RICE HALL JAMES
& ASSOCIATES, LLC

Market Review
First Quarter 2024

After an uncertain start, stocks continued their strong advance in the first quarter of 2024.

During the period, the S&P 500 Index returned 10.56% while the Russell 2000 Index increased 5.18%. The composition of performance was largely consistent with recent periods. Large fared better than Small, and Growth significantly outperformed Value. Although the rally broadened in March, it was still a narrow and momentum-driven market; the MSCI USA Momentum Factor ETF gained 19.41%. There was also a speculative element to the advance as evidenced by Bitcoin's 67.81% increase.

The rally built upon sharp gains in the prior quarter that began when U.S. Treasury bond yields peaked in October, and accelerated when the Federal Reserve ceded that the tightening cycle had concluded in December. This put stocks on a very favorable perch into the new year. The policy pivot created a "win-win" situation for investors in that promising economic data would help to support the case for a soft landing, while weak reports would improve the prospects for interest rate cuts. The positive sentiment was also bolstered by the continued fervor around the investment in, and proliferation of, Artificial Intelligence (AI).

As a result of these tailwinds, the S&P 500 hit a new record high in late January for the first time in two years, and finished even higher in February and March. In the process, however, investors had to look past two major deviations to the script that challenged parts of the bullish narrative.

First, there was a notable uptick in the January Consumer and Producer Price Indices. The data was initially dismissed as a seasonal glitch, but has persisted in subsequent reports. Although there is not much concern about a (significant) resurgence in inflation, the trend has already pushed out expectations for the timing of the first interest rate cut and has muddled the outlook for the trajectory thereafter.

The second anomaly was that the first quarter rally coincided with rising bond yields. This is inconsistent with the post-pandemic, inflationary cycle progression. After declining 69 basis points in Q4 of 2023 (and over 1% from the October peak), the 10-Year U.S. Treasury bond yield increased 32 basis points in the first three months of 2024. The push higher accelerated in the first week of April. Although there are multiple explanations for the move, one interpretation is that bond investors are less sanguine about the recent economic data and the implications for interest rate policy.

The other issue that has emerged for investors is how challenging it has become to put together the pieces of the economic puzzle. On one hand, there has not been much to derail investor enthusiasm for AI; the investment in high performance infrastructure required to support the training and processing remains robust. But the picture gets murkier from there. In March, manufacturing activity turned up, while the outlook for service-oriented businesses soured. This marked a major reversal in two long duration trends. Even more confounding is trying to reconcile lousy retail earnings reports with more constructive aggregate consumer spending data and booming job reports.

As we look ahead, we still believe that lower interest rates are imminent and appropriate. After the huge rally, however, it is starting to feel like investors are placing too much emphasis on the timing of the first cut, and are too complacent about the trajectory thereafter. Following a sudden and steep tightening cycle, we expect the path down for borrowing costs to look very different – with small increment adjustments and periodic pauses the norm.

This dynamic reinforces that we are taking the right approach to the right part of the market. By investing in durable businesses with good growth prospects in a long underperforming small cap market, we feel well-positioned to thrive in more realistic conditions and as investors begin to search more broadly for growth. We are also convinced that the market will reorient again around earnings and valuation as the realization sets in that higher-for-longer is still an appropriate interest rate framework.

Sources: *FactSet, GICS Sector Classification*

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The S&P 500 is widely regarded as the best single gauge of U.S. large cap equities. The index includes 500 leading companies spanning all sectors of the U.S. stock market. It covers approximately 80% of the U.S. equity market capitalization and over 50% of the global equity market.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 7% of the total market capitalization of that index, as of the most recent reconstitution. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small cap opportunity set.

The MSCI USA Momentum Index is based on MSCI USA Index, its parent index, which captures large and mid cap stocks of the U.S. market. It is designed to reflect the performance of an equity momentum strategy by emphasizing stocks with high price momentum, while maintaining reasonably high trading liquidity, investment capacity and moderate index turnover.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic area. Average price data for select utility, automotive fuel, and food items are also available.

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

The 10 Year Treasury Yield is the yield that the government pays investors that purchase the specific security. Purchase of the 10-year note is essentially a loan made to the U.S. government.

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Index Definition Sources: *Standard & Poor's, FTSE Russell, Investopedia, U.S. Bureau of Labor Statistics, MSCI*