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GenTrust Outlook 2024

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Executive Summary

2023 was a solid year for financial assets despite all the challenges faced by the market including multiple large bank failures, higher rates pressuring areas such as commercial real estate, the ongoing conflict between Russia and Ukraine and a new conflict in the middle east between Israel and Hamas militants. The main story coming out of 2022 was central banks tightening policy to deal with inflation. Headline US Consumer Price Index (CPI) levels fell from 6.5% at the start of the year to 3% by the summer as the US Federal Reserve increased short rates from 4.5% to 5.5%. At the same time, 10-year US Treasury yields traded in a 3.4% to 4% range for much of the first half of the year. Then inflation data started to show stickiness and would not go below 3%, causing 10-year US Treasury yields to rise from 4% to their year high of 5% in mid-October. At the same time, equity indices dropped 10% as the market feared more rate hikes. Since then, inflation data has weakened slightly, the market has begun pricing in rate cuts for 2024, and equity markets have rallied considerably. Year-to-date equities (ACWI, as of 8-Dec-23) are up 17.5%, while bonds (AGG, as of 8-Dec-23) are up 2.8%. However, these headline numbers hide large divergences. Seven stocks, AAPL, AMZN, GOOG, NVDA, META, MSFT, and TSLA, which have become known as the Magnificent 7 (Mag7), propelled by the hope of Artificial Intelligence (AI), account for the vast majority of the return of the S&P 500 as of 8-Dec-23. The average stock in the S&P 500 absent the Mag7 is up less than 10% through 8-Dec-23.

Coming into 2023, the consensus estimates were for slowing growth and a possible recession. The economy has handled higher rates better than most believed, so far. In the US, Q1 and Q2 real GDP growth was 2.2% and 2.1% respectively and Q3 has surprised at 4.9%. Higher bond yields pushed mortgage rates higher which also resulted in housing affordability hitting near all-time lows. However, given the lack of inventory in the housing market, prices have been slow to adjust lower. The consumer proved to be very resilient as they spent down their remaining savings from COVID. The labor market is one bright spot as the job market in the US continues to be strong, although employment tends to be a lagging indicator. Although 2023 data has been much better than expected, the economy has never seen a soft landing after such as large increase in fed funds and such a strong tightening of lending standards. Furthermore, many of the supporting forces that helped buoy the economy in 2023 have flipped from positive to negative for 2024.

"...the market is putting a lot of weight on the narrow scenario of: 1) inflation coming down, 2) avoiding a recession, 3) AI growing into the hype, 4) the delayed effects of higher rates not materializing, 5) geopolitical tensions staying contained."

"Inflation is unlikely to come down to the extent the market believes absent a recession, making rate cuts without a recession less likely than the market believes... The odds of a recession are higher than the market believes..."

For 2024 (as of 8-Dec-23), the market is pricing that the Federal Reserve will cut rates by 100bps from 5.25-5.5% to 4.25-4.5% by years end. Inflation is priced to drop to 2.1% in 2024. S&P 500 earnings are expected to be $245, up 11% from '23 estimated earnings of $220. At SPX 4,604 (as of 8-Dec-23), $245 of forward earnings would imply a forward PE of nearly 19 which is on the higher end. This number is also slightly distorted by the fact that the forward Price/Earnings of the Mag7 stocks is over 30. As we see it, the market is putting a lot of weight on the narrow scenario of: 1) inflation coming down, 2) avoiding a recession, 3) AI growing into the hype, 4) the delayed effects of higher rates not materializing, 5) geopolitical tensions staying contained.

In this outlook, we examine each of those questions and based on our views we conclude:

- Inflation is unlikely to come down to the extent the market believes absent a recession, making rate cuts without a recession less likely than the market believes.
- The odds of a recession are higher than the market believes.
- In the long run, AI is a game changer. However, short-term pricing on AI related stocks is extremely stretched.
- The impact of higher rates is priced differently across markets. Some markets, such as US Small Cap stocks and commercial real estate, have seemingly priced in most of the impact of higher rates, whereas other markets have not priced nearly as much in.
- While the world will see many elections in 2024, we don't believe they will have a profound impact on markets, although geopolitical tensions are likely to remain high.

2023 Market review (all numbers are through 8-Dec-23)

Fixed income (AGG) rose 2.9% YTD as rates moved higher but rallied back in the fall as the market shifted to possible rate cuts in 2024. Short duration (SHY) +3.1% YTD outperformed longer duration treasuries (TLT) -2% YTD. High yield (HYG) credit outperformed Investment Grade (LQD) 8.8% YTD vs LQD 5.8% YTD. Municipal bonds (MUB) also had a decent year +4.1% YTD. Many of the returns in 2023 were retracements of 2022 moves for shorter duration investments, although longer duration bonds have been slower to regain their 2022 losses.

Equities are up 17.5% YTD, although that headline hides the variation across geography and capitalization that includes US large cap (SPY) 21.7% YTD, US small cap (IWM) +8.3% YTD, European Equities (VGK) +15.5% YTD, Asia Pacific (VPL) +9.6% YTD and Emerging Markets

"US value stocks (IWD) underperform[ed] growth stocks (IWF) substantially at +6.4% YTD vs +38.1% YTD, a wholesale reversal of 2022's -7.7% and -29.3% losses, respectively."

