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Wealth Advisors™

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Market Update

March saw every broad asset class move higher, with strong returns especially in real-asset and equity asset classes. The US mega cap tech and communications companies were positive, but in a turn of events were the lowest performing stock asset class. Over the last several months investors have enjoyed guessing the number of interest rate cuts the Fed would declare in 2024. However they may have counted their chickens before they hatched. Inflation has seen an uptick over the last several months, and even the measure the Fed said it preferred to watch in 2022, the so-called SuperCore inflation measure, is up 1.3% in just the first two months of 2024. While inflation has slowed from the 9% level of mid-2022, a 3%+ inflation rate is on top of the 16% inflation we experienced from 2020-2022 and is still above the Fed's stated target. We may not end up getting those numerous rate cuts the market wanted.

For the month the S&P 500 was up 3.2%, while US large growth stocks were up 1.8% and US large value stocks were up 5.0%. International equities grew 3.3%, and emerging market stocks were up 2.5%. Small caps were up 3.6%. The broad bond market was up almost 1% and every income asset class rose between 0.3% to 1.2%. For real assets, REITs rose1.8%, MLPs were up 5%, commodities were +3%, and gold +8%.

Looking back at 2023 earnings, we see that the S&P 500 set a record, just barely. The full year's operating earnings came in at $214, just clearing the previous record of $208 in 2021. Overall this is positive and backs up the positive Gross Domestic Product (GDP) numbers we saw last year. However, while earnings barely cleared a new bar, prices have been jumping even higher bars over the last year and a half. The S&P is now 10% higher than it was at the end of 2021 (13% higher including dividends), and that year was swimming in stimulus and financed with 0% rates. With prices rising faster than earnings, especially for many tech/AI names, valuations are moving meaningfully higher and well above historical averages. While earnings are expected to set another record high in 2024 and provide some support to stock prices, the US large cap growth part of the market is priced for near perfection with little margin of safety. For us this is an issue we are watching closely and are purposely underweighting the most expensive parts of the market.

As the market has become less concerned about recession, the number of stocks participating in the last few quarters' move higher has grown and included smaller companies and internationals. These areas of the market remain more fairly valued and are close to or below their longer term averages. These names are more sensitive to slowdowns as a slowing economy will have a greater effect on their earnings.

Our base case for 2024 is that GDP will slow from 2023's level. While we didn't experience the recession many feared, higher interest rates and higher debt pressure on US households will begin to have a slowing effect on spending and growth. Household net worth will remain bolstered by home values which have remained high and higher investment account balances. Inflation should continue receding but may not get to the 2% target. The Fed will be under pressure from politicians and large investors to lower interest rates, but we hope they hold the line to drive inflation lower and disincentivize rampant 2021 style market speculation.

Performance Summary

The S&P 500 is up 10.6% while small caps are now up 5.2%. Developed international markets are up 5.8% while core bonds are down -0.8%. Growth stocks outperformed value stocks in both US and internationally, although the gap has narrowed. REITs are still down –1.3%, MLPs are up 13.9 and gold is now up 7.4%. Commodities are mixed with energy up and agricultural and metals down.

Fixed Income Strategy

Fixed income markets reversed course in the first quarter, following their strongest quarterly performance in the prior couple of decades last quarter. The Treasury yield curve moved higher in a mainly parallel shift, with the 10 year benchmark yield closing the quarter at 4.20%. The Treasury curve also remained inverted with shorter maturity yields higher than longer maturities, and the commonly cited 2s/10s curve ended at -42bps.

Following Fed Chair Powell's "pivot" at the December press conference, fixed income markets moved to over-price Fed cuts in 2024. However, so far this year economic data has generally proved more resilient, with inflation readings sticky. This has led markets to unwind much of the rate cuts priced in, pushing yields higher. Additionally, the Bank of Japan ended its negative interest rate policy in March; the final major central bank to begin normalizing monetary policy and another tailwind to higher yields.

While the Fed continues to project 3 rate cuts in 2024, it is questionable whether they will be able to achieve that estimate, given the economic and inflation data. It is our view that the data are currently too strong and market liquidity too ample for the Fed to be considering rate cuts at this juncture. Alas, the real question is: What do we think the Fed will do, not what do we think the Fed should do? We think that the Fed wants to cut rates in 2024, as they feel policy is very restrictive and want to stick the "soft landing". The burden of proof will be on the economic data to prevent them from cutting.

