PCM
Peak Capital Management

# Weighing Risk, Seeking Opportunity

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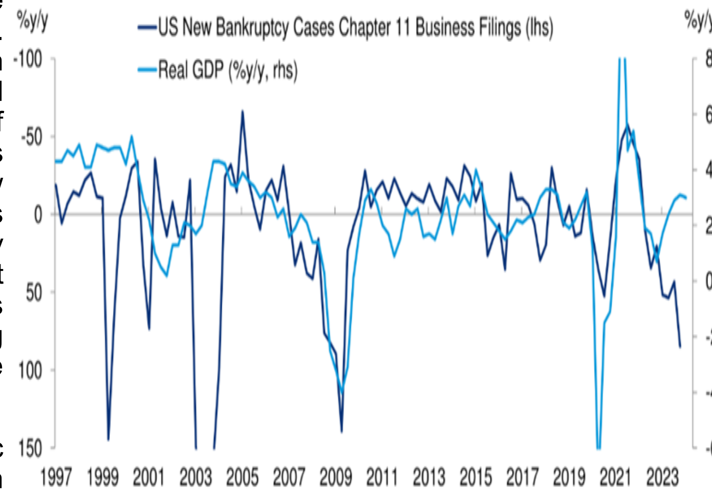
**Brian Lockhart**

As investors enter the seasonally weak period for equities (as the adage goes, "Sell in May, Go Away"), there are more questions raised by the macroeconomic environment than there are answers. At the top of the list, when will the Fed be able to start cutting rates. Recent market movements have been very tied to the expected timing of the Fed rate cuts as markets rally on news that suggests yields may fall in time to save stretched equity valuations and fall when inflation data suggests the Fed may sit on their hands longer than the market is expecting.

On the domestic front, there is as much good news as bad news. Consumer spending remains resilient, and earnings are generally beating estimates at the same pace they have for the past decade with three out of four S&P 500 companies beating their consensus estimate at the mid-point of earnings season. Forward guidance has been somewhat weaker than expected with companies citing a litany of concerns from employment costs to lack of access to credit to grow their business. Small businesses are being disproportionately impacted by tightening credit standards and higher rates causing them to slow their hiring expectations compared to late 2023.




There are signs of domestic growth concerns and confirmation of the two-tiered nature of the US economy with recent Chapter 11 bankruptcy filings. As the chart exhibits, the historic correlation between real GDP growth and bankruptcy filings are typically positive correlated. These data points have diverged in a surprising manner since the end of 2022 with real GDP climbing and filings increasing, suggesting not everyone is experiencing a rosy economic outlook. We also saw the first regional bank failure of the new year when the feds seized Republic First Bancorp of Philadelphia over the weekend. Credit card delinquencies, car loan defaults and home mortgage delinquencies are all at 10-year highs according to data Deutsche Bank data.

More concerning for investors, in my opinion, is what is happening with the global economy and the risk to financial markets from the rapidly deteriorating situation in China. Over the past couple of decades, China's debt-fueled growth saw their share of global GDP rise to 19% in 2023, compared to the US's contribution of 15% of global growth. What the world is now learning is that much of that debt was utilized on failed development causing significant strain on the Chinese economy. Actual Chinese growth is suspected to be far below official figures and the housing and commercial real estate markets are experiencing rapid deflation. Chinese equities (Hang Seng index) are down 41% since early 2021 with further losses expected by most analysts. Foreign investment into China in 2023 was at the lowest level in three decades as many multi-national companies reduced their exposure to China. Economic protests are increasing in the country as many homeowners, who were encouraged to purchase over-priced real estate, find themselves upside down on loans with little ability to repay. Further deterioration in China, coupled with growth estimates in the Euro zone of just 0.5%, suggests a global recession is a distinct possibility elevating market risk.

It appears to me, that it is highly likely investors will see a significant market rotation if we do not enter a bear market. The Communications Services, Information Technology and Consumer Discretionary sectors have been responsible for virtually all market gains over the last two years and have very stretched valuations. Healthcare, Energy, and Materials sectors have lagged far behind the leaders and are likely to see renewed attention as capital flows to more attractive valuations in light of rising global uncertainty.

