Managed Asset Portfolios

MAP VIEWS

MAP QUARTERLY COMMENTARY | APRIL 2024

"Be Fearful When Others are Greedy and Greedy When Others Are Fearful" - Warren Buffett

Broader stock market averages continued the advance that began during the previous three quarters. Moreover, the fourth quarter of last year was one of the best for stocks in recent years, as investors embraced risk in hopes that the Federal Reserve (the Fed) would embark upon an aggressive series of rate cuts in 2024. Exiting 2023, Wall Street was forecasting the Fed would cut rates six to seven times in the new year. As a refresher, we felt those forecasts were aggressive, and while we expected the Fed would cut sometime in 2024, we believed they would be very data dependent in determining the path of cuts. We also cautioned that cutting too soon posed inflationary risks to the economy unless the U.S. experienced significant economic weakness and unemployment rose substantially. As it stands today, markets are now pricing in three rate cuts in 2024, with the first expected in June, two months later than original expectations. We believe current estimates to be too aggressive. Rather, we are more in the camp of zero to two rate cuts. There are three primary drivers for our beliefs:

1. The U.S. economy continues to defy the skeptics. Last year's GDP was more robust than almost all forecasts, including our own. While economic growth will likely moderate this year, based on economic data released to date, a recession is not the baseline forecast.
2. The labor market remains strong. Although it has slowed slightly, it is still stronger than historical levels, with the current unemployment rate in line with pre-COVID levels.
3. Inflation remains above the Fed's target of two percent. Inflation came down nicely from the peak of nine percent in June of 2022, but "the last mile to two percent" has been elusive, with inflation actually picking up a tad over the past two months. As such, we continue to believe the Fed will remain data dependent and therefore may not cut rates as aggressively as currently forecasted.

Despite the fact that this is an election year, the Fed's dot plot is still calling for three rate cuts this year. We believe it may become difficult to accomplish after we move past the next couple of meetings. As mentioned above, the rollicking fourth quarter rally that began in October of 2023 was rooted in the prospects of materially lower rates in 2024. We question the logic of why the thinking in the fourth quarter should continue to apply today in light of the dimming prospects of aggressive rate cuts. In fact, Wall Street has moved from a place of demanding up to seven cuts from the Fed, to being complacent with three cuts.

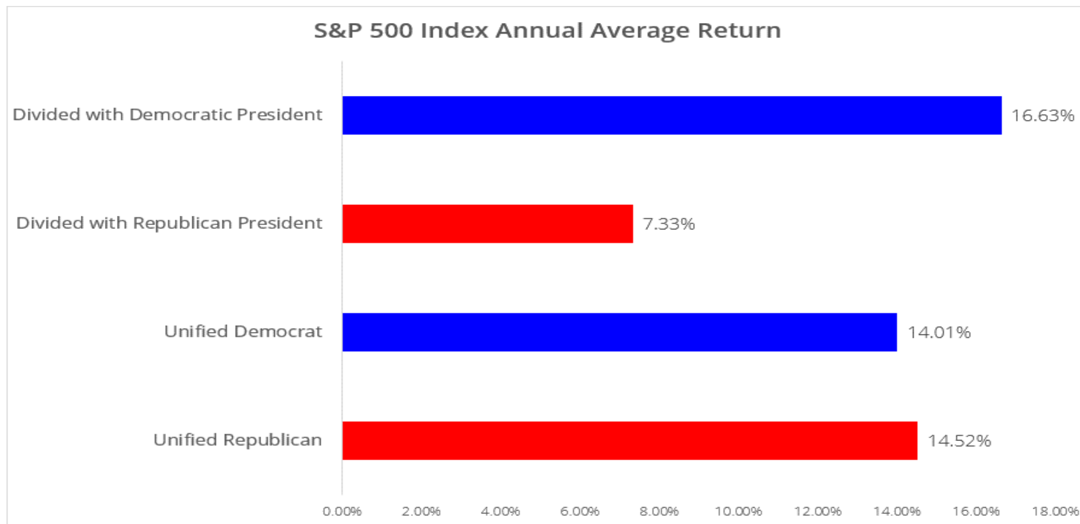
As of the date of publication, the yield curve marked its 636th day of being inverted, a new record for the bond market. Last year, investors piled billions of dollars into money market accounts, viewing 5.5% yields as too good to pass up. We would not be surprised to see the yield curve begin to normalize (or at least flatten), with shorter-term yields coming down slightly and longer-dated bonds nudging up in yield. We would also not be shocked to see the yield on the 10-year bond approach 5% later this year, as inflation remains in that 3%-plus range, in line with our expectations at the onset of the year. We realize this forecast goes against the grain of conventional Wall Street thinking. To make longer-dated bonds an attractive proposition, inflation, in our opinion, would have to fall closer to the Fed's 2% target, and it would likely take a material slowdown in the domestic economy for that to happen. As stated previously, this scenario runs counter to our baseline forecast.

