

Will Investors Eat Cake in '24?

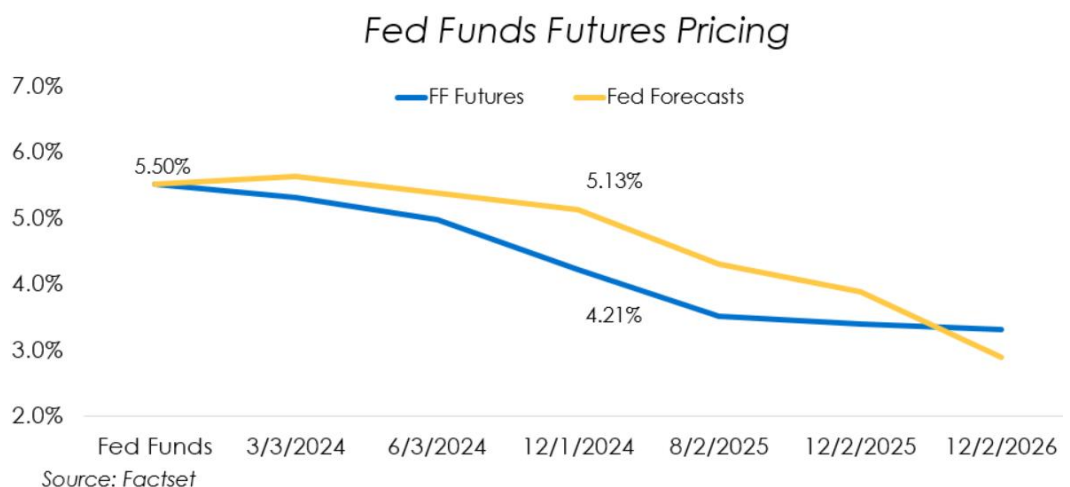
“Where there is cake, there is hope. And there is always cake.”

– Dean Koontz, *Life Expectancy* (2004)

As we head into the home stretch of this year, prognostications for next year abound. Both Stock and Bond investors are seemingly optimistic as the consensus implies investors will be able to “have their cake and eat it too”. Let’s explain.

After this year’s (albeit mild) earnings recession, expectations for next year imply healthy earnings growth for the S&P 500 in the low double digits. That improvement is already shaping up with a return to positive earnings growth witnessed over the past two quarterly earnings seasons (based on operating EPS on a trailing twelve month basis). A broader package of fundamental data seems to be evidencing a bottom as well – albeit one that remains more sideways than up. Further, our leading profit cycle indicator composite has also begun to bottom out. With multiple signs pointing toward a cyclical profit improvement as we head into next year, Stock investors have become more optimistic.

Meanwhile, Bond investors have been cheering the moderating inflation data that – while still above the Fed’s target – is now well off the cycle peak. The Fed has meaningfully hiked rates into restrictive territory (as defined



Funds rate) and the bond market now believes that the Fed is, not only done with tightening, but will start notably easing next year. As can be seen in the chart above, Fed Fund Futures (FF Futures) are now pricing in a full five cuts in '24 – which is more accelerated than Fed forecasts. The supporting argument for this is that,



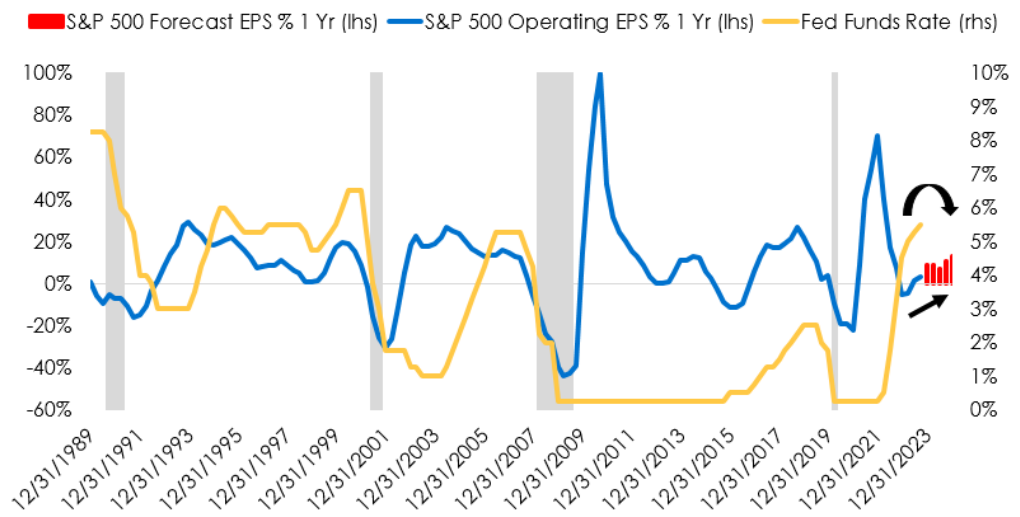
as inflation moderates, policy becomes more restrictive by simply standing pat. Therefore, interest rate cuts are needed in order to maintain the status quo of policy positioning in the form of a stable real Fed Funds rate.

