Market Update:

January 4, 2024

As we begin 2024, we continue to see short-term yields as attractive. We have dialed back our near-term enthusiasm for longer term yields following the sharp rally during the past couple of months. The move in longer term yields since October in part reflects what are likely faulty expectations for imminent Fed rate cuts. U.S. equities are very expensive and unattractive in aggregate, with limited pockets of value. Gold should continue to act as a good hedge to governmental irresponsibility and geopolitical instability. The energy sector should be well positioned following underperformance last year, expanding domestic production, a depleted strategic reserve which should provide a price floor, and war tensions in the Middle East that have the potential to drive prices sharply higher.

Volatility is likely to be a feature of the markets in 2024. Sources of volatility will likely include the federal budget gap and debt imbalances that were a factor in driving long term interest rates to new highs last fall. Markets today seem dismissive of potential supply issues for energy and other shipped goods passing through the Middle East. The conflict seems likely to expand, and other geopolitical hot spots have the potential to ignite. Political uncertainty leading up to what will likely be the most contested and divisive election in the U.S. is also likely to be a source of market volatility as the year progresses. But most importantly the very sanguine view the markets have taken with regard to the economic, inflation, and interest rate outlook for the year is likely to be challenged. The markets are priced for a perfect landing across all of these dimensions; continued economic growth, continued meaningful disinflation, and aggressive rate reductions by the Fed with no consequences for the continued ballooning of unsustainable federal debt growth. The odds of such a perfect outcome are quite low in our view.

Futures markets are currently priced for 6 interest rate reductions in 2024, beginning in March. With the solid economic and employment growth that markets are anticipating, there is little economic rationale to expect such an aggressive reduction in interest rates and the Fed has been trying to walk back its earlier miscommunications (or perhaps manipulation)[1]. Of course, if the economy falters interest rate reductions would greatly exceed what is currently priced in the markets and perhaps anticipated rate reductions reflect a probability of soft landing and limited cuts and a probability of hard landing and many cuts. With equity markets priced at historically high valuations, a much larger than normal price adjustment is a distinct possibility in the event economic growth, inflation, rate policy, geopolitical events or domestic policymakers fail to follow the optimal paths that the markets seem to currently assume.

The following charts clipped from various research sources or that we have produced ourselves illustrate these key measures of the markets and their fundamental drivers. We are happy to discuss our views in greater detail, as well as the portfolio strategies and tactics that we have implemented as a result of these current conditions.

[1] (19) Tucker Carlson on X: "Is the Fed lowering rates to get Joe Biden reelected, or is the truth actually much scarier than that? Jeffrey Gundlach explains. https://t.co/2Sko3CFRp9" / X (twitter.com)

CHART 1: Sentiment Extreme at Year-End

Both technical and opinion-based measures of sentiment showed that bullishness had pushed to extreme levels by year-end. Both measures are consistent with at least a moderate reversal in the market run-up since late October.

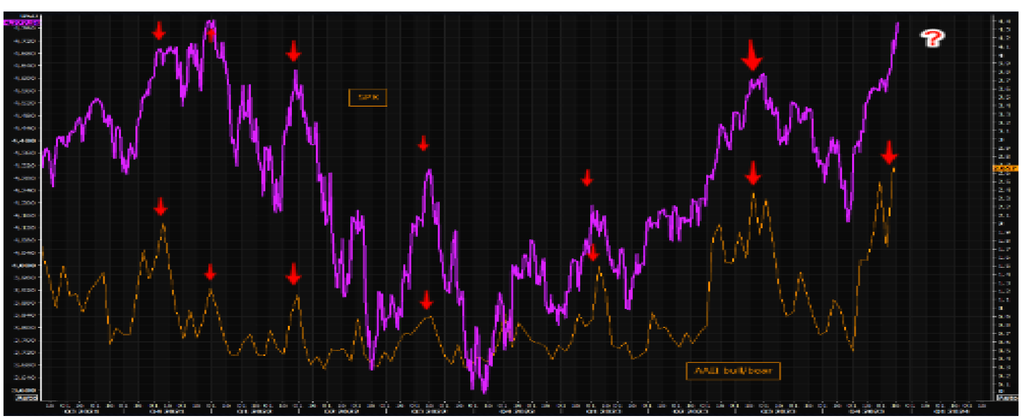
Red alert

Source: Tier1Alpha

Overbought/sold can last for longer periods than many think is possible...and this is now very overbought.

