STRATEGIC OUTLOOK

Strategic Frontier Management

Q2 2024

Wherefore Art Extinct or Endangered Species?

In our latest outlook we ask has anyone seen the allusive fundamental value investor? We still believe that intrinsic value of earnings yield, dividend yield or book value should drive investor decisions. Yet, sentiment and momentum seem to have had an outsized influence for well over a decade. We commented last quarter that it is feeling a whole lot more like 1999-2000 just prior to the Dot.com bubble bursting than any other time since.

Could it be that markets seem to reward activities that extract value rather than create value, as transparent as earnings or book value? Value and small-cap equity lagged so substantially for so long that there must be something extraordinary at work—these Endangered Species (fundamental investors) that historically benefited from basic risk premium tailwinds of value and size seem to be on the verge of extinction.

To ensure capitalism works requires scrutinizing the way economic value is created or derived. Transparency has been blurred in the pursuit illiquid private assets—but creates illusions of value in mergers, acquisitions, and other means that confuse rent-seeking activity with economic profits. Dependency on subsidies or other government support has distorted risk and the cost of capital, but also boosted growth as measured in GDP by hiring government workers and spending taxpayer money to bolster demand. We need to rethink the cost and impact of inefficient public policy, if not redefine how to measure value. Reindustrialization or *Rewilding of America,* as we've discussed, is a key theme for an economic recovery from current stagflation.

Many have become fixated on the inflation rate, yet price levels have risen over 19.5% since January 2021. Over the last 25 years, CPI inflation has averaged 2.5%, which would generally imply prices up 8.5-9.0 in contrast—so inflation has been more than double a reasonable rate.

Disinflationary effects of *Fourth Industrial Revolution* are moderating, although productivity of Artificial Intelligence initiatives already extended this a few years. Declining share of cheaper imports also will sustain inflation, particularly from China and other Emerging Markets with diminishing comparative advantage in labor, energy, and material costs with increased reshoring and automation. Anticipated economic hangover is visible now with fiscal spending and monetary cliffs ahead, as excessive U.S. government hiring should stall.

Unleashed higher inflation expectations and new found pricing power will be difficult to contain as higher wage increase persist, but still lagging behind higher cost of living. There is still a housing shortage keeping inventory low and prices higher given a surge in household formation among Millennials (post-1990 births) that deferred home ownership for the last 5-10 years, but now observe rising mortgage rates and continued price increases. Then there is the issue of global energy price inflation, which affects everything and unlikely to fall much given the policy of transitioning away from fossil fuels. *Magical Thinking* of "endless" disinflation and "inconsequential" massive fiscal deficits compounding US Federal Debt is illusionary.

Investors in Government Bonds were devastated for the last three years (US10Ts Return: -5.7% A.R.), and over the last decade barely exceeded cash despite greater risk. Why should investors leap back into the long end of the yield curve now when Treasury Bills are yielding over 5¼%? The inverted yield curve seems to have already anticipated lower rates in 2025 – we think it has already overshot. So, why not stick to floating rate or short-term bonds with a little credit exposure for higher yield without interest rate risk. 10-year Treasury yields at 4% at best support a 2.5-3.0% Fed Funds rate. There isn't much room for the yield curve to do any more than steepen. There is not immediate reason to cut rates more than ¼% every other meeting---by end of next year we expect the policy rate to be 3.75-4.0% or lower by just 1.5% (or 6 rate cuts in 18 months).

Manipulating bond yields for so long combined with rising rates has led to a challenging market for fixed income investors. An inverted yield curve should limit demand for extending portfolio duration, yet investors would rather anticipate rate cuts time and again even as the Federal pushes out their horizon of rate cuts. We remain in the camp of higher for longer interest rates.

Economic Outlook

High inflation and aggressive monetary policy tightening in 2022 triggered one of the largest return drawdowns for a US 60/40 portfolio in the last 100 years, yet markets still tended to muddle along for most of 2023. On October 31st, US monetary policy experienced a radical pivot that

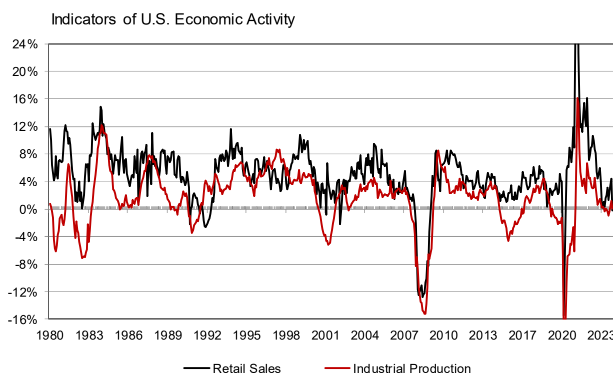
triggered a remarkable rally in large-cap growth that drove a stunning return to the S&P 500 for the last 6 months, but was this rational? Our view continues to be that the Fed would cut interest rates by ½% at most late in 2024 while unwinding its extended Treasury holdings.

We anticipated the now visible economic hangover with more fiscal spending and monetary cliffs ahead. If not for excessive U.S. government spending and hiring, as well as monetary stimulus, the U.S. economy would've likely slipped into deeper recession. Intermittent recessionary conditions in 2023 was a prelude to disappointing growth again in 2024. We forecast US real GDP of 1.8%, a rise in unemployment (4.3%) and CPI inflation averaging 3%, which is still well above the Fed's implicit target.

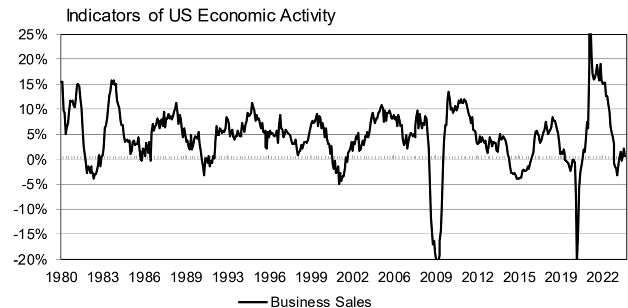
Economic Forecasts	**2020**	**2021**	**2022**	**2023**	**2024e**	**2025e**	**2026e**
GDP Growth (Y/Y Real)	-1.1	5.8	0.7	3.2	1.8	2.0	2.0
S&P500 Op Earnings Gr	-13.8	49.0	4.8	0.0	5.5	6.5	6.0
CPI Inflation (Y/Y)	1.3	7.2	6.4	3.3	3.0	2.8	2.5
Unemployment	6.7	3.9	3.5	3.7	4.3	4.5	4.5
Fiscal Deficit (vs.GDP%)	-15.5	-11.2	-5.4	-5.0	-4.5	-4.5	-4.0
Fed Funds Target[1]	0.25	0.25	4.50	5.50	5.00	4.00	3.50
10y Treasury Notes	0.91	1.50	3.83	3.87	4.80	4.50	4.00
S&P 500 Target	3756	4766	3840	4770	4800	5000	5500

1. Target denotes top of published ¼% policy target range
Source: Strategic Frontier Management (Year-end or Y/Y change)

The economic surprise of 2023 may be the resilience of U.S. Real GDP, indicating the economy skirted recession. It is surprising given the weakness in many other higher frequency economic variables such as growth in retail sales, industrial production, construction, business sales, and even earnings, which all indicate the economy experienced a recession in 2023. We'll discuss these in more detail below, but we conclude that without expanded government programs and hiring, real GDP growth would have been ~0%, if not flirting with recession. These next couple charts illustrate a clear economic decline in growth since early 2021 despite government spending more than an additional $3 trillion in uneconomic spending and expanded entitlements including a fillip to ACA or Obamacare. Given economic forces in 2023, we don't expect much difference in 2024.