Recent gains make it challenging for many investors to reposition portfolios given the tax implications of selling unrealized gains. Hedging strategies such as buying puts or taking "short" positions on broad markets can facilitate remaining invested while mitigating the magnitude of down-side market risk. Consideration should also be given to tax loss harvesting, selling holdings with unrealized losses, as a way to mitigate the tax impact of reducing market exposure by selling appreciated positions.

**Foreign investment into China in 2023 was at the lowest level in three decades as many multi-national companies reduced their exposure to China.**

The next couple of months will give more guidance as to whether the Fed will be considered friend or foe for investors and whether China is able to stave off a recession in 2024. Until those questions can be clearly answered, we think market risk is likely to trump market opportunity for the foreseeable future.

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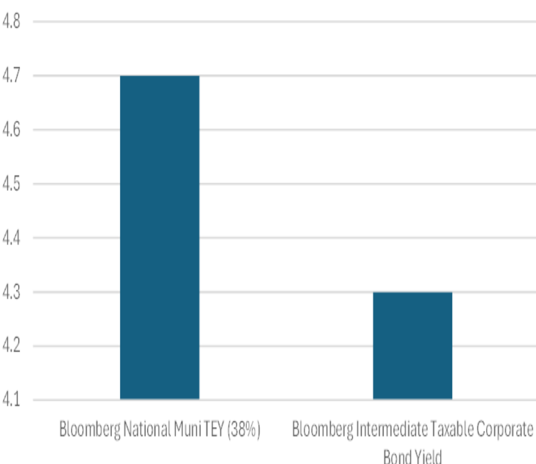
## All About Earnings

Benjamin Graham famously spoke about market earnings saying, “In the short run, markets are a voting machine, in the long run, they are a weighting machine.” Corporate earnings are the most direct component of valuations but not always the best gauge of future earnings. Companies are often able to “manage” earnings by deferring certain expenses or bring forward future revenue through contractual arrangements. While these tactics help in the short-term to meet expectations, it often puts additional pressure on companies to meet future expectations. Tracking revenues can be a helpful data point to determine if a company’s earnings are increasing because they are growing market share or simply a result of cost cutting in the short-term. It can also suggest a change in market leadership or future guidance.

- Healthcare and Energy sectors were among the worst performing sectors in 2023 with both generating negative returns as a group but are among the highest in 2024 in terms of beating revenue estimates.
- At the mid-point of corporate reports, 60% of S&P 500 companies have reported higher earnings which is below the 5-year and 10-year average of 69% beating on revenues according to FactSet.
- The year-over-year revenue growth is forecasted to be 4.0% which would comprise the 14th consecutive quarter of growth. Eight sectors show year-over-year growth with three sectors showing declines.

## Is It Time for Munis?




Now that interest rates are no longer zero, municipal bonds could be an attractive source of income for taxable investors. Consider that for an intermediate-term municipal bond portfolio (i.e., a portfolio with a duration of roughly 3-5 years), investors can achieve a yield of roughly 3% based on the Bloomberg Intermediate Municipal Bond Index. Assuming an overall tax rate of 38%, the tax-equivalent-yield for the average intermediate-term bond portfolio is roughly 4.8%. By comparison, the current yield on a fully taxable, investment-grade bond portfolio of intermediate duration is roughly 4.3%.

- National municipal bond strategies provide a way for investors to potentially achieve an attractive tax-equivalent yield. In general, municipalities are well funded with tax revenue. General obligation bonds broadly carry an A rating or above. Should we enter a recession, with a subsequent decline in tax revenue, most municipalities should be well financed to weather the storm.
- Likewise, for investors willing to assume a higher degree of credit risk and slightly longer duration profile compared to investment-grade portfolios, high-yield municipal bonds can offer after-tax equivalent yields as high as 7.0%, compared to a current yield of 6.5% for fully taxable junk bond portfolios of similar duration.

