46 PEAKS
INVESTMENT ADVISORY GROUP

Is Better Good Enough?

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Picking up where November and December left off, U.S. and Global stock markets continued to **rally in the first quarter**. U.S. Large Caps led the way again, advancing 10.5% – their 14th best first quarter in the last 98 years. Similar to 2023, non-U.S. and Small Cap U.S. stocks also gained, just not as much as larger U.S. companies.

The other pillar of many portfolios - Core Bonds - declined slightly (-0.8%) as interest rates rose (and bond prices declined) in response to increased uncertainty surrounding interest rate policy. All was not lost for fixed income investors, however, as more diversified and more aggressive bond strategies posted good quarterly results – High Yield gained 2.1% and Preferred Securities posted strong gains.

The main factor driving the sustainability of the stock market's advance seemed to be continued confidence that the Fed was not only done raising interest rates but was committed to lowering them substantially in 2024. Known as the "Fed Pivot", this change in course has been like an oxygen mask to stock and bond markets that not that long ago were choking under the pressure of the Fed's higher interest rate policies and restrictive rhetoric. So, is the coast all clear? Are things now all good? Or merely better? And is better good enough to justify the recent rosy results?

Starting with the economy – a potential recession has been on everyone's mind since the Fed started raising rates in 2022 and nearly every quantitative model designed to predict a recession flagged a strong warning at some point during the last two years. Nearly all these models said that a recession should have started somewhere between mid-2022 and late 2023. **Yet no recession came**. In January, many analysts, including us, were still unsure about whether the economy would dodge the recession bullet in 2024. While not 100% certain, we are now much more confident that there will not be a recession this year.

Why? For one, the few economists whose opinion we value have recently stuck their necks out saying that the economy should avoid a recession. Perhaps more importantly, all those quantitative models that I just mentioned? Many of them are now reporting that things are getting **Better**. In what must be one of the largest one month drops in its history, the Ned Davis Research Recession Probability Model dropped from 43.5% to start the year to a measly 0.7% in January! Among our research sources, even the most pessimistic provider over the past few years has turned the page. This table shows 31 components in one of their recession models – in the most recent report, 20 of the 31 indicators *improved*. Only 10 worsened. More and more analysts are concluding that the U.S. economy has already had its desired "soft landing" and is now actually **accelerating**.

MODEL COMPONENT INDICATOR/SURVEY DESCRIPTION	CHANGE
Leading Employment Index (Jan 2024)	BETTER
Initial Jobless Claims (for week ending 2/3/2024)	BETTER
Survey of Professional Forecasters ANXIOUS Index	BETTER
Weekly Leading Index (for 02 Feb 2024)	WORSE
Manufacturing Business Outlook Survey (Feb 2024)	BETTER
Initial Jobless Claims (for week ending 2/10/2024)	BETTER
Industrial Production (for January 2024)	WORSE
Weekly Leading Index (for 09 Feb 2024)	WORSE
Initial Jobless Claims (for week ending 2/17/2024)	BETTER
Weekly Leading Index (for 16 Feb 2024)	BETTER
Conf. Board Monthly Leading Economic Index (Jan 2024)	WORSE
Real GDP (fourth quarter 2023, second release)	WORSE
Chicago Fed National Activity Index (Jan 2024)	BETTER
RecessionALERT Monthly Leading Index (Jan 2024)	BETTER
Real Manufacturing and Trade Sales (for December 2023)	BETTER
Real Personal Income Less Transfer Payments (for January 2024)	BETTER
Initial Jobless Claims (for week ending 2/24/2024)	WORSE
Weekly Leading Index (for 23 Feb 2024)	BETTER
ISM Manufacturing Report on Business (Feb 2024)	WORSE
IHS-Markit Monthly GDP (Jan 2024)	WORSE
Initial Jobless Claims (for week ending 3/2/2024)	UNCH
Weekly Leading Index (for 01 Mar 2024)	BETTER
Payroll Employment (for February 2024)	BETTER
Leading Employment Index (Feb 2024)	BETTER
Initial Jobless Claims (for week ending 3/9/2024)	BETTER
Weekly Leading Index (for 08 Mar 2024)	BETTER
Industrial Production (for February 2024)	BETTER
Manufacturing Business Outlook Survey (Mar 2024)	WORSE
Initial Jobless Claims (for week ending 3/16/2024)	WORSE
Weekly Leading Index (for 15 Mar 2024)	BETTER
Conf. Board Monthly Leading Economic Index (Feb 2024)	BETTER

