PCM
PEAK CAPITAL MANAGEMENT

A Soft Landing, of Sorts

PCM Report January 2024 Volume 15, Issue 1

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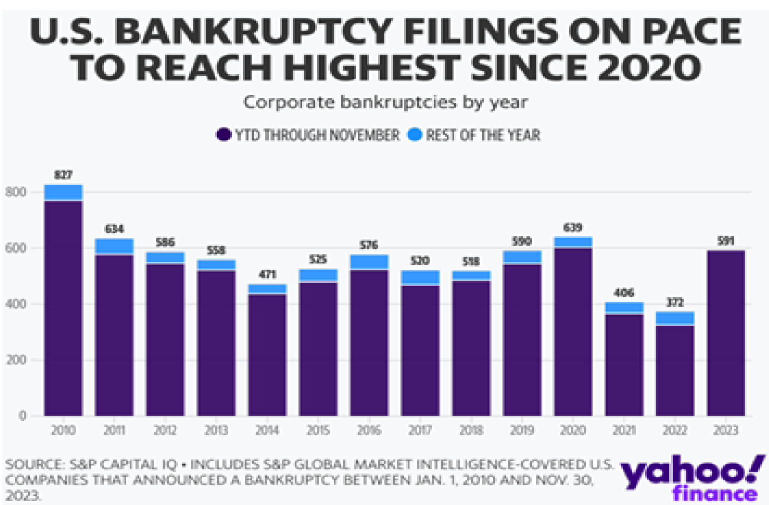
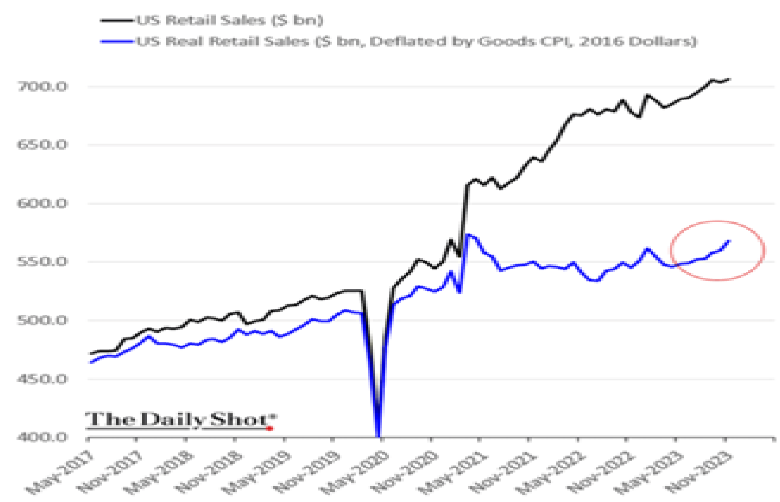
You can count me in the group that a year ago that thought there was a higher likelihood of a White Christmas in Puerto Rico than the Fed being able to navigate to a soft landing for the economy. Too far, too fast; lag time on impact of rate hikes; and bone crushing consumer debt rates were all reasons a recession seemed baked in the cake for the US economy. The Fed's ability to tame inflation, core PCE remained stubbornly at 5% until recent and seems to be trending down to 3% and end their rate hiking cycle without causing a recession should be applauded.

While it has been a holly, jolly stock market for most investors, not everyone has enjoyed the bumpy ride. As the chart below shows, bankruptcy filings will rise in 2023 to the highest level since 2020, nearly doubling last year's tally. Big name retailers like Bed, Bath & Beyond and David's Bridal (2nd BK in 5 years) and Rite Aid were forced into bankruptcy. Former tech unicorn, We Work, filed one of the largest bankruptcies on record and Silicon Valley Bank nearly brought down the entire banking sector with their bankruptcy. Bankruptcies do not typically spike during good economic times, but it is a symbol of how the economy is changing and will continue to with, among other factors, greater influence by AI.



The most recent data suggest Germany may already be in a recession and the UK is likely to be in a recession by 2Q24 if current trends continue. China's policy makers are unveiling some of the most aggressive economic growth policies in decades trying to pull their economy out of what appears to be a real estate tailspin. Yet the US economy is actually accelerating according to many data points. Take retail sales, they have looked impressive on a nominal basis but, after adjusting for inflation, just recently have surpassed 2020 levels and are climbing. Whether retail sales can continue to grow given ultra-high levels of consumer debt averaging an eye popping 24.25% according to a December 2023 report by Forbes. The Atlanta Fed's GDPNow, a volatile but historically accurate early look at GDP, has risen from 1% in early December to a 2.6% estimated growth for Q4 today.



