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Q2 Investment Perspectives 2024

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Q1 '24 Recap

After a fourth quarter surge in asset prices last year, the first quarter of 2024 continued the trend. Global equities (ACWI) are up 8.2% YTD, led by US equities (SPY) which are up 10.4% YTD. During the quarter, companies reported Q4 '23 earnings which brought S&P500 Earnings for 2023 to roughly $220. Expectations for 2024 are high as earnings are expected to increase 11%. The equity performance so far in 2024 was despite a rise in interest rates as 10-year US Treasury rates rose from 3.9% to 4.2%. The number of Fed Reserve rate cuts expected in 2024 declined from 6 at the start of the year to the current pricing of 3 as it became clearer that inflation was not coming down at the rate the Federal Reserve wants to see. 10-year inflation expectations rose from 2.16% to 2.32%. This increase in inflation expectations was also seen in commodity prices (GSG) which are up 10.0% YTD (all data from this paragraph is as of 28-March 2024 and from Bloomberg for returns and Yardeni Research for equity earnings info).

US Q4 '23 GDP growth came in at a 3.1% (vs 2.9% in Q3) as the consumer kept spending. The US unemployment rate was 3.9% in February, up from a cycle low of 3.4% a year ago. Across the globe, economies are starting to diverge. Eurozone GDP was barely positive in Q4 '23 and Switzerland surprised markets by cutting their policy rates in March. Meanwhile inflation in Japan has stayed above 2% for over 2 years, prompting the Bank of Japan to raise interest rates for the first time in 17 years (all data in this paragraph is from yCharts).

Geopolitically, the three current global hotspots of Ukraine, Gaza, and Taiwan are of varying degrees of seriousness and concern. The war between Russia and Ukraine has reached a stalemate with a decline in unity in the West, as the US was unable to agree on funding while France wants to put boots on the ground. US elections may delay the end of the war as Russia may hold out for a change in the US administration before it sits down for negotiations. We believe the war in Gaza will run longer than the US wants it to run because it is an existential issue for Israel, although it should not have a market impact unless the war spills over outside of the Middle East or causes significant shutdowns of oil production capacity. The stresses coming...

Big Picture

"The last 2 years have been characterized by declining, yet persistently high inflation as CPI has fallen from a high of 9.1% in June of 2022 to a low of 3% in June 2023, but since then has not recorded another print below 3%.... Increased interest rates have created stress in several inter-related areas.... Markets are expecting central banks to begin easing which seems premature to us as elevated inflation will make it difficult... The prospects for the value creation by Artificial Intelligence (AI) has propelled equities higher... and equity valuations look rich because the indices are dominated by large but fast-growing companies, but equities outside of the very largest names are not overly expensive by historical standards.... Despite strong employment, there are various signs of weakness in the economy... And the globe is at a record level of geopolitical risk by many metrics."

... from China's economic weakness are resulting in a continued slide towards a more authoritarian regime under Xi Jinping. China contributed significantly to the world's growth for many years before COVID, so this comes as a concern to the global economy. It may also accelerate China's ambitions in Taiwan, although timing remains uncertain with strategists saying as early as before the US election to as late as 5 or more years from now.

Stepping back: the big picture

In the years following the Great Financial Crisis, we were in an economic paradigm characterized by lower-than-expected growth and inflation, which enabled global central banks to stimulate the economy through low interest rates. Following the COVID pandemic, governments responded with fiscal stimulus as well, which injected large amounts of money directly into the economy and the hands of consumers. As the world began to normalize, consumers flush with cash from government stimulus spent money at record levels while at the same time supply chains were heavily strained and commodities markets were upended following Russia's invasion of Ukraine. These dynamics ultimately led to the highest levels of inflation we have seen in 40 years and resulted in central banks raising interest rates aggressively to slow demand and reduce pricing pressure.

The last 2 years have been characterized by declining, yet persistently high inflation. The Consumer Price Index (CPI) has fallen from a high of 9.1% in June of 2022 to a low of 3% in June 2023 but since then has not recorded another print below 3%. Increased interest rates have created stress in several interrelated areas, most notably in commercial real estate and regional banks. Markets are expecting central banks to begin easing which seems premature to us as elevated inflation will make it difficult for central banks to ease in the face of any weakness unless it is material.

