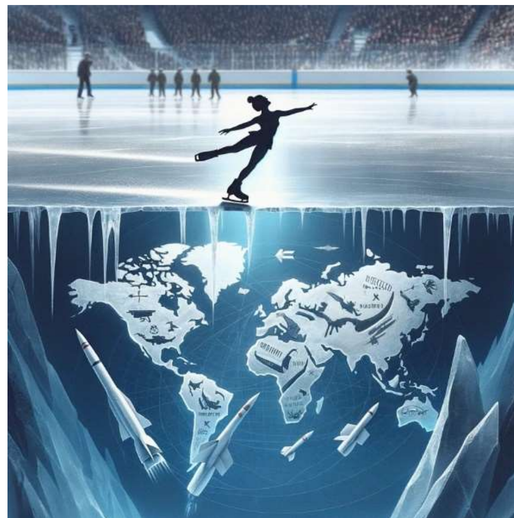
LIVIAN & CO.
INVESTMENT AND WEALTH MANAGEMENT

Quarterly Investment Letter - Q1 2024



April 10, 2024

Dear Valued Client,

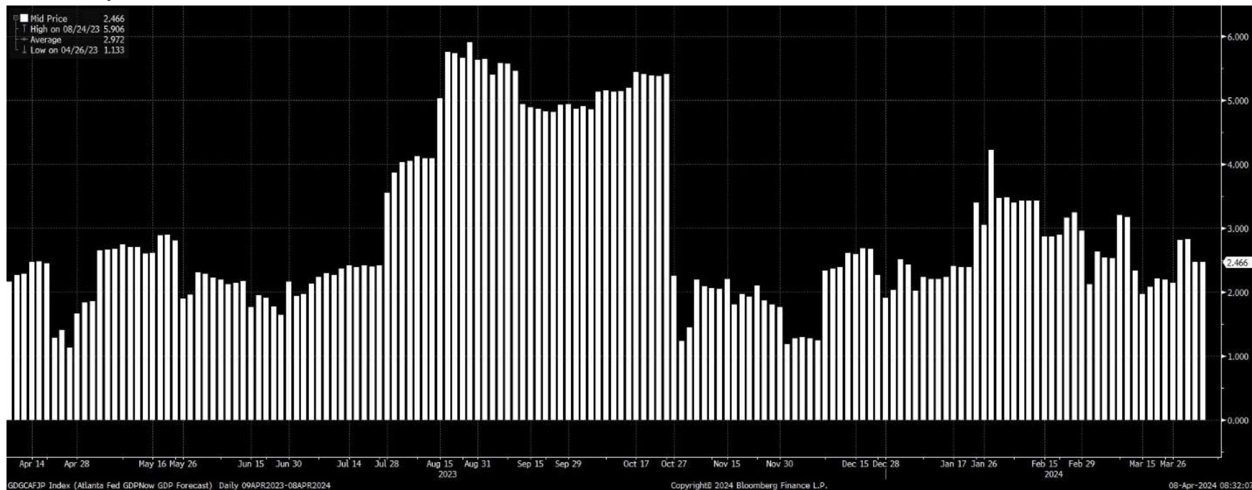
As we conclude the first quarter of 2024, we are pleased to share some key insights that are shaping our views and strategy. This period has showcased the U.S. economy's resilience, with robust labor market performance and shifting inflation dynamics, challenging previous recession concerns and expectations for interest rates.

In the equity markets, the ongoing rally has reached new heights and extended beyond the technology sector, reflecting a broader market engagement despite varying corporate earnings. Additionally, we discuss the unprecedented correlation between stocks and bonds and its impact on traditional diversification methods. Our analysis also covers fixed income and commodities, where sustained high interest rates and geopolitical tensions are playing a significant role.

