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VIEWPOINTS

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IN THIS ISSUE OF VIEWPOINTS, THE THEMES AND DRIVERS OF A TINDERBOX YEAR: 2024

Happy New Year from all of us on Mill Street. 2024 is set to be a unique and challenging year that will no doubt be full of surprises. A highly divisive election coupled with two global conflicts in a "higher for longer" interest rate world creates a frothy set up for proverbial fireworks in some fashion. Warren Buffet has famously never paid attention to market sentiment unless the market is at extremes in either direction (Chart 1), and these extremes, whether overly bullish or bearish, can frustrate market predictions with all manner of delays.

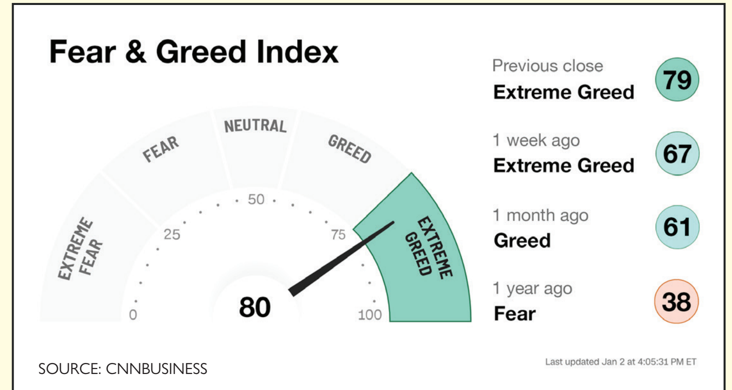

CHART 1

Market resilience in 2023 has lasted much longer than we and most other economists expected largely due to the overwhelming Federal outlays including direct payments to citizens under the guise of COVID Stimulus, the more recent ERC (Employee Retention Credit) program incentivizing businesses to prop up the jobs market, and the vast expenditures from the poorly named Inflation Reduction Act. Despite all of this, both corporate balance sheets and individuals' bank accounts are under significant strain at this point, with strong macro headwinds heavily signaling that a recession is imminent, if not already here.

We tend to think about investing not in terms of the calendar year, but rather within the context of market and economic cycles. Full cycle investing involves intentional asset allocation to protect against major drawdowns that are exceptionally difficult to recover from. As it happens, the current market cycle had its root at the very start of 2022 with the peak in prices of most global assets that ultimately resulted in a serious bear market for the balance of that year. As noted in Chart 2, despite a year of exceptional returns in 2023, most asset classes were unable to claw back the immense losses from that peak in 2022. With this in mind, the aforementioned extreme sentiments, as well as leading recessionary indicators flashing red, highlight the importance of a defensive asset allocation moving forward as an inevitable downturn spans the globe in coming months.

High inflation has been painful for consumers for the past couple of years. If the current administration is to be taken at their word, then we have seen peak inflation, with the Fed engineering an unprecedented and seamless "soft landing" - little to no jump in unemployment, while curbing discretionary spending with never-before-seen precision. We are especially skeptical of this view, particularly during an election year where political motivations for maintaining the status quo can take precedence over facts. In prior *Viewpoints*, we have mentioned that the current macro environment is eerily similar to the 1970s, which had multiple inflationary troughs and peaks before being tempered. Instead of Baby Boomers, "Guns and Butter", Glamour stocks, and Vietnam, today we have Millennials, ESG (Environmental, Social, and Governance) initiatives, a pandemic, Ukraine & Israel, and AI mania. As Chart 3 shows, the reward for prematurely claiming victory over inflation in the 1970s was a subsequent decade of combatting even more stubborn inflation.