(EEM) +3.7% YTD. Factor variation was larger with US value stocks (IWD) underperforming growth stocks (IWF) substantially at +6.4% YTD vs +38.1% YTD, a wholesale reversal of 2022's -7.7% and -29.3% losses, respectively. The variation between growth and value was less pronounced in small cap as US Small Cap Growth (IWO) was +9.6% YTD while US Small Cap Value (IWD) was +6.4% YTD. Divergence across sectors was also very large with the two hardest hit sectors in 2022 rebounding the most in 2023 with Technology (XLK) +51% and Consumer Discretionary (XLY) +35% YTD. On the underperforming side in 2023, Consumer Staples (XLP) was -4.2% YTD and Utilities (XLU) was -7.9% YTD.

Broad-based commodity indices (DBC) slid on a lower demand outlook -6.7% YTD, led by Natural Gas (UNG) -64.4%. MLPs (AMJ) and Uranium (URA) did well +23.8% YTD and +43.3% YTD, respectively, while REITs (VNQ) had a roller coaster but finished +4.5% YTD. Gold was up 9.4% YTD. The US Dollar has strengthened against the Japanese Yen (FXY) 10% YTD and weakened versus the Euro (FXE) 2.1% YTD, respectively. All figures in this section as of 8-Dec-23.

Asset Class	Ticker	YTD 2023	2022	'08-'21 Ann
Short Municipal Bonds	SHM	2.23%	-3.79%	2.32%
Long Municipal Bonds	MUB	4.05%	-7.50%	4.24%
US Aggregate Fixed Income	AGG	2.85%	-13.06%	4.35%
Short US Treasury Bonds (1-3y)	SHY	3.13%	-3.90%	1.71%
Intermediate US Treasury Bonds (7-10y)	IEF	0.72%	-15.23%	5.16%
Long US Treasury Bonds (20y+)	TLT	-2.05%	-31.41%	8.02%
Mortgage Backed Securities	MBB	1.92%	-11.86%	3.61%
US Investment Grade Bonds	LQD	5.77%	-17.92%	6.59%
International Treasury Bonds	BWX	1.12%	-19.46%	3.12%
US Treasury Inflation Linked Bonds	TIP	1.88%	-12.13%	5.00%
Global Inflation Linked Bonds	WIP	3.67%	-15.39%	2.96%
US High Yield Bonds	HYG	8.79%	-11.38%	5.81%
Floating Rate Bank Loan Bonds	BKLN	10.74%	-1.64%	4.15%
US Preferred Stock	PFF	6.68%	-18.24%	6.67%
Convertible Bonds	CWB	9.82%	-20.79%	18.16%
Emerging Market Bonds (Local Currency)	ELD	10.00%	-9.33%	3.07%
USD EM Bonds (JPM)	EMB	7.41%	-17.97%	5.87%
British Pound	FXB	6.72%	-10.64%	-1.01%
Euro	FXE	2.09%	-6.50%	-0.27%
Japanese Yen	FXY	-10.01%	-13.25%	-0.56%
Liquid Alternatives	QAI	7.98%	-8.46%	2.97%
CBOE S&P 500 Putwrite Index	PBP	9.62%	-11.72%	3.48%
S&P 500 VIX Short-Term Futures	VXX	-70.34%	-23.73%	-46.13%
Alerian MLP Index	AMJ	23.79%	30.05%	5.52%
US REITs (MSCI REITs)	VNQ	4.54%	-26.20%	8.93%
International REITs (Dow Jones)	RWX	-0.27%	-21.86%	1.76%
Commodities	DBC	-6.69%	19.68%	-1.84%
Natural Gas	UNG	-64.40%	20.24%	-27.83%
Gold	GLD	9.43%	-0.82%	7.55%
Gold Miners	GDX	3.59%	-8.00%	-2.12%
Silver	SLV	-4.18%	4.66%	6.10%
Agriculture	DBA	8.29%	2.14%	-1.98%

Asset Class	Ticker	YTD 2023	2022	'08-'21 Ann
MSCI All Country All World	ACWI	17.49%	-18.39%	8.39%
US Large Cap (S&P 500)	SPY	21.68%	-18.14%	11.27%
US Mid Cap (S&P 400)	IJH	10.05%	-12.99%	10.79%
US Small Cap (Russell 2000)	IWM	8.34%	-20.48%	9.38%
US Value Equities (R1000 Value)	IWD	6.37%	-7.73%	8.02%
US Growth Equities (R1000 Growth)	IWF	38.05%	-29.26%	14.48%
Canadian Equities	EWC	8.20%	-12.42%	4.22%
European Equities (FTSE Europe)	VGK	15.46%	-16.04%	3.85%
UK Equities	EWU	8.33%	-4.78%	2.29%
German Equities	EWG	20.49%	-21.86%	2.34%
French Equities	EWQ	18.26%	-11.84%	3.13%
Italian Equities	EWI	26.91%	-13.77%	-1.84%
Spanish Equities	EWP	29.10%	-5.16%	-0.36%
Pacific Equities (FTSE Pacific)	VPL	9.59%	-15.29%	3.66%
Japanese Equities	EWJ	16.13%	-17.31%	2.59%
Australian Equities	EWA	4.59%	-6.23%	4.01%
Hong Kong Equities	EWH	-20.39%	-7.43%	4.28%
Emerging Market Equities (MSCI EM)	EEM	3.74%	-20.66%	2.59%
Brazil	EWZ	23.99%	13.15%	-4.16%
China	ASHR	-14.49%	-26.51%	2.90%
India	EPI	21.32%	-4.85%	4.68%
Mexico	EWW	30.24%	1.30%	4.08%
MSCI Frontier 100	FM	4.99%	-25.68%	0.78%
Consumer Discretionary	XLY	35.01%	-36.41%	16.49%
Consumer Staples	XLP	-4.19%	-0.11%	11.23%
Energy	XLE	-3.47%	64.29%	0.97%
Financials	XLF	7.12%	-10.56%	4.31%
Health Care	XLV	-1.60%	-2.42%	14.17%
Industrials	XLI	12.30%	-5.13%	9.79%
Materials	XLB	6.96%	-11.88%	8.45%
Technology	XLK	50.97%	-27.71%	16.65%
Utilities	XLU	-7.92%	1.80%	7.76%

Source: Bloomberg all YTD 2023 numbers are as of 8-Dec-2023

How were our predictions?

