Journey Wealth
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JOURNEY WEALTH

Mid-Quarter Market Commentary

January 2024 Q1

Contents

Market Recap

From a capital markets perspective, 2024 has been a tale of two asset classes. Equity volatility has been muted, with the VIX volatility index sitting near 5-year lows. Fixed income markets have been bumpier as the market and the Fed's expectations on the path of rates have become more aligned. Inflation remains a concern and the likelihood of rate cuts in the near term appears remote. Equity market participation has broadened over the past quarter, as international and value equity performance have converged with the large cap growth segment. Fixed income offers attractive yields in addition to the potential for capital appreciation if interest rates decline. Equity valuations vary widely, with international, value and small caps presenting reasonable valuations on a historical basis and large cap growth priced for perfection.

Jack LaLiberte, CPA, CFA

Leading Topics

Inflation– While much progress has been made on inflation, the last mile continues to prove difficult. Part of the stubbornness is due to the stimulative nature of fiscal policy. The Fed's efforts to remain restrictive are being diluted by substantial deficit spending at the Federal level. Additionally, shelter inflation accounts for over half of headline CPI. Rent pressure has eased somewhat, which should start to slow shelter inflation momentum. However, housing starts have slowed and the path of interest rates has disincentivized homeowners from moving, constraining supply and maintaining inflationary pressure.

Federal Reserve/Interest Rates – Although we have likely seen the end of rate hikes, the Fed has been clear in its intent to leave rates higher for longer. Futures markets are currently pricing in 1-2 rate cuts this year, although there's a real possibility that cuts don't occur until 2025. Regardless of the Fed's actions, long-term rates are likely to remain elevated relative to recent history given the dynamics at play in the Treasury market.

Fixed Income – Yields across most fixed income categories are well above their ten-year averages, providing investors with an opportunity to earn meaningful yields for the long term. In either a soft landing scenario or a recession, we believe the outlook for fixed income is bright. In both scenarios, interest rates, particularly short-term rates, are likely to decline. In addition to attractive yields (approximately 6% for core bonds), declining rates present an opportunity for capital appreciation. When considering the reinvestment risk present in cash and somewhat elevated equity valuations, we believe fixed income offers an attractive risk-adjusted opportunity.

Equity Breadth– In 2023, the bulk of equity returns were concentrated in a narrow neighborhood of large cap US stocks. US large cap growth has slightly outperformed other segments year-to-date. However, participation has been much broader in 2024, with international equities picking up steam. Value continues to lag growth domestically, but the gap has narrowed. Valuations in the domestic large cap growth segment remain lofty, while other categories (value, SMID, International) remain at or below their long-term averages. Equity markets are concentrated relative to historic norms from a country, industry, and individual company basis, making diversification even more critical.

See Disclosures on final page

Pete Franz, CIO

On The Horizon...

JOURNEY

Journey Wealth is excited to announce our upcoming insights and events focused on providing market commentary and analysis. Join us as we explore the latest trends, strategies, and opportunities to help you navigate the complexities of today's financial landscape.

- ☑ Q2 Quarterly Commentary
  July 15th, 2024
- ☑ Semi-Annual Insights
  July 30th, 2024
- ☑ Q3 Semi-Quarter Commentary
  August 30th, 2024

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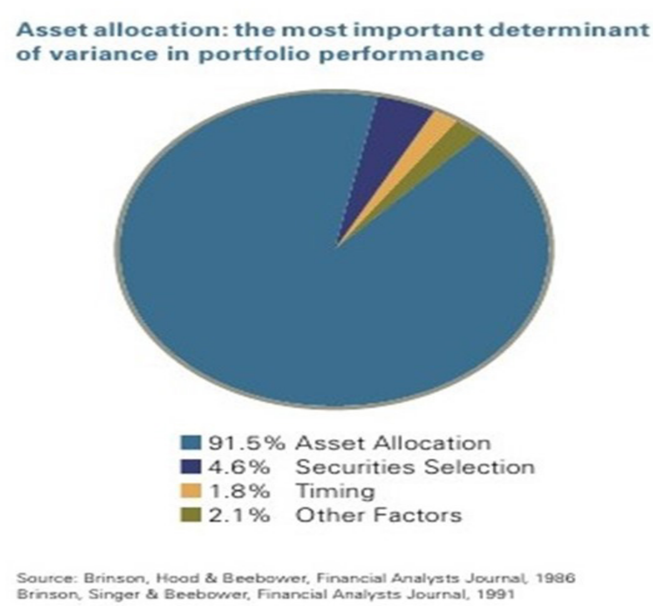
Asset Allocation

Much of the investing discussion in the financial media has centered on the timing of the Fed's first rate...

cut. While rates are an important input, attempting to time the Fed is not beneficial for long-term investors. Fixed income markets are likely to remain volatile while the Fed's path crystallizes, but higher yields help insulate bond investors. In contrast to 2022, investors have real yield in fixed income to lean on if the Fed takes longer than expected to cut rates. The path for equities is less certain. Rate cuts are likely to provide short-term catalysts for stocks. However, equities seem to already be pricing in a soft landing. Historically, both fixed income and equities typically outperform cash over the long term, including in the period after the Fed stops raising rates. We advocate building portfolios to achieve your long-term goals as opposed to trying to react to the latest Fed meeting or geopolitical event. Please don't hesitate to reach out to your advisor to schedule time to discuss your financial plan, including your goals and planning assumptions.



