April 2024 - First Quarter Investment Summary

Overall Assessment

The economic outlook remains divided. Optimists predict continued growth, accelerating even further this year. Others, however, see mounting problems simmering beneath the surface, waiting to erupt. Ultimately, factors like permanent job layoffs, interest rates and corporate earnings will determine which forecast prevails. Given the tensions that remain in key financial areas, we continue to advise maintaining current risk postures in your portfolios.

<u>Optimism from Wall Street</u>

Despite ongoing inflation concerns, escalating tensions in Gaza and Ukraine, and recessions in Germany, Japan, and the United Kingdom, stock markets defied expectations with a strong first quarter. Building on momentum from late 2023, equities surged to new highs – everything from stocks to Bitcoin to gold saw strong gains. The S&P 500 led the charge, climbing 10% in the first quarter, marking its best start to a year since 2019.

Fueled by Federal Reserve Chair Jerome Powell's comments in October 2023, hinting at a soft economic landing, stock markets have continued to climb despite the lack of expected interest rate reductions. Investors are currently embracing a "Goldilocks economy" – one that's not too hot or too cold. They're overlooking economic weaknesses and downward revisions, focusing instead on continued consumer spending, steady hiring, and low unemployment (below 4%).

Many Wall Street economists are forecasting continued economic growth in 2024. While inflation may not cool as rapidly as the Federal Reserve desires, these economists believe the Fed will still cut interest rates later this year. Their rationale? The Fed can potentially loosen its grip on rates without reigniting inflation. This forecast aligns with the "rolling recession" thesis, suggesting that certain economic sectors have already experienced downturns and are now on the rebound. For example, the Institute for Supply Management's (ISM) new orders index, which recently dipped, mirrors a similar soft patch from the mid-1990s. This suggests these sectors might be undergoing a "rolling recovery."

This market rally is driven by momentum and a belief in the resilience of the US economy, particularly compared to the rest of the world. Technology and AI themes are leading the charge. As we inch closer to November elections, political posturing might be influencing how economic news is framed in the media, creating a bias towards optimism. Additionally, the sheer volume of news bombarding us makes it harder to assess the full range of potential outcomes, which could lead to volatility if the "Goldilocks economy" doesn't materialize.

Pressures Building

Since late 2021's inflation surge and the February 2022 Ukraine war, investors have been navigating a complicated and tiring market landscape. It's understandable why some might tune out negativity and focus on positive trends. While market optimism is natural, it's crucial to remember that momentum-driven trends can shift quickly. We remain watchful and cautious as we enter this next phase. While headlines paint a rosy picture, we see concerning trends that demand attention. Here are some key warning signs:

- Soaring Debt: US government debt tops $34 trillion and is adding $1 trillion every 100 days. Additionally, the interest on our debt is exceeding another $1 trillion annually. Consumer debt is also at record highs, with delinquencies on the rise.
- Economic Indicators: Historical key indicators like the inverted yield curve and leading economic indicators continue to signal a potential recession.
- Banks/Commercial Real Estate: Rising commercial real estate defaults are squeezing banks and communities, forcing lenders to tighten their belts and making it harder for businesses to secure loans.
- Shifting Job Market: Layoffs are increasing in crucial private-sector jobs, replaced by part-time and government positions. This could signal weakening economic health.
- Global Slowdown: Major economies are entering recessions, impacting global activity and potentially corporate earnings.
- Geopolitical Tensions: Ongoing geopolitical issues remain unresolved, posing a threat to stability.

Prominent investors like Jeff Bezos, Mark Zuckerberg, Jamie Dimon, and The Gates Foundation are selling large amounts of stock, while others like Warren Buffet are holding significant cash positions. Additionally, investors and central banks are increasing their holdings of precious metals like gold and silver.

Despite some positive economic indicators, respected figures like Fed Chair Powell are acknowledging significant risks. These risks stem from high asset valuations and the massive amount of accumulated debt. The main debate centers on the timeline – how soon these risks might materialize. Most economists agree, however, that the current financial trajectory is unsustainable. Some economists argue that our seemingly resilient economy is fueled by debt, which is masking deeper issues and is more fragile than it appears.

