PCM
PEAK CAPITAL MANAGEMENT

Ticking Time Bomb

PCM Report March 2024 Volume 15, Issue 3

Brian Lockhart

We are approaching the conclusion of the 2nd year of the Fed's campaign to combat inflation by raising short-term interest rates from near 0% to today's rate of 5.25% to 5.50%. While the Fed has, by some measures, succeeded in bringing the rate of inflation under control, some would say they have also created hardship, and even failure, in other aspects of the economy. One of those sectors, commercial real estate (CRE), is still in the process of finding a bottom in what has become the new normal of high rates and tight lending standards.

As the market begins to deal with "higher for longer" Fed policy, CRE is being particularly negatively impacted that is coming to a head. Owners of CRE are being crushed under the additional costs associated with higher rates but also the lack of availably lenders in the space. There is also historically high vacancies rate that began with the COVID pandemic. Many employers have initiated requirements to return to offices, but others are finding employees who want to continue to work remotely and push back on returning to an office.

Source: IMF, TS Lombard

There was a recent 8%-9% rally in publicly-traded CRE REIT's following a CBRE report that suggested the worst is over for office leasing companies. I think that is overly optimistic. Some aspects of CRE, multi-family housing and industrial, have remained attractive to investors with strong fundamentals and income durability allowing sufficient transactions for reliable pricing of property. Office leasing, on the other hand, has become so dislocated that virtually the only transactions being done are extremely distressed sales. The result is very little price discovery or comps to make lenders comfortable.

I am skeptical we have seen a bottom in CRE for three reasons:

1) Economic slowdown overseas, particularly in China, is resulting in many international investors in US CRE selling their holdings to repair domestic balance sheets. This is likely to dramatically increase distressed sales and put additional downward pricing on transactions.

2) More than $1 trillion in commercial mortgages mature by the end of 2025. Many of the properties with these mortgages are currently underwater with debt that exceeds current fair market value. The inability to refinance these mortgages will also lead to an increase in distressed sales at discounted pricing.

3) Private non-traded REIT's have not been marked to market in many cases. Publicly traded REIT's are on average 25% below late 2021 levels while many non-traded REIT's are being carried at previous appraisals. The pension lobbying group Equable, noted that large pensions have increased alternative assets from 8% in 2008 to 34% in 2024 with non-traded REIT's the largest allocation.

If CRE does experience another significant leg down, the direct, and indirect, impact on the broader economy is likely substantial. The biggest casualty is likely to be regional banks who are the dominat lenders to CRE. Government statistics show that regional banks hold, on average, 30% of their balance sheet in CRE loans compared to only 6% of balance sheet with money center banks. A regional banking crisis 2.0 may be forming with the news last week that New York Community Bancorp was forced to book large losses on its CRE loan portfolio. The stock has lost over 60% of its market cap since January 1 leading some to speculate it is the next Silicon Valley Bank. The KKR Real Estate Finance Trust also recently booked large losses that led to a cut in their dividend rate by more than 40%.

Regional banks are the primary lender to small businesses in US who create the vast majority of new job opportunities. As forced sales begin to occur in office real estate banks will be required to mark loan portfolios to market. This is likely to shrink bank balance sheets and ability to lend. The latest NFIB small business survey did indicate that lack of access to credit is a major factor negatively impacting their businesses.

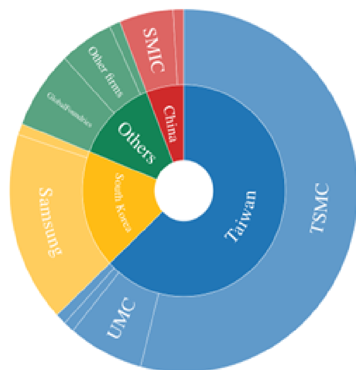
> **"If CRE does experience another significant leg down, the direct, and indirect, impact on the broader economy is likely substantial."**

With markets priced for perfection, a potential CRE crisis could derail the current stock market rally. The S&P 500 has risen 15 of the last 17 weeks, a feat only achieved on a handful of occasions since WWII. It was 1989 the last time the market was up 15 of 17 weeks and 1972 prior to that. A collapse in a sector as important to the economy as CRE could lead to both a recession and bear market for equities. People calling for the market's demise over the last couple of years have been proven wrong thus far, but that may change if the CRE dislocation proves worse than forecasted.

