

Stellar Start – Long Road Ahead

Spring Newsletter

April 1, 2024

It has been a strong start to 2024 for investors.

The 2023 Bull kept charging well into the new year, hitting fresh all-time highs to close out the month of March and Q1. It's been 5 straight months of gains. The rally has decisively been driven by the revolutionary innovation in Tech, which is Artificial Intelligence. Virtually all growth in 2024 is being tied to AI. Companies are aggressively investing. The difference between wants and needs has been blurred. It's considered a must-have for future success. The Market reflects it.

The Tech Titans have been leaders throughout this AI renaissance. These large companies possess the size, scope and scale to capitalize on the opportunity ahead. Artificial Intelligence is fueled by data. Companies like Microsoft, Google, Amazon and Apple have the money and the loyal, active user base, which create the data that AI covets. They know what's happening on devices like few others. Data is the prize of the 21st century. We remain invested there.

Tech has dominated the Stock Market for years. That's where the growth is. It's been the case going back to the Financial Crisis in 2008. The advancement of the internet followed by the move to mobility were the clear drivers. Silicon Valley shined. American innovation reigned supreme. The big winners were labeled the FAANG stocks and the Magnificent 7. America's Stock Market outdistanced all others around the globe.

Too Big to Exist?

The Tech Titans have been scrutinized for their size and tactics for years. Their dominance is being targeted. Apple has formally been accused of being a monopoly. The Department of Justice filed an antitrust suit against the popular iPhone maker. Last year, the DOJ filed a suit against Google for its dominance in digital advertising. That was on top of the existing suit for its alleged monopoly in search. Amazon and Facebook face similar suits for monopolistic behavior. Microsoft faced a similar wrath a generation ago.

What it comes down to is the question: Have these companies become titans because they cheat or because they're that good and their customers really value them? That will be answered, eventually. It's an important case with the burden of proof on the Federal Government. For now, it's an overhang that will hover for a while.



Beyond Tech

A positive sign of late has been the broadening out of the rally. It's not just Tech that's moved higher. Participation has spread to other sectors in 2024. Energy, Materials, Financials, Health-care, Industrials and Communication Services caught a bid. In fact, Technology is the 7th best sector year-to-date behind those mentioned prior. International stocks have also shown some strength. Even Small Caps, an area that has underperformed for years, came back to life in March. This broadening trend will need to continue in order for the Bull to have more legs. We're encouraged by these developments.



We interpret the rotation into the more cyclical sectors, away from Tech, as affirmation that global growth is on solid footing. Commodity prices are back on the rise, indicating increasing demand. That's a good sign. If it were the opposite, contracting commodity prices would imply potential recession and deflationary forces at play. That's not happening. Factories are busy. Companies are investing capital into their businesses. That's a sign of confidence with what lies ahead long-term.

To Cut, or Not to Cut?

This has not been a Fed-driven Market. But make no mistake, the Fed still matters. There was expectation of aggressive rate cuts in 2024. That has yet to materialize. The Fed remains on hold here. Higher yields have not slowed down growth, but they have helped cool inflation.



The Market is pricing in 3 rate cuts before year's end. That number was 7 back in January. It's hard to fathom aggressive rate cuts from the central bank with the Economy humming and the Stock Market sitting at all-time highs. Especially considering the fact that though inflation has come down considerably, prices are still rising. This is precisely the Fed dilemma. The point is, the Fed doesn't usually cut rates when things are going great.

Inflation

Innovation is deflationary. The internet brought significant efficiencies. Costs were cut. Automation is doing the same thing. Artificial Intelligence is bringing costs up as companies invest. The anticipated results: Costs come down.

Everything is political these days. It's impossible to get away from it. The Fed holds itself to complete neutrality. Well, that's what they say. So, it's no surprise that no matter what the Fed does this year, one political party won't be happy. The thing is, inflation is bipartisan.