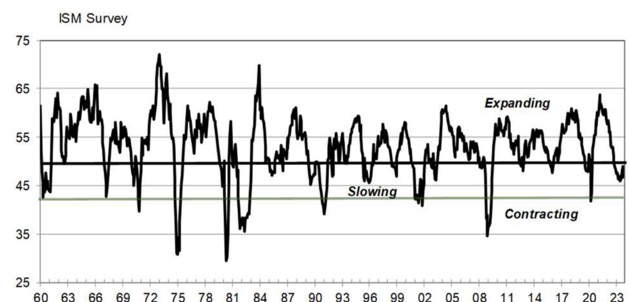


The private sector was in recession, so real GDP remains positive only by virtue of spending trillions by the U.S. government as the Federal Reserve boosted money growth and kept rates too low. If economic growth lags, then companies struggle to be profitable—of course, S&P 500 profits have languished over the first three years since President Biden began reversing major polices set in place by the prior Administration.



Real retail and business sales (net inflation) experienced recessionary conditions for over a year—even nominal retail sales and industrial production hovered near 0%. Since an economic growth peak in Spring 2021, real growth has declined to a negligible level. ISM dipped to 46.7 and was below 50 (slowing) since November 2022.

US Government spending bolstered an illusion of real growth and job growth, but we observed intermittent recession in 2023 with no real impetus for any better outcome this year—in fact, stronger headwinds. Higher interest rates and low-to-negative global money growth will limit global economic growth. Misguided US policies have reduced global competitiveness, potential growth and profit margins, resulting in lower nearly negligible U.S. earnings growth in 2022-2023, while triggering higher inflation. We expect persistent sub-potential economic growth without economic policy changes.

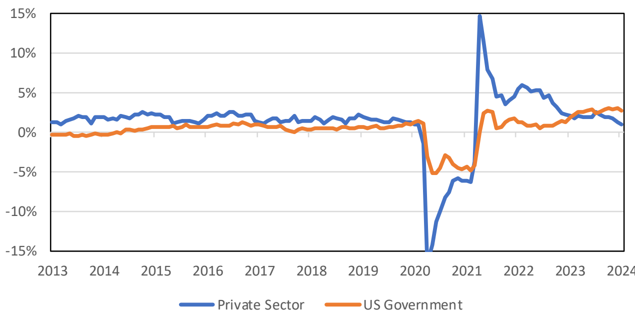


Source: ISM

The anticipated U.S. economic hangover is visible now with greater fiscal spending and monetary cliffs ahead as excessive U.S. government spending and hiring, plus monetary stimulus reverse. We expect lower potential economic growth of 1.8% or less. This could feel like 1970s stagflation, if not intermittent recession and lower productivity. Slower earnings growth with lower margins and productivity as QE holdings unwind with higher rates increase headwinds for the foreseeable future.

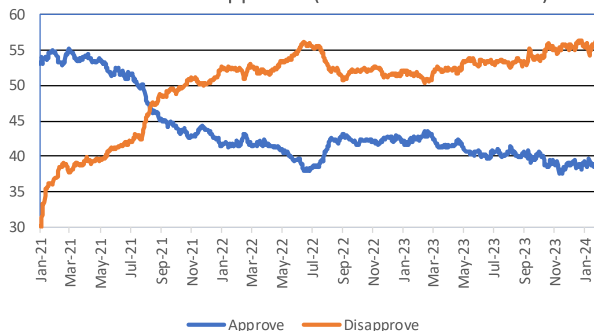
Given priorities of the progressive *Build Back Better* plan, which failed to become law, has now crept piecemeal

into various new fiscal programs and agency regulations or rulemaking, as well as Presidential Executive Orders. We observe unprecedented U.S. Government job growth rising from ~0% prior to 2020 to nearly 3% annually since January 2021. Job growth averaged ½% annually over the last 30 years, exceeding peacetime need. Private sector jobs have increased 1% per year, and similar to job growth observed last year. The U.S. Government is spending too much to bolster appearance of economic demand and job growth.



Source: Bureau of Labor Statistics

Bidenomics is an incoherent grab bag of new program subsidies and policies advancing special interests of the Democratic Party coalition that intervenes in free markets and unleashed the highest inflation since the 1970s. Magical Thinking assumed promoting clean energy jobs would offset adverse consequences of bad policies and social re-engineering. Belief in the theory government investment "crowds in" or bolsters co-investment from private companies is inconsistent with economic theory or precedent. Monthly U.S. Economic data on growth, earnings, and inflation reflect how Americans feel about the economy, mirroring the President's approval rating accounting for insufferable economic, fiscal, energy, and regulatory policies.

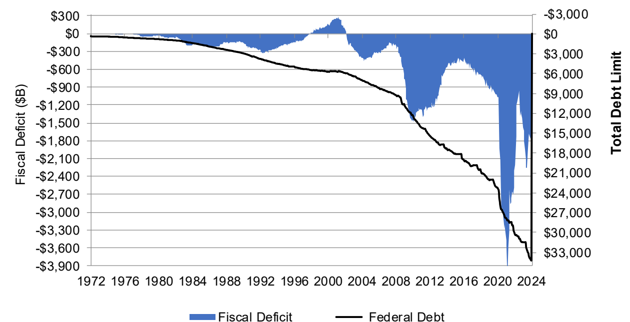


Source: fivethirtyeight.com

Election year approval ratings below 40% defined one-term Presidents, including Carter, HW Bush, and Trump. It didn't take long for America to figure it out since by mid-2022, given persistence of polling at this level, hopes of changing minds on the economy, immigration, fitness and health to serve, crime and violence, labor disputes, or foreign affairs and America's standing in the world is fading according to NBC and Gallup polls. No less than 86% of Americans think President Biden is already too old to serve four more years based on recent experience. This is devastating as Candidate Biden in 2020 promised to unify the country, not promote anger, violence, hatred, or division. What hasn't yet factored into his approval are potential impeachment charges related to political influence peddling, nor the criminal issue as a private citizen he retained and shared highly classified documents, removed as a Senator and Vice President.

The Administration also pressed for higher minimum wages, including imposing a $15/hour minimum for U.S. government contractors, or double the national minimum wage of $7.25/hr. This has widespread effect since a company seeking to contract with the U.S. Government cannot easily differentiate workers on a government contract from other work.

The fiscal deficit for CY2023 exceeded $1.78 trillion, yet we still don't have a budget for FY2024. With U.S. debt exceeding $34 trillion, conversations rarely mention the liability of $80 trillion in unfunded obligations from Social Security and Medicare, which is estimated to be 95% of unfunded US Government liabilities. Other unfunded liabilities are not insignificant, including Federal employee pensions, Pension Benefit Guarantee Corp. (corporate pension backstop, expanded SFA for multiemployer/union pensions under ARP), Savings and Loan Deposit Insurance (remember bank failures in 2023). Finally, there is about $1.5 trillion in unfunded state pension plan liabilities, including California ($300 billion) and Illinois ($211 billion).