Markets in 2023 were in many ways reversals of what happened in 2022. In 2022, we were well-positioned for higher rates with a conservative view on risk assets, shorter duration fixed income and the shift towards value and real assets. In 2023, we were hampered by the same conservative view on risk assets during the middle of the year and a portfolio that was widely diversified versus a greater focus on high growth stocks. In our 2023 Outlook written back in December 2022, we made the following comments:

"Equity earnings are likely to come in lower than expectations over 2023 due to the drag from higher interest rates and wages." Consensus earnings estimates for 2023 on December 31, 2022 was $234 share. Actual 2023 earnings seem likely to come in around $220, although despite lower results the market responded positively by looking forward to 2024 when earnings are expected to be $245.

"Even if they come in at expectations, equities could trend lower if equity valuations fully incorporate the move higher in interest rates that has already occurred." Earnings came in below expectations and 10-year US treasury yields moved from 3.9% to start the year all the way to 5% before retreating back to 4.1%, but equities proved very resilient and moved higher led by the Mag7.

"Historically, inflation takes much longer to return to the 2% than market is currently pricing. The primary mechanism by which inflation is likely to come down is through lower housing prices/rents." At year-end 2022, the market was pricing in inflation for 2023 to be less than 2% and the latest year-over-year reading of inflation was 3.2% in September. Housing prices turned negative year-over-year during the late spring, although have started to trend back higher in the fall.

"Central banks are likely to remain hawkish until inflation is broken." The Federal Reserve continued to move short-end rates higher from 4.25-4.5% to start the year to their current 5.25-5.5% range. Further, the Federal Reserve has maintained its hawkish posture until very recently when it has hinted at the possibility of rate cuts in 2024.

"Market timing is extraordinarily difficult, and we feel very content being neutral at current prices, with an eye towards significantly adding to risk should pricing move materially lower." The S&P 500 started the year at 3840 and never spent more than a day below that level so unfortunately, we never saw lower prices to increase our weighting to equities above neutral.

Big picture

From the Great Financial Crisis until COVID, the global economy was characterized by aging demographics and increasing globalization which resulted in low inflation and low but stable growth. Low inflation and growth allowed Central Banks to keep interest rates low, fueling increased valuations across almost all assets including equities, bonds, real estate, art, etc. In response to the large economic shock from COVID, governments responded by printing and distributing money at record levels to provide economic support. As the world began to normalize, citizens flushed with cash from government stimulus spent

“…the market is currently pricing in 100bps [of rate cuts], inflation to drop to 2.1% in 2024, and S&P 500 earnings to be $245, up 11% from ’23…”

heavily, creating shortages of goods while restarting supply chains took time. Meanwhile employment demand picked-up at a time when many were leaving the workforce, resulting in labor shortages. As a result, inflation increased to its highest level in almost 40 years. After decades of inflation coming in below target levels, central banks assumed inflationary pressures were transitory, caused largely, if not entirely, by supply chain disruptions. Unfortunately, the delay in taking action allowed inflation to spiral higher, pushing up both commodity prices and expectations for future inflation, creating longer lasting and seriously deleterious economic effects. Russia’s invasion of Ukraine and China’s zero-COVID policies exacerbated supply shortages. Central Banks were forced to raise interest rates aggressively to regain credibility and curb demand in hopes of reducing pricing pressure. The risk premium that had slowly left markets over the previous decade came back in 2022 as both bonds and stocks dropped aggressively in one of the largest moves in 150 years.

2023 started with low and declining expectations for global growth and elevated fears of a recession. Residual strength of the US consumer, aided by large fiscal stimulus in the US and Europe, helped stabilize growth concerns. Optimism about AI, sparked by the release of ChatGPT, created demand for AI-related names fueled massive price increases in what became known as the “Magnificent 7” (Mag7) consisting of AAPL, AMZN, GOOG, NVDA, META, MSFT, and TSLA. For much of the year, this demand did not spill over into other non-Mag7 names as more broad market indices underperformed dramatically. Inflation cooled to around 3% as a result of base effects, cooling energy pricing and lower capex. While still above the Federal Reserve’s target of 2%, inflation was low enough for interest rates to stabilize and for markets to begin to price in potential rate cuts in 2024.

2024 market pricing

We always start our analysis of markets by looking at current pricing. For 2024, the market is currently (as of 8-Dec-23) pricing in for the Federal Reserve to cut rates by 100bps from 5.25-5.5% to 4.25-4.5% by years end. Inflation is priced to drop to 2.1% in 2024. S&P 500 earnings are expected to be $245, up 11% from ’23 estimated earnings of $220. At SPX 4,604 (as of 8-Dec-23), $245 of forward earnings would imply a forward PE of nearly 19 which is on the higher end. This number is also slightly distorted by the fact that the forward PE of the Mag7 stocks is over 30.