Despite these challenges, employment has been strong and the prospects for the value creation by Artificial Intelligence (AI) has propelled equities higher. In our view, equity valuations look rich because the indices are dominated by large but fast-growing companies. Equities outside of the very largest names are not overly expensive by historical standards. Despite strong employment, there are various signs of weakness in the economy. The globe is at a record level of geopolitical risk by many metrics. The recession that we were worried about has yet to materialize and markets have climbed the proverbial "wall of worry."

Positioning

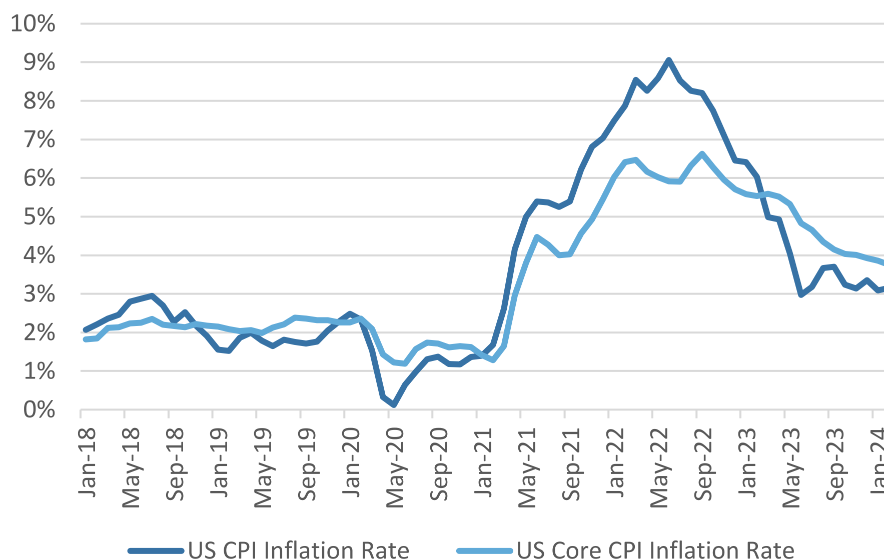
We came into 2024 marginally overweight fixed income, marginally underweight equities, and underweight real assets, although with positioning much closer to neutral than usual. At some point it will make sense to move positioning to a more cautious stance, but for now we are sticking close to neutral. Additionally, we have reduced the number of tactical tilts we are taking to keep our portfolios nimbler and more focused on responding to the evolution of events.

Inflation

"What has kept inflation high and will it change? … One explanation is that prices generally are "downward rigid" meaning that businesses routinely increase prices but they rarely decrease them… In the absence of broad-based price declines, overall inflation levels are susceptible to spikes in certain areas."

Inflation remains a key focus for markets. Despite market expectations that inflation would return quickly to 2%, inflation has remained sticky above 3%. While this may not seem like a big difference, from a policy perspective it makes it very difficult for central banks to declare victory over inflation and ease policy rates. To further complicate matters, inflation has historically shown a tendency to come in multiple waves, highlighting the need for central bankers to stay vigilant.