Even skeptics like me have to acknowledge that maybe the Fed has successfully created a soft landing and a recession is not in the cards for the foreseeable future. If 500 basis points of rate hikes over 18 months did not cause a recession, it seems unlikely that Fed rate cuts in 2024 will result in a contraction. There are still plenty of headwinds facing the economy. As noted, credit card interest rates are above 24% and have climbed more than $225 billion in less than 2 years. Total credit card debt stands at an all-time high of $1.08 trillion according to the New York Fed. There are also billions in commercial real estate losses that have not been realized that could spark another banking crisis.

> **"While it has been a holly, jolly stock market for most investors, not everyone has enjoyed the bumpy ride."**

The rise in equities since the pullback in October have taken valuations to historically high levels and investor complacency seems high given data like the put/call ratio. Many are expecting the Fed to announce when rate hikes will begin during the first quarter believing it will lead to further gains in the stock market. Investors have taken their mantra from Franklin D Roosevelt's 1933 Inaugural address, "The only thing we have to fear is fear itself." That bold approach has worked well for aggressive investors, particularly as market breadth has expanded off the October lows. I still believe risk remains elevated given valuations but would not be surprised to see markets hit new highs if the Fed announces plans for rate hikes in 2024.

Buffett's Cash Hoard

Recent news reports noted that famed investor Warren Buffett's Berkshire Hathaway is now sitting on a pile of cash totaling $157.2 billion as of September 30. Most of the cash is said to be in short-term Treasuries generating significant cash flow for the company. Reports indicate Buffett and team see a dearth of opportunity to make acquisitions in the current environment causing them to remain largely on the sidelines over concerns the broad economy may still struggle from the rate hikes. The stock of Berkshire Hathaway surged to an all-time high in September as investors demonstrated confidence in the value buyer. The largest investment the company made in the most recent quarter was purchasing shares in Occidental Petroleum and acquiring property and casualty re-insurance company Alleghany Corp in a $11.6 billion transaction.

- Berkshire Hathaway's portfolio contains around 60 publicly traded stocks but 70% of that is held in just 4 tickers: AAPL (47.5%), BAC (9.4%), AMEX (7.6%), and KO (6.3%).
- The company has shown confidence in its current holdings as evidenced by actively repurchasing shares of the stock. The company buybacks of $1.1B in Q3 and $7B through the first 9 months of the year.
- Berkshire Hathaway is famously known to own household names like Geico Insurance, BNSF Railroad, See's Candies, Clayton Homes, Heinz, Net Jets, Benjamin Moore Paints, and many others.

10-Year Treasury Yield

Investors have enjoyed a late-year rally in stocks, as measured by the S&P 500 Index. The benchmark has risen by roughly 15% since the October lows earlier this year. It's no coincidence that the recent rally – which has been broad based and not just limited to mega-cap AI stocks – has coincided with a pullback in longer-term interest rates. The chart to the right shows the yield of a constant maturity 10-year Treasury. After peaking at roughly 5% the yield has pulled back below 4%, or a roughly 1% retracement.

- Long-term yields reflect market expectations, and the recent pullback suggests that investors are pricing in a rate cut from the Fed next year. This could set the stage for a continued rally in stocks that could have broad support beyond mega-cap tech stocks.
- The spread between ten- and two-year Treasury yields has narrowed somewhat but remains negative. The spread has tightened to roughly -0.4% to from almost -1.0% in June. If an inverted yield curve is a recessionary signal, then the chances of avoiding a recession have improved somewhat. Indeed, if the shorter-term trend continues and the spread continues to improve, then the Fed might be able to manufacture a soft landing.

Broad Market Rally

Up until November, 2023 was going to be known as the year of the Magnificent 7; where these few names were almost entirely responsible for much of the S&P 500's gain for the year. However, after a rough end to Q3, we saw a broader participation in market performance from other areas of the market, specifically mid- and small-cap stocks. In the chart below of the iShares Core S&P Small-Cap ETF (IJR), not only will you see the rise of 24.5% since November 1st compared to only a 13.75% return of the S&P 500, but also broke through a major resistance level of $108 after consolidating in a range going back to April 2022. Even with a dramatic rise of late, many notable investors, such as Fundstrat Global Advisors and Villere & CO., are still very bullish on the asset class and hope to see a continuation in 2024.