Copyright 2023 © Peak Capital Management, LLC, All Rights Reserved

Pass the CHIPS

Semiconductor contract manufacturers by market share
Total foundry revenue stood at $85.13 billion in 2020



SOURCE: TrendForce (March 2021)

The FANG stocks of old have been replaced by the Magnificent Seven that dominate market weight and performance. Those companies, Microsoft, Google, Amazon, Apple, Tesla, Nvidia and Meta now comprise more than 25% of the S&P 500 and more than 35% of the Nasdaq 100. Recent market gains can be attributed to only these stocks as markets would be negative without their gains. Concerning for investors is that each of these companies share a common risk, ample supply of semi-computer chips. If there was any interruption to the supply of microchips, it would severely impact these companies' earnings and the markets. Given that 90% of advanced microchips and 60% of all microchips come from Taiwan, the risk should be factored in portfolios given the geopolitical uncertainty.

- Taiwan Semiconductor (TSMC) is the global leader in chip manufacturing whose customers include Apple, Nvidia and Qualcomm. In 2023 the company booked over $625 billion in annual revenues.
- China has become increasingly antagonistic towards Taiwan in recent years, including threats of military action. The West recognizes Taiwan's independence while China exerts increasing control.
- Demand for microchips continues to rise and 28 new foundries are being built in the US in an attempt to make US companies less reliant on Taiwan. Nvidia is the largest US manufacturer of microchips.

10-Year Treasury Yield

Markets ended 2023 on a positive note with most major equity indexes rallying as the 10-year U.S. Treasury Yield fell from roughly 5% to 4%. The chart to the left shows the three-year pattern for long-term Treasury yields and the corresponding 50- and 200-day moving averages. The benchmark yield has been more-or-less unchanged since the fourth quarter of 2022 as investors contemplate the inflation outlook and likelihood of a recession. At the end of 2023, investors were pricing in with almost certainty that the economy would enter a recession and that the Fed would subsequently cut interest rates.

- However, there are clouds on the horizon with respect to the inflation outlook. For example, while it has subsided somewhat since the onset of COVID, wage inflation (growth) remains at levels well above the prior fifteen years, according to the Economic Policy Institute. Moreover, current CPI is still running well above the Fed's long-term 2% target, although it has subsided since 2022.
- In response the 10-year yield halted its decline from 2023 and has since bounced modestly higher, as evidenced by the chart. If medium to longer-term rates settle in at the 4.5% to 5.0% level, equities could struggle to match their returns from last year. Investors might have to recalibrate their expectations regarding Fed policy and prepare for a "higher-for-longer" scenario.

Bitcoin Halving

Bitcoin price history with halvings marked

Note: This chart uses a logarithmic scale, which is nonlinear, to illustrate the magnitude of price movements between each halving. On a linear scale, the shape of smaller moves (eg from $0 to $1) would be difficult to see due to the magnitude of later moves (eg from $100 to $10,000).

Over the last month, the price of Bitcoin has surged dramatically gaining more than 47%. Following the landmark approval in January of spot Bitcoin ETFs in the United States and changing flows, the very structure of Bitcoin's market is evolving. However, another major event for Bitcoin is set to take place in April, where Bitcoin's price could see a dramatic increase. Bitcoin Halving is an important event in the cryptocurrency network that sees rewards for mining new blocks decreased by 50% - i.e: miners receive 50% less bitcoins for validating transactions as a result of mining new blocks. This process typically occurs once every four years in order to help control inflation by gradually decreasing block rewards to miners. However, while past results may show a positive reaction after each halving event has taken place historically, their effects can differ depending on prevailing market conditions or external influences at each particular halving event.

- The "halving" process reduces the rate at which new bitcoins are created, making them scarcer and increasing their value based on supply and demand principles of economics.
- Unlike fiat currency, which central banks can print in unlimited amounts of, Bitcoin's supply is limited to only 21 million. It also regularly halves to ensure gradual release of new bitcoins and to act as an anti-inflationary asset.
- While the enthusiasm surrounding Bitcoin and other digital currencies has risen over the last few years and many are still skeptical to fully adopt. However, major investment management firms such as Blackrock and Fidelity have taken major steps towards that adoption.

