From Inflation Fears to Rate Cut Hopes

Quarterly Investor Letter

Date: July 18, 2024

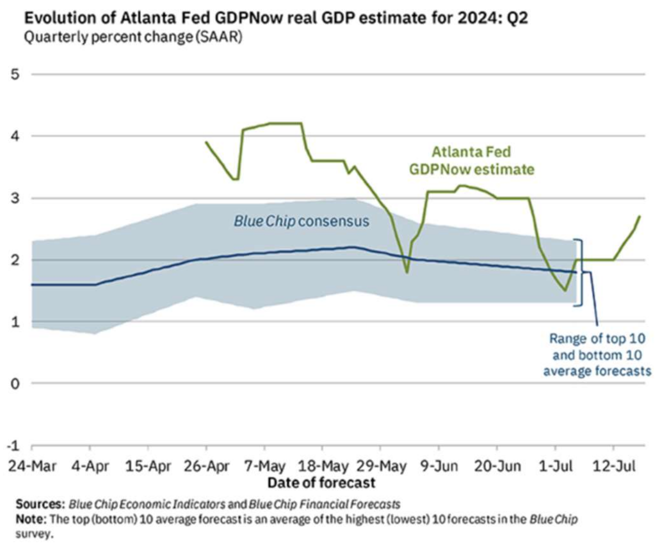
Dear Valued Investor,

We are pleased to present our quarterly letter, detailing our perspective on the current economic landscape and our strategic approach to managing your investments. As always, our commitment is to navigate the complex financial markets with prudence, guided by a long-term value investment philosophy.

1. Macro Outlook in Q2-2024

The macro-economic indicators that we track present a mixed yet intriguing picture. Forward-looking leading indicators within the US economy signal a notable slowdown ahead. Despite this, coincident indicators, which reflect the current economic activity, continue to demonstrate robustness. Specifically, metrics such as retail sales, housing, auto sales, and the wealth-effect remain strong, showcasing resilience in the present economic environment. The Atlanta Fed GDPNow estimates the US Q2 GDP to be at 2.7% above consensus expectation (*see below*).

GRAPH 1 – ATLANTA FED GDPNow at 2.7% for Q2



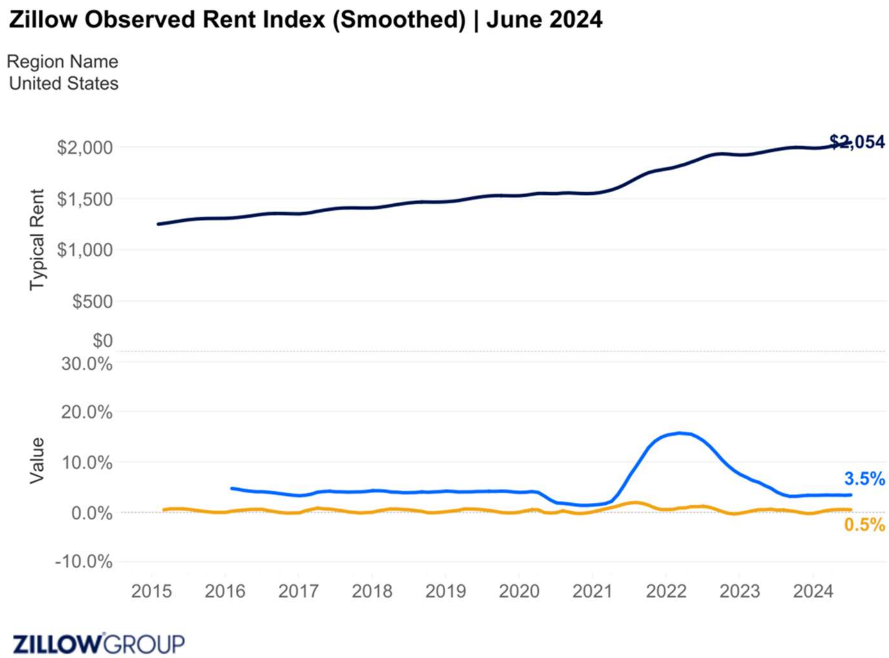
Consumer spending and housing market activity have experienced deceleration, yet they remain at levels that underscore underlying growth. Importantly, while these indicators suggest a decelerating economy, they do not point towards an imminent recession. The resilience observed in consumer spending and the housing market provides a buffer, supporting continued economic stability.

2. Inflation and Interest Rates

Inflation expectations are currently well anchored, with the Consumer Price Index (CPI) trending downwards towards 2.5%. This trend is supported by signs of moderating growth in wages and rents, indicating a broader easing of inflationary pressures. Rents nationwide are now growing annually at a rate (3.5%) lower than pre-pandemic.

GRAPH 2 – ATLANTA FED WAGE GROWTH TRACKER

GRAPH 3



Interest rate projections have undergone significant adjustments. At the end of 2023, the market anticipated as many as six rate cuts; however, current expectations have moderated to one or two cuts.

Should inflation continue its downward trajectory from 3.3% to 2.5%, we may see higher real interest rates (nominal rate minus inflation), which could prompt the Federal Reserve to consider rate cuts earlier than initially expected in the second half. Notably, several foreign central banks have already commenced rate cuts, setting a potential precedent for the Fed's actions.

We expect the first rate cut to occur in September. This expectation is primarily based on two key factors: the ongoing deceleration of inflation and economic growth, and the current Fed Funds rate being approximately 1% above their neutral level.

