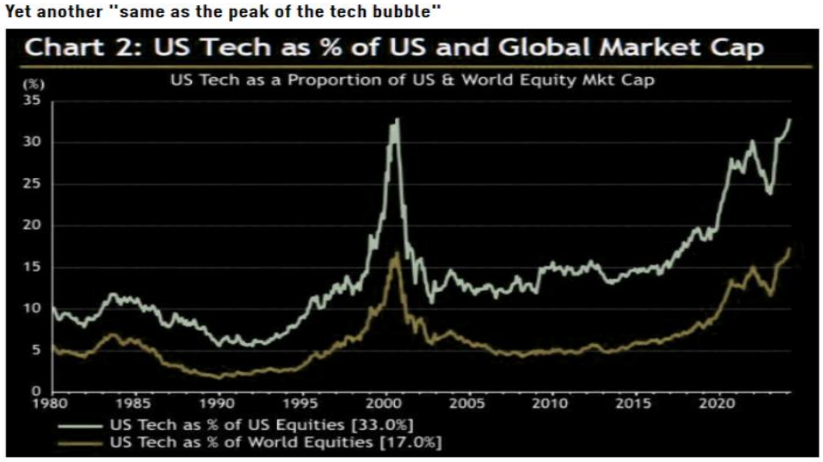
Market Update: March 14, 2024

The advance in large cap domestic equities over the past few months has been historic in the sense that moves of this magnitude and speed are typically seen only following recessionary bear markets, or in unsustainable bubble environments. We are not in recovery mode today and by many measures the market currently aligns with the extremes that were seen in the dotcom tech bubble in 1999-2000. The AI theme over the past year along with expectations of easier monetary policy have served as the catalysts for this last leg higher.

The market gains and the greatest expansion of valuations have occurred in the tech sector. By some measures the market currently compares to the extremes that were seen in the dotcom tech bubble in 1999-2000. Other measures are less extreme and some segments of the market, notably small cap stocks, have lagged and remain well below their 2021 highs.

Yet another "same as the peak of the tech bubble"



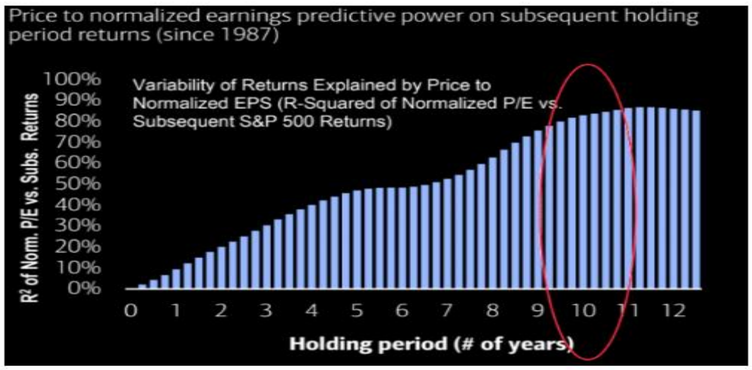
Source: ASR

Tech Stocks now account for as large of a % of total U.S. and Global Market Cap as they did during the Peak of the Dot Com Bubble.

We'd like to be able to say the market has reached a top, but strong recent gains and high valuations don't mean the market will not go higher from here or drop tomorrow. Current valuations do imply that equity returns in the coming years are likely to be subpar. Longer-term average forward returns have historically been highly correlated with beginning valuations.

