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Feeling Safe and (un)Sound

Highlights To Our Outlook

• We expect moderate (but slowing) economic growth with an uneven stubborn decline in inflation.
• Labor markets should slow and provide for interest rate cuts in the second half of the year.
• Our cautious but pro-risk stance in the first quarter portfolios was expressed through overweights to equities.
• We continue to overweight short term Treasuries due to expectations of a volatile interest rate environment. However, we have started to allocate into longer duration bonds with attractive yields, where appropriate.
• Equity markets present opportunities for alpha in specific sector/region selection, this is not an across the board buying opportunity given valuations.
• We favor U.S. cyclical sectors, Japan, developed Europe and specific emerging markets (excluding China, but including India).
• AI is the new buzz word (or letters). Yes, this industry/tech is "real" and will impact many jobs and industries. Specifically, the amount of economic productivity improvement (how much you can produce and at what cost) could be enormous. However, there will be a cost (jobs/personal data/security/economic class issues).
• 2024 includes a number of outsized short term risks, such as: elections, geo-political risks/wars, debt burdens, energy prices and a Federal Reserve policy mistake. Watching incoming economic data in the US as well as around the globe is critical to our investment themes and future investment decisions.

As we previously discussed, what started in March 2022 remains today with 2-year Treasuries yielding more than the 10-year Treasury (typically you pay more for loans the longer the duration). This yield curve oddity on the 2-year and 10-year US Treasury bonds has now been inverted for the longest period in US history. Long considered to be the most accurate predictor of recessions, the 625 days and counting period of inversion has not yet led to a contraction in the economy. The inversion has been blamed for the banking crisis that took down major banks like Silicon Valley Bank, Signature Bank, and First Republic Bank as those banks, along with others, found themselves on the wrong side of the carry trade when yields inverted. The question remains whether or not the economy, and markets, are free from danger or harm with the yield curve still inverted.

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There are signs that the labor market strength that has been in place post-Covid is showing some cracks. Much of the inflation of the last several years can be attributed to higher labor costs (as well as housing) so a slower market will certainly help the Fed remain committed to rate cuts. The problem is that consumer spending is closely tied to labor and new job creation and a fall in consumer spending might be all that is needed for the economy to reverse its growth trend. The last 3 US payroll reports have been revised lower by the BLS, a trend common to early stage economic contraction. Full-time employment has dropped sharply in 2024 as workers increasingly look to the GIG economy or work several part-time jobs. Lastly, the latest NFIB (National Federation of Independent Business) survey suggests small businesses have significantly scaled back hiring plans for 2024. If these labor trends continue, it will likely impact consumer spending and the economy's ability to maintain growth. We are starting to see other cracks as well, such as: Bank of America saw a 20% increase in 401k withdrawal hardships in 2023, Vanguard's hardship withdrawals were at a 19 year high and consumers added $150 billion to credit card balances. These impacts show over time with a typical lag of 6-9 months in the overall economy.

Even assuming a Fed-engineered soft landing for the economy, it does not mean investors are currently free from danger or being harmed. Equity valuations seem slightly extended based on prior periods. Virtually any metric you consider, price-to-earnings, price-to-sales, price-to-book value, we are at valuation levels that can only be justified by strong forward earnings growth that is difficult to forecast in a slowing but stable economy. So far, many "capital light" (limited cash needs, thus not interest rate sensitive) industries and firms have produced impressive earnings. These earnings are now baked into markets / firm share prices. Investors might also want to consider how market leadership might change once the Fed starts cutting rates in late 2024. Keep in mind, markets are forward looking, typically around 6 – 12 months. Our investing playbook considers these factors.

The prerequisites of successful investing, arguably include a long-term goal approach and a strong mental fortitude. That is not to say there are periods when one should not be cautious based on history and knowledge. We expect volatility to increase in 2024. So far it has been very low, given the multiple short term events we highlighted.

A diversified portfolio can benefit investors as volatility increases and valuations become more important in the future. Diversification can come in many forms: stocks, bonds, commodities, currencies, leverage, cash and real estate are good examples. Our goal is to match our portfolios to our clients' goals, risk levels, market opportunities and dynamics as well as current valuations and thoughts. These are never static given all the variables included in our analysis, examples are described above. The following page provides multiple index returns for the first quarter. Please reach out with any questions.

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Index Returns

Index	Q1 2024
Dow Jones Average (TR)	6.14%
S&P 500 (Price)	10.16%
S&P 500 (TR)	10.56%
S&P 400 (TR)	9.95%
Morningstar US Mid Cap Core (TR)	7.79%
Morningstar US Small Cap Core (TR)	7.13%
Morningstar Large Cap Value (TR)	8.89%
Morningstar Small Cap Value (TR)	4.64%
International Equity	
MSCI EAFE (International)	5.78%
MSCI Emerging Markets GR	2.44%
Fixed Income / Bonds	
Barclays Bond Aggregate (TR)	-.78%
BBGBARC Muni 10 Yr 8-12 TR US	-.54%
BBGBARC Muni Inter-short 1-10 (TR)	-.36%
Morningstar Target Risk Models	
Morningstar Conservative Target Risk (TR)	.76%
Morningstar Moderate Conservative Target Risk (TR)	2.52%
Morningstar Moderate Target Risk (TR)	3.91%
Morningstar Mod Aggressive Target Risk (TR)	5.41%
Morningstar Aggressive Target Risk (TR)	6.56%

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