As we see it, the market is putting a lot of weight on the narrow scenario of: 1) inflation coming down, 2) avoiding a recession, 3) AI growing into the hype, 4) the delayed effects of higher rates not materializing, and 5) geopolitical tensions staying contained.

In what follows, we will analyze each of those items in turn.

Will inflation keep coming down?

Inflation peaked in the US at 9.1% in June 2022 and has fallen to 3.0% in June 2023, although it has remained between 3% and 3.5% since then when looking at US Consumer Price Index (“CPI”).

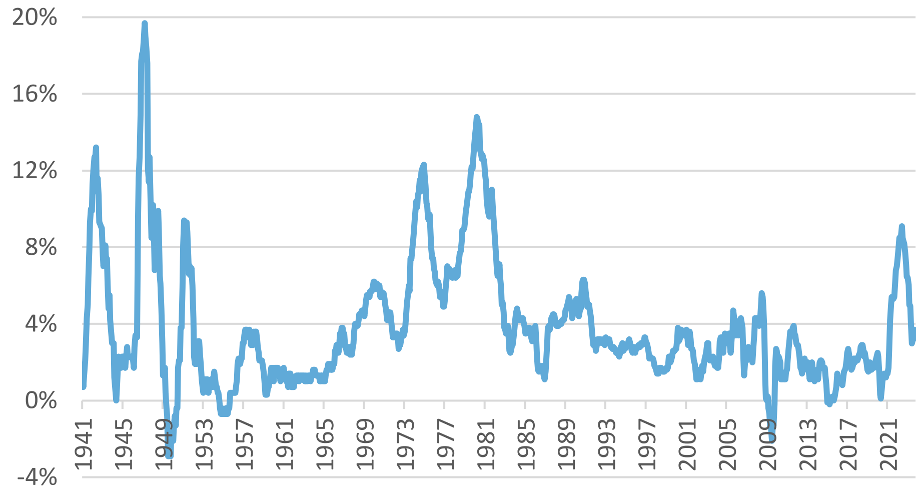
“...inflation [will take] longer to come down:

- Housing prices are sticky, and shelter represents 33% of the CPI

- Increased unionization makes it less likely that wages are not going to be pressured higher at an increasing rate

- Globalization has been replaced with reshoring.”

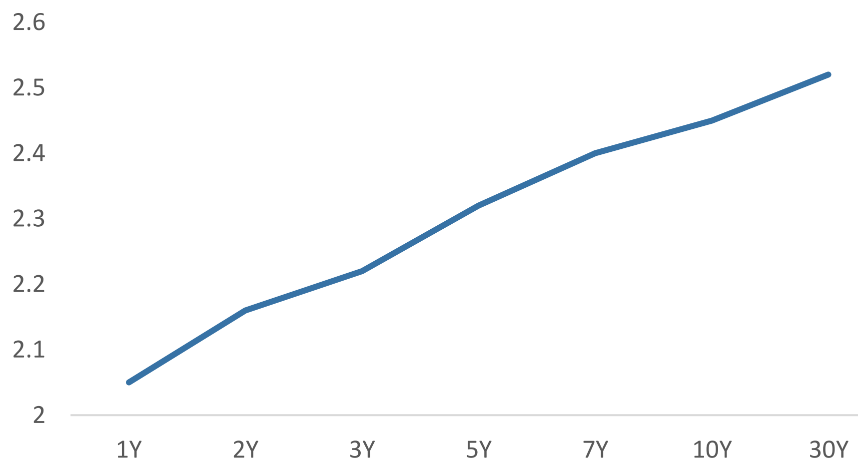
US Inflation (CPI YOY)



Source: Bloomberg US Inflation CPI YOY from 1/31/1941 until 10/31/2023

The market is currently priced for inflation to return to normal levels very quickly and stay there. The graph below shows inflation break-evens (the level of inflation is priced into inflation-linked bond markets) are 2% for the next year, 2.15% for the next 2 years and then between 2.2-2.3% for beyond 2 years.

US Inflation Breakevens (8-Dec-23)



Source: Bloomberg

We have made the argument in the past that it may be difficult for inflation to return quickly to sub-2% without a recession. Our rationale for inflation taking longer to come down is based on the following:

- Housing prices are sticky and shelter represents 33% of the CPI. We believe, in order for inflation to come down, shelter prices need to come down as they represent 33% of the index.
- Increased unionization makes it less likely that wages are not going to be pressured higher at an increasing rate.
- Globalization has been replaced with reshoring.

“...[housing] affordability is at an all-time low... 2023 marked an inflection point in the organized labor movement... amongst S&P 500 earnings calls, mentions of reshoring were up over 100%..”

Housing prices started to come down from mid-2022 through the early part of 2023 but began to rise again according to the Case-Shiller National Housing Index. Affordability is at an all-time low at the same time high mortgage rates make it a very unattractive market for buyers. However, sellers do not usually lower their price until they are forced to, which we may see in more earnest soon.

2023 marked an inflection point in the organized labor movement, highlighted by the United Auto Works (UAW) strike. For much of the past several decades, union participation has been in decline, from roughly 12 million people in 1983 to less than 8 million people currently. However, due to a confluence of factors including demographic changes in the workforce, rising inflation, and increased awareness through social media and other channels, unionization has never been more popular. Changes in attitudes towards unionization could pose several challenges for markets and policy makers. Inflation is largely dictated by people’s wages, since people’s wages determine how much they have to spend on goods and services. If the changes in attitudes towards unionization leads to more aggressive negotiating on wages, this could cause inflation to rise further and pose a significant challenge for policy makers.

