Think Strategically

Charting a Course in Market Uncertainty: Spotlight on Puerto Rico's Economic Outlook Amidst Challenging Times

May 12, 2024

Francisco Rodríguez-Castro, President & CEO

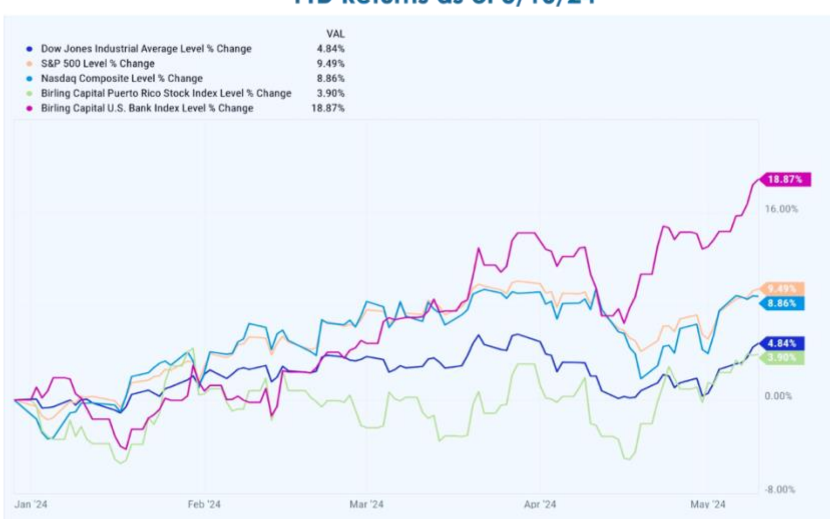
The Vix Volatility Index falls 95%

As the month of May rolled in, the change in sentiment in the markets has been resoundingly positive. The five key indicators we follow all have positive returns thus far this month, and the Vix Volatility Index, which had risen to 39.04% on April 12 and almost a month later closed on May 10 at a mere 1.93%, a whopping 95% decrease. The change in the Vix translated into positive returns for the markets.

The Five indexes have the following results thus far YTD:

- **Dow Jones** has a YTD return of **4.84%.**
- **S&P 500** has a YTD return of **9.49%.**
- **Nasdaq Composite** has a YTD return of **8.86%.**
- **Birlng P.R. Stock Index** has a YTD return of **3.90%.**
- **Birling U.S. Bank Index** has a YTD return of **18.87%.**

Dow Jones, S&P 500, Nasdaq Composite, Birling P.R. Stock Index & Birling U.S. Bank YTD Returns as of 5/10/24



Higher Interest Rates for Longer

While navigating an enduring 'Higher for Longer' interest-rate environment, characterized by the ever-persistent themes of inflation and Federal Reserve actions, financial markets are under the scrutiny of a new generation of investors, unaccustomed to such conditions. While the trajectory of interest rates undeniably holds significant sway over economic prospects and stock valuations, it's crucial to recognize a cornerstone of long-term market performance: corporate profits. Yet, amidst the fervent analysis of every data point through the lens of its potential impact on Fed policy, the fundamental importance of corporate earnings often goes unnoticed. Understanding this dynamic is critical to enlightening investors about the market's intricacies.

As the first-quarter corporate earnings parade concludes, it offers a unique vantage point to gauge the pulse of corporate America, which is often referred to as the compass that guides our understanding of the overall stock market trajectory. In this context, our focus naturally shifts to corporate profitability, even as the spotlight turns to the impending CPI release **on May 15**, sparking speculation on inflation. The latest Inflation Nowcasting the CPI at 3.50% and the Core CPI at 3.65%, both more than 40% above the Fed's target inflation rate.

Corporate Earnings the Great Upside Surprise

The recent performance of the S&P 500, a vital indicator of the U.S. stock market, underscores this narrative. The index extended its gains in May, leaving it at just 0.60% from its all-time high. The rise, fueled by positive earnings reports, coincides with the broader market rally, signaling continued economic vitality and profit expansion. This information is crucial for understanding the market trajectory and should keep our audience informed and engaged.

Close to 90% of S&P 500 companies have reported their 1Q24 earnings, surpassing analyst expectations by 8.5%, the most significant jump since the third quarter of 2021. Furthermore, amidst a backdrop of moderately decelerating economic growth, revenue expansion remains robust, hovering around the 4% mark. Notably, the profitability landscape is also undergoing a positive transformation, rebounding from the pressures witnessed throughout 2022 and parts of 2023 as the inflationary pressures on input costs begin to ease.