## Significant Milestone

Over the weekend, Tesla (TSLA) CEO Elon Musk made a surprise visit to China where the electric vehicle manufacturer passed a significant milestone to roll out its advanced driver-assistance technology. Previously imposed restrictions on the vehicles were removed as a result of passing the country’s data security requirements. As news on the announcement broke, the stock soared more than 10% in pre-market trading and finished Monday up by more than 15%. China, whose market is the largest for electric vehicles, has been top of mind for Tesla for years. However, until now, they have been unable to fully integrate their Full Self-Driving or FSD technology due to restricted features. The breakthrough for Tesla toward bringing its FSD technology to China marks a key win for the company at a time of fierce competition in the Chinese market.

- According to a report by the International Energy Agency, more than half of the electric cars on roads worldwide are found in China. The country was also responsible for 35% of global EV exports in 2022.
- In just the past two years, the number of EVs sold annually in the country grew from 1.3 million to a whopping 6.8 million, making 2022 the eighth consecutive year in which China was the world’s largest market for EVs. For comparison, the US only sold about 800,000 EVs in 2022 according to the MIT Technology Review.

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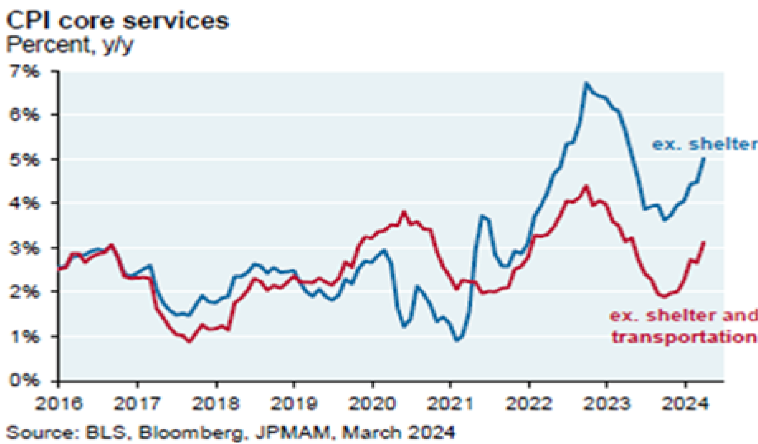
**Quinn VandeKoppel**

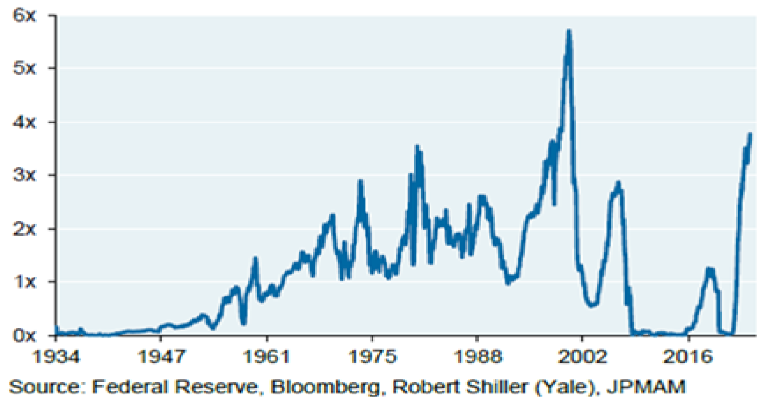
### Macro View – The Wrong Direction

Since August of last year, many of the economic indicators frequently monitored by economists and investors have shown improvement, highlighting the resilience of the U.S. economy. However, despite these positive trends, inflation, particularly core services, has taken a notable turn in recent months. As illustrated in the chart below, both ex. Shelter and ex. Shelter and Transportation have diverged from the trajectory anticipated by the Federal Reserve. According to the CME Group, recent economic data has led markets to revise their expectations, with only one to two interest rate cuts now priced in for this year, compared to the previously projected six. If inflation persists, the likelihood of any rate cuts this year could diminish to zero, potentially impacting a broader spectrum of the economy beyond just the stock market.




