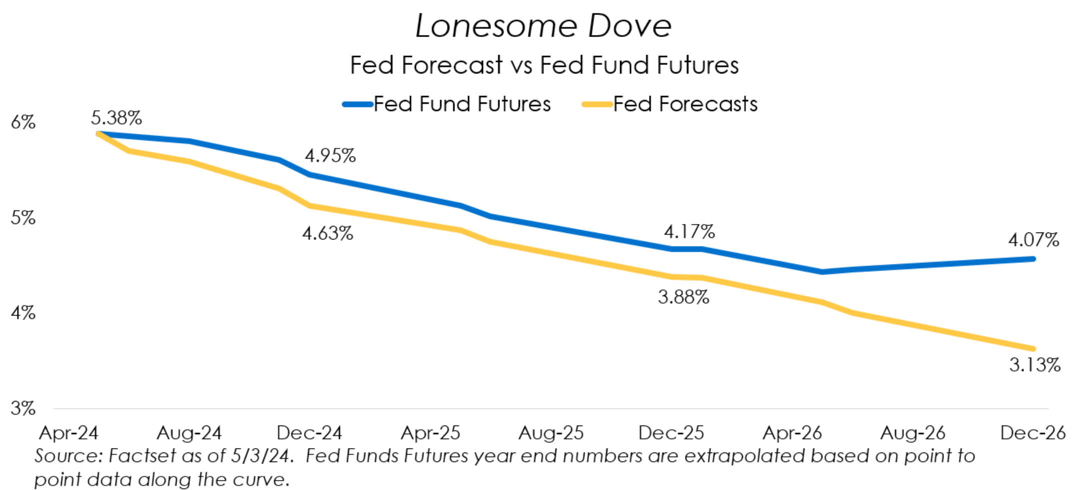
Lonesome Dove

"I guess this'll teach me to be careful about what I promise in the future."

– Captain Woodrow F. Call in *Lonesome Dove* by Larry McMurtry (1985)

This month's inspiration comes from the best-selling and Pulitzer Prize winning novel Lonesome Dove – a western centered around a good 'ol fashioned cattle drive from Texas to Montana. Many an investor, of late, has been focused on the Federal Reserve, often referring to the comments of its policymakers as dovish or hawkish. In investor parlance, dovish commentary is often referred to as a more peaceful lean (down) on interest rates while hawkish commentary is often referred to as a more aggressive lean (up) on interest rates.

Coming into this year, both the bond market and the Federal Reserve were increasingly dovish with expectations for multiple interest rate cuts on the horizon. At the December FOMC meeting, three rate cuts were being forecasted by the end of this year per the Fed "dot plot". The bond market was even more optimistic in forecasting as many as six rate cuts. However, hotter inflation data in each of the first three months of the year has thrown cold water on those dovish expectations. As can be seen in the chart below, the bond markets' expectations for the Fed Funds rate – as measured by the Fed Funds Futures curve – has now moved notably above the rate forecasts last updated by the Fed in March. The FOMC met early this month keeping rates unchanged for a sixth straight meeting. Fed Chair Powell was clear about the Committee being less confident on inflation moving sustainably lower, though he also noted that it would be "unlikely that the next policy rate move will be a hike". The Fed might be becoming a dove of the more lonesome variety. To be fair, the June meeting is the next opportunity for policymakers to update investors with their projections on rates so perhaps the yellow line in the chart will be moving closer to the less dovish orientation out of the bond market. Of course, softer fundamentals could move the bond market's rate expectations back down as well. Time will tell.



Source: Factset as of 5/3/24. Fed Funds Futures year end numbers are extrapolated based on point to point data along the curve.

