PCM
Peak Capital Management

Safe and (Un)Sound

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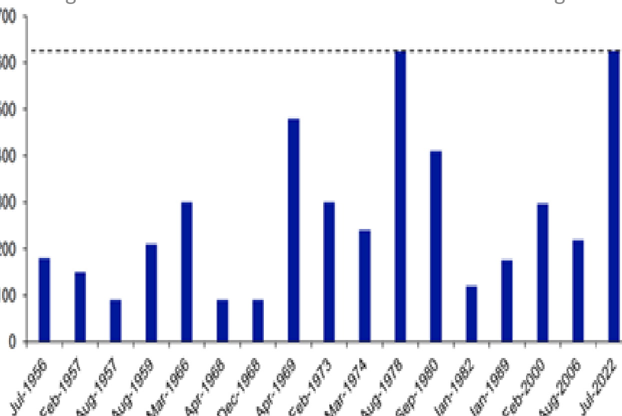
The English idiom, "Safe and Sound", means to be free from danger or unharmed. It has been used since the 14th Century, including in Shakespeare's play, The Comedy of Errors. Many economic commentators will suggest the economy is safe and sound now that the Fed has engineered a soft landing, free from recession. However, given the economic data available today, can we assume we are free from economic danger?

The chart illustrates that the yield curve on the 2-year and 10-year US Treasury bonds has now been inverted for the longest period in US history. What started in March 2022 remains today with 2-year Treasuries yielding more than the 10-year Treasury. 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 banking crisis' that took down major banks like Silicon Valley Bank, Signature Bank, and First Republic Band as those banks, along with others, found themselves on the wrong side of the carry trade when yields inverted.



It is reasonable to question why the most reliable indicator of recession has failed thus far in this economic cycle that largely explains why equities like the S&P 500 and Nasdaq are trading at all-time highs today. It is true that bank lending standards were already quite tight prior to the yield curve inverting meaning there were fewer bad loans to be written off. Consumer balance sheets were also more liquid as a result of COVID cash (government stimulus) in March 2022 suggesting the consumer continued to spend robustly even as rates rose and access to credit diminished. There are signs that consumers have largely worked through their excess savings as credit card utilization and premature withdrawals from retirement plans are at high levels.

> **"The question remains whether or not the economy, and markets, are free from danger or harm with the yield curve still inverted?"**

Fed Chair Powell did ride to the market's rescue in his late March press conference by stating the Fed would not overreact to the consecutive months of hot inflation readings. He reiterated the Fed's intention to cut interest rates three times in 2024 even if growth remains strong. The markets cheered by sending stocks, gold, crypto currencies and virtually every asset class higher with the exception of the US dollar. Investors seem convinced the recent rise in inflation readings will be temporary and the Fed will follow through with rate cuts to benefit stocks.

The question remains whether or not the economy, and markets, are free from danger or harm with the yield curve still inverted? 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 so a weaker 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.

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 'priced for perfection' more than at any time in recent history. 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 or contracting economy. Investors might also want to consider how market leadership might change once the Fed starts cutting rates. Some sectors that have not participated in the market's rally, Utilities, Financials, Healthcare and Consumer non-cyclical have lagged and may be poised to outperform once Fed policy shifts. Spreads on bonds remain at historically tight levels suggesting long duration Treasuries may outperform corporate and high yield bonds if the economic growth does falter.

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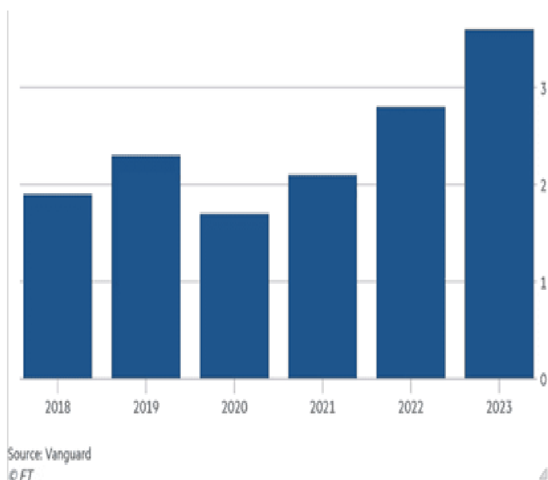
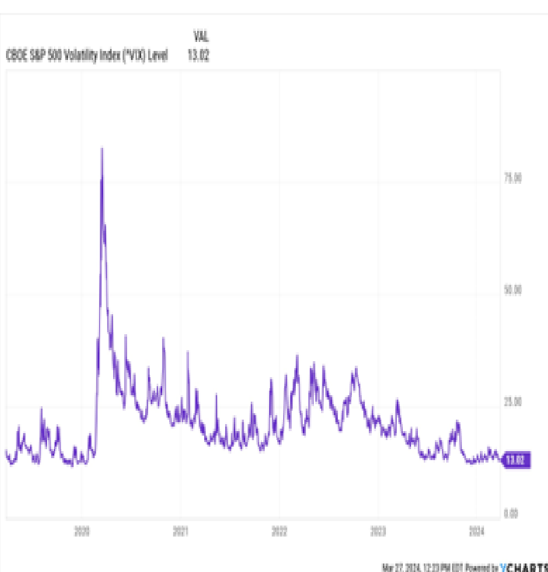
Strapped for Cash



