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Q2 OUTLOOK: WHY INVESTORS SHOULD COURSE CORRECT MORE FREQUENTLY

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It was 7 a.m. on June 28, 1927, when pilot Lester J. Maitland and his navigator Albert Hegenberger climbed into The Birds of Paradise, a Fokker C-2 Trimotor, and took off from an airfield in Oakland, California. They banked south, passing the Golden Gate strait—construction on the bridge wouldn't start for six more years—and heading out west over the vast Pacific.

Their destination was Oahu and the record books—this was to be the first flight ever from the mainland to Hawaii. It was a feat of endurance and navigation. In those pre-GPS days, Hegenberger navigated using a radio beacon and a sextant, making constant adjustments to hit Oahu. When the beacon and radio compass both failed, he relied on an azimuth and magnetic compass to navigate through dead reckoning; the same method Columbus used over four centuries earlier. After flying all night Maitland and Hegenberger landed in Hawaii to a cheering crowd of thousands, a booming artillery salute, and a strong desire for breakfast—they had forgotten to pack any food for the 26-hour trip.

Small deviations, if left uncorrected, can be disastrous. A plane that is just one-degree off course will drift one mile from its final destination for every 60 miles of flight. In other words, if The Birds of Paradise was off by just one-degree they would have missed Hawaii by 40 miles. Hence the importance of Hegenberger's constant course correction.

Why don't investors course correct more often? There is an array of cognitive biases that entrench the status quo. Investors become overly attached to current positions when there are better options; they are slow to react to new information and then hesitant to exit trades, especially ones showing a loss. Even if we start with a perfect portfolio, adjustments are necessary. A 60/40 portfolio may have been ideal in 1990s but today, it's out of date, lacking alternatives, crypto, or private market assets such as private debt, private equity, and private infrastructure.

Even Warren Buffett—whose favorite holding period is "forever"—makes significant shifts in his portfolio. In 2020 he was a big holder of banks and airlines, neither of which are in his portfolio now. Not every strong wind should result in changes (see our volatility section below for why you wouldn't want to change your investment strategy for the upcoming U.S. elections), but investors should keep in mind that no matter how well a portfolio was initially constructed, there might now be better options.

With an election looming, we will look at what investors should be watching for the rest of 2024. But first, a review of Q1 economic and market performance.

Markets*

	As of 3.31.2024	Q1 Return
S&P 500	5,254.35 pts	10.2%
NASDAQ	16,379.46 pts	9.1%
The Dow	39,807.37 pts	5.6%
Global Equities		11.0%
Emerging Markets		2.2%
Energy		12.6%
Gas	$3.97/gal	8.5%
Gold	$2,229.87/oz	8.1%
VIX	13.01 pts	4.5%
10-Yr Treasury	4.200%	32.1 bps

**See endnotes.*

Alternatives*

	Q1 Return
Direct Lending	5.5%
CLOs	4.3%
Private Equity	6.0%
Hedge Funds	2.6%
Equity REITs	-2.1%
Residential REITs	-0.7%
Industrial REITs	-3.2%
Wine & Cheese	7.6%
Crypto Market	57.3%
SPACs	3.1%

**See endnotes.*

US Economic Performance – Unshaken, Unstirred: A Stable Economy Gives the Fed a License to Chill

- Inflation is still sticky. CPI rose 0.4% in March bringing the trailing 12 months to 3.5%. Shelter and energy costs drove the increase.
- The US Economy added 303,000 jobs in March, but unemployment remained below 4%.
- US GDP increased at an annual rate of 3.4% in Q4, down from 4.9% in Q3.
- Manufacturing momentum: In March, the ISM manufacturing index climbed above 50 for the first time since September, rising from 47.8 in the previous month.

Monetary Policy – Rate Restraint: The Fed Holds Steady

- Although inflation has started to recede, the FOMC wants to continue to see more positive data before they cut rates. The market is still pricing in three cuts for 2024 (see chart below).
- Patience is a virtue. The bond market sees a 56% chance the FOMC will a cut by June, according to CME.
- Mortgage rates are back up. The average-30 fixed mortgage rate increased to 7.22% at the end of February due to the change in expectations of the Fed Rate cuts for 2024.
- Not too hot, not too cold: A strong US economy has allowed a slower approach to rate cuts and an increasing likelihood of a goldilocks scenario.

Credit Market Performance - Loan Rangers: Private Credit's Frontier Expansion

- The Federal Reserve estimated that the private credit market has reached nearly $1.7 trillion, compared to $1.4 trillion for leveraged loans and $1.3 trillion for the high-yield bond market.
- Credit markets held up in Q1:
  Investment Grade: -0.4%
  Leverage Loans: +2.5%
  High Yield: +1.5%
- Debt issuance surged in Q1 with new leveraged loan volume hitting $25 billion in Q1, just shy of the 2021 record.
- Preqin has forecasted an average IRR of 9.8% for private credit from 2022 to 2028, with more than half of current private credit investors going to increase their allocation to the asset class.

