Quarterly Market Letter

GENTER CAPITAL MANAGEMENT

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Highlights:

- Volatility in 2023; more uncertainties in 2024?
- U.S. economy proved more resilient than expected.
- Inflation, though still high, continues to decline.
- Market responds to Fed's "dovish pivot."

Introduction:

On December 8, 1940, the Chicago Bears squared off against the Washington Redskins in the NFL Championship. It was the first NFL game that was broadcast nationally, with people across the country listening on the radio. Although the Bears were slight favorites, the Redskins had beaten them 7-3 earlier in the season. What occurred on that cold, cloudy afternoon was the biggest wipeout in the history of professional sports.

On the second play of the game, Chicago fullback Bill Osmanksi broke free and scampered 68 yards to score. Down 7-0, the Redskins also moved the ball up the field. On the Chicago 25-yard line, Washington lost a touchdown opportunity when an open receiver missed a pass near the end zone. Washington then missed the field goal attempt, and the rest is history: Chicago ran off an unbroken string of points to defeat Washington, 73-0.

After the game, Washington quarterback Sammy Baugh was asked by a reporter if the game might have turned out differently had that early pass been completed. "Sure," said Baugh, "the score would have been 73-7."

In 2023, investors were generally successful. Despite the volatility, which is another word for "uncertainty," equities enjoyed a great year. Bonds also did well, thanks to an astonishing rally in the final quarter. Other asset classes, such as commodities and real estate, proved resilient in the face of higher rates. Even the political landscape, leaving aside the usual histrionics, remained relatively stable from a market perspective.

And yet, it seems like the market was "right" for the wrong reasons. In the fixed income space, the extended yield curve inversions reflect a market which has been "fighting the Fed" for quite some time. While the Federal Reserve was manifestly wrong about the "transitory" nature of inflation, the bond market has been wrong, at least so far, about an impending recession. And on the equity side, far from fighting the Fed, the market was acting more like its appendage, rallying when it seemed the Fed was going dovish and swooning when it seemed the Fed was remaining hawkish.

There is always the temptation, when life does not go as expected, to seize upon some variable along the sequential chain and claim that it made all the difference. Sam Baugh rejected that temptation and remained true to the basic reality that Chicago was too much for them—on both sides of the ball.

Review

Going into 2023, the consensus forecast among economists and market analysts was minimal growth and a 65% probability of a recession. That was wrong, as it appears GDP growth will be near 3% and there was no recession. The consensus forecast was 4% inflation; we are closer to 3%. The consensus forecast for unemployment was greater than 4%. We have just finished our 22nd consecutive month of sub-4% unemployment, the first time *that* has happened since the 1960s. In a word, the consensus view for 2023 was stagflation, and what we got was its opposite—continued growth and declining inflation.

While it is apparent there was not much "wisdom in the crowd" in 2023, it is even less clear why it broke that way. The Fed would be willing to take credit, as their confidence that higher rates could slow inflation without crippling the economy proved correct. Politicians would as well, especially as we enter the election season. Their fiscal largesse increased aggregate demand, which helped spur growth. The verdict is still out on whether that largesse has inflicted lasting damage upon the American economy.

Private consumption also helped provide a tailwind. Families, enjoying life after COVID and buttressed by high employment levels, maintained elevated levels of spending. Improved supply chains, which had flagged badly in 2021 and 2022, also supported growth and helped reduce inflation. Deglobalization and reshoring played a role, as the national economy is being retooled for a new, more adversarial, international dynamic. And as cheap labor becomes more elusive, labor-saving capital investments become more feasible. This *also* increases output, growth, and productivity.

It is fair to ask whether expanding aggregate demand—the Keynesian-style stimulus launched by COVID—though inflationary in the short-term, helped the economy on balance. To be sure, inflation is *not* popular with families who shop for groceries. The decades-long stability with supermarket prices has been disrupted and people are angry about it. While it may carry some adverse political consequences, we have pointed out that the massive fiscal injection during World War II helped create "escape velocity" from the Great Depression. It also created, temporarily, alarming rates of inflation.

Still, the Fed remembers the *1970s* experience, not the 1940s experience, and that institutional memory drives its policy. Despite our relative openness to the view that the 2022 inflation may ultimately prove benign, our baseline outlook remains recessionary. These two views are not necessarily contradictory.

We certainly did not think that since the financial markets suffered pain in 2022, it was the real economy's turn to suffer pain in 2023. Rather, there remain some disturbing factors in the economy which give us pause. The credit cycle and impacts of the higher costs of capital are becoming more evident. Commercial real estate is not out of the woods by any stretch of the imagination and the growth of consumer debt is approaching stall speed. Meanwhile, quantitative tightening, the Fed's exit from the bond market, is creating upward pressure on long rates, which may help restore a positively sloped yield curve, but may also create added pain for families and businesses.