The election calendar might convince some Fed officials to push for rate cuts at the May and June meetings. The thinking is, get it done before the party conventions this Summer. However, if inflation remains sticky, above the Fed's 2% target over the next few months, the central bank might put the cuts on ice. That could result in a holding pattern until after the election. There is a scheduled Fed meeting on November 7. It is 2 days after the election. This is setting up to be an issue. Of course, a lot will happen in the next 7 months.

Economic Resilience

America's Economy grew 3.4% in the final quarter of 2023. That's faster than expected. Strong consumer spending has the current quarter tracking at a solid 2.5% growth. We'll find out

the actual later in April. The unemployment rate is running at just 3.9%. It's historically low by any measure, though up from the 3.4% all-time low from last year.

Americans are expected to be out and about again throughout 2024. The Covid lockdown has triggered record travel activity. Summer cruises were booked up before the year began. Airports are buzzing. Hotel rooms are full. Theme parks are packed. Bars and restaurants continue to see large crowds with food and beverage consumption remaining elevated. We remain invested there.



Modern Medicine

Health Care stocks have come back to life, particularly in Biotech and other innovative therapy solutions. Weight-loss drugs have been all the rage, bringing results with a full share of controversy. But the theme is gaining steam as new therapies for various types of cancers, Alzheimer's, Macular degeneration and Multiple Sclerosis are coming to market. We're taking the long view here. It's very investable.



Complicated World

Politics and Geopolitics continue to play a role. They're not driving the Market by any stretch. But like the Fed, Politics and Geopolitics still matter.

Wars in Ukraine and the Middle East are testing resolve and resources. War fatigue has been a growing issue around the globe. Attacks on cargo ships in the Red Sea are designed to disrupt economic activity. It's working. Routes have changed. Delays incurred. Prices are also going back up.



The Baltimore bridge tragedy compounds the problem. More shipping delays ahead. It's a big issue. Baltimore is one of the busiest East Coast ports. Re-routing cargo has created delays and raised costs at a time when Americans were already feeling the financial weight of inflation.

Oil prices have been steadily climbing again despite record production from the United States. WTI banked its third straight monthly gain. It might come as a surprise, but America is the largest producer of Oil & Gas in the world. Russian production has slowed due to the war. Saudi Arabia has been curbing its output to try to put a floor under the price of Oil. Global demand has been tepid, particularly due to the economic slowdown in China.

New Cold War Staying Cool

The United States and China have decoupled over the years. There's simply not a lot of trust. Trade between the two largest global economies is at multi-year lows. China accounted for just 13% of American imports last year. It was 21% in 2017. The United States has aggressively restructured its supply chains away from Chinese dependence. It learned a hard lesson over Covid. Mexico is now America's largest source of imports.

But China and the United States are still inseparably linked economically. Sales of American products by its affiliates in China approached \$500 Billion. That's things like iPhones, Nike shoes and bottles of Coke. There are nearly 2,000 American affiliates operating in China, by far more than any other nation.

They also employ over 1 Million Chinese workers.

Affiliate sales in China are 3x larger than actual American exports to China. These are American products that are made in China. Success in China has long meant presence in China. What's more, US companies make far more from their affiliates in China than they do in any European country.

Presidents Biden and Xi had a breakthrough meeting last Fall. Tensions eased a bit. But there's not a lot of trust. President Xi could very well be leader for life in China. It's anyone's guess who will be in the White House next year. One thing is clear: America is staying tough on China.



Banning Chips

America has taken the lead in this Digital Age. Innovation is the key. The US has been restricting sales of advanced semiconductors to China over national security concerns. Beijing has been trying to replace foreign technology in sensitive operations with local brands. Chinese officials ordered an iPhone halt. Government employees can't use them at work.



In response to America's chip ban, China has adopted guidelines to stop the use of American-made microprocessors from Intel and AMD in government computers and servers. China also plans to replace Microsoft Windows and foreign-made database software with domestic alternatives. The problem for them, those alternatives simply aren't as good. China is racing to play catch-up in the Digital Age. But the nation is struggling to lead and innovate without American IP (intellectual property).

Strength Overseas



This has been quite a Bull Market run. It's not just the United States that is experiencing all-time highs for its Stock Market. It's been felt around the globe. Europe is seeing all-time highs. Emerging Markets, led by India, also at a record high. Even Japan is at record highs.

