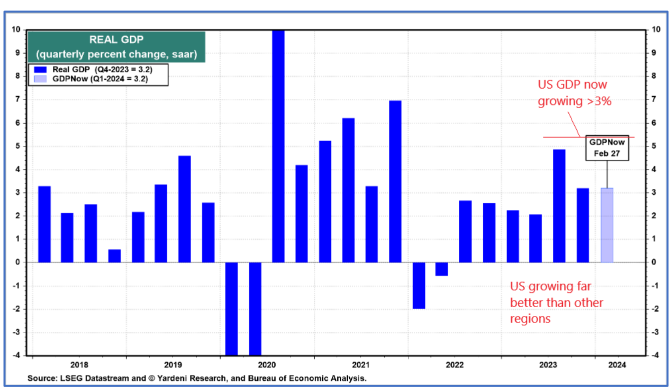
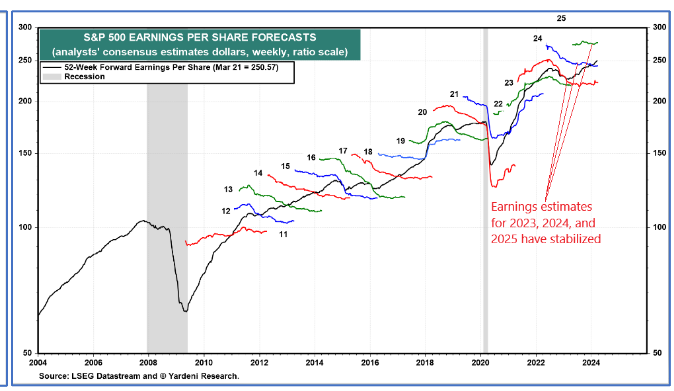
John's Market Outlook – March 28, 2024

We are in an unusual time: *the US will start an interest rate cutting cycle when its economy is overall doing well.*

The Federal Reserve normally acts contra-cyclically, cutting rates when the economy is cooling (growth slowing, unemployment rising) and raising rates when the economy is overheating. Currently, the Federal Reserve sees slowing labor markets, Fed Funds rate (5.3%) above inflation (3%), expensive credit pressuring the economy (real estate, consumer, small business). It knows its rate hiking cycles usually cause economic slumps. The Federal Reserve thinks inflation is on a path to 2% and has re-focused on maintaining full employment. Other developed countries are at a similar point; *I expect a global rate cut cycle to start this year*.

Rate cuts support the economy. When GDP is growing (left chart) and earnings are stable (right chart), rate cuts can also boost asset prices, at least for a time. Prices suffered when rate hikes started in 2022[1]; they are benefiting now, and *broadly* so.





December's outlook said *"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 . . . In general, rate cuts are positive for the broader stock market that was overlooked in 2023."*

Much of this has started to happen. More companies are reporting positive earnings growth (left chart next page) and more stocks are showing positive performance (right chart).

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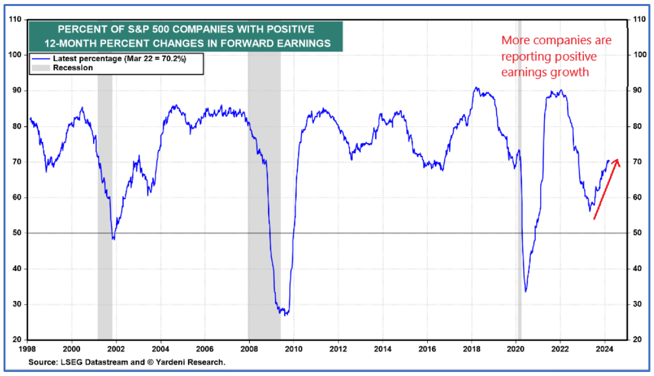
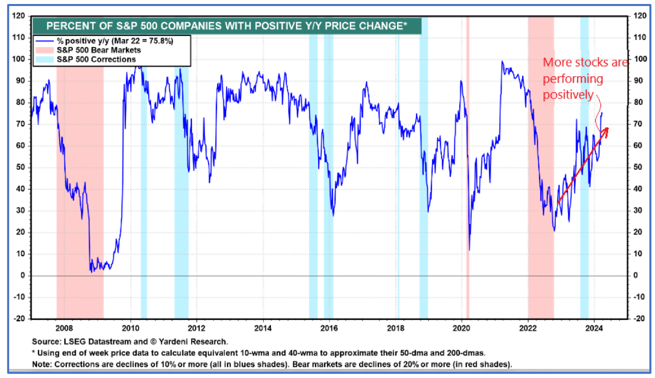
[1] See December 2021 Outlook.





