PCM
PEAK CAPITAL MANAGEMENT

Soft Landing, Uncertain Markets

PCM Report February 2024 Volume 15, Issue 2

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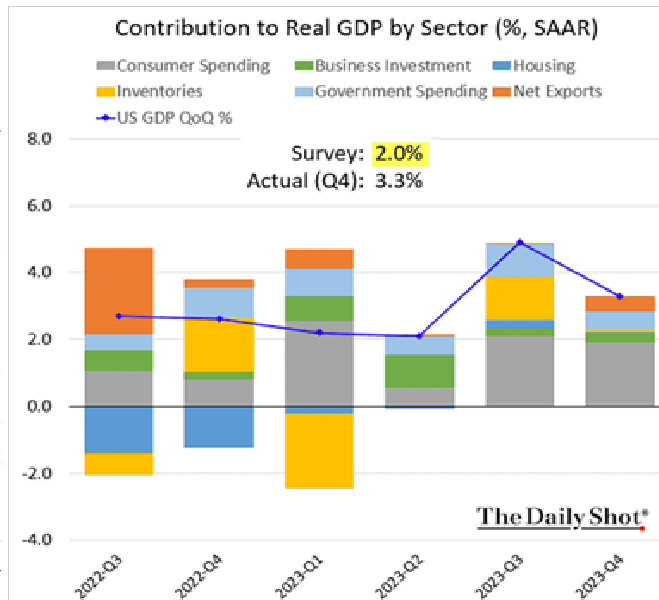
Real GDP for 4Q2023 came in well above consensus estimates, rising 3.3% versus the Survey of 2.0%. The rise in inventories that caused much consternation in Q3 was aptly dealt with as a result of strong consumer spending in Q4. Net Exports, absent from any contribution to GDP since Q1, made a nice contribution in Q4 that helped the Actual beat the Survey once again.

Earnings in January have been mostly above expectations, but companies continue to highlight risk and upside forward guidance remains overwhelmed by downside forward guidance. Macro indicators like Consumer Sentiment have risen sharply off the 2022 lows and are at 2021 levels but remain far below pre-Covid readings. Even manufacturing appears to be waking from a 2-year slumber with the PMI rising above 50 (barely) for the first time since 2022.



The economy appears poised to continue its growth pattern but that does not guarantee stocks can continue their path higher. The broad S&P 500 index is up 19% over the last 3 months placing that period in the 99th percentile of all market periods. In virtually every other occasion where the market posted 19% gains in 90 days was while coming out of a recession and bear market. This has many market analysts scratching their heads on what is stimulating such strong gains over a short period of time.

By many historic measures, the market has gotten ahead of itself, and we think valuations pose the greatest risk today. The Shiller PE (cyclically adjusted) currently sits at 33, a level only eclipsed in 1999 and 2020 when earnings crashed due to economic lockdowns. For context, the long-term median for the index is 16 suggesting markets are close to 50% over fair value. Traditionally calculated trailing PE ratio for the S&P 500 is 23 and 26 for the Nasdaq. These are both approximately 25% above long-term averages.

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The markets continue to hope the next buying wave will come when the Fed begins to cut interest rates, but it increasingly looks like a 'buy on the rumor, sell on the news' story. Stocks have risen so strongly that asset price inflation may cause the Fed to move slower on rate cuts over fears of reigniting inflation that has been trending towards their target. Taking a look at how large institutional investors are allocated, Gross Exposure today is nearly at a decade-long high while Net Exposure is right at its long-term mean according to Bloomberg data. This suggests a bullish but untrusting tone as sophisticated investors are comfortable being long equities but only with significant hedges in place.

I expect to see selling in early 2024 of big Tech names that drove the markets to highs in 2023. The Magnificent Seven as they have been referred to, have really stretched valuations and many worry that the companies may struggle to hit revenue and earnings targets. A rotation into some of the sectors that barely participated in current rally like Pharma and Consumer Staples would not be surprising if investors begin to take profits in Tech.