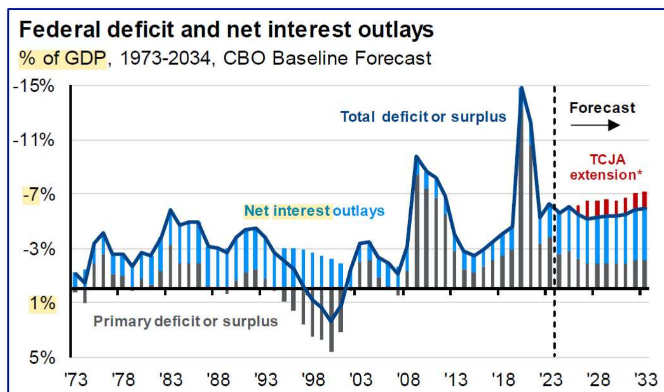
We continue to think one of the reasons so many models and experts were wrong this time is because we had a fragmented and unsynchronized economic cycle during and after Covid - far different than a traditional cycle where many more sectors of the economy ebb and flow together. As a result, various parts of the economy contracted at different times, but not enough at the same time to trigger a slowdown broad enough to qualify as a recession.

Then last year we learned that raising interest rates has a

muted impact on households after many of them locked in mortgages at interest rates under 4.0%. Shocking. There are even some thoughts in the economic community that higher rates, through higher yields on savings and reduced investment in productivity enhancing projects, are actually *contributing to* inflation. We are not there yet, but would not dismiss those perspectives either.

Over the last 6-12 months, we've seen another development that is abnormal for this point in the cycle – **government spending**. With the economy clearly not in a recession, it's highly unusual for the government to run a large deficit. But that's exactly where we are – thanks to low tax rates (from the previous administration) and stimulative spending from the current administration, the U.S. ran a deficit of $1.7 Trillion (with a "T") last year and is forecast to run a deficit of $1.6 Trillion this fiscal year.

The chart below - inverted to show deficits above the horizontal line and surpluses below - shows the total Federal deficit or surplus. (the only surplus was during the Tech bubble of the late 1990's). The deficit has historically spiked during recessions but then fallen back under 3% of GDP following the recession. Not this cycle. Not only is our current deficit as a % of GDP higher than any period other than the 2008 (Great Financial Crisis) and 2020 (Covid) recessions, but it's forecast to stay at these levels for at least the next ten years!

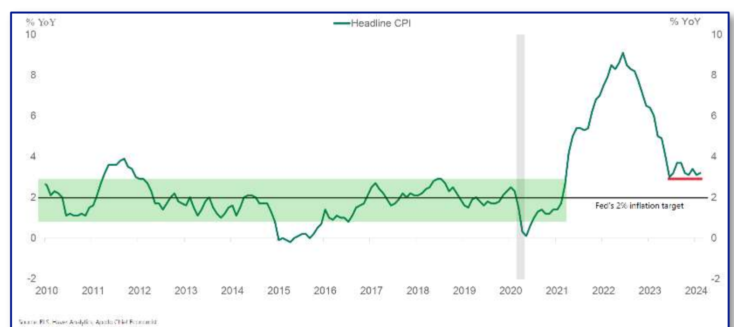


It's certainly a little alarming to see our elected and unelected officials print trillions of dollars year after year, especially when the economy doesn't need it. Americans, and those who run American businesses, thankfully, are not as reckless. While our government continues to add to its relative debt burden, American households and businesses have been much more prudent in managing their ability to pay their debts - **U.S. Household Debt as a percentage of GDP is at its lowest level since June 2001.**

In spite of higher rates, the jobs market remains strong – baffling many experts. Unemployment rose from 3.4% in April 2023 to 3.9% in February of this year, threatening to trigger another historically useful recession warning – a rise over 4.0%. But in the most recent reading, job growth was strong enough to push unemployment back down to 3.8%.

Depending on where you sit, or how the employment picture ultimately affects inflation, you might view a strong labor market differently. Wage growth has recently been around 4.5% - much higher than inflation. This is obviously a very good thing for workers and households' ability to maintain or even improve their standard of living. But as we've said for a while – if the strong labor market means stubbornly higher than desired inflation, then investors might view that as worse for markets, not better.

