Market Update – Q2 2024

"Recognize reality even when you don't like it. Especially when you don't like it."
- Charlie Munger

Buoyed by hopes for lower short-term interest rates in 2024, investors bid up the price of equities during the first quarter, with the S&P 500 turning in the 11th best quarterly return since 1950. Despite the Federal Open Market Committee's recent Summary of Economic Projections (aka, the Dot Plot) suggesting perhaps 3 or 4 rate cuts in 2024, Mr. Market turned a deaf ear and went ahead and priced in 5 to 6 potential cuts to the Fed Funds Rate. Now, as we begin Q2, investors are finding themselves a bit disappointed, as the odds for any rate cut in 2024 are diminishing by the day.

Since peaking just shy of 40,000 in March, the Dow Jones Industrial Average has given back nearly 2,000 points as traders re-rate risk, given stubborn inflation, rising energy prices and hence, higher interest rates. After bottoming out at 3.80% at year-end, the yield on the 10-year Treasury Note has drifted over 75 basis points higher, settling near 4.57% as I write. The yield on the 2-Treasury, the most sensitive to Fed rate activity, has risen from 4.15% in January to 4.95% today. Investors clearly weren't buying what the Fed was selling in December; but they appear to be coming to grips with a "higher for longer" reality as it pertains to interest rates.

Once again, the triumph of hope over experience proves illusory. At Nottingham, the old adage **Don't Fight the Fed** is stamped indelibly on our psyches. Inflation has yet to fall to the level the Fed has assigned as its target – 2.0%. In fact, prices continue to climb higher month after month with recent CPI headline inflation data coming in at 3.5% year over year. Whether Chair Powell calls it a day if/when we get a sub-3% CPI print is anyone's guess. Until then, we think the FOMC will remain vigilant in its fight against inflation, and interest rates may indeed stay a little higher for a little longer than markets currently anticipate.

The good news for investors, in our minds, is that both stocks and bonds remain in what famed investor Howards Marks terms the "zone of reasonableness." The heroic run in tech stocks and all things "AI" related notwithstanding, the median P/E on the S&P 500 at quarter-end stood at 19.0x, about average for the past 25 years. We think Small & Mid-cap equities also remain valued at reasonable levels. While the favorable impact on return of the "Mag 7" (now "Mag 5"?) makes it hard to fade the U.S. large-cap trade, valuations across those companies rest in the top decile over time. A degree of caution is warranted.

Now for the more sobering news, in our view. This "growth" in the U.S. economy is being driven to a meaningful degree by fiscal spending, which has increased from 20% to 23% of GDP over the past 10 years. The government's 2024 federal budget calls for spending of $6.5 trillion, with nearly 25% of that coming from borrowing. The net federal debt of the United States is at 100% of GDP, a level last seen at the end of World War II. Further, the Congressional Budget Office forecasts this debt growing to 124% of GDP over the next 10 years. To put this into some perspective, the net federal debt stood at less than 40% of GDP just prior to the Great Financial Crisis of 2008, and has exploded over the past 20 years.

The U.S. has long had the “exorbitant privilege” (a term coined by a French Minister of Finance in the ‘60’s) of having the Dollar as the world’s reserve currency. In spite of the government’s fiscal imprudence, other countries need to buy U.S. Dollars to finance foreign trade. That “privilege” creates massive demand for dollars, both at home and abroad. It provides liquidity and stability, and supports the position of the U.S. as an economic superpower. It is by no means guaranteed, however (just ask the French in 1815 or the British in 1920).

As the late great Charlie Munger observed in the opening quote, acknowledging inconvenient truths is an essential part of long-term investment success. Fiscal recklessness is by no means a new phenomenon; moreover, it’s not a one-party issue either. Successive Republican and Democratic administrations have taken borrowing and spending levels to new heights. The day may come when the role of the U.S. Dollar becomes marginalized in favor of other currencies, or gold, or Bitcoin. Probably not tomorrow, but it’s certainly possible in my lifetime, or that of my children. What then?

Diversification remains a vital component of successful long-term investing. With the S&P 500 index struggling with massive concentration risk and interest rates poised to stay higher for longer, investors may benefit from thinking about what will work over the coming 10 years, rather than focusing on what has worked over the past 10 years. As we often note, maintaining one’s intellectual flexibility is important as we progress through uncertain times.

U.S. equities down the cap scale, non-U.S. equities, beaten-down real estate, private equity and private credit are all areas of interest to us now. While we don’t know if this is 1995 (the dawn of irrational exuberance), 1999 (the beginning of the end) or 1975 (stagflation) for that matter, we do know you expect us to help guide you through the years ahead. And, while we also don’t know who the Commander-in-Chief will be come January, we do know that, historically, markets don’t really care. According to Strategas Research Partners, of the past 16 times an incumbent president ran for re-election, the S&P 500 only declined twice, 1932 and 1940. All the other years saw positive total returns averaging 13.9%!

Investment game plans should stay centered around time horizon, risk tolerance, return requirement, taxes, and peace of mind. Part of the discipline that is a key to long-term success involves re-visiting one’s circumstances periodically and making adjustments when needed. Investors, however, should be mindful of another of Munger’s great observations, “The big money is not in the buying and selling, but in the waiting.” Knowing you’re on the right path, and maintaining the discipline to stay on that path is crucial to realizing one’s financial goals. We’re happy to partner with you on that journey.

Sincerely,

Larry Whistler, CFA
President
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