Another concern for domestic equities is the recent rally in International equities as funds rotate into non-US markets. International performance has trailed domestic stock performance for a few years with many analysts suggesting Developed Markets provide a more compelling risk-reward ratio. Emerging Markets are not seeing strong interest yet and are mostly flat over the trailing 12-months. Lastly, bond yields and T-Bills above 5% continue to provide a reasonable alternative to more risk-adverse investors. If the Fed postpones initiating any rate cuts, you could see a move to cash to protect gains from the last year.

It is interesting to note how many macroeconomic indicators that have been relied upon for decades have seemingly failed. Most notably, the inverted yield curve that had accurately predicted a coming recession for a century. We are nearly a year beyond the longest timeframe from when the yield curve inverted to a recession suggesting the next recession may not be signaled as they have in prior years.

Risk of being long equities is elevated given the historically high valuations and technically overbought but there was a lot of money that sat on the sidelines watching the markets rise. As some of those funds get deployed, we could remain near all-time highs. The small-cap Russell 2000 is still almost 15% below its June 2021 high and if that index begins to break out, it would be bullish. The institutions appear to be well placed with strong hedges in place.

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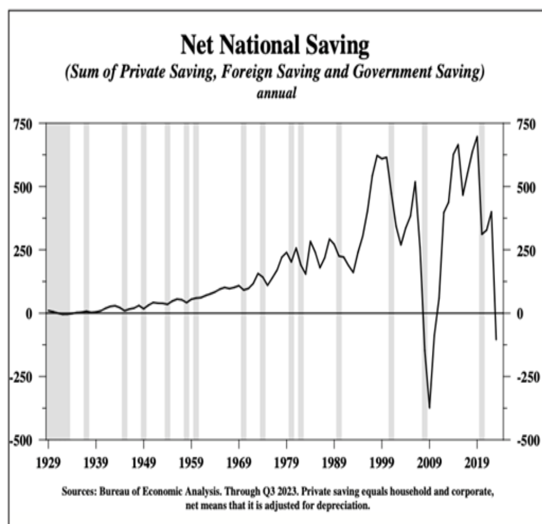
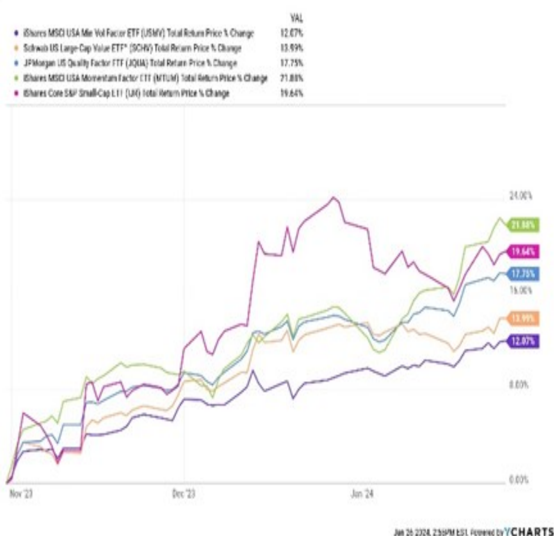
Where Did the Savings Go?



Something occurred in 2023 that did not draw much media coverage but could prove pivotal in forecasting future economic activity. For only the 8th time since 1929, there was a Negative Net National Savings (NNNS) meaning the budget deficit was greater than total national savings. The NNS calculation includes both household savings and corporate savings along with foreign savings in the US. These savings are essentially what provides capital for the economy to grow and banks to lend against. There were only 2 prior periods of NNNS, the Great Depression (1931-1934) and the Great Financial Crisis (2008-2010). A negative savings rate while the economy was expanding is difficult to explain and suggests a decline in future standards of living based on data from other countries who experienced negative net national savings.

- The Fed tracks ODL (Other Deposit Liabilities) such as bank deposits which fell in 2023 by 4% compared to an average annual increase of 3% in the long-term average.
- Bank lending also declines in 2023 that typically only occurs when the economy is in contraction (recession). Bank credit fell by 3.8% and included a drop in commercial and industrial loans.
- Bankruptcies, foreclosures, delinquencies and savings were all at levels normally associated with a recession even as GDP grew at above trend rates.