Politically, there's a focus on maintaining stability until the election. Our concern lies in potential disruptions before the election and the long-term consequences of this deficit spending approach. What kind of financial mess are we creating for the future? These factors, despite some market optimism, highlight potential risks on the horizon. It's crucial to stay informed and consider strategies to navigate this changing landscape.

Market Update

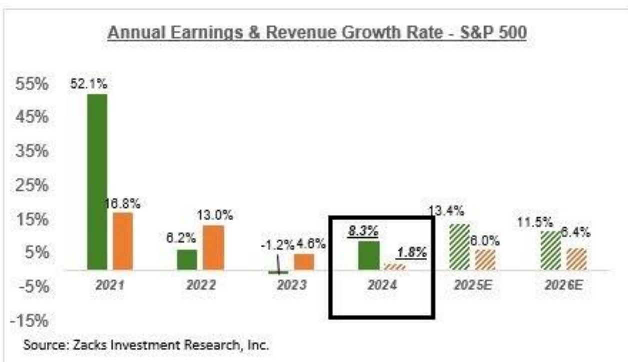
The S&P 500 concluded its strongest first-quarter performance since 2019. Investor optimism was high entering 2024, buoyed by significant gains in stocks last year, particularly in Mega-cap tech shares. A robust (albeit debt-driven) economy, excitement around artificial intelligence, and anticipation of interest rate cuts this year fueled the rally in stocks throughout the quarter, though concerns linger about long-term economic sustainability. Large-cap and technology stocks outperformed, with gains of 9-10% for the quarter, while smaller US stocks saw an increase of around 5%. International stocks also experienced gains of 3-5% for the quarter.

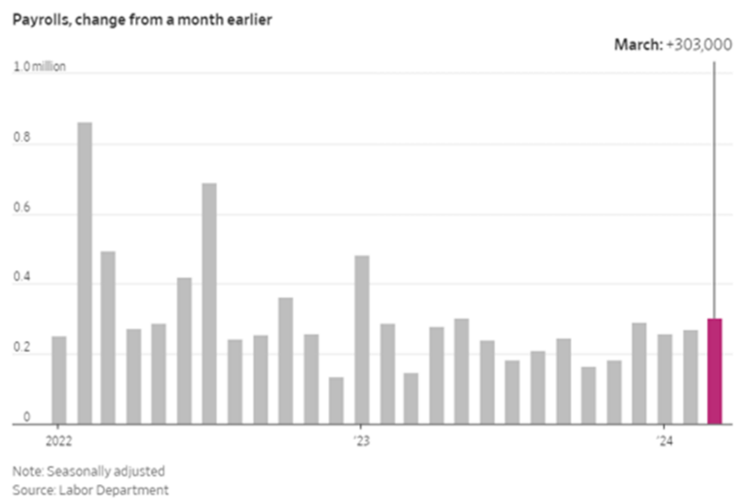
Entering the year, investors anticipated the Fed to implement six cuts to its benchmark short-term rate in 2024. However, this forecast proved to be overly optimistic, with expectations now adjusted down to 2 rate cuts later in the year. This adjustment contributed to some volatility in interest rates as concerns about inflation intensified, leading to an increase in rates. Treasury yields climbed as investors revised their rate-cut projections. The 10-year U.S. Treasury yield, serving as a benchmark for borrowing costs ranging from mortgages to car loans to corporate bonds, recently rose to 4.37% from 3.860% at the end of 2023. Consequently, the average rate on a 30-year fixed mortgage and borrowing costs in the corporate bond market have also edged higher. Within fixed income markets, less rate-sensitive high-yield bonds saw a gain of 1.5% due to further spread compression, while the broader market experienced a decline ranging from -0.4% to -0.6% as rising yields weighed on bond prices. Cash-like investments such as money markets and short-term treasuries posted gains of 1.0-1.4% during the quarter.

U.S. “Resilient” Economy -

The U.S. economy continues to stand out relative to its developed world peers, despite sending many mixed messages. Consumers are still spending but, in addition to higher credit card debt, they are turning to other less optimal financing sources. In line with a rolling recession/recovery scenario posited by some economists, the ISM Manufacturing PMI (blue) has improved over the past year, while the ISM Services PMI (orange) has weakened. Manufacturing was initially hit first, but is now showing improvement, while services are currently experiencing bumps in the road.

