The Road Ahead: Strategic Insights for 2024

January 18, 2024

Dear Valued Investor,

As we transition from 2023 into 2024, it is critical to take a moment to review the past year's economic developments and market activity and prepare for the opportunities and challenges that lie ahead. This letter is intended to provide you with an overview of our thoughts and our strategic investment considerations for the upcoming year.

1. 2023 Reflections: a year of resilience and challenges

The year 2023 was marked by several pivotal developments that shaped the global economic and investment landscape:

1. **China's Economic Reopening and Stimulus**: the year witnessed China's post-Covid economic reopening and stimulus measures, which had far-reaching implications on global trade and supply chains. This shift brought new dynamics to the global market, particularly affecting commodities, and emerging markets. China is undergoing a severe economic slowdown combined with deflationary pressures.

2. **Crisis in Regional Banks and the Fed's Response**: the turmoil in regional banks highlighted ongoing vulnerabilities within the financial sector caused by the sharp increase in interest rates. The rapid rise in rates both depressed the value of regional banks' assets (fixed income portfolios and loans) and triggered an exodus from bank deposits towards money market funds. The Federal Reserve's intervention was crucial in stabilizing the situation, but it also underscored the need for cautiousness in financial sector investments.

3. **Artificial Intelligence (AI) and Healthcare Innovations**: the significant advancements and adoption in artificial intelligence and the introduction of new anti-obesity drugs (GLP-1) were among the key highlights in technology and healthcare. These developments not only signify sectoral growth but also present new investment frontiers.

4. **US Consumer Strength**: despite numerous challenges, the US consumer showed a surprising and remarkable strength. Employment remained strong and so did consumer spending. This may be attributed to the remaining effects of the large monetary and fiscal stimuli extended during the Covid pandemic.

5. **Escalating Global Conflicts**: the intensification of geopolitical conflicts contributed to heightened market uncertainty. It is becoming clear that we are in a new Cold War between the US and a block of authoritarian countries including Russia, China, Iran, and North Korea. This war is manifesting in local military conflicts (Russia-Ukraine, Israel-Gaza) that have the potential to quickly turn it from "cold" to "hot."

6. **Market Performance Review**: the equity markets experienced a major rebound, led by technology-titans (the so called "Magnificent Seven"), while rate-sensitive securities such as small cap, utilities, REITs and dividend stocks lagged. Despite struggling for most of the year, the bond market saw a rally in the last quarter, indicating a shift in investor sentiment. The drop in bond yields in the last two months of the year contributed to a broadening of the stock rally.

Chart 1 – S&P500 Index (2021-2023)

The S&P500 index had a very strong 2023, after a terrible 2022. On a three-year horizon the annualized returns have been positive but modest (source: Bloomberg Professional Services)