As we mentioned above, the headline inflation rate has inched up to 3.2%. Excluding food and energy, the inflation rate is 3.8%. We have spoken about sticky inflation in past publications, and it continues to be a preferred measurement of the Investment Team as it includes goods and services that change price relatively infrequently. It is also thought to incorporate expectations about future inflation to a greater degree than prices that change on a more frequent basis. Today, sticky inflation less food and energy is 4.4%. Should the Fed begin to cut rates while the economy is humming along at a 2%-3% growth rate, we believe they risk increasing the rate of inflation.

We are also mindful of 'reglobalization' whereby countries, including the U.S., are intentionally lessening their reliance on foreign nations for goods. Stemming from the COVID pandemic, supply chain issues were a leading contributor to the peak inflation we saw in 2022. However, additional events brought new supply chain risks to the table. The war in Ukraine, now in its third year, has created supply constraints in the Red Sea, increasing both shipping times and costs outside the U.S. Climate change has affected a number of ports, including the restricted Panama Canal whereby authorities have reduced the number of transits per day by nearly 40%. Finally, the Maersk shipping vessel collision with the Francis Scott Key bridge on March 26, 2024, disabled the Port of Baltimore. The Port of Baltimore handles more autos than any other port in the nation. It also handles containers, coal, liquified natural gas and dry bulk tonnage (such as grain used in the agriculture industry). We believe these events place a renewed focus on reglobalization potentially becoming a catalyst for our higher for longer inflation argument, placing further emphasis on sticky inflation.

Stocks that are direct plays on Artificial Intelligence (AI) continued their strong performance during the first quarter, helping the technology sector to once again be the top-performing sector. We are firmly convinced that AI is real and full of potential. Before implementing changes to our portfolios, the Investment Team questions “how will AI impact this company?” Like the Internet, AI will be a blessing for some industries (not limited to technology) and a deathblow for others. Think back to the later stages of the dot-com bubble. Investors that bought Amazon and Microsoft in January 2000 waited ten and fifteen years, respectfully, to break even. There is no doubt that those two companies are clearly “winners” in the AI race, but it highlights the fact that investors need to be mindful of valuations when buying stocks. Investors piling into the AI frenzy may find that history does sometimes repeat itself.

As an investment advisor, MAP is not a political prognosticator, as such we will not opine on which candidate will win, but it is safe to say that regardless of the outcome, about half the country will be upset. With that said, as the November elections approach, more investors are beginning to question what impact they will have on the markets. The chart on the next page illustrates that markets have done well under the leadership of both parties. And, as has been the case historically, the best way for politicians to win over citizens is by spending money. Budget deficits ballooned under both former President Trump and President Biden, so it is probably safe to say that deficits will likely grow regardless of election outcomes. However, we note that should the U.S. elect a different administration this November, spending priorities will likely change.



Source: Retirementresearcher.com
Data from 1926 through 2023. Unified government means that the Presidency, the House of Representatives and the Senate are all controlled by a single party. Divided government means that at least one house of Congress or the Presidency is controlled by the other party. Indexes are not available for direct investment.

You may ask why does government spending matter? Government spending was a significant contributor to the stronger-than-expected GDP growth in 2023. With the deficit growing by nearly $1 trillion every hundred days, we believe this will likely put upward pressure on interest rates, providing one of the bases for our interest rate expectations. The laws of supply and demand do work. The increased supply of debt, combined with the fact that the Fed is no longer a buyer (as it was during the era of quantitative easing (QE). Also, the Chinese and Japanese, once large buyers of U.S. debt, are no longer active purchasers. As such, we believe that interest rates on the intermediate side and the longer end of the curve will have an upward bias, while shorter-term rates may come down slightly.

We truly value the trust and confidence you place in us. While tech-heavy indexes have continued to drive broader market performance, we remain confident in our long-term investment approach and its ability to deliver superior risk-adjusted returns throughout complete market cycles. We continually monitor the portfolios and their holdings and will make adjustments where necessary in an effort to capitalize on opportunities without taking on undue risk. We are committed to transparency and will continue to provide updates. Remember, the Investment Team invests a sizeable portion of their assets in the same securities and/or strategies as our clients. In other words, we eat our own cooking.

Please do not hesitate to contact your MAP representative with questions or concerns.

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