After 34 years, the Japanese Nikkei finally reached new, all-time highs. How about this for perspective: The Giants and the A's were in the World Series, while the Bay Area recovered from the earthquake in October of 1989, the last time the Nikkei was at these levels.

You know who is not at an all-time high? China is not. In fact, the Chinese Stock Market is closer to a multi-year low. The Market has been pretty clear what it thinks about the Xi regime. China is struggling.

Mountain of Debt

America has \$34.6 Trillion in debt and counting. That's over \$100K per citizen. It's never been that high. Debt to GDP is 123%. We owe far more than we earn. The cost to service it is \$1 Trillion and climbing. The average interest rate paid on the debt is 3.26% as of March. For perspective, the interest rate was 1.2%, before the aggressive Fed rate hikes ensued.

The massive mountain of debt with little evidence of plans to reduce it will ultimately matter. The Bond Market has shown some signs of stress in the back end of the yield curve. There isn't a lot of demand for long-term maturity Treasuries. At least the government will be funded through the fiscal year.



Bond Market – Navigating the Yield Curve

Investors are able to get 4-5% yields staying in the front-end of the inverted yield curve. The lower demand is likely one of the reasons that the Treasury Department is focusing its issuance duration short. It doesn't want to trigger a big move on the back end. So, staying short is keeping the back-end yield firm around 4.5% on 30-Year maturities.



The bet is the big move will come at the front-end when the Fed cuts. That would lead to the desired steepening of the yield-curve while lowering borrowing costs, not increasing them. We continue to navigate the yield-curve nimbly. At this point, we plan to extend our duration out a few years before the Fed's expected cuts this Summer. For now, we prefer Treasuries and high-quality Corporates.

Broadening Out

The big story for the Market heading into Q2 was the heavy rotation of leadership. The rally has spread across asset classes. The stocks that lagged for much of Q1 finally caught a bid while momentum and growth factors, mainly Tech, surrendered some of their outperformance. Materials, Energy and hard assets have responded well. Aerospace and Defense look really good to us in this environment. Both Gold and Bitcoin have surged to all-time highs too. It's a Bull Market for assets.

All of the 11 S&P 500 sectors were green in Q1, except for Real Estate. The timing of the rate cuts, which was a chief concern last year, has become less of a concern this year. Real Estate is very rate sensitive. Rates might just stay higher for longer. One influential Fed representative said the risk of waiting longer to ease is significantly lower than acting too soon. The Fed does not want to risk stoking more inflation.

Next Up: Earnings Season



The next focus will start shifting toward Earnings Season. Company report cards get released starting in April. The Street is estimating S&P 500 earnings to increase nearly 3.5% from last year. That would mark the third straight quarter of earnings growth. That said, companies have shown signs of caution. Q1 guidance trends from Q4 earnings season leaned negative. Of the 110 companies that provided guidance for Q1, 78 lowered expectations. The 71% negative guidance rate is worse than the 5- and 10-year averages. Big Tech have been the outsized drivers of growth. AI is once again expected to be the key theme.

Stellar Start – Long Road Ahead



It's been a stellar start. The S&P entered April up 10% on the year. According to Dow Jones Market Data, when the S&P 500 climbs 8% or more in Q1, the rest of the year goes well for investors. There's been an average advance of 9.7% in the following 3 quarters. That said, a breather is more than due. There has not been even a 2% selloff in over 100 trading days. That takes us back to October. An up-stretch like this has only happened 7 times since 1950. This is quite rare.

The Market was running pretty hot heading into Spring. We could see a cooling off period before another run higher. It's not a stretch to say volatility is likely to pick up as we head towards Summer. A lot of good stuff has been priced in from this rally. The Presidential election is heating up and we anticipate the road ahead to be quite bumpy. This Bull still seems healthy. It's just getting mature. And the next stretch could definitely be a challenge.

To view past Quarterly
Newsletters,
visit our website at:

BedellFrazier.com