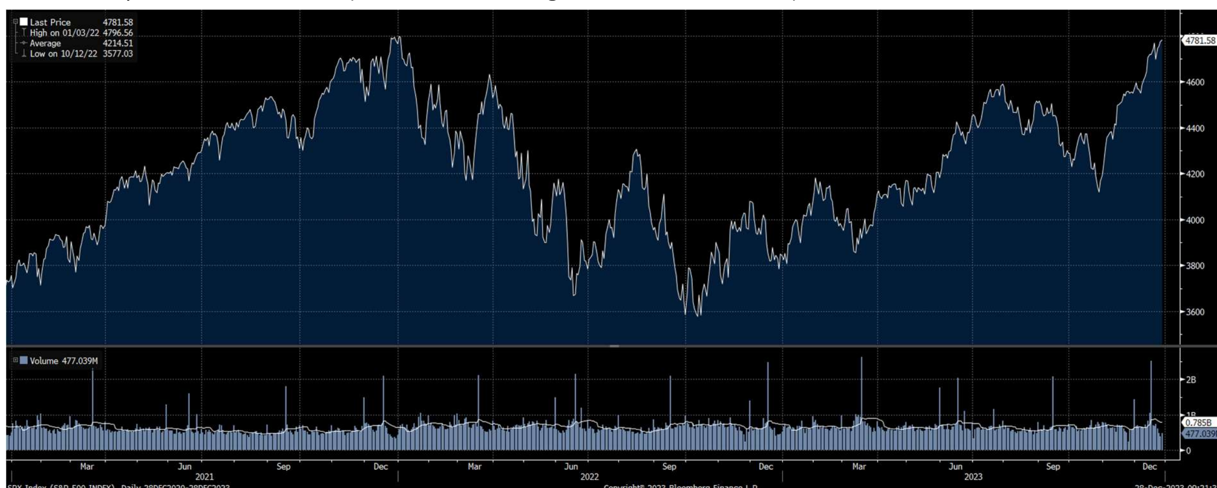


Chart 2 – Bloomberg Aggregate Composite Bond Index (2021-2023)
Bonds and income securities have been bearing (for now) the brunt of the interest rate increases. On a three-year horizon the annualized returns have been negative. This is one of several reasons why fixed income looks attractive now (source: Bloomberg Professional Services)

It is important to note that while the US equity market recovered all the losses experienced in 2022, fixed income and related markets remain significantly depressed from their peak levels in later 2021. In other words, balanced, defensive, and income-oriented portfolios (owning a combination of stocks and bonds) have not yet reattained their previous peaks. As frustrating as this may be, the income landscape offers great opportunities for the years ahead and so do more conservatively diversified portfolios.

2. Global Macro Considerations

2023 was in essence about inflation, the Fed, and the advent of generative AI.

- **Inflation Cooling but So is the Economy**

In 2023, the Federal Reserve's favorite metric of inflation (the PCE deflator) trended lower and is projected to drop to the 2%-3% region in 2024. This would represent a great success for the central bank. All components feeding into inflation look benign, albeit to varying extents; supply-side bottle necks have been solved, commodities prices are contained, long-term inflation expectations remain strongly anchored. Wages and rents have moderated, even if we need to see more conclusive evidence in this regard.

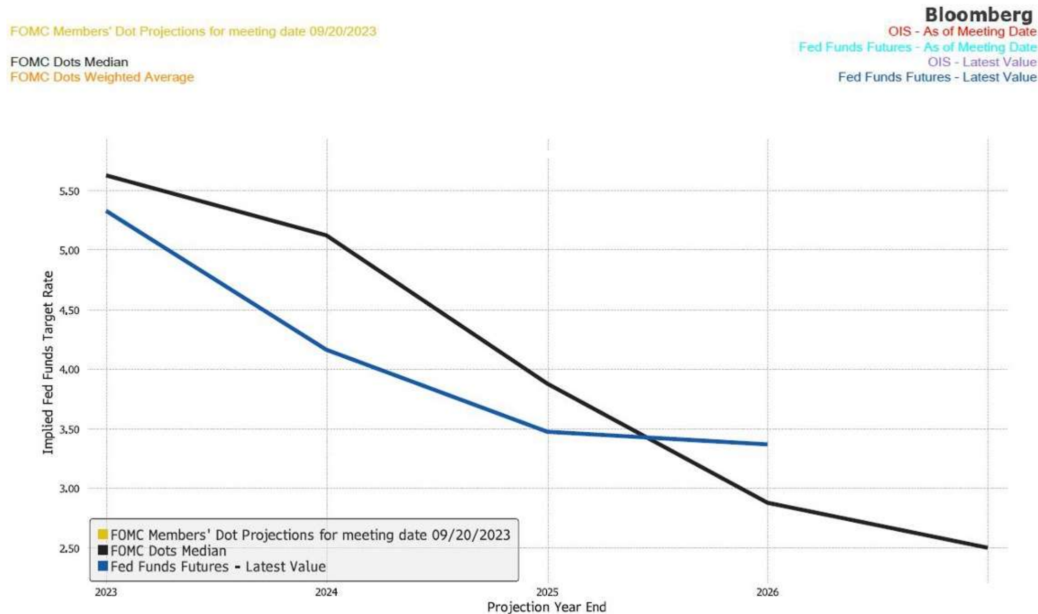
Along with inflation the US economy is also showing signs of moderation. Economists are split 50%-50% on their views about a possible recession in 2024, but almost all of them expect a significant slowdown. Metrics that have historically foretold a recession, such as the inversion of the yield curve and the monthly trend in the composite Leading Economic Indicator index (LEIs), are still pointing to a recession. However, the resilience in actual economic activity suggests a more robust structural foundation.

