2024 Investment Letter

Little Fires Everywhere

One thing we feel strongly about is the Fed's commitment to get inflation down to their 2% target. We also note that the Fed is setting policy using data out of the rearview mirror. Given the lagged effects of monetary policy, this approach increases the odds for a Fed overshoot. This is at the core of our more cautious stance in asset allocation positioning.

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Key Points

- We believe the U.S. economy will slow in 2024 and the window for just a soft landing is closing
- The key to avoiding a recession is based on the path for inflation and in our opinion it may prove sticky
- In positioning we are excited about fixed income and are overweight equities where valuations allow

We expected 2023 to be a transition year as we forecasted recessionary conditions that would offer opportunities to add more risk exposure. Ultimately our expectations proved wrong (or early) as U.S. economic growth reaccelerated as opposed to slowing down and, broadly, most risk assets did not provide a buying opportunity. But we still believe that opportunity is on the horizon.

We believe a number of one-time factors contributed to the stronger economic conditions that are likely to dissipate going into 2024. Meanwhile we are beginning to see signs of economic weakness in many places (little fires everywhere) as sustained high interest rates have begun to hurt more vulnerable sectors of the economy.

These are little fires, so currently not that concerning (at least individually, though the number of fires is disturbing). Another thing to note is that just 3 months ago these fires were not there, or were just embers. We believe we've reached something a tipping point for the economy and assuming the Federal Reserve (Fed) continues to hold rates at a high level, these little fires will begin to spread to more vital sectors of the economy.

While the Fed (and other central banks) is causing these little fires, they also have a fire hose to put them out. We will want to put on more risk asset exposure well before it becomes obvious that they are going to shift to a fire fighting policy. We believe this monetary pivot may occur initially in Europe, arousing our interest, but first let's look at the U.S. economy.

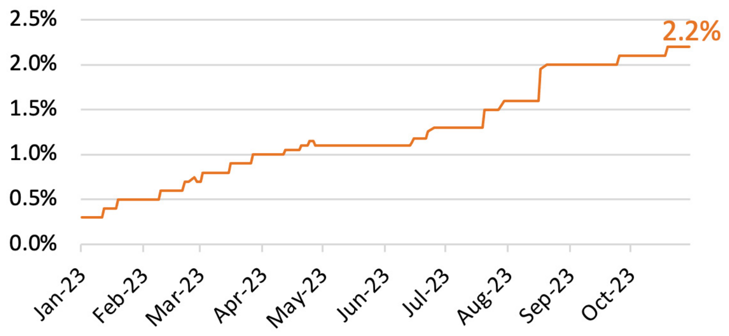
The U.S. Economy: Slowdown Coming

In our 2023 Investment Letter we laid out a base case for a mild recession. Our reasoning for a mild recession was based on the fact that a large portion of U.S. consumers and businesses had reduced their interest burden making them less interest rate sensitive. That suggested that monetary policy may be less effective leaving open the risk that they take rates higher or hold them steady at a high level for longer than anticipated. We reasoned that the Fed would do enough to put our economy into a mild recession.

But we didn't get a recession, mild or otherwise. In fact economic growth modestly accelerated (at least through the third quarter). We believe that the acceleration in economic growth in 2023 was a function of a few factors.

- An unexpected fiscal thrust as the deficit nearly doubled to almost $2 trillion.
- A recent revision to government data showed that consumers had more savings than previously shown. This meant consumers had more spending power than was apparent at the start of the year.
- Productivity grew faster than expected, though the improvement was partly due to lower labor costs, which is a bit of a head scratcher.

Change in Consensus 2023 Real GDP Forecast



Source: Bloomberg. Daily consensus readings through Oct 2023

None of these factors are likely to be sustained into 2024. And while it appears the economy is less interest rate sensitive than expected, it doesn't mean it is interest rate insensitive. The Fed has a very blunt tool for slowing economic growth and its impact on different sectors of the economy are uneven and come with varying lags. We expect the economy to slow dramatically from the third quarter pace as we move into 2024.