Corporate spreads tightened throughout the quarter, despite record investment grade issuance. Investment grade spreads ended at +88bps, while high yield closed the quarter at +299bps. Solid economic and corporate fundamentals, along with robust demand from investors, have been pushing spreads lower.

While we have a corporate sector focus in our strategies, we have incrementally reduced their weight in favor of government bonds, as corporate spreads at historically tight levels present a less favorable risk/reward profile. Our yield curve positioning is relatively balanced, within the context of an overweight to duration.

Equity Income Strategy

The Equity Income strategy's primary goal is to provide reasonable income while also offering the potential for capital appreciation.

Overall, traditionally defensive sectors like Utilities, Real Estate, and Healthcare (which make up most of the portfolio allocation) have underperformed for the year as this market rally has been entirely driven by the Technology, and Consumer Discretionary sectors. Additionally, we have seen the Energy sector go from best to last over the past year.

In the quarter we had no trades to report.

As always, we continue to look for opportunities to upgrade the quality of the portfolio while staying true to our disciplined valuation process. .

Defensive Equity Strategy

The Defensive Equity strategy remains focused on identifying companies with stable operating results and reduced stock price volatility in the broader market.

As such, the strategy was able to participate in the Q1 rally but given its defensive nature it lagged behind more aggressive Magnificent 7 driven indices.

From a portfolio allocation, we remain overweight high-quality stocks remain underweight cyclically sensitive sectors like financials, and materials.

Additionally, we continue to hold cash and have a small position in gold.

We added a new position in Q1 in Humana Inc.

Core Equity Strategy

Throughout the first quarter, the ongoing rally in global equity markets, which originated in the autumn of 2023, persisted. The impetus behind this upward trend stemmed from the expectation of multiple Federal Reserve rate cuts in 2024, coupled with a prevailing focus on investment in artificial intelligence.

From an economic standpoint, the US economy continues to stand on solid ground. Employment remains robust and while we have seen certain pockets of weakness, we are not witnessing any widespread economic malaise. Consumers continue to spend, and employers continue to hoard labor. It seems that despite challenging circumstances, the Federal Reserve has succeeded in achieving lower inflation rates without negatively impacting the economy. However, it would be prudent to refrain from declaring absolute victory at this stage. Nonetheless, the current situation can be summarized as: so far, so good.

From a portfolio standpoint, we added a few new names: Arthur J Gallagher, KLA Corp, Taiwan Semiconductor Manufacturing, and ANSYS Inc. We exited positions in Alaska Air Group, Charter Communications, Charles Schwab, Roche Holdings AG and Resmed in the quarter.

International Equity Strategy

During the first quarter, international markets mirrored the upward trajectory of the US market, reflecting the overall stability of the global economy. Additionally, it appears that most global central banks are nearing the end of their hiking cycles, further contributing to the positive sentiment in international markets.

China continues to struggle in its transition to a consumption-based economy. Unlike previous economic cycles, China has been reluctant to increase monetary easing, consequently hurting economic growth and consumer sentiment. Nonetheless, we are seeing some “green shoots” emerge, which could signal the start of an economic recovery. We view the potential of a China economic inflection in 2024 as a source for new ideas.

We added new positions in Komatsu and Mitsubishi UFJ Financial Group.

We exited positions in: Resmed

Our goal is to have a portfolio of high-quality businesses with competitive advantages that can withstand changes in economic conditions and thrive through a business cycle. Companies with established moats often expand market share and strengthen their business during a downturn. These are the types of companies that we continue to look for in the International Equity strategy.

While we cannot predict near-term risk factors, we can control the companies we invest in. Our disciplined approach of owning high quality, financially viable and intrinsically cheap companies form the International Equity portfolio.

Value Strategy

For the first quarter we saw a continuation of the global equity markets rally that started in the fall of 2023. A belief in multiple Federal Reserve rate cuts in 2024 and AI investment theme were the catalyst for this price movement.

As always, valuation opportunities drive the over and underweight positioning. Currently, we see value in Healthcare, Staples and some areas of technology.

In the quarter we added new position in Yum China Holdings

We exited no positions in the quarter.

Thematic Equity Strategy

Thematic is by far our most aggressive growth strategy with over 40% in Technology and 10% in Biotech –to this extent Thematic had a great quarter as investors increased their risk spectrum.