Copyright 2023 © Peak Capital Management, LLC, All Rights Reserved

Quinn VandeKoppel

Macro View – Slow to Cut

While the Federal Reserve is still expected to cut interest rates this year, expectations around the frequency of those cuts have changed. A month ago, the futures market was pricing in five to six twenty-five basis point (bps) rate cuts in 2024 (125 - 150 bps in total). Now, the market is only pricing in three or four cuts (75 - 100 bps total). In a policy speech delivered in Minneapolis by Federal Reserve Governor Christopher Waller, he concluded the speech with the question, “What’s the rush?” on cutting rates. The central bank official communicated that higher-than-expected inflation readings for January raised questions on where prices are heading and how the Fed should respond. Even with the elevated readings, Waller noted that he stills expects that it will be “appropriate sometime this year to begin easing monetary policy, but the start of policy easing and number of rate cuts will depend on the incoming data”.

Fixed Income – Still a Recession Indicator?

To the surprise of many economists and investors, the U.S. economy was able to avoid a recession in 2023. Despite aggressive rate hikes and elevated inflation, the economy remained strong and now many economists believe the Fed could reliably achieve a “soft landing”. However, a recession forecasting tool with a near-perfect track record continues to sound the alarm. The 10-year and 3-month Treasury yields have inverted before every recession since 1969, with no more than 16 months between the inversion and subsequent recession. For context, the current inversion began 15 months ago in November 2022, implying that the U.S. could slip into recession by the end of next month. Now, even though history has shown that the inversion of these two yield curves has been a reliable recession indicator, it appears that the Federal Reserve has successfully navigated the economy through the highest inflationary period in decades, barring any setbacks. The first true test will be the PCE Index, the Fed’s preferred inflation gauge, which is set to be released on February 29th.

Yield Curve Inversion	Recession Start Date	Time Elapsed
December 1968	December 1969	12 months
June 1973	November 1973	5 months
November 1978	January 1980	14 months
October 1980	July 1981	10 months
June 1989	July 1990	13 months
July 2000	March 2001	8 months
August 2006	December 2007	16 months
June 2019	February 2020	8 months

Taking Stock –MAG 7 or FAB 5

In 2023, The Magnificent 7 (Amazon - $AMZN, Apple - $AAPL, Google parent Alphabet - $GOOGL, Meta Platforms - $META, Microsoft - $MSFT, Nvidia - $NVDA, and Tesla - $TSLA) had an impressive average return of 111% compared to 26.29% for the S&P 500 TR Index. However, after two months into 2024, new grouping of companies, coined as the “Fab Five” has begun to separate itself from the two lagging companies. Nvidia, Meta, Microsoft, and Amazon are up significantly for the year and since June 30th, all outpacing the S&P 500 and the Nasdaq composite, with Google slightly lagging in 2024. Both Apple and Tesla have lagged over both time frames with concerns regarding China sales and new driver growth. However, just this week, Apple announced that they would be dropping their EV project to focus more on the development of the company’s artificial intelligence division. While no official announcement has been made by Apple, the focus on GenAI should give investors more optimism about the company's efforts and ability to compete at a platform level on AI.

Magnificent Seven Stock Performance

Company	Ticker	Stock chg since June 30	2024 chg
Meta Platforms	META	65.51%	34.19%
Nvidia	NVDA	56.40%	33.60%
Amazon	AMZN	31.80%	13.08%
Microsoft	MSFT	20.76%	9.36%
Google	GOOGL	18.95%	1.93%
Apple	AAPL	-4.19%	-3.47%
Tesla	TSLA	-28.22%	-24.4%
S&P 500		*11.42%*	*4.1%*
Nasdaq		*13.35%*	*3.96%*

Technical – Inflection Point

With equity markets slightly off of their all-time highs, the 10-Year Treasury Yield has climbed back to a major resistance level. This level of 4.35% was originally tested back in October 2022 and then was subsequently surpassed in September 2023 where we saw yields briefly touch 5.00% before falling down to 3.80%. With a heavy amount of economic data set to be released this week, the direction of yields, both short-and long-term, have the potential to fall due to the market pricing out Federal Reserve cuts later this year if readings such as the US PCE come in hotter than expected. With markets now only predicting three to four rate cuts this year instead of five to six, further persistent inflation could spook investors away from investing in speculative growth areas of the market.

