AAMA
ADVANCED ASSET MANAGEMENT ADVISORS

Rising Risks

Market Update From Advanced Asset Management Advisors
March 31, 2024

Stock prices experience changes in valuation over time as the level and expectations for economic growth, corporate earnings, and interest rates ebb and flow. Employing the simple price to earnings ratio, nine periods of over-valuation (high P/E ratio) can be identified over the last 50 years. We're currently in one of those periods. However, today's elevated valuation is noteworthy, because it is the first since the financial crisis that has occurred alongside relatively attractive interest rates.

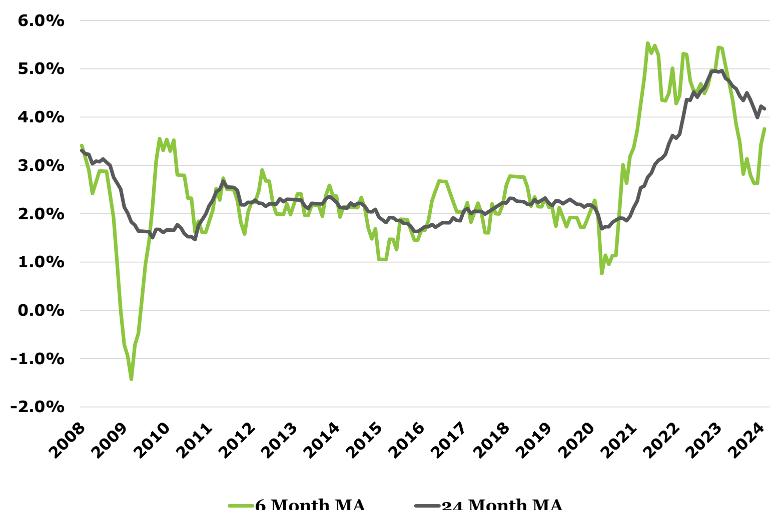
5.4% Treasury Bills and 4.25% Treasury Bonds provide competitive yields compared to the stock market earnings yield of 3.67% or stock dividend yields of 1.38%. An over-valued stock market does not automatically translate to lower stock prices or a crash. It simply means that more conservative investors should have less money invested in stocks and more in less volatile investments like short term Treasury securities.

An example of this shift can is demonstrated in our Strategic Balanced portfolio (which targets equity exposure between 40% and 80%). We recently reduced the portfolio's allocation to stocks from a neutral 60% to 50% (the other 50% is allocated to short-term, high-quality bonds).

Inflation Update

The Core Personal Consumption Services Price Index, ex-housing (the Federal Reserve's espoused favorite indicator) continues to be stubbornly high. The month-to-month annualized change has been volatile, but the six-month trend has clearly moved higher – now 3.76% versus 2.63% just four months ago. The 24-month average stands at 4.17%.

Annualized Monthly PCE
Core Services Ex-Housing



Federal Reserve Policy

Markets have expected a pivot towards lower interest rates several times over the last two years. Each time, the expectations have been proven to be over-optimistic and have reversed. The recent episode is no exception, as the market expected six rate cuts for 2024 as recently as January. The prediction today stands at three, leaning towards only two.

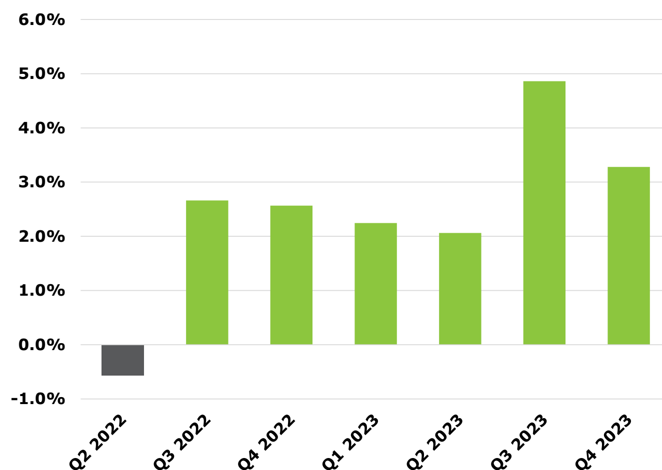
For the models run by the 450 Economic PHDs and 21,500 other individuals toiling daily at our "data-dependent" Federal Reserve, stubborn inflation has proven to be the key unsettling input. The 12 individuals who actually vote on monetary policy recently increased their guesses for the economic growth and inflation we might experience by year end. Recency bias is hard to avoid.

The Economy

Economic growth has been resilient, defying every tried-and-true recession indicator known to man. Since the Fed started raising interest rates two years ago, quarterly annualized real GDP growth has ranged from 2% to 5%.