Moreover, the traditional recession indicators are flashing yellow. The Leading Economic Indicator index has been reflecting a recession for the past 16 months, while the Institute for Supply Management index, which measures manufacturing, is also, persistently, reflecting an impending contraction. And there are concerns that much of 2023's employment strength was overstated, due to potentially inaccurate seasonal adjustments in the Bureau of Labor Statistics birth-death model. If this is true, the Sahm Rule—where an imminent recession is flagged when the three-month moving unemployment average has increased by half a percentage point relative to its low during the prior twelve months—may have already been triggered. We think it is useful to remember that ideas like "it is different this time" do not tend to age well.

Finally, the reshoring which has helped fuel the recession-defying expansion carries an implicit downside. Geopolitical risks are at the most elevated level in decades, and uncertainty and conflict are not good for business. These risks create the prospect of exogeneous shocks which can send markets into a tailspin. Given these uncertainties, our base case is that growth will be slow in 2024 but likely avoid a crippling recession. We look for 2024 GDP to finish in the 1 to 1.5% range.

Last year, we asked if a low unemployment, high nominal GDP recession is really a "recession" in the sense of a widespread dispersion of economic pain. That remains to be seen. We do think that recessions can purge the overextended elements of an economy and strengthen the foundation for the next wave of sustained growth. We also think that the American economy is overextended, both in the public sector and on the private side, and that will eventually have a negative impact on business.

Fixed Income Report

Through most of 2023, the Federal Reserve remained resolute in its war against inflation. Having missed the call that inflation was "transitory," the Fed engaged in the most rapid set of rate hikes in its history. Many in the financial markets thought the cure was worse than the disease, but the real economy took its medicine without wincing.

In December, the Fed announced for the first time that inflation had eased. Moreover, its "dot plots" projected a Fed Funds rate at 4.75% at the end of 2024, 50 basis points lower than the level projected in September. This, combined with lower inflation projections, helped drive rates lower. The market, sensing a "dovish pivot" prior to the December meeting, saw confirmation in its aftermath.

It is important to note, and Chair Jerome Powell has said as much, that the Federal Reserve wants policy to remain slightly restrictive. If inflation declines, and the Fed does not cut, then real rates (the nominal rate less inflation) become more-than-slightly restrictive. The Fed does not want to be too restrictive in an environment where inflation is already diminishing and the pronounced downside risks are evident. Slightly restrictive is one thing; significantly restrictive is another. If the Fed does cut rates, and we expect a few cuts over the course of 2024, it will probably do so with the explanation that the policy stance remains restrictive.

As of 12/31/23, the market was pricing more than *six* rate cuts by the end of 2024. Many traders think that monetary policy is too tight because the effective Fed Funds rate, at 5.31%, is more than 200 basis points higher than the inflation rate (PCE Core inflation is at 3.2%). We do not think this is an accurate read on Fed rate cut triggers. From 1960 to 2010, the 3-month T-bill (a reliable proxy for the Fed Funds rate) *averaged* 190 basis points over PCE Core inflation, not much less than the 200 basis points we see today. During that 50-year interval, GDP growth averaged 3.2%. In an historic context, today's real rates are not alarmingly restrictive.

There are also very few examples of the Fed preemptively cutting interest rates. The Fed may be imperious, but it does not regard itself as clairvoyant. As a rule, the Fed waits until it sees the "whites of the eyes" of an economic problem. The thinking that the Fed is terrified of recessions probably stems from the period of extreme monetary accommodation between 2008 and 2021. During that period, the Fed was managing the risk of a deflationary implosion. While it is a difference in degree and not type, the Fed's response to a prospective *depression* is different than its response to a prospective recession. Indeed, prior to the Great Financial Crisis, the Fed used downturns to opportunistically expunge the economy of inflation.

In the 2010s, the Fed had to convince the market that the throttle was wide open. With inflation risks, the Fed is on more solid empirical ground. Again, while we do see the Fed easing in 2024, it will be to keep rates slightly restrictive relative to inflation, not to preemptively avoid a recession at all costs.

While the Bloomberg consensus is for both Headline CPI and Core PCE inflation to finish 2024 at 2.6%, we think inflation can surprise to the downside. There are two main reasons for this view. First, the Fed will maintain its vigilance against inflation. While goods inflation has flatlined, service inflation remains high. The American economy is a service economy, which means service inflation is a concern for the institution charged with keeping inflation at bay. Second, and relatedly, the inflation driven by supply chain disruptions seems to be reversing as those problems get resolved. This is probably the reason why goods inflation has been effectively contained.