Copyright 2023 © Peak Capital Management, LLC, All Rights Reserved

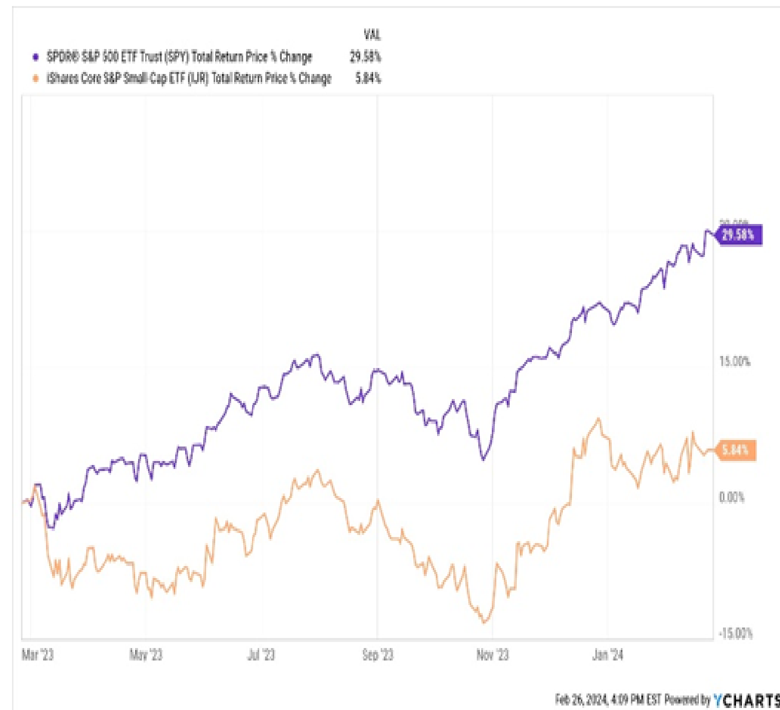
Performance Snapshot

Clint Pekrul, CFA

After a strong showing in 2023, equity markets are generally positive for 2024. In a continuation of last year's trend, performance has been led by U.S. mega-cap stocks, with shares of companies such as Nvidia and Meta having gained 50% and 40%, respectively, for the year.

Likewise, both developed and emerging markets are mostly higher in 2024, although performance overseas has been generally weaker than in the U.S. Conversely, fixed income returns are modestly negative for the year as interest rates have edged higher.

U.S. Equity



U.S. large-cap stocks, as measured by the S&P 500 Index, are higher by roughly 30% over the past year and 7% year-to-date. Likewise, small-cap domestic stocks are higher by approximately 6% over the past twelve months but are lower by roughly -2% so far in 2024.

As the chart above reflects, the gap between large and small-cap performance continues to widen in a continuation of last year's trend. Small cap stocks face headwinds – namely higher interest rates and cyclical economic effects – that large cap stocks can more easily navigate.

The performance gap between large and small caps reflects investor sentiment about inflation, interest rates and the overall business cycle. Today, investors simply don't anticipate robust growth potential for small caps. Rather, they see a challenging environment for earnings. Indeed, the average price-to-earnings ratio for small caps is roughly 14x, compared to 25x for large cap stocks. In other words, investors are willing to pay twice the multiple for the earnings of large cap stocks.

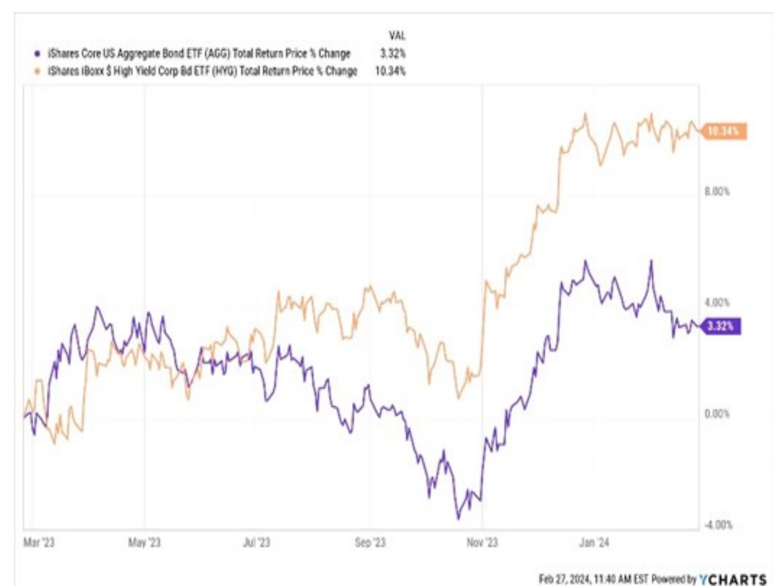
Small cap stocks can outperform should interest rates decline and the economic outlook remain favorable. Consider that in the last two months of 2023, when rates fell and the expectation was that the Fed would become dovish, the S&P 600 Small Cap Index gained roughly 22%.