Valuation matters in the long-term

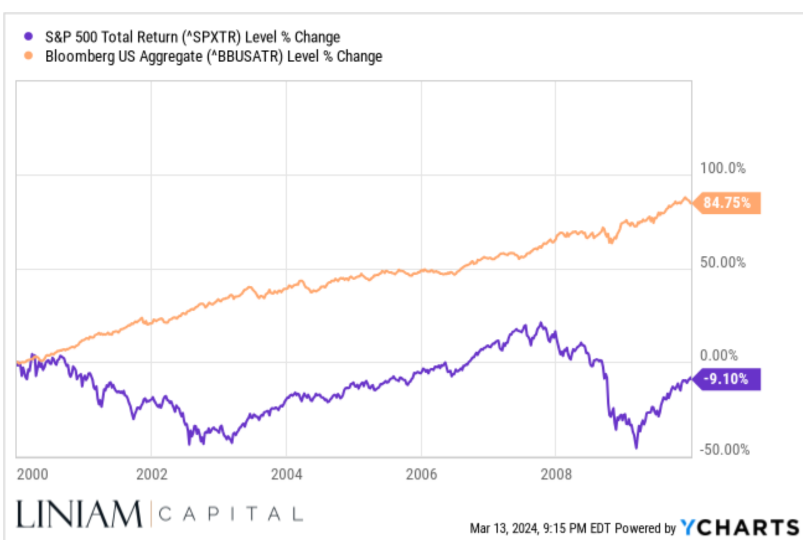
BY THE MARKET EAR



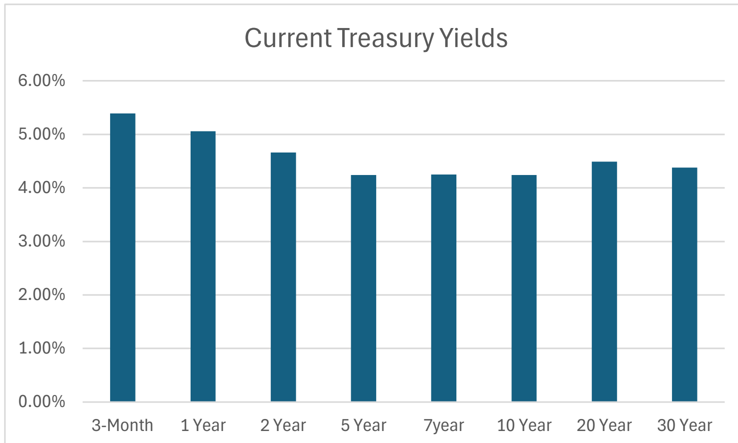
Source: BofA Quant

Valuation matters little in the near term, but is almost all that matters in the long-term.

The period following the dotcom era is the most recent example. From January 2000 until December 2009 the equity market's total return was -9% due to the high valuations at the beginning of the decade. In contrast, moderately high yields at the beginning of the period set the stage for solid fixed income returns over that timeframe. There were, of course, opportunities to tactically shift exposures over this period and produce meaningful gains from equity exposure.



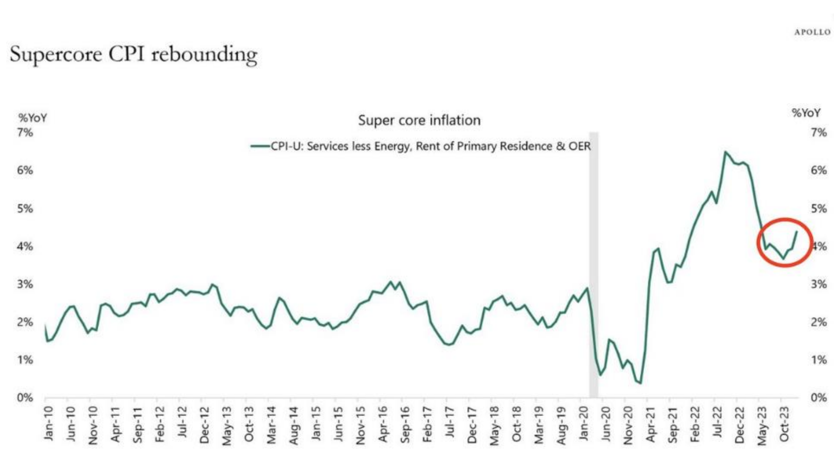
Today's high interest rate environment offers investors the best alternative to equities since the period preceding the financial crisis in 2007-2008. The stubbornness of inflation and federal deficits we are experiencing today makes it likely that bond yields will remain elevated, absent a crash in economic performance. Under a crash scenario bonds would likely experience significant price appreciation that would augment returns.



Source: Liniam Capital, Bloomberg

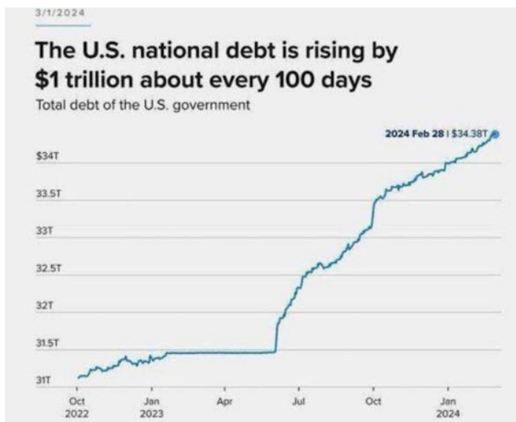
The equity market reaction to Tuesday's CPI report was perplexing as the report was anything but consistent with a return to low, stable inflation that would be consistent with appropriate reductions in interest rates that the market has been expecting.

