Quarterly Market Letter

GENTER CAPITAL MANAGEMENT

First Quarter 2024

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Highlights:

- Fed rate policy depends upon inflation trends.
- Inflation went sticky in the first quarter.
- GDP picture a bit more positive.
- There are still warning signals.
- Our security selection remains conservative.

Introduction:

How is it that economic news can be pretty good, yet people remain economically apprehensive? This is a relevant question, especially as we stand on the threshold of another campaign season. For the longest time, many Americans would "vote their pocketbook," and "pocketbook issues" were the same for everyone, regardless of their political leanings. Has something disrupted that logic?

Part of the answer to this question may be found with a Nobel-prize winning economist who passed away in March. Daniel Kahneman was born in 1935 and spent his childhood in occupied France. He always felt this experience presented him with fundamental contradictions about human nature, an experience which drove his life's work.

Kahneman, along with his research partner Amos Tversky, was instrumental in developing "prospect theory," a branch of economics which builds upon the concept of "loss aversion." In a nutshell, there is an asymmetric relationship between sure things and chance. Most people would rather be given $500 than flip a coin to win $1,500, even though the math says that it makes more economic sense to flip the coin. On the other side of the equation, though, more people would rather flip a coin to lose $1,500 than pay $500 up front. This puzzling and seemingly irrational side of our nature fascinated Kahneman and other behavioral economists.

Kahneman's book *Thinking, Fast and Slow* summarizes his findings. They are not particularly pretty. In his view, "confidence is a feeling, which reflects the coherence of the information and the cognitive ease of processing it." He adds, "declarations of high confidence mainly tell you that an individual has constructed a coherent story in his mind, not necessarily that the story is true." In Kahneman's opinion, human beings are overconfident in their ability to interpret events and underappreciative of the role chance plays in those events.

Whether or not this is true, Kahneman did raise an important question: if we can easily think causally, associatively, and even metaphorically, then why is it so difficult for us to think statistically? Ultimately, he answers, developing our statistical intuition can only occur through the discipline of thinking slow, as opposed to the expedience of thinking fast. The good news is that, with work, thinking slow can *become* thinking fast, in the form of expertise and professional judgement. Kahneman provides an example of chess master glancing at a board while walking by and declaring that "white checkmates in three moves."

What Kahneman did not address, however, is what happens when the chess master blunders, when he claims that white can mate in three, but it turns out that black mates in two. When this occurs, there is a natural erosion of faith in knowledge and expertise. People become distrustful and sour, which seems to be the state of things today.

The reality is that Americans are smart, Americans know their own minds, and Americans are open to finding a better way. It serves no purpose to assume that the reasoning is wrong. Quite the contrary, it could be that—despite the relatively sound condition of their pocketbooks—the reasoning is right.

The Economy

One good reason for economic apprehension is inflation. Although inflation stabilized since the alarming spike in the middle part of 2022, that spike was highly disruptive and still felt today. For thirty years, our country enjoyed a stable price environment for goods and services. Twelve ounces of frozen orange

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juice, for instance, generally remained in the $1.75-$2.50 range; after the inflationary spike, it costs $4.25. A pound of potato chips ranged from $3.00-$5.00; today, the average price is $6.50. Inflation may be waning, but it has left, in its wake, a set of permanently higher prices. For families that must budget, the corrosion of value is both disconcerting and annoying.

In fairness, the Federal Reserve has risen to the challenge, and almost miraculously, at least in the minds of the recessionistas who were everywhere in 2023, managed to bend the inflation curve without sending the economy into a tailspin. They were so successful that much of the market expected, at the end of 2023, six rate cuts in 2024. While we were never on *that* bandwagon, we did think that the Fed could cut two or three times while keeping its "restrictive" policy stance.

But even that moderate outlook was threatened by the behavior of inflation in the first quarter. Headline CPI in February, at 3.2%, was higher than headline CPI in November, at 3.1%, breaking (at least for the time being) the "steady retreat" narrative. While core PCE, which the Fed targets, has ticked lower for all three releases this year (December, January, and February), disturbing trends in the CPI must raise alarms at the Fed. Headline CPI may not be the Fed's explicit target, but it is certainly the index which reflects whatever pain Americans feel at the gas pump and the grocery store.