As ever, we remain vigilant in our efforts to identify new themes of secular growth that would benefit the strategy.

Covered Call Strategy

The primary goal of the Big Covered Call strategy is to obtain exposure to equities, with greater income potential at the cost of reduced upside participation. Should the broad US equity market continue to rise, but at a slower pace, or become range-bound, constrained by high valuations on the upside but buoyed by strong earnings on the downside, this may continue to be a fruitful period for the Covered Call strategy.

The first quarter of 2024 saw a continuation of the rally sparked by Fed Chair Powell's apparent "pivot" on monetary policy at the end of Oct 2023. In the ensuing months we've seen signs that inflation may prove stickier than expected, stabilizing above 4% annualized over the last quarter. Nonetheless Chair Powell has remained steadfast in his projection of 3 rate cuts of 25bps this year. The "last mile" of the journey from peak inflation levels back to the Fed's 2% target was expected to be the hardest and the most likely to inflict equity market pain, and it now appears that the Fed have elected to simply skip that stage of the journey. After spending all of 2022 and most of 2023 messaging "higher for longer" on interest rates and emphasizing the Fed's continued commitment to its inflation target, Powell changed his tone overnight, with no accompanying change in data or fundamentals to justify the change. It now appears that inflation rather than interest rates will be allowed to remain "higher for longer"! Powell has made it clear that looking forward, it will require a significant deterioration in the slow disinflationary process to derail the shift from hiking rates to cutting them, despite core inflation remaining nearly double the Fed's target level while unemployment remains near historic lows and financial asset prices skyrocket thanks to deficit spending at unprecedented levels in a non-recessionary period.

At his press conferences and speaking engagements since Oct, Powell has pointedly and deliberately ignored signs of a sharp loosening in financial conditions, claiming that rates are "sufficiently restrictive" to bring inflation back to the target level "over time." He has also made it clear that even a modest rise in unemployment would trigger supportive action by the Fed. There is no clear explanation for the 180 degree shift in policy, other than the obvious fact that 2024 is an election year. The Fed wish to appear apolitical, so if they want to cut at all this year, they need to do it well before November to avoid claims that they are favoring the incumbent candidate. However, this approach risks inflation becoming entrenched, potentially creating further market volatility if inflation data over coming quarters show potential for yet another pivot, back to further rate hikes. Although goods inflation has fallen sharply from 2021's peak, services inflation remains stubbornly high due to a tight labor market. Optimists have pointed to falling rents that are not reflected in official data (due to a lag effect) as evidence that inflation will continue to fall, but housing prices have risen further rather than falling.

As a result, OER (Owners' Equivalent Rent), a large component of inflation calculations, could potentially rise in coming quarters rather than falling as predicted. Additionally, goods prices have fallen in large part due to China's sharp economic slowdown, so any good economic news in China could translate rapidly into a cyclical reacceleration of US inflation, a point made by Bloomberg's Simon White.

Equity market gains in the first quarter came despite entering the period with technical and sentiment indicators suggesting complacency and risk of correction. The pace of equity gains since Chair Powell's unexpected flipflop has been nothing short of astonishing. The annualized gain in the S&P500 from the October lows through the March highs was over 80%, and over the same period the "magnificent 7" megacap tech stocks rose at an annualized pace of nearly 115%. In last quarter's commentary, I noted that I expected economic growth to reinflect upwards given Powell's Pivot and the sharp loosening of financial conditions. However, there has been insufficient time for this to translate into an improvement in corporate earnings. Rather, the Powell Pivot triggered a sharp turn in investor sentiment and an expansion of the equity P/E (price-to-earnings) multiple that investors are willing to pay rather than an improvement in earnings. This rise in P/E multiples came despite 10yr bond yields remaining well above 4%, driving the equity risk premium to its lowest level since the dotcom era. Compared to either nominal or real bond yields, current valuations in US large caps (particularly large cap growth and even more specifically the tech sector) imply either future earnings growth far above long-term trends together with profit margins remaining near record highs, or else future returns well below normal. Some pundits see the potential for a "roaring 2020s" scenario of rapid economic growth, however this scenario depends heavily on rapid gains in worker productivity, given that ageing populations across the developed world and high starting debt and valuation levels are not favorable for a sustained economic boom. While AI optimism abounds, there is no clear sign of end-user adoption nor of the widespread productivity gains that its proponents claim. Instead, based on prior cycles of technological progress, we could fall from the "peak of inflated expectations" into the "trough of disillusionment" suggested by the Gartner Hype Cycle, before the true gains and winners of AI become clearer in futute years, given time for realistic deployment assumptions.