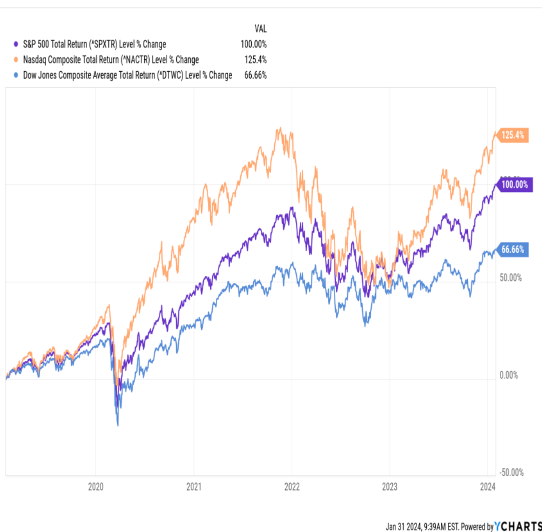
Factor Returns



The stock market rally that began in November 2023 continues into 2024. Investors are broadly anticipating a soft landing after a series of rate hikes from the Fed and that any recession will be relatively mild. Many investor surveys predict interest rate cuts before the end of the year. Consequently, equity valuations continue to edge higher. In contrast to much of last year, the current rally seems to have broad support based on factor returns since November. This suggests that we might achieve more compelling performance in 2024 beyond AI technology stocks.

- Whipsawed for most of 2023, momentum now appears to be on the right side of the trade and is positioned to participate in any continuation of the AI rally. Likewise, high-quality stocks, which tend to exhibit a growth bias, continue to drive overall performance.
- In addition, small-cap stocks, which can be highly sensitive to rates and the business cycle, have received a bid and are now among the top performing factors since the rally began. While still relative underperformers, both low volatility and value factors have posted respectable absolute returns. With the prospect of higher interest rates seemingly off the table, there is one less headwind for these factors moving forward.

Daily All-Time Highs



Equity markets are off to a hot start in 2024 as major indices continue to hit daily all-time highs. This week marks the busiest batch of earnings for the quarter with many of the mega-cap tech companies set to report. While the market has been on a positive trajectory since the October lows, many are unsure of where we go from here. If the market continues its upward momentum, one would be hard pressed to believe the Federal Reserve will cut what is expected by markets to be somewhere between 125-150 basis points. But what would have to happen in order for the Fed to cut rates by such amount? While some can only speculate, many are hoping the Fed will communicate what's to come in 2024 during this week's meeting.

- First Trust' Chief Economist Brian Wesbury offers two potential scenarios where the Federal Reserve cut rates to such a degree in his Monday Morning Outlook : "Either a sharp drop in inflation or a decline in economic growth". While a decline in inflation would be seen as a positive for markets, could such a drop occur without a weak economy?
- As of this writing, the market-cap weighted S&P 500 is up 3.85% for the year, while the Nasdaq composite index is up just north of 5% for the year. Both the S&P 500 and Dow Jones Industrial Average both closed for a record sixth time.

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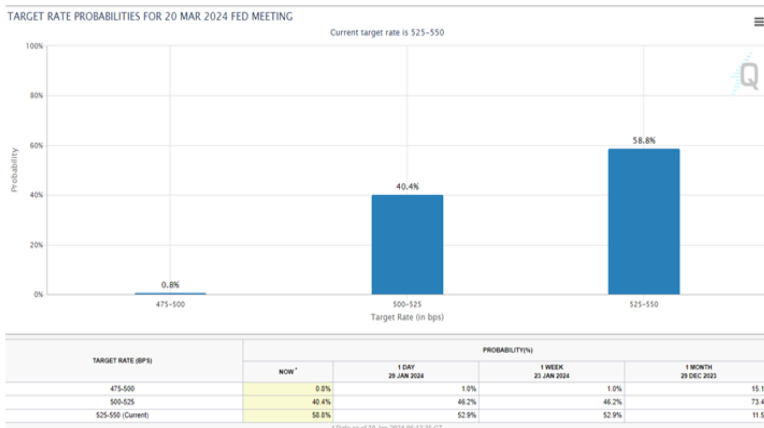
Quinn VandeKoppel