Below we highlight the larger spending programs authorized during the Biden Administration.

<u>*American Rescue Plan (ARP)*</u>: March 2021 ($1.9 Trillion) – Administration claims it was one of the most progressive pieces of legislation in history, including providing $1,400 per-person checks (not credits).

<u>*Inflation Reduction Act (IRA)*</u>*:* August 2022 *($900 Billion)* – Energy and climate change subsidies or initiatives, plus three years of Affordable Care Subsidies.

Circumspect tax reforms, include: Corporate AMT, Buyback excise tax, plus 87,000 new IRS agents will undermine earnings growth hoping to boost tax revenue.

CHIPS and Science Act: August 2022 ($280 billion) -- Boost investments in semiconductor manufacturing capacity and thereby increase competitiveness and innovation.

Student Loan Debt Relief Jan 2024 ($132 Billion) – Previously authorized June 2023 ($430 billion) under HEROES Act to discharge federal student loan debt, but struck down by the Supreme Court.

US debt increased rapidly since 2020 ahead of now much higher interest rates. Interest burden on U.S. debt will soon exceed $1 trillion/year or more than Defense spending. U.S. Government Debt/GDP exceeding 120% and fiscal deficits over 5% of GDP are unsustainable without a correction in budget spending. CBO expects fiscal deficits exceeding $1.5 trillion to persist for years under current law. The difference between $27 trillion in debt held by the public and $34 trillion in U.S. debt are net of unusual QE holdings by the Federal Reserve.

CBO's Baseline Budget Projections, by Category

	Actual, FY 2023	2024	2025	2026	2025–2034
	In billions of dollars				
Revenues					
Individual income taxes	2,176	2,469	2,520	2,789	33,007
Payroll taxes	1,614	1,663	1,734	1,812	20,892
Corporate income taxes	420	569	494	491	5,094
Other	229	234	247	259	3,656
Total	**4,439**	**4,935**	**4,996**	**5,351**	**62,649**
Outlays					
Mandatory	3,753	3,838	4,061	4,246	50,999
Discretionary	1,722	1,734	1,756	1,791	19,231
Net interest	659	870	951	1,005	12,435
Total	**6,135**	**6,442**	**6,768**	**7,042**	**82,665**
Total deficit (-)	**-1,695**	**-1,507**	**-1,772**	**-1,692**	**-20,016**
Debt held by the public	26,240	27,897	29,749	31,515	n.a.
GDP	26,974	28,177	29,256	30,504	352,197

Inflation

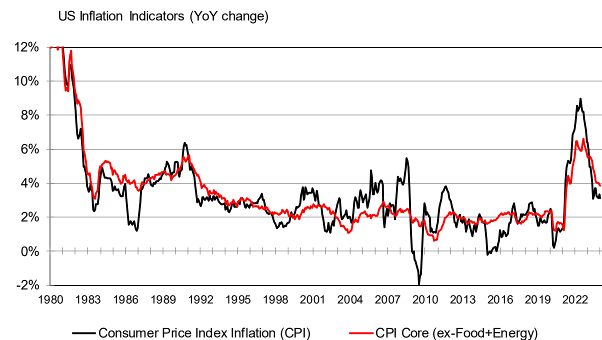
The hope inflation will continue to ease is wishful thinking in our opinion given forces driving labor, energy, and housing costs with higher inflation expectations. We could have avoided higher inflation expectations if not for excessive fiscal and monetary stimulus much beyond pandemic-driven support needed in 2020. The Fed was too late normalizing monetary policy, while the *Build Back Better* boondoggle, split between the *American Rescue Plan* and the *Inflation Reduction Act*, has proved costly in its prescribed policies for little benefit to society.

We expect CPI inflation to normalize around 3% (2.5% PCE equivalent) with heightened inflation expectations unleashed given policy-driven imbalances. Various forces that drove the initial inflation spike and now bolster this reversion to historic norms include: higher energy costs (regulation limiting fossil fuel exploration, production, distribution, and use), labor costs (higher inflation expectations), housing costs (greater household formation, limited supply), rising taxes (fiscal policies, including tax rates), interest costs (normalization, inflation risk premium), and receding globalization (ex: China's competitive advantages marginalized).

We expect hope of targeting 2% U.S. PCE inflation is unrealistic in the foreseeable future, absent a recession or deflation to drive inflation expectations lower. We expect higher-for-longer inflation, which will result in higher-for-longer interest rates. US CPI inflation averaged 2.5% over the last decade, but over the last 60 years it has averaged 3.9%. We know the last decade was unusual, characterized by disinflation, but we expect lower productivity (increased regulation, taxes, labor costs with higher inflation expectations), declining real potential growth of at most 1.8%, and CPI inflation settling near 3%. This paradigm implies a normal policy interest rate of 3.5%, not 2.5% expected by the FOMC, although still well below the 5.3% average since 1972. However, is this so surprising given the policies of the last 3 years, that inflation is behaving more like 1970-1990 then 2001-2021.

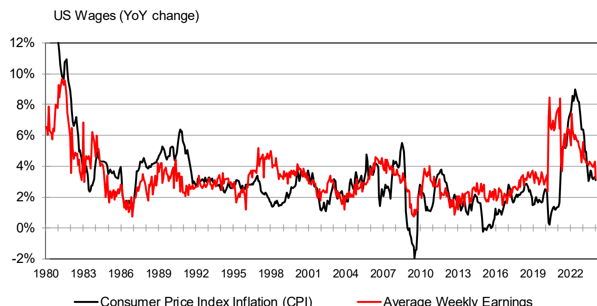
A long era of disinflation is winding down with maturation of the *Fourth Industrial Revolution*, and rising inflation expectations. Massive money growth and low rates for an extended period increased explicit moral hazard, but now monetary normalization exposed concerns about interest burdens and leverage, which compromised marginalized or zombie companies with increased interest burdens necessary to stifle high inflation.

Two decades of disinflation have been winding down, even if emerging *Artificial Intelligence* innovations bolster productivity a bit longer. Labor, Resource, and Energy intensity have declined, but further progress will be more challenging with increasing competitive threats, access to innovative software tools, and investment. Core CPI (ex-food and energy) bottomed out at 4%, rather than 3% CPI inflation as energy prices may head higher again with a now depleted Strategic Petroleum Reserve.

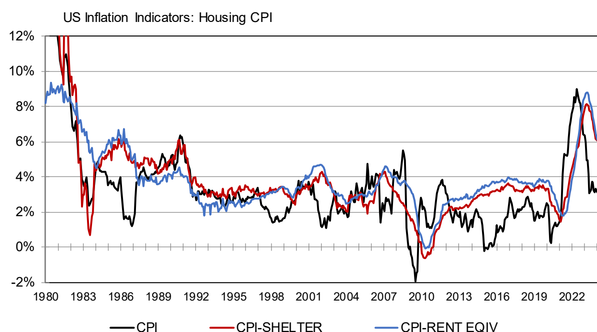


Poor U.S. policy decisions boosted prices of everything by mid-2022 from basic resources, energy, and transportation to goods and services. Higher inflation expectations, coinciding with lower productivity and potential growth, crippled US competitiveness and suggests increased potential for stagflation. Since mid-2023, the inflation rate moderated, but ***higher inflation***

expectations will take time to ease. Labor cost inflation will be slow to recede as workers seek to maintain purchasing power. Utilities only began raising prices given lags in PUC approval. Weekly earnings never fell below 1% for any meaningful period—even after the Financial Crisis. Pricing power was restored as consumers no longer expect relatively constant prices.