The Fed focuses on core inflation – excluding food and energy – because overall inflation tends to converge with core inflation over time despite the volatility in food and energy prices. In Tuesday's CPI report the core CPI fell to 3.8 percent on a year over year basis, which is the lowest reading since the inflation explosion in 2021. Markets appear to have focused on this decline, but that is where the good news ends. The core rate was up by 0.4% in February (nearly 5 percent annualized) for the second consecutive month. The three-month moving average stood at 4.4% and other measures of underlying inflation, such as the so called supercore services measure that excludes housing, and trimmed mean inflation measures are telling the same story.



The bottom line is that the data from the past couple of months, along with the ongoing rise in energy prices strongly suggests that disinflation is stalling out. The PPI report released this morning was also consistent with that conclusion. If that is the case, it would call for higher interest rates, a reduction in government spending, or both. Spending reductions are highly unlikely to happen under this administration. At next week's Fed meeting we should expect the Fed to reduce the number of anticipated rate cuts for this year in its economic projections and Powell should walk back his comments to Congress last week that he would soon have confidence that the inflation environment will be consistent with rate cuts.

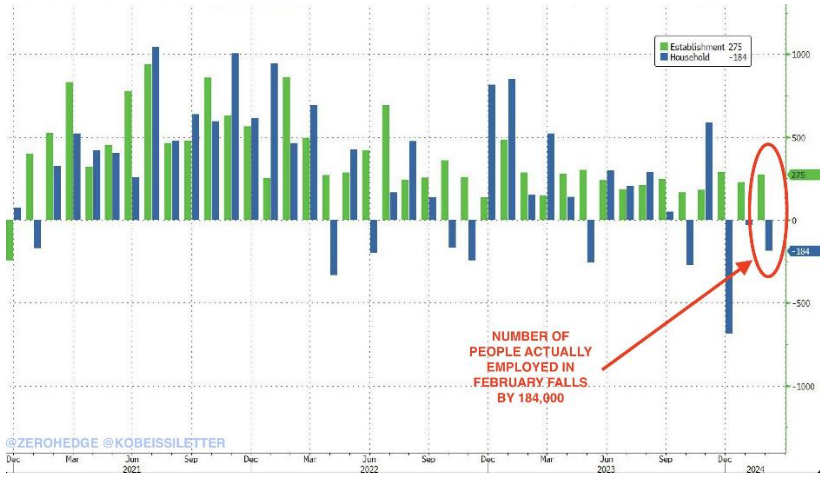
Gold and Bitcoin prices have surged as they sense the financial instability developing in response to not only the Fed's new permissive attitude toward inflation, but also in response to the ongoing explosion of Federal government spending and Federal debt. The Federal budget deficits have averaged 9 percent of GDP over the past 4 fiscal years. Deficits of this magnitude before the era of Bidenomics occurred only during the times of major wars or deep financial crises. Now they appear to be the new normal.



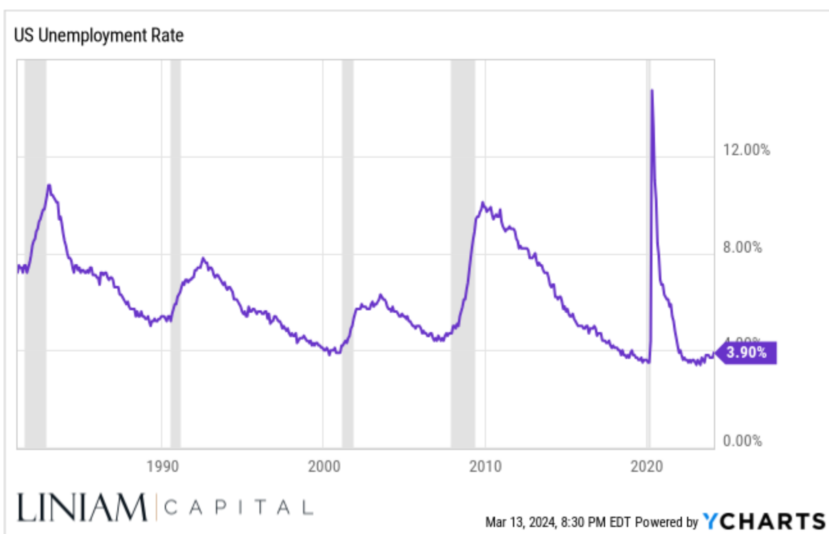
Because of these huge structural deficits federal debt outstanding continues to escalate with $1 trillion in new debt added roughly every 100 days. This spending has more than compensated for the reduction in activity in interest sensitive segments of the economy over the past couple of quarters and explains why overall activity has yet to materially respond to the higher interest rate environment.