1.0 Global Economic Overview

Throughout the first quarter of 2024, various indicators have highlighted the U.S. economy's enduring strength and a gradual easing of inflation rates, aligning with the Federal Reserve's objectives. Contrary to the prevailing expectations in 2023 and leading economic indicators that pointed to a potential economic downturn, the recent data suggest diminishing recession risks. According to a Bloomberg survey of economists, the probability of a recession in the US within the next 12 months now stands at 35%. Most anticipate that this economic robustness will extend into 2025, with a longer period of elevated interest rates expected in response to moderating, yet persistent, inflationary pressures.

GRAPH 1 – ATLANTA FED GDPNOW
Atlanta's Federal Reserve GDP tracker indicates some reacceleration of the US economy, currently projected to grow at a solid 2.5% this quarter.



Source: Bloomberg Professional Services

The US labor market keeps on showing a surprising strength that supports consumer spending. However, one should also note that personal saving rates having been consistently dropping in the last three years and credit card delinquencies have been rising. Higher interest rates for longer will ultimately be felt in the economy. This historical pattern warrants caution: It is statistically unlikely that a monetary tightening cycle ends without a recession.

The outlook above, however, is not without its challenges, including **rising geopolitical tensions** (note the behavior of gold) and the unforeseen repercussions that **sustained high interest rates** may have on the financial sector.

2.0 Equity Market Insights

In 2024, the US stock market has repeatedly soared to record highs, underscoring the remarkable momentum of the rally within the equity markets that extend beyond just the

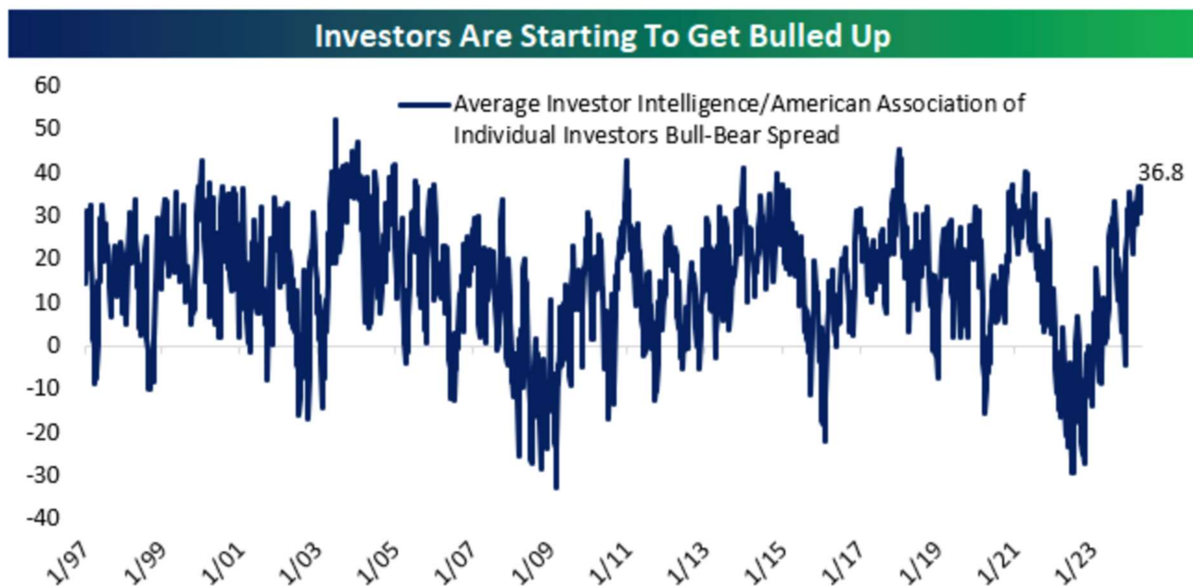
technology and AI. This broadening of the rally to include a wider range of sectors builds upon the trends observed in 2023, despite a notable downturn in corporate earnings.