This has been the most aggressive Fed tightening cycle seen in decades and we are beginning to see numerous signs of weakness. Currently most of these signs are seen in more vulnerable areas of the economy such as low income borrowers. The bottom quintile of the income distribution only makes up ten percent of total consumer spending; hence a little fire. But the longer the Fed keeps stoking these flames the more likely they are to spread and become uncontrollable.

The following is a sample of the many little fires we are seeing:

- Corporate chapter 11 bankruptcies are up 50% through September versus a year ago through September.
- Small business owners remain pessimistic as indicated by the NFIB (National Federation of Independent Businesses) survey, with credit availability being a particular sore point.
- Private equity firms are beginning to show signs of stress from higher interest rates
- Subprime auto loan delinquencies are the highest on record. Subprime loans are made to those with credit scores below 620.
- Delinquencies have jumped to 2008 levels for credit card holders with credit scores below 660.
- While the student loan payment freeze has mostly ended nearly 90% of borrowers are currently not making any payments.
- Even in the vaunted artificial intelligence space we are seeing little fires, with numerous startups laying off workers and tightening their belts due to high interest rates and limited venture capital funding.
- Based on CBRE analysis it costs 52% more to own than rent, the highest seen on record.
- The Mortgage Bankers Association measure of home loan applications is at lows not seen since 1995.

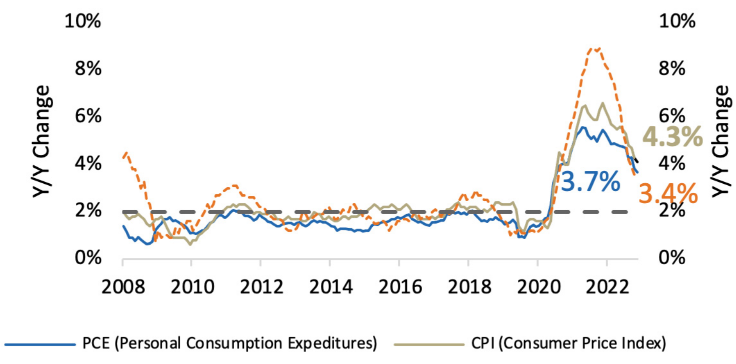
Meanwhile, we believe the timing of when the Fed can begin to loosen monetary conditions is more dependent upon the trend in inflation and not the fires they are setting.

Inflation: Are We There Yet?

During 2023 economic growth kept getting revised higher. Meanwhile the rate of inflation moved lower, but has remained well above the Fed's 2% target. In a historical context, seeing the rate of inflation improve prior to economic weakness is backwards.

Typically the Fed's actions work to slow economic growth (demand) which then slows inflation. So to see inflation fall without economic slowing is unusual and indicative that it has not been triggered by the Fed's actions. In other words, it appears inflation was destined to fall as supply side pressures eased. But with supply side pressures dwindling, does the path to 2% from here need slower economic growth? We think so.

Inflation Measures Excluding Food & Energy

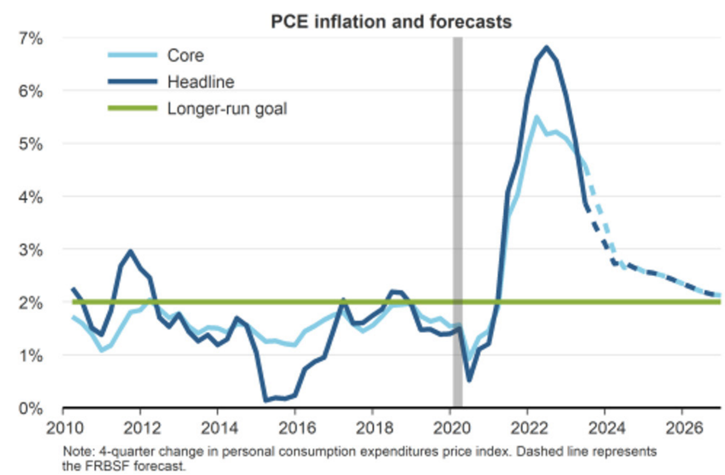


Source: Bloomberg. 15 years of monthly data through Sep 2023

If the rate of inflation begins to fall more slowly, that would mean the Fed is likely to keeps rates higher for longer which increases the potential for broader economic weakness.

