ADVANCED ASSET MANAGEMENT ADVISORS

Assumed Intelligence

Market Update From Advanced Asset Management Advisors
December 31, 2023

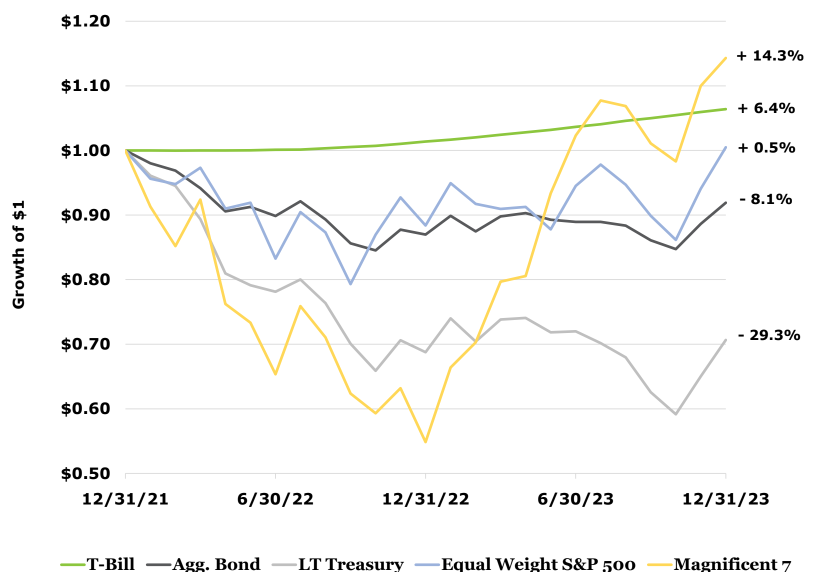
The financial markets over the last two years have been tumultuous. Stocks and bonds experienced extreme price swings as inflation and federal reserve policy drove rapidly changing perceptions of values, risks, and economic prospects. Over the two-year period, the CPI rose 8.9% while average hourly earnings rose 7.8%, leaving the average consumer a bit behind in meeting higher living expenses.

The tumult in the securities markets was most pronounced in long-term Treasury bonds, which finished the period with a 29% loss. The "magnificent 7" technology stocks initially lost 45% only to finish with a two-year gain of 14%. Broader market indicators were less volatile with T-Bills returning 6.4%. The Aggregate Bond index returned -8.1% and the average S&P 500 stock returned 0.5% over the period. Overall, T-Bills provided the best return compared to the group of broad market indices.

The Magnificent Seven:

The magnificent seven stocks that have provided a significant portion of recent stock market gains include Amazon, Apple, Google, Meta, Microsoft, Nvidia, and Tesla.

The 1960 film, "The Magnificent Seven", starred five actors with an average age of 34 — Brynner, McQueen, Bronson, Vaughn, and Coburn. All have since passed away. The lesson? Actors and companies rise and fall over time, and none are invincible.



The Economy...

has followed our script of "no recession in 2023". Our position a year ago was contrary to the consensus of mainstream economists who were calling for a recession starting by mid-year. Most of the traditional indicators that precede a recession have been wrong thus far – some experiencing their first false signal. Today, the traditional indicators are still pointing to a recession, but the mainstream economists have now adopted the Federal Reserve narrative of a soft landing with expectations of a reversal of the traditional recession indicators.

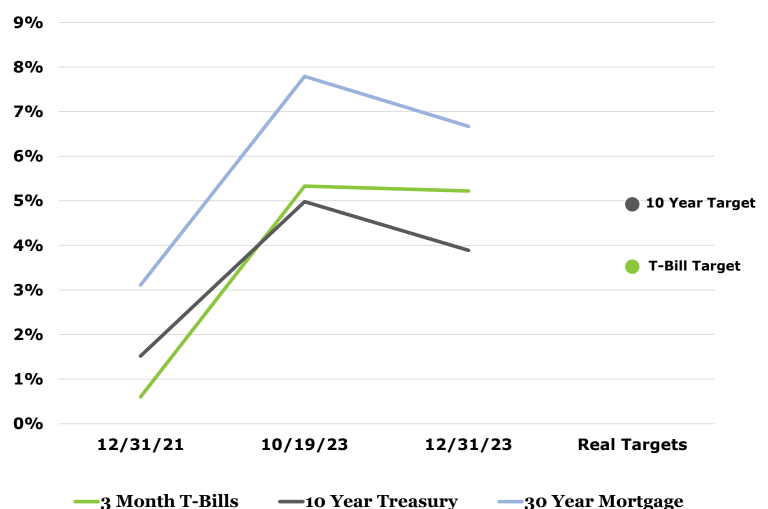
While we are not as steadfast as we were a year ago with a "no recession next year" position, the same factors that have supported our constructive view of the U.S. economy remain in place. The labor market is tight, fiscal deficits are stimulative, and monetary/liquidity measures still carry excesses from the last 13 years of easy money policies. If we are correct about the economy, the recently adopted expectation for six rate cuts next year seems overly optimistic.

The markets seem to have adopted the optimistic view based on assumed intelligence at the Federal Reserve. This is the same "intelligence" that delayed recognition of the inflation problem for a year and remained hawkish until just three weeks ago. Suddenly, we've seen an about face. There is room for disappointment if expectations for rate cuts do not materialize. While the rate of inflation has been cooling, stable economic conditions run counter to expectations that the Federal Reserve can claim victory over inflationary forces.

Our core position on monetary policy and the economy is unchanged. If the Federal Reserve is indeed steadfast in their stated goal of 2% targeted inflation, there will be significant collateral damage to the economy and the markets. However, if we do see a "pivot" in Fed policy as has been widely accepted, the real impacts will be determined largely by the size and timing of any cuts.