Options premia remained well below the average levels of the post-Covid period for most of the quarter, although they've risen modestly in April as the market had its first (very minor) dip. This can make the strategy less attractive if actual realized price volatility remains high, but thus far in 2024, realized volatility fell roughly in line with options prices. As a result, the "risk premium" embedded in monthly options remained relatively consistent. There are a myriad of strategies that have become very popular with investors, most of which sell options on a monthly, weekly, or even daily basis. As a result, it has become more important than ever to monitor options prices and ensure that the level of risk premium remains appropriate. If options prices fall too far, then I may choose to sell fewer options than normal, covering only half or even a quarter of our shares. If simultaneously leaning bearish, I'd also raise our cash level to maintain the net beta and volatility of the portfolio somewhere close to the normal range. If leaning more bullish, then simply holding uncovered stock would be the appropriate approach. Should options prices fall so far that I judge the risk premium to have turned negative, then I might hold stock and purchase some protective puts or cheap calls at discounted prices. This type of flexible approach is crucial now that so many assets much capital has flowed into options-selling strategies.

Any strategy that is deliberately price-insensitive and mechanically repeats the same trades regardless of valuation is doomed to failure in the long-term, a fact which investors in “passive” funds may be wise to ponder. I used air quotes on the term “passive” because there really is no such thing as a passive investment strategy- the decision-making is simply outsourced to other parties or done by obscure committees behind closed doors; the term “passive” is really a misnomer.

This quarter, I kept approximately 25% of our capital invested in the Russell 2000 via the IWM ETF. While small caps are more vulnerable during recession, the relative price of the Russell compared to the S&P500 remains attractive. A recession would cause the position pain, but for now, the upside still looks more favorable. Additionally, allocating a portion of assets to the Russell 2000 helps to lower the concentration risk in megacap tech that remains a concern in the S&P. Finally, option prices in IWM are higher, offering greater return potential. I maintained a high cash level (above 10% on average across accounts) thus far in 2024, which was a drag but provides flexibility in the event of a market dislocation. Now that recession risk is (potentially) ebbing, I’ll be tactically deploying that cash and running closer to the 3-7% cash range that’s normal for this strategy, if and when opportunities to deploy cash at reasonable valuations arise. Managing volatility via cash level and strike price selection for our call sales has outperformed put option purchases so far and remains the risk-management plan, barring a more substantive decline in options prices.

Investors in the growth and accumulation phase of their investing life cycle or those with a strong bullish outlook may wish to look at other strategies while those in the distribution phase or with a more neutral market outlook may find Covered Call an attractive complement to their traditional portfolios.

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Disclosures

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All earnings data comes from Standard and Poors' S&P 500 Earnings and Estimates Report as of 3/31/2023. Asset class performance numbers come from Morningstar as of 3/31/2023.

The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

The 10-year Treasury note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

GDP is the final value of the goods and services produced within the geographic boundaries of a country during a specified period of time, normally a year. GDP growth rate is an important indicator of the economic performance of a country.

REITs, or real estate investment trusts, are companies that own or finance income-producing real estate across a range of property sectors.

A master limited partnership (MLP) is a business venture in the form of a publicly traded limited partnership. It combines the tax benefits of a private partnership with the liquidity of a publicly traded company.

The Russell 2000 Index® measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

The iShares Russell 2000 ETF (the IWM ETF) seeks to track the investment results of an index composed of small-capitalization U.S. equities.

In the context of business and investing, a "moat" refers to a sustainable competitive advantage that a company possesses, which allows it to maintain its market position and protect its profits from competitors over an extended period. The term is derived from the idea of a castle surrounded by a moat, which makes it difficult for invaders to breach the defenses.

Market Beta (Beta) is a measure of a stock's volatility in relation to the overall market. By definition, the market has a beta of 1.0, and individual stocks are ranked according to how much they deviate from the market.

Price-to-Earnings (P/E) Ratio is a stock valuation metric comparing a company's share price relative to its earnings per share (EPS). The ratio helps to assess the relative value of a company's stock.

Owners' Equivalent Rent (OER) measures how much money a property owner would have to pay in rent to be equivalent to their cost of ownership. It is used to measure the value of real estate markets.