A broadening market helps diversified portfolios. "The Economy" is many sectors and industries. In the past two years, some industries went through downcycles, leaving their stocks relatively less expensive and somewhat overlooked. Examples: Domestic freight carriers added too much capacity during the 2020-2021 surge in consumer spending and in 2022-2023 suffered the worst "freight recession" in decades; they are now starting to recover. After Covid supply chain disruptions eased, industrial and agricultural companies needed less "safety stock"; suppliers are finally seeing the end of the resultant inventory de-stocking. Low interest rates drove over-supply of new apartments and weak rent growth; apartment REITs are starting to anticipate a new rent upcycle as high rates suppress new projects. In portfolios, I have added to names such as freight carriers Knight Transportation (KNX) and CH Robinson (CHRW), crop protection supplier FMC Corp (FMC), building materials supplier Carlise (CSL), and apartment REITs Mid-Atlantic (MAA) and Essex Property (ESS).

Peak rates also create fixed income opportunity. Investment-grade bonds have attractive yields (5-6%) that can be locked in for years. Higher rates drove bond prices down in 2021-23; lower rates ahead should lift bond prices. We can now buy bonds fairly *inexpensively, before* their defensiveness and stable income is needed.

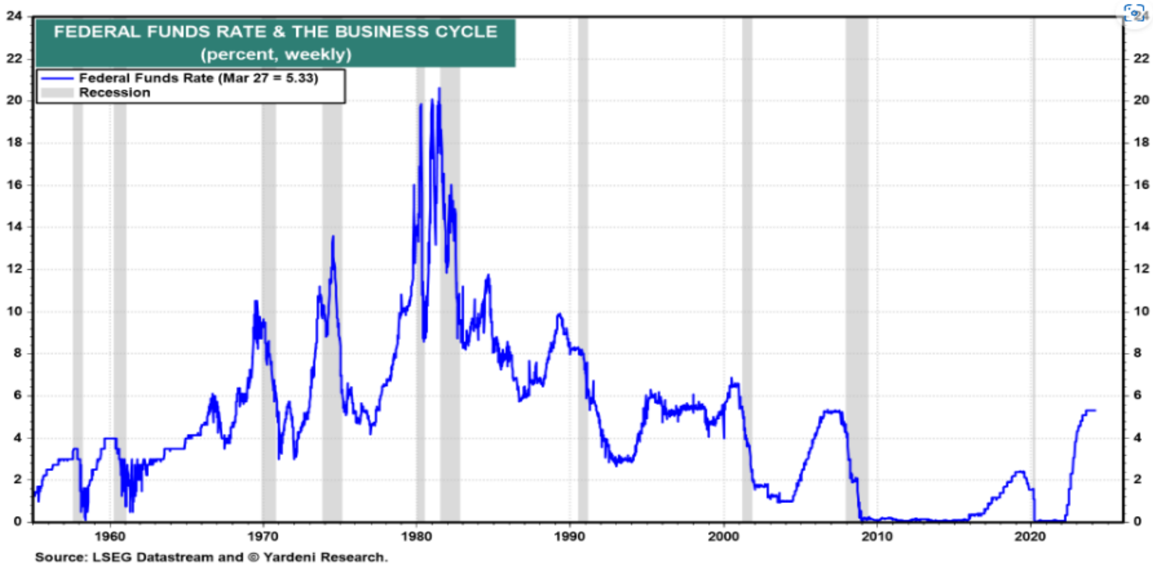
As for other sectors and asset classes:

- Switzerland kicked off the global rate cut cycle. Japan marked the end of its twenty-year deflation. We hold European and Japanese names, Japan ETFs, and, for developing market exposure, India ETFs.
- Banks' lobbying may manage to further soften new capital rules. We hold bank names like Fifth Third (FITB) and Bank of America (BAC) with low exposure to commercial real estate.
- By supporting economic growth, rate cuts indirectly help energy prices. We own oil majors like Shell (SHEL) and Total (TTE) and, for gas, Coterra (CTRA). With infrastructure funding flowing, we have added construction material exposure via Knife River (KNF). Aerospace (civilian and military) is in a strong upcycle, so we own General Electric (GE), Raytheon (RTX), and others, but <u>not</u> Boeing (BA).
- Healthcare device name Medtronic (MDT) is inexpensive. Life science stock Danaher (DHR) may benefit as biotechnology startup financing improves. Vertex's (VRTX) non-opiod pain drug is much-needed. With positive cardiac data, Lilly's (LLY) obesity drug should get more insurance coverage.
- The "AI" thesis is broadening from GPUs, which may benefit our names in memory Micron (MU), client-side processing Intel (INTC), and cloud software Salesforce (CRM) and Oracle (ORCL). AI creates new security risks; I have added Palo Alto Networks (PANW) to existing cybersecurity name Fortinet (FTNT).
- With the "Mega Tech 7" no longer dominating market performance, we are not greatly adding to names like Google (GOOG), Meta (META), and Microsoft (MSFT).

