



3/15/2024

March Market Commentary from Shaun Rowles

The Rowles Report

The Ides of March

Things are happening. So far this year, they have appeared to be favorable. After all, who does not like rising markets and lowering rates? 2023 went out on an almost euphoric note, spurred by unusually dovish language at the December FOMC meeting. 2024 has thus far, continued that favorable music with another recent adjustment to Fed communications.

In the Semiannual Monetary Policy Report to Congress on March 6th, 2024, Chairman Powell offered two statements that caught my eye: "We believe that our policy rate is likely at its peak for this tightening cycle", and "reducing policy restraint too late or too little could unduly weaken economic activity and employment". These statements followed sentiments expressed some two weeks earlier by the Royal Bank of Australia who noted that while inflation has yet to reach the 2% target, enough progress has been made and policy rates are restrictive enough to justify some "normalization" in advance of reaching the target.

Naturally, all eyes turn towards the March 20th FOMC meeting, not so much for an immediate rate cut but instead for additional communication and a potential change to the dot-plots. The dot-plot as it is called, is a summary of FOMC participant expectations for a range of economic data and the path of future policy rate formally known as the "Summary of Economic Projections". The most up-to-date dot-plot, from the December 2023 meeting, suggests 0.75 percentage points worth of cuts in 2024.

But as recently as a week ago, the market was expecting 4 cuts in 2024 and the 2-year treasury was similarly suggesting a 1.25% reduction in policy rate (the 2-year is often viewed as a proxy for where FFR policy rate is headed). But, what does the market know? In the January 14th 2024 Rowles Report, I noted that the "market" was pricing in a 74.5% probability of a March 2024 FOMC rate cut. I pushed back on this notion, continuing a theme I have written about for over a year now: sticky inflation that is unwilling to return to the 2% target. As of today, the "market" is now pricing only a 2% probability of a March rate cut, a 6.4% probability for a May rate cut, and is laying it's odds on the June FOMC meeting with a 55.2% probability (market probabilities courtesy of CME Groups Fed Watch Tool).

Suffice to say, the "market" is becoming less confident about inbound rate cuts as the inflation data continues to come in more resilient than prevailing narratives would have suggested. However, readers of this publication should not be surprised at how reality is unfolding relative to market narratives. Why? Because we have maintained a data-driven approach.

So does that mean no rate cuts? Not necessarily.

It appears to me that the Fed has placed itself in a challenging position. Embarrassed by a late start to the tightening cycle, media hulla-baloo over the word "transitory", and the shocking parabolic ascent of CPI readings, I suspect the Fed overplayed their hand with too many .75 rate increases and has landed at a policy rate that is more than "sufficiently restrictive". Readers from 2022 will remember that this publication anticipated this exact condition with a review of over a half century of FFR policy effects on GDP that suggested approaching the 6% bound on FFR began to provide meaningful destruction to GDP. In our current era, the Fed may be flying too close to the sun.

To compound the Fed's precarious position, this is an election year. As you know the Fed is "independent" and does not (or should not) factor political conditions into monetary policy. However, we live in a world in which people appear to perceive reality differently than their neighbors and like it or not, rate adjustments too close to the election run the risk of becoming politicized (rightly or wrongly).

So what may be in store for markets this year? That is where, once again, a data-driven approach may offer some insights.

