Portfolio Commentary

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Strong Economy and Earnings Overcome Rising Rates

Market Review

November and December 2023 witnessed a huge rally driven by a flurry of expectations of 2024 Fed interest rate cuts. By December, six cuts were priced in for 2024 by the markets, but a strong economy and job market, combined with sticky inflation soon proved those expectations short-lived. While interest rates moved steadily higher during the quarter, markets were encouraged by strong earnings, and the S&P 500 produced an over 10% gain. The markets' path was so smooth and upward that the S&P 500 never broke below its 50-day moving average and was only below its 21-day moving average for one day.

While the large-cap S&P 500 produced substantial gains, returns were particularly concentrated as A.I. stocks soared into the stratosphere. The gains were so concentrated that even the tech-heavy NASDAQ 100 underperformed, producing only an 8.6% gain, while small-caps were hampered by rising interest rates and produced only a 2.4% gain.

While stocks produced substantial, if narrow, gains, fixed income produced modest losses, with the Aggregate Bond Index down 0.7%. Corporate credit fared much better. The High Yield Corporate Bond Index produced a gain of 1.5%, as high yield repeated its historical pattern of outperforming during periods of rising rates.

Just over a week into April, we have seen interest rates spike higher as inflation surprised to the upside. So far, stocks have responded well, and we believevan important question facing investors in the second quarter will be at what level will higher interest rates bite and cause a correction? So far, risk markets, and credit markets in particular, have proven quite resilient.

First Quarter Portfolio Highlights

- Last fall, our models turned positive after interest rates turned downwards, and on November 6th, the portfolios moved to a risk-on stance owning equities where the portfolio has stayed through the first quarter. Since late November, equities have enjoyed strong gains; since taking a risk-on stance in early November, the S&P 500 is up 21.0%, while small-caps are similarly higher at 19.2%. International equities have produced more modest gains, with broad international equity up 14.1% and international small-caps up 12.6%. In contrast, broad U.S. Treasuries are up 4.5%, while cash equivalents are up 2.1%.
- On the quarter, our top equity holding was up 10.4%, while other equity ETFs produced smaller gains. U.S. small-caps were up 2.4%, while broad international equities were up 4.5% and international small-caps were up only 1.6%. In contrast, 7 to 10-year Treasuries produced a 1.3% loss.

Positioning and Outlook

The quantitative models that drive the portfolio allocations examine trends in credit markets to determine whether risk-taking is being rewarded or punished. We believe credit trends continued to be favorable in the first quarter as high yield spreads have declined to below 3.0%, a level which they have been below only 7% of the time. This overvaluation is not an imminent cause for concern, as we know from past experience that spreads can hold below 3% for extended periods. It is when spreads reverse from these low levels that risk management becomes important. As always, our models are watching for any reversal from stretched valuations, but we have seen very little evidence of weakness in corporate balance sheets or investors' willingness to lend.

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Thus, from our model-based perspective, the rally since November 2023 looks to be legitimate, with fundamentals and investor sentiment backing it. Market gains could well continue further, with possible wider participation from mid and small-caps as well as value stocks as the economy improves. While Technology and growth stocks have stalled a bit over the last month, our analysis indicates that while they are richly valued, they are not in a bubble that would represent outsized risks.

Over the past five years, the dominance of large-cap and Technology stocks has been strong. The S&P 500 (itself a large-cap index) is up 15% per year over the last five years ending March 31st, and the mega-cap Tech-heavy NASDAQ 100 is up 20.6%. Mid-cap stocks, in contrast, are up only 11.6% per year over that time, while small-cap stocks have gained only 9.1%, which is less than half of the NASDAQ 100.

The gains have left the NASDAQ 100 forward P/E at 27.1, which while certainly at the high end of its historical range is not in bubble territory. Meanwhile, small-caps stand at a very reasonable forward P/E of 14.6, which is not all that far from major lows seen in 2011, 2020, and 2023. While valuation measures by themselves are very poor timing tools, they are better measures of risk, and with small-caps reasonably valued, this argues for reduced risk of a major decline in markets.

We continue to believe that small-cap stocks and value stocks continue to offer potential and are compelling on a relative basis. Overall, our credit-based models and the macro indications that we follow point to a strong backdrop for equities and risk-based assets over fixed income and cash equivalents. While a slowdown and stalling from an overbought condition is overdue and inevitable, we would view that as a buying opportunity.

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Equity stocks of small and mid-cap companies carry greater risk, and more volatility than equity stocks of larger, more established companies.

The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 80% of U.S. equities.

The Nasdaq-100 is a stock market index made up of 101 equity securities issued by 100 of the largest non-financial companies listed on the Nasdaq stock exchange.

A small-cap ETF is a type of exchange-traded fund that invests in small companies whose value is less than $2 billion

The 10-year Treasury yield is the yield that the government pays investors that purchase the specific security. Purchase of the 10-year note is essentially a loan made to the U.S. government.

The Bloomberg Barclays U.S. Corporate High-Yield Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. The Index is frequently used as a stand-in for measuring the performance of the U.S. bond market. In addition to investment grade corporate debt, the Index tracks government debt, mortgage-backed securities (MBS) and asset-backed securities (ABS) to simulate the universe of investable bonds that meet certain criteria. In order to be included in the Index, bonds must be of investment grade or higher, have an outstanding par value of at least $100 million and have at least one year until maturity.

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