January 2024

What a Long Strange Trip It's Been

"Sometimes the light's all shinin' on me,

Other times, I can barely see,

Lately it occurs to me, What a long, strange trip it's been"

Lyrics from "Truckin" by Jerry Garcia of The Grateful Dead

These lyrics - while never intended for finance - succinctly describe the past two years in the markets.

As investors approached the end of 2021, the skies were clear, the economy was growing quickly, and only one small cloud was visible on the horizon. That was the Federal Reserve, having indicated a desire to begin raising interest rates. We wrote then that "The previous regime of easy money in search of inflation has ended. While the response is likely to be measured in the short term, over time, interest rates will move higher in an attempt to keep up with inflation." By the middle of 2022, that cloud had become a raging thunderstorm as we embarked on the fastest interest-rate hiking cycle in several decades. By the end of 2022, most investors in all asset classes were surrounded by darkness and negative returns.

Last January, in the midst of this uncertainty, we wrote, "The current market debate now centers around whether the fed funds rate, currently 4.50%, will top out at 4.75%, 5.0%, or 5.25%. Compared to where we began this journey, 0% rates with an expectation of maybe reaching 1.5%, the difference in terminal rate seems almost inconsequential. **We are almost there!!** Like the kids in the back seat, investors need to remember that "there" is a destination. Chair Powell has made it abundantly clear that he intends to stay "there" for a while. How long will be determined first by the persistence of inflation and secondarily by the strength of the economy. **This is not intended to be a pit stop followed quickly by a return trip to the fairytale land of 0% interest rates**."

As 2023 unfolded and inflation began to level off, the economic storm clouds began to subside. Investors were able to begin contemplating an environment where the economy continued growing while inflation slowed towards desired levels. Markets began recovering their losses from the prior year. As summer turned to fall, inflation continued to fall. At the same time, the economy stayed resilient heralding in thoughts amongst investors that perhaps the Federal Reserve had achieved nirvana, and they would be able to thread a historically narrow needle. In November, Federal Reserve Chairman Powell even hinted at the prospects of rate cuts in the future.

The December meeting of the Federal Reserve resulted in an economic forecast of three rate cuts in 2024 without an economic recession. This forecast was enough for investors to zoom past the last remaining clouds and once again see nothing but blue skies. For the past two months, investors in almost every asset class have enjoyed a **"the light's all shinin' on me"** moment. This furious rally into year-end has resulted in a new all-time high for the Dow Jones Industrial Average and nearly a new high in the S&P 500. Said differently, the markets are approaching where they were 2-years ago. "**What a long, strange trip it's been."**

While we are essentially back to all-time highs, the circumstances are quite different. Two years ago, the Federal Funds rate was still 0.25%. Today, it stands at 5.25%. Projected earnings for the S&P 500 were $224 for 2022 and $243 for 2023. The market was trading at approximately 22 times forward earnings, which was deemed reasonable in light of the very low interest rate environment. 2023 proved a bit more challenging as the storm clouds eroded a hoped-for $243 to a final number that will likely be around the same $220 as last year. However, hope springs eternal because estimates for 2024 are - you guessed it - $245. It strikes us as unlikely that earnings will exceed this level in 2024. Historically, earnings are revised lower as the year progresses except in recoveries off recessionary bottoms. We certainly are not in that environment. Starting near 20 times earnings with interest rates at 5.25%, it also seems unlikely that the market will assign a higher multiple to these earnings. What, then, is the case for a substantially higher S&P 500? **"Other times I can barely see?"**

Whereas equity markets recovered most of last year's losses, the broad fixed-income market, as measured by the Barclays Aggregate Bond Index, down more than 8% over the past two years remains significantly underwater. Investors that had reached for yield over the past several years were punished especially hard when rates rose, while those that were willing to endure low yields with short durations (our approach) have been rewarded with an opportunity to reinvest at higher rates and avoid significant losses.

As we look forward to 2024, we see an economy that remains resilient, with unemployment at historically low levels and inflation moderating towards the Federal Reserve's desired range. It is important to point out that inflation rates build on each other, so a reduction in inflation from the peaks of 9% in the middle of 2022 to current readings under 3% has not resulted in "falling prices" - they merely result in prices that are rising more slowly - off a higher base. This higher base is one of the reasons why the economy is perceived by many not to be so great. Over time, individuals will adjust their calibration for what prices ought to be, and this malaise will slowly fade away. It is likely, barring an unforeseen uptick in inflation, that the Federal Reserve will adjust rates lower to keep their policy from being too restrictive. The combination of full employment and a lowering of interest rates should result in an economy and earnings that continue to grow modestly.

While this forecast seems full of sunshine, much like year-end 2021, there are a couple of clouds on the horizon. The elections in our country, and around the world, are obvious wildcards, and we will not attempt to handicap the craziness we are likely to see. What we view as the long-term structural cloud that bears watching intently is the current state of our government's finances. There is a need to refinance approximately $7.6 trillion in debt in 2024, and the government is projected to run a deficit of approximately $1.8 trillion. That means that new debt issuance will be approaching $9.5 trillion next year. At the same time this is occurring, the Federal Reserve is committed to reducing its holdings of government debt, which means that new owners of $2.5-$3.0 trillion of debt will need to be found. If willing buyers don't emerge at current interest rates, the only way to attract them will be through higher interest rates.

It is important to note that there is always a list of things to worry about. Market volatility will continue to provide optionality, and we fully intend to use it. While we are holding more cash than normal, we are still finding opportunities to deploy our clients' capital on our terms. As individual stocks reach fair value, we will be happy sellers and, absent from finding new opportunities, will not hesitate to hold more cash if that is the best alternative. Cash, now yielding 5%, is once again a real alternative!

Having seemingly completed a very long, strange trip, now is a great time to revisit investment plans and modify them if necessary.

Happy New Year!!