

## Winter 2024 Edition

By: Henry Pizzutello, Chief Investment Officer

As we move into 2024, one of the key challenges to investment success is the identification of major themes that may influence markets in the coming months. At the beginning of last year, most of the experts were focused on what had already happened in 2022, and widespread predictions of imminent recession were found in every January letter. What wasn't as apparent was the identification of one of the major themes that drove markets - the emergence of artificial intelligence (AI) in technology. While the risks of inflation and economic growth were certainly not ignored, a handful of companies dubbed the Magnificent Seven – carried the market on its shoulders for much of the year until Fed Chairman Powell stepped in and convinced markets that rate hikes were about to end. While there a number of themes to look at in 2024, these are what we consider to be the most important in the coming year.

### 1. “Meet the New Boss, Same as the Old Boss?”

While we are focused on the upcoming Presidential election, it is surprising to note that in the coming year, national elections are set to take place in 40 countries, representing 41% of the world's population, 42% of its GDP, and nearly 80% of its stock market capitalization. This has the potential to change the global landscape significantly. In the U.S., the year prior to an election has historically been positive, and true to form, 2023 continued the trend despite major concerns as the inverted yield curve, the contraction in the money supply, and the deterioration of Leading Economic Indicators. The current funding a large budget deficit and large long-term liabilities with short-term debt has worked so far, but can also backfire if rate conditions do not follow suit. It is likely that this dangerous mixture will continue in 2024, as a strong

stock market, flat yield curve, low unemployment and low energy prices are usually a winning formula.

### 2. The Costs of Deglobalization

In just the last three years, Russia has initiated a war with Ukraine, six former French colonies in Africa have experienced coups d'état, Hamas attacked innocent civilians in Israel risking a greater conflagration in the region, and President Xi just stated that China's “reunification” with Taiwan is inevitable.

The theme of deglobalization is becoming more prominent, and has widespread economic implications. World trade is moving in the direction of individual spheres of influence with the U.S. and China/Russia on opposite sides. This will ultimately have the effect of increased inflation, as global trade becomes less secure and reliable, and more costly. One of the broad concerns will be the disruption of supply chains, as we saw happened during COVID and at the onset of Ukraine war. The solution of building more efficient and more resilient supply chains closer to home may become a necessity, but it will carry a high price tag. The potential for stickier inflation in the long term is introduced, prompting investors to reassess their risk management strategies.

### 3. Wage Inflation Pressure on Profit Margins

Wage inflation is emerging as a critical theme, with 22 states and numerous cities and counties raising minimum wage requirements for 2024, impacting almost 10 million workers. Twelve states have enacted legislation that will automatically adjust wages for future increases in inflation. It is notable that some high-profile work stoppages, such as the United Auto Workers and Screen Writer's Guild in Hollywood, ended up in successful wage and benefit increases for its members. While unionized labor is a small component of the overall workforce, there may be a trend toward more concentrated efforts among workers as they seek to achieve the same benefits.

While this is certainly positive for the workforce, there are signs that the recent goods price inflation (prices companies charge consumers may be starting to fall. If the wage increases for workers continues at the same pace, but prices cannot follow, this creates an issue for company's future earnings prospects and the resultant equity market valuations. There are still a large number of unfilled jobs in the U.S. – more than 8 million - so it is unlikely that companies will be able to cut back on hiring. The absolute level of profit margins for the S&P 500 remains high but is below its 2021 peak. This raises questions about the sustainability of profit margins amid wage inflation and calls for a nuanced approach to portfolio management.

### 4: Widespread Corporate Investment in A.I.

There have been few technological innovations that were so immediately exciting to businessmen and investors alike than the development of generative artificial intelligence. Even the commercial onset of the internet based technologies in the 1990's took a while for the mainstream public to pay attention. In 2023 more than 100 million consumers signed up for chatGPT in the early days of introduction.

There is good reason for this that goes beyond hype. The potential for A.I. to be truly transformative over time significant. Corporations who have embraced the technology have seen the potential benefits of adoption into their business practices. While it seems unlikely to us that it will have meaningful impact on output in the short-term, we have few doubts that corporate America will invest heavily.

The biggest benefit that most people see in the technology today is the potential improvement in productivity. Companies will have more reasons to invest in the technology than that, however. While gains in productivity are offensive reasons to gain market share and, there are also defensive reasons to

protect profit margins in a world in which inflationary pressures persist. Companies are looking defend their position against the competition by entering the technological AI "arms race" with the ultimate goal of creating the next nuclear bomb that could eliminate the competition. Given the price of the shares of many of the leading companies involved in the space today, this is likely to continue to present challenges for value investors seeking to outperform and growth investors seeking to dampen volatility or limit concentration risk.



### "Red Riding Hood or The Three Bears?"

The term "Goldilocks" has become a prominent descriptor in today's economic discourse, symbolizing a scenario where conditions are just right—neither too hot nor too cold—for favorable market performance. The prevailing belief is that 2024 will usher in significant interest rate reductions, benefiting both bonds and stocks, coupled with a steady and measured economic growth. This narrative has gained traction among investors, and early US data appears to support the optimistic Goldilocks scenario. There is certainly good news in some areas which seems to support that the recent late 2023 rally will continue in 2024.

Recent trends in mortgage rates have triggered an upswing in approvals for home mortgages, hinting at a potential resurgence in the housing market.