One topic we will cover later in this outlook is heightened geopolitical risks caused by increased global conflicts. As a result, companies have been forced to reevaluate their supply chains, making “reshoring” one of the most significant themes to consider going forward. Researchers at Bank of America found that, amongst S&P 500 earnings calls, mentions of reshoring were up over 100%—even more than Artificial Intelligence.

The reshoring trend began immediately following the COVID pandemic but began to accelerate following a series of favorable spending bills, most notably the 2021 Infrastructure Law, which directly incentivized companies to re-shore their supply chain. The chart below emphasizes the dramatic increase in US Construction and Manufacturing spending beginning in 2021.

Census Bureau US Construction Spending Manufacturing (B)

Source: Bloomberg Census Bureau Manufacturing from 12/31/2003 until 10/31/2023 is The Value of Construction Put in Place Survey (VIP) monthly estimates of the total dollar value of construction work done in the U.S

Ultimately, in our view, reshoring will not come without additional costs, as financing rates have soared and the cost of business in developed countries tends to be higher than in emerging countries. If the reshoring trend continues as we expect, it will likely be a long-term headwind for keeping inflation down.

The primary risk to our view that inflation will be sticky coming down is that technological advancements such as AI end up being a stronger deflationary force than the market expects. We will discuss AI later in this Outlook but in our view, those deflationary forces are likely several years away.

Will we have a recession?

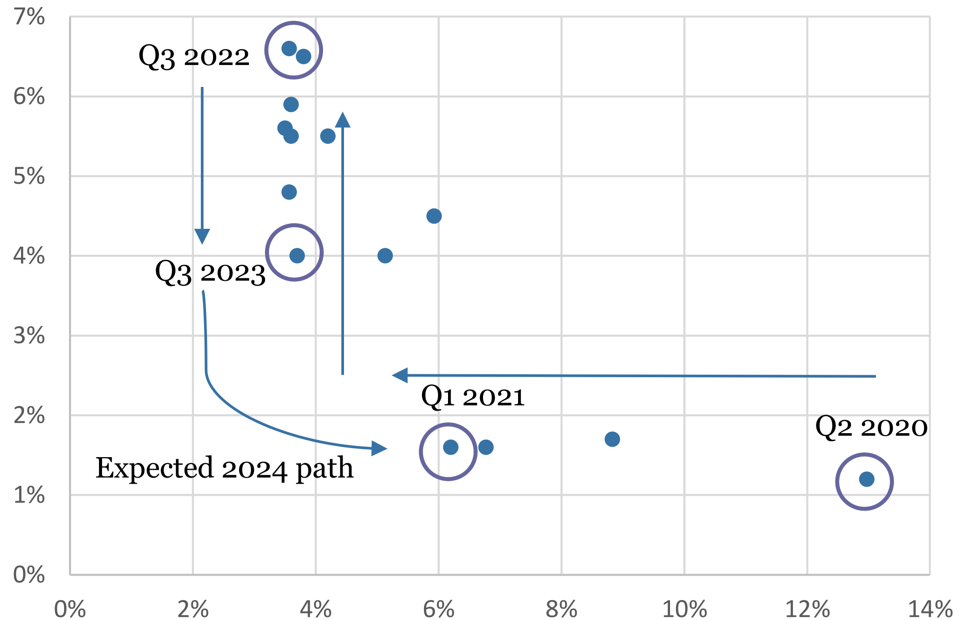
In our view, a recession is more likely than not to materialize in 2024. The Federal Reserve has raised interest rates at the most rapid pace since the 1980s, bringing Fed Funds from 0% to 5.5% in less than 24 months. Given the pace of this tightening, as well as the fact that rates remained low for so long prior to this hiking cycle, many segments of the economy will have difficulty functioning in this environment, such as commercial real estate, high yield borrowers, and regional banks.

> "In our view, a recession is more likely than not to materialize in 2024... the most likely scenario where inflation comes below 2% would be caused by a recession..."

As we mentioned, we believe the most likely scenario where inflation comes below 2% would be caused by a recession. The relationship between inflation and employment is described by the famous "Phillips Curve" named after economist William Phillips. The Phillips curve is an economic theory that states that inflation and unemployment have a stable and inverse relationship. The theory is that the lower unemployment is, the higher inflation is. The theory is sound but in practice it happens in a less linear fashion than theory describes. In our view, the kinked Phillips curve framework posted by BCA Research, an external macroeconomic research firm we subscribe to, explains the nonlinear relationship between employment and inflation, and offers some an explanation as to why the US economy has been able to avoid a recession thus far, and what might be in store for 2024. The graph below shows unemployment rate vs. core CPI beginning during the COVID pandemic. As you can see, when the pandemic began, inflation was very low and unemployment was very high, meaning that job seekers had little bargaining power when negotiating for a new job. As the economy started to recover, we reached full employment sometime in 2021, at which point workers gained the upper hand and companies were forced to raise wages in order to attract and retain talent. By 2022, the Fed began rapidly raising interest rates to combat rising inflation, which caused wages to fall back down despite remaining at full employment. As you can see on the chart, we have approached the "kink" in the Phillips Curve, which suggests that in order to bring inflation down further to 2%, unemployment will have to rise.

"...we have approached the 'kink' in the Phillips Curve, which suggests that in order to bring inflation down further to 2%, unemployment will have to rise.."

