The Lay of the Land **04/17/2024**

Critical Considerations, the Outlook from here, and GLOBALT'S positioning

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What do we know for sure? We know where we have come from and that's not nothing. It sets the stage for where we go from here. Large cap stocks have surpassed their 2021 all-time highs, mid-caps are mixed in that regard, and small caps have not. Growth and momentum have significantly outperformed value. Ten-year yields are still below the high for this cycle (so far). Valuation is on the expensive side, sentiment is quite bullish, and gold is at an all-time high.

First Quarter 2024 recap. The U.S. equity markets continued to rally from their October 2023 lows in the first quarter of 2024. Drawdowns in the quarter were minimal. The S&P 500 posted its fifth gain in the last six quarters, a second straight double-digit quarterly percentage gain, and its best performance to start a year since 2019. The Nasdaq just missed what would have been a fourth double-digit percentage gain in the last five quarters.

Treasuries came under pressure, with 2-year yields up 37 basis points to 4.62% and 10-year yields up 40 basis points to 4.20%. The dollar index jumped 2.9% after losing more than 4.5% in the prior quarter. Gold gained 8% after rallying 11% in Q4. WTI crude was up just over 16%.

What are the critical considerations going forward? It's the usual suspects: the path of inflation, employment, the Fed rate path, the interest rate path, consumer spending, capital spending, corporate earnings reports and growth, sentiment, positioning, and valuation. And yes, absolutely, AI. These are things that we have a decent chance of evaluating. Then, of course, there are ongoing wars, potential for war, politics, (unsustainable) debt and fiscal policy, and turbulent social underpinnings. But don't worry, this is a summary, not a treatise.

All of these qualitative things impact the quantitative and technical indicators we use, and we evaluate it all together to make decisions about how we think it best to allocate risk capital across asset classes.

Inflation--not dead yet. Kimberly covered this in the prior Spotlight. There are plenty of reasons there are pressures for it to stay higher for longer. Too much fiscal spending, too much money supply, de-globalization due to war and the threat of war, trade barriers, less benefits of comparative advantage, the energy transition, and a general ability to absorb higher prices. This creates uncertainty for the Fed, consumers, and businesses. We have positioned our portfolios for this scenario by owning gold and companies with strong cash flow, and less fixed income than the benchmark.

Employment and the consumer. Despite slow GDP growth and corporate earnings growth, companies have, overall, been resilient, in that revenues have been growing and companies have been able to expand their margins. They continue to look for efficiencies throughout their cost structure and improvement outside of cutting hours and headcount. Unemployment has stayed low, and participation has been increasing. Stable employment improves confidence, and people consistently earning money can consistently spend money. Offsets include subsidies running out, spending down savings, and racking up debt, as well as the difference between wage growth and inflation becoming more narrow. For now, this flywheel is working and suggests an overweight to stocks.

The Fed rate path. So far, this has been driven almost entirely by inflation. There are two main estimates of that path, that of the Fed "dot plot" (part of the Summary of Economic Projections or SEP) and that of the markets. Since the SEP is updated every three months (next one is June), it tends to get stale, while market estimates are real-time. The two were in agreement, more or less, up until the latest CPI report, at three 25 basis point cuts for 2024. Now the market has pushed that back to a 60% chance of two cuts by December of this year, and to get to something better than an 80% chance of two cuts, you have to go out to March of 2025. In the interim, all we

have to go on as to the Fed's thinking is public commentary by the Governors, which is on the vague and non-committal side. But their recent comments are more or less consonant with the markets.

For our part, we see the choice for them as very difficult. Continued high rates increases risk over time as it becomes harder for marginal credit situations to hold out without default. This is something the Fed wants to minimize, and Chair Powell went so far as to offer hope that they were close to being in a position to cut rates. But fighting inflation trumps that as the Fed has stressed repeatedly since they started raising rates. We think they will err on that side. No rate cuts at all in 2024 is a meaningful possibility. This raises the risk in the system, and to the probability that an event could provide the catalyst for a stock market correction. Although we are positive on equities, this tempers our enthusiasm.