2023 Returns Vs. 2022/2023 2 Yr. Returns Incorporating Bear Market Drawdown

Exposure	2023 *	2022-2023 *
U.S. Dollar (UUP)	+4%	-3%
Gold (per Troy ounce per Gold Council)	12%	+12%
Oil (West Texas Intermediate, per barrel)	-10%	-3%
Bitcoin (BTC)	+158%	-10%
Ethereum (ETH)	+98%	-37%
Long-Term Treasuries (TLT)	+3%	-29%
U.S. Large Cap Stocks (SPY)	+26%	+2%
U.S. Small Cap Stocks (IWM)	+18	-7%
U.S. Technology Stocks (XLK)	+56%	+12%
U.S. Regional Bank Stocks (KRE)	-6%	-23%
Chinese Large Cap Stocks (FXI)	-15%	-32%
Japanese Large Cap Stocks (EWJ)	+19%	-3%

* **Approximate** total return through 12/28/23. Raw return data drawn from FactSet.

SOURCE: HEDGEYE

CHART 2

Geopolitics and oil are also at the forefront of our minds heading into 2024. Ongoing conflicts in Ukraine and Israel have led to an altogether more unstable world, where Globalization may be a notion of the past. These two wars are slated to be long and cumbersome conflicts that have the potential to escalate into global affairs. Oil is historically both a bargaining chip and a hostage between Western powers and the Middle East during uncertain times. Given the ongoing conflicts, sources at the highly regarded BCA Research have pegged the odds of an unexpected oil shock around 50%. In this late stage of the economic cycle, along with President Biden's indication to refill our highly depleted Strategic Petroleum Reserve