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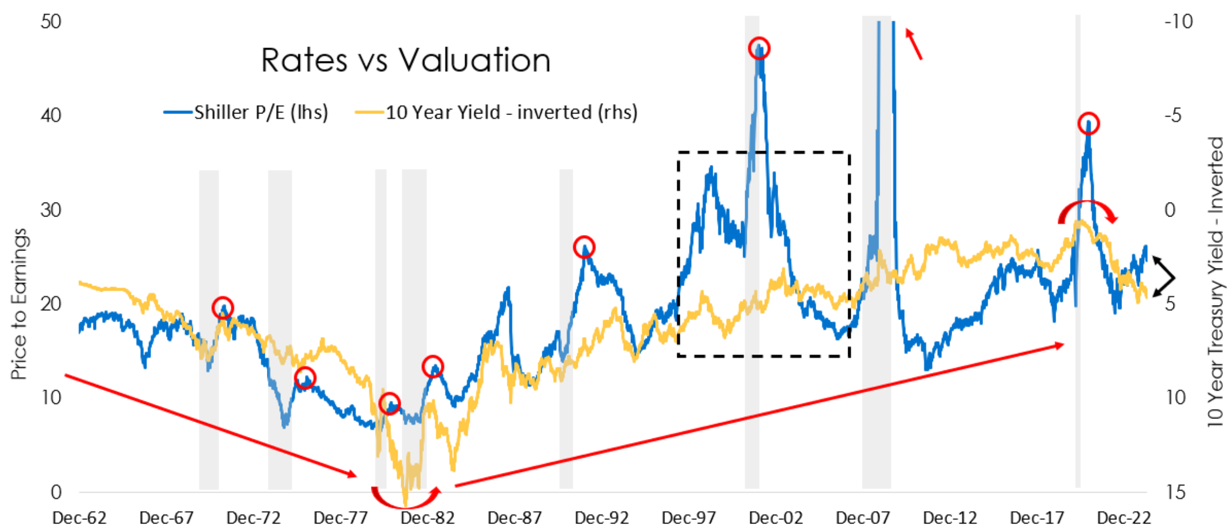
MARKET UPDATE
April 2024

For now, the "higher for longer" mantra is the order of the day – a material change in stance from the year's start. For investors, that raises a new series of questions regarding market implications. The chart below is one that we find very important to digest in helping to understand the range of outcomes across different scenarios. Below lays out the long-term relationship between interest rates (10 Year Yield) and stock valuations (price to earnings or P/E multiples). There are several takeaways of which we think investors should become familiar.

- There's a long-term negative relationship between rates and stock valuations. Rising rates pull down equity valuations and vice versa. Note that the right hand axis for interest rates is inverted.
- Cyclical P/E spikes (red circles) happen around recessions (shaded regions) as earnings decline, but the secular P/E trend resumes in the direction of the underlying rate regime (red arrows).
- The more notable deviations to this were the intra-cycle behavior surrounding the '87 crash, the Tech Bubble unwind and today.
- The jury is out over whether there's been an inflection on the secular rate regime currently. It should be noted that occurrences in '18 and '22 saw rates make higher highs for the first time since the early '80's.
- The current disconnect between rates and valuations (black arrows) will need to get resolved eventually. Several options include (1) rates moving materially lower in line with the higher stock multiple (2) earnings growing substantially leading to a lower stock multiple (3) prices moving materially lower leading to a lower stock multiple.
- A final scenario might be a blow off top in equities (dashed box). Today's multiple is comparable to '98, which ultimately went to 35X by late '99. The equivalent would lead to materially higher stock prices.
- The bottom line is that today's backdrop suggests the possibility of several extreme outcomes as a consequence of the disconnect brewing between rates and valuations.



Source: Factset; P/E is a trailing twelve month calculation based on company reported results from Factset as of January-April 2024. Current 10 Year Yield and P/E as of 4/26/24, Current CPI as of 3/31/24. Historical earnings are taken from Robert Shiller's U.S. Stock Markets 1871-Present and CAPE Ratio (http://www.econ.yale.edu/~shiller/data.htm). P/E truncated from December 2008 to October 2009 due to Great Financial Crisis.