US and Global Market Summary – Bit by Bit Crypto Stages a Comeback

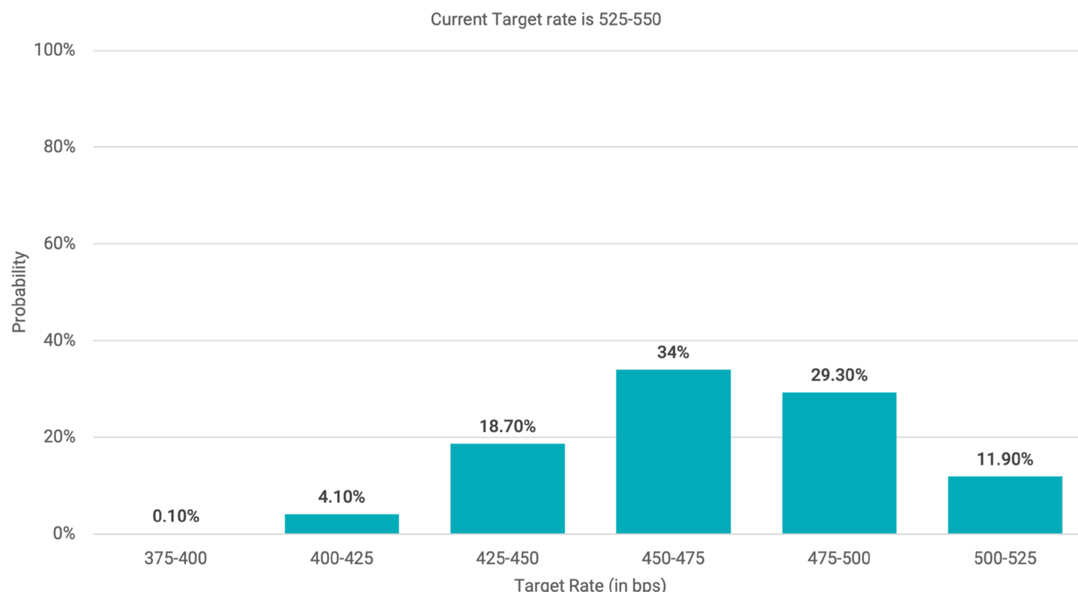
- The bulls keep charging. The S&P 500 had its best start since 2019, gaining more than 10% in the quarter. The NASDAQ finished up 9.1%. The Dow finished up 5.6%.
- Crypto is cool again. Bitcoin experienced its largest gain since December 2020, seeing an astonishing 69% increase in Q1 from $42,200 to $71,300. Bitcoin ETFs have raked in more than $20 billion since they started trading in January.
- Ethereum experienced a similar jump with a 57% increase bringing its price from $2,300 to $3,600. This was partially driven by speculation of a Ethereum ETF in the near future.
- Global private infrastructure funds ended 2023 with $328.9 billion in dry powder available for investment, up 4.8% from the prior year's $313.9 billion, according to Preqin data

A strong start to the year with some rocky roads ahead. Rates may contract this year. Investors looking for stability and yield are increasingly turning to alts.

The Fed Will Only have Limited Market Influence Until the Election

At the start of January, a mere three months back, rate cuts by May appeared to be all but certain. Futures markets were pricing in just a 1% chance that May rates would stay at 5.25-5.50%. At the same time, there was a 65% chance of the rate declining to the 4.75 – 5.00% level. As of early April, May futures are pricing in no rate change with 99% certainty. Yet, the stock market has surged

Target Rate Probabilities for 18 Dec 2024 Fed Meeting



Source: CME Fed Watch Tool, based on 30-Day Fed Funds Futures Pricing data as of April 9, 2024

The S&P 500 was up over 10% in Q1 with no rates cuts done or pending. It turns out that financial markets didn't need rate cuts after all. The strength of the underlying economy has overcome the gravity of higher rates. It might not be the vibe but the economic data remains healthy with low unemployment, continued economic growth, and almost no increase in defaults. These things were not supposed to happen during an extended period of higher rates.

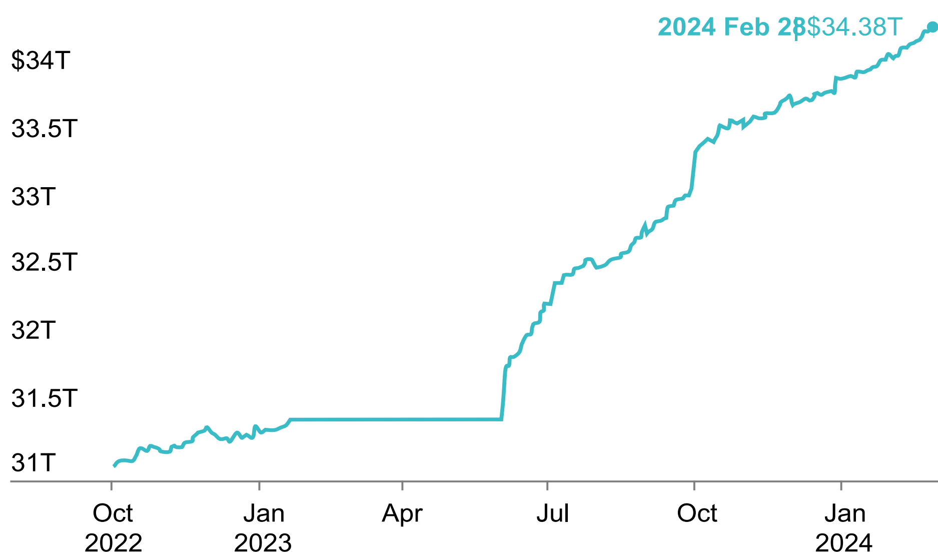
All of this good news is encouraging the Fed to hold off on rate cuts as long as possible to ensure the inflation beast is cold and dead. The Fed's message is clear: until something breaks, don't expect rates to materially decline.

