INVESTMENT PERSPECTIVES

MARCH 2024

Key Takeaways —

- The economic evolution of Mexico
- The Fed's many misconceptions
- New highs ahead for the S&P 500?

OH, MEXICO

Mark Luschini, Chief Investment Strategist

Famed singer and songwriter James Taylor released a tune in 1975 that invited listeners to envision the warm sun and appealing lifestyle of our North American neighbor with whom we share a southern border. While those attributes still apply, the country has evolved into much more.

Mexico has a population of almost 130 million, making it the 10th most populous in the world, and its Gross Domestic Product (GDP) ranks it the 14th largest economy. It exports more goods to the United States than any other country on earth, having recently surpassed China, and has benefited economically from its proximity to its northern neighbor.

The resilience of the U.S. economy has been an important factor in propelling Mexico's economic performance. Indeed, 83% of the country's exports go to the U.S. (accounting for 26% of its annual GDP), and conversely, the largest and growing percentage of goods imported to the U.S. come from Mexico, exceeding that of both Canada and China. However, its structural outlook is also a formula for long-term growth. Among other things, its economy will benefit from a healthy demographic picture and advances in productivity. Until the last few years, GDP growth in Mexico had been meager for decades, falling well behind those of other major emerging market countries, such as China, India, Chile, and Brazil to name a few, but that is changing.

A country's GDP is a function of its labor force growth and productivity. Regarding the labor force, Mexico's working age population is expected to grow almost as fast as the enviable pace of India, another rapidly growing economy. On the productivity front, huge advances have occurred to induce structurally higher domestic and foreign investment in the country. Indeed, much of that is in manufacturing, but it has also been directed to construction, infrastructure, and technology, all of which has led to a marked improvement in worker output. Mexico is also geographically positioned to benefit from the diversification of supply chains away from China.

The catalyst may be geopolitically motivated, but Mexico is also advantaged because it shares a trade agreement with the U.S. and Canada, the time zone is convenient, and it has lower manufacturing wages. Consequently, a substantial upsurge in foreign direct investment, including from but not exclusive to the U.S., is taking place and will likely continue for some time to come. Even the passage of President Biden's fiscal initiative, the Inflation Reduction Act, which offers tax incentives for the purchase of North American batteries and electric vehicles, includes many components made in Mexico. The wave of nearshoring alone is expected to nearly triple the amount of inbound foreign direct investment in Mexico over the next two to three years. By one estimate, that alone could create over 225,000 new jobs in the country. All this has taken place concurrent with Mexican-domiciled industries expanding capital expenditures, which in turn fosters incremental benefit to domestic economic activity.

In terms of the political environment, current but outgoing President Obrador has been quite stable legislatively and not the interventionist as was feared initially. This, in turn, has allowed business confidence to improve under his regime. In June of this year, there will be an election leading to a new President, but the leading figure represents the incumbent Morena party, so it would seem there may be some positive carryover from the Obrador administration.

To be sure, there are risks, such as a hot labor market and inflation that remains high. The unemployment rate of 2.8% is near a record low, and wage gains are running in the high single digits. Such high wage inflation is encouraging companies to hike prices, stoking the inflationary impulse that, while easing to 4.9%, remains well above the target of 3% set by the Bank of Mexico (Banxico). Consequently, Mexico's central bank has raised rates to a cycle high of 11.25%. Should Banxico's policy setting stay too tight for too long, growth could be stunted as both the high cost of capital and a rising real interest rate causing a stronger currency (the Peso) would be powerful headwinds.

The Mexican stock market, whose proxy is the Bolsa Index, has been on a tear since the COVID low in early 2020, nearly doubling in value to its recent peak just last month. During this time, it has handily outperformed most of its emerging market peers. However, expectations may be a bit overextended at this point, and while valuations remain attractive, the market may be due for a breather. Beyond the very near term, however, Mexico's cyclical and structural investment fundamentals outshine that of many others. ■

DECODING THE FED'S BALANCE SHEET

Guy LeBas, Chief Fixed Income Strategist

Few areas of mainstream finance create as many misconceptions as does the Federal Reserve's (Fed) balance sheet. Since the 2022 policy tightening cycle (tightening is code for tapping the brakes on economic growth and inflation), the Fed has been gradually reducing its holdings of bonds. But wait! In some months the Fed's portfolio actually grew, engendering cries of "stealth QE!" And what about the reverse repo program and the money supply? In short, there are a lot of moving parts involved. We're taking the space in this month's Investment Perspectives to provide a bit of framework on the Fed's balance sheet, what investors should care about, and what they should ignore as noise.