Earnings forecasts for the S&P remain positive (+8.3% for 2024), despite the overweight towards technology and AI. The hope is that other sectors will begin to improve as a "soft-landing" scenario emerges, along with a lowering interest rate environment. Below, we illustrate the overall earnings (green) and revenue (orange) picture for the S&P 500 index on an annual basis.





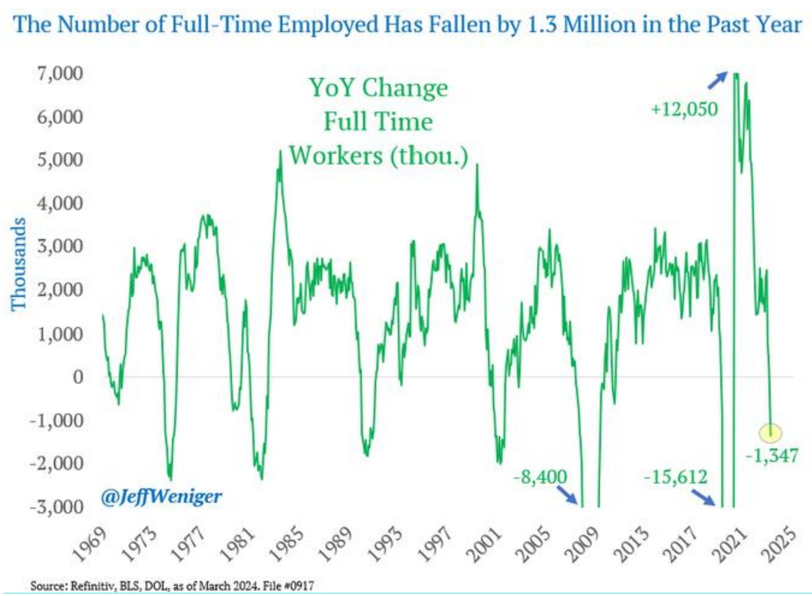
Supporting an optimistic tone for markets are the headline job numbers, which once again posted strong figures. Jobs grew at a brisk pace in March, but wage growth was contained, confirming a hopeful belief among some economists that the U.S. can continue to expand employment without fueling inflation. U.S. employers added a seasonally adjusted 303,000 jobs in March, the Labor Department reported, significantly more than the 200,000 economists expected. The unemployment rate slipped to 3.8%, versus February’s 3.9%, in line with expectations.

However, investors have been on edge recently over economic data suggesting that Federal Reserve interest-rate cuts might not be imminent. The strength of March’s report feeds into those concerns—though that is less because it stirs worries of inflation, and more because it leaves the central bank comfortable with its wait-and-see stance on interest rates. Fed Chair Jerome Powell, in recent months, has signaled, however, that he no longer regards strong hiring as something to fear. That is because the labor force has been growing steadily, largely due to a strong rebound in immigration. As a result, brisk hiring isn’t stoking concern on Powell’s part that the economy is at significant risk of overheating. Instead of focusing on hiring, Powell and other Fed officials have suggested that inflation data in the coming months will be much more important in determining whether the central bank can cut rates in June.