Unemployment Rate vs Core CPI (Q2 2020 – Q3 2023)



Source: Core CPI Data is from Bloomberg CPI XYOY Index from 04/30/2020 until 10/31/2023 and Unemployment Rate from Bloomberg EHUPUS Index from 04/30/2020/until 10/31/2023

Will AI change the world? (or deliver what's priced in?)

Artificial Intelligence (AI) is a transformative technology that simulates human intelligence in machines, enabling them to perform tasks that typically require human cognition. This is achieved through machine learning, where algorithms learn from data, and deep learning, which uses neural networks to mimic the human brain's structure and function. AI has the potential to revolutionize every aspect of our lives, from healthcare, where it can assist in diagnosing diseases and developing new treatments, to transportation, with the development of self-driving cars. In the business world, AI can optimize operations, enhance customer service, and drive innovation. On a broader scale, AI can address complex global challenges, such as climate change and resource management, by analyzing vast amounts of data for insights and solutions. As AI technology advances, it will continue to reshape industries, redefine how we interact with technology, and profoundly impact the fabric of society.

The above paragraph was written by ChatGPT as a response to the prompt "write a paragraph describing what AI is and how it will change the world." AI is certainly the buzzword of the year. Its potential to boost productivity is significant and we at GenTrust are firm believers in its long-term power. We have been building AI technology for close to 10 years now to help with our trading analysis and portfolio management. We have recently started to explore non-portfolio management ways in which we can use AI to help better serve our clients and are very excited about the possibilities. AI will impact just about every industry from manufacturing to services businesses to healthcare. Similar to the early days of the internet, the greatest use cases of AI might not even be known yet. Along the same lines, the impact on society is a topic of great concern with many of the original

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users of AI warning of its potential pitfalls. As a result, we've seen there is a scramble to set-up an effective regulatory framework for AI.

The largest beneficiary of the hopes associated with an AI revolution are the Mag7: MSFT, META, AMZN, AAPL, TSLA, GOOG, NVDA. Up over 100% on average this year (as of 8-Dec-23) as a group, they now represent close to 30% of the S&P500. Despite all performing well in 2023, the drivers and expectations within the group vary widely. In 2023, only NVDA, AMZN and META had their performance driven by earnings growth, while TSLA and AAPL's performance was driven multiple expansion.

The Mag7 are expensive on traditional valuation metrics, although their profit margin differential and enormous cash balances explains most of the valuation premium they have over the S&P 500. When looking at analyst revenue and EPS growth estimates for the next year compared to the previous 5 years, a few things stick out:

- ❑ MSFT is expected to have higher revenue growth going forward than they have in the past, mainly related to AI
- ❑ META and AMZN are both priced to see rather sizeable EPS jumps from what they've experienced in the past 5 years
- ❑ NVDA is expected to more than double revenue growth and see EPS grow by 268% next year. While anything is possible, it usually makes sense to bet against things when they are priced to such a degree of perfection.

Ticker	Name	Market Cap (bn)	Total Return YTD	Fwd Price/Sales	Fwd Price/Earnings	Previous 5y Revenue Growth	Next Year Revenue Growth	Previous 5y EPS Growth	Next Year EPS Growth
MSFT UW Equity	Microsoft Corp	$2,781	57	10.8	31.1	13.9%	14.8%	20.1%	16.7%
META UW Equity	Meta Platforms Inc	$855	177	5.7	18.6	19.1%	13.1%	13.7%	21.7%
AMZN UW Equity	Amazon.com Inc	$1,523	75	2.4	32.9	19.6%	11.6%	21.6%	35.4%
AAPL UW Equity	Apple Inc	$3,043	51	7.6	29.2	7.6%	3.7%	15.5%	7.8%
TSLA UW Equity	Tesla Inc	$755	98	6.6	62.9	35.3%	21.4%	215.0%	26.8%
GOOG UW Equity	Alphabet Inc	$1,699	54	6.0	19.4	17.4%	12.0%	21.3%	15.3%
NVDA UW Equity	NVIDIA Corp	$1,173	225	13.4	24.7	22.7%	118.6%	22.1%	268.3%

Source: Bloomberg as of 8-Dec-23

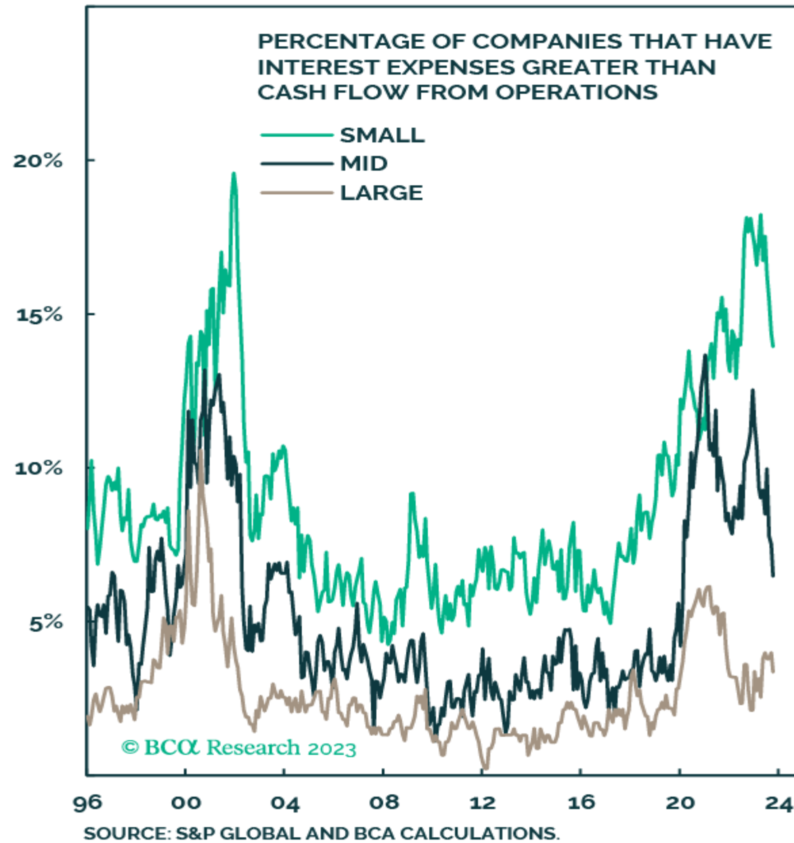
What impact will higher rates have?