- Fundstrat Global Advisors Managing Partner Tom Lee recently appeared in an interview on CNBC where he mentioned his belief that Small Cap stocks could possibly climb an additional 50% in the next 12 months.
- With Small Caps still trading at more than 20% off of their all-time highs compared to only 0.67% on the S&P 500, there appears to be potentially significant upside left in this area of the market.

Quinn VandeKoppel

Macro View – Recession still in the cards?

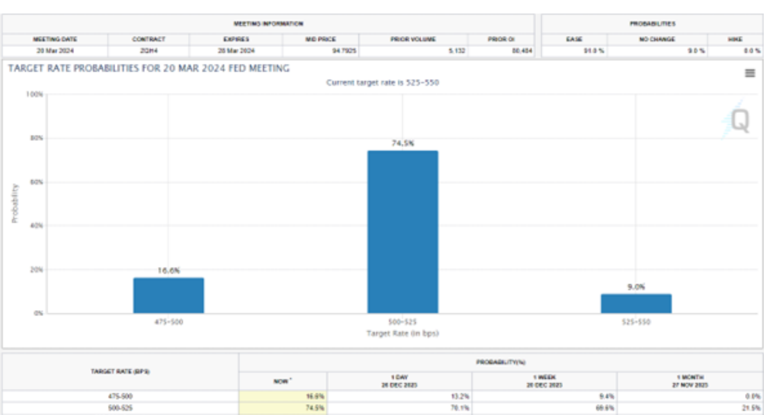
As we approach the end of the year, it appears the forecasted economic downturn was avoided in 2023, to the surprise of many. In a year where we saw regional bank failures, the highest inflation in decades, and historic increases in the Fed Funds rate, markets and the consumer proved to be resilient through it all. Now, as we look to 2024, some are still optimistic that a recession can be avoided. However, according to a December survey from the National Association for Business Economics, "more than three-fourths of economists — 76% — said they believe the chances of a recession in the next 12 months is 50% or less". Even if we were to see a downturn occur, that does not necessarily mean it has to be dramatic, with many, including UBS and Bank of America, predicating it will be more of a "mild" recession if any.

Taking Stock – Looking Back at the Santa Claus Rally

Every year, investors wish for the so-called year-end "Santa Claus Rally". Well, it appears that investors received exactly what they asked for. Off of the late-October lows, the S&P 500 Index rose 16.5% and is just one percent off of its all-time high as of the time of this writing. Not only did the S&P 500 provide a year-end rally, but other areas of the market that have lagged throughout the year, such as mid-and-small -cap stocks, rose 20.7% and 25.2% respectively. This broad market rally was certainly on the wish list for those who failed to hold meaningful allocations to the magnificent 7. As the Federal Reserve points as numerous interest rate cuts next year, many of these areas that underperformed in 2023 should benefit in 2024.

Fixed Income – Fixed Income 2024 Outlook

After a few rough years as a bond investor, many should be very much looking forward to what's to come in 2024 and beyond. As the economic data is set to potentially moderate and the Federal Reserve begins to take a more balanced policy stance in 2024, the backdrop for bonds appears extraordinarily compelling. Historically speaking, fixed income assets have tended to perform very well after the Fed has paused its interest rate hikes, when the Fed Funds rate has been greater than the rate of inflation, and when the yield curve has begun to de-invert. Whether looking at current yields relative to volatility, or at the pricing of forward markets, where markets currently stand today offers the opposite of what we saw heading into 2021, which could create the potential for very generous returns in the years ahead.



Technical – Short term bounce for Long Term Yields

The picture below shows a weekly chart of the iShares 20+ Year Treasury Bond ETF (TLT) going back to January 2022. After bottoming out with the rest of the market in late October, the long-duration Treasury ETF has risen almost 20%. However, after the recent rally, the treasury ETF is hovering below a major support/resistance level. With positive optimism around the Federal Reserve cutting interest rates as early as March of next year, I would not be surprised if we see a continuation before we are met with more resistance around the 100-109 price range. However, because the fund is a bit extended on the daily RSI (70), there could be some consolidation at these price levels before a direction is established.