Discretionary spending will be limited without a rise in household income in excess of 3-4%, and the savings rate will struggle to remain positive. Manufacturers' pricing power will be difficult to contain. There is also still a housing shortage keeping inventory low and prices higher, even as household formation surges. Housing affordability remains challenging as average mortgage rates exceeded 7½% or highest rate since 2000—with the widest spread of mortgage rates vs U.S. Treasuries, something has to give.



Marginalization of China's comparative advantages of low-cost labor, energy, and resources with limited regulation as supply chain and transportation costs rise imply challenging margins for cheap exported consumer goods. Strategic basic resource exports are declining as post-pandemic backlash resets global supply chains with respect to China. This suggests higher cost of imports, particularly consumer goods, supporting the US dollar.

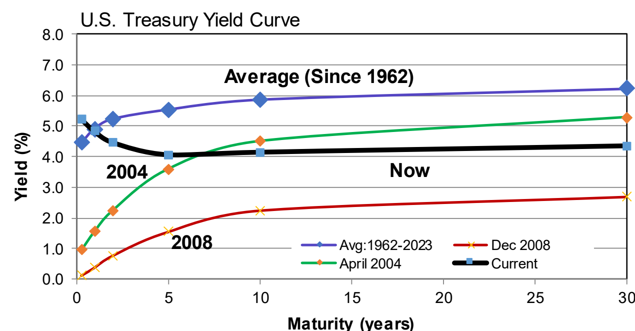
Adopting Personal Consumption Expenditures or PCE inflation, as the Federal Reserve did in Jan. 2012, can't change the inherent historical relationship of inflation risk premiums (yield - inflation rate). PCE inflation averages ½% lower than CPI inflation, although changes in inflation tend to be highly correlated, most of the time. Yet, we observe a divergence now. CPI has advantages with a century long record for comparison, whereas PCE has been relevant for just over a decade, and only used by the Fed. CPI is still used to adjust cost-of-living and contract pricing changes, and is comparable globally based on a similar methodology worldwide. What differs are component weightings: Housing – CPI @ 32.9% vs. PCE @ 15.9%, Food – CPI @ 13.4% vs. 7.4%, Vehicles – CPI @ 9.2 vs. 3.7, Healthcare – CPI @ 8% vs. 16.8%, and Financial Services CPI @ n.m. vs. 8.1%.

These differences result from the fact CPI focuses household consumer expense costs, while PCE also considers various expenditures made to third parties, such as healthcare insurance or financial services, which may not impact households directly in a timely way. CPI weights are adjusted biannually, whereas PCE adjusts monthly to account for substitution effects that may or may not be relevant. Given high correlation of inflation rates, but lower bias of PCE inflation, losing historical and global cross-sectional comparability leads us to prefer CPI for forecasting and econometric analysis.

Interest Rates

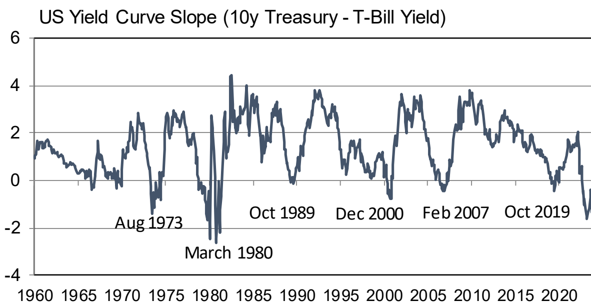
The Federal Reserve raised interest rates by 5¼% since the first hike on March 16, 2022, yet the US 10-year Treasury bond rose just 2% from 1.85% to 3.85% over this period. Inflation is still well above the implicit 2% PCE inflation target after interest rates rose 5¼%. This rise in interest rates matched our forecast, but our US10T yield forecast didn't hold through Q4, after matching our 5.0% expectation at the end of Q3.

What happened? When the Fed indicated it was likely done hiking, the bond market discounted no less than six rate cuts by mid-2024. The yield curve remains unusually inverted given economic conditions. Sticky inflation refers to elements whose prices don't adjust rapidly to supply-demand, driving more persistent inflation. We also believe limited labor market slack with low initial claims and unemployment rate, plus tight housing should lead inflation to settle above a higher long-term target.



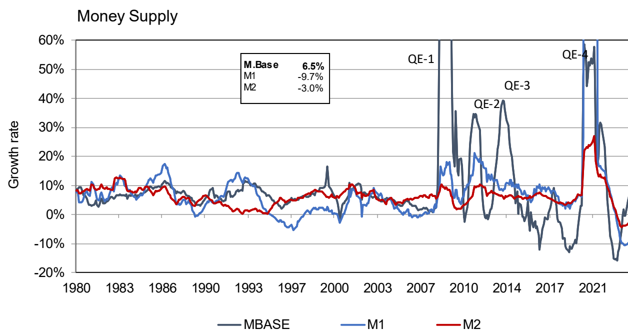
The historical yield curve relationship to the economy is critical for investors to understand. We observe that the shape and level of the yield curve is very unusual given current economic conditions, likely due to the Fed manipulating market interest rates for a decade, which we deemed *explicit moral hazard*. Bond yields may reflect an increased risk premium beyond normalizing

the yield curve. We expect 10-year Treasury yields will rise toward 5.0-5.5%. Persistent upward sloping yield curves are necessary for term risk premium or investor compensation for systematic risk of longer duration bonds. Global economic conditions do not support yield curve inversion. Economists often associate yield curve inversions with recessions, but yield curve inversions seem to also anticipate equity corrections with greater predictability. We suggest there are various similarities today vs. 1999-2001 (Dot.com bubble). Consider the timing of six yield curve inversion troughs below.



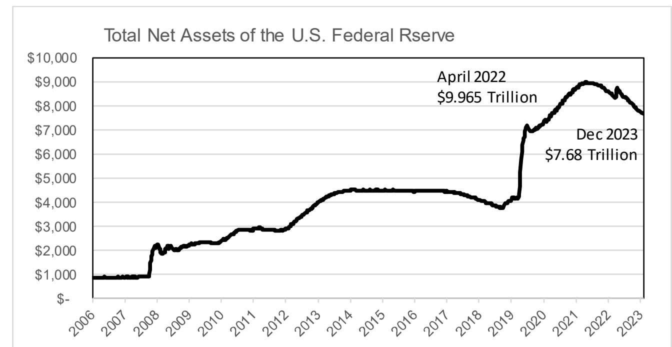
Loose monetary policy failed for a decade to boost inflation, but we believe benign inflation is not assured with unleashed higher inflation expectations. Beyond earnings challenges, stretched valuations and slowing growth with higher interest rates are a cruel potion for global equity and bond markets already engaged in *Magical Thinking,* but the *Big Reveal* may be troublesome with increasing risk of a *Global Debt Crisis*.

Restrictive monetary policy (i.e., hiking rates and reducing Treasury holdings) has limited economic activity as we've observed in retail sales, industrial production, and business sales. Money supply has been extremely volatile, but now is likely to expand well below the normal pace of nominal growth. We have cautioned about consequences of extended Quantitative Easing. Money growth will be low-to-negative for the foreseeable future as the Fed reduces its bond holdings by $5-6 trillion. Consequences of explicit moral hazard were initiated by misguided central bank policies for a decade.