> "…Some markets, such as US small cap stocks and commercial real estate, have seemingly priced in most of the impact of higher rates… Whereas other markets such as broad credit markets have not… "

The impact higher rates have had varies across different markets. Some markets, such as US Small Cap stocks and commercial real estate, have seemingly priced in most of the impact of higher rates. Whereas other markets such as broad credit markets and equity markets have not taken into account the potentially higher funding costs going forward.

It is true that US small cap stocks are more susceptible to increases in interest rates. This graphic shows that at current rates, close to 15% of US small cap stocks have interest expenses greater than cash flow from operations while that number is less than 4% of US large cap stocks.

If you factor in that the Mag7 are close to 30% of the US large cap universe and have huge cash balances, the market cap weighted number is significantly less than 4%. It is interesting to note that the last time this happened around 2000, the subsequent decade saw small caps outperform large caps by around 5% per year.

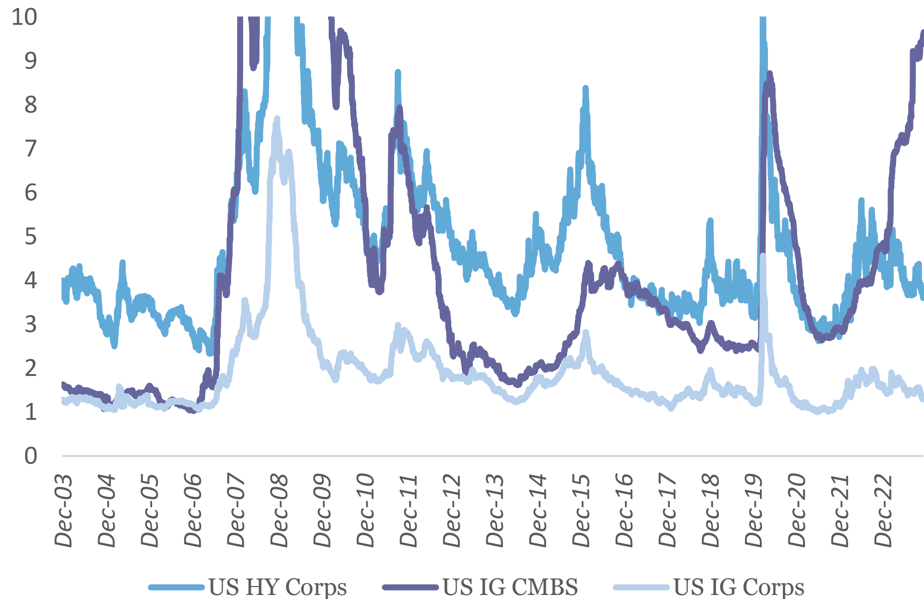


> "...There is a clear divergence in what's priced into the credit markets, with commercial real estate priced similar to other recessionary periods such as the great financial crisis and the pandemic, but the broader IG and HY corporate bond markets priced as if the odds of a recession are low... "

The $4.5tr commercial real estate market is showing significant signs of stress as a result of higher interest rates, which could begin to flow through to other parts of the market. When interest rates were low, many commercial real estate borrows were able to receive financing at very low rates, which meant that a greater number of projects seemed viable. Fast forward to today and the one-two punch of falling occupancy rates following the COVID pandemic and higher interest rates have left it harder for real estate borrowers to refinance their projects. Many projects that were viable just 5 years ago are no longer sustainable.

There is a clear divergence in what's priced into the credit markets, with commercial real estate priced similar to other recessionary periods such as the great financial crisis and the pandemic, but the broader IG and HY corporate bond markets priced as if the odds of a recession are low. If we zoom in to just the recent hiking cycle which began in March of 2022, investment grade and HY bonds spreads are lower than they were at the beginning of the cycle.

US IG CMBS, HY, and IG Corporate OAS



Source: Bloomberg.US HY is represented by High-Yield Corporate Bond Index (LF98OAS Index). Option-adjusted spreads (OAS) are quoted as a fixed spread, or differential, over U.S. Treasury issues. OAS is a method used in calculating the relative value of a fixed income security containing an embedded option, such as a borrower's option to prepay a loan. US IG Corps is represented by the Bloomberg Barclays US Corporate Index Investment Grade Corporate OAS (LCB1OAS Index), it refers to the spread over the risk-free rate (such as US Treasury bonds) that investors demand for investing in investment-grade corporate bonds. This spread compensates investors for taking on the additional credit risk associated with corporate bonds compared to risk-free bonds. US BBB CRE is represented by CMBX (LCB1OAS Index) are indices (that track the prices of a basket of tranches in commercial mortgage-backed securities. Commercial mortgage-backed securities (CMBS) are fixed-income investment products that are backed by mortgages on commercial properties rather than residential real estate. All information charted is from 12/24/2003 until 12/12/2023.