We think the Fed tries to bifurcate its responsibility to contain inflation from its responsibility to ensure stability in the banking system. If the banking system faces challenges, the Fed will infuse liquidity back into the system, even though that means growing its balance sheet. It will be interesting to see if the Fed continues its Bank Term Funding Program, which grew out of the banking crisis last March and is set to expire this March. That decision will provide a read on the extent to which the Fed thinks the banking system is vulnerable.

Despite the volatility and missed forecasts, fixed income assets provided strong absolute returns in 2023. The Fixed Income team at Genter Capital was able to deliver outstanding relative performance, as all key fixed income strategies outperformed their respective benchmarks.

On the tax-exempt side, AAA benchmark yields declined somewhat for the year. While this may be welcome news for municipal bond investors, it does not come close to telling the whole story. At the end of the third quarter, yields were significantly higher, but in the final quarter, we saw a rally of more than 100 basis points across the curve. The table below shows what happened:

Maturity	12/22	9/23	Spread YTD	12/23	Spread QoQ	YoY
1-Yr	2.82	3.73	+91	2.59	-114	-23
3-Yr	2.58	3.51	+93	2.35	-116	-23
5-Yr	2.56	3.38	+82	2.22	-116	-34
7-Yr	2.56	3.38	+82	2.19	-119	-37
10-Yr	2.64	3.44	+80	2.27	-117	-37
15-Yr	3.16	3.99	+83	2.88	-111	-28
20-Yr	3.31	4.18	+87	3.14	-104	-17
30-Yr	3.63	4.42	+79	3.40	-102	-23

For the broader market, tax-exempt securities were attractive. Despite a continued exodus of money from open-ended municipal mutual funds, inflows to exchange-traded funds and robust buying from retail investors helped propel municipal bonds to outperform other parts of the fixed income market. The table below shows indices with similar durations and their 2023 returns.

Market	Duration Years	2023 Return
U.S. Treasury	6.11	4.05%
U.S. Mortgages	5.87	5.05%
U.S. Aggregate	6.20	5.53%
Municipal Bonds	6.05	6.40%

While municipal bonds outperformed the other markets on an absolute basis, the improvement was even more eyepopping when adjusted to a tax-equivalent basis.

For our taxable portfolios, given our view that interest rates have moved too far, too fast, we are comfortable maintaining portfolio durations slightly short of index benchmarks. We are not aggressively short due to the uncertainties outlined above.

Given our outlook for slow (but positive) growth, moderating inflation, and decently strong employment, we are comfortable maintaining an overweight to corporate bonds. While we still see relative value in individual credits and sectors, we recognize that the corporate bond market is no longer "cheap" and may look for opportunities to reduce our exposure. Still, an economy that is middling is not bad for carry strategies. We are avoiding Treasury Inflation Protected Securities (TIPS) at this time since, given our broad inflation outlook, we view them as expensive.

In 2023, the Treasury curve changed, as the joke goes, 360 degrees. It was an exceptional year for rate volatility. In the 35-year history of the Merrill Option Volatility Estimate (MOVE) index, which measures treasury volatility, only 2008 and 2009 had higher average volatility than 2023. The uncertainty was driven by various factors, from underappreciated Fed hawkishness to a mini banking crisis to supply/demand mismatch fears to, eventually, overappreciated Fed dovishness.

For 2024, we expect that the Fed pivot from fighting inflation to a more balanced risk assessment will hasten the return to a positively sloped yield curve. While we do not necessarily expect curve normalization to occur this year, the combination of lower rates on the short end with the Fed's reduced support on the long end points towards that direction. In the meantime, we continue to look for opportunities created by the "U" shaped yield curve, using credit selection and barbell strategies to provide extra income for our clients.

Equity Report

Equities had a strong year with an S&P 500 total return of 26.2%. The year-end close at 4,770 put the index just shy of its all-time high of 4,796, which occurred on January 3rd, 2022. Through November, the "Magnificent-7" (AAPL, AMZN, GOOG, META, MSFT, NFLX and TSLA) drove over 90% of the returns in the S&P, while the equal weighted S&P was more muted. But sparked by a more dovish tone from the Fed during its final meeting of the year, the market broadened out in December, as animal spirits were stirred with renewed hope for interest rate cuts in early 2024.

While headline returns for the equity market were strong, it was a tale of two tapes as investors once again fell in love with Growth. The Russell 1000 Growth Index was up 41.4% compared to the Russell 1000 Value Index, which was up 8.8%. Despite the strong performance for Growth, the returns just retraced the losses from 2022. Since the market peaked at the end of 2021, Growth and Value have performed in-line with one another, although Growth has been a much more volatile ride.