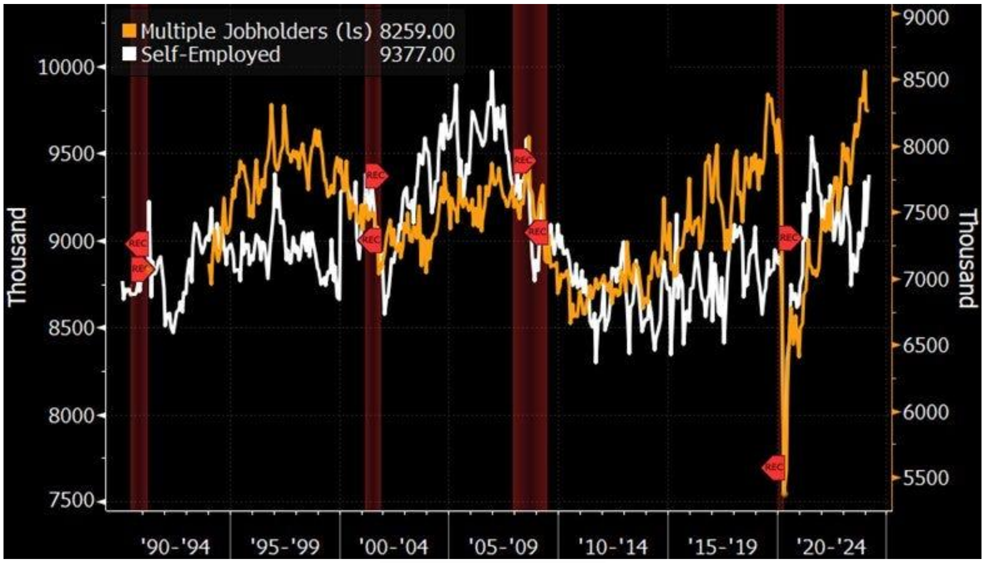
Economic fundamentals suggest downward momentum is likely for much of the economy this year, likely resulting in a mixture of slowing growth for some markets and mild decline for others. The hope is that enough growth in parts of the economy will buy enough time for the rest of the economy to catch up. Our concern is that there is an imbalance in this economy, with deeper weaknesses lurking beneath the surface that could lead to unexpected challenges for the markets. Similar financial surprises occurred in 2008, catching experts off guard. In many ways, these pressures are more complex and significant, as debt levels are much higher, and inflation poses a much greater threat.

Job Market Imbalances

There are many inconsistencies in details within the US labor market data, which makes things a bit convoluted. Headline job numbers have consistently been revised lower over the past 18 months and, according to the Philadelphia Fed, may still be overstated by at least 800k. The key takeaway is that the employment data has not been as robust as the initial headlines suggested. Looking below the surface, we see that despite the non-farm payrolls showing 303,000 jobs created in March, in reality, 6,000 full-time workers lost their jobs. Over the past 18 months, more than 1.3M full-time private sector jobs have been lost despite the overall positive job numbers reported. The Fed is well aware of all these misconceptions and under-the-surface data weaknesses. Despite that, it will still be looking at the main headlines of non-farm payrolls count, unemployment rate, and average hourly earnings when contemplating their future monetary policy decisions.



The reality is that most of our job growth has been driven by part-time and government positions. Private sector full-time employment continues to decline, approaching recessionary levels. Consumers are increasingly needing to take on multiple jobs to manage their lifestyles, as illustrated by the orange line below, which is at its highest level in decades.



source: Bloomberg

Such a large number of people holding multiple jobs is likely due to the hardships households have been facing in maintaining their living standards as a result of higher costs (inflation) and interest rates. In a strong economy, the number of full-time workers should be increasing, leading to a decrease in the number of part-time workers and those holding multiple jobs. Currently, the opposite trend is true, which is very concerning for the US economy.

Additionally, while US large-cap stock investors are becoming increasingly bullish, US small businesses are growing more pessimistic, with their optimism falling to a more than 11-year low and nearing recessionary levels. There are 33 million small businesses in the US, accounting for 44% of our total GDP and employing 62 million people, which represents a 46% share of the private sector. From 1995 to 2021, small businesses created 17.3 million net new jobs, constituting 63% of net jobs created. Now small businesses appear to be hunkering down for a worsening economic cycle.

source: Bloomberg

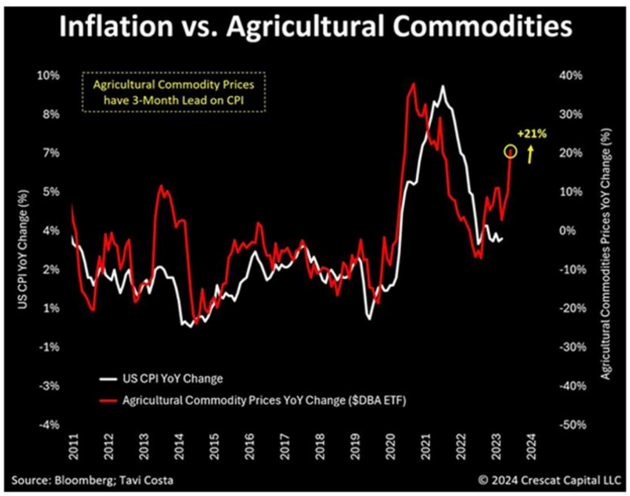
Growing Inflation Concerns and Supply Chain Disruptions

March inflation numbers came in higher than expected for the third straight month. Both headline and core prices rose 0.4%, bringing the annual measures to 3.48% and 3.8%, respectively. This results in continued pressures on consumers, as well as the Fed and the markets which have been pricing in a lower inflationary/interest rate scenario.