Valuations, Trends, Momentum, and Sentiment

In the fast-paced realm of equity markets, short-term movements are often not dictated by **valuations** alone. Instead, technical factors like **trend**, **momentum**, and **investors' sentiment** play pivotal roles. Despite the current high valuation of equity markets, suggesting lower expected long-term returns, bullish trends and momentum persist. This optimism is largely fueled by the anticipation of future interest rate cuts and a substantial amount of uninvested investors' capital parked in money market funds, which continues to support market strength. This is despite the fact that, according to Factset, an unusually high number of S&P 500 companies (71%) have lowered their earnings per share (EPS) guidance, in the first quarter of 2024.

Is the market really overvalued? In a recent report, Bloomberg analysts shed light on the intricate nuances of the equity market's valuation, particularly focusing on the S&P 500. They challenge the prevalent notion of an overvalued market by diving deeper into the earnings cycle and the potential for earnings recovery post-contraction. This detailed examination reveals that the market's valuation, while seemingly stretched at first blush, offers a more nuanced picture when considering forward earnings and the recovery trajectory. The analysts highlight that, contrary to a surface-level view, certain sectors within the S&P 500 might still harbor undervalued gems.

GRAPH 2 – SPREAD BETWEEN PERCENTAGE BULLISH INVESTORS AND BEARISH INVESTORS (II AND AAII SURVEYS)
According to Bespoke, the net bullish spread of individual investors is currently in the 96th percentile of all times. Historically, such elevated level of bullishness translated in sub-par forward returns for the S&P500 Index.



Source: Bespoke Investment Group

Investors' sentiment has shifted towards excessive optimism, a situation historically correlated with subdued short-term returns. This heightened optimism, while contributing to the bullish momentum, raises caution flags for the immediate future of equity market performance. Such sentiment extremes can often precede market volatility or pullbacks.

In navigating this landscape, our stance is not to oppose the current positive market trend but to adopt a more measured approach to equity exposure in the medium term. This cautious strategy involves:

- maintaining a defensive position in stock selection,
- implementing covered calls strategies for certain clients to manage risk,
- and staying agile to reassess our market stance as conditions evolve.

By blending vigilance with a respect for market dynamics, we aim to safeguard and potentially enhance investor portfolios amidst the complexities of the current equity market environment.

Beyond the "Magnificent Seven"

The equity markets have demonstrated remarkable resilience and growth over the past year. Since February 2023, we've observed a substantial rally, with the S&P 500 climbing by 28% through February 2024. However, this surge has not been uniformly distributed across all sectors. The growth sector, particularly Information Technology, has seen outsized gains, with a staggering +57% increase, led by what many have termed the "Magnificent Seven" (Nvidia, Meta, Amazon, Microsoft, Google, Apple, and Tesla), which alone surged by +68%. The value sector (Russell 1000 Value Index) trailed behind at +11%.

This concentration of gains raised concerns about market breadth and the sustainability of the rally. However, as of March 2024, we're witnessing a significant shift. The broader market, including value stocks and those outside the "Magnificent Seven," began to outpace the previously dominant growth and tech sectors. This broadening of the rally suggests a healthier market dynamic, possibly indicating greater confidence in the market's fundamentals beyond just a handful of tech titans.

Despite mixed performances within the "Magnificent Seven," including a notable decline in Tesla, investor enthusiasm for artificial intelligence and technology remains strong, highlighted by Nvidia's continued ascent. Real Estate is the only S&P500 sector with a negative return in 2024, driven by mounting concerns over the implications of "higher for longer" interest rates on the refinancing capabilities of property owners.

Health Care is also teetering, reacting to recent policy announcements. Specifically, the Centers for Medicare and Medicaid Services' decision to set the 2025 payment rates for Medicare Advantage plans at a level that effectively constitutes a 0.16% decline relative to this year has introduced additional volatility. This adjustment is emblematic of the broader challenges facing the sector, including regulatory pressures, and changing reimbursement landscapes.

3.0 Fixed Income

Fed Policy on Hold

As the curtain fell on 2023, the investors braced for a pivotal shift in monetary policy, fueled by expectations of a more accommodating stance from the Federal Reserve. The consensus leaned towards an optimistic forecast, with many (not including us) banking on the first rate cut to materialize as early as March 2024. This anticipation was built on the premise of easing inflationary pressures, thereby granting the Fed leeway to pivot towards rate reductions. However, as the calendar turned, reality diverged from expectations, leaving March devoid of the anticipated policy ease. Now, eyes are set on the June meeting as a more probable juncture for adjustments in the interest rate policy.