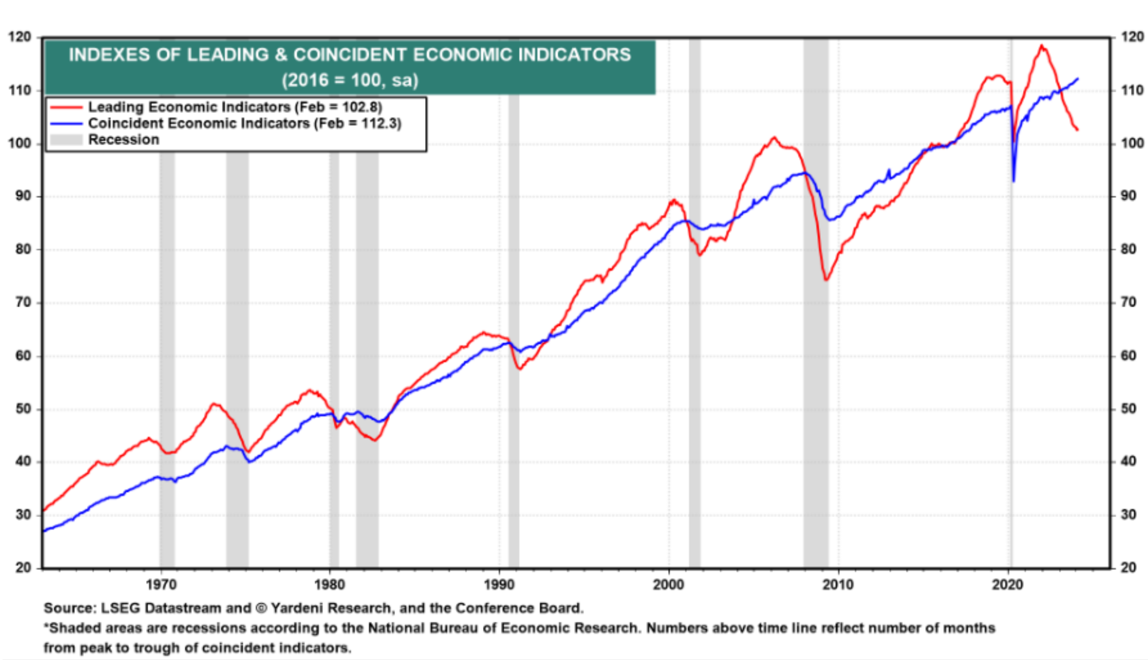
I would be happy to go deeper into this outlook and other investment topics than was possible in this brief summary. Please email johnliu@laurelhurstasset.com or call 510 847 0070. Happy holidays and thank you!

APPENDIX TO MARCH 2024 OUTLOOK – SELECTED CHARTS AND TABLES

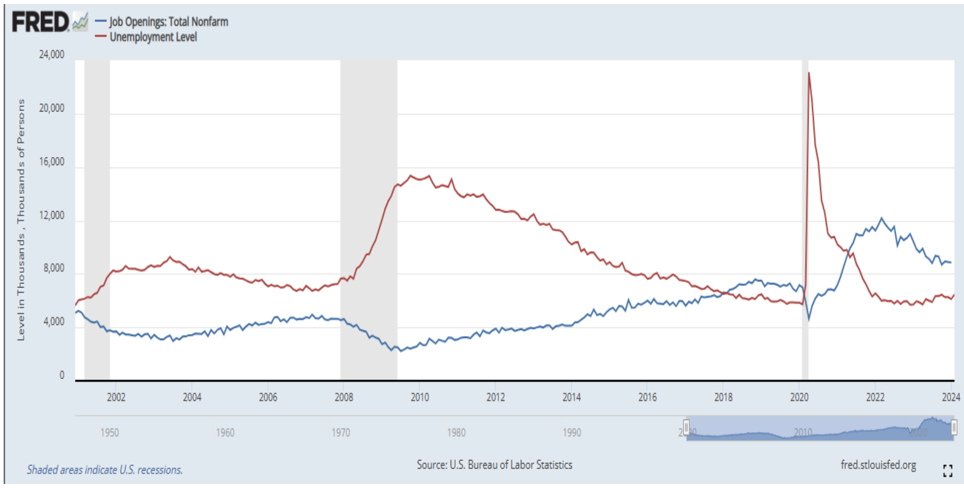
The Fed funds rate is 5.25-5.50%. *The Federal Reserve now expects to start <u>cutting</u> rates this year.*