Source: Federal Reserve

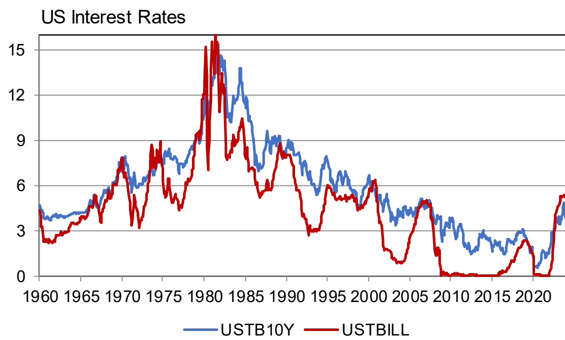
So far, Federal Reserve's bond holdings have declined just over $1.2 trillion after peaking in 2022, yet the Federal Reserve has only begun to reduce bond holdings from Quantitative Easing accumulated since the Financial Crisis. U.S. Treasury has limited issuance of long-term bonds. Policymakers must increase refunding and issuance over the next couple years—best to do it while the yield curve is inverted.



Within a year, $7.6 trillion of $34 trillion in US government debt will mature, representing 31% of outstanding debt. Refunding issuance combined with a U.S. fiscal deficit of about $1.8 trillion, and tendered Fed holdings of up to $1 trillion suggest a need to issue or refund up to $10.5 trillion of government bonds (supply), which could drive bond yields much higher (if demand falters). A similar effort to unwind central bank holdings is playing out in other countries, particularly the similarly situated European Central Bank ($8.7 trillion). The Bank of England, Bank of Canada, Bank of China, and Bank of Australia also must reduce their holdings. However, the Bank of Japan is in a difficult position given holdings of ¥70 trillion ($466 billion) in Equity ETFs, as well as 54% (¥576 trillion) of outstanding JGBs. As yields rise, holdings of central banks incur losses (not marked-to-market) that can eventually impact fiscal budgets. Like unfunded government liabilities, it is easier to ignore these problems until the *Big Reveal*—which is coming.

Concern about the bond market's ability to absorb a growing supply of long debt hasn't diminished. Debt is compounding faster with higher interest rates now—but the U.S. Treasury is paying higher rates over 5% by issuing short maturities, rather than issue 10–30-year Treasuries around 3.9-4.3%. Taxpayers should be disappointed that US Treasury hasn't taken advantage to extend debt maturities at sale prices less than 4.5%, which is well below expected long-term yields of 5-6%.

Falling bond yields triggered a rally in equities—specifically the Magnificent Seven, which drove the S&P 500. We maintain that until an increase in unemployment or stabilization of inflation near the Fed's target, interest rates will remain higher-for-longer. We also believe the Fed's long-term equilibrium Fed Funds (policy) target of 2.5% is too low vs. a more historically appropriate 3.5%. This assumes U.S. CPI inflation averages 3.0% (PCE: 2.5%), as we expect.

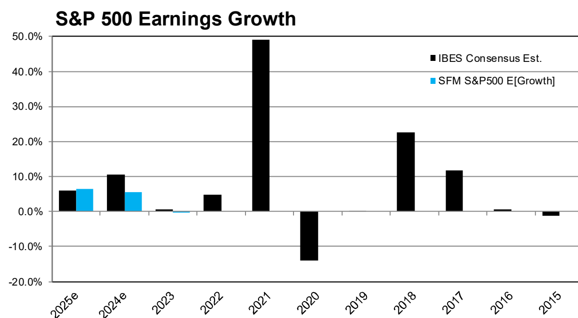


We think the bizarre behavior of Treasury bond yields in 2023 is in part a consequence of *explicit moral hazard* for over a decade of unnecessary monetary stimulus, including exceptionally low interest rates, successive periods of quantitative easing, and extended forward guidance since the Financial Crisis of 2008.

Earnings

Earnings growth and profit margins have been core principles driving our asset allocation research for over three decades. Economic growth translates revenue into earnings growth through profit margins. Lower tax rates and lower interest costs can drive up profit margins, as productivity increases with incentivized investment and R&D spending. Investors often fail to fully appreciate the translation of economic growth to earnings in their investment process—today equity investors seem fixated on high economic growth, but overlook differences in margins, competitive threats, substitution, and even translation of revenue to earnings.

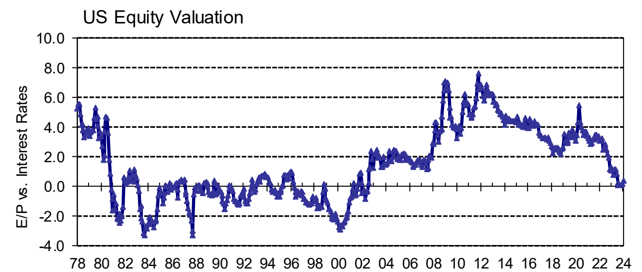
Observe the volatility of earnings growth, as well as general absence of growth for a decade—except for 2021 as companies rebounded from the pandemic. It begs the question, why investors bought equities without regard to already stretched valuations? Is forecasted consensus of 10.5% earnings growth sufficient? Analysts are chronically overly optimistic. It is likely they are again in 2024--we expect about half of that or 5.5%.



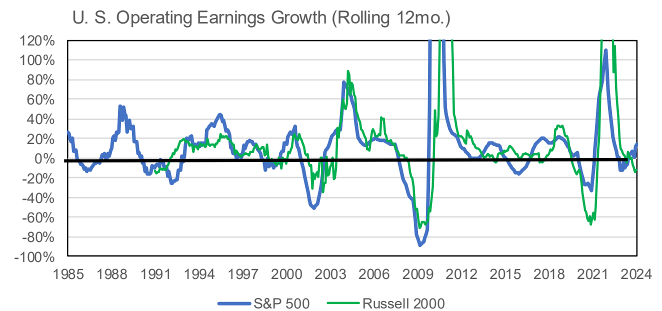
Operating Earnings	2025e	2024e	2023	2022	2021	2020
IBES Consensus Est.	6.0%	10.5%	0.7%	4.8%	49.0%	-13.8%
SFM S&P500 E[Growth]	6.5%	5.5%	0.0%			
SFM S&P500 Target	5000	4800	4770	3840	4766	3756
Index Return (no Div)	4.2%	0.6%	24.2%	-19.4%	26.9%	16.3%
Dividend Yield %	1.64	1.61	1.47	1.75	1.29	1.48
S&P 500 @18x SFM TE	4410	4140	3924	3926	3746	2515
S&P 500 P/F12 (SFM)	16.3	16.7	16.6	17.6	21.9	18.0

Source: LSEG I/B/E/S vs. Strategic Frontier Management Estimates

US companies will struggle to grow into the current valuation multiple (S&P 500 > 20x) with recent lackluster S&P 500 earnings growth. We believe the equity market is stretched as P/E multiples rose with marginal earnings and extended given higher interest rates. Equity valuation has been supported for some time by exceptionally low interest rates, but rising rates and higher P/E multiple implies the lowest valuation since 2002. The stock market has been more volatile recently with changes in bond yields and outlook for Fed interest rates. The strong 4Q equity and bond return was triggered by the Fed indicating it would pause hiking rates and investors discounting up to six rate cuts in 2024 (-1.5%). We expect two cuts in or about 4Q/2024.