The economic landscape of 2024 has been anything but predictable, characterized by signs of reacceleration that have muddied the waters for those forecasting a swift and significant rollback of interest rates. Contributing to this complexity are several supply-side and commodity-related challenges, which have stubbornly kept inflationary pressures in the mix. Notably:

- Geopolitical tensions in the Middle East.
- Logistical disruptions in the Suez Canal
- Environmental constraints exemplified by the drought in the Panama Canal, and the recent seismic activity in Taiwan,

These events have collectively exerted upward pressure on commodity prices, underscoring the fragile nature of global supply chains and the risks of a reaccelerating inflation.

Bond Yields rise in 2024.

The bond market's reaction to these unfolding events has been telling, with the yield on 10-year US Treasury notes witnessing an uptick from 3.88% at the close of 2023 to 4.19% at the of year's Q1. This movement in yields reflects a broader reassessment among investors, who are now factoring in the resilience of inflationary pressures and the potential delay in the Fed's rate-cutting cycle.

Consequently, bond benchmarks logged a challenging first quarter, marking a period of negative returns for investors. This turn of events serves as a poignant reminder of the complexities inherent in forecasting monetary policy and economic trends, especially in an environment rife with both anticipated and unforeseen challenges.

GRAPH 3 – CORE BOND INDEX BEAR MARKETS

According to Blackrock, the current bear market for bonds is the longest on record (44 months) and the deepest (-17.2%) in history. What happens next?

Largest drawdowns for the core bond index

1/1/26 - 3/31/24

Start (peak)	End of bear	# of months	Max drawdown
July 2020	?	44	-17.2% *(currently -10.5%)*
May 1958	March 1960	21	-5.2%
June 1980	November 1981	16	-9.0%
August 1954	January 1956	16	-2.0%

Source: BlackRock

It is noteworthy that higher government bond yields are not only a US phenomenon. Following the recent Bank of Japan interest rate hike, all countries now display positive interest rates. So much has changed since May 2020, when 21 countries worldwide showed negative interest rates.

After more than a decade, bond yields are back to levels that offer investors both an acceptable remuneration and the potential for portfolio risk reduction.

Credit Spreads Tighten: A New Perspective on Credit Risk and Private Credit

In today's corporate bond market, the compensation for credit risk is notably scant. The yield spread between corporate bonds and their Treasury counterparts, which carry no default risk and boast a more robust secondary market, is remarkably thin. This observation particularly pertains to the Option-Adjusted Spread (OAS) of the investment grade ICE BofA US Corporate Index and its high-yield counterpart.

As of the close of March 2024, the spread for investment-grade corporates stood at a mere **+94** basis points, starkly contrasting the long-term average spanning from 1997 to 2024, which hovers around **+149** basis points. Similarly, high-yield bonds recorded a spread of **+315** basis points, significantly narrower than the historical norm of **+535** basis points. This contraction in risk premiums would perhaps be understandable were the overall risk correspondingly low, yet the prevailing conditions suggest otherwise.

A robust indicator of credit risk, closely correlated (about 60%) with the spreads between corporate and Treasury yields, is the ease with which businesses can secure loans. This is encapsulated in the Federal Reserve's quarterly survey of senior loan officers, which contrasts the proportion of banks tightening their credit standards against those easing them. The latest findings reveal a

discernible caution among banks towards extending credit, evidenced by a 14.5 percentage point differential – not unprecedented, but certainly indicative of **a tight credit environment**.

Historically, in periods marked by similar credit conditions, credit spreads have been considerably wider. Yet, today's figures are **anomalously low**.