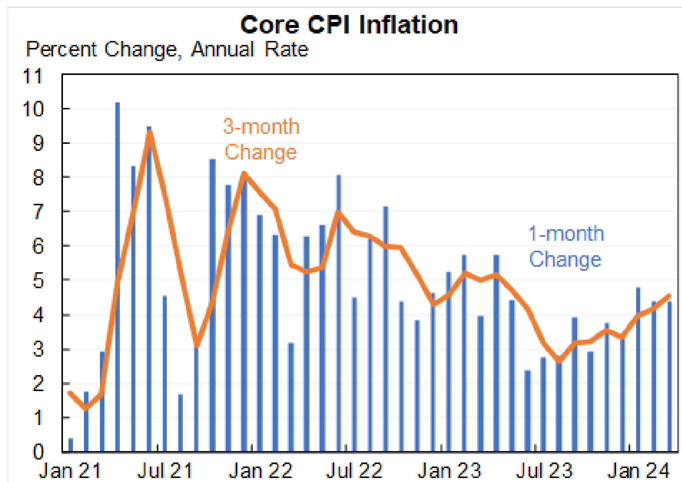
Accordingly, interest rates have recently surged higher, with the 2-year currently trading above 4.9% and the 10-year nearing 4.60%. The market is now pricing less than two Federal Reserve cuts this year as it takes another step in the "later and fewer" direction for the Fed. The US Inflation Rate has now been above 3% for 36 consecutive months, the longest period of high inflation since the late 1980s/early 1990s.

Large US budget deficits and world events aren't making it easy for the Fed to gain control over inflation. Food prices continue to reflect the strain of higher agricultural prices. A potential geopolitical energy shock and OPEC's recent reduction of output quotas are beginning to push up oil prices. Furthermore, supply chain bottlenecks in shipping through the Red Sea persist, and more recently, unfortunate events in Baltimore and Taiwan have resulted in new supply chain costs and delays in goods, including automobiles and computer chips.

Food prices won't necessarily cooperate. This chart from Tavi Costa shows how agricultural commodity prices are rising and CPI often follows.



Source: Tavi Costa



Source: Bureau of Labor Statistics via Macrobond; author's calculations.

The Fed is facing a growing dilemma:

1) Prematurely cutting rates and risk triggering stagflation, the worst possible scenario for the Fed.

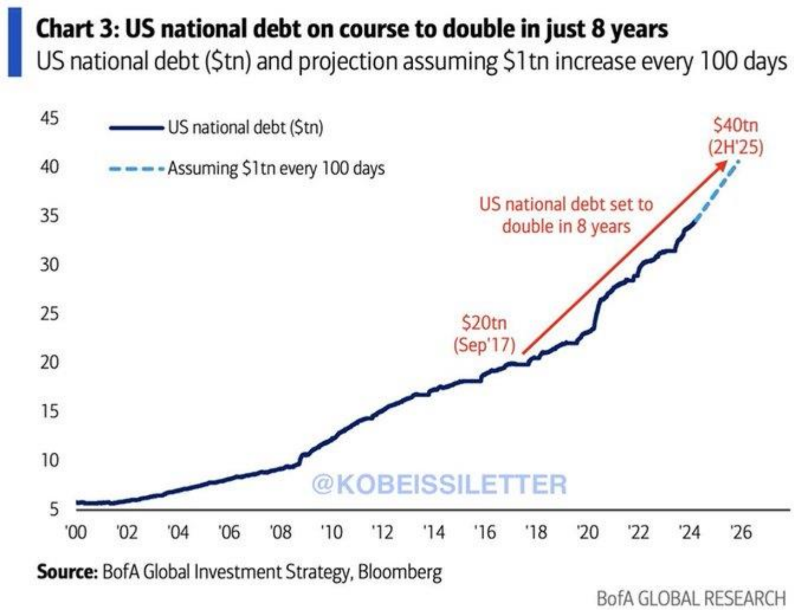
2) Waiting too long and risk a recession, which would cause the Fed to cut deeper and faster than they would like.

