January 2024

Market Update

Markets ended on a positive note in December as every broad asset class except commodities and Mastered Limited Partnerships (MLPs) rose. Investors became more excited as thoughts of interest rate cuts danced in their heads and inflation remained near a recent low of 3%. As interest rates dropped asset prices moved higher. The 10 year treasury yield, which briefly touched 5% in late October, ended the year at 3.9% and many investors are going into 2024 hoping for the Fed to cut rates so valuations can increase even more.

Commodities and energy MLPs were negative for the second month in a row and this was one reason inflation has been tame recently. Interest rate sensitive assets like longer term bonds and real estate did very well, but also some assets that are more sensitive to recessions like small caps did better as investors began thinking the US economy will manage a soft landing after all. For the month intermediate to long-term bonds were up 3.5%-8.0% and US large cap stocks both value and growth were up 5% as were international large cap stocks. The biggest winners were Real Estate Investment Trusts (REITs), up 8.9% and US small caps which were up 12%.

We enter 2024 in a different environment than the one in which we entered 2023. Then, investors were worried about high interest rates and a hard economic landing into a recession. Now investors are pricing in interest rate cuts and are betting the US avoids recession altogether. Markets and prices were depressed in early 2023 after the worst year for bonds in a century and the biggest prolonged stock market downturn since 2008. In early 2024 investors are in a good mood and prices are much higher.

This is where our attention is. Investment assets are no longer broadly cheap. While there are some assets and sectors that do still appear attractively priced there are several areas of the market that appear expensive relative to their historical valuations. We are working to manage our exposure to the most expensive areas of the market while increasing our weights to those areas and assets we believe are more attractively priced. This has meant tilting away from market cap weighted indexes like the S&P 500 that became very concentrated in 2023.

Our base case for 2024 is that Gross Domestic Product (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 was up 26.3% while small caps were up 16.9%. Developed international markets were up 18.2% while core bonds were up 5.5%. Growth stocks outperformed value stocks in the US but int'l value slightly outperformed int'l growth. REITs were up 11.4%, MLPs were up 26.6%, and gold was up 12.8%. Commodities were the only negative returning asset at -5%.

Fixed Income Strategy

Fixed income markets in the 4th quarter 2023 continued their volatility theme. Near the beginning of the quarter, the 2-year Treasury reached 5.22% and the 10-year Treasury yield surged to 5%, a 16 year high. At the time, Treasury auctions were experiencing supply indigestion due to increased issuance and indicating a "buyers strike". The Fed's two 4th quarter meetings both resulted in the Fed Funds Target Rate upper bound unchanged at 5.50%, which were considered 'pauses' following the last hike at July's meeting. However, the Fed's December 13th FOMC meeting was significant, in that the quarterly Summary of Economic Projections (SEP) Fed Funds dot plot indicated 75 basis points (bps) of cuts in 2024, a more significant move than had been projected previously. At Chair Powell's press conference that meeting, he implied the committee was moving away from a hiking bias and 'higher for longer' tilt, to discussing moderating policy. This unexpected pivot caused an immediate and substantial market reaction, with rates beginning a sustained decline across the yield curve through year-end.

The benchmark 2-year Treasury yield fell 80bps for the quarter from 5.05% to 4.25%, while the benchmark 10-year Treasury yield fell 69bps from 4.57% to 3.88%, but not before reaching a 16 year high of 5% October 19th. These declines in yields resulted in the largest quarterly performance gain for broad fixed income in more than 20 years. The yield range for 2's was 98bps and 10's was 120bps, also a significant move in yields for one quarter. The oft cited 2's/10's curve remained inverted throughout the quarter, steepening slightly by 9bps and ending the year at -37bps.

Investment grade corporate spreads started the quarter somewhat tighter than historical averages at +121 bps, and ended the year significantly tighter at +99 bps. High yield corporate spreads also fell during the quarter from +394 bps to +323 bps, which was the lowest level reached all year. These tighter spreads indicate the market is pricing in a soft economic landing and/or no recession, but we remain cautious on such an outcome.

