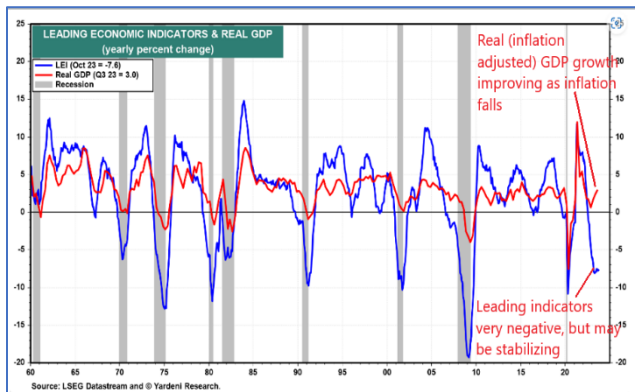


LAURELHURST ASSET MANAGEMENT

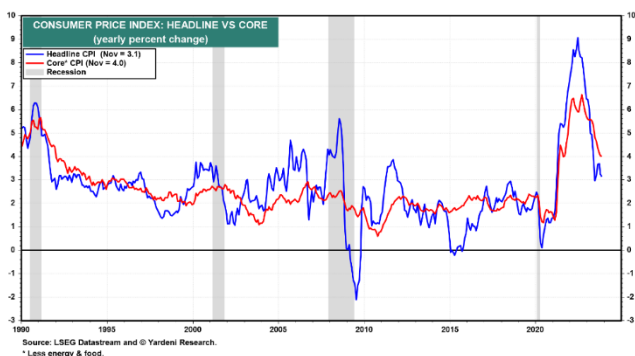
John's Market Outlook – December 20, 2023

After 18 months of rapid rate increases by the Federal Reserve, expensive credit is pressuring the economy, mostly visibly in real estate, consumer debt, and bankruptcy rates. Higher interest cost is increasing the federal deficit and eroding its stimulus effect. During this rate increase cycle, the economic picture turned broadly negative, with leading indicators down, yield curves inverted, and earnings estimates declining. As positives, labor shortages are easing with unemployment still low and consumer spending is growing modestly.



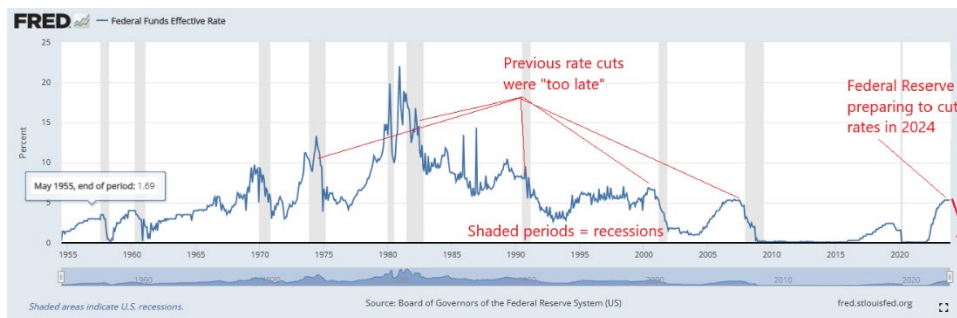
In the September outlook, I said *“whether this [rate increase] cycle will [lead to a recession] (“hard landing”) or if progress on inflation allows the Fed to lower rates before causing a recession (“soft landing”) is very uncertain.*

The good news is that inflation continues to fall, with November headline CPI down to 3.1% (peak was 9%) and core (ex- food and energy) CPI 4.0% (peak 6.5%). Housing (shelter) inflation, 35% of CPI, is now down to 6.5% in November (peak 8.2%). Wage growth is down to 5.2% (peak 6.7%) and services inflation is also declining.



*My opinions and best judgment as of the date written, not investment recommendations or guarantees.
For clients of Laurelhurst Asset Management, 1001 SE Water Ave Ste 217 Portland OR 97214.*

The Federal Reserve now believes it has done enough to achieve 2% inflation by 2025. It is now focused on achieving a soft landing and preparing to cut interest rates in 2024, maybe as early as spring.



