PCM

PEAK CAPITAL MANAGEMENT

Peering through the Haze

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The art, and possibly science, of forecasting took a major hit in 2020 when the pandemic left the global economy in shatters and responses from Central Banks and governments ranged from the unthinkable to the absurd. Economic theory could be thrown out the window as governments simply invented strategies to avoid economic depression when economies literally closed and private companies were forced to close for extended periods of time. Helicopter money, a phrase made famous in a paper penned by Nobel economist Milton Friedman in 1969, became a reality even though no actual helicopters were utilized.

It turns out that paying people NOT to work for extended periods of time has adverse consequences. When free money from the government finally ended, companies were in desperate need for labor that often preferred to stay home rather than work. Wages had to rise, and ultimately higher prices were passed along to consumers. Inflation was reported to be around 6% or 7% but for most people, actual inflation felt like 15% to 20%. Debt has skyrocketed as evidenced by the US government needing to borrow $1 trillion in just the 3rd quarter alone. Global economies have been held together by bailing wire and duct tape as the markets whistle while walking past the graveyard.

Markets rely on confidence, from consumers and businesses. Both are falling dramatically right now. The Dallas Fed Manufacturing Index was expected to come in at -16% last month but was -20% instead. New Order growth rate fell to -25.4% last month, the lowest since the depths of Covid-related shutdowns. Capacity Utilization fell 10.1% in October reminiscent to the March 2020 period.

> **“Creating a market forecast for 2024 feels like looking through a smoke-filled room trying to find someone on the opposite side.”**

Not all news is dismal, however. Consumer discretionary income has remained resilient as witnessed by November travel which finally exceeded pre-pandemic levels. Bloomberg’s consensus estimate for 2024 GDP growth sits at 1.2%, up from 0.6% a couple of months ago. Home prices and sale data have remained surprisingly strong in the face of the highest mortgage rates in several decades.

Globally, growth is challenged by debt levels in Europe and the reversal of the wealth effect in China as property values have fallen dramatically along with the Chinese stock market. The low-cost, easily available credit that drove asset prices higher since the conclusion of the Great Recession of 2007 has gone away and replaced by restricted lending and high rates to combat inflation.

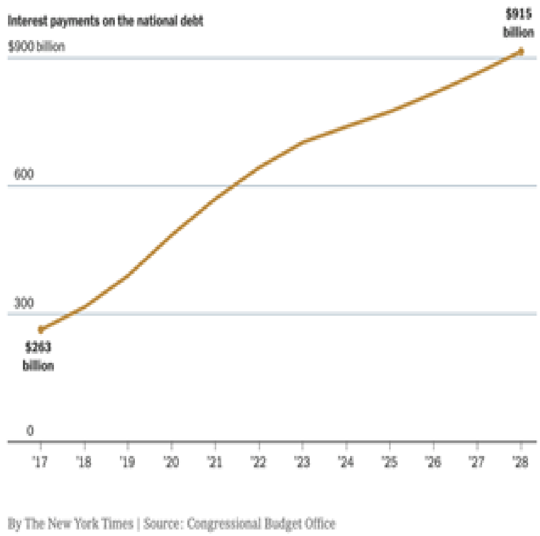
Market optimists are betting on inflationary pressure being behind us, but the data suggests something else. For example, demographics suggest inflation may remain high as the workforce ages and population growth rates continue their decline. China has seen its birth rate decline by 50% over the last 10 years to below replacement rates for retiring workers. This has been true in Europe for decades and the US is on the verge of joining that unenviable club. Rising government debt levels are also inflationary and many countries, the US included, likely have no option for repaying their debt other than to monetize the debt through inflation. The Fed may claim to have a target inflation rate of 2% but the reality is 4% to 5% inflation is needed to mitigate the impact of high debt-to-GDP levels.