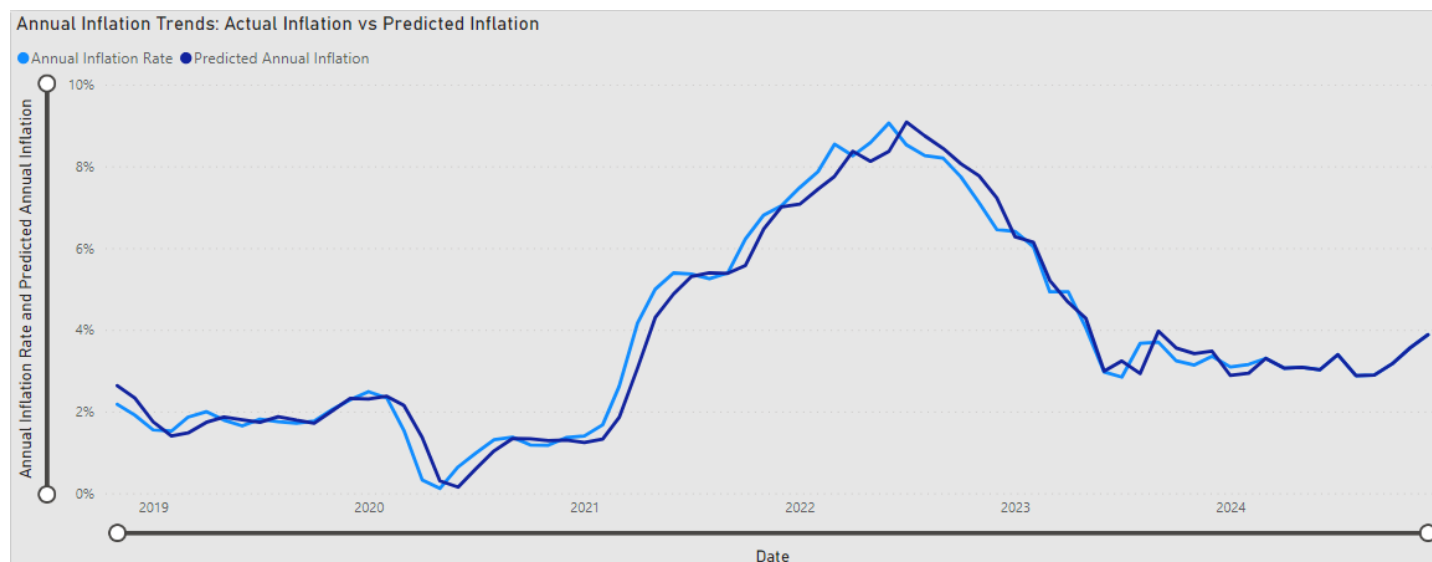
In this installment of the Rowles Report, I will offer the latest look at a number of my favorite big-data driven models to tease out where we may be in the markets and how to manage risk against the myriad conditions that currently exist. I see this year in particular as unique and especially challenging. This does not mean doom and gloom, and in fact means fairly meaningful opportunity. The challenge however, will be in keeping your wits about you. Let us dive in.

So what does the data say now?

I utilize a number of sources to help inform my situational awareness with respect to risk. Given the outsized role of Federal Reserve Interest Rate Policy in our current environment, we will start with what has been bedeviling the Fed for the past three years now, inflation.

Yes, inflation has come down dramatically. But contrary to popular belief, in recent months it has appeared to be stabilizing rather than declining. I have repeatedly telegraphed this potential issue, discussed as the Post WWII Playbook in prior dispatches, in which inflation stabilized well above 2% and the interest rate curve dwelled reluctantly below it.

In the latest look at the forward inflation projected curve, we see potential issues driven by base effects in which inflation data becomes even more uncooperative as we approach the end of the year. The situation is aggravated by longer-run projections for inflation to continue to be sticky in the upper 3's.



Source: US Bureau of Labor Statistics March 14th 2024

Equity Valuations

Runaway Train?

On March 7th, I posted an update on LinkedIn for those interested in a data-driven approach:

“Current S&P 500 price continues to accelerate beyond the Shiller Adjusted Fair Value, resembling the valuation behaviors of 2021. Of the 7 predictive algos I follow, the most aggressive has a target price of 5,177. Yesterday’s close at 5,157 brought us close. Historically, the market tends to take a breather after reaching this upper target.

***However, this was not the case during the 2021 mini-bubble!

If we are indeed looking to 2021 as a potential market proxy, the S&P pushed above the most aggressive target and continued to climb from a 10% overvaluation until reaching a zenith at 23% overvaluation from the adjusted fair value. All told it spent 10 months above the upper band before engaging a meaningful correction (25% peak-to-trough).

This builds on the potential melt up risks discussed in the January 2024 Rowles Report. I post this to add context to current moves, and remind everyone that the greatest challenge in this environment is to stay disciplined and keep your head. If we shoot past the upper band, things are likely to get exciting and concerning.”

Just a few short days later, the S&P 500 closed at 5,175.27 on Tuesday March 12th, notably exceeding the upper bound of the most aggressive predictive algorithm that I track. This price behavior continues to suggest a potential melt-up, that gains speed as we lean into potential Fed rate cuts. At last update, March 13th 2024, we began to see the predictive algorithms moving their targets lower. This is a new development that may suggest a weakening underlying market, but certainly reinforces a situation in which S&P 500 current pricing continues to dwell outside the historical channel,

reinforcing a mini-bubble thesis. Not a sell signal per se, but certainly something one should keep in mind when evaluating incremental positioning with respect to risk.