A shift from raising to lowering rates will be a tailwind for rate-sensitive sectors, which include banks, housing, real estate, construction, utilities, consumer finance, some consumer goods, and some healthcare. Emerging market

economies benefit when interest rates decline, as do smaller companies and those with higher debt loads. In general, *rate cuts are positive for the broader stock market* that was overlooked in 2023.

Technology stocks that rose in 2023 on *“artificial intelligence” promises now must deliver accelerating earnings*. Prices and expectations are very high; Adobe (ADBE) and Oracle (ORCL) recently fell on so-so results.

We still want to be careful and emphasize under-owned, lower-valuation names. Historically, the Federal Reserve cuts rates too late to avoid recessions (chart above); we don’t yet know if 2024 will be the exception.

Another beneficiary of lower rates is fixed income (bonds). Rising rates drove bond prices down and yields up. Investment grade bonds now offer yields solidly above inflation, from over 5% in Treasury bills to 5%-to-6% in medium duration corporates. For the first time since 2019, *bonds are an attractive low-risk yield (income) source for portfolios*. This Outlook’s Appendix is a “primer” on bonds.

As for sectors and asset classes:

- Europe may shift to cutting rates in early/mid 2024. Japan is exiting deflation. China’s economy is struggling; other emerging markets like India look better. iShares Japan and India ETFs (EWJ, INDA) and Japanese stocks like Tokyo Electron (TOELY) and Tokio Marine (TKOMY) are in some portfolios.
- Banks will benefit from lower deposit rates; with higher bond prices, new capital rules are tolerable. We are adding to Fifth Third (FITB) and Bank of America (BAC), funding from insurance names.
- Rents should stabilize in 2024 then rise, as the development slump in 2023 means less new supply in 2025. Housing demand is strong. We are adding to REITs like Mid-America (MAA).
- Oil prices are down on recession fears, but demand is growing and producers are very profitable. Construction names like Jacobs (J) and Granite Valley (GVA) benefit from lower rates.
- Defense names like General Dynamics (GD) and L3 Harris (LHX) benefit from global re-arming amid geopolitical conflict (Ukraine, Middle East, China/Taiwan) and the emerging “new Cold War”.
- The healthcare sector is inexpensive, aside from obesity drug names like Lilly (LLY). Risks include lower public spending and the federal government’s drug price and antitrust efforts.
- We have “big tech/AI” names like Google (GOOG), Meta (META), and Microsoft (MSFT), but also less-owned names like Intel (INTC), AMD (AMD), Micron (MU), and Jabil (JBL).

I would be happy to go deeper into this outlook and other investment topics than was possible in this brief summary. Please email johnliu@laurelhurstasset.com or call 510 847 0070. Happy holidays and thank you!

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APPENDIX TO DECEMBER 2024 OUTLOOK – PRIMER ON BONDS

A bond¹ is a security that periodically pays specified interest income (the “coupon”, usually paid semi-annually) and, at the maturity date, the face value of the bond (usually \$1,000). Also called “fixed income” securities, bonds are issued by the federal government and agencies, state and local governments, and corporations.

Investment grade. This primer covers *only bonds that are “investment grade”*, which means the issuer is financially strong with a high credit rating (AAA to BBB)² and the risk of default is very low.

Bond basics. We’ll use *Indiana Gas 7.08% 10/05/2029* as our example. This is a bond, issued by Indiana Gas, a subsidiary of CenterPoint Energy (CNP), priced in the market at 106.982 ask. The bond’s “**face value**” is \$1,000 and it will pay \$70.80 = 7.08% x \$1,000 in “**coupon interest**” per year (in \$35.40 semi-annual payments on April 5 and October 5) until the “**maturity date**” of October 5, 2029 when the final coupon payment and the \$1,000 face value payment are made. This bond can be purchased for \$1,069.82³ plus accrued coupon interest from October 5, 2023.