While expectations for interest rate cuts and an acceleration in earnings growth don't seem outlandish separately, taken together, they appear to be at odds to a degree. That's because, historically, it tends not to happen that way.

Investors typically don't get to "have their cake and eat it too". As can be seen in the chart below, the Fed typically is cutting rates

as earnings decelerate – often into a recession. Over the last thirty years, it's been rare to see a Fed cutting into an earnings reacceleration apart from being on the back end of a recession. However, next year, bottom-up earnings forecasts imply earnings acceleration while rate forecasts suggest the Fed Funds Rate should be headed south.

Let Them Eat Cake



Source: Factset; S&P Dow Jones Indices with EPS defined on a trailing twelve month basis.

Can both be right? It's possible but this soft landing would be the truest definition of the phrase and would also suggest we return to the same environment we were in pre-COVID where disinflation was the norm allowing interest rate policy to be perennially loose. If that's not the case, both conditions would be less likely to occur simultaneously. Either earnings growth reaccelerates preventing the Fed from cutting rates OR earnings growth disappoints materially enough to force a Fed rate cut.

Right now, both earnings growth acceleration and moderating inflation are the prevailing trends, so it remains unclear which (if either) of these consensus views may not pan out. Bottom-up earnings growth forecasts remain more optimistic than top-down predictions, though both evidence improvement. Meanwhile, there are some leading inflationary indicators (regional pricing surveys, unprocessed goods inflation) that suggest a bottoming out trend, though realized inflation data continue to point to further reductions. The hope is that there will be enough cake to go around, however, it also may behoove investors to remember that, historically, some might go hungry.



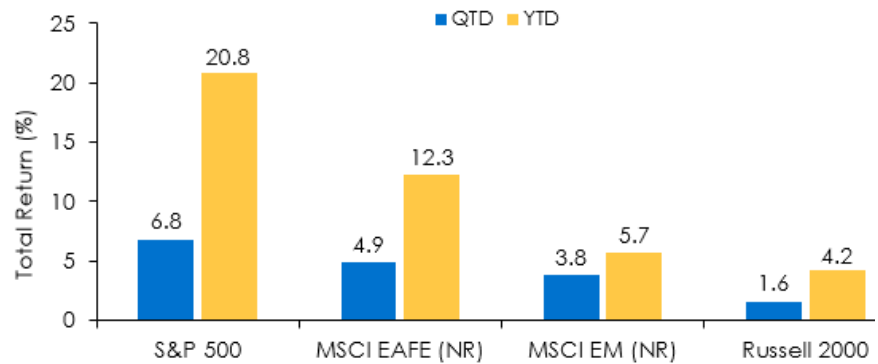
Market returns were strong this month with the S&P 500 turning in its best monthly performance for the year and its best November since 2020. Stocks were up high single digits, REITs up low double digits and Bonds up mid-single digits. Commodities finished lower as the outlier. Optimism around peak rates, moderating inflation and an increased likelihood of a soft landing contributed to the strength. Meanwhile, year-to-date, Stock returns continue to hold a notable lead over other asset classes – albeit with a more narrowed composition.