We see the direction of rate policy as dependent upon inflation, both the target core PCE prints *and* the more widely promulgated CPI prints. If you want to predict what the Fed will do with rates, then predict what will happen with inflation. If inflation resumes its downward trend, then there will be rate cuts in 2024. If inflation ticks upward or even moves laterally, then rate cuts will be delayed and the Fed will have some difficult decisions to make.

Although the "steady retreat" narrative has been shaken, and although we have nudged our projections higher, our base case continues to be declining inflation. While the CPI numbers have surprised to the upside, the core PCE numbers have been aligned with market expectations. We are alert to a reduced pace of disinflation in the shelter component of the inflation indices, but we also think that continuing refinements of supply chain efficiencies will further the disinflationary trend. In other words, we think that inflation will resume its downward track, although we acknowledge an increased likelihood that it will not.

Whatever else about inflation, it does mean that there is spending in the economy. Spending is one of those "necessary but not sufficient" conditions for economic growth. In 2023, the widely forecasted recession did not materialize. As we exited 2023, there were both positive and negative factors weighing on the outlook for 2024. Today, three months later, we continue to see a "mixed bag," but the overall picture is a bit more positive.

Metrics from the National Bureau of Economic Research (NBER) continue to point away from a recession. The Institute for Supply Management (ISM) numbers turned positive on the manufacturing side (while remaining positive on the services side). The highly negative LEI (Leading Economic Indicators), though still meaningfully negative, became less so in Q1. Employment levels continued to soar, and fiscal spending, perhaps an underrated driver of GDP growth (at least when coming out of a sustained period of slow growth), also provided a baseline of support.

There remain some real concerns. These include weakening consumer finances, more business bankruptcies and loan problems, negative regional manufacturing indices, a shrinking labor force, a growing servicing burden for public debt, and LEI's which, though improved, continue to flash negative. It is perhaps worth noting that the yield curve inversion, which was compressing in January, widened out again as the market began pricing fewer rate cuts from the Fed. The inverted curve has become a fixture in today's economy, although historically, it was seen as a harbinger of an impending recession.

GDP growth estimates are proximate, a rough number drawn from high level aggregates. Still, the more robust economic picture has led us to increase our estimates of 2024 GDP growth from a muddling 1.25% to 2%. We expect inflation to remain sticky and we also expect Fed policymakers to try to wring inflation closer to their 2% target. We do think that the Fed would prefer inflation remain above 2% than fall below 2%. From the perspective of central banking, upside risks are easier to manage than downside risks; better than either is inflation nestling close to target. Towards that end, the

Fed still has work to do, and the economy will have to deal with notably restrictive rates until the job is done.

The Fed has considerable power over interest rate levels, primarily on the short end, but interest rates generally are determined by investor expectations regarding inflation and growth. Since the financial markets are highly sensitive to the cost of capital, these evolving expectations play an outsized role in investment performance. At some point, there will be a downturn, the recessionistas will be proven "right," and rates will drop dramatically. Despite the pain of such an event, it makes the cost of capital more attractive to investors and heralds a new day, where the markets are reset and "up" is the path of least resistance.

Is this Day of Reckoning imminent? We do know that Days of Reckoning occur when they are unexpected, not when they are expected. We also know that they arise regularly, whether we like it or not. We certainly do not foreclose the prospect of a Day of Reckoning. And so, a quarter into 2024, and despite seeing marginally better growth prospects than we did at the end of 2023, we continue to manage the portfolios entrusted to us with an eye towards both prospects: continuing growth *and* an abrupt shock to the system.

Equity Report

The economy continues to be more resilient than many investors expected, with the first quarter GDP on track to come in north of 2.5%. This is down slightly from the final quarter of 2023, which was 3.1%, but in line with the overall 2023 GDP of 2.5%.

The initial monthly readings for inflation this year suggest that there are still signs of sticky inflation on the Services side of the economy, which accounts for two-thirds of the American economy. As noted above, we expect the Fed to favor restrictiveness until across-the-board inflation is brought under control. This contrasts with the broader market view, which reacts sharply to any news which might change the Fed's thinking and is eager for the Fed to reload the punchbowl.