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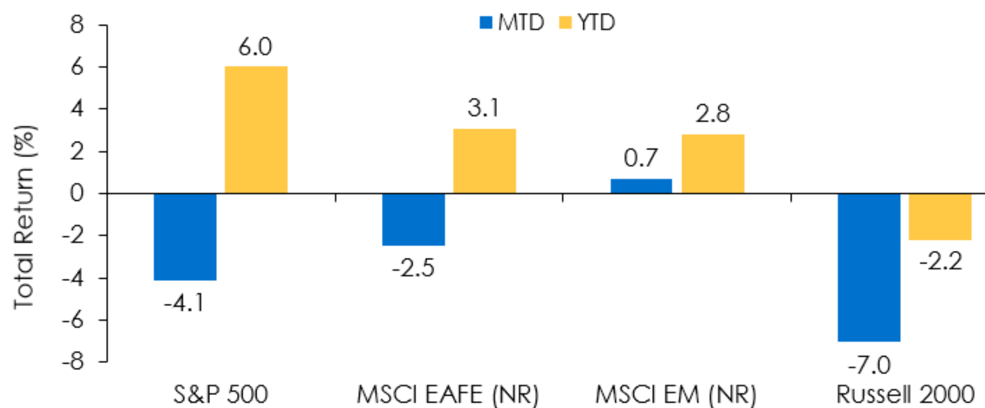
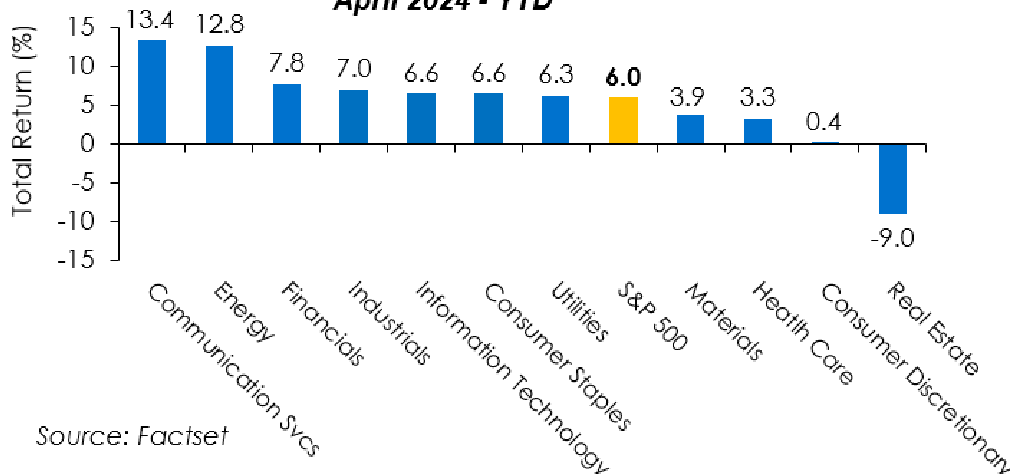
Stocks, Bonds, and REITs posted negative returns in April while Commodities delivered another month of solid gains. Meanwhile, returns across asset classes continue to be disparate year-to-date. Following strong performance in the first quarter, Stocks pulled back and consolidated in April as a result of stickier inflation data. Still, the S&P 500 continues to lead global equity markets for the year given its growth oriented bias (despite some evidence of broadening). Rate sensitive areas like Bonds and REITs have been held back by dampened expectations for rate cuts. Finally, Commodities have posted positive returns with particular strength in Industrial Metals during the month.

Stocks

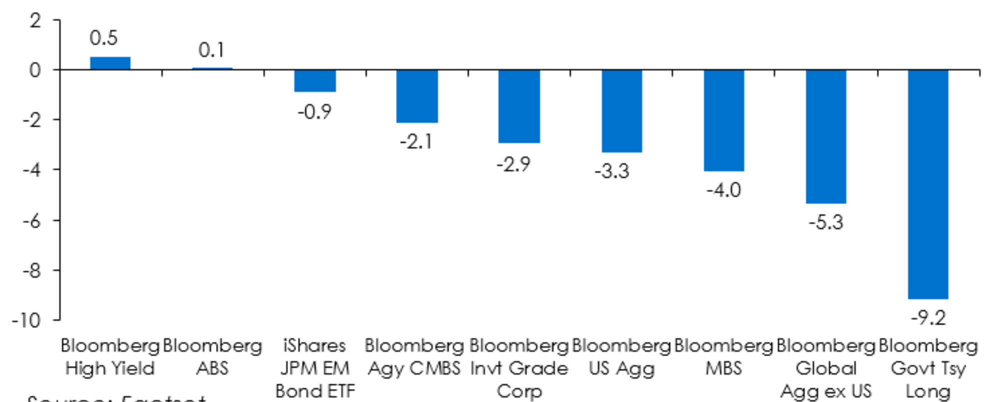
Stock returns were pressured in April with US Small Caps (Russell 2000) down significantly and turning negative for the year. Year to date, US Large Caps (S&P 500) continue to lead but with more sectors participating like Energy, Financials, Industrials, Staples and Utilities – all of which have outperformed along with last year's leaders in Communication Services and Technology. Overseas, International Developed Markets (MSCI EAFE) held up better in April given the continued anticipation of easing from foreign central banks and improving economic data. Meanwhile, Emerging Markets (MSCI EM) were one of the few bright spots in the month, posting positive returns as Chinese equities rallied.