Stocks

Equity performance broadened in November with strong returns across size and geographical factors. Still, a narrow subset of U.S. Large Caps (S&P 500) have dramatically led for most of the year. US Small Caps (Russell 2000) have lagged but are now positive for the year after strong returns in November due to declining interest rates and optimism around a soft landing. Overseas, equity performance in International Developed Markets (MSCI EAFE) remains solidly positive – helped by a better than feared start to the year given warmer weather and the avoidance of an energy crisis in Europe along with better economic data out of Japan. Emerging Markets (MSCI EM) posted strong returns in November and are now also positive for the year. Meanwhile, US Large Cap sector outperformance has favored the higher priced “Magnificent 7” within the cyclical growth sectors (Technology, Discretionary and Communication Services). Conversely, both cyclical value (Energy, Materials & Financials) and defensive sectors (Health Care, Utilities and Staples) have starkly underperformed.

Global Equity Returns

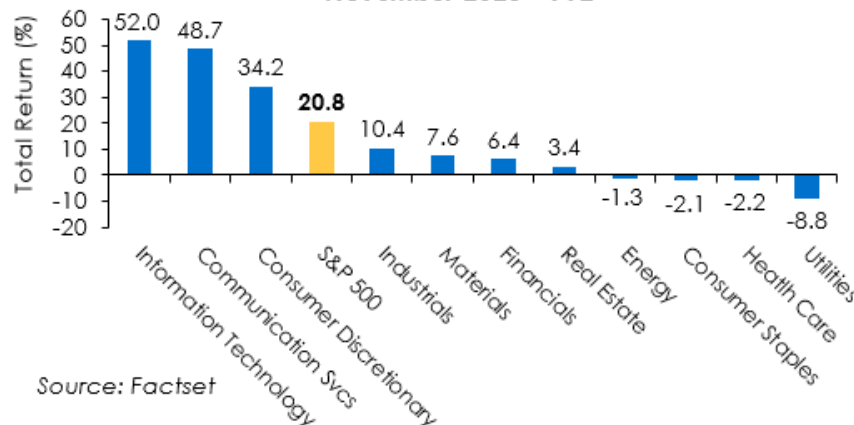
November 2023



Source: Factset

S&P 500 Sector Returns

November 2023 - YTD



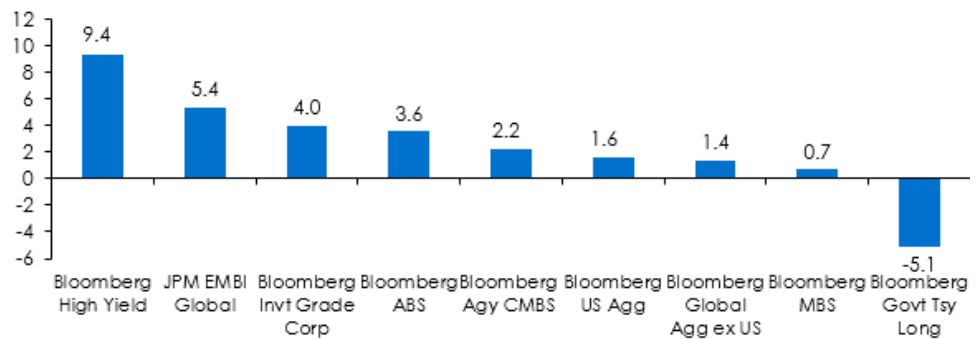
Source: Factset



Bonds

Following aggressive moves by the Fed (Fed Funds at 5.25-5.50%) amid ongoing balance sheet reduction – policymakers have now indicated a “wait and see” approach in their fight with (elevated but moderating) inflation as the Fed has now left rates unchanged at their last two FOMC meetings. Rates have been volatile, with 10 Year Treasury yields declining over 50 bps in November after increasing roughly 80 bps from August through October. Meanwhile, the yield curve remains inverted but has steepened off the lows. Bond performance returned to positive territory (US Agg) in November with the recent decline in longer term interest rates. Still, the higher rate move year-to-date, along with tightening credit spreads, led to outperformance in shorter duration High Yield corporate bonds. Conversely, longer duration securities represented by Long-Term Treasuries (Govt Tsy Long) remained in negative territory, though much improved since the end of October.