Return of the Bond Hedge?

Clint Pekrul, CFA

The notion that holding bonds in conjunction with equities to manage portfolio risk was put to the test in 2022, and, to a lesser degree, for much of 2023. The reason is simple – higher interest rates repriced most asset classes lower, including both stocks and bonds. For most investors, particularly for those without alternative investment strategies or long-only allocations, there was no reprieve from the deleterious effects of soaring interest rates.

Many investors might now question the efficacy of their investment policy. Afterall, why hold bonds in combination with stocks if both asset classes exhibit similar volatility and correlated price movements? The point of diversification is to prevent your portfolio from looking like a single bet, completely exposed to a single factor, such as interest rate risk.

While the notion of the "60/40" balanced portfolio has come under fire by advisors and academics alike, we are indeed in a different place now compared to a few years ago. Most notably, the forward risk-adjusted return expectation for bonds today is light years away from the onset of Covid in 2020, when we essentially hit the lower zero bound for interest rates.

There was nowhere to go as the secular decline in rates that began in the early 1980s effectively hit the floor. Coupons were more-or-less nonexistent. The only way out was to push the reset button, which is basically what happened in 2022. Perhaps the worst for the bond market is behind us. If so, there is reason to believe that bonds could once again play a role as an equity risk diversifier.

Consider why bonds have hedged equity volatility historically. What typically disrupts the stock market the most are unexpected events, or what academics and economists call black swans, exogeneous shocks, crises, or contagions. These events are only understood and studied in retrospect.

In the moment, however, investors have typically responded by shifting to the relative safety of bonds, particularly those issued by the US Treasury, which in theory have no default risk. As demand for bonds increases, yields are pushed lower, typically in rapid fashion, and bond valuations are consequently pushed higher.

In theory, higher bond valuations help offset losses on the equity side of the portfolio. When the outlook for stocks is uncertain, bonds are there to help mitigate the risk. Historically, investors would bide their time in bonds, collect a coupon, realize some capital appreciation and wait for equity volatility to subside. Hence, the rationale for the "60/40" portfolio.

What occurred over the past four decades via a secular decline in interest rates, however, was a gradual structural change in the fixed income market. Investors could still hedge their equity side of their portfolio with bonds, but it was increasingly through capital appreciation and less through the coupon payments.

This dynamic extended the overall duration of the bond market and made fixed income securities more susceptible to the slightest change in interest rates. The rubber band was stretched, so to speak, until it snapped in 2022. The Fed tightened and both stocks and bonds fell precipitously.

Today, the return expectation for bonds isn't quite as asymmetric as before. Lifting above the zero-interest rate bound has given investors a cushion should the Fed decide to lower interest rates when the next crisis comes along. Investors can generate income and reasonably expect a rally in bond prices at a time when stocks come under pressure.

Consider a simple example using duration, which measures the approximate change in a bond's price for a one percent move in interest rates. Today, the duration for a long-term Treasury bond portfolio is roughly seven, which suggests that for a percentage change in interest rates, the value of a long-term Treasury bond portfolio will change by roughly 7%.

We think a move lower in interest rates today is probably more likely than a move higher, considering the action the Fed has taken since 2022 and recent moves in CPI. If the Fed is forced to ease monetary conditions for whatever adverse scenario – a credit crisis, terrorist attack, pandemic, etc. – then the return prospects for bonds look attractive. Investors can lock in current yields of 4% - 5% and capture upside appreciation through duration.

There are two scenarios, however, that would jeopardize the effectiveness of bonds as an equity hedge. First, if the Fed is forced to further tighten the monetary supply due to higher inflation, then bond prices will fall (likely in conjunction with stocks). Second, if the creditworthiness of the U.S. Treasury becomes suspect, then the relative safety of U.S. sovereign debt might not hold. This type of credit event could likely send both stocks and bonds lower in favor of cash.

In summary it seems like bonds are much better positioned to hedge potential equity volatility going forward compared to a few years ago. Portfolio diversification, which essentially disappeared in 2022 for the "60/40" portfolio might start working again.

Q: When do you anticipate the first rate cut by the Fed in 2024?