# Winter 2024 Edition

Simultaneously, the US labor market seems to be aligning with the Goldilocks narrative, as the rate at which workers are quitting their jobs returns to normal levels. Despite a sustained level of job vacancies, the job market appears to be cooling without signs of a significant downturn.

Manufacturing supply manager surveys indicate a modest recovery, providing hope that the economy can sidestep both recession and overheating. Investor confidence in the Goldilocks scenario is reflected in the market's response to the release of December's Federal Open Market Committee meeting minutes, which offered no hints of imminent rate cuts and, as a result, 10-year bond yields managed to fall.

However, the rosy picture painted by the Goldilocks scenario is not without its concerns. The market's prior pricing of this outcome may limit potential returns, as such scenarios tend to deliver robust returns when unexpected. Indeed, if we move the calendar back to the beginning of 2023, the consensus was that a recession was inevitable, and almost every respected economist had mountains of data to back up that claim. Such is the nature of markets that much of the information is digested and priced in before the actual events happen. Thus, there is a looming worry about what happens if Goldilocks has an evil twin. Recent market actions have been very correlated to the perceived actions of the Fed with respect to interest rates and unfavorable conditions. Market behaviors have shown this oscillation, particularly in response to each Federal Open Market Committee meeting, with notable shifts in sentiment, especially following Chair Jerome Powell's statements. Even though the year has just started, we have already seen stock market declines in conjunction with rising bond yields. This trend is underscored by the proportion of stocks that positively correlate with bonds, reaching historic highs. A potential rise in bond yields, possibly triggered by unexpectedly strong inflation data, could have adverse effects on the stock market.

If the bond market is mispricing economic strength due to central bank interventions, a correction may be imminent, posing a risk to the stock market, particularly if it remains correlated with bonds. If inflation does not continue on its downward path, that poses a risk to interest rate cuts, which poses a risk to equity markets. If corporate earnings do not continue to rise to a level that justifies the higher than normal PE level, that poses a risk to equity markets. If all of the above happen, then we have the elusive "soft landing" scenario being priced into current market valuations. While the current outlook suggests a promising year ahead, a realistic concern as to whether all of the above may occur makes the landscape less predictable, especially in the wake of the US election.

In summary, the Goldilocks scenario, though currently steering the economy smoothly, is not without its challenges. The market's anticipation of this outcome may limit its impact, and the potential for a reversal into "Reverse Goldilocks" presents a precarious situation. Vigilance is required, especially concerning the interconnectedness of stocks and bonds. As 2024 unfolds, navigating these economic crossroads requires a keen understanding of evolving market dynamics and an awareness of potential risks on the horizon.

# Winter 2024 Edition

## **Bitcoin Grows Up**

In terms of assets to own in a “risk-on” environment, nothing rewards risk like Bitcoin. Bitcoin exhibited a notable surge in 2023, and has moved to a 21 month high during the first week of 2024, even as most financial assets declined.

The Fed rally was fueled by expectations that the US Securities and Exchange Commission (SEC) would approve a batch of spot Bitcoin exchange-traded fund (ETF) applications, which was confirmed and announced on January 10th. This situation draws parallels to the atmosphere preceding Bitcoin's surge in late 2021, which was followed by a dismal performance in 2022 culminating the fraud and ultimate conviction of Sam Bankman-Fried and the collapse of many platforms around him. This recent action, which had been pursued for years by bitcoin backers poses a very important question: Can an ETF stabilize Bitcoin and move the asset to the next level out of its current extreme boom-and-bust cycles?

Many experts have considered the approval of ETF's tied directly to Bitcoin's spot price a significant moment for the industry, potentially democratizing access to digital assets. However, doubts have been raised about how much the transformative impact of a spot Bitcoin ETF would be on attracting inflows, as there were similar claims surrounding large crypto exchanges such as FTX and Binance.

The unknown impact on Bitcoin demand is a crucial factor to consider. The main influence of a spot Bitcoin ETF is expected over the longer term as issuers prepare to educate the mainstream investing public. Once the initial excitement subsides, the crypto market narrative may pivot to focus on other factors driving prices, such as macroeconomic conditions, currency volatility in emerging markets, and global adoption.

Those who believe that mainstream media has excessively emphasized the ETF story point to the excessive volatility exhibited over the past few years, but in the context of risk and return and Bitcoin's volatility should be considered quite typical. Over the past 5 years, the return on Bitcoin if held through the Grayscale Trust (GBTC) has been more than 700%. The adoption of an ETF goes a long way to legitimizing the asset class, even with the volatility concerns, and as more institutional investment firms look at the potential revenue gained from opening crypto divisions, this will provide an incremental positive toward price stability.

The biggest concern regarding any asset class but especially Bitcoin, is liquidity. Bitcoin's most recent rally occurred when there was an abundance of liquidity in the system. Historically, Bitcoin tends to follow the flow of liquidity, and if liquidity becomes less plentiful, it could lead to a pullback in cryptocurrency markets in the early part of the new year. More importantly, if the Federal Reserve makes a sudden reverse back toward fighting inflation, markets will be shocked into a short-term “risk off” pattern, and Bitcoin volatility would be the result.

For now, Bitcoin appears to be aligning well with a “Goldilocks” scenario, thriving in an environment of plentiful liquidity. The cryptocurrency's performance remains closely tied to market dynamics and regulatory decisions, but the recent decision goes a long way in answering some of the most important questions regarding the future of the asset class in financial markets.