"...Of the roughly $1.8 trillion dollars of commercial real estate debt coming due over the next 4 years, the most significant holders of that debt are regional banks, and their share increases to more than 50% of all loans in 2026-2027... "

While the size of the commercial real estate market alone is significant, our concerns about the sector are also a function of how the stress might spread to other markets. Almost half of all commercial real estate loans are held by banks, with just 14% of those being held by a top 25 bank, according to Cohen and Steers. This means, that roughly a third of all commercial real estate loans are held by smaller regional banks, which have already come under stress following the collapse of Silicon Valley Bank and others. Of the roughly 1.8 trillion dollars of commercial real estate debt coming due over the next 4 years, the most significant holders of that debt are regional banks, and their share increases to more than 50% of all loans in 2026-2027 according to MSCI. In our view, these contagion risks are not adequately priced in across the credit complex, particularly in financials who have seen their spreads tighten considerably in the second half of the year.

Geopolitics and elections

Another risk to markets, and a risk to inflation coming down, is the increased level of global conflicts we are observing between Eastern and Western powers. From the 1990s to the 2010s, globalization was a significant factor in maintaining low and steady inflation. However, with an increase in conflict comes the risk of decreased global trade, increased reshoring, and higher input costs for many goods and services.

“…political elections are more political theater than market moving events. The rare times elections have made material economic impacts is when governments have embarked on big structural reforms…“

The United States is still heavily dependent on China as an input into many supply chains. However, increased conflict over Taiwan, semiconductors, and influence on the global stage has led many US based companies to begin moving their supply chains back to the US or to other countries in the Southeast Asia. Additionally, the US Dollar’s status as a reserve currency is now under threat by China, who is aiming to create a replacement reserve currency with other Emerging Market nations. While this process may take many years or even decades to fully play out, it highlights an existential risk to US supremacy and the US’s ability to manage their growing national debt.

There are several major presidential and parliamentary elections taking place in 2024 including the US, India, Mexico, Russia, Taiwan, and most likely in the UK. We have often said that political elections are more political theater than market moving events. The rare times elections have made material economic impacts is when governments have embarked on big structural reforms such as wholesale changes to monetary policy. As a result, our view is that most elections this year (including the US one) are likely to have limited economic impact. Given the increased focus on trade, our view is that elections are more likely to impact globalization than they are overall economic activity this year, particularly the Taiwanese elections on 13-Jan and the US elections on 5-Nov. India’s election this year may prove crucial, although which candidate wins is probably less relevant than whether the elections deliver stable governments with a working majority in parliament. Majority governments would mean fewer barriers to pushing through structural reforms. In this respect, India’s “first past the post” electoral system suggests the odds of the election resulting in a majority government there are relatively high compared to many other countries.

If the US has a recession, we believe Biden’s chances of winning go down. We see it as incumbents have a greater than 50% chance of winning during an expansion, and less than 50% chance during a contraction. If a recession were to occur, this could also embolden foreign nations to be more aggressive against the US.

Summary

For 2024, the market currently pricing in for the Federal Reserve to cut rates by 100bps, for inflation to drop to 2%, and for S&P 500 earnings to be up 11% from 2023 at a level which would imply a PE of 19. We believe the market is putting a lot of weight on the narrow scenario of: 1) inflation coming down, 2) avoiding a recession, 3) AI growing into the hype, 4) the delayed effects of higher rates not materializing, 5) geopolitical tensions staying contained. We believe inflation is unlikely to come down to the extent the market believes absent a recession, making rate cuts without a recession less likely than the market believes. We also believe the odds of a recession are significantly higher than the market believes. In the long run, AI is a game changer, but the near-term pricing on several AI stocks is reminiscent of 1999. The impact of higher rates has variable and differing lags in different markets. Some markets, such as US Small Cap stocks and commercial real estate, have seemingly priced in most of the impact any of the impacts of higher rates. Whereas other markets such as broad credit

markets and equity markets have not considered potentially higher funding costs going forward. While the world will see many elections in 2024, we don't believe they will have a profound impact on markets, although geopolitical tensions remain high. As a result, we enter 2024 overweight fixed income but underweight credit, underweight equities but with bias toward small cap stocks and underweight real assets.

Positioning

Asset Class	GenTrust Positioning vs Benchmark	Commentary
Cash	0.0%	
Munis	-10.0%	
Fixed Income / Credit		
US Core Bonds	30.0%	
US Gov't Bonds	30.0%	
US Investment Grade	-20.0%	
US High Yield Bond		No Position
Floating Rate Debt		No Position
US Inflation Linked Bonds		No Position
Emerging Market Bonds	15.0%	
Equities		
US Large Cap Equity	-15.0%	Underweight but focus on Infrastructure
US Mid/Small Cap Equity	15.0%	Focus on Biotech
European Equity	0.0%	
Emerging Market Equity	0.0%	
Pacific Equity	0.0%	
Real Assets		
Commodities Ex-Metals	-25.0%	
Clean Energy	10.0%	Uranium
REITs		No Position
MLPs	0.0%	
Metals	-25.0%	
Uncorrelated Hedge Funds		

Source: [1] GenTrust positioning as of 8-Dec-23

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