Creating a market forecast for 2024 feels like looking through a smoke-filled room trying to find someone on the opposite side. You may see something that looks familiar, but you are still guessing. The data is mixed and unreliable at best. If inflation does persist, the Fed may have no choice other than to keep monetary policy restrictive, which means a very difficult year for the economy and markets. A mild recession might be the best possible solution as that would see unemployment rise, labor markets soften, and have the potential to see inflation ease. It is a strange world where a recession seems to be the best hope for the markets.

I am closely watching the ratio between the S&P 500 and gold as a possible leading indicator for a serious bear market in 2024. The ratio has changed dramatically over the years from over 600 in the 1930’s and 1940’s to as low as 32 in the early 1980’s. The important data point is where it stands over its long-term moving average. The ratio has been above its long-term average the last decade but has recently traded right at that average. A sustained move below that average would be a warning that stocks could be in for a very bumpy ride in 2024.

If we learned anything from 2023 it is that safe havens can be a mirage. Speculative companies producing nominal earnings with weak balance sheets tended to outperform dividend paying companies with strong earnings and little or no debt. The only thing we can be certain of is that the future is uncertain.

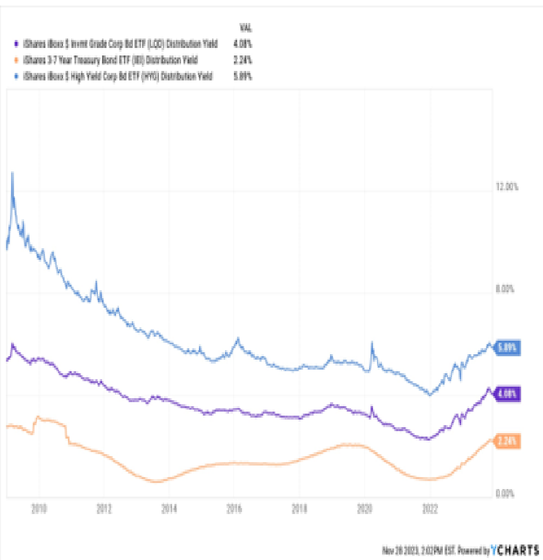
Wanting a Do Over



Officials at the US Treasury Department would like a do over. Remember passing on Apple below $10 in the mid-1980's? How about Google at $9/share in 2008? Or Tesla at $25/share in 2016? We all have regrets about passing up opportunities but maybe none larger than Treasury officials and the decisions they made regarding US debt. As recent as 2020, when short-term interest rates were almost 0% and long rates were at generational lows, the Treasury had 33% of their debt come due. It was the perfect opportunity to lock up maturing debt at long-term rates but instead, officials rolled the dice that rates would remain low. Fast forward to 2024 where 31% of all US government debt will mature and have to be placed at significantly higher rates for 1-year paper than 30-year paper was 3 years earlier.

- Interest payments as a percentage of GDP have ranged from 1% to 1.5% for most of the last 80 years but have risen to almost 2% and may hit 3% of GDP by the end of 2024.
- The weighted average of all US Treasury debt stands at 2.97% today, up from 2.07% last year and just 1.61% in 2021. It could hit 4% by the end of 2024.
- The Treasury was forced to pay $76 billion in interest payments in October 2023 representing a 77% increase from the $43 billion it paid in October 2022