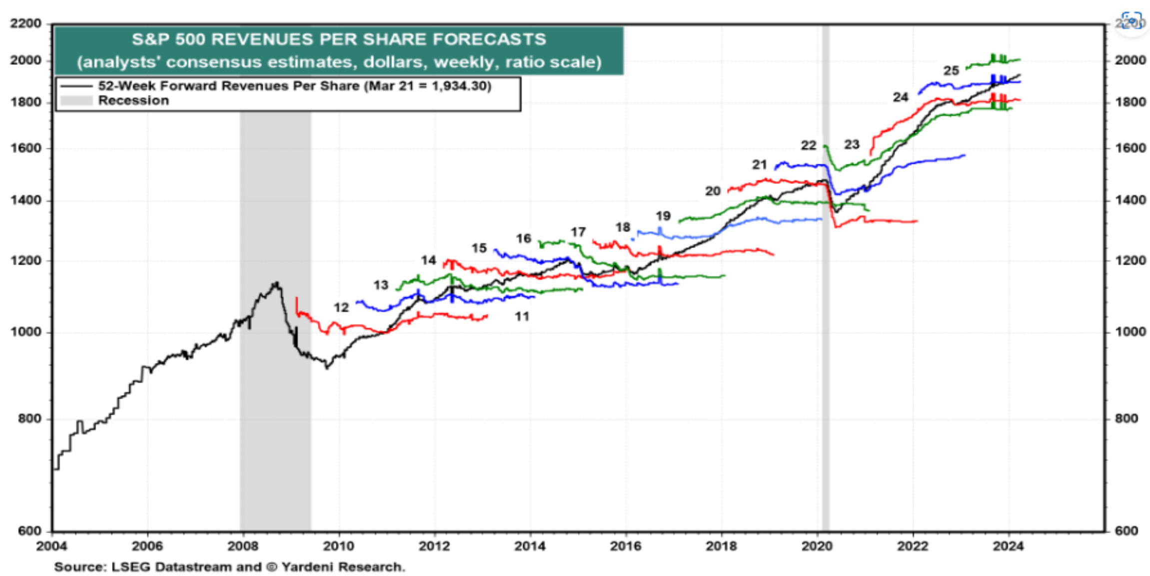
Leading economic indicators (red) continue weakening. *Coincident indicators reflect the economy now. Leading indicators suggest the economy's future direction. Shaded periods are recessions.*



Job openings are stable. *The number of open jobs (blue) has stabilized since summer 2023, the number of unemployed persons (red) has risen slightly.*



S&P 500 consensus forecasts are rising. *Multi-colored lines show evolution of revenue/share forecasts for each year revenue/share, blue is "next 12 months" forecast. Forecasts for 2024 and 2025 are stable or slowly rising.*