Macro View – Risk of Recession Subsides

Over the last few years, economists and talking heads on many of the popular financial networks made it seem as though an impending recession was all but imminent. However, economists at the International Monetary Fund are now seeing improving data on both inflation and growth, compared to just a few months ago. According to the IMF, "the global economy will likely grow 3.1% this year, with a similar rate of growth in 2025". Markets were able to withstand a dramatic rise in inflation over a short period of time, to the surprise of many. Now, central banks are poised to lower interest rates. Lowering interest rates would certainly alleviate the strains higher rates have caused the economy, but should they be looking to lower rates while the economy remains strong? That is a question the Fed must consider as markets are predicting up to six interest rate cuts in 2024.

Fixed Income – Target Rate Cut Probabilities Decline

According to the CME Group's Fed Watch Tool, we have seen a dramatic decrease in the probability of an interest rate cut during the Federal Reserves' March 2024 meeting. As you can see in the chart below, just one month ago, markets were predicting the possibility of a 25 basis point cut to be 73.4%. However, as of today, the probability of that same 25 basis point cut is now only 40.4%. What could have caused such a dramatic decrease in just a month? For one, the economy is improving and consumer confidence levels, indicated by the Consumer Confidence Index, are at their highest levels since January 2021. With the economy improving, the Fed may be hesitant to begin cutting interest rates with the risk of inflation picking back up.

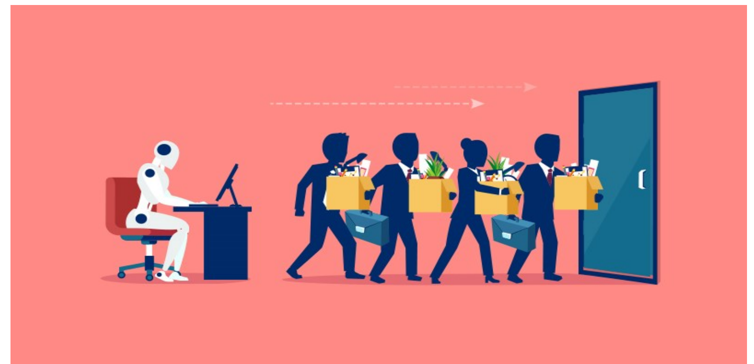


TARGET RATE (BPS)	PROBABILITY(%)			
	NOW*	1 DAY 29 JAN 2024	1 WEEK 23 JAN 2024	1 MONTH 29 DEC 2023
475-500	0.8%	1.0%	1.0%	15.1%
500-525	40.4%	46.2%	46.2%	73.4%
525-550 (Current)	58.8%	52.9%	52.9%	11.5%

* Data as of 30 Jan 2024 06:17:35 CT

Taking Stock –Start of a New Era?

A slew of companies across the tech, media, finance, and retail industries made significant cuts to staff in 2023. Unfortunately, the cuts continue into the new year as just this week, the United Parcel Service (UPS) fell short of Wall Street revenue estimates Tuesday. The company also announced 12,000 layoffs as part of an effort to align resources in 2024. In similar fashion, the payments firm PayPal Holdings (PYPL) is mulling over cutting about 2,500 jobs, or 9% of its global workforce, in 2024. With the rise of technology, many believe that companies are shifting their resources towards replacing workers with artificial intelligence. Companies such as Dropbox, Google, and IBM have already announced job cuts for that very reason. As artificial intelligence continues to develop, how companies ultimately decide to integrate the technology within their own systems, while also reducing their human workforce will be an interesting dynamic to examine.



Technical – Uncharted Territory

After a strong finish to 2023, the S&P 500 Index continued its rally in the month of January, marking six consecutive all-time high closes, before slightly pulling back on Tuesday. At current levels, the index is up 3.34% for the year. Given the index is currently trading at all-time highs, there are no overhead resistance levels for investors to be concerned about. Barring disappointing earnings reports from many of the largest tech companies this week, a further rise in the market cap weighted index is certainly possible. However, as you can see on the chart below, I believe it's worth mentioning is that the Relative Strength Index (RSI) has risen above 70 (currently at 75), indicating that the market is currently overbought and that there could potentially be a small pullback.