Compounding our current position, the March 2024 mid-month refresh of Robert Shiller & Yale Universities big-data set offers some additional sobering insights. Allow me to explain.

As of the March 13th, 2024 update to the Shiller Models, from a current market price as compared to the Shiller Adjusted Fair Value, the S&P 500 is now overvalued by approximately 12.2% (up from February's read of 10.3% overvalued). Such an overvaluation is not yet approaching extreme levels, but the trajectory on the chart suggests it might make a run for it. What it does indicate is that the slightest breeze could trigger a rapid ~12% correction that I think would be fully rational and justified. Thus, from an investors perspective, this allows us the opportunity to conduct a spot-check: are you comfortable with a sudden 12% decline in your equity positions? If yes, carry on. If no, then now is as good a time as any to adjust your risk appetite.

Perhaps more concerning was the change in risk level that occurred this month. On a scale of 1-5, with 5 being the highest risk reading, the S&P 500 shifted from a 4 to a 5 reading this month (per the Shiller Data Set 3/14/24). This metric does not in of itself indicate bad things to come, rather it suggests a strained system primed for nothing less than perfection. To be sure, we cannot rule out further excesses in asset price movements, but we can suggest that without a meaningful change to a few macro inputs, such a move is more than likely unsustainable.

But once again, what about AI?

AI continues to be a driving force of optimism within the economy. Fortunately, in recent months we have begun to witness a broadening out of participation within the equity markets, systematically reducing the hyper-concentrated leadership from just a handful of stocks that powered the 2023 market higher.

That said, we just concluded earnings season and according to my preferred S&P 500 earnings analyst Howard Silverblatt of S&P Global, we registered approximately 7% earnings growth (S&P Global March 14th 2024 S&P 500 Earnings and Estimate Report).

This is shy of the approximate 12.7% full year growth that Howard is expecting for 2024 (\$240.78 in earnings currently expected) and a far cry short of the 14% growth that was expected by consensus analysts on the street coming into the year. For now, most analysts seem content pushing expectations for double digit growth further out in the calendar year. As for Howard, he is currently projecting 14% year-over-year growth 2024 to 2025, with 2025 expected EPS of \$274.72.

Why does this matter? And more importantly, what should we be expecting?

In a quick review of S&P 500 Earnings per share growth history from December 31st, 1989 to September 30th, 2023 as published by Multpl, we find that the average annual EPS growth rate is 14.67%. However, as you might expect, the road to earnings growth is highly bumpy with a standard deviation of approximately 51.10%, and a range from -77.52% to +242.54%. The median annual EPS growth rate is 10.98%, thus current trajectory for ~7% earnings growth remains weak, especially in the context of "recovery" time periods.

Using the Multpl data set and Minitab statistical modeling, I also took a quick look at the impact of inflation and Fed Funds Rate on EPS growth through a series of regression models; both only offer correlation coefficients of approximately -0.30. This suggests that despite a regime in which inflation and Fed policy rates are declining, the boost to S&P EPS is mild at best. So will Artificial Intelligence be the driver of a surge in EPS, or at least enough to get us to the ~14% historical average and current analyst expectations?

As stated in prior dispatches, if AI is to have the effect that many are predicting it will most likely be picked up in the earnings of a wide range of corporations and theoretically could offer outsized boosts to productivity, margin, and profitability. As of yet, this phenomenon is still isolated to only a small number of companies. I remain skeptical that the effects will distribute throughout the system fast enough to be observed in the next quarter or two. As such, I am not banking on AI as the cure-all to the stretched valuations, at least not in the short-run.