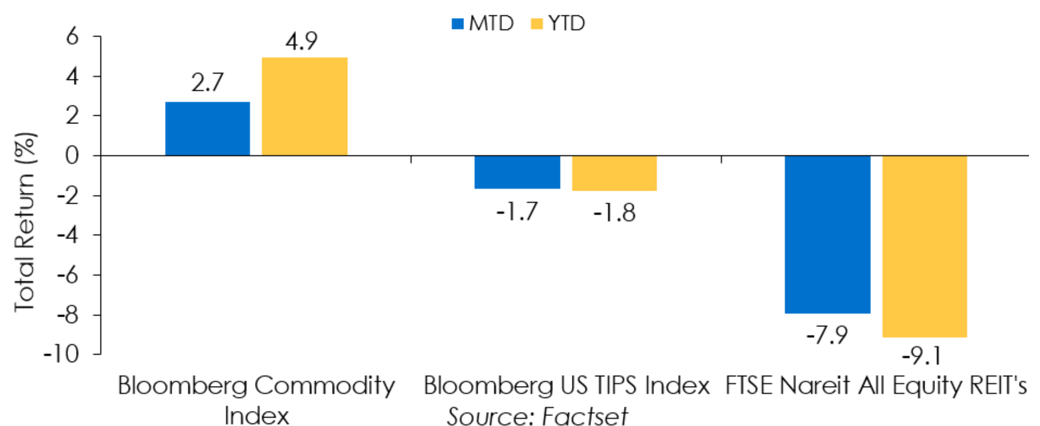
Bonds

Following aggressive moves by the Fed (Fed Funds at 5.25-5.50%) amid ongoing (albeit slowing) balance sheet reduction – policymakers have indicated a "wait and see" approach with rates unchanged at the last six meetings. The Fed has recently become less confident on inflation moving sustainably lower but, at the same time, suggests a rate hike is not likely. Meanwhile, the bond market dialed back its more aggressive rate cut expectations and is now forecasting less easing than the Fed. Longer term rates rose in April and are up for the year while the yield curve remains inverted (albeit off the lows from last year). Year-to-date, Bond returns were mostly down amid lowered rate cut expectations and the back up in rates. The exceptions were positive returns in High Yield corporate bonds and Asset Backed Securities (ABS) – both of which benefited from higher starting yields and tightening spreads.



Alternatives

Commodities traded higher year-to-date with strong returns in April, particularly in Industrial Metals. Meanwhile, publicly traded Real Estate (REITs) lagged – hurt by dampened rate cut expectations due to stickier inflation data. Finally, returns on Treasury inflation protected securities (TIPs) were subdued though outperformed nominal Treasuries on the recent rise in inflation expectations.

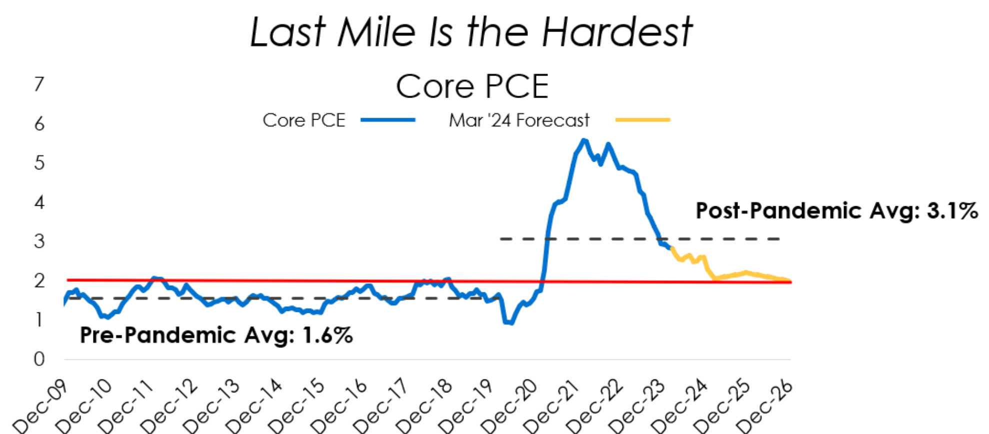


Market Outlook

"It's Tricky to rock a rhyme, to rock a rhyme that's right on time. It's Tricky."
– Run DMC, *It's Tricky* (1986)

We continue to believe that it's important to maintain two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

From a secular lens, we remain sympathetic to the notion that the paradigm is changing to one that ushers in the potential for more persistent and volatile inflation. Such a backdrop might set the stage for a higher cost of capital environment acting as a weight on stock valuations along with changes in market leadership. We find historical parallels today to the higher and more volatile inflation regime that existed back in the '60's-80's and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it hopes not to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money supply) and supply (de-globalization, labor markets, energy complex).