Despite a solid showing for the headline S&P 500 index, under the covers, key segments of the market were exhibiting caution about the broader economy. Technology and Artificial Intelligence (AI) driven businesses did very well, but the more cyclical (economically sensitive) corners of the market remain lukewarm to the prospect of a soft landing. Almost half of the stocks in the S&P are still down over 10% from the peak of the market at the end of 2021, and a quarter of the stocks are down more than 20% from that peak.

Technology was the clear winner, with the sector up 55% for the year, recouping most of the losses from 2022. Interest rate sensitive sectors like Utilities and Consumer Staples were the big laggards, down 10% and 3% respectively. This was largely due to higher interest rates, which provided income-oriented investors with more alternatives.

From our perspective, the most curious sector was Energy, which was down 4% and also lagged the broader market. With strong returns for the S&P 500, and increased optimism for a "soft landing," the market seemed to hedge its bets by avoiding Energy, which should do well if we avoid a recession. Moreover, between low private inventories, the Strategic Petroleum Reserve at 40-year lows, geopolitical tensions, and wars in Ukraine and the Middle East, it seems to us that higher risk premiums should be driven into the energy market.

There are signs that consumer spending has been decelerating from quite strong levels over the past several quarters. This has been the Fed's goal all along: snuffing out high inflation before it becomes entrenched. Higher credit costs, rising delinquency rates, and shrinking excess savings seem to be weighing on consumers more recently. And we would expect the cumulative effects of inflation and higher cost of capital to become more evident in 2024. But we also must acknowledge that a solid job market continues to provide a good tailwind for aggregate demand, which should translate into rising corporate earnings.

While equity market perceptions vacillated between "Goldilocks" and "hard landing" for most of the year, Goldilocks pulled convincingly ahead at year-end as the Fed seemed to pivot to a more dovish tone. The dilemma for the Fed is that cutting rates too early runs the risk of repeating the mistakes of the 1970's, where on-again and off-again tightening kept reigniting inflation before the job was done. Conversely, cutting rates too late risks allowing a more serious slowdown to take hold, inflicting unnecessary pain on businesses and families.

Our view is that the Fed needs to err on the side of caution and wait for significant signs of slowing. The extreme fiscal stimulus from COVID and ultra-loose monetary policy over the past decade helped create the highest inflation in 35 years. We think the Fed needs more time to purge those excesses from the system. If warranted by the facts on the ground, the Fed can cut rates rapidly and decisively. In our view, small, premature cuts run the risk of undoing much of what has been achieved over the past twelve months on the inflation front. It would also waste bullets for when they are really needed. The market may be eager to have the Fed fill the punchbowl and get the party going, but we think the relatively solid economic footing today will lead the Fed to err on the side of being restrictive, at least until inflation is brought squarely under control, across the board. Again, the Fed may have limited ability to jumpstart the economy, but they know, with some precision, how to cool it down.

We are maintaining our conservative view of the market as we enter 2024 and continue to advocate increased stock selectivity. We think investors need to pay close attention to valuations as the market is once again approaching heady levels on the broad indexes. Moreover, there is no shortage of risks in 2024. These include contentious elections, both here and abroad, mounting deficits, quantitative tightening, elevated refinancing risk, and the worst geopolitical backdrop in a generation.

We continue to favor businesses and sectors with above-average cash generation that are selling below their long-term averages. This includes the Healthcare sector. We also think that Energy offers very good opportunities, with well above-average free cash flow yields and a much more disciplined industry from a supply/demand perspective.

For patient investors, we are becoming more constructive on Financials, which became extremely inexpensive in 2023. There are still some near-term hurdles which the industry and economy need to overcome, but we added great new franchises to our portfolios during market pullbacks and continue to look for opportunities to increase our exposure. Finally, strong stock selection within the Technology sector allowed us to participate in gains from the group without having to move into more speculative corners of the market.

We have positioned our equity portfolios to perform in either a soft-landing scenario or a tighter credit regime. If a soft-landing is engineered, then we expect to see earnings improve for many of the laggards which have been discounting further slowdowns. And if the economy eventually succumbs to a recession, with the discipline it imposes, then our portfolio businesses with stronger balance sheets and more defensive business profiles should do a good job weathering the storm.

Conclusion

The wise words of Sam Baugh remind us not to get too clever in looking for explanations. He deserves credit for recognizing the broad truth that the Bears were better—much better—on that December afternoon. Life moved on. Although “73-0” is remembered to this day, it did not define, nor even tarnish, Sammy Baugh. He went on to win another championship and was selected to the inaugural class in pro football’s Hall of Fame. More importantly, he led an admirable life off the field until his death in 2008, at the age of 94. But on that championship afternoon, more than eight decades ago, standing on the wrong side of the most lopsided defeat in the history of professional sports, Baugh gave the rest of us a lesson on how to think, when, inevitably, events do not unfold as expected.