- **Federal Reserve's Pivot**

With inflation moderating and the economy slowing, in Q4-2023 the Fed changed its tone, hinting at possible rate cuts in 2024. We think Fed Fund targets rates have peaked for this cycle at 5.5%, creating more benign conditions for financial assets going forward, especially fixed income ones.

Chart 3 – Fed DOT Plot and Fed Fund Futures

Investors foresee a much faster and deeper cycle of rate cuts than the Fed (source: Bloomberg)



Indications from the Fed are for two or three 0.25% cuts in 2024, while the market (Fed funds futures) is predicting six or seven cuts. The market may be overly optimistic about the speed at

which the Fed will relax monetary policy. Barring some significant adverse economic event, we believe the Fed will be very prudent in cutting rates to avoid re-igniting inflation. We also estimate the equilibrium value of the 10-year US Treasury bond yield to be between 4.25% and 3.5%.

- **Generative Artificial Intelligence (AI)**

The commercial launch of the generative AI, ChatGPT, by Open AI in November 2022 started the race for Artificial Intelligence. Much of 2023 was dominated by stories of **AI enablers** such as Nvidia, Microsoft, and Google. According to the Bespoke Group, just five mega-capitalization companies in the S&P500 index accounted for 50% of the returns of the US stock market. A new gold rush towards AI began in the venture capital space.

As of today, only a few tech titans have directly and immediately profited from the advent of AI, while many other potential beneficiaries have remained in the shadows. 2024 is likely to be the year of wider adoption of these new technologies by businesses. It is fair to assume that **AI-adopters** will increase the productivity and profitability and be part of the next leg up in the markets.

3. Income: abundant opportunities

In 2023 income investors once again bore the brunt of the Fed's battle to rein in inflation. By the year's final months, however, it appeared that the tightening phase in monetary policy had concluded. Bond yields dropped sharply and prospects for 2024 looked bright. **After many dry years, the fixed income landscape offers both attractive yields and the potential to mitigate other market risks.**

Under pressure from the increase in the Fed funds effective rate from 4.10% to 5.33% over the course of 2023, the ten-year Treasury's yield jumped from 4.36% to a peak of 4.98% on October 18. The resulting damage was sufficient to produce a disappointing price loss of nearly a full percentage point on that benchmark bond and a 2.83% total return for the full year. From October 18 through December 31, however, the ten-year yield fell by more than a full percentage point to 3.90%. The total return over that two-and-a-half-month interval was a staggering 9.16%.

As the year closed, the Fed was signaling that it would likely be lowering interest rates in 2024, although somewhat less aggressively than the futures market indicated. **That bodes well for high-quality income investments, the prices of which are driven primarily by the general movement in interest rates. The outlook is not quite as bullish for instruments that are characterized by credit risk.**

Notwithstanding the "soft landing" camp's self-congratulatory tone as 2023 wound down, it is by no means certain that the U.S. will avoid a recession in 2024. The two-year Treasury yield remains higher than the ten-year yield, a condition known as an inverted yield curve that has consistently preceded recessions. Ruling out a recession on the grounds that the inversion has persisted for a year-and-a-half without a recession beginning overlooks the fact that historically, recessions did not begin until after the yield curve inversion ended.

True, the probability of recession within 12 months, as estimated by Bloomberg-surveyed economists, declined during 2023. At year-end, however, it was still at an elevated 50 percent level. That is double the series' 24 percent average since inception for months in which the economy was not already in recession.

One might expect to see forecasters' view of a one-in-two chance of recession in 2024 reflected in risk premiums on lower-quality fixed income instruments. **Instead, the ICE BofA US High Yield Index's option-adjusted spread finished 2023 at just +339 basis points, far below its historical average (since December 31, 1996) of +537 basis points**. The risk premium is also meager relative to the fair value level indicated by our proprietary model that considers various economic and financial market indicators. This all makes speculative grade bonds highly susceptible to price deterioration, even if the GDP gains merely slow down, rather than turn negative.

In view of that vulnerability, our search for higher yielding opportunities is currently concentrating on opportunities in the **private credit space**.

Within the market for preferred shares, we are focusing on investment-grade issues. In the investment grade bond area, we are extending duration, entering the "belly of the curve" (maturities of three to seven years). The favorable rate outlook gives us confidence to be opportunistic across a multi-sector spectrum.