The Fed's policies that led to much tighter lending standards is affecting consumers in many ways. The inability to secure traditional credit has led to a spike in people requesting hardship withdrawals from their IRA's and 401k plans. Vanguard reported that 3.6% of defined contribution participants took hardship withdrawals in 2023, the highest number in the 19 years they have tracked the data. That is more than 60% higher than the figure from 2021 and double the 2020 level. Even though the labor markets showed strong wage increases, mortgage rates, car loans and credit card rates are the highest in several decades causing some people to fall further behind on living expenses. Another factor for the rise in withdrawals might be the strong market performance over the last couple of years.

- Bank of America similarly reported an all-time high in retirement hardship withdrawals with a 20% increase in 2023 over 2022 along with a higher withdrawal amount from previous years.
- The NY Fed reported that credit card balances soared in 2023 by more than $150 billion taking the total to more than $1.1 trillion as consumers lacked cash to pay certain living expenses.
- The average rate on credit cards is currently 14.3% above the Prime rate compared to just a 9.6% spread in 2010 causing record high delinquencies according to the NY Fed.

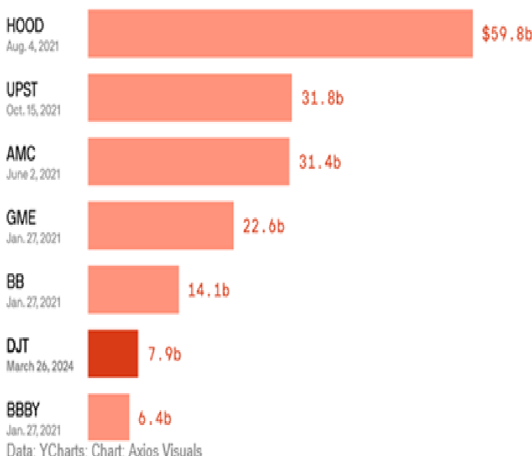
VIX – No Fear…for Now



The VIX is a widely followed index that measures investor sentiment regarding short-term volatility in the equity markets. It is quoted in terms of the expected standard deviation of returns over the next 30 days that's implied by put and call options on the S&P 500 Index. Higher readings typically coincide with periods of market stress and declining share prices. Likewise, lower readings generally coincide with periods of relative calm and rising share prices. The average reading historically is roughly 19 but can typically explode to the upside when panic strikes, such as during the onset of COVID (see chart).

- Currently the VIX is roughly 13, which is well below its historical average. Perhaps investors have become somewhat complacent as the VIX has not traded above 20 in 101 trading days (October 30, 2023). Perhaps this is justified if we do indeed avoid a recession and earnings continue to support current valuations.
- But for investors looking to hedge volatility, the cost of doing so is relatively cheap today. Hedges can be established at a relatively low premium, and, if markets do tumble, can deliver attractive upside potential. This asymmetry might not last for long if the VIX reverts to its longer-term average.

The Newest "Meme" Stock



Yesterday, Trump Media & Technology Group, trading under the ticker DJT, emerged as the newest "meme" stock for retail investors. Formerly known as Digital World Acquisition Corp. (DWAC), a blank check company, it finalized a merger last month with Trump Media & Technology Group. Following the market's close on 3/26, the company boasted a total market capitalization of $7.9 billion. During the peak of the "meme" craze in January 2021, stocks like GameStop and Bed Bath & Beyond surged to extraordinary valuations. However, valuations for those companies have since normalized, with some even declaring bankruptcy. While the fundamentals of DJT do not align with its current valuation, in typical "meme" fashion, it could continue to rise in popularity among investors.

- TMTG reported a $49 million net loss on $3.38 million in revenue for the first nine months of 2023. However, positive revenue and solid fundamentals do not seem to matter when it comes to these "meme" stocks.
- TMTG will be listed on the Nasdaq with a board of directors that includes Donald Trump Jr. and several former members of the Trump White House.
- While he is restricted from selling any of his shares for the next six months, the merger between the two companies effectively added billions of dollars to Trump's net worth.

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Quinn VandeKoppel

Macro View – Fallout from Bridge Collapse

Last week, the Francis Scott Key Bridge in Baltimore collapsed after being struck by a container ship, marking a tragic event for the 50-year-old bridge. The collapse of this bridge has now complicated shipping logistics along the East Coast as shippers are forced to divert to other nearby ports. It remains uncertain how long it will take to rebuild the bridge, with estimates ranging from two to 15 years. While this port ranks 17th in the nation in terms of cargo tonnage handled, it leads all other U.S. ports in imports and exports of cars and light trucks, according to data from the state of Maryland. Despite the collapse, Ryan Sweet, chief U.S. economist at Oxford Economics, does not anticipate that the increase in transportation costs and disruptions will be widespread or significant enough to cause notable shifts in either headline or core consumer prices.

Taking Stock –Change on the Horizon

Boeing's CEO, David Calhoun, announced last week that he would be stepping down from his role at the end of the year. Calhoun, who has held the position since 2020, witnessed the company's stock price plummet by more than 50%. Boeing has recently been under scrutiny due to numerous safety concerns surrounding its commercial airline fleet, particularly the 737 Max jetliner, which experienced a mid-flight panel detachment in January. Additionally, just last month, passengers on a United flight bound for Boston captured video footage showing damage to the wing of a 757, resulting in an emergency landing. Whoever succeeds Calhoun will face the daunting challenge of overhauling a corporate culture that prioritized quantity over the quality of its aircraft.

Fixed Income – High Yield Spreads

A significant influx of funds has poured into the U.S. corporate bond markets this year as investors seek to capitalize on the highest yields in years, anticipating potential interest rate cuts by the Federal Reserve. According to EPFR, a fund tracker, inflows into corporate bond funds have totaled $22.8 billion so far in 2024, marking the first positive start to a year since 2019. These inflows have driven up prices and narrowed spreads—the additional interest paid by corporate borrowers compared to U.S. Treasuries—to their lowest level in two years. However, despite spreads reaching such low levels, some investors remain wary about the health of the world's largest economy and the possibility of worsening corporate distress or an increase in defaults—especially if the Federal Reserve fails to implement the anticipated interest rate cuts.

Technical – Poised for a Breakout

After a rough two years, it appears that small caps could soon see a breakout. As you can see on the chart below of the iShares Russell 2000 ETF (IWM), the ETF has been on a solid uptrend since the lows of October of last year. While it has a habit of nasty false breakouts, most recently in January where it gave back all its gains from the prior month after the December FOMC meeting, if the IWM can hold over this $205 area (and thus not come down and tag the uptrend line) it would indicate strength. However, if that level does not hold, we could see a reversal where prices fall back down to the 200-day SMA, around $190.

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U.S. Equity Performance Snapshot

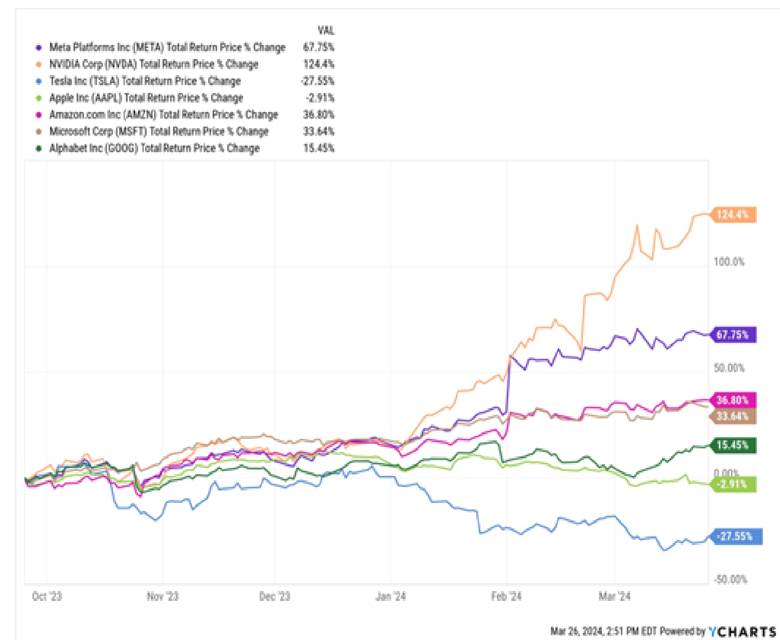
Clint Pekrul, CFA

As we close out the first quarter of 2024, it's helpful to take a market snapshot and evaluate what has driven recent performance. We, along with almost every other asset management firm, have written about the impact that advances in AI technology have had on equity valuations (i.e., the so-called "Magnificent Seven" phenomenon). The earnings potential that comes with AI development could drive stocks higher for years to come.

Likewise, we are now dealing with a Fed that is more likely to cut, or at least maintain, its target interest rate than raise it again to fight inflation. Lower interest rates suggest higher current valuations for risky assets, such as stocks. Should the Fed pull off the so-called "soft landing", the runway seems clear for another liftoff in terms of asset valuations.

Still, not every economic indicator is flashing green. The bond market – with its persistently inverted yield curve – could spell trouble for the financial sector. The lagging effects of higher interest rates might now just be coming to the forefront as a wave of debt refinancing is on the horizon. Moreover, the commercial real estate market remains on shaky ground.

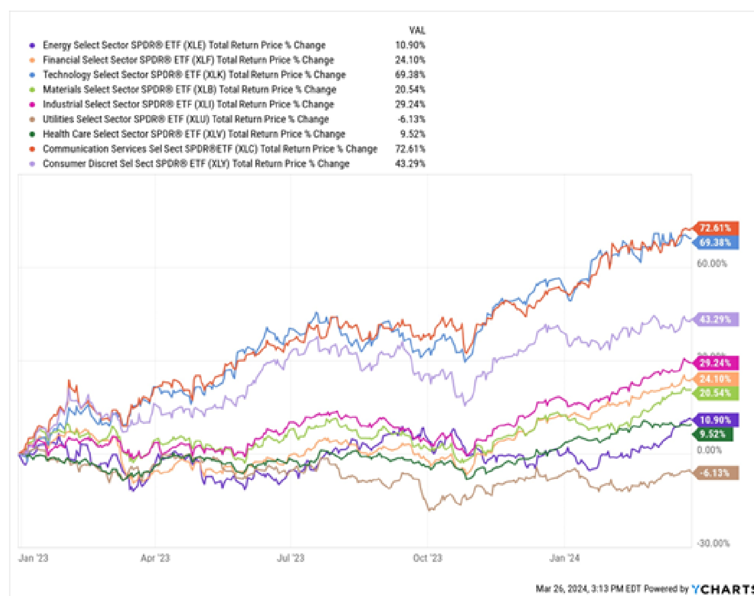
Mag 7 Six-Month Returns



The Mag 7 stocks have fragmented somewhat this year in terms of performance. While Nvidia (NVDA) and Meta (META) have continued to surge, shares of Apple (AAPL) and Tesla (TSLA) have rolled into negative territory. These two stocks, along with Google (GOOG), have now underperformed the broader S&P 500 Index year-to-date.

The dominance of the Mag 7 stocks has diminished somewhat, but as a group, these companies still dominate the returns of the broader index.

Sector Six-Month Returns



While returns last year were dominated by both the telecom and technology sectors, so far this year we have seen broader upside participation, particularly from the energy and financial sectors. Meanwhile, utility stocks continue to underperform the broader S&P 500 Index.

Sector Multiples

Sector	Forward PE Ratio
Technology	28.82
Telecommunications	16.67
Energy	12.18
Financials	15.54
Basic Materials	20.99
Industrials	21.07
Healthcare	18.95
Consumer Staples	19.79
Consumer Cyclical	23.91
Utilities	15.37

Source: Ycharts

Not surprisingly, the technology sector commands the highest price multiple for expected earnings. The sector carries a roughly 12% five-year earnings growth projection. Likewise, earnings for the consumer cyclical sector are projected to grow at a 10% rate over the next five years. The sector trades at a multiple of roughly 24.

Energy stocks, which trade at a forward multiple of roughly 12, carry a forecasted five-year earnings growth rate of 15%. From a valuation perspective, the energy sector still looks attractive despite gaining 12% for the year. Likewise, financial stocks, which trade at a multiple of roughly 15, carry a five-year earnings growth forecast of approximately 12%.

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Q: How might a credible 3rd-Party Presidential candidate impact the markets?

There has not been a credible third-party candidate since 1992 when Ross Perot's self-financed Presidential candidacy received just under 19% of the popular vote. Many suggested Perot's popularity and fiscal conservatism resulted in Bill Clinton beating George Bush in many of the toss up states. There is renewed interest in a third-party candidate this year as many voters abhor the idea of a rematch of Biden and Trump. Robert F Kennedy, Jr. has elicited a lot of interest, particularly among independent voters, who appreciate his willingness to break ranks with the traditional political parties. RFK certainly benefits from the name recognition associated with the greatest political dynasty in US history. Reuters just reported that RFK has chosen California-based attorney, Nicole Shanahan as his running mate. The 38-year old Shanahan is a political novice but well known for advocacy for reproductive right, criminal justice reform and the environment. Kennedy was only polling at 9% in the latest WSJ poll and it seems unlikely Shanahan as a running mate would drive that figure towards Perot's 1992 popularity.

As for impacting the markets, a third-party candidate only shifts sentiment if they have the ability to change the outcome of the election. Trump's policies (and baggage) are well known after serving as the 45th President of the United States. I do not see RFK, Jr having much of an impact on the 2024 election or the markets but may set the stage for a future third-party candidate pulling together support from the political right and left and making history.

Although it is unlikely at this point, a viable third-party candidate could be somewhat disruptive. However, I don't think a third option on the ballot is going to derail the key narratives that are driving stocks higher – the promise of AI technology and the potential for lower interest rates. By and large we know what to expect from either a Biden or Trump presidency. Since Trump was elected in 2016 through today, the S&P 500 Index, including dividends, is higher by about 170%, despite a mild recession, global pandemic, and the highest inflation in forty years. Furthermore, both Biden and Trump are well entrenched with Wall Street.

Investors realize that a third-party candidate, while appealing to disgruntled voters, would face almost insurmountable odds of accomplishing anything of substance in Washington. The gridlock that defines Congress wouldn't likely be solved by a third-party candidate. For the markets this means more of the status quo with no game-changing legislation coming out of Congress. For example, a third-party candidate, if elected, won't likely accomplish an overhaul of the tax code. Perhaps a few modifications, but nothing to spook the markets. Likewise, a third-party candidate won't be able to solve the country's fiscal woes. For transformative change, we would need to see a shift in party membership from both sides towards a new centrist coalition in Congress.

Q: Will planned Fed rate cuts keep stocks at all-time highs?

Based on the market's reaction to Fed Chair Powell's press conference, it is certainly possible, and possibly even likely. There have been 22 Fed rate cutting cycles since 1928 and the average return for stocks in the 12-months following the first rate cut has been 11% above inflation according to a recently published study by the St. Louis Fed. While there are exceptions, stocks typically did rise once the Fed began cutting rates. What may be unique about the current stock market environment is that stocks typically began declining 7 months prior to the first Fed rate cut. With equities at all-time highs, the typical decline leading to a rate cut is not present. In fact, the S&P 500 has not experienced a 2% correction in over 100 days and the last 5% correction was September 2023, more than 6 months ago.

As noted in the Introduction of this report, stocks seem to be priced for perfection more than anytime in recent memory and the prospect of rate cuts and increased liquidity is driving a buying frenzy. The Nasdaq is at record levels but also trading above 30 times its trailing 12-month earnings and at over 5 times its trailing sales. History and reversion to the mean would suggest these are not sustainable levels and would require much higher earnings per share than forecasted by FactSet to keep stocks at record levels.

At this point it seems like the anticipated rate cuts from the central bank are already priced in to current valuations. We are almost through the first quarter of 2024 and the broad S&P 500 Index is higher by almost 10% on a total return basis. At this pace, the market is on track to end the year higher by 40%, which would be remarkable considering that a year ago the main topic of discussion was the depth of the looming recession. It seems that the market has shrugged off recession fears despite indications that we aren't out of the woods just yet. However, inflation – as measured by core CPI – is closer to the Fed's long-term target than a year ago. Investors have seen this development for some time, and consequently have priced in at least a few rate cuts before the end of the year.

What could send stocks soaring is a larger-than-expected rate cut on the back of softer inflation data. In other words, if core CPI comes in meaningfully lower than forecasted, investors would then rationally assume that the Fed would ease more quickly than anticipated. Under this scenario, the major equity indices would likely rip higher. Conversely, if the Fed does nothing this year, it wouldn't necessarily imply an immediate pullback in stock valuations. Investment in AI technology is substantial, and its earnings potential could support current valuations regardless of the Fed's actions. Likewise, investors are sitting on over $1 trillion in money market balances that should provide a downside cushion to any market pullback.

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