Plus, just to make life harder, this is an election year. The Fed will likely be accused of political mischief no matter what they do. Traditionally, the Fed will try not to make major monetary policy changes a few months before an election.

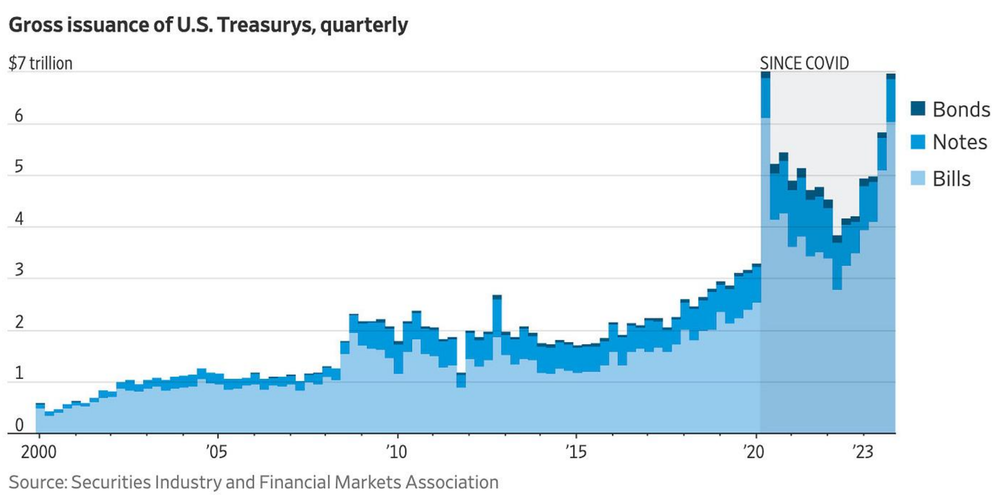
Growing U.S. National Debt

The US Federal debt is just over $34.6 trillion and is set to double in just 8 years, rising from $20 trillion in 2017 to $40 trillion in 2025. Currently, US Federal debt is rising by a whopping $1 trillion every 100 days. To put this in perspective, if US debt hits $40 trillion in 2025 that would be a $17 trillion increase from 2020. That would be a

~570% jump in US Federal debt since 2000, a 25-year period. This projection assumes that we are on track for a "soft landing" and would balloon higher and faster if a recession hits.



Equally problematic is the rate of debt issuance. The Department of Treasury has been recently issuing debt at emergency pandemic like levels. It's worth noting that the pandemic record was double the previous record, which had stood for 231 years. In raw numbers, the latest numbers for Q4 2023 show Treasury issued $7 trillion in new debt. For the entire year, it came to $23 trillion.



Given we're not in a World War, nor are we in a pandemic, why is so much debt being issued now? At their core, our deficits are buying growth for today. The bedrock of our economy is under scrutiny, and the repuercussions of our debt are causing an imbalance that could lead to larger issues in the future. This imbalance in debt comes at a time (in an election year) when financial tensions are growing worldwide.

Economists and CEOs are increasingly voicing concerns about national debt levels. While there seems to be agreement on the issue, there's a lack of consensus on how immediate the problem is. Politicians often portray it as a long-term challenge, yet inaction could leave us unprepared to address the issue effectively when it becomes more pressing.   Concerns exist that by the time politicians openly acknowledge the need for solutions, it may be too late for easier remedies. The lack of current focus by Congress reflects the very nature of the problem itself.

Below are global areas of concern we believe are significant and continue to monitor.

- **Geopolitical problems and new alliances**: The ongoing conflict between Russia and Ukraine shows no signs of resolution in the near future. Recent remarks from both Putin and Zelensky suggest escalating tensions. Additionally, the prospect of Ukraine joining NATO heightens the possibility of increased direct involvement by the US.

  In the Middle East, tensions with Israel have escalated with direct conflict between Iran developing. This conflict risks expanding into other countries and is causing the US to take a more active role in the conflict. The Middle East is changing as countries are restoring diplomatic ties and moving earnestly in cooperation with Russia and China. Recent disruptions in the Red Sea, and more recently expanding into the Persian Gulf have implications for supply chains and shipping. How this unfolds and impacts oil and gas prices will need to be monitored.