There are still signs that consumer spending is decelerating from its high levels. There is also growing bifurcation of spending among the various income cohorts. Higher credit costs, rising delinquency rates, and shrinking excess savings seem to be weighing heavily on consumers with income levels in the bottom half. This cohort of consumers are overrepresented as renters and tend to carry more revolving credit. They did not benefit from locking-in low mortgages and are bearing the brunt of higher credit card interest rates. While the interest burden on all mortgages has increased about 25-30% since the Fed started raising rates (in March 2022), the interest payments for revolving credit have *tripled*. We think it is a matter of "when" and not "if" that these households are forced to scale back their spending.

In the near term, though, we fully acknowledge that the solid job market continues to provide a good tailwind for rising, albeit slowing, aggregate demand. This should also translate into rising earnings. Historically, unless and until employment stalls and turns negative, the broader economy avoids an outright recession and equities follow earnings higher.

In the first quarter of 2024, equities continued to build on the positive momentum from last year. The S&P 500 closed the quarter at 5,254, up 10.1% on the year so far. It also achieved new highs versus the prior high of 4,796 in the early part of January 2022.

As in 2023, the "Magnificent-Seven" stocks (AAPL, AMZN, GOOG, META, MSFT, NFLX and TSLA) continued to deliver outsized returns. The market-weighted "Mag-7" group was up 13% while the rest of the S&P 500, ex-Mag-7, was up 6% for the quarter. The equally weighted S&P 500 was up 7.4% in the quarter, which reflects sturdy, broad-based quarterly returns.

In 2023, it was tale of two tapes, as investors strongly favored Growth over Value. The Russell 1000 Growth Index was up 41.4%, compared to the Russell 1000 Value Index which was up 8.8%. This year, the spread between Growth and Value has been less pronounced, with Growth up 11.2% and Value up 8.4% for the quarter. Interestingly, from the prior market peak in early January 2022 through the end of the first quarter in 2024, Growth and Value have performed in-line with one another, with Value up 11.9% and Growth up 11.8%.

Despite the solid returns for the headline S&P 500 index last year and the beginning of 2024, the market continues to exhibit some caution about the broader economy under the hood. Technology and Artificial Intelligence (AI) driven businesses continue to perform well, but the more cyclical and economically sensitive

market segments remain lukewarm. Almost one-third of the stocks in the S&P are still down over 10% from the prior peak of the market, and a quarter of the stocks are down more than 20% since that peak.

We said last quarter we found it curious that Energy was a laggard in 2023, given the strength in GDP and general optimism that the Fed can engineer a soft-landing. The Energy sector was the market leader in the new year, with the group up 12.6% for the quarter. The other leaders were Financials, which were up 12%, and Industrials, which increased 10%. Financials also lagged last year, so there is clearly some sense that economic growth can expand and that some of the sector laggards represent good value.

The overall Technology sector was up 8.2% for the quarter, compared to the S&P 500's 10.1%. As usual, the Mag-7 names stood out. Despite two of the names, Tesla and Apple, being down by 29% and 11% respectively, the average (non-market weighted) stock in the Mag-7 was up 16.8%. The prospect for an innovation and productivity boom driven by all-things AI continues to motivate the sector. Still, investors are becoming more discerning among Technology names. Companies which do not currently benefit from AI sales, and are not seeing the same robust growth, have been segregated from the narrow universe of highly successful Tech companies.

Due to stickier-than-expected inflation readings, interest rate sensitive sectors continue to be near-term laggards, with hopes for several rate cuts this year receding. The Telecommunication sector was the biggest laggard in the quarter, down -3.4%, followed by Real Estate, down -1.3%, and Utilities, up a relatively modest 3.7%.

While the headline economic numbers are reason for optimism, we must balance that against equity valuations which are becoming increasingly extended. The S&P 500 is currently trading at 21x forward expected earnings, well above the 30-year average of 16.6x. For most valuation multiples, the S&P is now trading over 1 standard deviation above long-term averages. While stretched valuations are not necessarily a reason to run for the exits, they do suggest that earnings need to accelerate from here to justify further moves higher.