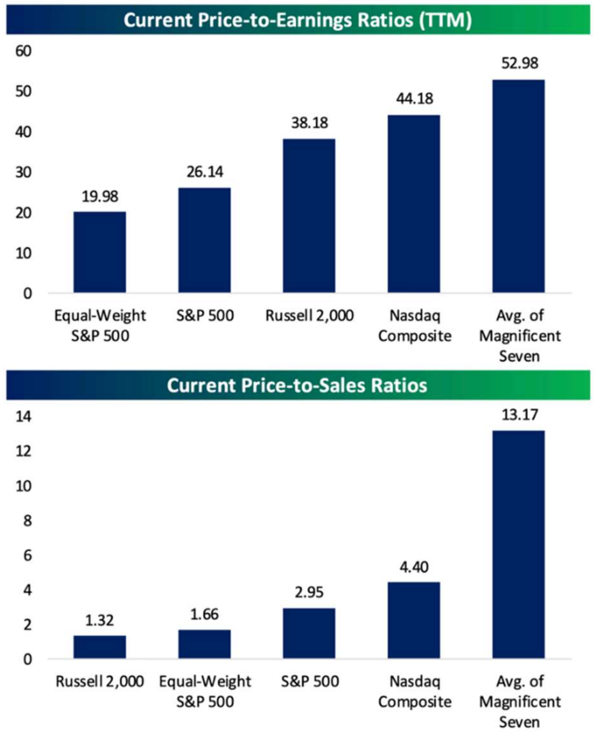
According to CNBC, traders are now pricing in a 100% probability of a rate cut in September, based on fed funds futures trading data. This market sentiment is bolstered by Fed Chair Jerome Powell's comments, which Reuters reports as suggesting that interest rates could be cut as soon as September if the U.S. economy follows its expected path. The Fed's apparent shift from being "*highly attentive to inflation risk*" to being "*attentive to the risks to both sides of its dual mandate*" further reinforces the view that the central bank is preparing to pivot from its inflation-fighting stance to a more balanced approach, potentially supporting economic growth through rate cuts.

3. Equity: Valuations, Trend, and Momentum

Equity valuations remain elevated, with the S&P 500 Forward Price-to-Earnings (P/E) ratio standing at 22 times earnings. This is relatively high when compared to historical averages and current US Treasury rates, which are at 4.3%. The Bespoke Investment Group, however, does an excellent job at illustrating the wide valuation discrepancy between the "Magnificent 7" and the remaining 493 stocks included in the S&P500 Index.

An equal weighted version of the S&P500 index displays a P/E ratio that is 6 turns lower than the market capitalization weighted S&P500 index P/E and a P/S valuation that is nearly half.

GRAPH 4 – EQUITY VALUATION MULTIPLES (BESPOKE GROUP)



Despite these elevated valuations, trends and momentum in equity markets remain solidly positive, indicating sustained strength and investor confidence. As we have repeatedly said in the past, equity valuations are a terrible market timing tool. Conversely, market "technicals" (trend and price momentum measures) may be more insightful.

4. Geopolitical Risks

Geopolitical tensions continue to be the primary source of risk in the current environment. These tensions are reflected in the rising prices of gold and other commodities, as investors seek safe-haven assets amid uncertainty. The Middle East may be on a brink of a major regional war. We remain vigilant in monitoring these developments, understanding their potential impact on global markets and investment strategies.

As the US elections loom on the horizon, many are asking themselves if portfolio changes are warranted. History shows that over a longer time horizon, US election results are largely inconsequential for equity markets.

5. Asset Allocation Recommendations

Equities

We recommend maintaining full exposure to equities, with a particular focus on growth stocks and US equities. The positive trends and momentum, coupled with robust corporate earnings, support our confidence in this asset class. Our strategic emphasis on growth stocks is driven by their potential for superior returns in the current economic landscape. The AI story that started in October of 2022 continues to be one of the main drivers of investment returns.

Fixed Income

In the fixed income space, we observe that credit spreads are currently too tight. As a result, we recommend reducing exposure to credit-sensitive fixed income assets. Instead, we advocate for a focus on the short and intermediate end (1-5 year) of the US Treasury yield curve. These positions offer a more favorable risk-return profile in the current environment.

Mortgage-backed securities (MBS) present an attractive opportunity, given their potential for a boost in a scenario of lower interest rates. We advise considering allocations to MBS as part of a diversified fixed income strategy.

Yield Curve

We anticipate that rate cuts will coincide with a bull steepening of the yield curve. Our estimated equilibrium level for the 10-year US Treasury yield is between 3.3% and 4.3%. This steepening is expected to present opportunities within the short to intermediate segments of the yield curve, reinforcing our strategic focus on these maturities.

Real Estate Investment Trusts (REITs)

The REIT sector warrants a reevaluation in light of potentially lower interest rates. Lower rates can enhance the attractiveness of REITs, as they typically benefit from reduced borrowing costs and improved property valuations. We will closely monitor interest rate movements and adjust our exposure to the REIT sector accordingly.

6. Conclusion

In conclusion, despite signs of an economic slowdown, the current market conditions and indicators support maintaining a strong position in equities, particularly US growth stocks. We will continue to pay close attention to interest rate movements and geopolitical developments, adjusting our fixed income exposure and reevaluating the REIT sector as necessary.

Our approach remains rooted in a long-term value investment philosophy, emphasizing careful analysis and prudent decision-making. We believe this strategy will continue to serve our investors well, navigating the complexities of the market while seeking to achieve sustainable returns.

Thank you for your continued trust and partnership.

Sincerely,

Livian & Co. team
Lehmann Livian Fridson Advisors team