Let's start with what the Fed wants the market to believe based on the December 13 update to their Dot Plot that shows the range of expected changes by voting members of the Fed. The latest update shows the Fed plans to cut Fed Funds rates by 2.50% by the end of 2026. This would move the rate from the current 5.25%-5.50% range to 2.75%-3.0% range over the next 2 years. There is expected to be .75% in rate cuts next year, mostly in the 2nd half of 2024. The estimates are based on the Fed's assumptions for inflation, employment and GDP growth so as future data is revealed the Dot Plot can change quickly.

I had expected the Fed to start rate cuts in the 2nd quarter of 2024 and also assumed they would need to cut a minimum of 100 basis points in 2024. That assumed a recession in early 2024 that may not materialize unless the current economic growth trend reverses. It has been my assumption that higher mortgage rates and rising credit card balances and interest rates would dampen consumer spending and slow growth which has not yet occurred. I am closely watching the labor market for signs of weakness. The private sector only created about ½ of the jobs in 2023 compared to 2022 (183,000/month vs 376,000/month) but the population/employment ratio continues to improve and unemployment remains at 3.7% suggesting jobs are plentiful and the Fed does not need to rush to rate cuts.

Predicting what the Fed is going to do with respect to monetary policy is almost akin to throwing darts at a board. I recall in 2018, when the Fed insinuated that tighter monetary policy was on the horizon, the markets threw a tantrum and the S&P 500 dipped roughly -20%. Then, somewhat inexplicably, the Fed pivoted, and suddenly higher rates were no longer on the table. The market responded accordingly to the "lower-for-longer" sugar high and the S&P 500 soared to record levels. Then came Covid in 2020 and the tsunami of government stimulus that followed. The inevitable inflation was only transitory, claimed the Fed, and rates remained at record lows until it became evident that inflation was stickier than predicted. Rates went from basically zero to over 5% in 2022.

If I wagered a guess, with slightly higher than 50% probability, interest rates are set to go lower in the second half of 2024. Powell doesn't want to cut too soon and stoke inflation, thus reversing the progress they have made so far. Likewise, the Fed will feel the pressure for keeping rates too high for too long, particularly if the economy slows. It's a wait and see game that's dependent on the data. Based on recent market performance, it seems like investors are betting on at least one cut next year.

Q: What are some surprises you expect in 2024?

I think some level of decoupling between the markets and economy is inevitable in 2024. Valuations are high across the board but especially so in the tech-laden Nasdaq. Technology represents the same percentage of the broad market indices as it did in the Summer of 2000, just before the Nasdaq bubble burst. I am not expecting a drop of 40% in the Nasdaq in 2024 but I think it could give back 50% of the gains from this year leaving growth investors scrambling. There is nearly $5 trillion in government debt that needs to be refinanced in 2024 that may keep yields higher than people expect even with Fed rate cuts. More concerning for investors, I think the spread between high quality (government and AA/AAA) and low quality (below BBB) will blow out in 2024 creating double-digit losses for many high yield bond investors. Junk bonds today pay on average 3.3% above a similar duration Treasury bond and that will change rapidly if corporate bond defaults rise from 4% today to near 8% next year.

On the upside, I think large logistic companies could have a very good 2024 as a result of companies continuing efforts to re-shore manufacturing. There are also efforts by some to move certain types of manufacturing into space where zero gravity provides real benefits. This is happening with microchip development as well as chemical compounding for pharmaceuticals. We are still at the tip of the spear on this but expect it to gain traction in the coming year.

Firstly, with respect to stocks, I think we could see a "catch-up" trade in 2024. As we've reported numerous times this year, broad swaths, or sectors, of the market have been left behind this year in the wake of the AI rally in mega-cap growth companies. The dispersion of returns has been substantial. I'm not suggesting that the AI rally has run out of steam – the growth potential from this technology is promising for years to come. But from a pure valuation standpoint, parts of the market look cheap today. As companies have adapted to higher interest rates, perhaps their future is a bit clearer going forward. A rotation within the equity markets could narrow the performance dispersion we saw this year. Indeed, a rising tide could lift more boats in 2024.

Secondly, if the Fed does indeed lower interest rates in 2024, bonds could provide attractive risk-adjusted returns and perhaps even rival stocks in terms of absolute performance. This would come after a disastrous run in 2022. Unlike the past fifteen years, bond investors can now clip coupons rather than rely solely on capital appreciation via declining rates. Combining income potential with the prospect of a modest rate reduction could provide a tailwind for fixed income. By most technical measures, bonds are in oversold territory heading into 2024.

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