We Need to Talk About Debt

From a fiscal perspective, rates cuts are an eventual necessity, with the word eventual doing a lot of work. U.S. national debt keeps growing and so does interest expense. The percentage of the federal budget that interest consumes grows faster than nearly every other category of spending. Everyone agrees that this is not sustainable. The US will have to either cut the budget, increase taxes, or inflate away the debt.

Right now, there is no political momentum to reduce the deficit. There is also no appetite from the populace to suffer what budget cuts or higher taxes entail. No interested party has an incentive to change, so none will. No one expects budget cuts during an election year. The national debt, now at $34 trillion, will continue to increase by $1 trillion every 100 days. (By contrast, to win WWII the US spent $4 trillion, adjusted for today's dollars.) US debt numbers are staggering, growing, and not yet near their limit.

Total Debt of The U.S. Government



Source: U.S. Treasury Department

Based on current GDP and interest rates, the US is not nearly as leveraged as it could be. The all-time high of interest on debt vs GDP was in 1991 with 3.2% of GDP consumed by interest alone. Currently that number is at 2.4%. At current borrowing rates, we will surpass 3.2% in 2025 as lower interest rate treasuries roll over and debt continues to increase.

Poll Position: Navigating the Volatility of Election Season

Investors have no fear. At least that's what the persistently low levels of the volatility index, the VIX, seem to suggest. Volatility has remained below its long-term average of 20 for most of 2023 and year-to-date in 2024. Despite interest rate uncertainty and mushrooming geopolitical issues, the VIX stays low and steady.

Investors anticipating an increase in volatility due to the presidential election have history on their side. Historically, the VIX is slightly elevated in presidential election years according to research by Stifel which assessed the previous eight presidential elections. But the annual change is moderate. The VIX averages 20.7 during those years vs. 19.4 otherwise. More relevantly, the VIX typically surges from September to October, up 25% during election years.

Regardless of the outcome, investors should not make any rash moves. The research revealed no persistent pattern of sector winners and losers. The overall result was that returns post-election were positive. In 7 of 8 of the last elections, in the six-month period after an election, the S&P 500 performed better than before the election. The average six-month return was 7.6% compared with less than 1% prior to the election. The one exception, it should be noted, was in the 2000 aftermath of the dot-com bubble burst.

Adjusting for the Future

If you fly from New York to Paris and miss, you'll still land safely in Europe. If you fly from California and miss Hawaii, you'll run out of fuel and die. When Maitland and Hegenberger made history, the wings were wood and the men were iron. Course correcting for them was an existential matter.

For investors, failing to update a portfolio can make the difference between a comfortable retirement and just getting by. Why are investors so hesitant to change? At times it's due to embarrassment. Instead of seeing changes as a better way to invest, some investors see changes as an admission of a mistake. Think like Hegenberger: course correcting happens even with perfect starting conditions. The world changes and we must change with it. These days institutions are increasing allocations to alternative assets such as private credit, private equity, and infrastructure. Investors should view corrections as adjustments that help reach an intended destination and not a sign of an error.

Endnotes

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"Crypto Market" represented by the Bloomberg Galaxy Crypto Index. "NASDAQ 100" represented by the NASDAQ 100 Index. "S&P 500" represented by the S&P 500 index. "Private Equity" represented by the Invesco Global Listed Private Equity ETF. "Direct Lending" represented by the DLX Direct Lending Index. "US Residential REITs" represented by the MSCI US Residential REIT Index. "CLOs" represented by the Palmer Square CLO Debt Index. "Leveraged Loans" represented by the S&P/LSTA Leveraged Loan Total Return Index. "High Yield Bonds" represented by the Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged. "Gold" represented by the SPDR Gold Shares. "Emerging Markets" represented by the iShares MSCI Emerging markets ETF. "Investment Grade Bonds" represented by the Bloomberg US Corporate Bond Index. "Hedge Funds" represented by the Bloomberg All Hedge Fund Index. "Equity REITs" represented by the MSCI World Equity REIT Index "Financials" represented by the Financial Select Sector SPDR Fund. "Telecom" represented by the iShares US Telecommunications ETF. "Utilities" represented by the Utilities Select Sector SPDR Fund. "Commodities" represented by the Invesco DB Commodity Index Tracking Fund. "Oil" represented by the United States Oil Fund LP. "VIX" represented by the Chicago Board Options Exchange's CBOE Volatility Index. "Natural Gas" represented by the United States Natural Gas Fund LP.

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