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Capital Market Assumptions – 2024

Clint Pekrul, CFA

Every year, the Callen Institute publishes their capital market assumptions about long-term risk and return expectations for the major asset classes, such as equities and fixed income. The annual report is available to the public on their website (www.callan.com).

The report is helpful for wealth managers as a framework for making asset allocation decisions and for setting client expectations. In general, the assumptions don't change materially from year to year. Callan uses long-run averages for various asset classes and then tilts those averages based on shorter-term bias related to inflation and interest rates.

The tables below highlight a select set of return assumptions for the major asset classes:

Equities – 10 Year Compound Return Projection	
Broad U.S. Equity	7.65%
Developed x.US Equity	7.50%
Emerging Market Equity	7.70%

Source: Callan

The rate of return required to double your money every ten years is approximately 7%. The outlook for stocks is in line with this required return, with a slight bias to emerging markets. This bias is based on valuation metrics for emerging markets relative to developed markets.

US equities have recouped the losses from 2022 and now trade at elevated multiples (e.g., price-to-earnings, price-to-cash flow), relative to long-term trends. If we do experience a recession, emerging markets could be poised to outperform as we come out the other side and business cycle expands.

Fixed Income – 10 Year Compound Return Projection	
Core U.S. Fixed Income	5.25%
High Yield Bond	6.80%

Source: Callan

After the Fed lifted interest rates from zero in 2022, the forward return expectation for bonds is considerably improved compared to several years ago. According to Callan, the return spread between the S&P 500 Index (stocks) and the Bloomberg Aggregate Bond Index (fixed income) is at its narrowest level since 2000.

The return driver for bonds has returned to interest coupons. Since 2008, fixed income investors have relied primarily on declining interest rates (i.e., capital appreciation) to drive performance. Once we hit the so-called zero bound in 2022, the potential for capital appreciation was no longer on the table. Combined with zero interest rates (i.e., very low coupons), the outlook for bonds was abysmal.

Now, with interest rates hovering around 5%, investors can secure meaningful, real rates of return (we call this the "normalization" of interest rates). Moreover, should the Fed ease and trim interest rates due to a recession, fixed income investors can capture potential appreciation. Hence, from a total return standpoint, bonds look attractive. Fixed income, from a risk-adjusted standpoint, looks more attractive than equities.

Alternatives – 10 Year Compound Return Projection	
Private Equity	8.75%
Private Credit	7.40%
Real Estate	6.00%
Commodities	3.90%

Source: Callan

The outlook for private equity remains attractive relative to the public markets, which is expected given the required liquidity premium. Demand for investment opportunities outside the public arena remains robust. However, Callan expects some write-downs in private equity that have not yet been factored into performance. Likewise, they see a tremendous disparity between the best and worst performing managers (selection matters).

Private credit continues to see strong institutional demand. The yield expectation has risen along with overall interest rates. On a levered basis, Callan projects yields above 10%. Likewise, real estate, which has experienced short-term headwinds, could provide a compelling entry point for long-term investors.

In summary, in relation to 2023 assumptions, Callan maintained its inflation outlook at 2.5%, raised its core fixed income return expectation by 1.0%, modestly increased its expectation for public equity by roughly 0.3%, and broadened its set of diversifying alternatives within private infrastructure and natural resources.

From a risk standpoint, private equity remains the most volatile exposure at 25% expected risk (wide dispersion of return across managers). Expected U.S. equity volatility is more-or-less in line with the longer-term trend at 20% standard deviation. Expected U.S. fixed income volatility is also in line with longer-term trend at roughly 4% standard deviation.

Disclosure:
Past performance is no guarantee of future returns. The return expectations reflect opinions from the Callan Institute and are for informational purposes only. Return assumptions do not include the impact of investment fees, taxes or other expenses.

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Q: Has the housing market hit a bottom on future rate cuts?