Ratio associated with reversals

BY THE MARKET EAR



Source: Refinitiv

The AAII bull vs bear ratio overalid vs the SPX. This one has been beyond extreme...

Chart 2: Diverge Between MegaCap Tech and the Market

In addition to the extremely bullish sentiment that drove the overall markets higher, megacap tech names drove the performance of the broader markets. As the chart below shows, the last time relative performance was this extreme was in 1999 and coincided with the last gasp of the tech bubble. The extreme valuations of the top 7 tech stocks that drove this move suggest a reversal in sentiment could produce a large repricing in these names, which in aggregate account for nearly 30 percent of the entire market's value.

Largest disparity since the peak of the tech bubble

BY THE MARKET EAR

FRIDAY, DEC 29, 2023 - 8:20

Source: @dailychartbook

We are currently experiencing the largest disparity between the S&P 500 and the median stock return since the peak of the tech bubble.

Capitalization Weighted Index Concentration	Weight	Price/Earnings	Price/Sales	Price/Book
AAPL	7.39%	30.6	7.2	43.5
MSFT	7.41%	35.8	11.2	11.8
GOOG	3.94%	26.1	5.4	5.7
AMZN	3.52%	75.7	2.2	7.4
NVDA	3.22%	119.7	26.9	32.4
META	1.97%	29.6	6.9	6.0
TSLA	1.60%	75.6	8.5	14.0
7 Tech Names	29.05%	56.2	9.7	17.3
S&P 500	**100.00%**	**21.6**	**2.47**	**3.89**

Chart 3: Historically Extreme Valuation

Valuation is not a market timing tool. Even though we are at a historical extreme in terms of both overall market valuation and market concentration it's possible that we could move to even greater extremes on a short-term basis. On a longer-term basis high valuations imply lower longer-term returns. Current high valuations also suggest the risk of a larger price correction should valuations normalize.