Cash flows. The cash flows from this bond are shown above. The initial cash flow is negative (cost to investor) and the remaining cash flows are positive (payments to investor).

12/17/2023	-\$1,083.98	price + accrued interest
4/5/2024	\$35.40	coupon
10/5/2024	\$35.40	coupon
4/5/2025	\$35.40	coupon
10/5/2025	\$35.40	coupon
4/5/2026	\$35.40	coupon
10/5/2026	\$35.40	coupon
4/5/2027	\$35.40	coupon
10/5/2027	\$35.40	coupon
4/5/2028	\$35.40	coupon
10/5/2028	\$35.40	coupon
4/5/2029	\$35.40	coupon
10/5/2029	\$1,035.40	face value + last coupon

Premium and discount. This bond’s 7.08% “**coupon rate**” reflects interest rates when the bond was issued in 1999. The coupon rate is higher than current interest rates, so the bond is now priced at a “premium” to its face value. At maturity, the face value paid will be less than today’s price, a loss that partly offsets the high coupon.

Bond yields. The “**current yield**” of this bond is 6.62% = \$70.80 / \$1,069.82, the annual coupon divided by bond price. “**Yield to maturity**” (YTM) is about 5.72% and represents the annualized total return to be received over the life of the bond, including the timing and reinvestment of payments and the premium or discount. *Yield to maturity is the primary measure of a bond’s return.* Yields are quoted on a pre-tax basis.

Call and other features. Most bonds are “**callable**”; the issuer can redeem the bond before its maturity by paying the face value, cancelling future coupon payments, which is usually bad for investors.⁴ *If a bond trades at a premium, the issuer is more likely to call the bond.* If a bond trades at a discount, the issuer is less likely to call the bond. “Yield to call” (YTC) is the total return if the issuer calls the bond at the earliest opportunity. “Yield to

¹ This is just a primer; please treat it as simplified, approximate, and subject to many exceptions and caveats.

² Bonds rated below BBB are considered “high yield” and are *substantially* higher-risk.

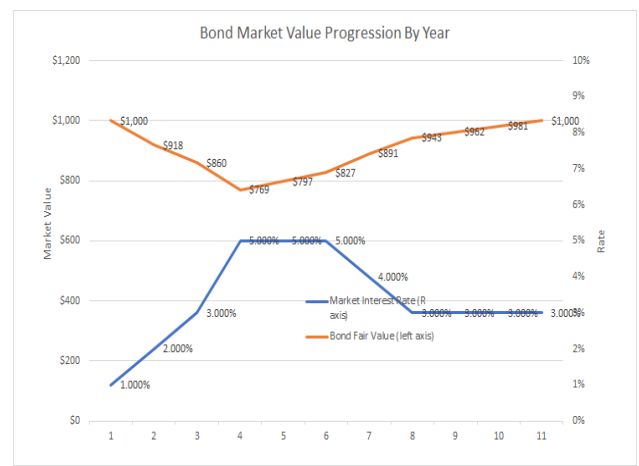
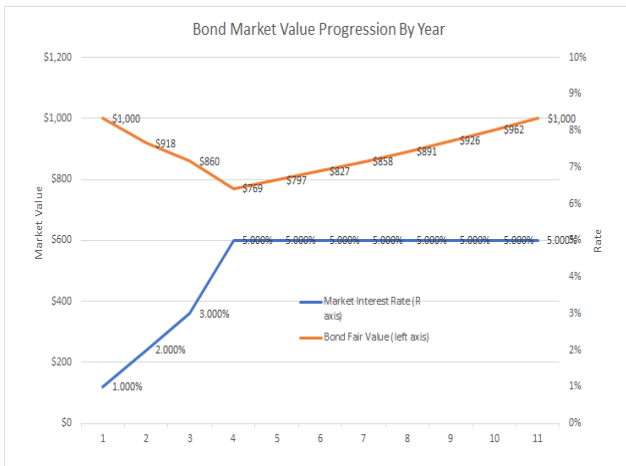
³ Bond prices are quoted in hundreds; scale by 10X to the actual price. Price and yields as of this writing.

