Quarterly Market Letter

GENTER CAPITAL MANAGEMENT

Second Quarter 2024

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Highlights:

- Big picture data remains mixed.
- Some data reflects slowdown - and soft landing?
- Fed's risk assessment changes to "balanced."
- Yields remain near multi-year highs.
- Equity market led by a handful of outperformers.

Introduction

In a letter written to his wife Abigail in early July 1776, John Adams informed her that the thirteen American colonies had declared their independence from Great Britain. It was a moment that Adams had pursued, with single-minded ferocity, for several months. His native Massachusetts had borne the brunt of the fighting and the fact that the Revolution had been formally expanded to include all thirteen colonies was an immense relief to him. Noting the importance of the date, Adams said, "I am apt to believe it will be celebrated, by succeeding generations, as the great anniversary festival," and predicted that Independence Day would be "solemnized with pomp and parade, with shows, games, sports, guns, bells, bonfires and illuminations from one end of this continent to the other."

That letter was written on July 3, 1776. Adams was excitedly writing about the "Lee Resolution," which the Continental Congress had enacted the previous day. The Lee Resolution declared that "all political connection" with Great Britain was "totally dissolved."

The day after John Adams had written his letter to Abigail, the Continental Congress ratified a 1,320-word "Declaration of Independence." Written by Thomas Jefferson, with some legislative revisions, it is a document which still stirs and inspires Americans. Where the Lee Resolution spoke to what we were *not* (we are not Great Britain), the Declaration of Independence spoke to what we *were*.

There is always that push and pull between what we are and what we are not, and it extends to investment strategy. We make our capital allocation decisions, not just from what we think is going to happen, but also from what we think is not going to happen. Risk-management is the amalgamation of what we regard as high probability events and low probability events.

Given confirmation bias, we tend to remember our successes and forget our misses. There is no great sin in missing forecasts. After all, predictions are not knowledge. But it is important to acknowledge the misses rather than let them implode down the memory hole. Marking the errors to market helps stabilize our forecasting discipline. We *do* know that it is better to be wrong for the right reasons than right for the wrong reasons, even when being "right" makes some extra money in the moment. The alternative is being lurched from one random event to another, perhaps benefiting from the capacity of the free enterprise system to lift all boats—and perhaps not.

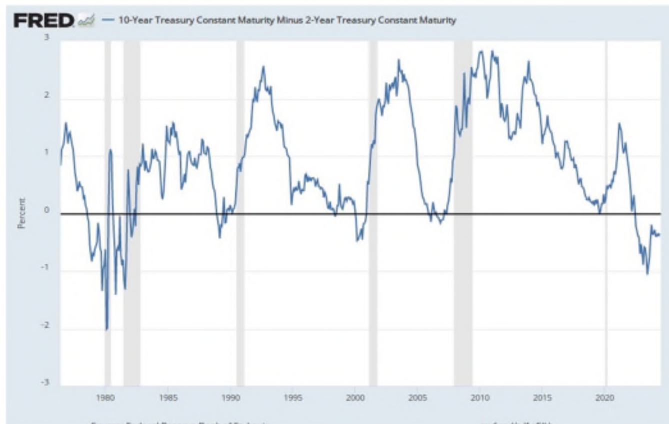
The Economy and Interest Rates

An economy, too, is characterized by what it is and what it is not. Notwithstanding the post-COVID snapback, this economy is *not* booming. It is also *not* recessionary, at least so far. This economy *is* inflationary. It *is* also resilient, at least so far. The resiliency is particularly interesting, given the inverted yield curve. In a normal rate environment, shorter-term rates are lower than longer-term rates. In this rate environment, for two full years now, the benchmark two-year Treasury note has been *higher* than the benchmark ten-year Treasury note.

Short-term rates are driven by the Federal Reserve while long-term rates are largely derived from market expectations on long-term growth and inflation. When the curve is inverted, it does not necessarily mean that the market thinks Fed policy will spin the economy into a recession; it means that the market thinks that future growth and inflation will be less than where the Fed Funds rate is currently.

In the chart on the next page, the gray bars are recessionary periods, and when the blue line dips below zero, it is because the shorter-term two-year

Treasury has a higher rate than the longer-term ten-year note. The graph shows how difficult it is for Fed policymakers to stick the soft landing. This time around, at least so far, the Fed has been managing it.



In our prior quarterlies, we have listed the variables which point to economic weakness as well as those which point to economic strength. We continued seeing a mixed bag in the second quarter. The unfavorable data points include restrictive interest rates, weakening consumer finances, more business loan problems (including a greater degree of "payment in kind" refinancings), negative regional manufacturing indices, a static labor force, the growing servicing problem with federal debt, and a negative index of Leading Economic Indicators.