It is tempting to say yes, the Fed has completed their rate hiking cycle and when rates start moving lower housing should rise. Just as the macroeconomy can be confusing today with GDP exceeding expectations and bankruptcies and delinquencies rising, housing's path is likely to be complicated as well. Housing will always be interest rate sensitive as rising mortgage costs have a direct impact on affordability and prices. Housing also tends to be non-homogenous as local factors often play a greater role than national factors like interest rates. For example, home prices in the South; Tennessee, Georgia, North Carolina, South Carolina and Florida did not rise anywhere near the increases seen in California or the Northeast over the last decade, so they remained far more stable when mortgage rates spiked. Cities whose population is growing will typically fare better than cities where population is declining. Taxes, State income and property, are playing a greater role in where people are deciding to live so states with lower tax burdens will likely see stronger housing markets on a per capita basis. I am concerned about labor and its impact on housing over the coming years. Employment has remained very strong with unemployment at historically low levels yet bankruptcies and delinquencies are high. If unemployment were to trend higher and a recession materialize in the next 24 months, it would be likely we have not yet seen the bottom of the housing market.

The housing market has been in a precarious situation ever since Covid hit in 2020. When the Federal Reserve took interest rates to zero to stimulate the economy, existing homeowners were eager to refinance their existing mortgages into very attractive rates. Meanwhile, potential new homeowners rushed to buy while financing was relatively cheap. This surge in demand pushed existing home prices to the stratosphere, particularly in states like California. Limited inventory was already an issue prior to Covid. Supply-demand imbalances were exacerbated by easy money.

Existing homeowners saw their property values rise and with refinanced mortgages at historically low rates, were in a favorable position economically (i.e., increased equity with lower monthly mortgage payments). However, when the Fed lifted rates from zero to 5%, they essentially locked the housing market. Existing homeowners are not inclined to move, and affordability remains out of reach for many potential buyers. Meanwhile, inventory is still limited. Easing from the Fed might help unlock the housing market, but I think we have a way to go before we see a better balance between supply and demand. Consider that even if the Fed were to ease just modestly, financing rates on 30-year fixed mortgages would likely remain well above pre-2022 levels.

Q: How will the Bitcoin ETF change crypto investing?

The impact will be significant in my opinion because it will facilitate an entire different demographic group trading Bitcoin. To be an early adopter investing in cryptocurrency, you needed to open accounts and digital wallets that a large swath of the investing public was not comfortable doing. Bitcoin has become far more mainstream over the last several years but still required utilizing tools many were not comfortable with. By making owning a stake in cryptocurrency as easy as buying an ETF, I believe the population of investors who will participate in Bitcoin will rise dramatically and create a new source of demand and liquidity for the markets. ETF's are very good at price discovery so the data that the ETF trading provides should result in those assets trading more efficiently over time. It is also likely that facilitating trading in Bitcoin by less sophisticated digital investors will ultimately lead to more volatility. Cryptocurrencies have traditionally traded with very high levels of volatility and many who decide to take the plunge may not prove to be long term investors after 40%+ swings in both directions occur. Bitcoin has certainly proven itself as the leader of a legitimate asset class so making it available to the broad public should ultimately be a win for free markets. The fact that the Bitcoin almost immediately raised $2 billion in assets in the Fund suggests it will be good for Blackrock as well.

The ETF structure will likely lead to greater adoption of Bitcoin, particularly among retail investors. Historically, accessing Bitcoin was not necessarily efficient, and investors lacked a central exchange on which to trade the cryptocurrency. With the fund structure, investors are now afforded the protections of regulatory oversight and can purchase Bitcoin (spot price) through a publicly traded vehicle. There is little doubt that there will spring up a new class of Bitcoin "experts" that utilize the ETF to build portfolios. This initial launch is only the first iteration. In time, there will probably be leveraged and inverse crypto ETFs.

Despite the launch, it is still not clear what exactly Bitcoin, or cryptocurrencies in general, is with respect to portfolio theory and construction. Should Bitcoin be categorized as a commodity along with precious metals? Neither pays a dividend nor produces anything, but in theory is a store of value and an inflation hedge (although this theory is highly debatable). Should Bitcoin be considered an alternative investment that can diversify an existing portfolio of traditional stocks and bonds? In 2022, the price of Bitcoin collapsed along with both stocks and bonds. So, the diversification theory is questionable. My guess is that the ETF structure for spot price Bitcoin will mostly be relegated to day traders.

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