Global Fixed Income Returns
November 2023 - YTD

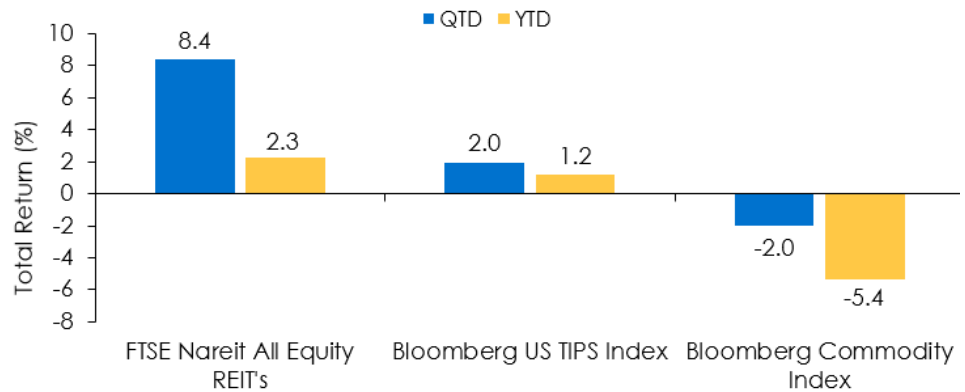


Source: Factset

Alternatives

Commodities traded lower year-to-date with flat to negative returns in Agriculture, Industrial Metals and Energy. The positive outlier has been Precious Metals, including Gold. Meanwhile, publicly traded Real Estate (REIT's) continues to lag equities but turned positive, year-to-date, after a strong rally in November. Finally, Treasury inflation protected securities (TIPs) benefited from the positive carry in bonds year-to-date, while inflation expectations have moved sideways.

Alternative Market Returns
November 2023



Source: Factset



Market Outlook

***“It’s Tricky to rock a rhyme, to rock a rhyme that’s right on time.
It’s Tricky.”***

– Run DMC, *It’s Tricky* (1986)

We continue to believe that it’s important to maintain two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles. We’ve referred to this theme as “Seeing Both the Forest and the Trees”.

From a secular lens, we remain sympathetic to the notion that the paradigm is changing to one that ushers in the potential for more persistent and volatile inflation. Such a backdrop might set the stage for a higher cost of capital environment acting as a weight on stock valuations along with changes in market leadership. We find historical parallels today to the higher inflation regime that existed back in the ‘60’s-80’s and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it hopes not to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money supply) and supply (de-globalization, labor markets, energy complex).

As can be seen in the table at right, correlation changes between stock prices and interest rates over the past 60 years have led to the demarcation of two different regimes that we’ve dubbed the “Gravity” Regime and the “Zero G” Regime. The former witnessed a period where

	Gravity 1963-1997	ZERO G 1998-2022	Current
10 Year Yield	7.8	3.4	4.2
CPI	4.9	2.4	3.2
P/E	15.7	22.7	23.1

Source: Factset; 10 Year Treasury Yield and CPI measures are averages over the respective time periods. P/E is a trailing twelve month median calculation based on company reported earnings. Historical earnings are taken from Robert Shiller’s U.S. Stock Markets 1871-Present and CAPE Ratio (<http://www.econ.yale.edu/~shiller/data.htm>). Current 10 Year Yield and P/E as of 12/1/23, Current CPI as of 10/31/23.

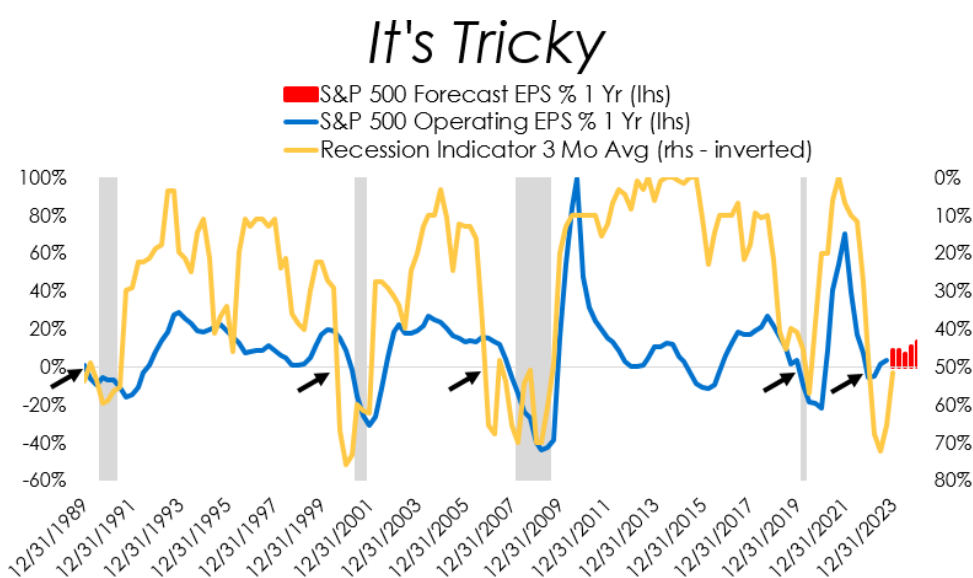
interest rates and inflation were higher and more volatile creating a gravitational pull down effect on stock valuations. The latter period saw the opposite – whereby lower and less volatile interest rates and inflation removed the gravitational pull down effect and allowed stock valuations to expand. We can’t help but wonder if today’s current environment might have shifted to be a bit more like the former than the latter. If so, this might