The divergence from historical patterns can partly be attributed to shifts in **supply and demand** dynamics in the market. A notable pivot towards **private credit** markets has decelerated the growth of outstanding investment-grade corporate debt, and remarkably, the available supply of high-yield debt has seen a contraction. According to Federal Reserve data, the size of private credit markets in 2023 ($1.7tr) surpassed that of the high yield and bank loan markets. Concurrently, the allure of fixed income has been rekindled by a rise in absolute yields following a prolonged period of decline, prompting institutions to allocate more substantially to fixed income than was viable in a lower-rate environment.

Given these conditions, the market's current tolerance for diminished credit risk premiums may wane, particularly when we hit the next economic downturn. The Federal Reserve's efforts may stave off immediate concerns through a hoped-for soft landing, but prudence dictates a cautious stance on credit risk in the interim. We see a potential easing of interest rates later in the year, which would more directly bolster higher-quality bonds than lower-quality ones.

4.0 Commodities: Gold's Defiant Rally

Gold has once again proven its mettle as a "safe haven" asset, rallying towards all-time highs despite traditionally unfavorable conditions (positive real interest rates). This counterintuitive performance, spurred by geopolitical tensions and strategic central bank acquisitions, reinforces gold's enduring value in a diversified investment portfolio.

Geopolitical Risks and Gold as a Safe Haven

Gold's reputation as a hedge against geopolitical risks and uncertainties is well-established. With escalating tensions in regions such as Russia and the Middle East, investors are increasingly turning to gold as a haven.

Central Banks and Gold Reserves

Further fueling gold's rally are the actions of central banks, particularly those in Asia, which have been significantly bolstering their gold reserves. This strategic accumulation, partly a response to the increased global hostilities, reflects a broader shift towards diversifying reserves and reducing dependence on traditional fiat currencies, especially the US dollar. The concerted move by central banks to increase gold reserves contributed to the upward pressure on its price.

Implications for Investors

While the conventional wisdom linking real interest rates to gold's performance holds, these additional dimensions offer a more nuanced understanding of its current rally. For investors, this highlights the importance of considering a broad spectrum of factors when evaluating gold's role within a diversified portfolio. As a non-yielding asset, gold's intrinsic value in times of uncertainty and its role as a hedge against geopolitical risks become particularly salient.

5.0 Digital Currencies: Bitcoin's Remarkable Rebound

Bitcoin has surged in 2024, buoyed by factors including its symbolic status as "digital gold," regulatory advancements, and intrinsic value propositions such as the "halving" phenomenon. This rally not only reflects growing acceptance of digital currencies but also their potential to redefine investment paradigms.

Sympathy with Gold: Bitcoin as 'Digital Gold'

Much like gold, Bitcoin has been increasingly regarded as a "safe haven" asset. With its finite supply and decentralized nature, Bitcoin has earned the moniker "digital gold" among enthusiasts and investors alike. This comparison to gold is particularly relevant in times of economic uncertainty and inflationary pressures, where traditional fiat currencies may lose value. As geopolitical tensions rise and the allure of gold strengthens, Bitcoin similarly benefits from this flight to safety, reinforcing its status as a hedge against macroeconomic instability.

SEC's Approval of the First Spot Bitcoin ETFs

A landmark development contributing to Bitcoin's rally has been the U.S. Securities and Exchange Commission's (SEC) approval of the first spot Bitcoin Exchange-Traded Fund (ETF). This approval, long sought after by cryptocurrency advocates, represents a significant milestone in mainstream financial acceptance of Bitcoin. It not only enhances Bitcoin's legitimacy as an investment asset but also makes it accessible to a broader range of investors, providing a more secure and regulated avenue for cryptocurrency exposure.

The Bitcoin "Halving" Phenomenon

A unique technical factor contributing to Bitcoin's value is the process known as "halving." In the Bitcoin network, halving refers to the reduction of the reward for mining new blocks by 50%, an event that occurs approximately every four years and is scheduled in April this year. This mechanism is designed to control the supply of Bitcoin, ensuring that its total circulation gradually approaches the 21 million cap. The halving process can lead to increased scarcity of Bitcoin, potentially driving up its price as supply tightens.