Much like any other bank, the Federal Reserve has assets and liabilities on its balance sheet. Like most commercial banks, the Fed's assets consist of:

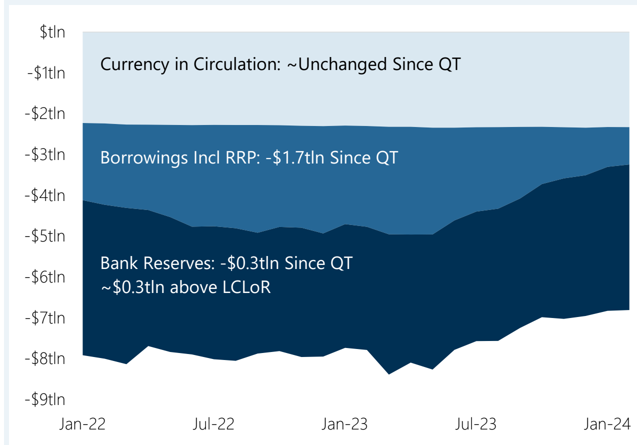
- $7.0 trillion of bonds, such as those purchased during rounds of QE
- $170 billion of loans, such as those made under the 2023 bank funding program
- $297 billion of "other" stuff, such as gold, foreign currencies, and such

Unlike most commercial banks, the Fed's liabilities consist of:

- $3.6 trillion of commercial bank reserves held at the Fed
- $2.3 trillion of currency the Fed created
- $875 billion of various borrowings including the Reverse Repurchase Program (RRP)
- $953 billion of other deposits such as Treasury Department cash held at the Fed

In the process of quantitative tightening, or QT, the Fed is letting about $100 billion of its bond portfolio mature each month. Arithmetically, when $100 billion of Fed assets "go away," an identical amount of liabilities must also "go away." So far, the declined liabilities have been assets in the RRP. Since the 2022 start of QT, the RRP has fallen about $1.7 trillion—though not in a straight line. In some months, the Fed actually increased its assets, and in most months, they decreased. Still this variance has created a story that the Fed is not reducing its balance sheet but executing some sort of secret stimulus program. Nothing could be further from the truth.

Chart 1: Liabilities on the Fed's Balance Sheet are Shrinking



Source: Janney ISG; Federal Reserve Board

At some point in 2024, the Federal Reserve will likely stop allowing its bond portfolio to decline, ending QT. No doubt that this change in policy will encourage conspiratorial thinking: "The Fed knows something about the markets we don't!" The reality will be much less sinister but also more complicated. One of the Fed's key functions is to manage the quantity of "bank reserves" outstanding. Bank reserves are the cash that private sector banks hold to handle day-to-day payment flows. While individual banks set the amount they believe is necessary, the Fed has complete control over the total quantity of reserves outstanding. At the risk of over-simplifying, when the Fed buys bonds on the asset side of its balance sheet, it creates bank reserves, and if it allows bonds to mature, it destroys bank reserves.

We anticipate that the Fed will run into the "lowest comfortable level of reserves (LCLoR)" within the financial system this spring, a situation which it faced most recently in September 2019. When that happens, the Fed cannot reduce its balance sheet any further without creating volatility in borrowing markets, so very simply, it'll stop reducing its balance sheet. From the outside, the Fed approaching the LCLoR point might look scary, but it'll be an exercise that it has gone through numerous times before and one that it can easily manage.

The Federal Reserve is a complicated entity. While markets have spent the last 18 months worrying about decisions on interest rates, we will hear much more about the Fed's balance sheet in the coming months as well. Knowing what noise to ignore will be a critical theme in taking investment risk in 2024.

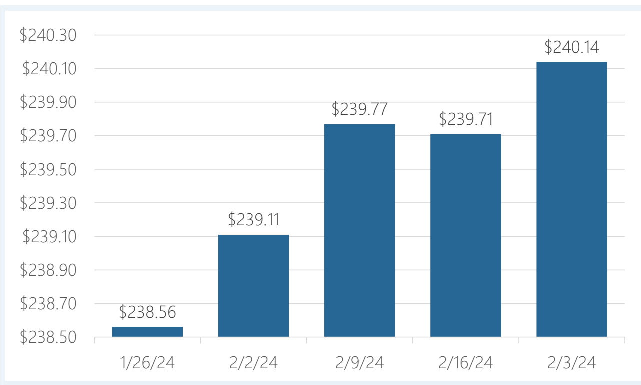
IF SPRING FORWARD IS FALL BACK INSTEAD

Gregory M. Drahuschak, Market Strategist

The February edition of Investment Perspectives highlighted that earnings are what really matter. This premise was underscored dramatically throughout the past month.

Despite already lofty expectations, Nvidia (NVDA) topped Wall Street's earnings and revenue consensus, which ignited a 4.97% gain in the semiconductor SOX Index, a 6.83% gain in the Vaneck Semiconductor ETF, and a 105.23-point rally in the Standard & Poor's 500 (S&P), which was its biggest one-day percentage gain since January 6, 2023.