The path for interest rates. While the Fed controls short-term rates, long rates tend to have a mind of their own. Generally speaking, market rates one or two years out reflect expectations for the Fed rate path and adjust to that fairly quickly. We agree with the market's view at this point and so don't see a lot of movement from here on short-term rates. Rates beyond that reflect longer term factors including the underlying growth of the economy, inflation, and risk. All of those are higher now than they were earlier this year, and we see risk to the upside in the combination of the three relative to current market marks. This is the most significant contributor to our fixed income positioning, which is shorter duration and underweight the benchmark.

Corporate earnings growth, capital spending and AI. We see sources of both opportunity and risk here. While overall capital spending growth has ticked back up to a 5% rate near its average over the last thirty years, the real action has been in manufacturing and intellectual property which has been growing quite a bit higher. Some of this has been driven by cloud computing, datacenter growth, energy demands, and more recently by increasing investment in AI, both processing infrastructure and software, to say nothing of human capital talent chasing.

The ability to do this has been supported by a reacceleration in corporate revenue and earnings growth which is expected to continue in 2024, and into 2025 and 2026. The opportunity is that strong and stronger-than-expected growth supports higher stock prices.

The risk of this part of the narrative is that these expectations are high relative to historical experience. Three years of double-digit earnings growth in a row are unusual. Should these expectations be missed to a meaningful degree, there is the possibility of significant downside. Another reason for maintaining caution and prudence with regard to equities even while maintaining a positive outlook.

AI is the thing to watch. Expectations are high, the race is on, and imagination is wild. Visibility on understanding actual end-user use cases and how they will evolve is fuzzy to say the least. But creating the capacity to provide for whatever they will be is gobbling up real money, human capital, and physical resources. Ramping the compute power required to run the quickly evolving models, and ramping the models to make reality meet hype, and ramping the energy and other physical infrastructure to run everything, is where the resources are going for now. Ultimately it will all depend on true revenue generating products and services that create value for those users. Many companies have had large (and very large) increases in their share prices due to AI, some because of actual revenue and earnings realizations, and some based on expectations for the future. The size of the market is potentially huge. The question is how huge, how do we get there, and how are the bumps going to be along the way? Our view is that we want to be involved where measurable metrics are actually happening and to be alert for signs of investments getting too far ahead of themselves, slowdowns/consolidations, and shifts in how value is created as well as the broader macro implications.

Sentiment, positioning, and valuation. This group of indicators is somewhat more worrisome. With regard to sentiment and positioning, many are in high or excessive territory and are giving bearish or close-to-bearish signals. This is not something to be dismissed or taken lightly. On the other hand, it is important not to overreact or to act too soon. There are still several indicators that are not in danger zones and some that are at high levels that actually have been followed historically by strong forward performance. We believe there is not enough evidence yet to significantly reduce our equity allocations or to raise additional cash. Valuation is also high, whether on a P/E basis or compared to the economy as a whole. But valuation has not been a good timing indicator and is better suited to give a feeling for how much downside there is if and when the right catalyst comes along. These factors lead us to continue to be positive, but cautious, and to be on the lookout for information to the contrary.

All that other stuff. War, politics, debt bombs**.** We don't say it doesn't matter, because, of course, it does. It does feel like there is more of it than there has been in a long time. It is not, however, discountable, because the odds or the timing or the outcome or all three are unknowable. The best an ongoing investor can do is to stay invested, stay alert, be ready for new information and to make rational changes as things develop.

Putting it together. Our asset allocation in our strategies is an expression of our view of the world and the markets, taking into account a wide range of qualitative and quantitative datapoints, many of which are conflicting. We remain overweight equities with an emphasis on the U.S., on large companies, and on growth. We do not own any real estate. We are underweight bonds and have a substantial position in gold. We take very seriously our role and the trust you place in us to manage your investments prudently.

Source: FactSet, Ned Davis Research, New Street Research, Strategas

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