Interest Rates...

are significantly higher over the last two years, even considering the decline over the last two months, as markets celebrated the apparent Federal Reserve "pivot" away from its monetary tightening scheme. If one were to predict modest economic growth of 2%, a new inflation target of 2.5% to 3.0%, and apply historical inflation premiums, one would expect T-Bills lower by 1.70% and Ten-Year Treasuries higher by 1.00% (separate dots on the trend chart).



Lower short rates and higher long rates would 'fix' the negative yield curve that has been one of the most consistently correct recession warning indicators. Lower short-term rates would help reduce the funding pressure on the most vulnerable (highly leveraged) companies. Higher long-term rates would be a negative for equity market valuations (lower P/E ratios would be expected). Absent a renewed and aggressive bond purchase program by the Fed, supply and demand factors in the longer-term bond market are negative.

Corporate Profits...

Expectations for 2023 operating profits have declined by 6% since the beginning of the year, but appear on pace to recover the decline registered in 2022. Not unlike the trend of stock prices over the last two years, earnings declined in 2022 and recovered in 2023. The final number for 2023 should result in a 2.7% gain over the two-year period. A 2.7% gain is hardly robust, but is likely better than many feared during the high inflation and rising interest rate environment.

Additional earnings growth is expected next year (very seldom do we see negative projections, and final numbers are typically lowered over the course of the year). Stock prices reflect both the level of expected growth and the risks to the expectations. Risks can develop in actual earnings or from higher interest rates that provide attractive, lower-risk investment options.

The S&P 500 currently trades at 22 times current earnings and 19.5 times expected 2024 earnings. The ratio on current earnings is higher than 82% of historical observations — meaning stocks are expensive. The dividend yield is 1.4% which provides scant competition with bond yields. Current stock prices reflect an optimistic outlook for earnings gains and dividend increases. High valuations do not predetermine a stock market decline, but they do suggest that any negative surprises would have a larger impact than if stocks were less expensive.

Geopolitical Factors...

We seldom comment on geopolitical issues and even less on politics. However, it is prudent to continuously monitor and evaluate the geopolitical landscape to identify potential risks and influences on the markets. Today, there are multiple factors worth discussing.

Congress is facing a new funding deadline in mid-January. Legislation to fund the government has always been passed, but not always without drama. The January deadline has the potential to inject some nervousness in the markets. We are in an election year which often influences policy makers, and the Federal Reserve tends to avoid making dramatic or negative policy changes.

Globally, there are three headline situations. First, it seems that Ukraine is at a standstill, which will eventually be resolved with a peace agreement. One key lesson is that sanctions tend to be counter-productive.

Two years ago, Russia sold most of its petroleum exports to Europe. Now, 90% is sold to China and India. Markets work. We wonder most about if, how, and when the sanction of $630 billion of Russian central bank reserves will be released.

Taiwan garners a lot of headlines suggesting the situation will become volatile and soon. However, if we look at the long-standing positions, there should be no confusion. The U.S. publicly states it will abide by the Taiwan Agreement and its long-standing policy under which it officially recognizes Beijing rather than Taipei, and the Taiwan Relations Act, which makes clear that the U.S. decision to establish diplomatic ties with Beijing instead of Taiwan rests upon the expectation that the future of Taiwan will be determined by peaceful means. While that act binds the United States to provide Taiwan with the means to defend itself, Washington acknowledges China's stance that the island belongs to it and that there is "one China". China's recent rhetoric of a peaceful "reunification" does not seem inconsistent with U.S. policy.

The Middle East is not a new issue but has obviously heated up. The most striking image to us is the number of military installations (more than 30) that the U.S. has in the area along with significant naval assets. Some locations are in relatively friendly areas, some in less-than-friendly. All are vulnerable. Ocean shipping rates are on the rise due to increased risks and altered routing. So far, oil markets have not been negatively impacted, but there are heightened risks of shipping and supply disruptions.

Geopolitical issues are always present, but the current status seems to present higher risks than normal.

The Bottom Line — How We're Approaching The Market Today

AAMA is a fundamentally rooted manager. That means we use the black-and-white statistics of sector valuation and market pricing to guide our decisions. As a result, our views on the market have been relatively stable through the past few years of volatility. Despite the wild ups and downs, sensational headlines, and unprecedented changes in monetary policy, the fundamentals haven't changed significantly. As such, we remain committed to a more defensive sector tilt (healthcare and consumer staples stand out) with a focus on earnings and balance sheet quality. Quality is the focal point for us, with a market that is widely overvalued and primed for yet another disappointment from the anticipated Fed pivot (pricing in six 2024 rate cuts, which we feel is quite lofty, and premature).

In fixed income, we remain positioned in short-term and high-quality debt instruments — a strategy initiated to reduce the risk to principal in a rising rate environment, which we feel remains appropriate today.

The team at AAMA will continue to diligently monitor and evaluate the markets and will position our portfolios accordingly. If you have any questions about the markets, the economy, or our portfolios, please don't hesitate to reach out to us at **engage@aamamail.com**.

Disclosures

The information and opinions in this report have been prepared by the investment staff of Advanced Asset Management Advisors (AAMA). This report is based upon information available to the public. The information herein is believed to be reliable and has been obtained from sources believed to be reliable, but AAMA makes no representation as to the accuracy or completeness of such information. Opinions, estimates and projections in this report constitute AAMA's judgment and are subject to change without notice. This report is provided for informational purposes only. It is not to be construed as a recommendation to buy or sell or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy in any jurisdiction in which such an offer or solicitation would violate applicable laws or regulations.

engage@aamamail.com
4995 Bradenton Avenue, Dublin, Ohio 43017
aamaweb.com
614-717-4451