My opinions and judgment on the date written. Not investment recommendations or guarantees.
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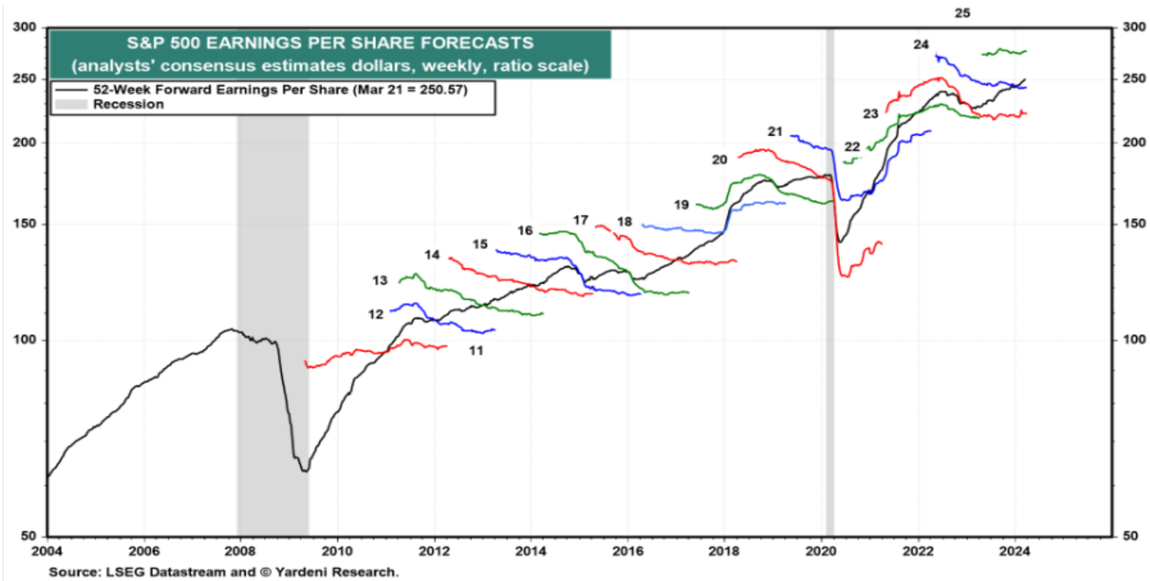
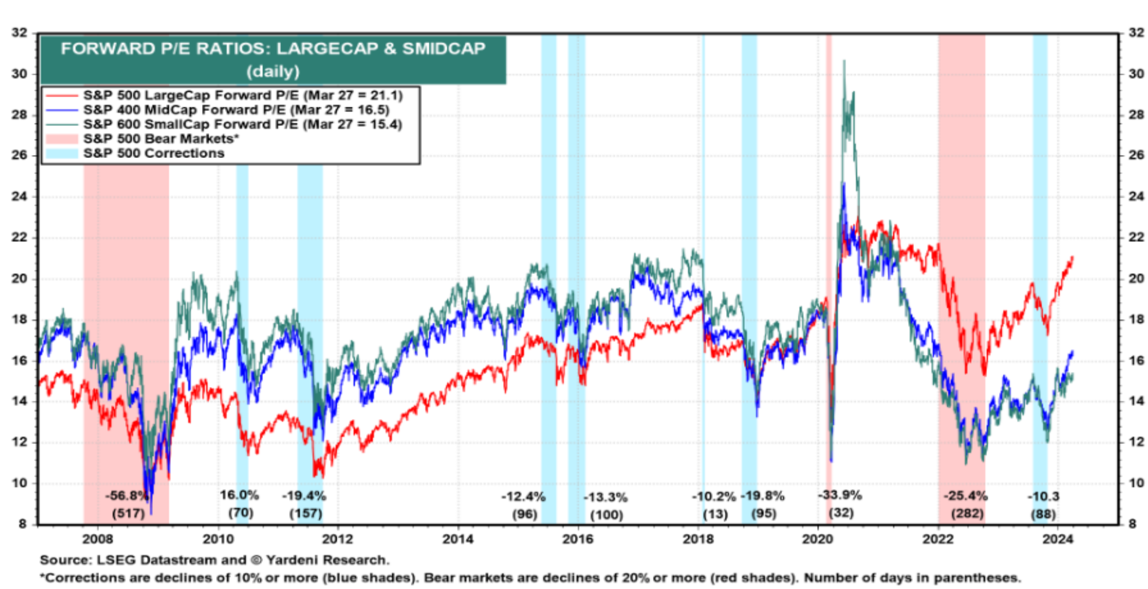
Firm information including current Form ADV available upon request to johnliu@laurelhurstasset.com.

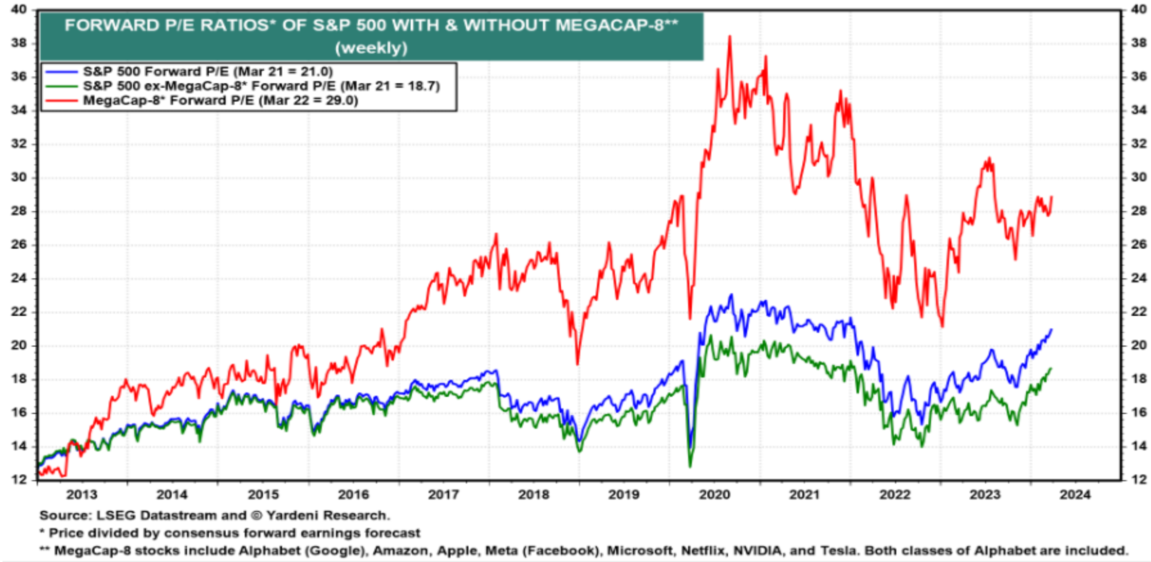
Consensus S&P 500 2024 earnings forecast has stabilized, 2025 forecast is gradually improving.



