Thinking Out Loud

As you may recall, in my opinion, forecasts (like insincere promises) are only worth the paper on which they are printed. In the case of market forecasts, there are simply way too many variables at play to have any degree of confidence in prognostications. That said, as an investment manager, having a view on the elements impacting the near-term direction of the markets is mandatory. For those seeking to achieve their investment objectives, a strategic orientation is essential; however, we can be somewhat opportunistic in where and when to deploy additional capital into the equity or bond markets and, for those approaching their later chapters, when to emphasize capital preservation and income over growth.

With the most aggressive monetary policy in history last year, the Federal Reserve combatted runaway inflation, leading to a general consensus for an impending recession. Closing out the first quarter of 2024, this has not manifested outside of the commercial real estate space, specifically offices and shopping malls to identify two sectors that have had difficulty recovering. Economic growth (per the REAL GDP statistics) remains solid with the first estimate of Q4 2023 GDP rising 3.2% with the Personal Consumption Expenditure deflator ("PCE"), an inflation metric closely followed by the Fed, coming in at 2.4%; still above the Fed's target. While manufacturing remains in a contractionary mode, the service economy continues to stay in expansionary territory, albeit at a slowing pace – perhaps the last vestiges of the Covid pandemic working through the economy. The labor market remains strong, notwithstanding a slight uptick in the unemployment rate in February to 3.9%.

Entering 2024, market participants expected six interest rate cuts from the Fed commencing in March, despite Chairman Powell's assurances that ongoing evidence of dampening inflation toward the Fed's 2% target would be a precursor to easing of rates. Hotter than forecast CPI and PPI prints for January and February have dampened expectations of impending interest rate cuts, with expectations being dialed back to 3-4 cuts, perhaps commencing in June.

Similar to last year, equity market index returns (the S&P 500) have been largely fueled by the constituents of the "Magnificent Seven" (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla), although Apple and Tesla have been under pressure of late. As expectations shifted from a potential recessionary outlook to the sustained resilience of the economy and stock market, leadership has begun to extend beyond just the "Fabulous Five" remnants of the "Magnificent Seven", driving the S&P 500 to record highs.

From a technical perspective, participant's euphoria has pushed the S&P 500 into overbought territory AND there is an important divergence amongst some of the technical indicators, as annotated on the weekly chart below. This suggests that the recent momentum of this bull trend may be waning, curtailing the rapid run-up since October of 2023. This could be an actual correction OR the market may just trade sideways to allow it to digest its recent gains.

Source: Barchart.com

At this juncture, it's important to take a look <u>behind</u> the curtain….

- Inflation remains persistent in our daily lives.
  - Food, concerts, clothes, gasoline and used cars.
  - An actual shortage of housing inventory is keeping pressure on this component of inflation.
  - Quantitative tightening is another Fed "lever " to keep inflation in check.
- Fed rate cuts could be a harbinger of a struggling economy and portent bad news for the equity market.
- Boeing, a stalwart of the transportation and defense sectors has been decimated with collateral damage extending to the airline industry.
  - manufacturing flaws; safety concerns following several incidents.
- Regional banks, who are heavily levered to the commercial real estate market are not out of the woods.
- Equities reporting softer guidance for future earnings are being shellacked, despite putting up good growth in revenues and earnings in the current period
- Retail Sales, which accounts for a substantial portion of our economy, dipped dramatically in January with a subsequent tepid rebound in February.
- The equity market has been dominated by Momentum – a largely psychological driver.
- Expected drivers that will affect equities and bonds in the coming months/years include:
  - Expanding adoption of technology, specifically Artificial Intelligence and the associated capital expenditures to fuel these productivity enhancing technologies.
  - Further capital investment to facilitate the ongoing transition to green energy, further digitization, repair/replacement/development of our crumbling infrastructure (think roads and bridges!), and "on-shoring" of manufacturing capabilities (a further extrapolation of

the supply bottlenecks that manifested during covid and are currently being exacerbated by bottlenecks in the Suez and Panama Canals and the Red Sea.)
    - Political uncertainties in the mid-east and eastern Europe
    - Expanded US government deficits and the necessity of funding said budget deficits at higher interest rates.
        - Fiscal year 2024 projected deficit of $1.5 trillion is +- 5% of GDP (Barron's March 11, 2024, p.19)

So how does this translate for investors?

- 10- year U.S Treasury rates are likely to remain in the 4.0% to 5.0% range for the year.
    - Powell likely avoid actions with any political overtone as we approach the election.
    - Fixed-income holdings may now assume a more "normal" role in one's portfolio, actually providing income.
- Beneficiaries of the drivers noted above will include the Healthcare, Industrial and Technology sectors
    - Technology firms that are able to monetize and demonstrate productivity benefits from the application of AI and cybersecurity threats.
    - Healthcare is the most obvious beneficiary of AI, improving diagnostics and drug trail efficiencies. The sector generally underperformed last year and the potential for Medicare reimbursement pressures, influenced by the upcoming US elections, will be a headwind for some in the sector, while merger and acquisition activity is seen increasing.
    - Industrial companies benefitting from fiscal stimulus expenditures for infrastructure and onshoring projects.
    - Defense industries due to heightened geo-political tensions and demand for their products and services.

We are NOT market timers! The purpose of this missive is to help explain the underlying tendency of the market and provide a broad general framework for expectations at this time. The equity market remains the best possible means to grow one's assets and the long-term trajectory remains upward. Committing incremental capital to the market should be done judiciously at this time, recognizing that there are select sectors that are more likely to benefit from the current economic environment. Further, everything depends upon each client's situation and objectives.

Be patient, remain calm and optimistic and focus on the achievement of your objectives rather than short-run market performance.

March, 2024

(With apologies to Ed Sheerin for appropriating the title!)

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