We're tiring of talking about inflation, and perhaps you're tired of reading about it, but it remains the key to today's markets – both stock and bond. Headline Inflation (CPI) was down to 3.2% in February. While much better than the 9% level seen in 2022, 3.2% is still not "officially" good - the Fed wants inflation around 2.0%. While the Fed is willing to be patient, investors need to consider that the decline in inflation has **stalled**. Here's a chart of inflation going back to 2010. The pattern is clear. For over 10 years, inflation rarely left the desirable, green-shaded range between 1-3%. We climbed and descended the Covid inflation mountain, but for five months have been stuck on an elevated plateau at an altitude of a little over 3%.



The inflation data for March, released recently in April, came in at 3.5%, the third month in a row of slightly *higher* inflation than the month before - confirming that the "inflation is transitory" crowd's victory lap was premature, and that inflation seems to be... pick your word – Sticky? Persistent? Stubborn? Those are all fair choices. But we think the more enlightening and potentially damaging-to-the-bullish-thesis descriptor would be "**embedded**".

"Embedded" inflation means that there are dynamic, interconnected factors at play creating a reinforcing loop that's difficult to break. For example, businesses raise prices and landlords raise rents, so then workers demand higher wages. Consumer spending goes up. Businesses and

landlords raise prices again, so workers ask for more raises and wages go up again, restarting the cycle. One example of the embedded, interrelated nature of inflation – Postage Stamps. This month the USPS filed a notice to increase the price of a first-class stamp for the second time this year alone, and **the fourth time in the last 16 months**!

With the economy accelerating away from recessionary levels, stocks up near all-time highs, unemployment under 4.0%, and inflation better but still not good, most analysts think it's hard to justify lowering rates. Yet one could argue that the Fed lowering rates soon is still justified for the same reason that I often eat _before_ I get hungry. Those who know me know that by the time I get real hungry, **it's too late**, I'm already cranky (the biological term is "hangry"). And since I wish to avoid that for myself and those around me, I'll eat pre-emptively. To the Fed, they might believe, and they're probably right, that they can't wait to see the full effects of higher interest rates show up in the economy. If they do, the economy will already be too weak and barreling toward a recession. At this point, while we agree that it's hard to make the case for rate cuts in light of current data, we continue to think the Fed is likely to lower rates this year for two very different – and not good – reasons.

1. For one, with the U.S. Government running such large deficits, and with Washington's lack of foresight to lock in low rates for decades like consumers and businesses did, the interest expense on U.S. Government debt is growing. A lot. And the higher rates stay, the more interest expense our government will incur. $8.9 Trillion of U.S. Government debt will mature in the next year - The U.S. needs rates to come down.

2. Secondly, the Fed is aware that this is an election year. They also know that a failure to lower rates after saying they will would almost certainly trigger sharp declines in both stocks and bonds. Much like a referee who does not call a penalty late in a game, we think the Fed doesn't want to play a prominent role in November and would prefer to broadcast its intentions (like it already has), and then deliver as promised this Spring or early Summer, to limit impacting markets in the 4th quarter.

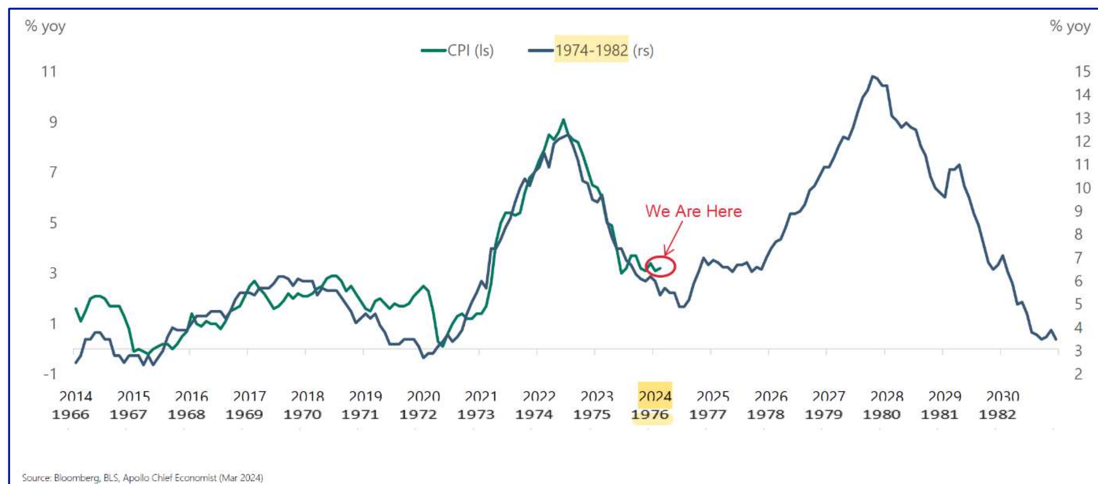
Clearly, while investors started the year convinced that inflation was in an unstoppable decline and the Fed would sharply lower rates, there is a lot of uncertainty now. Nobody knows for sure what inflation and the Fed will do for the remainder of the year. One thing seems certain, there's more tension in the air and market watchers will be holding their breath prior to the release of every piece of inflation-related economic data in the months ahead.