It does seem probable that the progress in inflation may begin to slow as it is more dependent upon on the Fed reducing demand, and as we note, the economy is less interest rate sensitive. While this narrative appears logical and is consistent with staff economists at the Fed (as can be seen in the latest forecast from the San Francisco Fed in the nearby chart), we need to be careful here as inflation forecasters' haven't been very accurate. We take this as our base case, but hold it somewhat weakly and are prepared to adjust our view and positioning if the data compels us to.

Inflation Expected to Return to 2% Gradually



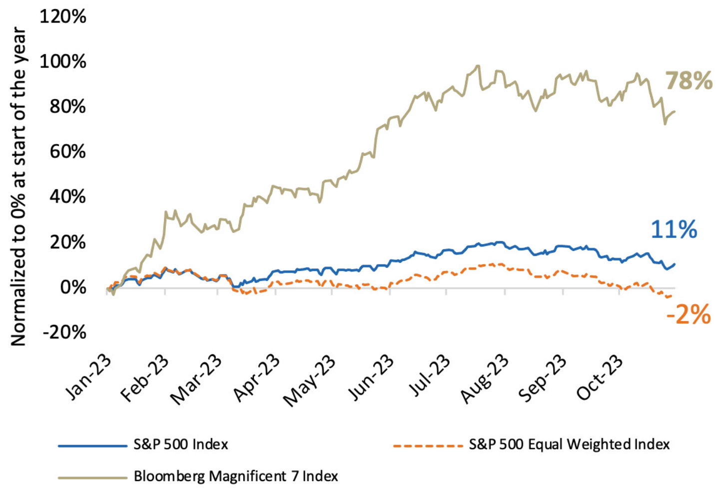
Source: Bureau of Economic Analysis and FRBSF staff

One thing we feel strongly about is the Fed's commitment to get inflation down to their 2% target. We also note that the Fed is setting policy using data out of the rearview mirror. Given the lagged effects of monetary policy, this approach increases the odds for a Fed overshoot. This is at the core of our more cautious stance in asset allocation positioning. We will accept risk only where we feel we are being appropriately compensated for that risk.

Domestic Equities: The Magnificent 7

2023 has been a story of haves and have nots. As of the end of October 55% of the stocks in the S&P 500 Index had negative year-to-date returns. The index return through October was 10.7%, yet the top 7 contributors accounted for 100% of that return. Remove those names and the return drops to 0%. It is very difficult to get a macro call correct when micro factors (just 7 stocks) drive returns.

YTD Total Returns



Source: Bloomberg. Daily observations through Oct 2023

While the S&P 500 index rallied more than 20% off the October 2022 low, we believe we are still in a bear market. The characteristics of the rally are much more consistent with the late cycle as opposed to the early cycle. Does that mean we expect the market to make a new low? This is a question we have been struggling with and don't have a good answer. This is mainly due to the nature of the rally being driven by a small part of the index. We would suggest the S&P 493 has acted fairly rationally this year.

We have been operating on the assumption that the market makes a long "U" shaped bottom. This is partly due to how early the market swooned, but also relates to tight labor conditions and generally healthy consumer and business balance sheets. We believe these factors help keep the floor from dropping out from under the market.

But upside may be difficult as well due to fundamentals as we don't believe the market will be able to deliver on 2024 consensus earnings growth of 12%. Implied in that growth rate is top line growth of 5.5% and margin expansion. With economic growth and inflation slowing that seems like a reach.