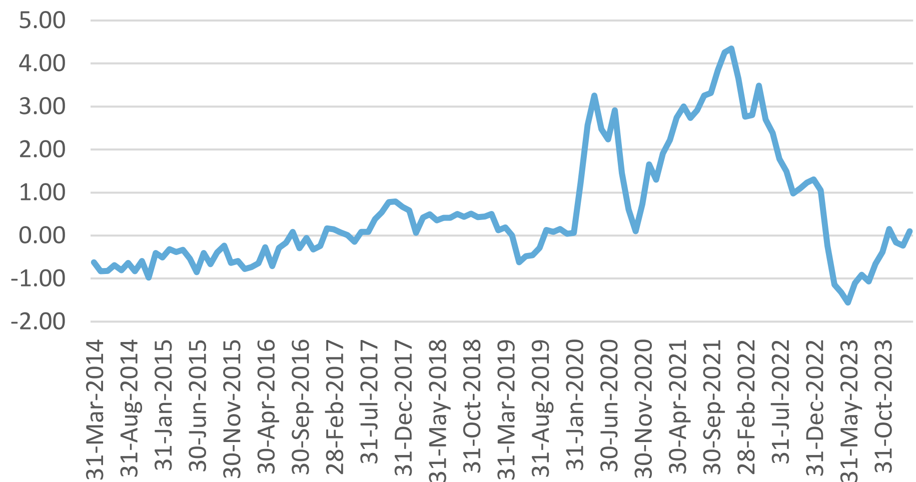
US CPI and Core CPI Inflation Rates



Source: yCharts.com. Monthly Consumer Price Index and Core CPI Inflation Rates from 1/31/2018 until 02/29/2024. CPI measures price change from the perspective of the consumer. The Core Consumer Price Index (CPI) measures the changes in the price of goods and services, excluding food and energy.

What has kept inflation high and will it change? Core CPI has continued to slowly trickle down from 4% to 3.75% over the last 6 months but not at the rate expected. Headline CPI has actually increased from 3% in June '23 to 3.15% in February. One explanation is that prices generally are "downward rigid" meaning that businesses routinely increase prices, but they rarely decrease them. In the absence of broad-based price declines, overall inflation levels are susceptible to spikes in certain areas. 2023 was a year of food price disinflation following two years of notable increases in food prices. However, fertilizer price levels remained elevated and food prices began to tick up in Q4 '23. Oil is up 15% in 2024 and 25% since the middle of last year. Further, the low inflation print in June '23 also happened to correspond to the low reading of the Global Supply Chain Pressure Index.

Global Supply Chain Pressure Index



Source: https://www.newyorkfed.org/research/policy/gscpi#/interactive. The GSCPI integrates several commonly used metrics with the aim of providing a comprehensive summary of potential supply chain disruptions. Global transportation costs are measured by employing data from the Baltic Dry Index (BDI) and the Harpex index, as well as airfreight cost indices from the U.S. Bureau of Labor Statistics. The GSCPI also uses several supply chain-related components from Purchasing Managers' Index (PMI) surveys, focusing on manufacturing firms across seven interconnected economies: China, the euro area, Japan, South Korea, Taiwan, the United Kingdom, and the United States.

Impact of higher for longer: "Maturity Wall" and corporate bonds

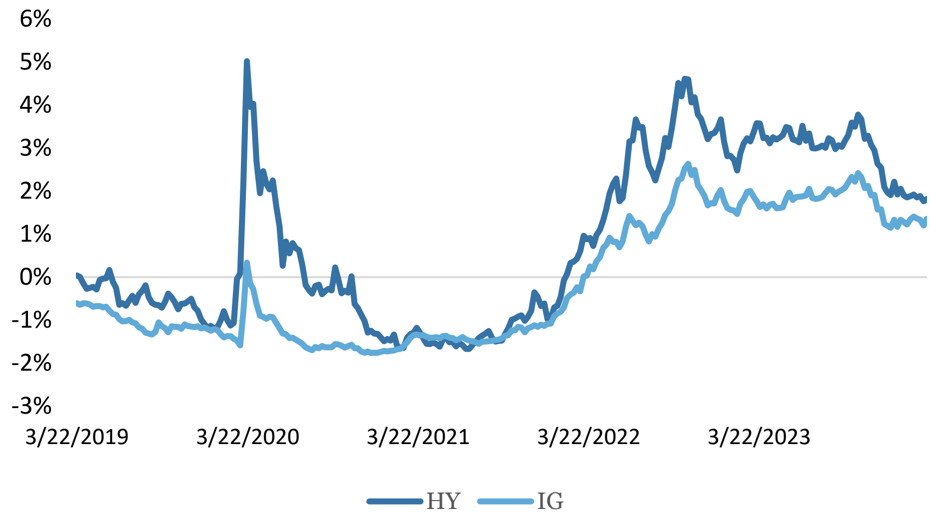
One of the consequences of keeping interest rates higher for longer that we have touched on in previous quarterly letters is the reality that in our view many companies are going to be forced to refinance their debt at higher interest rates. In our Q4 '23 Investment Perspectives we wrote:

"As long as these companies could continue to refinance their debt at low levels, they were effectively being kept alive by the low interest rates, hence the nickname "zombie companies". Now that interest rates have started to rise, the cost of funding for many of these companies has soared to over 10%. These higher interest rates resulted in high yield bond issuance plummeting in 2022 and 2023. However, a significant amount of debt is going to need to be repaid beginning in the next few years. If rates do not go down, or these business don't materially improve, it's possible that we could see a wave of defaults from these businesses."