have implications for a company's cost of capital, a stock's valuation multiple and changes in market leadership. As a result, we've referred to this secular mantra as "Doing the Opposite".

At the other end of the spectrum is the cyclical perspective which, admittedly, has gotten more "Tricky" of late. A broadening package of both Fundamental measures (manufacturing/service sector surveys, building permits/new home sales/home prices, unprocessed goods inflation, copper prices, and the leading economic indicator composite) and Liquidity measures (lending standards, yield curves, money supply growth) appear to be in some stage of bottoming. Perhaps not coincidentally, corporate profit growth is also forecasted to improve with a return to positive growth (based on an operating trailing twelve month basis) seen over the past two earnings seasons.

At the same time, we remain committed to the idea of being late in the business cycle with current conditions that have often been precursors to recessions historically. In fact, while our recession indicator has recently improved, that's not unprecedented in other eventual recessionary patterns. As can be seen



Source: Factset; S&P Dow Jones Indices with EPS defined on a trailing twelve month basis. Yellow Cardinal Research; the Recession Indicator is a proprietary dashboard of financial conditions that historically have provided some lead time on recessionary events. When more than half of the weighted average signals were triggered, this often precluded a recession. The Recessionary Indicator is a weekly signal with the 13 week moving average smoothing the volatility.

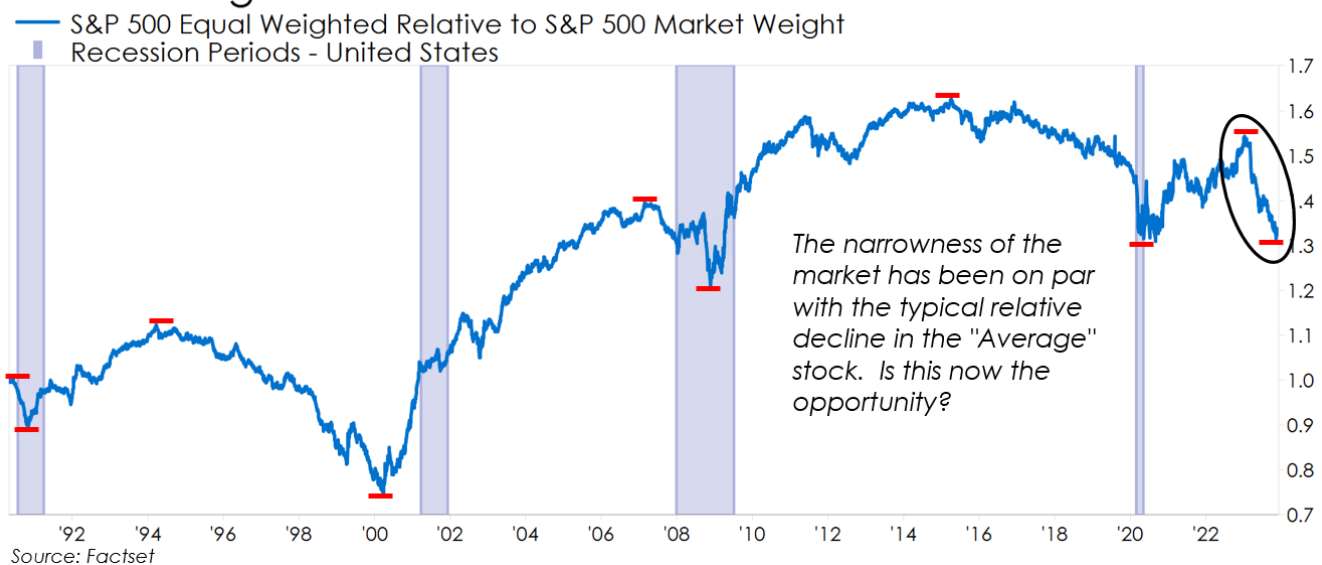
illustrated in the chart above, the recession indicator remains at comparable late cycle levels while earnings growth is bottoming and forecasted to improve. This makes for a desynchronized setup between the business cycle and the profit cycle – perhaps driven by the lingering aftermath of the COVID shut-downs. The combination of the two makes for a "Tricky" cyclical backdrop with sustainability of profit growth improvement unclear and largely contingent on labor market and inflation trends.