These data points continue to be offset by favorable data, such as still-strong employment numbers, healthy job availability, positive real income growth, positive service indices, and, despite the higher rates, relaxed financial conditions for qualified borrowers. At this moment in time, even the Recessionistas acknowledge that persistent economic strength cannot be ignored. As the facts and data evolve, investors work to refine their forward-looking narratives. It is the clash of those narratives, of course, which make markets.

The foremost variable over the past two to three years has been inflation. When inflation started rearing its head in the first half of 2022, the Fed began responding aggressively, and after some scary months, inflation began bending downward. This continued until the end of 2023. Starting in 2024, though, the steady progress was supplanted by a more complex sequence of inflation prints. The headline CPI numbers all surprised to the upside in the first months of the year, although the last print for May was lower than expected. Core PCE, the Fed's actual target, moved laterally over the course of the year, remaining at 2.8% for months before the May print dropped it to 2.6%.

The Federal Reserve also manages risk. From a central banking perspective, upside risk, or inflation, can be more directly attacked than downside risk, or recession. When dominant risks are inflationary, the Fed only needs to raise rates until inflation breaks. To be sure, reactive policymaking creates unnecessary hardship, but in the worst-case scenario, the Fed can effectively deal with upside risk, even when they are late to the game. In contrast, there are no good reactive policymaking options against downside risks. The Fed can open the spigot when the recession arrives but that is like pushing a string. It also creates a mess which must be cleaned up when the economy regains its footing. In other words, when confronting downside risks, central bank policy must be more anticipatory.

Through most of 2022 and all of 2023, the Fed regarded inflation as the dominant risk and signaled that it would put inflation back into its box regardless of the consequences. Starting in January 2024, the Fed began to claim "that the risks to achieving its employment and inflation goals are moving into better balance." By May, that transition was deemed complete: "The Committee judges that the risks to achieving its employment and inflation goals have moved into better balance over the past year." We went from "moving" to "have moved." The Fed's current risk management orientation is no longer biased towards inflation, but to guiding the economy to a soft landing.

At the start of 2023, the market expected the real economy to break under the weight of higher rates. That did not happen. At the start of this year, 2024, the market backed off the recession predictions, but thought that plunging inflation numbers would lead to a series of rate cuts. Then inflation stopped plunging. The lesson now seems to be that the economy can handle high rates AND that, after the debacle in 2022, and the halted progress in early 2024, the Fed is afraid of its own shadow when it comes to inflation.

We do not quite see it this way. While the median Fed projection is now one rate cut for 2024 rather than three, the Fed can still rationalize any cut on grounds that policy remains restrictive. At this point in the policy cycle, any "straw in the wind" from the employment data will be weighed *alongside* the inflation prints. Until recently, Fed policy was singularly focused on containing inflation, even if it meant crashing the economy. The economy did not crash, so now, with the risks more fully in balance, the Fed has the opportunity, and the space, to try and stick the soft landing.

Fixed Income

With fixed income, the flat performance of the overall market belied variations between segments of the market. Muni bonds, mortgages, and fixed rate Treasurys were off, while corporate credit (especially high yield credit) and inflation-protected Treasury securities were up. All of our fixed income strategies, whether taxable or tax-exempt, outperformed their respective benchmarks.

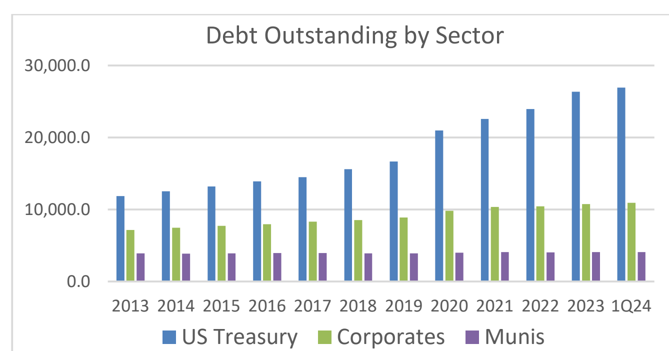
On the taxable side, since interest rates have repriced closer to our year-end targets, we think that neutral durations are currently the best approach. We do not think it makes much sense to tilt the strategies to very aggressive or very conservative. Rather, we are maintaining a fairly tight balance between longer duration Treasurys, to hedge recession risk, and shorter duration corporates, to take advantage of the inverted yield curve.

In the second quarter, credit option adjusted spread (OAS) widened four basis points to +89. We think spreads may widen further. Spread widening could result from an economic slowdown, where Treasury yields move lower in conjunction with Fed rate cuts, or conversely, from higher rates impairing fundamentals by creating pressure on leveraged balance sheets and debt service coverage. Either way, while still seeing good relative value in individual credits and sectors, we recognize that the corporate bond market is no longer "cheap."