### Fixed Income – "Cash" is Key

Currently, the rate on a three-month U.S. Treasury Bond is 5.397%, which is almost four times the dividend yield for the S&P 500. As you can see on the chart below, the ratio of cash yields to S&P 500 dividend yields is at more than a 20-year high. With doubts growing around the Federal Reserve cutting interest rates this year, the implementation of cash-like alternatives within investors' portfolios remains extremely attractive. Second quarter earnings season is now upon us, with mixed reports by some of the world's largest companies. As uncertainty mounts as to how the rest of the year is going to shake out with persistent inflation, and presidential elections, earning +5% on "risk-free" assets might be a great option until the dust settles.




### Taking Stock –Wealth Gap

A study published in the American Journal of Sociology reveals that the wealth gap between affluent millennials and the rest of their age cohort is the largest observed across generations. This widening chasm between the "haves" and "have-nots" is fueling a new level of resentment and animosity. According to the study, the average millennial possesses 30% less wealth at the age of 35 than baby boomers did at the same age. However, the top 10% of millennials possess 20% more wealth than the top baby boomers did at the same age. Despite facing significant financial challenges, millennials—typically defined as individuals between the ages of 28 and 43 today—are poised to benefit substantially from what many refer to as "the great wealth transfer." This phenomenon entails a considerable amount of wealth expected to be transferred from the baby boomer generation over the next two decades.

### Technical – Caution for Now

At the time of writing, the S&P 500 Index was trading at 5116, approximately 2.8% below its previous all-time high. As depicted in the chart below, the large-cap index recently fell below both its 20-day and 50-day simple moving averages. Moreover, the 20-day SMA has just crossed below the 50-day SMA. If we use history as a guide to what might happen in the future, we can look back to August of last year where the two moving averages crossed and then subsequently saw the S&P 500 index fall by 8%. Presently, with uncertainties surrounding economic data, inflationary pressures, and geopolitical conflicts, predicting market movements becomes challenging. However, with Q1 earnings season upon us, investors should remain cautious as many major companies are set to report over the coming days, which could dramatically impact the overall market.

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# Asset Class Returns

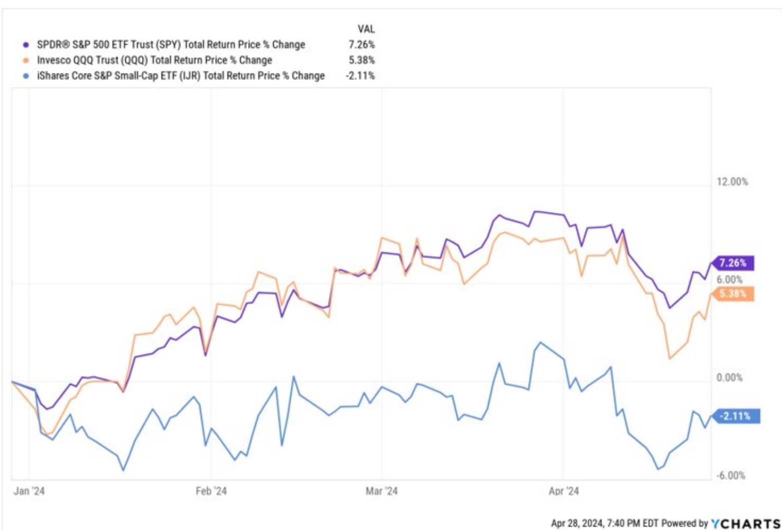
Clint Pekrul, CFA

Markets surged higher to start the year on the premise that the Federal Reserve, having orchestrated a seemingly unattainable task of raising interest rates from zero to roughly 5% with no consequential economic disruption, achieved a "soft landing". Manufactured zero interest rates for the past 15 years are now in the rear-view mirror. Rates have normalized to pre-GFC levels, we're at full employment, and earnings are reasonably supportive of current valuations.

However, there's some trepidation among market participants that perhaps above-target inflation, once thought to be transitory and manageable by Fed monetary policy, might be more persistent than originally thought. Consequently, the rate cuts we were expecting this year might be delayed. Higher rates imply lower valuations for assets like stocks and bonds.

The market discounted the probability of "higher for longer" in April as most equity indexes pulled back from their all-time highs achieved in March. Below is a summary of year-to-date market returns for the major asset classes.