We maintain our more conservative view of the market and individual stocks and continue to champion increased stock selectivity. We think that investors need to pay close attention to valuations as the market, led by individual names, is once again approaching heady levels on the broader indices (not unlike the Tech Bubble in 2000). There is no shortage of risks this year, including contentious elections, mounting deficits, quantitative tightening, elevated credit costs, and the persistent threat of fiscal and monetary policy mistakes. And, as we move into the back half of 2024, the market will need to contend with tax policy sunsetting in 2025, which could also be a meaningful headwind to longer-term earnings growth.

We continue to favor businesses and sectors with above average cash generation that are selling below their long-term averages, such as the Healthcare sector. Valuations in that sector are near generational lows while the long-term growth outlook for the sector is well anchored in an ageing demographic. We also continue to think that Energy offers good opportunities with above average free-cash-flow yields and much more disciplined practices from a supply/demand perspective. For patient investors, we are becoming more constructive on Financials, which became extremely inexpensive in 2023. Finally, prudent stock selection within the Technology sector allows us to participate in gains from the group without moving into the market's more speculative corners.

Our portfolios are well positioned for 2024 to perform in a soft-landing scenario, where the economy grows, and earnings improve for many of the laggards discounted for slowdown and recession. And if the economy does succumb to the tighter credit regime, as it usually does in the aftermath of Fed hiking cycles, then the strong balance sheets of our portfolio businesses and their more defensive business profiles should weather the storm better than the average stock. We are structuring our equity portfolios under management for both of these outcomes.

Fixed Income Report

The sell-off in the fixed income markets over the past two years was jarring for many investors. At the same time, bonds are "conservative investments," and not just because they are "senior securities." Bonds are also conservative investments because they have guardrails

on the valuation side. When rates rise, the prices of fixed income securities decline, but the potential for income going forward increases. After a long period of serving as little more than stores of value, fixed income portfolios have become income-generating vehicles again. Almost by definition, the ability of fixed income investors to buy *income* is a welcome relief.

While no one knows for certain if we have achieved "escape velocity" from the slow growth, low rate, low inflation torpor of the 2010s, it was interesting that rates resumed their drift higher in the first quarter of 2024. The spectacular rally in Q4 2023 had put brakes on the upward trend, but the trend reestablished itself in Q1 2024.

Perhaps the most interesting development in the fixed income space has been the significantly higher yields on the short end. During January, the yield curve seemed to be edging towards "rate normalization," with the spread between the two-year Treasury and the ten-year Treasury compressing to -14 basis points. But a positively sloped yield curve was put on hold as higher CPI prints rolled in. Expectations regarding Fed rate policy shifted from an exuberant six cuts to a more down-to-earth two or three. The 2 year/10 year spread widened to -43 at quarter end, after starting the quarter at -34 (and hitting that relatively tight spread of -14 on January 25).

On the muni side, the renewed inversion was even more striking. The benchmark AAA curve began the quarter with a narrower two/ten inversion than Treasuries (-24 vs. -34) but ended wider (-48 vs. -43). Right now, our short muni product is yielding more than our intermediate muni product, and our ultra-short product is yielding most of all. This is the counterintuitive result of an inverted rate environment, where more duration does *not* provide more yield, even when the credit curve is positively sloped.

Our portfolios which own taxable bonds, such as Treasury and corporate securities, have a longstanding record of excellence, outperforming their benchmarks nearly every year for more than a decade. Our tax-exempt products have also tracked well relative to their benchmarks. Our view of the municipal bond market in 2024 is optimistic and it is perhaps useful to highlight some of the key elements of our active management approach on the muni side.

In the relatively inefficient municipal bond market, there are usually opportunities arising from technical factors. For instance, in the first quarter of 2024, new issue supply came in at $99 billion, an increase of 24% over Q1 2023. Increased supply typically leads to higher rates and wider spreads. We see this as an opportunity.

Additionally, and as a rule, the primary market offers wider spreads than the secondary market. In fact, "spread compression" from the primary to the secondary is a strategic linchpin for us. Partly because of this, and in the face of the flood of new issuance, we more than tripled our new issue purchases in Q1 2024 versus Q1 2023. This is a cornerstone to our active management philosophy: seize the opportunities that the market is providing.