Then there's stock market valuations. We haven't mentioned them in a while, what with all the attention on the Fed, inflation, and interest rates, but in some corners of the stock market, valuation metrics are historically high – Many valuation measures for the S&P 500 index are more expensive today than they have been over 90% of the time.

Besides the challenges of inflation, the Fed, and valuations, investors face **a big wild card this year** – the Presidential Election. Space prohibits us from doing a deep dive here, but there are two important things you should know. For one, Presidential election years often have their own unique seasonality to them, with an increase in volatility during the April – October period, followed by a year-end rally beginning around election time. Another important consideration this year is that to us, both presumptive nominee's policies are likely to be inflationary. While very different on a lot of issues, neither side seems inclined to reduce spending or raise taxes enough to slow the economy or inflation.

So as much as we've enjoyed the last five months, we expect volatility to pick up. Not just because of the election dynamic, but also because of the run we've had - the S&P 500 index is up five consecutive months, posting a five-month gain larger than 98% of the other five-month periods since 1936. While this type of momentum usually continues and can be considered bullish, the index has gone more than 12 months without a 2% daily decline, the sixth longest streak since 1965. Streaks eventually get broken.

Big picture, we think many investors are still unaware of how different this investing environment is from anything experienced in decades and how this may not be a "stocks always go up" and "bonds are safe" investing paradigm. To illustrate what **a critical juncture** we are at, consider this chart which takes much of the recent inflation graph we shared earlier (the green line that stops between the two mountains) and overlays it with inflation from 1966-1982 (the grey line that creates "twin peaks").



This shows that inflation from 2014-2024 has so far tracked very closely to the pattern (not the levels) of inflation from 1966-1976. It also shows how in the 1970's, after falling down the backside of the first inflation mountain, inflation climbed another mountain from 1977-1980. A year or two ago, we didn't think another sharp inflation spike was possible, but now **we're not so sure**. If Washington – both the politicians with their money printing and the Fed if they make a policy mistake – doesn't get the next 6-12 months right, then inflation could reignite again. We're somewhat comforted by research suggesting that much of the 70's inflation was due to severe oil price shocks, but can we rule out an oil shock this year in light of wars in Europe and the Middle East? Thus, while we are not predicting one, investors should at least be alert to the possibility of another inflation spike, and keep in mind that the 1970's were much better for music and fashion than for stock and bond investors.

All things considered, we remain neither overly bullish nor bearish on stocks or bonds. For stocks, economic growth surely beats a recession. Across the economy and especially within Tech, Artificial Intelligence is likely to be a meaningful catalyst for productivity and profits. And there are pockets of value in some stock markets. For example, on a price to earnings valuation basis, non-U.S. stocks are trading at a 34.5% discount to U.S. stocks - more than double the average discount of 16.5% since 2004.

Even with inflation around 3%-3.5%, with most Bonds yielding between 4.5% and 6.5%, the Bond market is much more attractive today than it has been for a very long time. And of course, there is a chance that inflation subsides under 3% this year; many experts still think that it will. If so, then both stocks and bonds would likely rally strongly.

On the other hand, if inflation really is embedded and accelerates again, stock and bond markets could face simultaneous pain. Facing this real risk, we think portfolios limited to just the two core asset classes are **not good enough**. So, we remain overweight alternative strategies that benefit from higher cash yields, could perform well in an inflationary environment, and which are designed to perform differently than stocks and bonds. Many of these – including Private Credit, Managed Futures, and Reinsurance strive to offer returns of 4-6% over cash yields over the long-term – potentially offering equity-like returns with lower volatility and currently-very-valuable diversification benefits. To us, compared to plain vanilla portfolios, robust portfolios with these types of alternative exposures are clearly better.

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