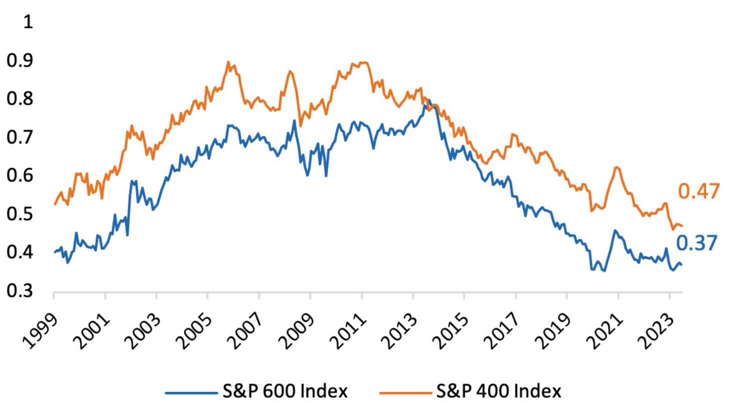
Valuation

S&P 500 Index valuations are not favorable, regardless of the lens. Nor are profit margins. Generally at the start of a bull market, valuations and profit margins are low and they set the market up for multiple expansion and earnings growth. This is the main factor that tempers our enthusiasm for large caps.

Small and Mid-Caps

While we wait for better large cap valuations we are finding better opportunities by looking down in market cap. Small- and mid-cap stocks enjoy much lower valuations, in an absolute sense as well as relative to large caps. In fact, small and mid-cap valuations relative to large-cap are the lowest in two decades. Admittedly, small and mid-cap companies are more economically sensitive and there is earnings risk. We believe that current valuations discount this risk, but we don't want to create too much false comfort as valuations can move lower.

Price/Sales Relative to S&P 500 Index



Source: Bloomberg. 24 years of monthly data through Oct 2023

One other consideration is that small and mid cap stocks typically outperform in the early cycle stage of a bull market in part due to having approximately twice as much cyclical sector exposure as large-caps. We believe that there is a strong likelihood that the market begins to find its feet sometime during 2024 as investors begin to anticipate the Fed moving into an easing mode.

Growth versus Value

Growth stocks have dramatically outperformed this year. But just like the broad market, the leadership has been very narrow with just a handful of stocks accounting for nearly all of the gains. While there was some earnings support for the rally, the majority of the gains have come from rising valuations.

Given we continue to see significant risks for a recession, the natural expectation is to become more constructive on value stocks as they have greater exposure to cyclical stocks that typically lead a post-recession recovery. Yet, unlike small and mid-caps, value stocks are not cheap relative to history. Without that valuation support it is more difficult to justify looking through probable economic risks.

At this stage we think it is premature to have a style bias; however, assuming a recession materializes and value equities react in a historical manner, we would expect to become more favorably disposed to them.

International Developed: Getting Interesting

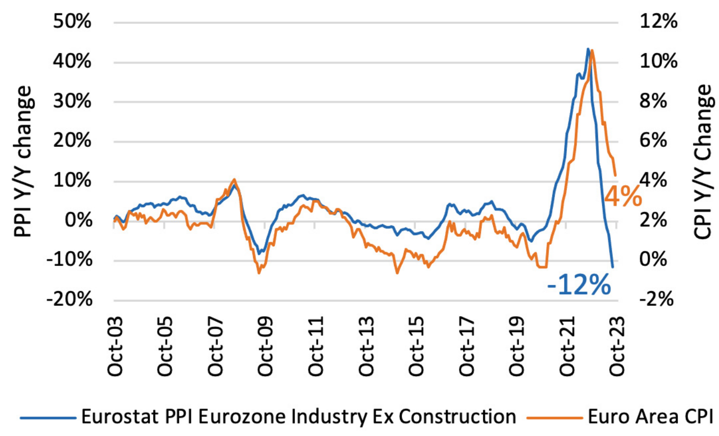
Following a pause in rate hikes, European Central Bank (ECB) president Largarde said that it is premature to talk about rate cuts. We think she is jawboning the market and that rate cuts will come sooner than expected and that is building our appetite for international developed stocks.

Europe didn't provide nearly as much monetary and fiscal pandemic support as the U.S. And Europe's economy is more interest rate sensitive given most lending goes through banks.