Given our baseline outlook for moderating inflation, decent employment levels, and slow (but positive) growth, we remain comfortable maintaining a significant overweight to corporate bonds. While we may look for opportunities to reduce our exposure, we also know that carry strategies (yield) win in middling economies.

On the tax-exempt side, the extra value earned in the primary market is an increasingly important source of alpha for our strategies. New issuance is up 24% year-to-date, but we have tripled our participation in new deals.

We also think the uptick in issuance may herald an important inflection in municipal finance. Looking back over the past decade, the municipal bond market has been stuck in a rut. Uncle Sam's debt more than doubled. Corporate America's tab also swelled, by over 50%. Amid all this borrowing, total municipal debt outstanding barely budged, inching from $3.9 trillion to just $4.1 trillion.



There are reasons for the vanishing municipal footprint. The United States government, which issues the very currency required to redeem its debt, is always dealing with the temptation to inflate. Corporations, too, reap benefits when levering up. But state and local governments, constrained by balanced budget requirements—and taxpayers fed up with the expense of inefficient government—are forced to make hard choices between delivering services and capital development.

In recent years, new issuance has been suppressed by pandemic relief. Municipalities could use emergency support from the federal government to meet budgetary needs and fund projects. With that funding rolling off, state and local governments are tapping the market again. Is it a potential renaissance in the market? The need is certainly there. In our country, government services are generally delivered at the state and local level. Services like roads, schools, and

prisons are not only an operating expense, they require upkeep and development.

Any wave of new issuance would result in higher ratios and more opportunities. For investors, tax-exemption is convenient and satisfying. We think the moment is approaching when tax-exempt securities can be relatively profitable as well.

For the most part, the price erosion we have seen with the higher yields this year has been offset by the income that bonds are generating. Year-to-date, fixed income performance is flat. Still, after the harsh medicine of 2022 and most of 2023, and prior to that, the seemingly endless drone of low rates, we have at last recovered the "income" side of "fixed income"—which we think is a good thing.

Equity Market

While the overall economy, supported by full employment, appears to be on stable footing, some of the more cyclically sensitive corners of the stock market remain unconvinced about the Fed's ability to stick the soft-landing and extend the current business cycle.

As of this writing, the Fed's GDPNow growth forecast is tracking second quarter GDP to an 1.5% annualized rate, down from estimates higher than 3% at the start of the quarter. This would be in continuity with first quarter GDP, which has been revised down to 1.4%. If the second quarter GDP comes in as forecast by the Atlanta Fed, then we would need to see an acceleration of growth in the back half of 2024 to achieve the consensus estimate of 2.3%.

Our outlook is for full-year GDP growth closer to 2.1%, implying a slightly softer back half of the year than the consensus view. Current S&P 500 earnings estimates imply above average growth in 2H/1H earnings, mainly driven by robust performance in AI-related names. But those estimates also require that company earnings demonstrate some acceleration in growth. On that point, we are a bit skeptical. We are seeing pockets of softness with lower- and middle-income consumers, as well as a persistent softness in the legacy industrial economy.

The equity rally since last October has driven the aggregate equity risk premium negative and well below the lows of the last market cycle (which culminated in the Great Financial Crisis). As equity risk premium and future market returns are highly correlated, the current low equity risk premium will likely be a headwind for index returns over the medium term.

Historically low volatility continues to suggest that complacency is still running high. Despite signs of growing stress for consumers and the economy, investors seem unfazed by above-average market multiples. These signs of stress are caused by elevated rates and persistently sticky Services inflation. We expect that inflation will eventually be tamed by Fed policies but worry that it may come at a higher cost than currently expected by many market participants.

The increasing trend towards deglobalization, near-shoring of manufacturing, protectionist tariffs, and a more hostile geopolitical environment, are all significant headwinds to the broad disinflation which characterized the 30 years prior to COVID. Couple that with profligate monetary policy over the last fifteen years—and profligate fiscal policy over the past five—and one might understand why we remain a bit more conservative in our investment outlook.

We expect volatility could pick-up in the second half of the year as election season moves into full swing. Investors will weigh prospective changes in fiscal and regulatory policies with every change in the tick and tempo of the campaign season. And with the Fed firmly set on their quantitative tightening course, albeit now in scaled-down form, reduced liquidity may have a more pronounced crowding out effect on businesses competing for capital. The prospect for higher average long-term rates call into question the elevated multiple of the aggregate S&P 500, which is now greater than 20x forward estimates. The historical average is closer to 15x – 16x.