Q/Q Annualized Real GDP

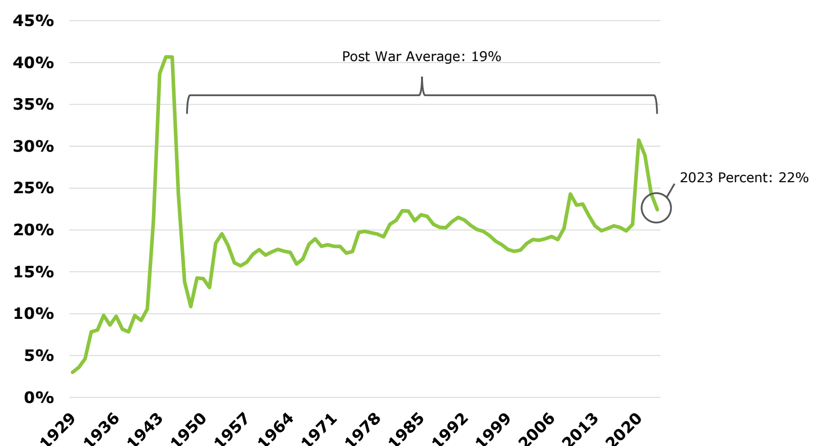
Since Rate Hikes Began



Following the large stimulus payments in response to the pandemic, government outlays remain elevated. Last fiscal year (ended 9/30/23), Federal outlays footed to 22% of GDP, a number standing 3% above the post war average of 19%. This $680 Billion of relative excess has surely contributed to the economy's resilience — a trend that will not likely be reversed this year.

Federal Outlays, Percent Of GDP

1929 - 2023

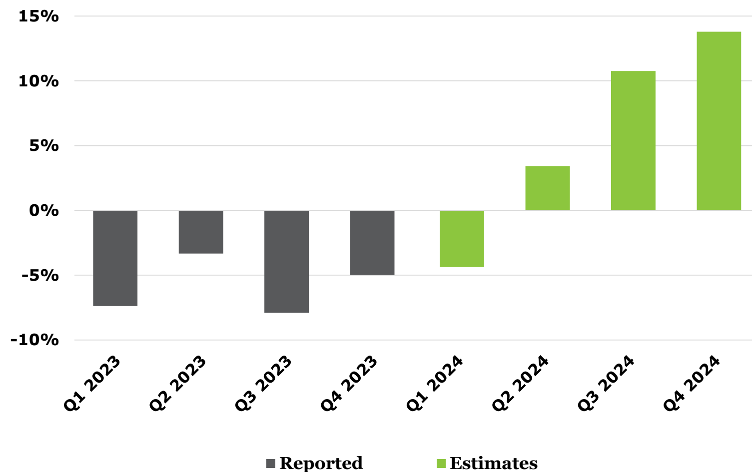


Higher government spending translates into higher economic growth. The irony is that spending is good for the economy over the short run. However, government debt created by spending that does not enhance productivity growth is bad for the economy in the long term.

Corporate Profits

Corporate profits have completed a mini-recession. Compared to peak earnings from the 4th quarter of 2021, earnings were running 3% to 8% lower. The 2nd quarter of 2024 promises to post a new high. And, for now, the perennial optimism for future earnings promises further gains later this year.

Companies have enjoyed a seller-friendly market as buyers of goods and services have not yet balked at higher prices. Profit margins, like the economy, have been resilient. Earnings forecasts assume that recent, fat margins will continue to keep corporate profits and cash flow robust.



The False Dichotomy Of The "Soft Landing"

Market commentators actively debate the binary question…"soft landing or not?". The implication is a (generally undefined) "soft landing" is the best forward scenario. But what is a soft landing? Any landing at all implies a "coming down to earth from a flight".

Thus, a landing implies that the Fed will be successful in slowing a hot economy — a slowing designed to reduce inflationary pressures, yet "soft" enough to avoid ruining the economy. So far, the economy and its attendant inflation have defied the Federal Reserve's needle-threading efforts.

We suspect the debate is uninformed of the time required to reverse 14 years of monetary accommodations that have force-fed the global economy since the great financial crisis. A 5.25% policy rate, by itself, is not necessarily restrictive when central bank balance sheets still sport 8 to 10 times the monetary credit of pre financial crisis balances.

"Financial Conditions" measured by market indicators are not restrictive. Buyers and lenders share a common expectation of "lower rates tomorrow", as indicated by $350 Billion of commercial real estate loans that were mutually adjusted (by borrower and lender) to delay refinancing from 2023 to 2024. This is but one issue bubbling below the surface of the hoped-for soft landing and the widely anticipated lower interest rate scenario that "is surely to come tomorrow".

We expect surprises to continue to defy the "lower growth and lower inflation" prognostications. Yet, the financial accidents that often accompany less accommodative monetary policy are still lurking.

Until wheels are on the ground for the Fed's targeted "soft landing" and their elusive inflation target is met, a less aggressive exposure to the stock market is warranted.

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.

AAMA
ADVANCED ASSET MANAGEMENT ADVISORS
engage@aamamail.com
aamaweb.com
4995 Bradenton Avenue, Dublin, Ohio 43017
614-717-4451