Interestingly, we are starting to see the wave of refinancing play out in 2024, although defaults have remained relatively muted so far. As of writing this piece, IG corporate bond issuance has totaled ~476bl and HY issuance has totaled ~70bl, an increase of 36% and 179% respectively. Part of the reason for this is that credit spreads have tightened significantly since last October, which has given corporations a window of opportunity to refinance. As you can see from the chart below, refinancing costs for corporate borrowers have dropped meaningfully since last fall, however refinancing costs are still elevated, with both IG and HY issuers paying between 1-2% more in interest.

"We are starting to see the wave of refinancing play out in 2024... Part of the reason for this is that credit spreads have tightened significantly since last October, which has given corporations a window of opportunity to refinance... however refinancing costs are still elevated, with both IG and HY issuers paying between 1-2% more in interest... corporate bond spreads are approaching some of the richest levels we have seen in the last 2 decades... based on where credit spreads are right now, the forward return expectations for credit based on our model is negative 0.7%.

IG and HY Bond Yields Minus Coupons

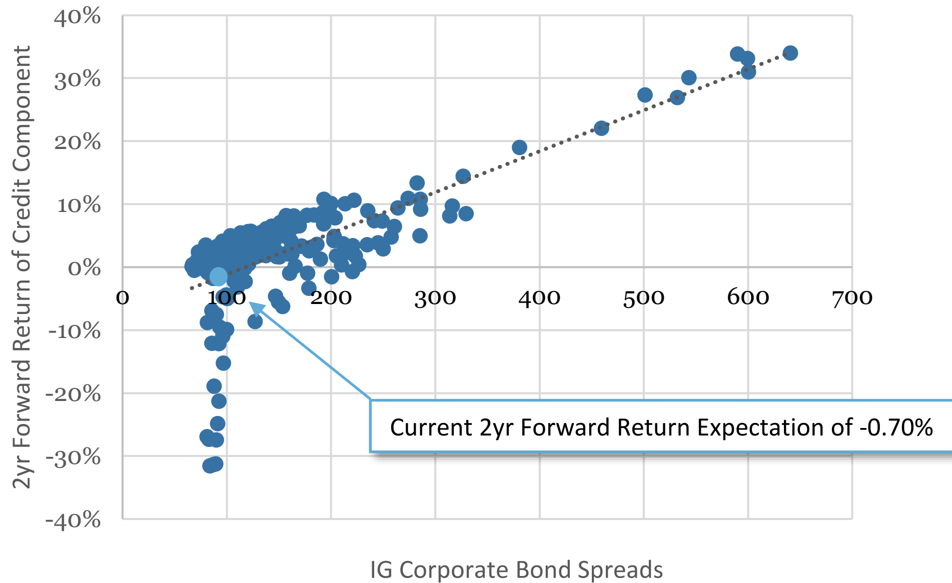


Source: Bloomberg- High Yield Bond Yields is represented by Bloomberg Global High Yield Corporate Total Return Index Unhedged USD and Investment Grade Bond Yields are represented by Bloomberg AGG Corporate Total Return Index Value Unhedged from 03/22/2019 until 03/15/2024

Despite the wave of new issuance, corporate bond spreads have continued to grind tighter and are approaching some of the richest levels we have seen in the last 2 decades. As the economy has continued to hold up, investors seem comfortable deploying capital in the corporate bond market now that they can lock in yields that are higher than they have been since the Great Financial Crisis. One way to measure the demand of the corporate bond market is to look at how much interest there is in new corporate bond deals as measured by how oversubscribed they are. Year to date we find the average corporate bond deal is 3.7x oversubscribed compared with 3.5x in 2023 and just 3x in 2022. Given the high levels of interest in new issues, dealers have been able to issue bonds with much smaller concessions, and therefore lower yields.

Unfortunately for investors, the forward return expectations from credit markets are much dimmer now that spreads have tightened. The following chart plots US IG credit spreads compared with the 2 year forward return proxy of just the credit component. As you can see there is a strong correlation between credit spreads and forward returns. Currently, based on where credit spreads are right now, the forward return expectations for credit based on a linear regression model are -0.70%. Due to these rich spreads and poor forward return expectations, we have reduced clients' allocation to credit where appropriate.