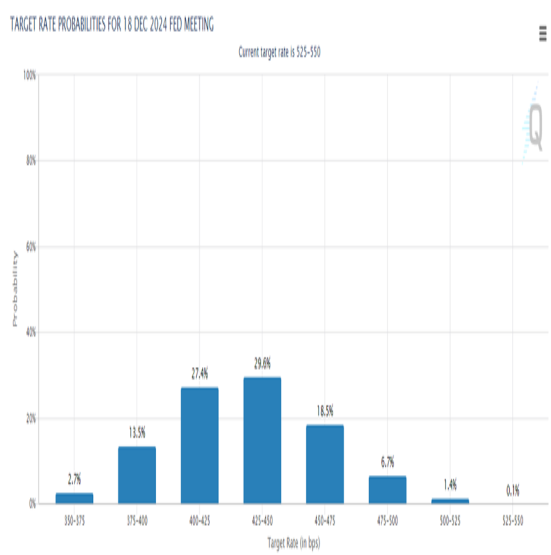
Credit Spreads



Credit spreads measure the compensation investors receive in terms of yield for assuming default risk and is quantified by the yield premium over U.S. Treasuries over comparable maturities. The chart to the right illustrates the distribution yields of the iShares 3-7 Year Treasury ETF (IEI), the iShares Investment Grade Corporate ETF (LQD) and SPDR Corporate High Yield ETF (JNK) going back to 2009. The spread for corporate bonds reflects expectations about profitability and the business cycle. Since the financial crisis, spreads have tightened largely due to improved corporate balance sheets and an accommodative Fed. But 2024 could pose a challenging scenario if interest rates remain elevated, which is the current consensus.

- According to data from Morgan Stanley, roughly $2.6 trillion in corporate debt will need to be refinanced at higher rates between 2024 and 2025. While cash balances are at healthy levels now, refinancing could prove challenging if corporate profits don't improve. If true, and conditions worsen beyond expectations, credit spreads should widen from current levels.
- Financing costs will impact sectors of the economy differently. Despite short-term headwinds, higher yields could present an opportunity for credit investors, particularly for companies that can right size their balance sheets to cover higher interest costs.

Time to Cut



After a disastrous last few months of market performance where we saw the S&P 500 TR Index fall by 8.25%, the market cap weighted index has rebounded by more than 11% as of the time of this writing from the October lows. While one could certainly point at one of many technical indicators to rationalize the bounce, the market's hope that the Federal Reserve is going to start cutting interest rates aggressively in 2024 could potentially be the driving factor. While traders appear to have more certainty than Fed officials, Fed Chair Powell has maintained his stance of being data-dependent and maintain current target rate levels until the Fed sees "convincing evidence" to suggest a change in tide.

- According to the CME's FedWatch Tool, indications suggest the there is a 29.6% probability that the Federal Reserve will cut its target rate by one percentage point, and a 26.6% probability there will be a 1.25% rate cut.
- Futures pricing Tuesday indicated no probability of additional hikes this year and the first quarter percentage point cut coming in May 24', followed by another in June or July, and likely two more before the end of 2024.

Quinn VandeKoppel

Macro View – Rising Debt

Earlier this month, Bridgewater Associates Founder Ray Dalio appeared on CNBC to discuss the current state of the economy and the rapid rise of the U.S. Government's debt. According to the US Treasury Department, the U.S. has $33.8 trillion of debt, a total that exploded by 45% since the COVID pandemic in early 2020. In Dalio's eyes, he believes that borrowing will continue, and will only exacerbate the political and social problems the country is facing. When rates were near zero, the cost of borrowing was cheap, and nobody batted an eye. However, as the Federal Reserve rapidly increased interest rates to combat inflation, the interest has begun to accumulate. Just this year, the government has spent $659 billion on net interest costs, and will only accumulate further unless spending is reduced and/or interest rates fall towards manageable levels.

Fixed Income – Falling like a Rock

Over the last month, we've seen the 10 Year Treasury Note Yield fall like a rock from 5% to 4.27% as of the time of this writing, equating to a 14.6% decline. This decline marks the first time since September that the benchmark rate traded below 4.3%. With one final Federal Reserve meeting scheduled for this year on Dec. 12th-13th, markets are expecting the central bank to keep rates unchanged and are hoping for hints about when policymakers believe rates could come back down. Investors also assessed the outlook for interest rates as they digested hopeful comments from Federal Reserve Governor Christopher Waller, who said earlier this month that monetary policy was "well positioned" to achieve the Fed's goals of slowing the economy and lowering inflation. Many took this as a sign that the central bank could be done hiking interest rates.