This is not to say that AI could not surprise us all. In fact, historically speaking, great waves of innovation have a track record of shocking us. Consider just a single example from the 1830's in which the great innovation of steam powered rail travel captivated the public attention. Keep in mind that just a few years before this event, there was an extensive public debate as to whether or not humans could even survive travel at speeds greater than 5-7 miles per hour, as conveyed in Richard Rhodes 2018 book "Energy". Celebrating the grand opening of the first passenger railway from Liverpool to Manchester, the event was attended by throngs of people and several key dignitaries such as the Prime Minister and Liverpool's MP, William Huskisson. Author and co-founder of DeepMind Mustafa Suleyman describes what happened next:

"During the celebration the crowd stood on the tracks to welcome the new marvel as it approached. So unfamiliar was this striking machine that people failed to appreciate the speed of the oncoming train, and Huskisson himself was killed under the locomotive's wheels. To the horrified spectators George Stephenson's steam-powered Rocket was monstrous, an alien, belching, terrifying blur of modernity and machinery" ("The Coming Wave", Suleyman p. 131).

This serves as a gruesome reminder that along with innovations comes a level of change that is rarely comfortable for all of society. For as much hope we imbue in the latest technological innovations, we should also understand the large and unanticipated risks that can accompany them. From an investors perspective, waves of innovation often usher in conditions ripe for speculation. The challenge becomes monitoring the pace of adoption and ensuring that those active in the frontier are generating economic value and not just blowing bubbles.

To be sure, this is the battleground to watch. Should AI continue to defy expectations and accelerate or amplify earnings growth across an increasingly broader base of corporations, bubble concerns will likely continue to be alleviated and valuations may quickly become rationalized. But we cannot dismiss the human tendency to get carried away with a compelling narrative and become unduly separated from our hard-earned capital.

When investing on the frontier of innovation, one simply must do their homework. Indeed, in a recent extensive UBS publication focused on the AI ecosystem, some of the more compelling opportunities were in 2nd and 3rd derivative plays with energy consumption and data center utilization as likely near-term beneficiaries (UBS Cloud Infrastructure – AI Infrastructure Bottlenecks 2/19/24). For those interested in more detail, please reach out to request the full report.

Market Proxy Revisited

A market proxy is an attempt to overlay current market behaviors with prior time periods. It can be a tempting tool, especially when uncertainty is elevated. Indeed, earlier in this text I suggested similar valuation characteristics to the 2021 time period and offered a corresponding signal that arises from such an analysis: namely that our last foray into mini-bubble-like valuations lasted 10 months before correcting. The obvious takeaway from this exercise being to set a mental clock for how long the conditions persisted in our most recent experience and be wary of staying too long at the party.

But, as I repeatedly emphasize, predicting the future is exceptionally difficult. It is, after all, unknowable. Any such analysis of historical time periods are at best imperfect and rudimentary frameworks to help manage expectations. The critical key being to stay both nimble and observant, aware when conditions agree and when they conflict, then pursuing "why".

That said, there have been numerous arguments made to align our current macroenvironment with periods from history that seem at first glance to resemble each other. Of such arguments, the late 1960's and early 1970's seem to be getting a high degree of airtime. Such arguments can be highly compelling, especially when they come from those you know and respect within the industry. I will offer one such example.

In his March 14th, 2024 market note, Fidelity's Director of Global Macro Jurrien Timmer, offered a compelling comparison of today's "soft landing" thesis to the events of the 1966-1968 analog. Chiefly, Timmer noted that the cycle began with similar fiscal spending dominance coupled with easy Fed policy (referred to as the "guns & butter" period) as what was witnessed during Covid. Timmer aptly points out that this time period also enjoyed the similarity to today with a positive stock/bond correlation and a maturing equity bull market (I have covered Timmer's thesis and supporting evidence of today's maturing bull in prior dispatches).

From a Federal Reserve perspective, Timmer also notes that in 1966 the Fed shifted from a tightening cycle to an easing policy stance in a move he characterizes as "premature". I suspect the many readers may similarly view today's evolving market narrative as indicating a similar situation. All told, in Timmer's analysis, the mixture of policy decisions and valuations relative to earnings behavior was successful in postponing what appeared to be an in-bound recession to 1970. In Timmer's words "It was a cycle delayed, not canceled" (Jurrien Timmer, Market Note 3/14/24).

Many others also reference this time period with discussions of elevated inflation famously characterized by the 1970's and references to Fed Chairman Powell being fearful of the ghost of Arthur Burns who pivoted too early only to find the economy experiencing a second, more damaging wave of inflation.