More realistic future earnings growth of 5-8% won't be enough to correct currently extended valuations. We seem to be entering a period of declining margins as economic growth slows with higher inflation expectations. We observed sequential negative quarterly earnings growth in 2023, which overall shouldn't exceed 1.5%. If the US economy slows and margins decline, US earnings growth will be limited.



Source: LSEG I/B/E/S, Strategic Frontier Management

Performance of US small-cap companies in 2023 lagged, although starting off 2024 with more constructive expectations. LSEG estimates 2023 revenue of small

companies in the Russell 2000 declined 1.7% as earnings tumbled 11.7%. This was indicative of recessionary conditions. Beyond the *Magnificent Seven*, the economy flirted with intermittent recession throughout the year. Russell 2000 consensus earnings are forecast to grow 48% in 2024, after a decline in 2023, which even if they disappoint by half.

Bankruptcies accelerated with financing more difficult to secure given rising interest rates and bond yields, as well as critical failures of specialty banks (i.e., SVB, First Republic, and Signature Bank) for venture and small business in 2023. Venture funding remains challenging.

Focus on the U.S. Dollar

Others have talked of a multipolar world for some time, even complete demise of the U.S. Dollar as the world's reserve currency. Why should America benefit so richly from transcendent value attributable to the *privilege*, of being the world's reserve currency? China, Russia, and OPEC nations complain about preference for the US$, but what do they offer instead? The only alternative is the Euro, but it isn't in a better position to serve that role.

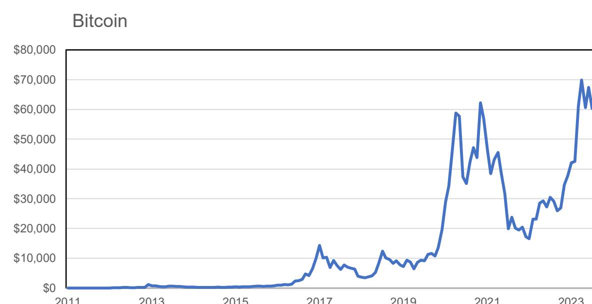
Source: LSEG DataStream and Strategic Frontier Management

For the better part of the last 15 years since the Financial Crisis, the U.S. dollar steadily appreciated, despite forecasts for its imminent demise. For the U.S. dollar to be replaced as the world's reserve currency (i.e., de-dollarization), some other currency would have to emerge as a better alternative. China would like to claim that mantle, but China's geopolitical instability and difficult economic performance for the last three years—as discussed—is hardly fit for purpose. Not since its designation in the Bretton Woods Agreement (1944) has any other currency rivaled the U.S. dollar.

Reasons that investors should care about currency appreciation effects include: lower inflation of imported goods, and reduced term risk premiums of long bonds or lower cost of capital. Foreign investment returns increase, as does inflation, when one's home currency weakens. Investors should benefit from a currency tailwinds favoring non-US developed market exposure in 2024. On the flipside, currency translation effects impact earnings growth—company earnings may disappoint when currencies experience higher volatility or appreciate. Depreciating currencies are a competitive advantage as exports become cheaper elsewhere.

The US$/Yuan rate is important given China's reliance on exports. If the Bank of China maintains a fixed currency rate versus the U.S. dollar, then as the U.S. dollar appreciates, generally so does China's trade weighted exchange rate. China's economic growth has disappointed despite weakness in US$/Yuan. Beyond China, we remain concerned about Emerging Markets.

Cryptocurrencies are not currencies or a store of value, but instead are speculative virtual commodities without intrinsic value as compared to gold or other commodities. We oppose strategic allocations to cryptocurrencies, including Bitcoin, because they are too volatile to be considered a store of value (see chart), provide little benefit to portfolio diversification, nor are they an inflation hedge. When interest rates are >0%, cash is a better investment than cryptocurrencies given interest on a time deposit or even Treasury Bill, let alone on a risk adjusted basis. We've gotten so used to low interest rates that we forgot the importance of comparing yields of alternative investments such as commodities or even technology companies with 0% dividend yields, many which also don't produce much if any earnings. Confidence is repeatedly shattered by its volatility and $\leq$0% correlation with inflation. Market failures, including collapse of FTX/Alameda Research, BlockFi, Terra, and Luna, as well as Celsius, and Three Arrows hedge fund are somehow easily dismissed or forgotten.



Regulators, including the Fed, have cautioned investors about the risks of dealing in digital assets. Yet, the SEC recently approved ETF applications for Bitcoin, which was the basis of the recent strong move up on soaring retail demand---the question is whether it is sustainable. Recent approval to begin ETF trading has enhanced liquidity and lowered transaction costs, but expense ratios are still not cheap at 0.25% for Blackrock's IBIT[1]. It doesn't insure it is a prudent investment for most client accounts either. The rise in the price of Bitcoin since October is not an unexpected result. In the first 18

[1] IBIT plans to waive half the management fee for one year. SFM does not endorse or recommend purchasing or selling any specific securities mentioned in our Outlook.

trading days, ETFs acquired 180,000 Bitcoin or 3% of total supply according to the Economist. ETFs provide a newly acceptable means of exposure to Bitcoin, but expecting gains to be more challenging beyond 1H2024.

As with Currencies, the long-term expected return of cryptocurrency is 0%—Bitcoin is inferior to cash, particularly as risk-free interest rates rose over 5¼%. Higher interest rates increase the cash yield hurdle for cryptocurrencies, so tend to decline in value as interest rates rise. This is the opposite of fundamental interest parity that governs the relationship between interest rates and currency exchange rates--if the ECB raises interest rates more than the U.S. Fed, we'd expect the Euro to appreciate versus the U.S. dollar. Thus, if higher inflation drives up interest rates, which tends to drive Bitcoin lower, then cryptocurrencies cannot hedge inflation. Average Cryptocurrency returns should not exceed inflation with higher volatility than commodities.

The Federal Reserve has been evaluating creation of its own Central Bank Digital Currency, as have many other central banks. It may seem the purpose is to facilitate transactional efficiency, reduce fraud, and enhance economic activity. Forcing digital currency payments expands governments' ability to track private financial dealings. Suppressing cash enhances government control enabling monitoring transactions, as well as ability to freeze or seize accounts. There is no reason that the world's reserve currency needs a CBDC—what more would a CBDC offer over existing stablecoins such as Tether or USD Coin?

The theoretical notion of eliminating paper currency is not based on evidence of measurable benefit, increased revenue, or greater economic growth by phasing out cash. Central bankers and some economists are intrigued with the notion of reducing or eliminating paper currency, but most if not all the benefits of blockchain technology can be achieved through alternative and targeted policies. We don't recommend strategic allocations to cryptocurrencies, nor believe there is a strategic return forecast other than 0% (vol = 161%), or support the notion of Central Bank Digital Currencies.

Review of our 2023 Outlook

Looking back at our dozen or so forecasts can be humbling some years, particularly when markets seem to be driven more by sentiment and anticipating trends, rather than mean reversion to normal or equilibrium. Year-end forecasts can imply precision that overlook the importance of direction and relative magnitude or multi-year sequencing of our outlook versus a point in time.