⁴ Exception for “make-whole calls” which compensate the investor for future coupon payments.

worst” (YTW) is the lower of YTM and YTC. The Indiana Gas bond is non-callable, so there is no YTC. Other bonds may be convertible, stepped coupon, floating rate, putable, etc.; we won’t get into those.

Bond valuation. The fundamental **value** of a bond is the present value of all future cash flows discounted to today at current interest rates, adjusted for credit and other risks. *Interest rate and bond values move inversely; when interest rates go up [down], bond values go down [up].* A bond can be at a premium to face value if interest rates have declined since the bond was issued, or at a discount if interest rates have declined. As a bond approaches maturity, any premium or discount fades and the bond’s value converges on its face value. Market **price** can diverge from value; for investment grade bonds large divergences typically don’t last too long.

Selling early vs holding to maturity. We’ll illustrate this with a \$1,000 face value bond, non-callable, annual coupon 1.00%, ten year maturity, 1% YTM, no credit risk. Suppose in year 1 the market interest rate is 1.0%; the bond value is \$1,000. Suppose interest rates (blue line) then climb to 5.0% by year 4; the bond value (orange line) will decline to about \$770 in year 4, a -23% loss. Over the remaining years to maturity, the bond’s value will then recover back to \$1,000; if rates stay at 5.0% (left chart), the recovery will be slow; if rates decline (right chart), the recovery will be faster.



For the investor who buys this bond to re-sell, the return is *unknown* - the bond may rise or decline in value. For the investor who will hold this bond to maturity, the return is *known*, being the YTM at purchase.

YTM needs to be reasonably attractive. The example above reflects the experience of investors/banks who bought bonds in 2020-2021 when interest rates were near zero. As the Federal Reserve raised rates to 5% those bonds lost value⁵; investors who hold to maturity will recover the loss over time, but will get a YTM well below both inflation and current interest rates. *Moral: buy bonds only when YTM's are reasonably attractive.*

Types of bonds, taxation⁶. In taxable accounts, any *gain/loss* from buying the bond at a discount/premium is taxed⁷, mostly as ordinary income. Tax on *coupon income* is based on bond type:

- **US Treasury bills and bonds.** Subject to federal tax as ordinary income, exempt from state and local tax.
- **Federal agency bonds.** Some (e.g. FHLB bonds) are exempt from state and local tax; others (e.g. Fannie Mae bonds) are fully taxed like corporate bonds.

⁵ Losses on bonds was a major cause of the bank crisis in March 2023.

⁶ These are general guidelines, not tax advice for a particular situation; consult your CPA.

⁷ This is for bonds bought in the secondary market. For a bond issued at a discount or premium, gain/loss is not taxable.

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- **Municipal bonds, from investor's state of residence.** Exempt from federal, state, and local tax; except taxable municipal bonds which are uncommon.
- **Municipal bonds, from another state.** Exempt from federal tax; subject to state and local tax as ordinary income; except taxable municipal bonds.
- **Corporate bonds.** Subject to federal, state, and local tax as ordinary income.

In non-taxable accounts, neither bond gain/loss nor income is taxed.

Types of bonds, risk. Investors treat US Treasuries as zero-risk, federal agency bonds as nearly so, municipal bonds as extremely low risk, and investment grade corporates as very low risk. *Historically, investment grade bonds are indeed very low risk.* The US government has never defaulted. The average annual default rate for municipal bonds is about 0.02%. The average annual default rate for corporate bonds is about 0.1% to 0.2% for AAA-through-A rated bonds and about 0.4% for BBB rated.

Types of bonds, available YTM. Reflecting tax and risk, corporate bonds typically offer the highest YTM, and municipals the lowest, with Treasuries in the middle.