4. Equity: looking past the “magnificent seven”

As we reflect on the Equity market's performance over the past year, we find ourselves at the intersection of opportunity and caution. The bull market, which commenced on October 12, 2022, has displayed resilience and optimism, aligning with historical trends. Contributing factors to this recovery were the expectation that the Fed was done raising rates, along with the resulting decline in the 10-year yield, the slide in WTI oil prices, the better-than-expected Q3 2023 earnings reports, and the continued avoidance of recession. **A quantitative analysis conducted by the Bloomberg and the Bespoke Group indicates that the equity market performance is less related to the GDP growth and more to 1) interest rates, 2) oil prices, and 3) the US Dollar exchange rate. All three were lower in 2023 while the stock market was up.**

This recovery was driven by the communications services, financials, and information technology sectors, leaving eight others in the dust, with consumer staples, energy, and utilities groups having the furthest to go. In their second year, bull markets have achieved 12.6% price gains on average and have sustained their momentum into the third year 85% of the time.

Despite some normal potential pullbacks due to profit taking, **the US equity market trend and momentum remain positive.** The current rally is broadening its participation beyond the tech behemoths. Despite initial concerns, 93% of the 153 sub-industries in the S&P 1500 are above their 10-week moving average, 66% are above their 40-week moving average, and 62% are above both. Additionally, nearly 60% of the stocks in the S&P 500 are higher on the year.

At the same time, we acknowledge the challenges ahead. Credit card delinquencies are on the rise, indicating pressure in consumer spending and the next leg up for global equities, supported by laggards, may face hurdles due to an economic slowdown, continued high interest rates for longer, and vulnerability of underperforming sectors.

Defensive sectors and industries, such as utilities, staples, non-office REITs, and aerospace defense, may be positioned for potential increases in price-to-earnings ratios. The disparity between large/mega caps and mid/small cap stocks is still evident and further presents opportunities for long-term value investors.

Our strategy involves a careful balance of seizing opportunities in **high-quality growth companies**, defensive areas of the markets such as **dividend-oriented stocks**, and a **thematic investment approach**.

5. 2024 Asset Allocation Strategy

Considering the above, here are investment policy adjustments for H1 2024:

- Gradually reduce cash & equivalents, considering potential rate cuts.
- Increase Investment Grade bond exposure. Increase the duration of our fixed income exposure with a particular focus on the "belly of the curve" (3-7 year maturities). Given the possible volatility in interest rates, we will use more active fixed income and covered call strategies.
- Favor investment grade preferred shares over high yield ones.
- Reduce high yield bond exposure and favor private credit funds.
- Maintain equity exposure with a focus on the US. Favor very high-quality companies and defensive areas of the market.
- Use liquid alternative investment for diversification purposes.

6. Key Risks

- **2024's most prominent risks are geopolitical**. According to *The Economist*, 2024 will see the highest number on record of general elections in the world. In the US we are expecting a very contentious presidential election. There are two on-going conflicts in Ukraine and Israel that may expand into larger regional military confrontations. Wars do not bode well for inflation.

- **Persistent Inflation.** The so called "last mile" in the fight against inflation is typically the most difficult one. Should the Federal Reserve not be convinced about inflation's trajectory, rates may not be cut as much as the market expects.

- **Unexpected casualties of higher interest rates**. After an extremely aggressive tightening policy by the US Federal Reserve, it is possible that some financial institutions (that we are not aware of) may find themselves wrong footed. It generally takes time for an increase in interest rates to show its impact on the system.

We remain vigilant regarding several key risks, including the potential escalation of geopolitical tensions, the trajectory of inflation and interest rates, evolving credit market conditions, and the rapid pace of technological advancements.

7. Concluding Notes

The investment environment for 2024 presents a complex mix of opportunities and challenges. We advocate a well-rounded, diversified investment approach, emphasizing quality and strategic positioning in sectors poised for growth, while maintaining a defensive posture to manage through potential economic uncertainties.

Our commitment to you is to navigate these challenging times with a focus on long-term value creation and risk management. We look forward to working closely with you in 2024 to help you achieve your investment goals and thrive amid the evolving economic landscape.

Sincerely,

Livian & Co. team