This same philosophy, taking what the market is giving, extends to our barbell positioning. The yield drift towards short and ultra-short maturities makes barbells even more attractive. Being overweight on the short end captures extra yield while enhancing our ability to contain portfolio duration. The barbell approach puts us in a part of the curve which is more liquid and is currently producing much more income. We "keep the powder dry" for new opportunities elsewhere along the curve while picking up more yield now.

Extra yield, or income, strengthens investment performance. Since the municipal bond market is comparatively inefficient, compared to the stock market or the market for Treasury securities, it is not written in stone that extra yield means extra risk. Good credit work is imperative to finding relative value in the municipal bond market. Right now, we regard the credit picture as generally solid. For instance, in the first quarter of 2024, Fitch Ratings posted more positive than negative outlook revisions (21 to 16) and three times as many upgrades as downgrades (45 to 15). Our baseline view is that most issuers would be able to navigate the challenge of an economic slowdown. At the same time, we know that from a credit perspective and ultimately from a valuation perspective, the main driver of any municipality is its fundamentals.

We have continued to add to our pre-paid gas, puttable and AMT holdings. These deal structures reinforce our significant yield advantage over our benchmarks. As we get closer to reaching capacity in those areas, we

have begun to look at some housing and bank qualified issues. Both housing and BQ offer attractive yields, especially on a relative value basis. They are also nice diversifiers.

We are using insurance to provide more liquidity and marketability for our active strategies, while also extracting above-market yields for AA credit. Tax-exempt ratios to Treasuries are much more attractive in the AA and A sectors than with high grade AAA and AA+ credits. The relative credit stability today helps boost our A-rated holdings. We are seeing some credit weakness in the healthcare and continuing care retirement communities and have scaled back our holdings in those sectors.

In other words, we fight for extra yield without jeopardizing the basic tenets of conservative money management. Right now, the extra yield is both found on the short end and with selected credits offering relative value, usually in the primary market.

On the taxable side, since our outlook calls for modest but positive growth, moderating inflation, and decently strong employment, we are comfortable maintaining our overweight allocation to corporate bonds. While we still see good relative value in individual credits and sectors, we recognize that the corporate bond market is no longer “cheap”, and we may look for opportunities to reduce our exposure. We do note that a middling economy is not bad for “carry” strategies. We are also currently avoiding TIPS because we view them as expensive relative to our inflation outlook.

Now that interest rates have repriced closer to our year end targets, we are disinclined to tilt towards either very aggressive or very conservative stances. We think maintaining a neutral duration posture relative to the appropriate index is ideal. We prefer to maintain a roughly equal balance between longer duration Treasuries (to hedge for recession risk) and shorter duration corporates (to take advantage of the inverted curve). Here, too, we structure the portfolios under our management for both outcomes, not making an unambiguous bet in either direction.

We agree with Daniel Kahneman that managing risks into the unknown future is better done with probabilities than with certitudes.

Conclusion

In addition to the unparalleled prosperity it generates, the moral basis for free enterprise is its respectful treatment of the individual. People are trusted to sensibly manage their own lives. Some of the findings of behavioral economics challenge this assumption. In the caustic words of Kahneman, “our comforting conviction that the world makes sense rests on a secure foundation: our almost unlimited ability to ignore our own ignorance.”

And yet, at the bottom of it, the work of economists like Kahneman and others does not contradict the fundamental premise that rational human beings can govern their own affairs. Do we need to get better at thinking slowly about our assumptions? Sure. Is it important that we are open to the truth, even when it is unfamiliar and uncomfortable? Of course. Few Americans would disagree with those assertions.

Kahneman’s insights help us to think more empirically. They help us toward data-driven decisions, even towards AI (which basically integrates algorithms and big data with statistical methods to generate useful output). In a word, his insights can help us avoid the tragicomic errors which come from thinking fast.

But Daniel Kahneman would probably be the first to tell us that we are rational agents, endowed with the responsibility, and the power, that a rational agency brings. Towards that end, building our statistical reasoning—embedding it into our intuitive circuitry—also helps. It helps us in our individual lives, as investors and economic actors, and it helps our lives as citizens, as we reflect upon the ideas put forward to make our country better. We only need to avoid the pratfall of the blundering chess master, where there is just enough knowledge to make ourselves look foolish.

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