Bond maturity and coupon. "Ultra-short" refers to bonds with less than 1 year to maturity. "Short term" usually means 1 to 3 years to maturity, "medium" 4 to 7 years, and "long" over 7 years. Normally, YTM is lower for short term bonds and higher for longer term bonds, called a **positively sloped "yield curve"**. Currently, for US Treasuries the opposite is true: the Treasury yield curve is **inverted**, with yields over 5.0% for ultra-short (Treasury bill⁸) and about 4.0% for longer term (Treasury notes and bonds, 10 to 20 years). For corporates and municipals, the yield curve is flattish to positively sloped.

Bond selection. Bonds are selected by searching for attractive YTM or YTWs in the desired maturity range and credit rating, given tax considerations (taxable or non-taxable account, investor's state and tax brackets). Other considerations include call risk, price sensitivity to interest rate, and issuer's industry.

Review an example bond. Below we see the Indiana Gas bond in my bond model:

- This bond is probably not good for an Oregon investor's taxable account (aftertax YTM only 3.2%); that investor will probably get better aftertax YTM in Oregon municipal bonds.
- This bond is okay for a Washington investor's taxable account (aftertax YTM at least 4.1%⁹).
- It is attractive for either investor's non-taxable account (pretax YTM about 5.7%)¹⁰.
- The current yield is 6.6%, so the investor will receive a nice income stream; the bond is priced at a premium, so there will be a capital loss at maturity partly offsetting the income, hence the 5.7% YTM.
- If interest rates rise [fall] one percentage point, the bond's price is likely to decline -5% [rise +3%]; the hold-to-maturity investor needs to be willing to ignore that degree of volatility.
- The total return over 1 year (coupon + price change) if rates rise [fall] one percentage point is +2% [+10%].
- If this bond were callable, the risk of call would be significant.
- The bond is rated BBB+, well within investment grade, and the issuer is in a stable industry.

⁸ For Treasury bonds, "bills" means < 1 year to maturity, "notes" means 1 to 10 years, and "bonds" means > 10 years.

⁹ Possibly higher, given the deduction to Washington's capital gains tax.

¹⁰ Aftertax YTM is an approximation based on the investor's assumed taxable income and 2023's tax brackets.

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Example: Indiana Gas bond – for Oregon investor

BOND CALCULATOR

Use only for > 1 yr maturity. Does not calculate YTC.

Bond Data

Price \$106,982
Face 100,000
Settle 12/17/2023
Maturity 10/5/2029
Mat Yrs 5.8
Coupon 7.080%
Curr Yld 6.618%
Amt Cpn \$3,540
Num Cpn 12
Freq Cpn semi
Basis 360/360
Disc Rate 4.598%
YTM Pretax 5.723%
Spread to TSY 113bp
YTM AftTax 4.110%
Sprd AT to TSY 79bp
Calc Value \$108,426
Accr'd Int \$1.42
Px+Acc'dInt \$108,398
Duration 4.9
Convexity 20.4
NPV 0.03

CUSIP 45475QAR4
Coupon Type fixed
Investor Income \$250,000
Issue Indiana Gas Company, Inc. 7.08% 05-OCT-2029

Bond Type Corporate
Investor State OR
Manual Notes Non-callable, putable (date past)
S&P Rating BBB+

above steps IGNORED

Return over 1 Year		Rate Chg	Rate	Time	Interact	Value	Px Rtn	Cpn Rtn	Tot Rtn	De-Min	Px Rtn	Px Rtn	Tax Rt	Tax Rt	Tax Rt	Tax Rt	AT Rtn
Over 1 Yr	Effect	Effect	Effect	In 1 Yr	In 1 Yr	In 1 Yr	In 1 Yr	In 1 Yr	In 1 Yr	Px Rtn	De-Min	Excess	De-Min	Excess	Px Rtn	Cpn Rtn	In 1 Yr
unch	\$0.00	-\$1.05	\$0.00	\$107.37	-0.97%	6.62%	5.65%	1.25%	-0.97%	0.00%	32.70%	32.70%	32.70%	32.70%	32.70%	41.70%	3.20%
-100 bp	\$5.11	-\$1.05	-\$0.81	\$111.67	2.99%	6.62%	9.61%	1.25%	1.25%	1.74%	32.70%	41.70%	37.94%	41.70%	41.70%	5.71%	
+100 bp	-\$4.81	-\$1.05	\$0.73	\$103.29	-4.73%	6.62%	1.88%	1.25%	-4.73%	0.00%	32.70%	32.70%	32.70%	41.70%	41.70%	0.67%	