There are indications that may be changing at the margin. First quarter GDP is currently estimated to be running at about a 2.5 percent annual rate. That is still a solid rate, but it is a deceleration from the previous quarters and other monthly data suggest an ongoing deceleration into the second quarter. The employment report was very mixed. A large gain of 275K in nonfarm payrolls was reported though large downward revisions to prior months put the net gain at just 108K. The number of people employed during the month fell by 184K, the fourth time in the last 5 months we have seen a decline in the number of job holders.

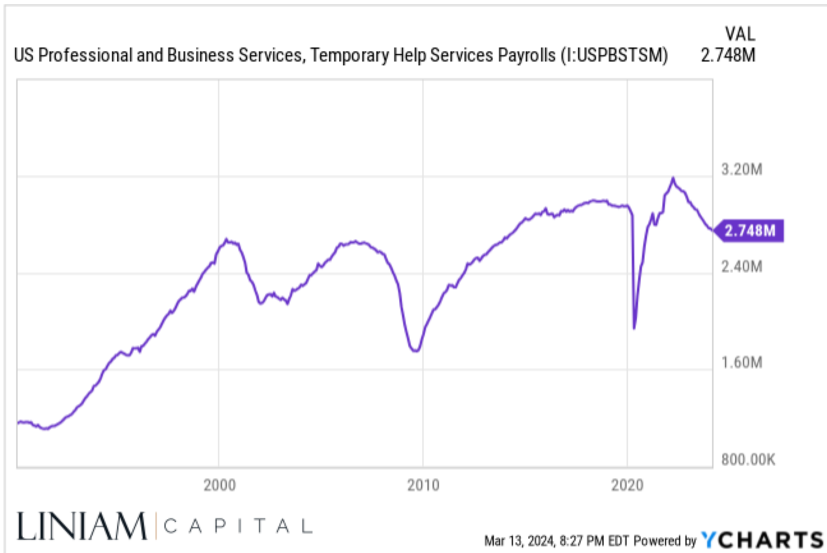
NONFARM PAYROLLS vs. HOUSEHOLD EMPLOYMENT



The unemployment rate rose to 3.9% in February which is its highest reading since January 2022. The upward trend in unemployment has been mild since reaching a low of 3.4 percent last April. Further increases in the coming months would challenge the assumption of an economic soft landing that most investors now assume.



Another indicator which suggests softening labor market conditions, in contrast to the strength in reported payrolls, is temporary employment. Temp jobs tend to lead overall employment as temp workers are the last hired and the first fired has been in steady decline. Temp employment has been trending downward since peaking in December 2021.



The bottom line is that based on data so far for the first quarter we are likely to see downward revisions to growth expectations, but inflation is to this point looking more persistent than the Fed or the markets expected. This is a stagflationary backdrop that from a bond yield perspective provides pressure in opposite directions. More persistent inflation produces upward pressure on yields while slowing growth provides for downward pressure on yields – a higher inflation premium but a lower real yield. This should result in yields remaining somewhat rangebound. We have barbelled our exposure to the front and back end of the yield curve and have increased our covered call overwriting to generate additional income in this environment while avoiding most spread sectors. We have begun to add a small allocation to non-dollar bonds.

While it has not impacted markets yet, this type of environment should put downward pressure on equity prices due to the effect of slowing growth on sales volumes and a higher discount rate applied to earnings as a result of higher inflation. But beyond the near term, valuations for equities today are oppressive from the standpoint of forward returns if history is any guide. We see value in some sectors such as energy, staples and other select companies but anticipate returns from the broad equity indices are likely to disappoint over time.

We expect that market volatility is likely to rise and move in both directions in the coming months, rather than essentially just upward has been the case since late October. Gold and related investments should benefit from the sorry state of federal finances. We are happy to discuss our views and their rationale in greater detail. Call or send us a message.

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