Source: Factset; PCE forecasts are produced by the Federal Reserve as of March 2024

As can be seen in the chart at right, there's no doubt that inflation has moderated with the Core PCE (the Fed's preferred inflationary measure) now well below its peak of 5.6% back in February 2022. Still, the current reading remains elevated with the Fed not expecting it to get back to its stated goal of 2% until the end of 2026. Additionally, there are now other metrics that point to inflation leveling off above that target suggesting the "last mile is always the hardest". This begs the question, will inflation allow the Fed to maintain their dovish lean? From a longer term perspective, according to Strategas Research Partners, historical bouts of meaningful inflation evidence multiple waves more often than not. As we move

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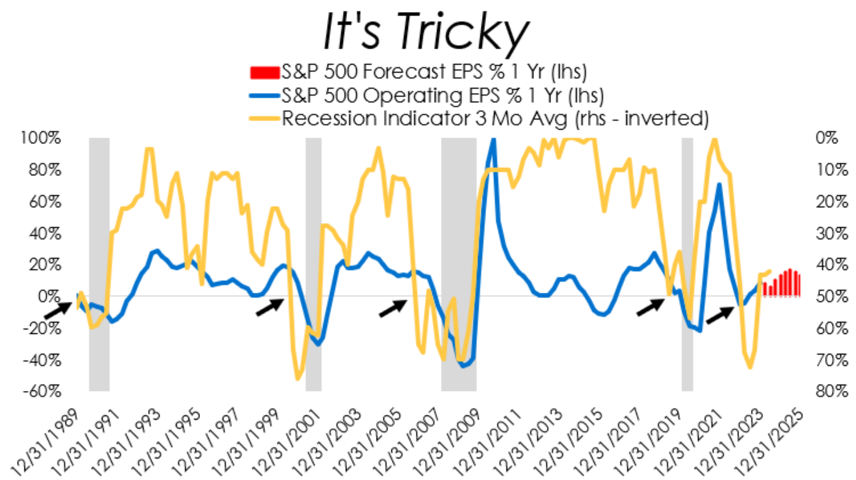
toward the trough of this inflationary wave, much will depend on how the Fed reacts. By our estimates, the money supply is still sitting above its long-term trend so if policymakers ease too agressively, we wonder if a second wave of inflation eventually takes shape. If so, this might have implications for a company's cost of capital, a stock's valuation multiple and changes in market leadership. As a result, we've referred to this secular mantra as "Doing the Opposite".

Meanwhile, the cyclical perspective has, admittedly, gotten more "Tricky" of late. Part of this tricky backdrop is related to: (1) being late in the business cycle but earlier in the profit cycle and (2) the disparity among valuations driven by the increased concentration of the market.

With regards to the first point, an extended inversion of the yield curve and limited incremental economic capacity suggests that we remain closer to the end than the beginning of the business cycle. However, the earnings recession that occurred last year is now resolving with an upturn in profit growth expected throughout this year. The chart at right evidences both of these conditions. Our recession indicator has previously registered comparable late cycle levels while the consensus forecast for S&P 500 earnings growth shows a re-acceleration into next year. We believe this setup requires investors to keep their proverbial "head on a swivel" in recognizing the cyclical earnings improvement while also understanding that its sustainability remains up for debate.



Source: Factset; S&P Dow Jones Indices with operating EPS defined on a trailing twelve month basis. Yellow Cardinal Research; the Recession Indicator is a proprietary dashboard of financial conditions that historically have provided some lead time on recessionary events. When more than half of the weighted average signals were triggered, this often precluded a recession. The Recessionary Indicator is a weekly signal with the 13 week moving average smoothing the volatility.