*U.S. Domestic Equity*



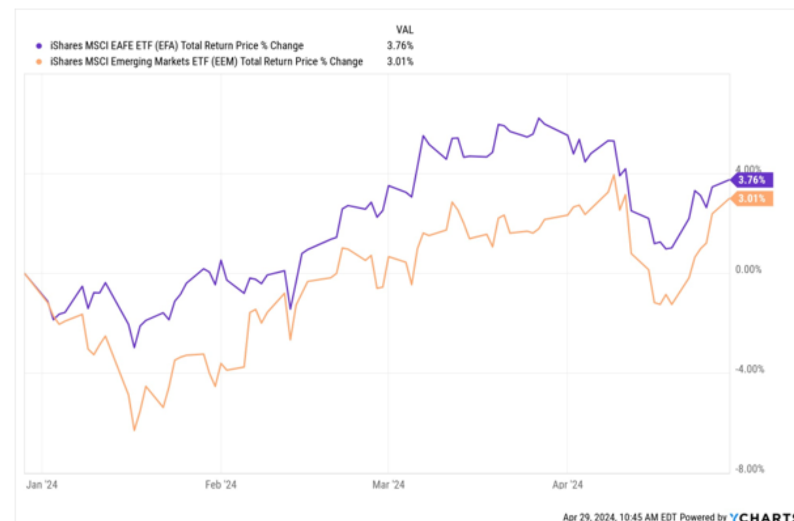

For the year, the S&P 500 Total Return Index has advanced roughly 7.3% for the year. As the chart above illustrates, the bellwether large-cap index stormed out of the gate to begin the year, buoyed by the expectation of easing inflation and lower interest rates. In April, however, the S&P 500 retreated as CPI levels suggested that, despite aggressive Fed rate hikes, inflation remained stubbornly above the central bank's target.

The tech-heavy NASDAQ is higher for the year by roughly 5.4%, or slightly below the broader S&P 500. Valuations for tech stocks overall were lofty by historical standards heading into the year. The prospect of higher rates reset prices in April; however, earnings overall for tech suggest that the sector could move higher after the recent drawdown.

Not surprisingly, small-cap stocks, which are sensitive to changes in interest rates, have underperformed the broader market year-to-date. In a continuation of relatively weak returns, small-cap stocks have lagged their larger-cap counterparts by roughly -30% over the past three years.

Still, from a valuation standpoint, smaller cap stocks trade at a price-to-earnings multiple of roughly 14x compared to a corresponding multiple of approximately 22x for large-cap stocks.

*Developed and Emerging Market Equity*




Except for small-cap stocks, developed and emerging markets generally underperformed their domestic counterparts. The MSCI EAFE Total Return Index advanced roughly 3.8% for the year, while the MSCI Emerging Markets Index gained roughly 3.0% over the same period.

On a relative basis, Japan has outpaced Europe as the strongest developed market region for the year. The MSCI Japan Total Return Index is higher by 4.7% year-to-date while the MSCI Eurozone Total Return Index is higher by approximately 2.6% for the year.

*Observations*

It seems like the markets are climbing a wall of worry. While reported earnings are more-or-less in line with expectations, particularly for the tech sector, inflation remains stubbornly high relative to the Fed's long-term CPI target of 2%. The sugar high from lower interest rates, which was anticipated later this year, might not materialize until 2025.

The first quarter rally stalled in April. The narrative for stocks – strong earnings combined with a possibly more hawkish Fed – isn't the worst scenario. Perhaps we moved too far too fast to start the year, but there is ample reason to believe stocks could edge higher from current valuations.

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## Q: Are Risk Parity funds dead?

Risk Parity is an investment strategy, popularized by Ray Dalio's Bridgewater Associates, that utilizes algorithms to determine the risk contribution of an asset class within a portfolio. The idea was to create a "smarter" portfolio for a typical 60/40 investor (60% in stocks, 40% in bonds) by allocating based on risk of each asset class. These portfolios were often referred to as "All Weather" portfolios with the belief that it would smooth both returns and volatility in portfolios. When equities show high levels of volatility, the fund would reduce exposure to that asset class.