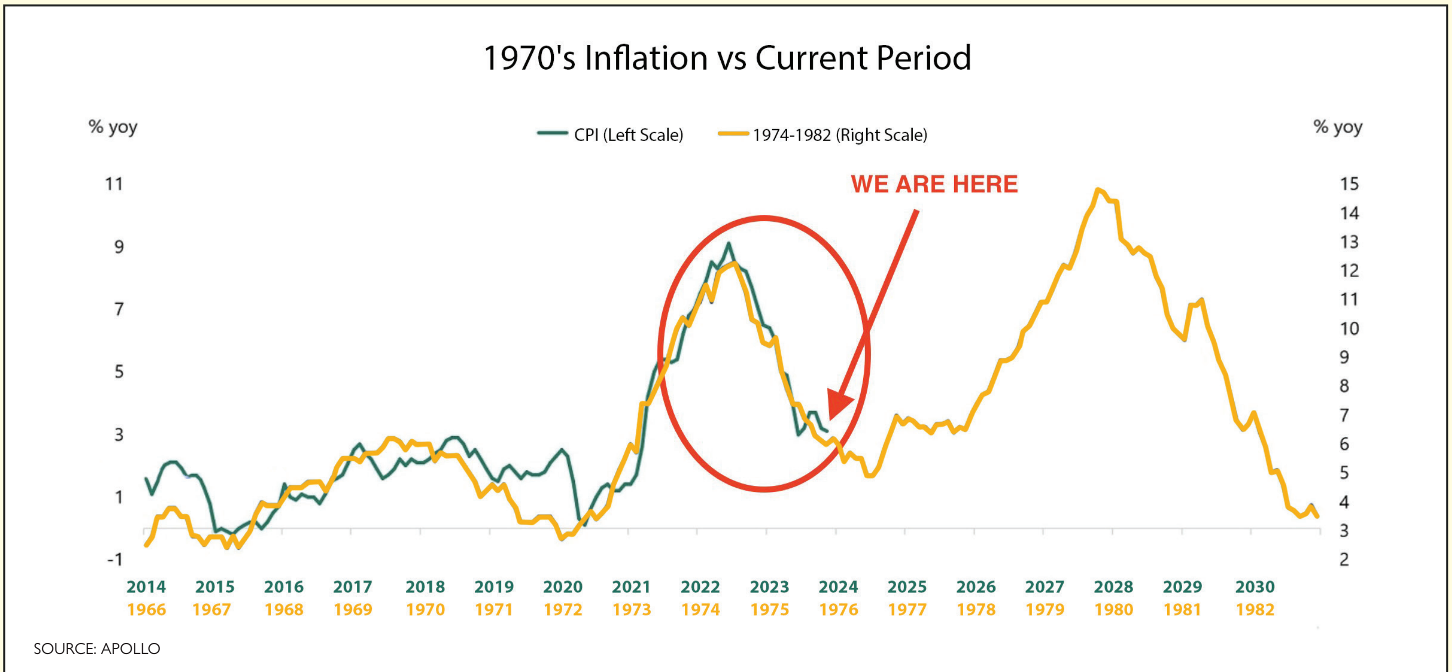

CHART 3

at $79 per barrel, an extremely high floor has been placed under the price of oil for the foreseeable future, despite potential waning demand due to a recession and overblown EV (electric vehicle) hype narratives. As such, we have positioned portfolios to appropriately preserve capital under an array of outcomes.

Our preference for long-term quality companies, agnostic to "Growth" or "Value" designations, allows us to seek, buy, and hold the stocks of companies with proven market leadership that have displayed resilience over the course of multiple business cycles. Our specific attention to valuations ensures that we stay away from the market manias that often disintegrate as reality sets in that these companies will not be able to meet the unrealistic expectations that euphoric sentiment has priced in. As we enter uncharted territory in the United States with a looming National Debt issue (Chart 4), the yearly interest expense is now greater than the entire defense budget and will surely require bipartisan austerity. In addition to a changing world order which is resulting in de-globalization, our emphasis on companies with strong balance sheets, fundamental strength, and a propensity to pay and increase dividends on a regular basis, positions us well to preserve capital for our clients over the long run. In addition to our equity portfolio, we have capitalized on opportunity in the shorter end of the treasury issuances in recent months. While maintaining a healthy cash reserve, currently yielding around 5%, we can be nimble and opportunistic to go discount shopping for quality names both in the equity and bond markets.

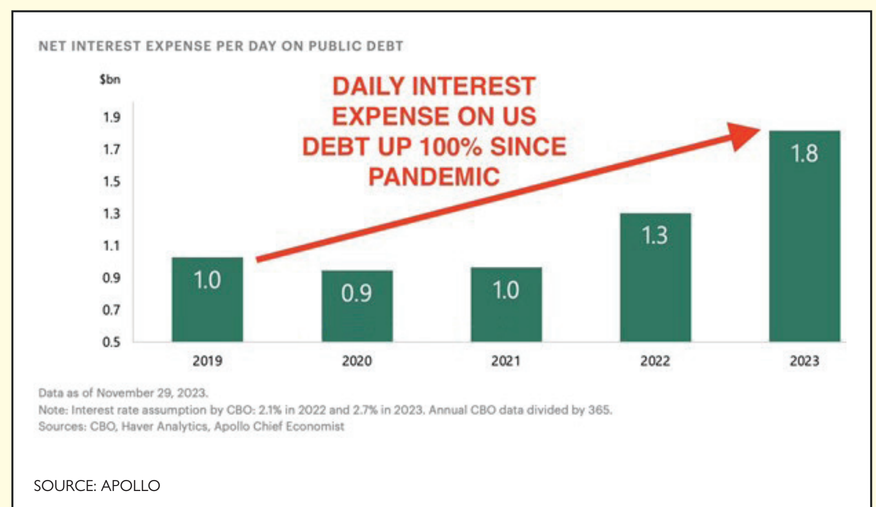

CHART 4

> "Time is your friend, impulse is your enemy."
> John C. Bogle, Founder of Vanguard

IN CONCLUSION

The new year appears to be a tinderbox waiting for a spark. With a recession on the horizon, a highly contested election setup where the winner will be in an unenviable position, and the Fed having an impossible decision to make between killing inflation or killing the economy, intentional asset allocation will be critical this year. The Fed is almost certainly going to cut rates at some point, with the markets speculatively betting on March and a very ambitious 6-7 rate cuts thereafter. The real challenge will come when lower interest rates reignite demand for commodities and real estate, reimagining the 1970's destabilizing double top in inflation and interest rates. Mark Twain's oft quoted "History doesn't repeat itself, but it often rhymes" seems to be cautionary advice in an uncertain world.

Best Wishes in the New Year.

Michael P. Moeller
Portfolio Manager and Research Analyst

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