We were surprised in 2023 (along with others) that even with the Fed aggressively raising rates 525bps cumulatively since 2022, growth remained resilient, inflation moderated but at a slower pace than expected, and unemployment remained near multi-decade lows (3.7% as of November). Looking forward into 2024, the Fed is positioning itself to begin cutting rates in the 1st half of the year, but will remain data dependent and loosening financial conditions could make it challenging for the Fed to fight the last mile of inflation from 3% to its stated 2% goal.

We are now at the monetary cycle's inflection point. As the Fed attempts to stick the soft landing, the FOMC has pivoted and has begun discussing future cuts. This presumes the FOMC believes that inflation and employment risks have become more balanced. In view of the Fed's change, we are maintaining both our longer maturity/duration stance and an increased government allocation in the form of Treasuries, in anticipation of wider credit spreads due to weaker economic growth.

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 year-end 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 Q4 in Allegion, and we increased our exposure to Emerson Electric.

Core Equity Strategy

For the fourth quarter we saw a global equity markets rally, taking most of the indices to near all-time highs. Successive lower inflation prints were the catalyst for this price movement as investors grew in confidence that the Fed was finally done with raising rates.

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 would appear that despite the unfavorable odds, the Fed has managed to thread the needle of delivering lower inflation without hurting the economy. That been said, it is perhaps too early to declare victory, but we can definitely say; so far, so good.

From a portfolio standpoint, we added a few new names: ASML Holdings, Abbott Laboratories, Nestle and Diageo. We did not exit any existing positions in the quarter.

International Equity Strategy

For the fourth quarter international markets followed the US market higher as the potential of a Fed "pivot" allowed investors to grow in confidence. From a global monetary standpoint, we have entered a goldilocks period in which inflation is decreasing without the need to break the global economy. Whether this goldilocks period continues into 2024 remains to be seen, but for the most part Central Banks have been successful in arresting the upward price spiral that we had witnessed over the past couple of years.

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 "greenshoots" 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 ResMed, Siemens, HDFC Bank, NXPI Semiconductor, Rentokil, GFL Environmental, CNH Industrial, Rolls Royce, Nutrien, and Yum China Holdings

We exited positions in: WPP, Experian, Ryanair, and Methanex

We are seeing value in the healthcare sector and consumer staples sector where we added to positions throughout the year.

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 basis of the International Equity portfolio.

Value Strategy

For the fourth quarter we saw a global equity markets rally, taking most of the indices to near all-time highs. Successive lower inflation prints were the catalyst for this price movement as investors grew in confidence that the Fed was finally done with raising rates.

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 positions in TransUnion, ON Semiconductor, and Waters Corp.

We exited our position in Amazon.

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 final quarter of 2023 saw a little volatility, with stocks selling off in late Oct, but within weeks the S&P 500 rebounded strongly to close the year within a whisker of all-time highs. Stocks had been up for most of the year, but only due to the strong rebound in the “magnificent 7” tech stocks after their drubbing the previous year. The median stock was performing significantly worse. The rally broadened out in the final weeks of 2023, with the Russell 2000 moving from a 52-week low to a 52-week high in record time. This late-year surge was precipitated by Fed Chair Powell’s apparent “pivot” on monetary policy. After spending over a year trying to convince investors that he is the second coming of Paul Volker and that the Fed’s 2% inflation target should be taken seriously, Powell flipflopped without warning (again). Markets had expected the Fed Chair to push back on easing financial conditions, but he declined to do so and instead suggested that the committee had begun to discuss rate cuts, only two weeks after denying any intention of switching gears. Within hours, the market had begun to price in 7 rate cuts for 2024, and risk assets of all varieties ended the year on a strong positive note.