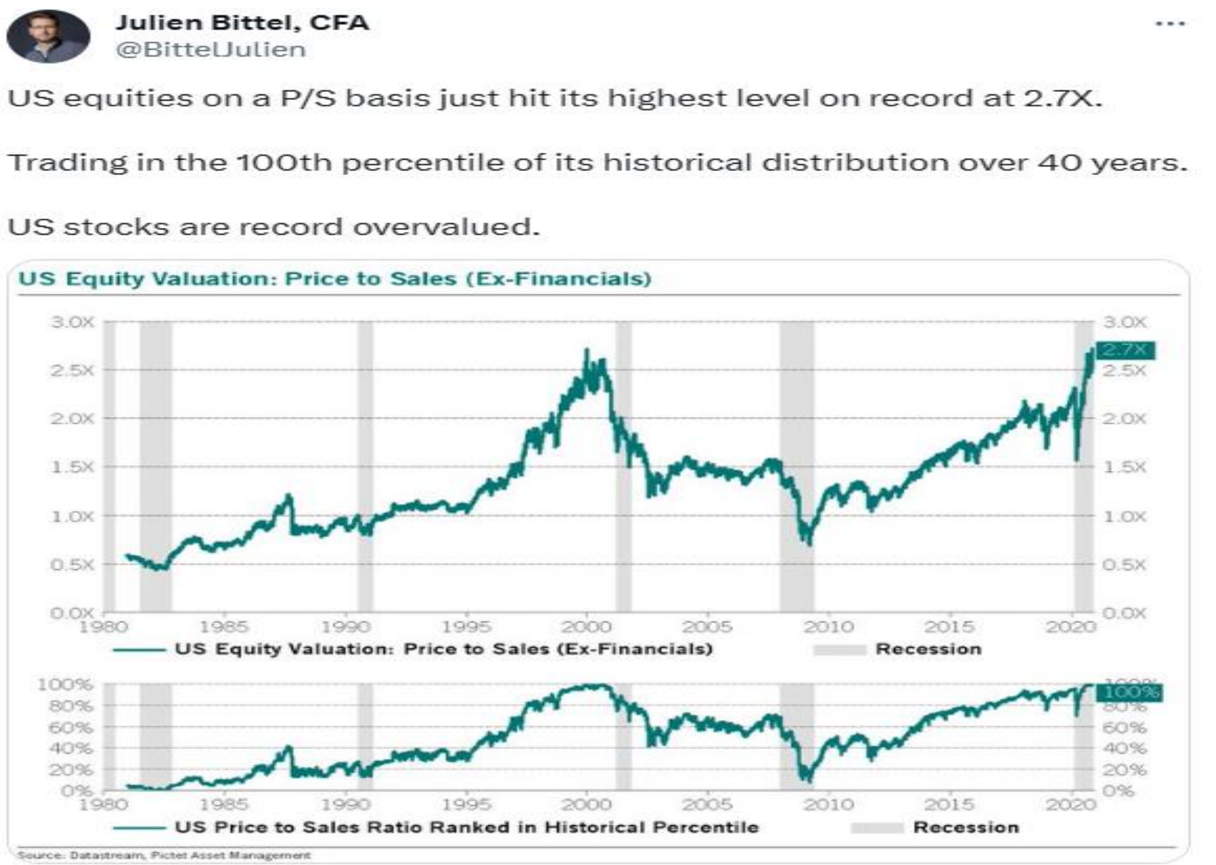
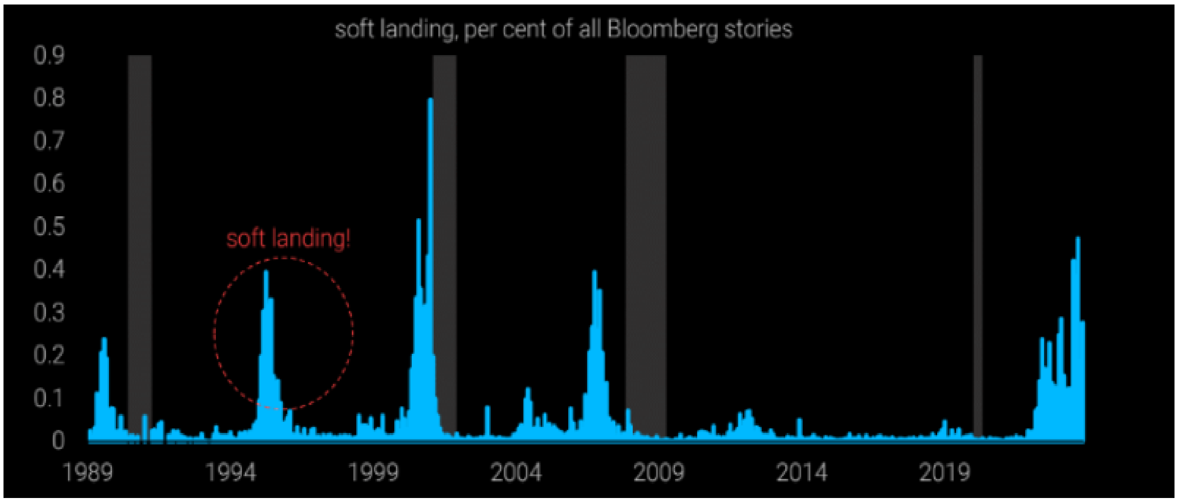


Chart 4: Soft Landings are Always Expected

The soft-landing narrative became the dominant market theme during the past year. The anticipated effects of the Fed's tightening cycle have been slow to materialize while at the same time inflation moderated significantly. As the chart below shows, soft landing expectations have been the norm ahead of each of the past recessions, though the only actual soft landing the economy experience following an interest rate cycle occurred in the mid-1990s. A unique feature of the 1990s experience was that the yield curve never inverted (long-term rates stayed higher than short-term rates) in contrast to the other experiences. Today, the yield curve is significantly inverted and has been for a protracted period of time. The economy has continued to show growth but the trends in employment and activity are slowing.

