded in a well-defined range of 3.5% to 5.0% since October 2022. We would expect this range to hold unless the U.S. economy begins to show signs that a deflationary "hard landing" (lower rates) or a reflationary "no landing" (higher rates) is around the corner.

At his post-Federal Open Market Committee (FOMC) meeting press conference on January 31, Fed Chairman Jerome Powell said a March rate cut was not his "base case." In recent weeks, many Fed officials have indicated rate cuts beginning in the summer would be appropriate if inflation continues to move toward their 2% annual target.

CORPORATE CREDIT ISSUANCE PICKED UP
U.S. INV. GRADE AND HIGH YIELD MONTHLY NET ISSUANCE



Source: Bloomberg. Past performance does not guarantee future results

U.S. corporations reentered the primary market with authority in January, issuing $230 billion of combined investment grade and high yield debt, the highest January issuance in ten years. As the accompanying chart shows, net new issuance last month was $126 billion after excluding about $104 billion of newly issued debt that replaced maturing bonds. This was the largest monthly net new issuance since April 2022 and second largest since June 2020.

An improving economic backdrop, a pullback in yields from 15-year highs in early November, and narrow credit spreads created a favorable backdrop for corporate Treasurers to issue new debt in the first month of 2024 after staying on the sidelines for most of 2023.

According to the Bloomberg Intelligence U.S. credit strategy team, $910 billion of domestic investment grade corporate debt is scheduled to mature in 2024, up 12% from $810 billion last year. Scheduled maturities increase by 25% in 2025 to $1.14 trillion before leveling off at $1.12 trillion in 2026.

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NOT A DEPOSIT	NOT FDIC INSURED	MAY LOSE VALUE	NOT BANK GUARANTEED
NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY			