PCM
Peak Capital Management

Sky High

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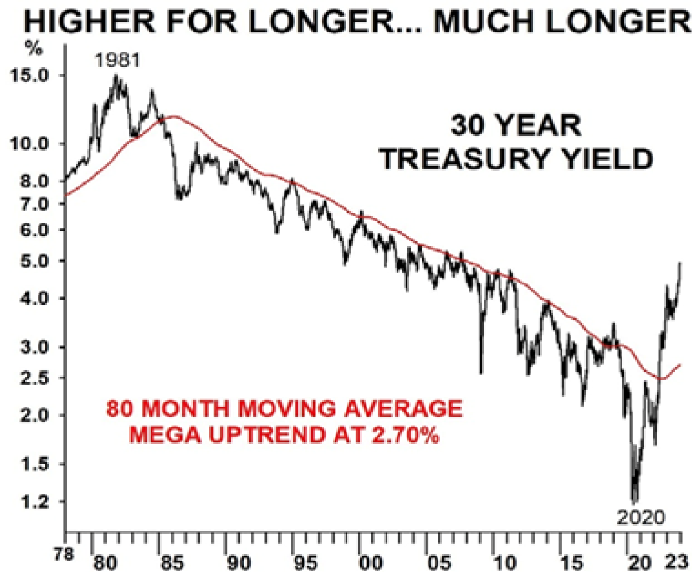
Brian Lockhart

I think the most heart-wrenching illnesses occur when someone goes from apparently healthy and living a normal life to a terminal diagnosis and passing in just a few weeks. While uncommon, it does happen and always leaves friends and loved ones in a state of shock. I expect something similar is building with the economy and markets. Looking at GDP growth, employment or a host of other indicators can lead something to think the “patient” is healthy when it simply is not the case. A ‘terminal’ diagnosis could be just around the corner and the ailment would be likely to happen very quickly.

Coming out of the Great Recession of 2008, ultra-low-cost money that was almost being given away drove the prices of risk assets to extremely high levels. Stocks, bonds, real estate, farmland, timber, even bitcoin benefited from access to credit that was both easy and low cost. Today, it is a very different story.



You can make the argument that bond yields today are not out of line of where rates have been over the last 30 years but that does not tell the story. The Fed tightened monetary policy in an unprecedented way that had not been seen in over 200 years. Compounding that, banks today have decided the only people to whom they are willing to extend credit are borrowers who don’t need it. Bank lending standards are the strictest in decades because bankers, for all their flaws, share our prediction of what is coming, and they do not want to be holding collateral instead of getting repaid. Banks believe asset prices have the potential to fall dramatically which will impair their balance sheets when loans default. Banks tend to play a popular game they are very good at; heads we win, tails you lose (apologies to all my banker friends, you are obviously exempt from these comments).

> **“The Fed tightened monetary policy in an unprecedented way that had not been seen in over 200 years”.**

We feel that the economy has entered a vicious cycle, regardless of what the Fed and talking heads on TV try to tell us. Debt is skyrocketing with the annual deficit projected to rise above $1 trillion in this fiscal year. As debt rises, you need buyers of debt and that requires high enough interest rates to attract lenders. Higher interest rates lead to the need for higher debt and thus even higher interest rates. This cycle is going to continue until there is a collapse in asset prices and massive defaults by borrowers. Asset prices will decline along with interest rates as the economy shrinks and unemployment rises sharply.

While many are dismissive of technical analysis in markets, long-term trends are often extremely helpful, particularly in hindsight. The chart shows the yield on the 30-year Treasury bond from 1978 to 2023. You can see that while yields peaked in 1981, the trend did not start to move lower until 4 years later in 1985. In over 40 years of data, with all the economic shocks and technology breakthroughs, there was a consistent pattern of yields moving lower. It was 40 years of lower highs and lower lows until the lows of 2020 during COVID. At this point, nearly one-third of sovereign debt around the world traded at negative yields and governments did everything but drop money from helicopters.

It has taken three years for the long-term trend line, known as the mega-trend, to reverse and start moving higher. When mega-trends turn, history tells us it will likely continue in that direction for decades. We would judge anyone who thinks rates are going to return to levels of the last 15 years to have sadly failed economic history. It is possible they will be right but only if the most mocked phrase in the markets, “this time will be different”, becomes a reality.

The implications for this rosy outlook are somewhat obvious; trends suggest that we are headed towards a financial crisis of a magnitude that many alive have never experienced. While some analysts try to compare today with the 1970’s, when the economy was stagnant, inflation soared and interest rates spiked, I am not sure it is a fair comparison because of the debt situation today. The debt-to-GDP ratio in the 1970’s was very different than what we are dealing with today. The CBO forecasts interest payments on the trillions in debt will exceed spending on national defense in less than 7 years. If rates continue to move higher, we may get there even faster and force Congress to cut spending on budget items that seem off-limits today. The unthinkable may become a reality much faster than anyone thinks is possible. A portfolio of hedged equities, real assets, private credit, and cash seems to make the best sense in today’s environment.

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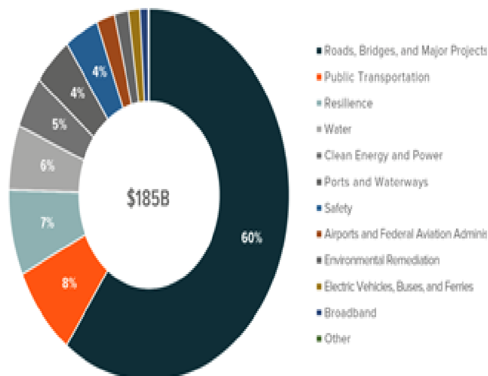
If You Build It

ANNOUNCED INFRASTRUCTURE INVESTMENT AND JOBS ACT FUNDING BY SPENDING AREA (%)

Source: Data to Decisions (D2D). (2022, October 25). BIL_Map_Data_CAOOCT2022 [Data set]. General Services Administration.



One of my favorite lines of any movie was from Field of Dreams when Kevin Costner hears a whisper, "If you build it, they will come." Infrastructure spending, both public (i.e., governments) and private (corporations), has lagged on a per capita basis by a large margin over the last 3 decades according to data from Bloomberg. Whether looking at spending data on roads, bridges, water treatment, or government-owned buildings on the public side, or refining and microchip manufacturing capacity on the private side, we think infrastructure spending is likely to rise. Spending on infrastructure is often the easiest to defer, until it isn't, because something no longer works, or a crisis occurs. It is likely we are entering a period when corporate and government budgets are going to be stretched as revenues recede and costs rise.

- Highly respected Gartner Group projects spending on IT will increase by 8% to $5.1 trillion in 2024 with cybersecurity a main focus for over 80% of CIO's. AI and GenAI should also see significant spending increases.
- President Biden's FY 2024 $6.8 trillion budget highlights increased spending on infrastructure that is focused on the EPA's clean water infrastructure, new starts for public transportation projects, and VA building renovations.
- Climate is front and center of Biden's budget with clean energy R&D being allocated $11 billion to the Dept of Energy, an 18% increase over 2023 spending, and $17 billion for improvements to ports and airports.

Has the AI Rally Stalled?

Headlines this year have been dominated by the AI technology explosion and the handful of companies that stand to benefit from its evolution. The chart below shows a hypothetical equal-weight composite of Apple, Amazon, Nvidia, Microsoft, Google, Tesla and Meta – the so called Magnificent Seven. Over the past year this seven-stock composite has advanced roughly 62% compared to a gain of 12% for the broader S&P 500 Index. Collectively, these seven stocks represent a combined market capitalization of roughly $10.5 trillion and have carried the market higher for the year. However, the rally that started at the beginning of the year seems to have stalled.

- Consider that the median P/E multiple for these stocks is already roughly 38x. These companies not only have to meet earnings estimates going forward, but also beat estimates to support current valuations and sustain the rally. If they don't there will be implications for the broader market going forward.
- The stall we've seen in the rally could be short-lived, considering the immense potential that AI technology holds for the long run. It seems a repricing of expectations considering higher-for-longer interest rates is under way, and that is weighing on current multiples.

Middle East Conflict

Ever since the October 7th terror attacks by the Hamas militant group, the whole world has been on edge in hopes that the situation in Gaza will not escalate into a regional conflict with implications for global financial markets. However, Mohamed El-Erian, Chief Economic Advisor at Allianz, seems to believe that is the direction we are headed. "The higher the risk of escalation, the higher the risk of contagion to the rest of the world in terms of economics and finance". El-Erian also noted that such contagion would further compound the already pervasive issues facing the global economy, including stagnating growth, stubbornly high inflation, and the broader fragmentation of markets. There is no telling at this time how long this conflict will persist but will likely have a negative economic impact on others in the region, such as tourism and trade.

- The impact on global markets in response to the onset of the war was initially limited. However, the prospect of a regional spill-over pulling in other countries, such as Iran and Lebanon, has added to a sense of unease in markets.
- WTI Crude Oil has been particularly volatile, jumping almost 10% in the days after the attack, but has since fallen back to around $82 per barrel.
- General Dynamics (GD) the biggest U.S. artillery shell producer, had already been ramping up production to meet needs amid the war in Ukraine, according to finance chief Jason Aiken. Now, the company is working to increase production to as high as 100,000 units per month, up from 14,000.

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Quinn VandeKoppel

Macro View – New Leadership

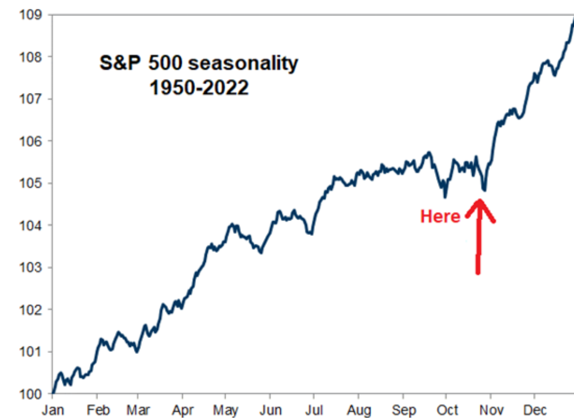
After Representative Kevin McCarthy's historic ousting and three weeks of chaos trying to elect a new speaker, the GOP finally came to a unanimous decision to elect Representative Mike Johnson (R-LA). Johnson now faces a daunting list of challenges, with a fast-approaching government shutdown chief among them. The House now has all eyes on a deadline of November 17th, when current government funding expires. In his blueprint for the next few months, Johnson said a stopgap measure extending funding until January or April may be needed to approve more spending and avoid a shutdown. If representatives on both sides of the house cannot come to some sort of resolution by the deadline, any prospects of a year-end market rally may be in jeopardy.

Fixed Income – Historic Highs

Just last week, the yield on the 10-Year Treasury momentarily breached 5%, a level not seen since 2007. This benchmark government bond yield serves as a crucial indicator of the overall interest rate environment and economic conditions. Over the last three years, Treasury yields have climbed rapidly with the 10-year yield rallying over four percentage points. And while higher yields are certainly beneficial to fixed income investors looking to lock in these rates, it can also have far-reaching implications for various sectors of the economy. Mortgage rates and other borrowing costs are likely to rise, in turn affecting the housing market and consumer spending. Additionally, higher yields often put pressure on risk assets, potentially leading to market volatility. With the Federal Reserve continuing their efforts to tame inflation, we think these yields very likely will remain high for the foreseeable future.

Taking Stock – Year End Seasonality

As we head into the final quarter of the year, even as conflict in the Middle East concerns both equity and fixed income markets, major indices such as the S&P 500 and Nasdaq Composite have held their major support levels. The chart below from Goldman Sachs Global Investment Research shows the seasonality of the market cap weighted index going back to 1950. The median return for SPX during November is +1.50% going back to 1928 and is higher in 10 of the last 11 Novembers. However, with companies now reporting on Q3 earnings and revenue, any prospects year-end rally could be in jeopardy, especially if many neglect to provide positive future guidance and market sentiment does not improve.



Source: Goldman Sachs Global Investment Research, Cormac Conners, as of 10/24/23. Past performance is not indicative of future returns.

Technical – Hanging on by a Thread

In a recent update from Andrew Adams CFA, CMT, of Saut Strategy, he noted that while the S&P 500 has failed to hold all of its support levels in the midst of this latest decline, the market cap index traded down to its volume-weighted average price (VWAP) since the October 2022 low (chart below). This indicator is a rough estimate of the "average" price paid by buyers of the major index over the past year-plus and could possibly provide an additional level of support. Additionally, the index has fallen into correction territory after declining more than 10% off if its July high, which could lead towards a possible relief bounce. However, if these levels fail to hold, more selling could persist until a notable bottom is established, potentially around the 4050-4100 range.

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Forward Returns for Stocks and Bonds

Clint Pekrul, CFA

Investors have endured the pain from rising interest rates ever since the Federal Reserve lifted off from the zero lower bound after the onset of Covid back in 2020. Over the past three years, we have been on a wild ride by any measure. First, the markets fall off a cliff in March 2020 as the global economy shut down due to the pandemic.

Governments and health officials halted business activity, which in turn sent the markets into a death spiral the likes of which not seen since the Great Recession of 2008. To provide liquidity to a faltering Treasury market, the Federal Reserve stepped in and purchased vast amounts of government bonds which sent yields to record lows. The 10-year Treasury bond traded at a yield-to-maturity of less than 0.5%.

Suddenly, markets rallied in response to the Federal Reserve's quantitative easing, with the S&P 500 finishing higher for the year. The government initiated several stimulus programs to help energize the economy and help ensure we didn't fall into a deep recession. This stimulus suddenly provided dry powder to the consumer. Increased demand, coupled with record low interest rates, sent the markets soaring in 2021.

However, there was ultimately a price to pay as inflation soared to levels not seen since the early 1980s. To no surprise, the Federal Reserve poured cold water on the fire via a series of interest rate hikes throughout 2022. Higher interest rates essentially repriced all assets lower. Stocks tumbled from their stratospheric valuations – the stimulus sugar high was waning. Meanwhile, bond investors were torn asunder as higher rates sent the value of their fixed income portfolios into a chasm.

Then, suddenly, equity investors were rewarded with a rally to start 2023. Evolutions in AI technology sent a handful of mega-cap growth stocks soaring (think Microsoft, Meta and Nvidia). But the rally had very narrow breadth - most stocks have suffered declines this year. Meanwhile, bonds have slid further as the 10-year benchmark interest rate hit levels not seen since 2007.

In a nutshell, markets were humming in 2019 before the Covid tsunami hit in 2020. Markets plummeted but the Federal Reserve saved the day with quantitative easing. Governments injected massive fiscal stimulus and markets soared to new highs. The euphoria was short lived, however, as inflation became a problem. Markets fell back to earth in 2022, and, outside of a handful of mega-cap companies, continue to fall in 2023.

So, where do we go from here? What are some likely return scenarios for both stocks and bonds over the next three years?

Outlook for Bonds

Over the past several decades the return investors received from bonds has gradually shifted from coupon income to capital appreciation due to a secular decline in interest rates. Methodically, fixed income investors could roll over their positions at a profit as rates trended lower.

Last year was an inflection point, of sorts. It seems likely that going forward, the return for fixed income will come from coupon payments. Today, investors can receive 5% interest on Treasuries with maturities of 3-5 years, for example. If the Federal Reserve does indeed achieve its inflation target of 2%, then locking in today's yields seems like an attractive proposition.

Unlike a few years ago, investors stand to make a real rate of return on their bond portfolios at current interest rates. The risk, of course, is that the Federal Reserve remains hawkish and pushes rates higher. But considering that inflation is now cooling, it seems likely that we're near the end of the tightening cycle. Bottom line – the outlook for bonds today seems favorable.

Outlook for Stocks

The outlook for stocks seems less certain than for bonds. Simply put, equities now have competition from fixed income considering the rise in yields. The equity risk premium – or the excess return that investors demand above the risk-free rate for assuming stock market risk – implies that equities must compound at around 7-10% over the next several years (based off the current 10-year benchmark rate).

Consider the current valuation for the broad S&P 500 Index. The price-to-earnings multiple for equities historically has been roughly 16. Today, the current valuation for the S&P 500 Index is approximately 25. While not a perfect measure, comparing the current S&P 500 Index price-to-earnings ratio to historical norms can tell us in a general sense if stocks are over- or under-valued. Today, stocks seem expensive.

To be clear, equity valuations are skewed somewhat by the mega-cap growth companies that dominate the S&P 500 Index. Indeed, there are pockets in the equity markets that trade closer to historical valuations. But the path forward for stocks seems like a rough one at this point, at least in terms of achieving not only the returns that bonds can now provide, but also providing a sufficient equity risk premium.

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Q: Does war in the Middle East pose a threat to the global economy and markets?

The obvious answer is yes but the subtle answer might be, only a little bit. Market data over dozens of conflicts and wars that have occurred over the last 5 decades suggest the impact is almost always forecasted to be greater than reality. Russia invading Ukraine threatening the start of WWIII? A few missiles from North Korea? Markets argue probably no big deal. I believe the markets have developed a mentality of resilience that believe any impact would be so short-term in nature that there is no reason to even react when something like a terrorist attack or invasion occurs. The death toll from the Hamas attacks in Israel, on a per capita basis, was equivalent to three "9-11's" and yet the markets barely reacted.

At the end of the day, markets should trade on earnings and growth and the ability for companies to deliver economic benefit to their shareholders by way of dividends and capital appreciation. If a war, attack, or invasion does not impede a company's ability to create shareholder value, there is no reason for that company to see a selloff of their stock. The reality is that markets do not always reward companies with strong balance sheets and growing earnings or punish companies with loads of debt and negative earnings. The result is that markets can rise during geopolitical turbulence and fall based on inoculant news like OPEC cutting production targets.

There's always a degree of uncertainty with conflict in the middle east, but unless the war escalates materially it's not likely to pose a meaningful threat to the global economy and markets. The business cycle, with tighter monetary policy and recession concerns, will weigh more on the market than the conflict in the Middle East. Based on research from JP Morgan, historically, geopolitical conflicts like what is currently unfolding generally don't have long-lasting effects on the markets. There is a caveat, however.

If the conflict extends beyond Hamas and Israel and to a broader regional conflict, the markets will take notice. For example, if Iran and Hezbollah enter the fray, then there could be disruptions in the oil market. Iran could impose sanctions that could restrict the supply of oil through the Strait of Hormuz. If you recall, when Russia invaded the Ukraine, there was a spike in oil. A similar situation could occur if Iran becomes enthralled in the conflict. Lower supply means higher energy costs which in turn could stoke inflation fears. We're now at the point where it seems that the Fed has brought inflation under control through its rate hikes without pushing the economy into a recession (at least for now). An oil supply shock could change the narrative and rattle the markets in the short run.

Q: Where does gold and precious metals go from here?

I have to think any alternative to fiat currencies will be higher over the next decade although I expect that volatility in these asset classes will be significant over that period. A lot of people ask my opinion on the potential for the US dollar to collapse as China's currency emerges and countries increasingly settle trade in something other than USD's causing the greenback to lose its status as reserve currency. Others suggest that bitcoin and other digital currency, maybe even those introduced by sovereign governments, will be the end of fiat currencies and benefit their substitutes. I do not believe trade occurring in non-USD settlement or digital currencies pose much a risk to the dollar, but debt levels do. The US national debt, fueled by annual deficits, is the threat to a stable USD and what could cause USD-alternatives like gold and precious metals to climb.

I think the debt of the so-called "Developed" world is unsustainable and headed for a collapse if responsible leaders do not quickly emerge. When banks loan money to individuals or companies that they know cannot be repaid, there is not a lot of sympathy when they have to write-off a bad debt. When major economies cannot service their debt without printing more money, the end is near, and it is only a matter of time before a collapse. I view gold and precious metals as insurance against the absolute collapse of fiat currencies and encourage holding it with that in mind.

Gold started the year at about $1813/oz and is currently trading at about $1988/oz, or roughly 10% higher. Gold is often considered a safe haven asset, particularly as an inflation hedge due to its scarce supply. Gold's rise this year is not too surprising considering that inflation, as measured by CPI, is still above the Federal Reserve's long-run target of 2%. The central bank could very well raise interest rates one more time. If inflation expectations remain elevated, then the demand for gold should remain elevated as well. Likewise, should the war in the Middle East escalate unexpectedly, the price of gold would likely move higher.

However, if market sentiment is that inflation has peaked or is heading lower, there might not be much upside for gold. Remember, gold is a store of value due to its scarcity but does not pay interest or produce anything of economic value. Today, for example, investors can lend money to the US Treasury for two years and get a roughly 5% coupon in return. This hasn't been the case in nearly 15 years. The one catalyst that would likely move gold higher is if US Treasuries, or sovereign bonds in general, are no longer perceived as risk-free. This scenario would likely be a tailwind for gold.

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9250 E. Costilla Avenue, Suite 110.

Greenwood Village, CO 80112

Phone: 720.361.4016

Email: info@pcmstrategies.com

Website: www.pcmstrategies.com

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