Soft landing



Source: TS Lombard

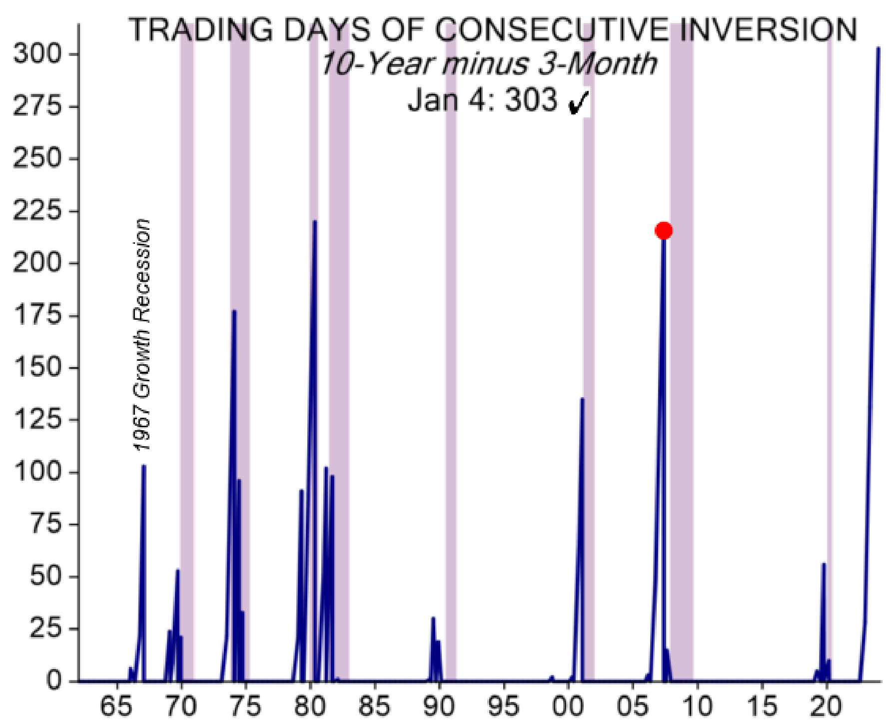
Why do economists always assume a soft landing?

LINIAM CAPITAL

Chart 5: Will the Yield Curve Fail This Time?

The yield curve has now been inverted for a record 300 days, considerably longer than was the case in the early 1980s and the 2007-2009 recession. We believe this largely reflects the surge in fiscal stimulus spending in 2023 which is quite different than had been the case late in prior economic expansions. We think it is unlikely a further jump in deficit spending above the 2023 level is likely this year, though budget talks are ongoing. Without a repeat of the fiscal stimulus provided last year, we think the monetary tightening that began in 2022 will gain traction and the historical track record of the yield curve in predicting recessions will remain intact.

Inversion	Recession	Days
Jan 1989	July 1990	380 days ✓
May 2000	Mar 2001	210 days
June 2006	Dec 2007	380 days ✓
Nov 2022	???	300 days ✓

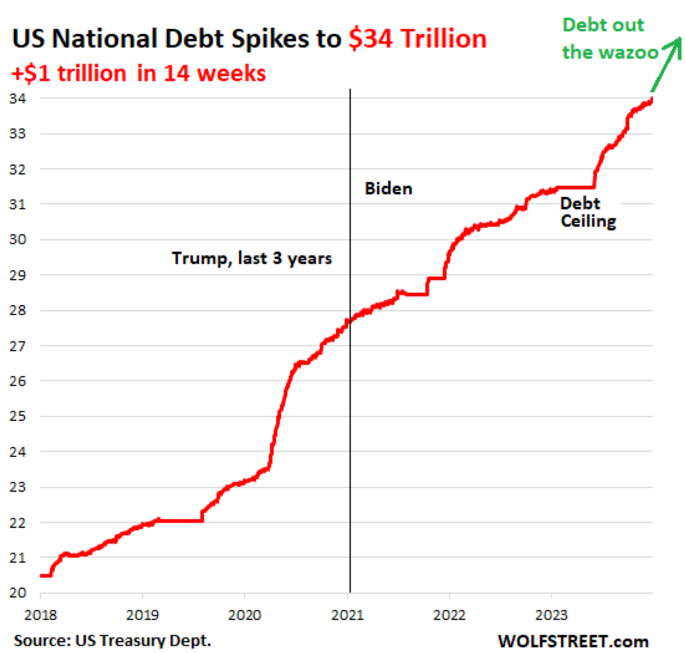


Source: ISI

Chart 6: Gold Price Behavior Not Consistent with Low Inflation/Soft Landing Market Narrative

Today the equity markets remain slightly below the peak level reached in late 2021 while gold prices have moved to new highs. At the same time, federal debt outstanding has continued to explode higher. Congress will need to take action to reign in the unsustainable level of indebtedness. Gold remains a good hedge to the risk that Congress fails to do so and the Fed is forced to relinquish its inflation battle to head-off a revolt in the bond market and a broader financial crisis.

Since December 2021, Gold has outperformed the S&P Index. When Gold outperforms stocks, ex-horrid geopolitics, it means inflation is a problem and the Fed is too loose.



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