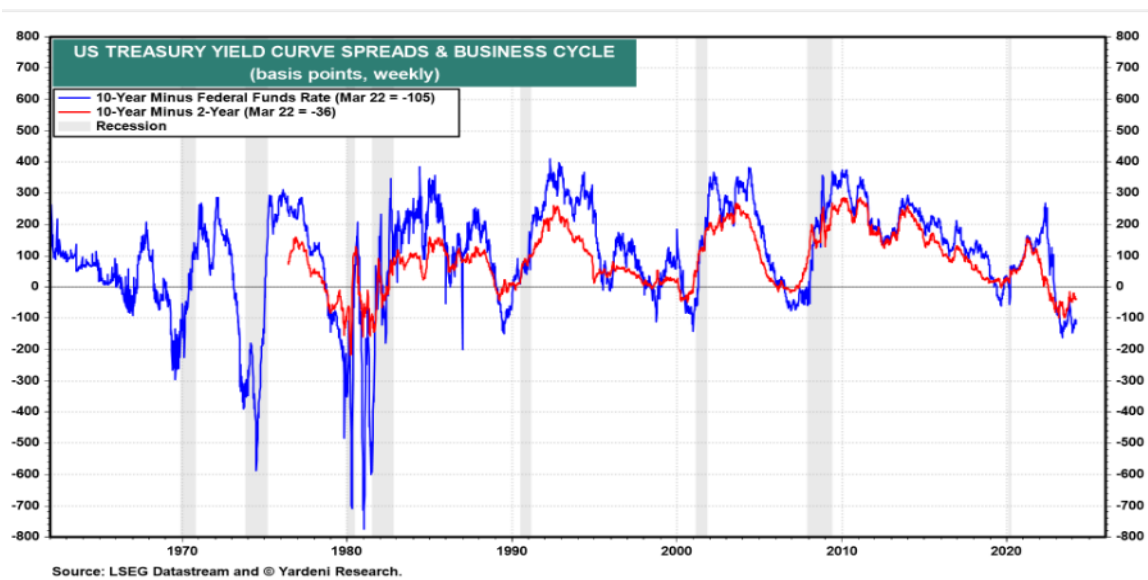
S&P 500 (large-cap) forward price/earnings ratio is 21X. *This level (red line) is historically* *<u>expensive</u>, approaching 2021's overpriced 22X. Mid-cap and small-cap forward P/Es (blue, green lines) are historically <u>not</u> expensive.*