International Equity

Developed markets stocks outside the U.S., as measured by the MSCI EAFE Index, are higher by roughly 16% over the past year, or about half the gain of the S&P 500 Index over the same period. Year-to-date developed markets are higher by roughly 3%. Likewise, emerging markets, as measured by the MSCI EEM Index, are higher by a meager 9% over the past year and are slightly positive year-to-date.

The earnings growth forecast for international developed markets is not as robust as the U.S. earnings forecast. Valuation multiples for Europe and developed Asian countries are considerably lower than in the U.S., according to Callan Research.

Fixed Income



Investment grade fixed income is higher by roughly 4% over the past year as measured by the Bloomberg Aggregate Bond Index but is lower by roughly 2% in 2024. Credit conditions have remained favorable. Hence, high yield bonds have provided a return premium over investment grade. The iBoxx High Yield Bond Index is higher by roughly 10% over the past year and slightly positive for 2024.

Copyright 2023 © Peak Capital Management, LLC, All Rights Reserved

Q: Do you anticipate any market moving surprises on November election?

It is very hard to forecast when political events rise to a level to impact the markets. Even when political surprises occur that impact markets, the initial reaction is often the opposite of the long-term impact. Consider the election of Donald Trump in 2016. There was a massive sell off in the markets when it was clear Trump won the election, but markets soared afterwards. I do expect surprises to occur in the 2024 Presidential election so handicapping what happens in November will be difficult this far out. While it appears the race for President will be between Biden and Trump, I do not think that will ultimately be the case. It is possible that one of the many lawsuits against Trump could cause him to drop out of the race but that seems very unlikely from a legal standpoint. I think the odds are very high that Democrats find a way to replace Biden on the ticket throwing uncertainty into the mix. Leading potential candidates to replace Biden, at this time, would include California governor Newsom and former First Lady, Michelle Obama. Given the claims of voting irregularities from 2020 and the contentious nature of politics today, there is an increasing chance the markets could be spooked if no one is declared the winner of the election within a day or two of the vote. That would be the most significant market risk in my opinion.

One aspect about this election is that we know markets have performed under both a Trump and Biden administration. In general, markets have done reasonably well under both presidents. Under Trump, the S&P 500 Index moved higher by about 15% annualized. Likewise, under the Biden term do-date, the S&P 500 Index has gained roughly 11% annualized. Despite the shutdown from Covid in 2020 and the pullback in 2022, the market ride over the past eight years has been a relatively smooth one. So, the election results alone aren't likely to spook the market as investors have set expectations about both candidates.

What could surprise the markets, however, is a scenario whereby either Trump or Biden, or both, are not their party's nominees for the November general election. Remember, Trump still faces indictment charges and polling shows that if convicted, his approval rating would deteriorate. This could pave the way for Nikki Haley, who, despite losing to Trump in the primaries, is still in the race. Biden would most likely have an easier path to reelection against Haley. However, if Trump is not indicted and Biden continues to blunder in public, the Democrats might push for another candidate. While a Trump versus Biden contest is the most likely scenario, much can happen between now and November.

Q: Will markets remain hyper-concentrated and what risk does that pose?

The rally in equities has seen some broadening in terms of participation lately but not enough to materially change the overall market cap of the Magnificent Seven stocks discussed earlier in this report. I think it is highly likely that we remain in an overly concentrated market as long as the current rally extends. In other words, only a bear market in stocks will likely change the status quo. The mega caps dominating the market today have all thrived during the Fed's tightening cycle even as other technology companies have struggled. As discussed in prior reports, if the Fed is able to successfully navigate to a soft landing for the economy and begin to cut rates, the number of sectors that would likely begin to participate in the rally should grow substantially. Factors like Value, Low Volatility and Quality have struggled to post large gains during the Fed's tightening cycle making Growth and Momentum the clear winners. It would be natural, if not expected, for the market's to rotate and defensive sectors like healthcare, pharmaceuticals, consumer durables and energy to rally. If the Fed is forced to postpone rate cuts due to a resurgence in inflationary pressures, it is likely all sectors of the market to retreat as the risk to economic expansion would be heightened. If this scenario play out, the defensive names mentioned above should be somewhat sheltered from the volatility as their fundamentals and valuations will be attractive.