We also highlight some unusual risk premiums. Consider longer horizon returns to Value – Growth (10 and 30 years) or Small-cap – Large-cap (3 years) equities. These equity relationships have been and continue to be perverse, in our opinion. Yet, we've seen this before, specifically in the lead up to the Dot.com correction of 2000-2001. Investors will also observe the continued lagging performance of Emerging Markets vs. U.S. equities (1, 3, 5, 10, and 30 years), just as we have been concerned about for some time. Also, US10Y Treasuries have lagged simple cash for 5 years, and lagged cash on a risk-adjusted basis for more than 10 years.

We have long favored higher short-term bond exposure in our strategic asset allocation recommendation for over two decades. With interest rates over 5% and a steeply inverted yield curve (long-term yield < short-term yield), there is no yield pick-up and little reinvestment risk to waiting until at least the first cut or two before extending bond portfolio maturity. Advisors may avoid cash if they don't get paid on bank deposits, but that shouldn't preclude using ultra-short bond funds for higher yield.

Total Return	**1-Yr**	3-Yr	5-Yr	10-Yr	30-Yr
S&P 500 Index	26.3	10.0	15.7	12.0	10.1
NASDAQ Composite	44.0	5.8	18.5	14.6	12.2
Russell 2000	16.9	2.2	10.0	7.2	8.6
Russell Value-Growth	-31.2	0.0	-8.6	-6.5	-1.3
Non-US (World xUS)	18.6	5.0	9.0	4.8	5.8
Emerging Markets	10.3	**-4.7**	**4.1**	**3.0**	4.8
Small-cap Global	18.5	3.0	10.4	7.1	
US 10-Year Treasury	3.6	**-5.7**	**0.7**	**1.8**	4.2
US Aggregate Bonds	5.5	**-3.3**	**1.1**	**1.8**	4.4
BAML High Yield Bonds	13.5	**2.0**	**5.2**	**4.5**	6.7
Short-term Bonds	4.9	**-0.6**	**1.5**	**1.2**	3.3
JPM Non-US Bonds	5.7	**-7.9**	**-1.9**	**-0.7**	3.4
Cash (US T-Bills)	5.0	2.3	1.9	1.2	2.3
US Dollar (TWI)	-0.9	2.9	1.0	2.4	0.2
CRB Commodity Index	0.0	19.1	11.4	0.7	5.2
WTI Oil (US$)	-10.2	14.3	9.8	-3.1	5.6
Gold (US$)	13.8	2.9	10.0	5.5	5.7
Bitcoin	153.5	13.2	62.7	50.0	

Source: Strategic Frontier Mgmt. Returns as of December 31, 2023 in US$. Performance exceeding 1-year annualized

We anticipated the US Fed would hike rates by 5¼%, which was more than consensus or the Fed's forecast. We deduced that government bond yields should follow suit, and through 3Q/2023 were on track. However, since October, Treasury yields plunged toward unchanged levels, but we expect the pivot to cut interest rates is further out than consensus expects. We believe inflation is not yet contained and will settle above the Feds implicit 2% PCE inflation target. Thus, Treasury yields should rise ~1% providing a positively sloped yield curve.

Our strategic asset allocation includes a higher mix of short-term bonds based on our strategic asset allocation construction methodology called *Optimal Empirical Resampling*—with a similar objective to mean-variance portfolio construction, the solution leads to an interesting result. With riskless cash yielding up to 5.5% in some money market funds and bank CDs, as short-term bond

funds approach 6% yield, longer bond fund allocations returning at best 0.0-3.0% are inferior to cash and short-term bonds on a risk-adjusted return basis. Increasing risk of an equity correction suggests cash and short-term bonds are more compelling. Short-term interest rates raise the hurdle rate for volatile Cryptocurrencies (0% expected return) and commodities (2.5% expected return). Cash should earn 0.5-1.0% greater return than inflation on average. We favor overweighting cash versus equities and bonds.

Most of 2023 was playing out according to our playbook. The Fed continued to raise interest rates and global yield curves were steepening until Halloween. Consensus shifted dramatically on Nov. 1st when the U.S. Federal Reserve held interest rates constant and indicated their next move was to cut rates. This sparked a rally in both US equity and bond markets, which drove the S&P500 to 4770 and US10y Yields to 3.87% despite hitting our Fed Funds target, rising 1% to 5.25-5.5% and very disappointing S&P 500 earnings growth of just ~1%. While such pivots historically boosted equity and bond markets, in this case the yield curve was inverted already anticipating more than a 1% cut to interest rates.

Seven technology stocks, know as the *Magnificent Seven (inc. Amazon, Apple, Nvidia, Tesla, Microsoft, Meta, and Alphabet/Google)*, drove the 26.3% S&P500 return. The S&P500 also outperformed small-cap (Russell 2000) equities by nearly 10%, as the Russell 1000 Growth beat Value by 31.2% in a year we favored Value and Smaller companies. Such investor behavior unsupported by fundamentals is similar to 1999.

Global Tactical Asset Allocation Strategy

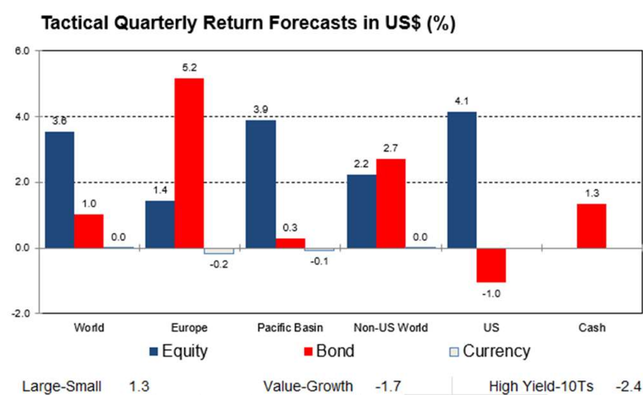
Global asset allocation is the primary determinant of long-run portfolio performance, and thus wealth creation. Our outlook reflects mean reversion of global bond and equity valuations, both which are stretched. Negligible growth in earnings in 2023 as the S&P 500 index rose over 24%, combined with higher interest rates, suggest the fundamental downside for US large-cap equities deteriorated. Investors should expect higher equity, bond, currency, and commodity volatility as interest rates and monetary policies normalize globally. Increased volatility within and between asset classes is expected, whereas relative fundamentals should become more critical driving relative returns vs. observed momentum.

Our market expectations for key indicators in 2024:

Index	Target	2024 Change
S&P 500 Index	4800	0%
US10T Yield	4.8%	+0.9%
Fed Funds	4.75-5%	-0.5%
S&P Earnings	$230	6.0%

Source: LSEG, Strategic Frontier Management Expectations

Our Global Tactical Asset Allocation forecast model output is summarized below. These quarterly forecasts are designed for tactical use relative to a well-defined strategic asset allocation.