Return Held to Maturity		Px Rtn	Cpn Rtn	Tot Rtn	De-Min	Px Rtn	Px Rtn	Tax Rt	Tax Rt	Tax Rt	Tax Rt	AT Rtn
Cumul	Annld	to Mat	to Mat	to Mat	Px Rtn	De-Min	Excess	De-Min	Excess	Px Rtn	Cpn Rtn	to Mat
-1.16%	5.93%	5.06%	0.21%	-1.16%	-1.37%	32.70%	32.70%	32.70%	32.70%	32.70%	41.70%	18.76%
												3.01%

Assumes MultiCo resident.

Example: Indiana Gas bond – for Washington investor

BOND CALCULATOR

Use only for > 1 yr maturity. Does not calculate YTC.

Bond Data

Price \$106,982
Face 100,000
Settle 12/17/2023
Maturity 10/5/2029
Mat Yrs 5.8
Coupon 7.080%
Curr Yld 6.618%
Amt Cpn \$3,540
Num Cpn 12
Freq Cpn semi
Basis 360/360
Disc Rate 4.598%
YTM Pretax 5.723%
Spread to TSY 113bp
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Investor Income \$250,000
Issue Indiana Gas Company, Inc. 7.08% 05-OCT-2029

Bond Type Corporate
Investor State WA
Manual Notes Non-callable, putable (date past)
S&P Rating BBB+

above steps IGNORED

Return over 1 Year		Rate Chg	Rate	Time	Interact	Value	Px Rtn	Cpn Rtn	Tot Rtn	De-Min	Px Rtn	Px Rtn	Tax Rt	Tax Rt	Tax Rt	Tax Rt	AT Rtn
Over 1 Yr	Effect	Effect	Effect	In 1 Yr	In 1 Yr	In 1 Yr	In 1 Yr	In 1 Yr	In 1 Yr	Px Rtn	De-Min	Excess	De-Min	Excess	Px Rtn	Cpn Rtn	In 1 Yr
unch	\$0.00	-\$1.05	\$0.00	\$107.37	-0.97%	6.62%	5.65%	1.25%	-0.97%	0.00%	25.80%	25.80%	25.80%	25.80%	27.80%	27.80%	4.06%
-100 bp	\$5.11	-\$1.05	-\$0.81	\$111.67	2.99%	6.62%	9.61%	1.25%	1.25%	1.74%	25.80%	27.80%	26.96%	27.80%	27.80%	27.80%	6.96%
+100 bp	-\$4.81	-\$1.05	\$0.73	\$103.29	-4.73%	6.62%	1.88%	1.25%	-4.73%	0.00%	25.80%	25.80%	25.80%	27.80%	27.80%	27.80%	1.27%

Return Held to Maturity		Px Rtn	Cpn Rtn	Tot Rtn	De-Min	Px Rtn	Px Rtn	Tax Rt	Tax Rt	Tax Rt	Tax Rt	AT Rtn
Cumul	Annld	to Mat	to Mat	to Mat	Px Rtn	De-Min	Excess	De-Min	Excess	Px Rtn	Cpn Rtn	to Mat
-6.53%	39.71%	33.18%	1.25%	-6.53%	0.00%	25.80%	25.80%	25.80%	25.80%	25.80%	27.80%	23.83%
												3.75%

Note \$250K/yr deduction for WA capital gains tax

There's a lot more to bonds, but that's enough for a primer. Happy Holiday reading!