Despite our more cautious outlook, select equities continued to build on their positive momentum, with the S&P 500 achieving a new all-time high of 5,487 on June 18th, and finishing the quarter just shy of that high. The index increased 3.9% in the second quarter, bringing year-to-date returns to 14.5%. The lion's share of returns in the second quarter were again

concentrated in a small handful of Technology and AI-related issues,

Despite the solid returns for the S&P 500 index, the results masked an increased narrowing of the equity market. During the quarter, the equal-weight S&P 500 declined 3.1%, reducing equal-weighted year-to-date gains to 4.1%. Essentially, all the incremental returns in the quarter were driven by just 3 stocks: Apple, Google, and Nvidia. Apple is up 22.8% for the quarter and 9.4% for the year, Google is up 20.5% for the quarter and 30.1% for the year, and Nvidia is up 36.7% for the quarter and 149.5% (!) for the year. Expanding just a little, the “Magnificent-7” stocks accounted for *more* than all of the incremental gains in the quarter. The market-weighted concentration of those seven stocks has now reached 32.5% of the S&P index, beginning to eclipse what was seen during the Tech Bubble of 2000.

While we acknowledge the current strength of these businesses, driven by a significant investment cycle in artificial intelligence, we also note a more mixed and muted growth outlook for the rest of the equity market—and the economy. In our view, this modest outlook will become a longer-term gating factor even for AI. We understand that AI represents a very fertile green field opportunity within Tech, but we also understand that businesses away from the AI epicenter are still tied to the fundamental underlying growth of their own markets. And those businesses have very real limitations on internal cash generation and their capacity to borrow in a world where there is an actual cost of capital again. As such, we see businesses having to balance their AI spending with other spending priorities, and all against a backdrop of slowing aggregate economic growth.

More than half of all stocks in the S&P remain below their highs reached in 2021. Forty percent of the S&P stocks are in correction territory, down over 10% from the prior peak, and more than one-quarter are still stuck in bear-market territory, down more than 20%. This is consistent with what we see in the Small and Medium Business (SMB) segment of the economy, which is the historical driver of job formation and new industry growth. SMBs have taken a decidedly more cautious tone about business conditions. Unlike most Fortune 500 companies, which benefit from wide open capital markets, SMBs face significantly higher borrowing costs and more stringent lending standards—when they can get a loan at all.

Within our various equity portfolios, we have been able to participate in many of the best performing stocks in the market, but like the indices, our strongest returns have been concentrated in a small handful of names. Given the softness outside of this select group of companies, we have been finding attractively valued opportunities. We use these to establish new positions and to add to existing holdings. These are stocks which are either experiencing near term cyclical weakness or abandoned by the market in favor of the “growthiest” issues.

Over the past five decades of managing equities for our clients, we have seen this movie before. As students of the market, and as active managers, we firmly believe in the precept that “trees do not grow to the sky.” We will continue to manage around our positions to lock in gains from some of our best performing investments, and to recycle those gains into the great long-term businesses which are now on sale.

Conclusion

Throughout his life, John Adams continued to believe that July 2nd was the proper day to celebrate our independence. But to the great majority of Americans at the time, the principles outlined in the Declaration of Independence, including “inalienable rights” and “consent of the governed,” did a much better job than the Lee Resolution in explaining why we exist as a nation. We were—and are—something more than “not Great Britain.”

To compound the irksomeness for Adams, Thomas Jefferson, his friend and ally during the Revolution, became his great political rival in the earliest days of the federal republic. The schism between Adams and Jefferson reflected our nation’s first partisan divide—and involved two bitter Presidential campaigns. After two decades of acrimony, feelings between these two old colleagues were still raw when their mutual friend, Benjamin Rush, sought to restore the connection. With the help of Abigail Adams herself, the two reestablished their letter-writing relationship. During the final fifteen years of their lives, these two great

Americans renewed their philosophic friendship. They still would disagree, even about fundamental and ultimate things, but their shared patriotism, combined with pride in what they had achieved together, kept them close to one another.

On July 4th, 1826, our country turned fifty years old. The young republic had grown from 2.5 million at the time of the Founding to 10 million by the mid-1820s. New York had vaulted past Philadelphia as the country's largest city. Canals and highways stitched the country together—soon, railroads would come. The narrow string of colonies along the Atlantic seaboard was now a vibrant democracy stretching to the Mississippi River.

As the nation celebrated its golden anniversary, Mr. Adams of Quincy, Massachusetts, and Mr. Jefferson of Charlottesville, Virginia, lay on their deathbeds. It must have been extraordinary and wondrous for Americans to learn, in the days immediately following the nation's fiftieth birthday, that the two great men had died on that very day. And how lovely for us, as their posterity, to reflect upon, and learn from, their profound friendship. Because although we define ourselves by what we are—and what we are not—we are also, like Jefferson and Adams, always open to hearing opinions unlike our own, always open to rethinking our assumptions, always open to the idea that we could be wrong. For investors and market participants, anything less is foolishness.

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