Lately, the weather has not been very good for all weather portfolios. In 2023, this balanced beta strategy was down 22%, a worse result than the Global Financial Crisis in 2008 when the strategy lost 20%. Driving the poor performance was the extended period where stocks and bonds have been positively correlated. One of the basic tenets of the strategy is to maintain diversification, but if you are limited to traditional assets classes, like stocks and bonds, that has been difficult to achieve. Results were not better for investors sticking with the traditional 60/40 portfolio as the WSJ reported that 2023 was the worst year in generations for passive 60/40 portfolios. I think it is too early to throw in the towel on the strategy as it is likely for correlations to revert back to the mean and risk parity to provide reasonable future returns.

Risk parity funds have gained wide acceptance across both the institutional and retail marketplace over the past twenty years. The concept behind a risk parity strategy is to combine complementary asset classes, such as stocks, bonds, and commodities, in such a way that balances the risk that each asset contributes to the entire portfolio. The rationale that changes in the market forces that drive returns are difficult to predict. Rather than statically allocating a portfolio, a risk parity strategy adjusts the weightings in response to prevailing volatility and return correlations to balance risk.

Risk parity strategies benefited from declining interest rates, whereby bonds were almost assured to hedge equity volatility. When stocks came under pressure, investors moved to bond and, subsequently, their portfolios were sufficiently hedged. The problem, however, was when interest rates hit zero in 2020 and then inflation hit in 2022. Bonds, which were supposed to provide a ballast to equity risk, became the primary source of volatility. Risk parity funds suffered as a result as correlations went to one. The outlook for parity funds is much improved today because there is upside return potential for fixed income. Rates have room to fall, which could coincide with an equity market selloff. In other words, return correlations between stocks and bonds could turn negative, which supports a risk parity strategy.

## Q: Are growing protests a threat to the economy or markets?

While protests and social unrest dominate headlines when they are occurring, the reality is they have very little impact on the economy or the financial markets. What started as a few dozen Columbia students protesting against Israeli actions in their conflict with Hamas following the October 7, 2023 massacre, has now spread to dozens of campuses across the country. The response by school Administrations is often comical as they publicly discuss the "negotiations" that are ongoing with the protesters and their demands. For context, there are roughly 5,000 Jewish students who clearly do not feel the protests represent their viewpoint. The IMF created the Daily Index of Social Unrest to measure how economies and markets are impacted when social unrest occurs. Their data suggests when episodes of daily unrest occur, there is a corresponding 1.4% drop in stock market indices over a 2-week period. Reviewing the non-scientific data, I think the drop could as easily be explained by earnings reports, Fed announcements, or other factors that have historically driven market performance.

In the summer of 2020 when the George Floyd protests were raging, the stock market actually moved higher. This was in the midst of the uncertainty (and market pullback) associated with COVID but those protests involved the destruction of millions of dollars of property and destroying entire businesses along with mass looting of stores. It would be difficult to assume a tiny percentage of protesting college students would have a greater impact on the markets than what occurred in 2020.

I don't think so. While the protests are very real, and represent angst regarding the geopolitical climate, they don't likely present a threat to economic stability or underlying market fundamentals. The protests against what is unfolding in areas such as the Ukraine and Gaza speak more to U.S. foreign policy and the handling of political unrest in areas that have been fraught with turmoil for decades. The angst largely among college students on campuses across the country draws parallels of the 1960s during the Vietnam war. But students evoking their first amendment right to protest doesn't have much impact on the economy of the financial markets.

In the long run, however, the youth that are protesting today will eventually occupy positions of political influence. As elected officials ten years from now, they will ultimately dictate U.S. foreign policy, economic trade, tax policy and America's status in the world. While I think the protesters we observe today are exacerbated by the media (as always), and represent a somewhat extreme faction, they are, by and large, empathic and represent change to the old guard. It's a repeat of American history (remember the 1960s?). Markets will eventually respond as they always have. The protests are simply part of our culture and identity as a nation.

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