For now, we think it's important to acknowledge the recent improvement in Fundamentals and Liquidity and reposition portfolios from a defensive to a more balanced tenor. We believe one of the bigger opportunities exists in the "Average" stock which has already experienced valuation pressure from the earnings recession that we've now exited. While the market cap weighted S&P 500 is trading at an elevated valuation (19X vs



LT average 18X), more attractive valuations are apparent in the “Average” stock (with the equal weighted S&P 500 trading at a more modest 15X). Another way to illustrate this disparity is in the relative price action seen in the chart below. This year the equal weighted S&P 500 has underperformed the market cap weighted S&P 500 by what is typical during late cycle environments. To the extent that there’s some degree of cyclical improvement, the “Average” stock might have an opportunity to reverse this trend.

The “Average” Stock versus The Index



The bottom line is that late-cycle conditions make growth sustainability unclear, however, we’ve noted cyclical improvement in the Fundamentals and a bottoming in earnings growth. As such, our view is becoming more balanced while keeping in mind the “Tricky” setup calls for that “Head on a Swivel” mantra.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, we continue to believe that it’s important to “See both the Forest AND the Trees”. To us, that means being cognizant of the potential changing paradigm (i.e. Secular) while also recognizing the recent improving profit cycle setup – albeit within a late-cycle frame (i.e. Cyclical). While we entered this year with an UW to risk assets, we’ve let that UW lessen amid the year-to-date market rally as Fundamentals appear to be bottoming. We recently adjusted our positioning within US Large Caps to more of a balanced posture. We accomplished this by adding to some late-cycle cyclicals along with a smaller cap size bias and did so at the expense of more defensive oriented exposures.

Within equities, our Large Cap positioning has now shifted toward more balance between traditionally defensive sectors (like Staples, Health Care, Utilities) along with the recent add to late cycle cyclicals (like Energy, Industrials) and the “Average” stock (Equal Weighted S&P 500). We continue to be decidedly UW



the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services) as investors have taken on a “Heads I Win, Tails You Lose” mentality with speculative fervor. This remains where the most concentrated and most expensive stocks reside.

Within fixed income, we remain UW the most cyclical parts of the bond market where spreads have tightened considerably (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are slightly OW corporate bonds, though we’ve previously moved up in credit quality by adding some Treasuries and lengthening duration (along with the more recent adjustment from a barbell to belly approach).

Within alternatives, we’re slightly OW in aggregate. We remain OW to Diversified Alternatives which provides some hedge against market volatility (especially in an environment where there’s lower correlations between stocks and bonds). We’re slightly OW to Commodities as a way to bolster inflationary hedges. Meanwhile, we’re slightly UW Real Estate.

The information presented in the material is general in nature and should not be considered investment advice, is not designed to address your investment objectives, financial situation or particular needs. Information is gathered from sources deemed reliable but its accuracy or completeness is not guaranteed. The opinions expressed herein may not come to pass, are as of the date of publication and are subject to change based on market, economic or other conditions.

You cannot invest directly in an index. Indexes are unmanaged and measure the changes in market conditions based on the average performance of the securities that make up the index. Investing in small and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. Asset allocation and diversification does not ensure a profit or protect against a loss.

Yellow Cardinal Advisory Group, a division of First Financial Bank, provides investment advisory, wealth management and fiduciary services. Yellow Cardinal Advisory Group does not provide legal, tax, or accounting advice. The products and services made available by Yellow Cardinal Advisory Group:

Not Deposits | Not FDIC Insured | Have No Bank or Federal Government Guarantee | May Lose Value