With regards to the second point, leadership in the growthier corners of the market has led to extended valuations and concentrations relative to the rest of the market. To that point, the top 100 companies in the Nasdaq are now comprised of almost a 60% exposure to the Technology sector alone. Meanwhile, the largest sector in the S&P 500 Equal Weighted index is represented by Industrials with just a 16% allocation. As can be seen in the chart on the next page, the former has dramatically outperformed the latter over the last decade and looks to be at a critical juncture. The relative outperformance of the Nasdaq 100 is beginning to level off relative to the S&P 500 Equal Weight. Is this relative trend performance merely basing or does this indicate a shift in tone toward a broadening of the market? Support or breakdown of the 200 day moving

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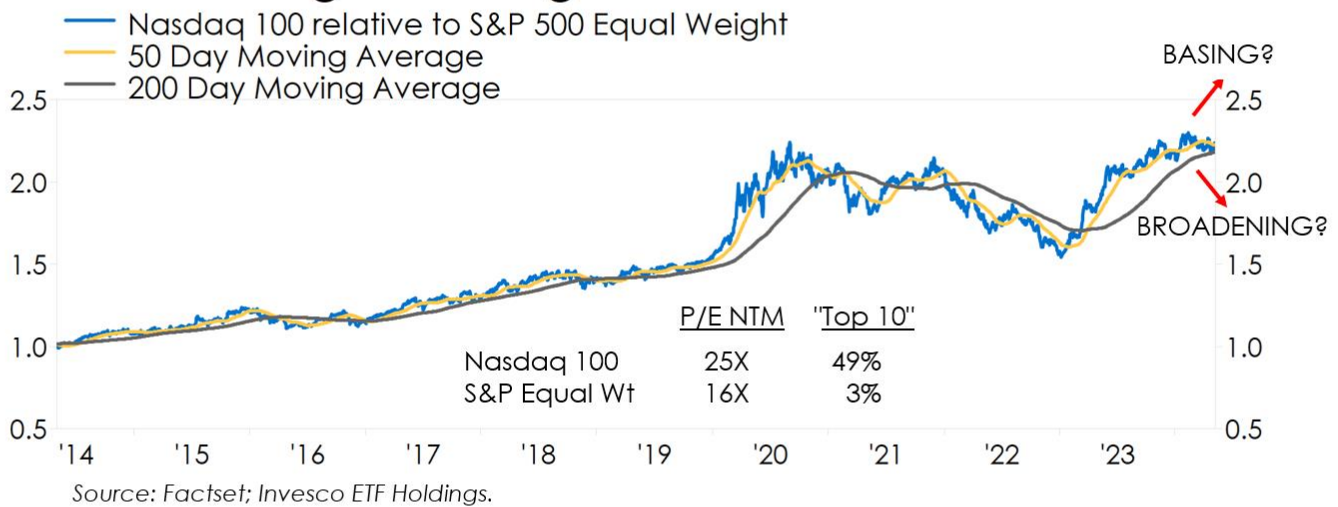
average may hold the key. Also worth considering is the dramatic differences in valuations (P/E NTM 25X vs 16X) as well as concentrations ("Top 10" 49% vs 3%). A key takeaway for us is that this kind of market action has conditioned investors to become accustomed to succeeding with much less diversifcation than in the past – regardless of valuation risk.



As we look ahead, we think investors might have to think differently or "Open the Aperture" from both a cyclical and secular lens. Alternative scenarios to the existing leadership trends might be beneficial to consider. Given the narrowing set of market conditions, expanding one's investment field of view might lead to the realization that the future opportunity is now in the diversity of the investment universe rather than in the concentrated focus of a few select investments. As suggested above, we're encouraged by the recent expanding market breadth and think this market rotation makes sense within the context of increased risks apparent in both valuations and concentrations.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, consistent with the above view, we continue to emphasize balance across asset classes and market segments while remaining UW to the most expensive and concentrated areas. We also continue to believe that it's important to be cognizant of the potential changing paradigm (i.e. Secular) while also recognizing the recent improving profit cycle setup – albeit within a late-cycle frame (i.e. Cyclical).

Within equities, in acknowledging the increased evidence of a bottoming in the Fundamental data, our positioning incorporates more balance geographically and within our US Large Cap exposure. While taking profits in the latter, our bias has generally been to have more exposure to less expensive areas (broader vs top). As such, we've maintained a greater OW in Cyclical Value and a lesser OW in Defensive

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sectors combined with a smaller cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – which remains our biggest OW in portfolios for diversification purposes notwithstanding a recent trim of that exposure. Those proceeds were recently redeployed to Emerging Market debt, where we've moved back to equal weight given more attractive spreads and improved fundamental and liquidity conditions. Maintaining an OW to the higher quality US Core Fixed Income segment means that we still remain UW the most cyclical and expensive part of the bond market (High Yield) where spreads have tightened considerably.

Within alternatives, we remain fairly balanced having previously reduced our UW to Real Estate and our OW to Diversified Alternatives as we think valuations in the former have come down to reflect the challenges of this interest rate senstive area.

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