Taking Stock – An Investing Legend

Earlier this week, the world lost Charlie Munger, an investing legend, at the age of 99. It is hard to encapsulate the impact Charlie had on many in few words but was truly a pioneer when it came to "Value Investing". Munger, who was Warren Buffet's right-hand man at Berkshire Hathaway since 1978, helped build Berkshire into one of the most successful and long-lasting business partnerships. In a statement, Buffet said that "Berkshire Hathaway could not have been built to its present status without Charlie's inspiration, wisdom and participation". As the world moves on, we will certainly miss his maxims about business, investing, and life, especially during the annual Berkshire shareholder meetings.

Technical – Possible Double Top

After a dismal Q3 and start of Q4, major indices like the S&P 500 Index have roared back with authority and are on track to finish the month up by almost 10%. As of the time of this writing, the S&P 500 Index closed just 1.22% from its high earlier this year and just 5.56% off its all-time high of 4,818.62 back in January 2022. As we closely approach the high from earlier this year, I believe it's important to point out that a possible Double Top pattern could be forming if the S&P 500 reaches and surpasses that level. A Double Top is widely considered an extremely bearish technical reversal pattern and would be confirmed once the indices price falls below a support level equal to the low between the two prior highs, around 4,400. We are still in the beginning stages of a possible reversal pattern, but after the move we've had over the last month, I would not be surprised if there's some year-end selling by both money managers and investors.

Technical Watch

Clint Pekrul, CFA

As we approach the end of the year it is helpful to take a snapshot of current technical across the equity market. With the November rally, both domestic and international stocks have gapped above their 50- and 200- day moving averages, based on the S&P 500 and MSCI EAFE Indexes. Meanwhile, emerging markets remain in a bottom support range based on the MSCI Emerging Markets Index.

Domestic Equities – S&P 500 Index

After breaking below the 50-day moving average in late October, the S&P 500 (SPY) has notched higher by roughly 11% and is testing the levels of late July. The move higher has helped sustain the upward trajectory of the longer-term 200-day moving average. Still, SPY is roughly 6% below its all-time high back in 2021.

Developed Markets – MSCI EAFE Index

Like the S&P 500, developed markets, as measured by the MSCI EAFE Index (EFA) broke above its 50-day moving average with the November rally, although not to the same extent as SPY. The 50-day moving average exceeded its 200-day counterpart.
However, the direction of the 200-day moving average is more-or-less flat since the lows of October 2022. The EFA is still roughly 11% below its highs reached in 2021.

Emerging Markets – MSCI Emerging Markets Index

In contrast to domestic and developed market equities, emerging market stocks, as measured by the MSCI Emerging Markets Index, have somewhat languished as evidenced by a declining 200-day moving average. While current levels have broken through the 50-day moving average, emerging markets have traded in a narrow range over the past year.

Interestingly, when the S&P 500 traded above both its 50- and 200-day moving average at the end of November, the index returned, on average, 7% through the first half of the subsequent year going back to 1994. The table below illustrates the results:

November Ending:	Subsequent Return (Through June):
1995	10%
1996	16%
1997	19%
1998	18%
1999	5%
2003	8%
2004	2%
2005	1%
2006	8%
2009	-6%
2010	10%
2013	9%
2014	-1%
2015	-1%
2016	10%
2017	3%
2019	-2%
2020	18%

Source: Peak Capital

While just a casual observation, history suggests that based on where the S&P 500 is trading today, past trends suggest that the index will move higher into the first half of next year. Conversely, when the S&P 500 is trading below its short- and long-term moving averages at the end of November over the same period, its subsequent return through the following June is, historically, roughly -2%. Overall, from a technical standpoint, we seem to be in a favorable position relative to historical performance patterns.

Q: What was the biggest financial surprise for the markets in 2023?

There are plenty of options to choose from, but I would probably start at the performance delta between high quality and low-quality stocks this year. In times of uncertainty, which certainly described 2023, stocks with strong balance sheets that pay healthy dividends usually do well as they are deemed less risky than speculative stocks that have limited earnings. That backfired this year as dividend stocks are among the worst performing asset class in equities. Negatively impacted by higher yields and massive outflows after large inflows the prior year, the largest Dividend ETF's are down 5-6% in 2023 while the S&P has marched higher.