The current ECB rate hiking cycle is the most aggressive in the history of the ECB. When we put these pieces together, less stimulus, more interest rate sensitive economy, and monetary tightening, it helps explain why we believe the ECB may have overtightened which could put the ECB closer to easing.

Producer prices in Europe have been a good predictor of consumer prices. Europe's inflation appears to be more supply-driven and supply pressures are quickly receding. If consumer prices fall at a similar pace as producer prices the ECB should be in a position to pivot long before the Fed.

European Inflation



Source: Bloomberg. Daily observations through Oct 2023

European stocks are historically cheap, but profit margins are still high. If we are correct that the ECB has overtightened, then earnings risk remains.

Last year we highlighted Japan given decent earnings, low inflation, and incentives for companies to be more investor friendly. In local currency terms the Japanese market has produced the best returns through October, though more than two thirds of those returns disappear when they get translated into USD.

Japan's currency may begin to strengthen as they remove yield cuve control efforts, but currency is a two-edge sword for an export driven country like Japan. A strong currency can hurt the competitive position of Japan's exporters.

Overall we remain modestly underweight international developed equities, but believe we may get an opportunity to close out the underweight in 2024 and possibly move to an overweight.

Emerging Markets: Diverging

Late in 2022 and early in 2023 we tactically added emerging markets exposure following China's about face on COVID lock-downs. We anticipated a robust rebound, which happened initially, but lacked follow through. By the spring we tactically retreated.

China is very important given its large weight in the index as well as being a significant growth driver for other Asian economies.

The challenges facing China are beginning to look more structural in nature and it is likely that their economy will not attain its past rapid growth profile. The International Monetary Fund is forecasting that China's economic growth will slow to 3.4% by 2028.

China's property sector is reeling from overcapacity and too much debt. According to the Financial Times more than 50% of China's largest property developers in 2020 have gone into default. The property sector has been a major engine of growth for China and an important vehicle for Chinese savings.

Unfortunately, that is not the only issue:

- China's population is no longer growing.
- China is also suffering from deflation risks due to excess production capacity.
- President Xi has consolidated power and has pursued a much less business friendly approach to managing the economy.

Outside of China the emerging markets picture is mixed but should provide opportunities for selective investors.

Brazil was again a relative bright spot in 2023 as commodity prices rose and remained elevated, and the country is on the backside of peak inflation.

India is the world's third largest economy and is taking steps to create long-term structural advantages. For example, in recent years steps were taken to make the economy more efficient, including digitization, especially in the financial sector, and simplification of regulations for businesses. Infrastructure remains a driver of growth and new policies have been introduced to kick start the country's manufacturing in more than a dozen sectors. India's economy is expected to grow approximately 6% per annum for the next five years.

Many emerging markets are benefiting from foreign direct investment as companies look to move manufacturing out of China. While these investments certainly help these emerging economies there is a caveat. China's manufacturing capacity is not going away. Building more capacity outside of China could have a deflationary impact on global goods prices and potentially hurt profitability.

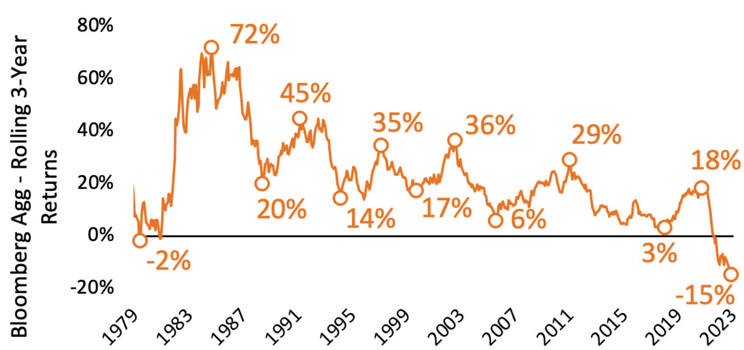
Overall, we remain neutral on emerging markets.