Looking at sector performance, the communication services, consumer discretionary, and technology sectors continue to shine with robust growth. In contrast, other sectors, notably industrials, financials, and consumer staples, also display commendable results. However, three sectors, including energy, materials, and health care, have declined for the quarter, with health care particularly impacted by a quarterly accounting loss from Bristol Myers.

Artificial intelligence is the trending topic, driving gains for mega-cap tech companies and the so-called "Magnificent Seven" stocks. However, the potential benefits of AI are not limited to these giants; over time, companies that leverage AI to enhance existing processes or venture into new markets could also reap rewards.

Taking a broader view, the S&P 500's first-quarter results, coupled with company guidance, instill confidence that earnings are poised to grow by slightly more than 10% in 2024.

Although uncertainties surrounding the Fed's policy direction and potential concerns related to the upcoming U.S. presidential elections could trigger volatility in the months ahead, the upward trajectory of corporate earnings provides a stable foundation for market gains. Despite stocks hovering near record highs, approximately 8% above the previous bull-market peak in early 2022, earnings have also scaled similar heights.

Improved Market Sentiment and Changing Economic Indicators

Also, market sentiment has been buoyed by a decline in bond yields, which was observed this month. The 10-year Treasury yield retreated below 4.50% after briefly touching a six-month high of 4.7%, primarily influenced by expectations of an impending interest-rate cut by the Fed later this year.

Recent economic indicators suggest a potential softening in economic growth and the labor market, including the advanced estimate of first-quarter GDP, the Purchasing Managers' Index, April's job gains, and last week's jobless claims. Also, the **GDPNow** for the second quarter of 2024 was updated on May 8, increasing to **4.20% GDP**.

From the Federal Reserve's perspective, a gradual deceleration of economic activity, hovering around or slightly below its potential growth rate of approximately 2% could contribute to achieving target inflation levels, a development likely welcomed by policymakers. Consequently, investors, at this juncture in the central bank's policy cycle, favor a modest slowdown over further signs of economic vigor.

Regarding market expectations, following the recent FOMC meeting where Fed Chair Powell hinted that the following policy adjustment is unlikely to be a hike, the bond market has again begun pricing in the likelihood of two rate cuts for the year. With this inclination toward rate cuts, we believe these current expectations are grounded.

Which direction will inflation ultimately take?

Undoubtedly, significant strides have been made since inflation peaked at 9.10% in June 2022, but the journey towards stabilization still needs work. Market sentiments resemble kids in the back seat of a car, less concerned with the distance traveled and more focused on reaching the destination, saying the always funny **"Are we there Yet?".**

However, after recording three consecutive rises in the CPI since 2024 began, confidence in the trajectory toward the 2% target could be more secure, making the road ahead bumpier than riding a wild bull.

Against this backdrop, all eyes are set on the forthcoming CPI release. If the forecast of 3.50% for the CPI and 3.65% for the Core CPI is met, it would mark a positive step towards achieving the needed decrease.

For the Fed to meet its year-end projection, core inflation would need to increase at a monthly rate of 0.17%, compared to the average of 0.36% observed over the past three months.

While monthly inflation readings are volatile and challenging to forecast, indications suggest further disinflation.

We maintain a bias towards lower rates when preparing portfolios for various scenarios. If inflation remains stubborn in the near term, mega-cap tech companies will likely remain favorable due to their robust balance sheets and reduced vulnerability to high borrowing costs. Additionally, international stocks may offer attractive returns, particularly if a divergence between the Fed and other central banks emerges, leading to rate cuts abroad.

In conclusion, amid heightened uncertainty surrounding inflation and interest-rate outlooks, diversification across asset classes, regions, investment styles, and sectors remains crucial.

The Final Word: Puerto Rico Economic Update

The latest economic indicators from Puerto Rico present a complex scenario, with specific metrics indicating a decline. For instance, the unemployment rate has experienced a slight increase of 1.75%, moving from 5.70% to 5.80%.

The Economic Activity Index (EAI) for Puerto Rico has been downward for two quarters and has contracted for two successive months. Here's the breakdown:

Month	EAI	Change
Sep 2023	5.10%	64.51%
Oct 2024	4.80%	- 5.9%
Nov 2023	4.70%	-2.1%
Dec 2023	1.60%	-193.8%
Jan 2024	1.10%	-31.3%
Feb 2024.	-0.20%	-118.2%
Mar 2024	-0.80%	-300.0%