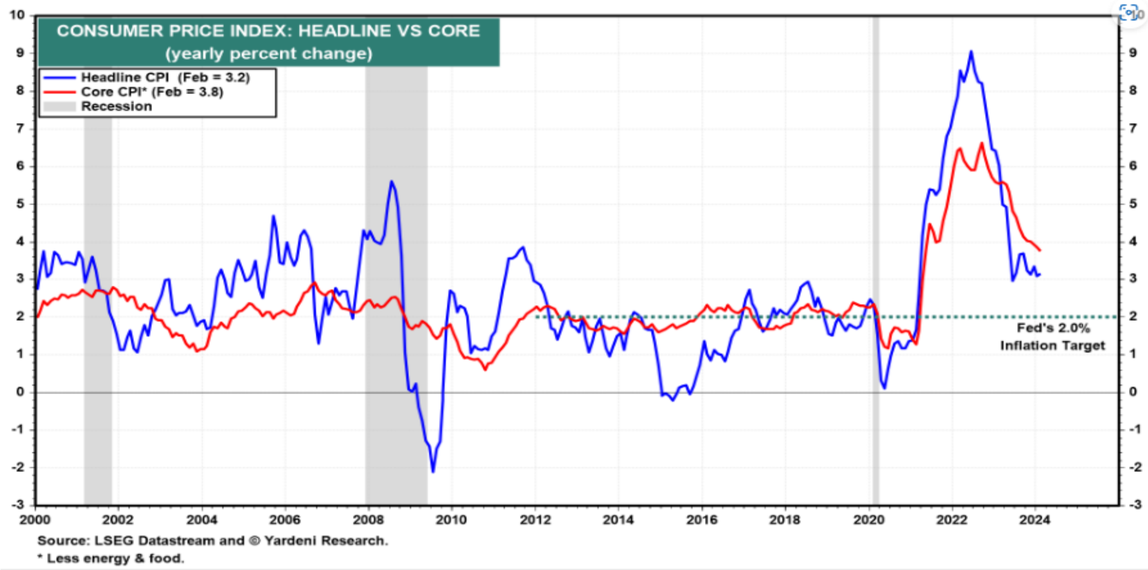
Without "Mega Tech" names, the remaining large-cap index's forward P/E (green line) is 19X, not quite as expensive.



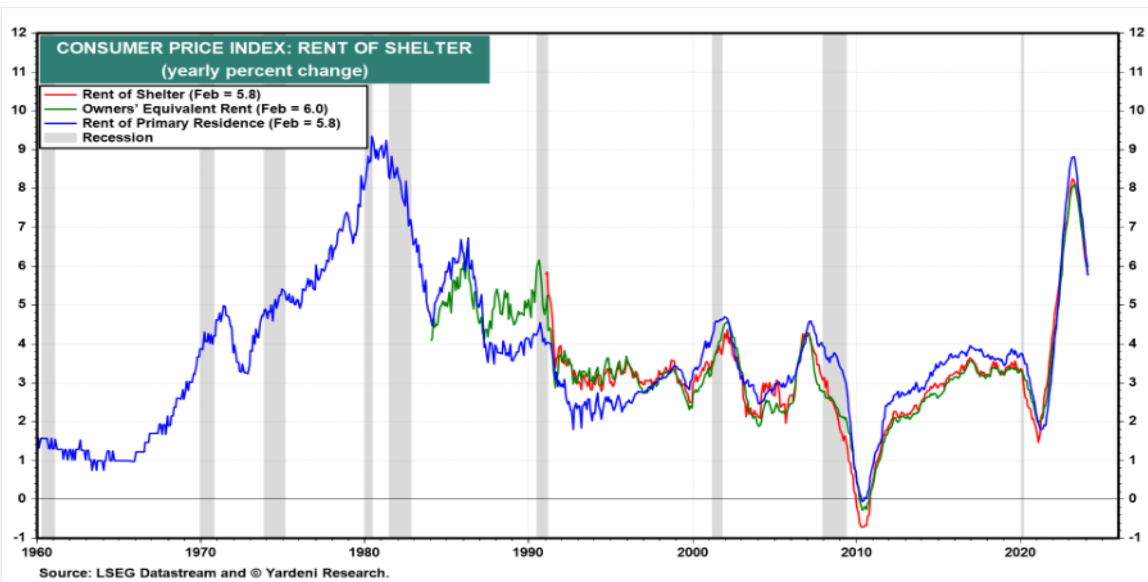
Yield curves remain inverted. *Inverted yields (long Treasury rates lower than short rates) are historically a reliable recession indicator. The "lag" from inversion to recession is long and variable, but this inversion started over two years ago.*