We're roughly two months into the new year and based on total returns, the S&P 500 Index, which is capitalization weighted and fairly concentrated in the technology sector, is higher by roughly 7%. By comparison, the S&P 500 Equal-Weight Index, which balances sector exposure across the domestic equity market, is higher by roughly 3% for the year. By comparison, over the first two months of 2023, both the capitalization and equal weighted versions of the S&P 500 Index were more-or-less even in terms of performance.

If the first two months of 2024 are any indication, markets could become even more concentrated, especially if mega -cap tech firms keep surpassing earnings expectations. Today, the top ten holdings represent roughly one-third of the S&P 500 and collectively generate roughly $467 billion of net income with an average return-on-equity of 50%. These mega-cap companies are highly profitable, and command lofty valuations based on expected earnings growth from AI innovation. Investors' appetite for this growth potential, or perhaps the fear of missing out, continues to push share valuations higher. The risk, however, is that at some point, the growth potential for these companies will not meet expectations and as a result, investors will take profits and look elsewhere. Considering their collective weight in the S&P 500, such a move could put tremendous downward pressure on the broader market.

Copyright 2023 © Peak Capital Management, LLC, All Rights Reserved

9250 E. Costilla Avenue, Suite 110.

Greenwood Village, CO 80112

Phone: 720.361.4016

Email: info@pcmstrategies.com

Website: www.pcmstrategies.com

Fundamental Technical Discipline

PCM

This material is for general information and education purposes. The information contained in this report represents the opinions of Peak Capital Management, LLC, as of the report date and does not constitute investment advice or an offer to provide investment management services. Before purchasing any investment, a prospective investor should consult with its own investment, accounting, legal and tax advisers to evaluate independently the risks, consequences and suitability of any investment.

To the extent this deliverable incorporates statements of expectation, belief, projection, prediction, anticipation, or otherwise corresponding to future conditions, those statements are forward-looking statements. Please note that any such statements are inherently susceptible to uncertainty and changes in circumstances. Forward-looking statements are not guarantees of any future performance and actual results or developments may differ materially from those projected. Any projections, market outlooks, or estimates in this material are forward-looking statements and are based upon certain assumptions and should not be construed as indicative of actual events that will occur. Any forward-looking statements herein speak only as of the date on which they were made. Peak Capital Management is under no obligation to, and expressly disclaims any obligation to, update or alter its forward-looking statements, whether as a result of new information, subsequent events, or otherwise.

An investor cannot invest directly in an index. Index performance does not represent the performance of any investment product offered by Peak Capital Management, LLC. The performance of client accounts may vary from the Index performance. Index returns shown are not reflective of actual investor performance nor do they reflect fees and expenses applicable to investing. Portfolio composition will change due to ongoing management of the Funds. References to specific securities or sectors should not be construed as recommendations by the Fund, its Advisor or Distributor.

Past performance is not indicative of future results, loss of principal is possible. Please consider charges, risks, expenses and investment objectives carefully before investing. No representation is intended that any security discussed in this presentation was or would be profitable to any investor.

The data and information presented and used in generating this report are believed to be reliable. Peak Capital Management, LLC. does not warrant or guarantee the accuracy or completeness of such data.

Peak Capital Management, LLC, is a fee-based SEC Registered Investment Advisory firm with its principal place of business in Colorado providing investment management services. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request. Advisory services are only offered to clients or prospective clients where our firm and its representatives are properly licensed or exempt from licensure. No advice may be rendered by Peak Capital Management, LLC unless a client service agreement is in place. Nothing herein should be construed as a solicitation to purchase or sell securities; this can only be done by prospectus, which can be obtained by contacting Peak Capital Management, LLC or other financial professional. Likewise, nothing herein should be construed as an attempt to render personalized investment advice. A full listing of investment decisions made by PCM in the past year and relative performance is available upon request. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities presented here. Opinions expressed are those of Peak Capital Management and are subject to change, not guaranteed, and should not be considered recommendations to buy or sell any security.

GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

Copyright 2023 © Peak Capital Management, LLC, All Rights Reserved