Fixed Income: 8th Wonder of the World

The sheer magnitude of pain absorbed by fixed income investors over the past three years has been staggering. The cumulative three year total return for the Bloomberg U.S. Aggregate Bond Index is down -15.8% through October. This was the worst three year return we've ever seen.

And as bad as it sounds, we want to put it in a positive light as we believe the next three years will see a reversal of that downward thrust. As has happened in the past and can be seen in the nearby chart.

Bloomberg US Aggregate Bond Index: Rolling 3-Year Total Returns

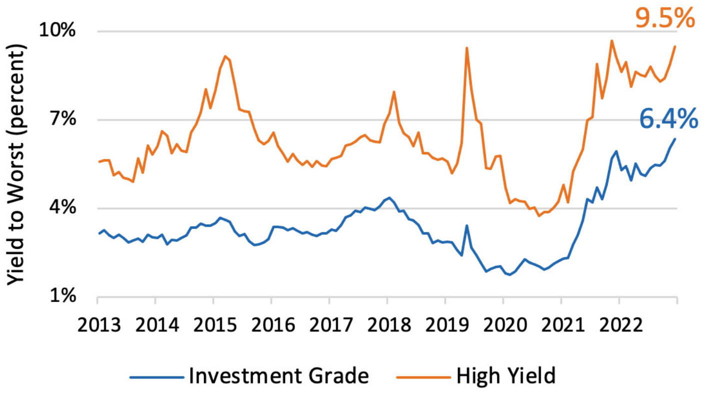


Source: Bloomberg. 44 years of monthly data through Oct 2023

The negative returns are almost solely due to rising interest rates. Credit spreads have barely changed over the last three years. It is unusual for interest rates to rise to such an extent without investors demanding more compensation for taking credit risk. Are investors not concerned by the most aggressive monetary tightening campaign in four decades?

We continue to focus on higher quality credit, where we can still earn a high rate of income, without needing to accept much economic risk. Investment grade corporates yield 6.4% using the Bloomberg index. That yield is more than double the average over the last 10 years. Finally fixed income is actually delivering income.

Bloomberg U.S. Corporate Bond Indexes: Yields



Source: Bloomberg. Trailing 10 years of monthly data through Oct 2023

At the end of October the Bloomberg U.S. Aggregate bond Index had a yield of 5.6% which was 0.9x its duration. This yield-to-duration ratio can be used to measure how much yields would need to rise to extinguish a year's worth of income (using current data, yields would need to rise to 6.5%). It was just 0.3x at the start of 2022 when yields were much lower. While yields could rise further (not our forecast), there is more yield cushion to absorb an increase.

Albert Einstein is often quoted as having said, "compound interest is the eighth wonder of the world. He who understands it, earns it, he who doesn't, pays it." The fixed income market is now priced to deliver more attractive compounding interest in the future and providing a better outcome for investors and savers alike. This should return the asset class to its traditional role of providing income, diversification and capital preservation.

Concluding Thoughts

While 2023 is not over, now is when market participants shift their focus to the next year. Visibility is low and there are many powerful forces pushing in opposing directions. Last year, given the unique backdrop for the markets, we felt it best not to stray too far from our tactical weights and we continue to operate under that policy.

We believe that sometime during 2024 it is likely most central banks will be signaling a course change from policy tightness to easing. This signaling should kick off the next bull market. Where valuations allow we are overweight risk assets that typically outperform in the early stages of a bull market. Otherwise we are waiting patiently in higher yielding fixed income for other risk assets to become more attractive.

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Word About Risk

Investing in Equities is subject to market volatility and loss. International and Emerging Markets equities also carry the associated risks of economic and political instability, market liquidity, currency volatility and differences in accounting standards. The risks associated with investing in international markets are magnified in Emerging Markets. Fixed Income/Debt securities can lose their value as interest rates rise and are subject to credit risk which is the risk of deterioration in the financial condition of an issuer and/or general economic conditions that can cause the issuer to not make timely payments of principal and interest also causing the securities to decline in value and an investor can lose principal.

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