At the end of 2022, counter to the Wall Street consensus of imminent recession, I suggested that the first half of 2023 would be a non-event, with the economy cooling but not yet in the window of maximum risk to investors. I believed that towards Q3 or Q4, the economy would cool more quickly, and we could potentially tip into recession. Surprisingly strong consumer spending and arguably irresponsible deficit spending pushed the time window for that potential recession back a few months, but in my opinion, the lagged impact of tightening was still working through the economy, and we were not out of the woods. Powell’s Pivot has changed things. Now, the economy’s cooling process may be interrupted by the rapid loosening of financial conditions. Historically, looser financial conditions have translated into greater economic growth (with a lag). Given the rapid loosening of conditions in Q4, I would expect leading economic indicators such as the ISM Purchasing Managers’ Index to inflect higher within a quarter or two. As such, recession risk has now fallen. Additionally, the combination of irresponsible fiscal spending and potentially over-dovish monetary policy in an election year, where incumbents are highly motivated to use all means at their disposal to “juice” the economy, the potential for an unsustainable “meltup” in financial assets has increased. For 2023, I was roughly split between recession and soft-landing as the most likely outcomes, but with little certainty of which we’d see. For 2024, I must now downgrade recession risk in light of this sea-change at the Federal Reserve.

Reduced odds of recession do not imply that there is no risk for investors or that risk assets will continue their parabolic rise. To the contrary, markets entered 2024 in an over-stretched state, with technical indicators such as the RSI above the 70 level that signifies "overbought" conditions. Sentiment indicators such as the AAII bull-bear spread, and the CNN Fear and Greed indicator suggest that investors are more frightened of missing out than of capital loss, a contrarian signal suggesting complacency and risk of correction. Valuations have been elevated in megacap tech since the AI hype took hold in July, but beaten-down sectors such as regional banks, real estate, small caps and cyclically exposed stocks all moved rapidly from cheap back towards average valuations by the end of the year. Overall, the slight pullback with which we've begun 2024 is little surprise. From a longer-term perspective, the high allocation to equities amongst US households (another contrarian indicator), the buildup of government debt, elevated valuations using metrics like market cap to GDP or CAPE, high wealth inequality, political polarization and stubborn services inflation are all risk factors. Geopolitical tensions made headlines all year but tend not to deal much market damage so long as the conflicts are contained. If we see any of the current (or new) hotspots develop into a larger, more widespread conflict that could meaningfully impact corporate earnings and would therefore represent another risk. It remains possible that the rapid pace of rate hikes in 2022-23 is still working through the economy and we continue to slow and eventually fall into recession as the lagged impact of prior tightening hits, but I don't consider this to be as likely now. Perhaps the biggest risk of all is that the Fed have declared victory too soon, another wave of inflation occurs as economic growth re-accelerates, and the Fed are forced to backtrack yet again, tightening financial conditions, and slamming risk assets back down.

Options premia are currently far below the average levels of the post-Covid period. This can make the strategy less attractive if actual realized price volatility remains high, but over the course of 2023, realized volatility fell roughly in line with options prices. As a result, the "risk premium" embedded in monthly options remained relatively consistent, aside from the brief bout of volatility in late October. 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 have 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) throughout 2022 and 2023, which was a minor drag but provided 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. 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.

Disclosures

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All earnings data comes from Standard and Poors' S&P 500 Earnings and Estimates Report as of 12/31/2023. Asset class performance numbers come from Morningstar as of 12/31/2023.

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 ISM Purchasing Managers Index is a diffusion index summarizing economic activity in the manufacturing sector in the US. The index is based on a survey of manufacturing supply executives conducted by the Institute of Supply Management. Participants are asked to gauge activity in a number of categories like new orders, inventories, and production and these sub-indices are then combined to create the PMI.

The cyclically adjusted price-to-earnings ratio, commonly known as CAPE, Shiller P/E, or P/E 10 ratio, is a valuation measure usually applied to the US S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation.

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