US IG Spreads vs. Forward Returns



FOR ILLUSTRATIVE AND EDUCATIONAL PURPOSES ONLY. Source: Bloomberg, GenTrust Calculations. Ig Corporate Bond spreads from 02/28/2003 until 03/31/22. Forward returns are represented by 5–10-year Corporates 2 year forward rates and 5-10 year Treasury 2 year forward return rates from 02/28/2003 until 02/29/24. The X axis is represented by the Option Adjust Spread of Credit Index. The Y axis is represented by the corporate bond index 2 year forward returns minus the 5-10 Treasury Index 2 year forward returns.

Commercial real estate

The roughly $20tn U.S. Commercial real estate[1] ("CRE") market sits on the precipice of volatility. The current landscape is riddled with potential headwinds and looming deadlines that could weigh on valuations and balance sheets. Cap rates across all properties have increased roughly 75bps in 2023 while the average interest rate on newly originated commercial real estate loans has broken through 6%. This dynamic creates a market where the cost of debt in many situations is higher than the current cap rate for those properties, which creates gridlock and lower transaction volumes. Annual sales volume for 2023 was just over $300bln, which is the lowest since 2012, and that is predicted to further decrease in 2024. Adding fuel to this fire is a broad pullback in bank leading for the CRE space. Many banks are advancing closer to 50% Loan to Value ("LV"), when two years ago they would advance closer to 65%. These dynamics can be overlooked in the short term but property owners that face refinancing deadlines may be forced to come up with more capital to make the deal work or enter into expensive alternative financing options such as mezzanine loans or sell into a very soft market. This saga is coming to a head as more than $2.8tn[2] of loans come due over the next 3-4 years and given the aforementioned backdrop, we would expect a significant need for capital to be infused into this highly levered sector. While we don't have any direct exposure to commercial real estate in portfolios generally, we are monitoring certain investments looking for attractive entries and staying cognizant of the fact that the need for capital from the CRE sector will pose headwinds for other sectors that are competing for the same capital.

[1] Source: https://www.capitaleconomics.com/publications/us-commercial-property-outlook/another-year-double-digit-value-falls-2024
[2] Source: https://www.colliers.com/en/research/nrep-capital-markets-us-snapshot-q4-2023

Passive vs. active

“The end of 2023 marked a milestone in the world of passive investing. As of December 31, 2023, US investors had $13.244tn in the active funds compared to $13.252tn in passive strategies... We explore: “Is there a limit to how much money can go into passive before it makes sense to look back at active? And “Have any risks been created by this large move to passive investing?”

The end of 2023 marked a milestone in the world of passive investing. As of December 31, 2023, US investors had $13.244tn in the active funds compared to $13.252tn in passive strategies, according to a report by Cerulli Associates, which cited Morningstar Direct data.

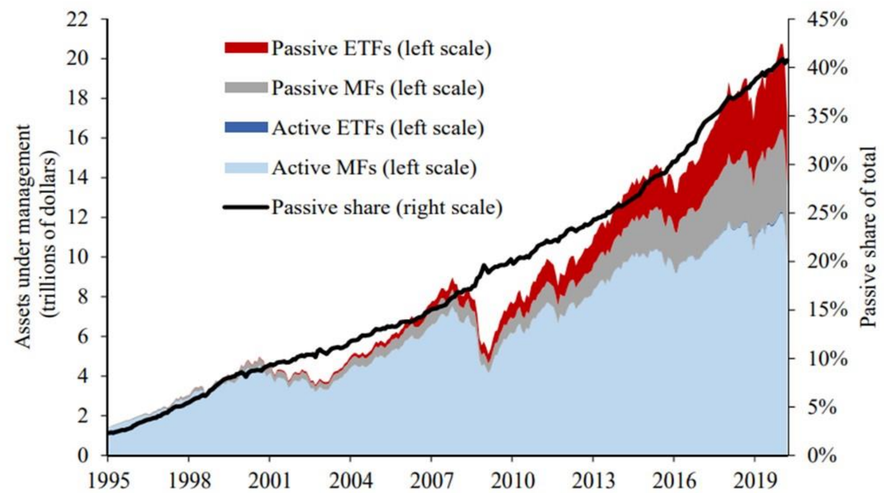
As our clients know, we have been huge advocates of passive/ETF investing since our inception back in 2011. In 2011, passive investing only accounted for approximately 20% of all investments in the US and the ETF market was roughly 10% of its current size. The rise of passive investing is due in large part to a 20-year trend in the wealth advisory space as clients shift from commission-based trading to advisory accounts where advisors are fiduciaries and act in the best interest of their clients, instead of just what is suitable for them which is the model of traditional broker dealers.