  China continues to be a political concern. China's President Xi has emerged as a leader in a Eurasian bloc, posing a dilemma for US strategists. For a generation, a central goal of US foreign policy was to separate China from Russia, but now Xi has taken advantage of deteriorating US-Russia relations. Additionally, China's close relations with Iran have allowed it to achieve a diplomatic breakthrough between Saudi Arabia and Iran, something the US has been unable to do. As a result of these shifts, a realignment in the Middle East is forming, and US influence in global affairs appears to be declining. It appears that China is seeking to advance on the world stage and dismantle the United States as the leading global superpower.

- **US and Chinese real estate concerns**: In the US, higher interest rates have put pressure on real estate prices and are beginning to cause a slowdown in construction projects. Additionally, there are growing concerns about commercial real estate (CRE) in the US, where over 50% of the $2.9 trillion in commercial mortgages will need to be renegotiated in the next 24 months. This renegotiation coincides with higher lending rates, which are likely to have increased by 3.50 to 4.50 percent. The sector is particularly vulnerable as regional banks accounted for 70% to 80% of all new loan originations in the past cycle. Remote work has also created "secular headwinds" for office properties, which are facing a 20-year high in vacancy rates. Some scenarios are forecasting a CRE price decline of up to 40%, surpassing the Great Financial Crisis.

  China's property sector, a pillar of the world's second-largest economy, has lurched from one crisis to another since 2021 after a regulatory crackdown on debt-fueled construction triggered a liquidity squeeze. The ongoing collapse of Chinese real estate companies such as Evergrande and Country Garden continues to be a major concern. Bankruptcy and liquidation petitions are beginning to work their way through these and many other companies. Government officials have affirmed they would be willing to allow companies to go out of business and not prop up insolvent firms. These petitions are likely to revive homebuyer and creditor concerns about the Chinese property sector's debt crisis at a time when Beijing is trying to boost confidence in the industry that accounts for a quarter of China's GDP. A liquidation of Evergrande and Country Garden would exacerbate the real estate crisis, put more strain on its onshore lenders, and could delay the prospect of a recovery of not only the property market but the overall Chinese economy.

- **BRIC's expansion, currency risk and de-dollarization**: The imposition of sanctions on Russia, particularly those related to their SWIFT banking status and central bank reserves, has led to changes in international banking practices using other currencies apart from the US dollar. China and Russia have ramped up economic cooperation and diplomatic contacts in recent years, with exchanges growing closer since Russia's invasion of Ukraine last year. The BRICS alliance continues making financial waves and non-dollar global trade continues to grow.