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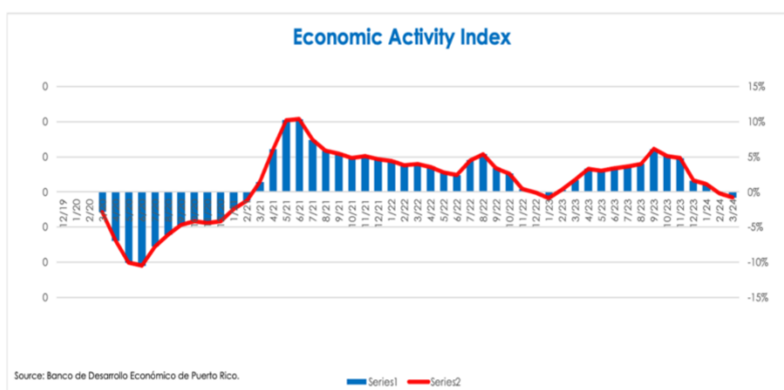
Economic Activity Index

December 2019- March 2024



The EAI was positive in September 2023 but began to fall in October 2023. The decline intensified in March 2024, with the EAI plummeting 300%. The negative trend persisted, with the EAI contracting in February and March.

Factors Influencing the Economic Activity Index:

- **Nonfarm payroll employment** averaged 953,400 in March, a decrease of 0.6%, and 959,500 in February, an increase of 0.3%.
- **Electric Power Generation** in March and February 2024 was 1.576.4 and 1.528.3 million kWh, respectively, marking monthly changes of +3.1% and -2.2 %.
- **Gasoline Consumption** in March 2024 was 60.1 million gallons, a monthly decrease of -6.5% and an annual decrease of 22.8%.
- **Sales of Bags of Cement** in March and February 2024 were 1.2 and 1.1 1.3 million 94lb. Bags respectively. The yearly decreases were -4.0% and -12.2%.

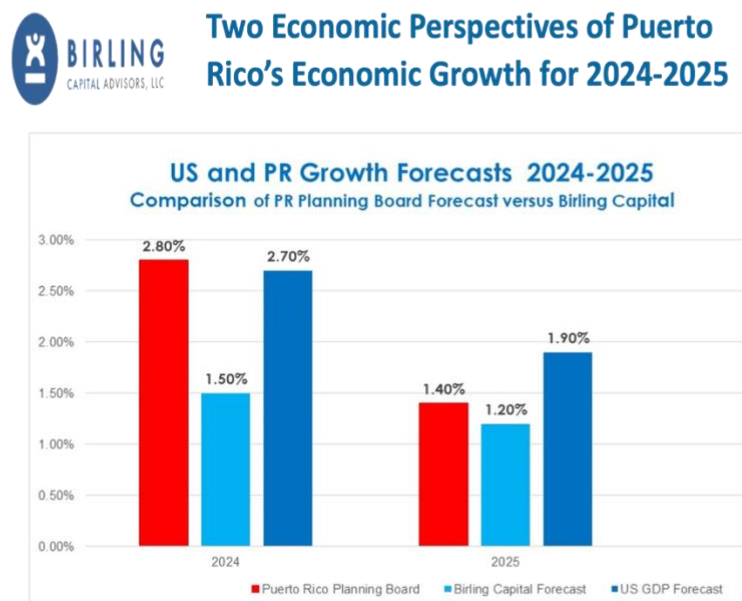
Puerto Rico GDP Forecasts for 2024:

The Puerto Rico Planning Board increased its forecast for GDP growth from 1.8% to 2.8%, marking a significant increase of 55.55%. Compared to the GDP growth rate of 0.7% in 2023, this represents an increase of 300%. Moreover, this growth rate exceeds the IMF's projected GDP growth rate for the U.S. in 2024, estimated at 2.7%.

Given the latest economic indicators, attaining Puerto Rico's revised GDP growth projection of 2.8% in 2024 presents a formidable challenge.

Recent trends in unemployment and the Economic Activity Index (EAI) indicate that the economy is currently grappling with headwinds. The sharp contraction in the EAI over two consecutive quarters signals an economic slowdown. These challenges, compounded by adverse impacts on nonfarm payroll employment, electric power generation, gasoline consumption, and sales of cement bags, contribute to the complexity of the economic landscape.

In conclusion, while the upward revision of Puerto Rico's GDP growth projection for 2024 is encouraging, achieving this target will demand concerted efforts, effective policies, and possibly favorable external conditions. Policymakers must address current economic challenges and implement strategies to stimulate growth and enhance Puerto Rico's overall economic well-being.



Sources: IMF World Economic Outlook, Puerto Rico Planning Board & Birling Capital

Francisco Rodriguez-Castro, President & CEO • frc@birlingcapital.com
PO Box 10817 San Juan, PR 00922 • 787.247.2500 • 787.645.8430

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