Given this massive shift in the way assets are managed, the obvious question is: “Is there a limit to how much money can go into passive before it makes sense to look back at active?” And a secondary question is “Have any risks been created by this large move to passive investing?”

Prior to his passing in 2019, John Bogle, founder of Vanguard and the "father of index funds," cautioned in a WSJ article (November 29, 2018) about what might happen if index investing became too successful for its own good. He wrote: “Public policy cannot ignore this growing dominance, and consider its impact on the financial markets, corporate governance, and regulation." More candidly, he’s also quoted as saying at a Berkshire Hathaway meeting “If everybody indexed, the only word you could use is chaos, catastrophe. The markets would fail.”

Have any risks been created by this move to passive? In Limits to Diversification: Passive Investing and Market Risk (Fang, Jiang, Sun, Yin, Zheng), the authors conclude “the rise in passive investing could lead to higher correlation among stocks and higher market volatility, limiting its own benefit of diversification.” They cite Campbell et al. (Have individual stocks become more volatile? Journal of Finance) that documents that between 1962 and 1997 correlation among stocks dropped but that correlation among stocks roughly doubled during the 1998-2020 period from previous levels.

A 2018 paper by Anadu et al. (The Shift from Active to Passive Investing: Potential Risks to Financial Stability?) concludes that the shift from active to passive investment strategies appears to be increasing some types of risk while diminishing others. “The shift has probably reduced liquidity transformation risks, although some passive strategies amplify market volatility, and passive-fund growth is increasing asset-management industry concentration. They found mixed evidence that passive investing is contributing to the co-movement of assets.”



Source: Morningstar, Inc.

As markets pass 50% passive investing, we believe we may be in the midst of a case study on the impacts of passive investing involving the 6 largest holdings in the S&P500 (AAPL, AMZN, GOOG, MSFT, META, NVDA) [3]. Four passive ETFs (SPY, IVV, VOO, QQQ) that hold over $1.2 trillion dollars in investments each have 27% (SPY/IVV/VOO) and 37% (QQQ) respectively invested in those holdings.

Since these passive investments are market capitalization weighted, the greater the amount that goes into these stocks, the bigger they become, and the larger the percentage of those funds they become in a virtuous upward cycle. Like all reinforcing cycles, the reverse can also happen if things go the other way. We don't believe we are at a point where this is problematic (yet) although it is something we are monitoring.

GenTrust strives to have a comprehensive, timeless, and research-driven investment process. Part of that process is to continually question ourselves about decisions we've made, even fundamental core value decisions such as the choice of using primarily passive vehicles. We are continually analyzing the prospects of active management and testing our approach. We approach such analysis from both a conceptual as well as data driven basis. Conceptually, we believe markets are mostly efficient, which would imply market capitalization weighted indices are a good investment choice (they also have the added advantage of being tax efficient as well). But we also believe there is a limit to passive investing and while 50% may not be the point at which to abandon the approach, it likely happens well before we reach 100%. Conceptually we also believe that the less efficient markets that are best candidates for active management are the ones that are less crowded (less analysts and capital devoted to them) or that have non-profit maximizing players (such as central banks). That means we mainly focus our search for active management in those areas and have implemented active approaches in various parts of fixed income such as municipal management which we believe is less crowded. Active management...

[3] As of March 28, 2024 information from Bloomberg

…will always have the hurdle of higher fees and less tax efficiency, but it is prudent for us to continually question the assumptions of our approach. From a data perspective, despite the large increase in passive allocations, we have not seen an improvement in active managers ability to outperform passive benchmarks.