A close 2nd place would go to the performance delta between the Cap-Weighted S&P 500 and the Equal-Weighted S&P 500. Virtually all of the gains this year have come from what have been referred to as the Magnificent Seven: Alphabet, Apple, Amazon, Meta, Microsoft, Nvidia, and Tesla. These stocks have driven the cap-weighted index to +18% in 2023 while the equal-weighted S&P languishes up just 3% for the year. On a trailing 5-year basis, the equal weight index slightly outperformed the cap -weight index at the end of 2022 but is now almost 25% higher total return over the last 5 years. The outperformance of 7 stocks has been astonishing. Long-term averages dictate reversion to the mean suggesting it might be an opportune time to allocate to the equal-weight index.

Without question the biggest surprise was the AI rally in mega-cap technology stocks. Rewind to last December and the outlook for stocks was not all that rosy. The Fed had lifted off from zero and interest rates hit levels not seen since before the financial crisis of 2008. The outlook for 2023 suggested below-average returns over the near term and investors were by-and-large positioned defensively. Moreover, cash balances were at elevated levels considering there was no consensus about the Fed's terminal interest rate. Then, in January, the AI rally took off and a handful of mega-cap stocks accelerated higher despite legitimate economic headwinds.

What unfolded over the following months was unusual by historic standards. The dispersion of returns across sectors was considerable, as the market went in two directions. Technology, led by AI innovation, soared on earnings expectations while the rest of the market largely went nowhere. The S&P 500 Index will likely deliver double-digit gains this year but this return masks the rally's weak support. The gains seemed fragile considering the likelihood of a recession. Investors who might have underweighted the largest capitalization stocks likely realized only modest gains for the year. Market leadership typically isn't this narrow so the results this year are somewhat unusual.

Q: What will be the most likely surprises that no one is expecting for 2024?

For investors with a strong threshold for volatility, they might consider buying zero-coupon US Treasury bonds. These are long-term bonds issued by the government that do not provide any yield or coupon payments. Instead, they trade at large discounts to their maturity prices. The ETF 'ZROS' is an easy way to buy zero-coupon bonds. This ETF peaked at $184 in July 2020k before falling to $65 this October. The price has recovered to $75 and while I do not see the price recovering to 2020 levels for many years, they could provide strong returns, potentially in excess of 30% in 2024 if the US economy slips into a recession.

The other surprise I anticipate for 2024 is Emerging Markets. Because of their dependence on developed markets, emerging markets tend to be sensitive to interest rate movements and Central Bank policies. They often borrow in US dollars so when the USD appreciates it is a strong headwind for these economies. Returns in 2023 were not bad but trailed the S&P 500 and Developed Markets by a wide margin. If rates fall in the US there will likely be weakness in the USD that would become a tailwind for Emerging Markets and could lead EM to outperform developed markets and the US markets in 2024. Because of the impact of currency translation, Emerging Market Debt may perform even better than equities with less volatility.

The narrative over the past few years has been higher interest rates and what it means for asset valuations. This narrative is justified, and investors adapted their expectations and portfolio allocations within the context of interest rate levels not seen since 2007. In 2022 investors became largely defensive after the sugar-high returns from 2021, then likely got caught off guard when the AI rally took off in 2023. As we approach the end of the year, I think the consensus is higher-for-longer with respect to interest rates and a soft landing orchestrated by the Fed. Any recession is expected to be modest in terms of GDP contraction.

I think the surprise might be that interest rates come down, albeit to a marginal degree. Next year falls on an election cycle. If there is some improvement to the fiscal outlook and monetary policy turns somewhat dovish, then bonds could recoup some of their losses from the prior two years, particularly with longer duration maturities. Today there is upward pressure on the long end of the yield curve. Looming government shutdowns, U.S. downgrades and bank failures weigh heavy on the current outlook. But should these clouds dissipate then investors could be rewarded with compelling total returns on longer-duration bonds.

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