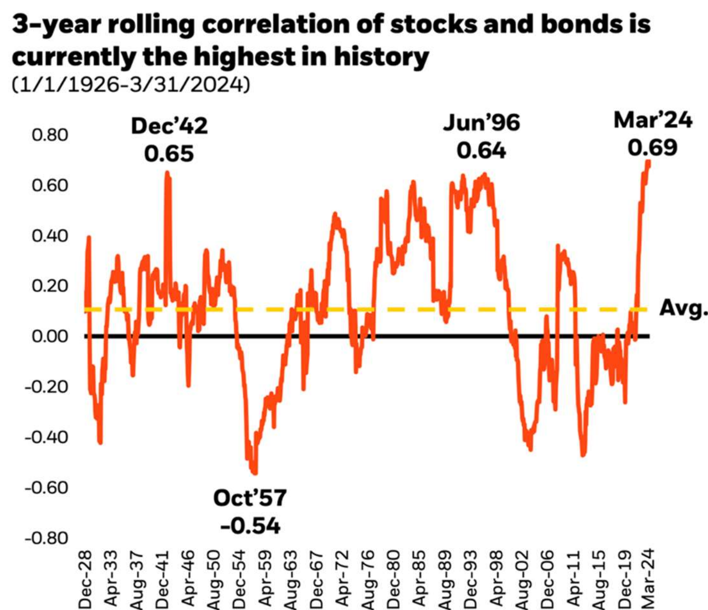
6.0 Conclusions

In conclusion, the actions of the Federal Reserve seem to be yielding results. Inflation is moderating and the US economy seems to be resilient. The promise of artificial intelligence has been key in reigniting an equity market rally. This rally has been broadening to sectors beyond technology. This augurs well.

However, we caution against excessive optimism and complacency. Geopolitical tensions may be rekindling inflationary pressure at a time when Fed's fight is not over. Higher interest rates for longer may result in economic and financial issues down the road. Monetary tightening cycles rarely end without a recession. Below are some considerations about our investment strategy in the current context.

- **Correlation Trends**: according to insights from BlackRock (see Graph 4), the correlation between stocks and bonds is currently at an all-time high. This unusual alignment suggests that traditional diversification strategies may not be as effective temporarily. However, historical patterns indicate that these correlations will likely revert to long-term averages, restoring the effectiveness of a balanced portfolio approach over time.

GRAPH 4 – 3-YR CORRELATION BETWEEN STOCKS AND BONDS
According to Blackrock, the current correlation between stocks and bonds is the highest in history. This generally happens in inflationary periods when interest rates are elevated. Over time the correlation reverts to its mean. High correlation between stocks and bond, temporarily negates the benefits of portfolio Diversification.



Source: BlackRock

- **Alternative Investments for Diversification**: during periods when traditional assets move in tandem, incorporating alternative investments can enhance portfolio diversification.

Options such as managed futures, commodities, and private credit are viable considerations to mitigate risk and enhance returns in the current market environment.

The current tight monetary policy is likely to lead to significant economic adjustments, potentially resulting in lower interest rates. However, this shift might not materialize in the near term. With this in mind we, are:

- **Focusing on Investment-Grade Bonds**: prioritize high-quality bonds with durations extending from 3 to 5 years.
- **Reducing Cash Holdings**: gradually decrease cash positions in anticipation of interest rate adjustments to optimize portfolio performance.
- **Maintaining Full Equity Exposure**: despite potential volatility, the overall uptrend in equity markets supports maintaining full investment exposure for now.
- **Emphasizing High-Quality Stocks**: focus on companies with robust fundamentals capable of enduring downturns.
- **Covered Call Strategies**: implement covered call strategies to generate income and provide some downside protection.
- **More Frequent Portfolio Reviews**: continually reassess and adjust equity positions to respond agilely to market changes.

Please do not hesitate to contact us for any further clarification.

Sincerely,

Livian & Co. team