Geopolitics

The three current global hotspots of Ukraine, Gaza, and Taiwan are of varying degrees of seriousness and concern. The war between Russia and Ukraine has reached a stalemate with a decline in unity in the west. Ukraine is also slowly running out of able-bodied men it can draft into the war. The US is unable to come up with fresh funding for Ukraine due to differences in opinion amongst the Democrats and Republicans on whether the war should be funded. If Trump gets elected, the odds are high that the US will further dissociate itself from the war. The current budget, which passed in the 11th hour on March 22nd, the last day it could pass without mandatory budget cuts, carefully avoided funding for Ukraine or Israel. Despite France's desire to put boots on the ground in Ukraine, we think this war is scheduled for a slow wind down, likely coming to a stop after the US elections, as Russia may hold out for a change in the US administration before it sits down for negotiations.

The war in Gaza will run longer than the US wants it to run, because it is an existential issue for Israel. The US has less control on the war than it likes, as is evident from Israel's refusal to not invade Rafah. The Biden administration is between a rock and a hard place with polling losses in Michigan regarding their support for Israel. This war has laid bare some of the fault lines in the President's own party and may affect the US election on the margin. In addition, the war has the potential to cause a significant adverse reaction from the rest of the Middle East against both Israel and the US if it expands further. It may also lead to a resurgence of ISIS. All of these factors are hard to handicap but should not have a market impact unless the war spills over outside of the Middle East, or causes significant shutdowns of oil production capacity.

Finally, the stresses arising from China are two-fold. First, we could have a continuation of the ongoing reversal of some of the political reforms undertaken by Hu Jintao, and a continued slide of China into a more authoritarian mode under Xi Jinping. This has the power to exacerbate the effects of the demographic slowdown, and slow Chinese growth further, and may eventually cause political unrest in China. This slowdown in economic growth in China has the potential to affect markets globally, as China contributed half of world growth for many years before COVID. Second, partly as a consequence of these internal stresses, China may choose to walk into Taiwan. Geo-political commentators vary widely about the timing of such an action by China. The earliest of these estimates call for a siege and occupation of Taiwan before the US election in November, so as to avoid potentially dealing with a less predictable President Trump should there be a change in the US administration. Xi's desires for a legacy (given his advancing age)…

…also suggest an earlier time frame for the move. Other commentators look for a move in the next 5 years, given that in their judgment, China is not fully prepared to face the consequences of war. Still others think that the timing is further away. The longer-term estimates don't concern us from a markets point of view.

As many of you know, we continually develop, maintain and subject client portfolios to stress scenarios we create which mimic how we believe markets would move during adverse market conditions. Since 2021, we have been modeling what a war with China would look like in various severities from a Taiwan proxy skirmish to a full-on NATO vs China+Russia war. In our latest update of the stress scenario, we modeled rates to rise 2% (and bonds to lose 13%), equities to fall 25%, and real assets to rise 25% led by gold and oil. Our thinking was that supply chains may be permanently disrupted, and the US would lose access to critical semiconductor chip production for some period, as well as lose access to raw materials needed for batteries. The US would run larger budget deficits to finance increased defense spending and reshoring efforts would accelerate, resulting in lower global trade. Inflation would likely rise and interest rates would likely also rise (despite a slowing economy) both from increased inflation but also as China may sell some of its US Treasury holdings.

To be 100% clear, we envision this scenario as having a very small probability of happening, well less than 10%. However, it is very useful to subject portfolios to these sorts of "what ifs" as it highlights potential weaknesses in our portfolio construction and also gives us a game plan as to how to deal with the crisis if it were ever to happen. Although we didn't predict COVID would happen, we had modeled severe growth shutdowns and it helped us navigate 2020. We did predict inflation would pick-up markedly after COVID and had modeled the negative impact of a rapid rise in inflation in 2022 which allowed us again to navigate that period with confidence.

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Active ETFs are managed by portfolio managers who actively buy and sell securities with the goal of outperforming the market or achieving a specific investment objective. Investing in Active ETFs can entail risk such as manager risk, market risk, liquidity risk, performance and tracking error risk. Investors should carefully consider these risks, along with their investment objectives, time horizon, and risk tolerance, before investing in active ETFs. Consulting with a financial advisor can also provide personalized guidance based on individual circumstances.

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