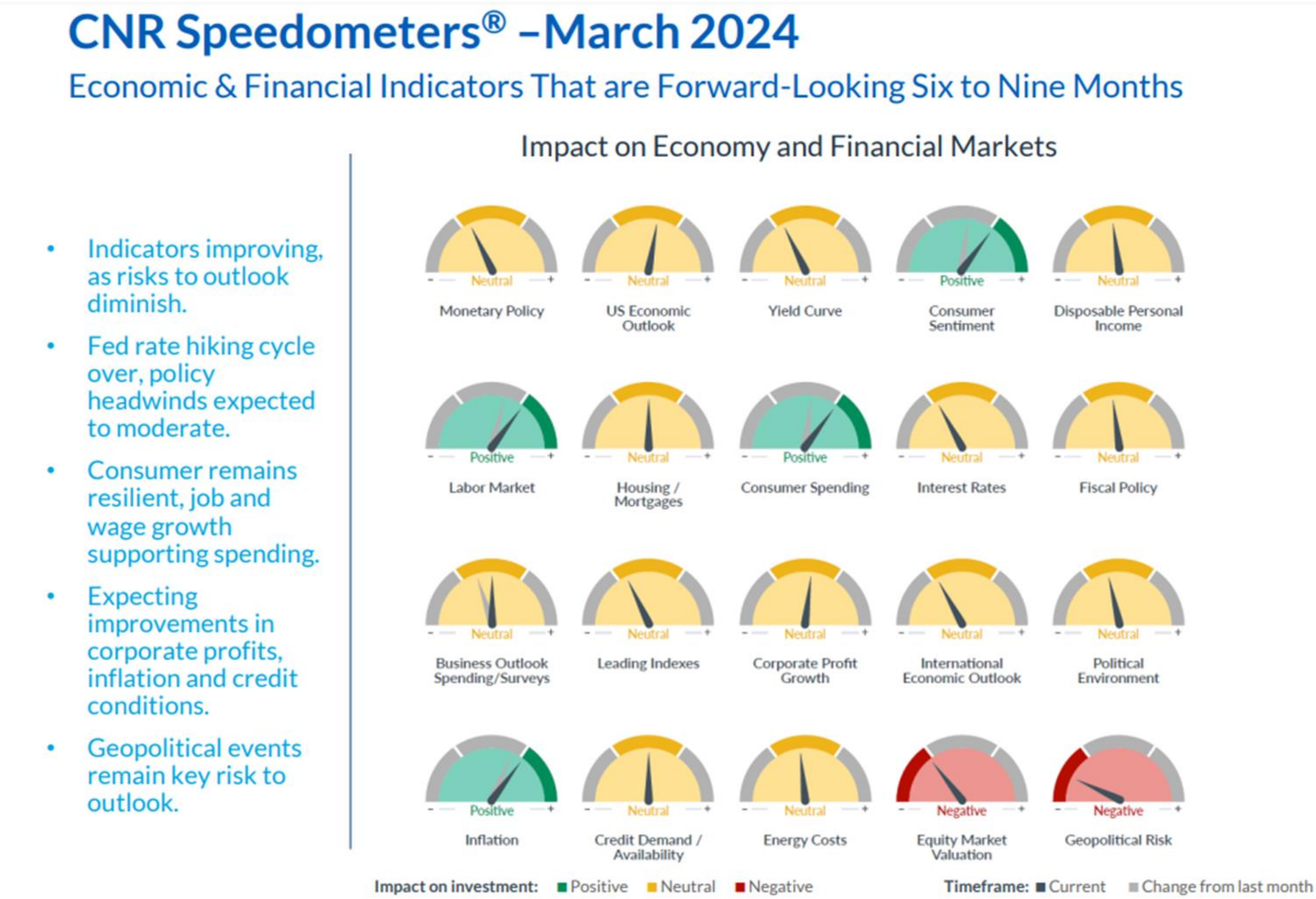
  This shift could have implications for the dollar's reserve currency status, potentially leading to a decrease in demand for dollar-backed assets. The BRICS nations - Brazil, Russia, India, China, and South Africa - are developing a strategy that reduces their dependence on the dollar for global trade, and discussions around the possibility of a new currency have already begun. BRICS countries account for approximately 40% of the global population and a quarter of the global GDP. As of January 1, 2024, Egypt, Iran, the United Arab Emirates, Saudi Arabia and Ethiopia became full members of the association. The BRICS alliance has seen 20 new countries apply to join the alliance in 2024 and an additional 20 countries have expressed interest.

Unfortunately, economic risks are not receding, and the range of possible outcomes remains wide given the geopolitical and financial pressures that exist today.   Circumstances are extremely complicated both here and abroad, and we will continue to focus on risk and more conservative strategies. Markets like this are challenging and will test your view of risk. As a result, we encourage clients who are uncomfortable with present risk levels to contact us for a call. Additionally, we will continue to send out notices with our thoughts as circumstances change. Thank you for the trust you have placed in us. We do not take that lightly. We are always available to discuss your situation by phone, zoom, email or in person.

Jim Evens
Investment Director

Below and on the next page is an economic summary from a firm we respect, City National Rochdale, which has a long history of summarizing economic information in this way. The colors provide an easy way to look at the trends. The report below shows a strong overall economy but potential problems around political and geopolitical events.

(Green = positive, Yellow = neutral, Pink or Red = negative)



CNR Speedometers® –February 2024

Economic & Financial Indicators That are Forward-Looking Six to Nine Months

- Indicators improving, as risks to outlook diminish.
- Fed rate hiking cycle over, policy headwinds expected to moderate.
- Consumer remains resilient, job and wage growth supporting spending.
- Expecting improvements in corporate profits, inflation and credit conditions.
- Geopolitical events remain key risk to outlook.

Impact on Economy and Financial Markets