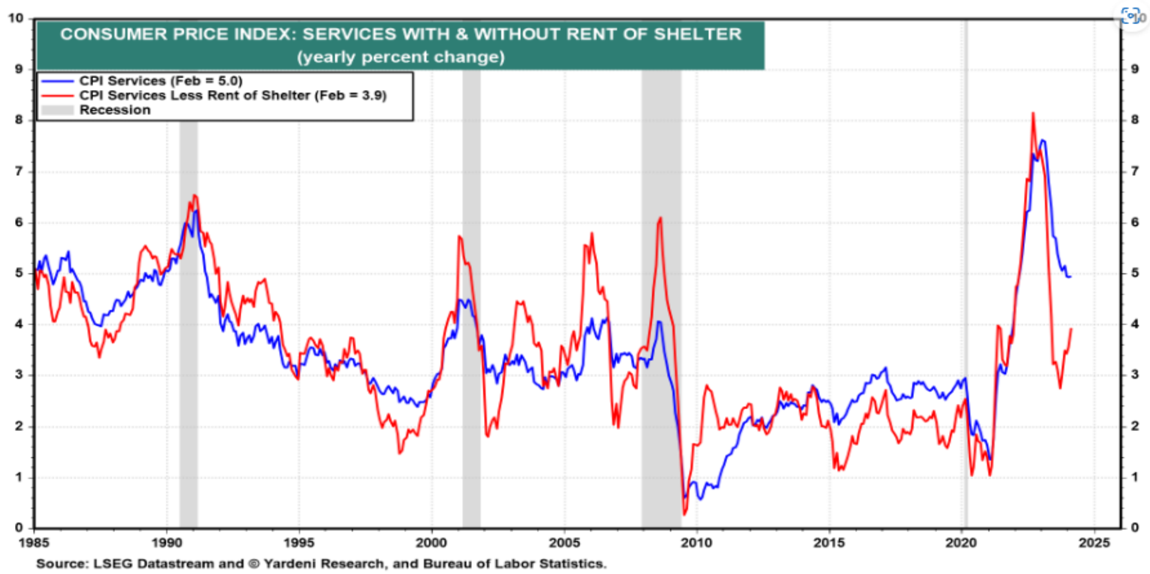
US inflation remains too high. *Consumers see "headline" inflation (blue line) which is about 3%. The Federal Reserve focuses on "core" inflation (red line - excludes food and energy) which is now under 4%. The more inflation declines, the more rate cuts the Federal Reserve is likely to deliver.*



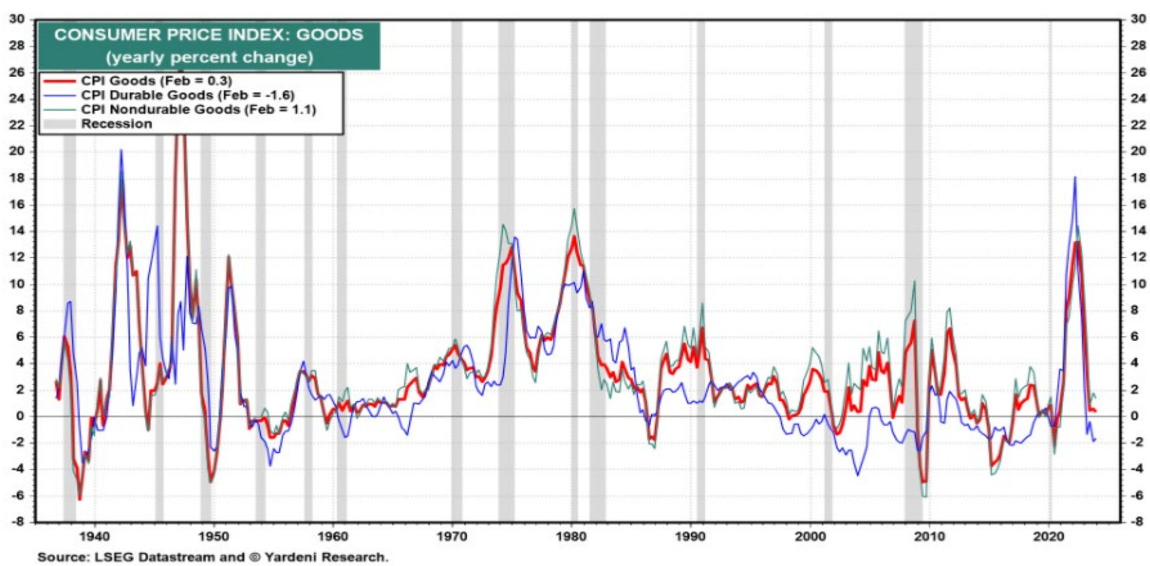
Housing services (here called "rent") are about *<u>35%</u>* *of the total CPI weight. Price/rent increases in recent years drove extremely high housing inflation.* *<u>If</u>* *prices/rents stay stable from here, housing inflation should keep declining.*



Services other than housing (education, transportation, medical services, insurance, etc) are about 25% of CPI weight. Services ex-housing inflation (red line) was declining through 2023, but unexpectedly rose in the first two months of 2024.



The remaining 40% of CPI weight is "goods" (food, energy, appliances, cars, other things consumers buy). Goods inflation is overall low.



Charts and tables from reliable sources, including FRED Economic Data and Yardeni Research, or prepared from primary data.