Here again, analysis of the Shiller & Yale big data set offers some fruitful guidance and enable me to respectfully push back on the late 60-70's thesis. From a valuation perspective, equity markets were substantially more reasonably priced throughout the 1966 to 1968 time period with the S&P 500 spending a great deal of time below the adjusted fair value, which is a fairly rare phenomenon. This metric accounts for both inflation and interest rates and serves to "level" the analysis playing field.

From a risk perspective, the market was in a wildly different place throughout this time period. Utilizing the Shiller/Yale 1 to 5 risks scale, the market had dropped all the way to a 1 (lowest risk environment) by September 1966 and did not make its way back to a 3 risk rating until 1972. In fact, our recently achieved current risk level of 5 has shockingly few historical analogs over the past 75 years, joining the years 2000, 2007, and 2020 as it's analogues.

I will conclude this comparison with one final macroeconomic note that is often overlooked, which in this author's opinion leads to analytical errors. Until August 15th, 1971 the US economy, and the rest of the world via the Bretton Woods system, was still firmly rooted on the Gold Standard. For better or for worse, the gold standard offered a level of credit creation governance that is wildly different from our more contemporary experience. It is perhaps owing to this meaningfully different operating paradigm that overall risk levels remained low throughout the late 1960's. It certainly alludes to a completely different monetary policy system for the Federal Reserve at that time. Perhaps, most importantly, it was the "Nixon Shock" in which the US abandoned the gold standard by closing the "gold window" and ending dollar convertibility into gold that fueled the inflationary tendencies of the 1970's. After all, this was the first time in modern history in which all major global currencies became untethered to a uniform unit of account and began to frantically search for "real price discovery" in what became the beginning of the fiat era.

In fact, it could be argued that our current macro environment is attempting to tease out a situation mirroring that of the late 60's in reverse. With the emergence, and now universal permeation (via the recent ETF launches), of Bitcoin, the global participants of the financial system may be engineering their own modern form of the gold standard, call it a "digital gold standard". The argument at root in this new asset frontier is the notion of finite supply hard-coded into the Bitcoin protocol. With the upcoming halving (scheduled reduction in supply growth), Bitcoin may break away from its recent parity with gold which tends to average approximately a 2% annual increase in supply (James Rickards, "The New Case for Gold" 2016). Moreover, as we move further into the future, Bitcoin's capacity for new supply may continue to diminish. This is not, in of itself a justification for bullishness in Bitcoin, but does appear to live at the heart of arguments for the new asset to represent an escape path from fiat currency debasement. Only time will tell if this logic holds to be true, or becomes a digital hallucination.

Lest you think that price appreciation in Bitcoin is just speculation, or animal spirits, keep in mind that as the digital asset has been reaching new all-time highs in price, it has been doing so with much company. Not only has a large segment of the digital asset ecosystem reached for higher and higher price levels, but the original asset at the core of the gold standard has also been making new all-time highs in price.

Come what may, we are in a notably different environment than that of the late 60's or the 70's, and an increasing number of financial market participants are seeking protection from government deficits and currency debasement.

Putting it all together

My playbook is rather simple. Don't get caught off-sides, don't commit unforced errors, this is no environment for "Hail Mary's" or to summarize in financial parlance: risk management is everything.

My internal clocks are ready. I am monitoring to see if mini-bubble conditions persist and have commenced a 10-month count down timer corresponding to the 2021 analogue. I am watching for the first official rate cut from the Federal Reserve, at which point I will be especially alert for a potential blow-off top to manifest.

Driven by the change in risk levels for the market overall, I am minimizing exposure of new capital to risk. But owing to the tendency of markets to overshoot and our collective tendency to prolong periods of overvaluation, I am not abandoning legacy equity positions. I am building my 'wish list' of securities I want to own if a sudden correction were to provide a better entry point. I am continuing to be opportunistic within fixed income while we still have reasonable rates, but maintaining my standards for minimum hurdle rates, real yields, and high credit quality (extra protection should the credit markets suddenly abandon their current complacency).

Above all, I am using the current favorable environment to re-assess overall risk appetite. As conditions accelerate further beyond historical standards for valuation and the highest reaches of predictive algorithms, we may take additional chips off the table. After all, when did Noah build his Ark? Before the rain.

Fortunately, we appear to still be within a moment of opportunity to reposition for anyone whose tolerance for risk may be changing.

As always, I hope you have found this both enjoyable and helpful.

Kindest regards,



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