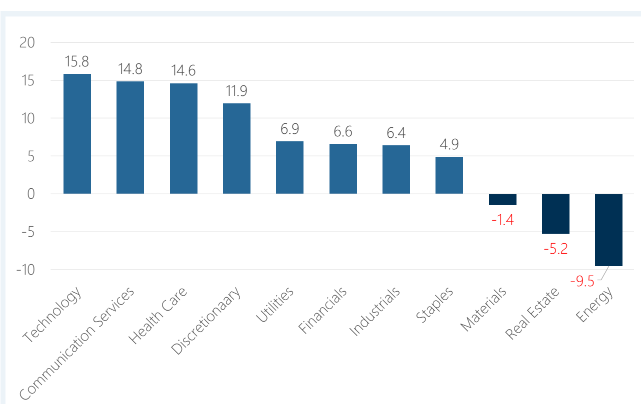
Chart 2: S&P 500 2024 Earnings Estimate



Source: CFRA-Standard & Poor's; Janney Investment Strategy Group

Nvidia's report, along with surprisingly positive results from major tech firms like Microsoft, Apple, QUALCOMM, and Intel, helped the technology sector stay on track for the best annual earnings gain (15.9%) expected among the 11 S&P 500 sectors. They also helped the overall S&P 500 earnings estimate increase through the prior five weeks. The full-year 2024 estimate, however, was still 2.64% below the high for the 2024 earnings expectations.

Chart 3: Estimated 2024 % Sector Earnings Change



Source: Janney ISG

Technology stocks were largely responsible for the late-month gain in the S&P 500, which was the seventh best for the month since 1950. A worrisome pattern, however, continued so far this year.

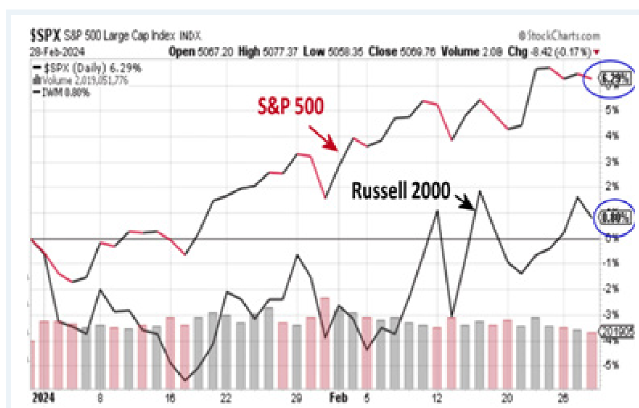
Through most of 2023, performance of the tech-heavy, capitalization-weighted S&P trounced an equally-weighted version of the index (the Invesco S&P 500 Equal Weight ETF). This performance spread reached a high of 1840 basis points (18.4%).

As the accompanying chart below illustrates, from January 1, 2024, through February 28, 2024, the performance spread continued. The performance gap is even larger when comparing the cap-weighted S&P to the Russell 2000.

Chart 4: S&P 500 Large Cap Index

Source: Stockcharts.com; Janney Investment Strategy Group

Chart 5: S&P 500 Large Cap Index



Source: Stockcharts.com; Janney Investment Strategy Group

The S&P 500 has tended to have a positive bias in March as it has ended higher in 47 of the previous 74 years for an average 1.05% gain. Although "Super Tuesday," which usually falls in March, might have election influence, the equity market often ignores it. The S&P 500 has posted a gain in 14 of the 21 election years since 1952.

1980 was a significant exception when the S&P 500 fell 10.18%. That year, seven primaries and caucuses were held on March 11, 1980. In January of that year, the S&P 500 hit a 7-year high, but by mid-February, it began a slide that led to a 20% drop in seven weeks. March 2020 ended with a 12.51% loss as the market was pummeled by the impact of the pandemic. Minus the 1980 and 2020 losses, the average election-year March has produced a 1.02% gain, 0.03% below the average for all March periods.

We continue to believe that despite the string of new S&P 500 highs last month, still higher levels are ahead. Getting to them, however, might not be accomplished as easily as was experienced in February. At the same time, market pullbacks should be well within the confines of what is common, even in the midst of strong bull market moves.

A consequence of the performance spread detailed earlier provides a key reason a pullback could be contained.

If the major names that have driven the market higher for four consecutive months pull back, we believe that cash generated by these sales will be redistributed across a majority of sectors that have underperformed lately. Although these sectors might not match the weighting of the so-called "Mag Seven" and others like them, the repositioned cash could cushion the overall market as it prepares for its next major upleg. ■

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