Source: Strategic Frontier Management

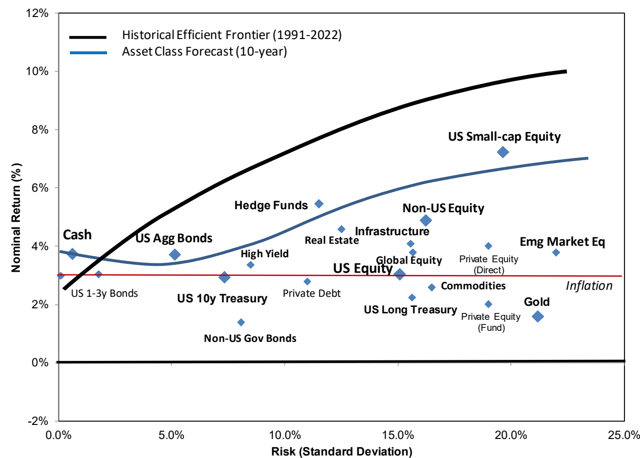
Concerns about valuation and economic growth for equities persist, but the recent rally in bond markets (lower bond yield) offsets that for now. Our greatest tactical concern remains U.S. Bonds. Japanese and Australian equities rank highest for now. What models can't anticipate is when BoJ's equity ETF exposure winds down or bond liquidity struggles with quantitative tightening, higher rates, and interest burden of excessively high fiscal deficits given Debt/GDP.

We recommended underweighting US equities since mid-2021, which worked well for 2022, but not so much for 2023. On the other hand, we have been avoiding Emerging Market Equities, and particularly China, for three years for the right reasons. Valuations should be consistent with slower earnings growth due to withering profit margins and diminished competitive advantage.

Strategic Asset Allocation Forecasts

Return and risk forecasts are among the most important elements needed to achieve investment objectives. Therefore, a consistent, disciplined, and rigorous approach revisited regularly e is needed to develop and maintain robust intermediate-to-long-term *Global Strategic Asset Allocation* forecasts.

Forecasting returns is not simply a matter of projecting historical averages of returns, variances (risk), and correlations assuming historical consistency. Our forecasting methodology relies on central tendency, thus expect fundamentals, and particularly valuations and risk premiums to revert toward equilibrium over time. Risk premiums, valuation ratios, and other mean reverting characteristics rise and fall with changes in asset prices, whether driven by momentum, persistence, behavioral biases, or contrarian behavior in the short run. Over longer horizons, economic and financial fundamentals tend to normalize toward equilibrium, which itself may evolve or may be stable.



Dismissing History and Speculative Myopia

The most effective way to destroy people is to deny and obliterate their own understanding of their history.

— George Orwell

We believe risk of a global bond liquidity crisis in 2024 is increasing, exacerbated by manipulating free markets (bond yields) for an extended period, coinciding with massive fiscal deficits driving increasing issuance of government bonds. Central banks are still under scrutiny to deal with rising inflation—those who explicitly target inflation have little choice, but to raise interest rates until inflation is contained relative to their respective targets. Yet bloated holdings of central banks must be eventually wind down through refunding or sale, likely recognizing losses that flow through fiscal budgets. This will further extend the government bond supply/demand imbalance, and fiscal deficits adding to U.S. debt. Inflation came down slower than expected and interest rates rose more than consensus forecast—we'd suggest that *dismissing history* had destructive financial consequences.

Considering U.S. economic statistics, we believe the U.S. experienced a modest recession in 2023. Real GDP was boosted by exceptional, as well as unsustainable, government spending and hiring. Recent U.S. Policies undermined global competitiveness, potential growth, and productivity, as inflation expectations were unleashed. Slowing economic growth and declining margins have reduced earnings growth. This is the key question for U.S. equities—can sufficient earnings growth turn valuations around or will a market correction be required with higher-for-longer interest rates imposing less speculative earnings multiple—we suggest the Big Reveal is either 20% earnings growth (with no change in index level) or a 20% correction in U.S. equities. Income tax revenues will be disappointing and raising tax rates now will only drive a wider fiscal deficit.

The Administration's policy agenda unleashed higher inflation expectations after a massive persistent surge in consumer prices for energy, labor, consumer staples, durables, and services. Low-to-negative money growth are a consequence of extending emergency monetary stimulus well beyond the needed horizon. Reversing QE (reducing bond holdings) will limit potential growth and liquidity needed to achieve sufficient income growth, and tax revenue. *Magical Thinking* seems to assume that fiscal deficits over 5% and debt exceeding 120% of GDP has no consequences—a global government debt crisis may change that view. Rising bankruptcies, debt and interest burdens, leverage, loan delinquencies, and spiraling up bond yields, as we expect, increase risk of a global bond crisis, which also could trigger a U.S. equity correction of stretched valuation.

President Biden's innumerable government policy mistakes are rooted in *Magical Thinking* of his progressive advisors (influenced by *Modern Monetary Theory*) and agency heads, much of which can be traced back to the *Biden-Sanders Unity Task Force Agreement*. Ideological wishful thinking, sought to justify a massive expansion of federal government spending, reflecting progressive socialist ideals Six individual task forces focused on initiatives for: climate change (i.e., Green New Deal, net zero), criminal justice reform, economy, education, health care and immigration policy. Worst-of-the-worst policy initiatives adopted by the Biden Administration had adverse effects on the economy or living standards reversing nearly every successful policy of Trump's Administration from domestic to foreign policy, criminal justice to immigration policy, fiscal to economic and market policies, as well as regulatory policy reforms. The task force playbook drove higher inflation (spreading globally), emboldened crime and violence, increased unchecked immigration, flipped foreign energy dependency, while undermining global competitiveness, productivity, and profit margins. It also compromised rule of law, liberty, and equal opportunity.

Most economic and fiscal objectives instilled in the failed *Build Back Better plan* were resurrected piecemeal (i.e., ARA, IRA, and CHIPS). That which could not be done legislatively (i.e., student loan forgiveness, permits, open boarder, gutting the *Fiduciary Rule* to support ESG/DEI, etc.) was pursued through agency rules and regulations, if not signed into law by Executive Order. Although many rules and executive orders were successfully challenged in court, the process was excruciating and the damage was done. The chaotic method of policy change has struggled to balance many opposing special interests.

EPA and other agencies imposed their new regulations and rules upon all essential services, holding back permits for exploration, production, transmission, and distribution, as well as building or modernizing pipelines displacing ships or rail. Upgrading or new construction of reservoirs, sewers and treatment plants, highways, pipelines, electricity transmission, telecommunications, and other essential services to increase efficiency or lower cost are stalled or delayed. The infrastructure-oriented IRA did everything but reduce inflation. We know modernizing gasoline formulations can increase

fuel efficiency and reduce emissions, but tax credits and subsidies are targeted only for preferred uses, such as solar, wind, high speed rail, and electric vehicle or charging station projects. Project and investment failures assumed by taxpayers are piling up fast. For what its worth, investors favoring DEI (Diversity-Equity-Inclusion) investment mandates or related criteria also may find their "style" resigned to wherever *Extinct Species* go given the pace companies have reset in this regard.

We have long championed Artificial Intelligence in our future themes work (i.e., Fourth Industrial Revolution). Yet, we expect adoption across the AI spectrum will be slower than anticipated as it has evolved slowly but steadily for the last 40 years. The drive to invest in *anything-AI* across private and public markets, *particularly GenAI,* is still speculative. We caution there will be successes, and modest gains, as well as remarkable failures. Where AI will have the greatest impact has been and will continue to be in automation and systematic workflows, or quantitative analytical work. Generative AI has expanded our thinking and what is realistically possible tapping unstructured data and natural language, which has overnight increased public visibility and accessibility. Commercialization potential increased a lot in just a year.

To develop expectations about the future, we often must look to the past and consider what is similar and what is not. An axiom in investing suggests assuming its just different this time has been foolish time and again. That said, the influence and behavior of central banks since the Financial Crisis has been without precedent, so relying on history can be misleading.

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