Equity Breadth

Big Fish in a Small Pond: The S&P's Concentration Conundrum

The weight of the ten largest stocks within the S&P 500 remains near all-time highs. In 2023, the bulk of US equity returns were generated by a narrow subset of large cap growth stocks. Thus far in 2024, participation in the rally has broadened out, particularly amongst value and international equities. The valuation gap between large cap US growth equities and the rest of the equity universe (value, SMID, and international), remains near historic levels. Not only do ten stocks make up about a third of the S&P 500, but seven of those are in the Technology and Communications sectors. While we don't think it's valuable to prognosticate where equity markets are heading, we firmly believe in diversification. The value of diversification is even more critical when equity markets are as concentrated as they currently are. We advise caution when it comes to the illusion of diversification provided by indices like the S&P 500.

To use an overused quote, "Life is 10% what happens to you and 90% how you react to it"*. The same can be said for investing. As investors, there are many things we can't control, such as which sector will outperform over the next quarter or when the Fed will cut rates. One thing that investors can and should do is ensure that portfolios are regularly rebalanced, particularly after a year like 2023. If you haven't rebalanced in the last few years, your investment risk may be more concentrated than intended. Rebalancing can be difficult, as our recency bias can make us attached to the holdings that have provided the best recent performance. Additionally, rebalancing likely involves tax consequences, as nearly by definition, rebalancing involves selling a portion of your best-performing assets. Those costs can feel more tangible than the elevated risk investors expose themselves to by not rebalancing. Vanguard published a study on the benefits of rebalancing, where they found that a 60/40 portfolio of equities and fixed income that was not rebalanced over 60 years produced a lower return and a higher volatility than an 80/20 portfolio that was rebalanced regularly. That elevated volatility that you expose yourself to when you don't rebalance can then lead to poor investment decisions, including attempting to time markets. Historically, average investors have proven to be poor market timers. Regular rebalancing takes the decision away from the realm of emotion and systematizes it.

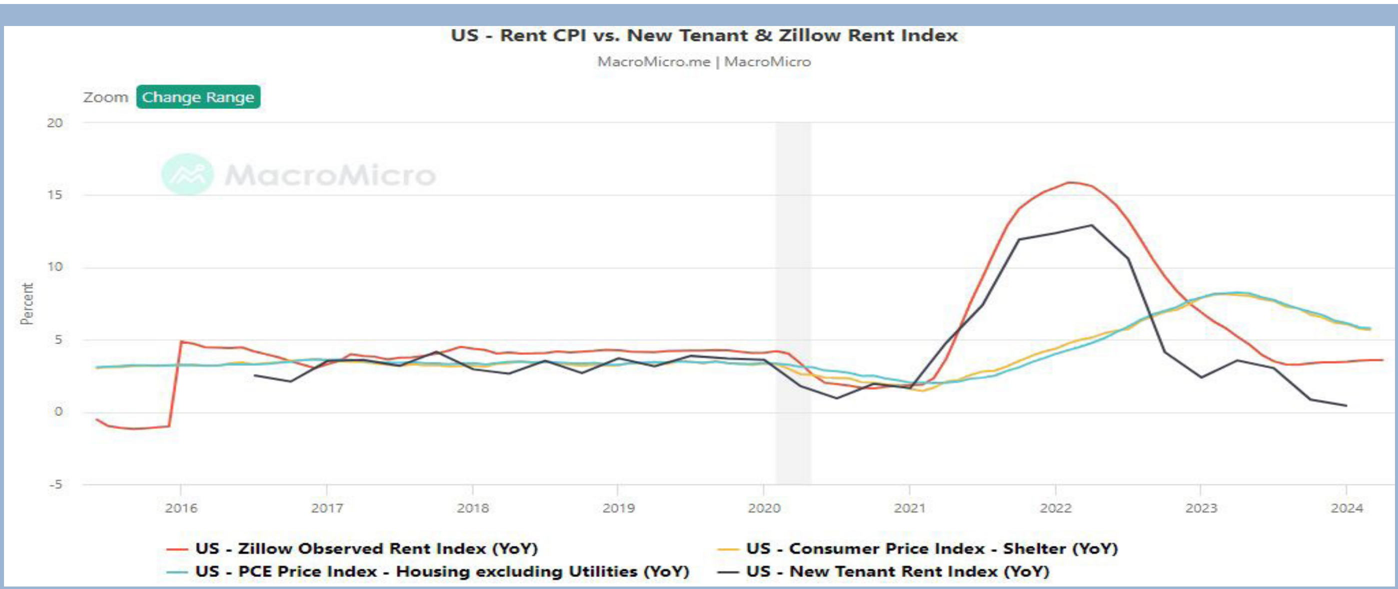
Source: JP Morgan

Equity Breadth

Diversification Delight: Embracing the Shift in Equity Dynamics

While large cap US growth equities have driven equity performance over the past year and a half, the dynamic has shifted in 2024 with other equity segments participating in the continued rally. We don't know which equity segment will outperform over the next year or decade, which is why we believe in diversification. Rebalancing is critical to maintaining target risk exposure in a portfolio and the importance of doing so is elevated during periods where there is a wide dispersion in returns between asset classes.

> The only investors who shouldn't diversify are those who are right 100% of the time.
>
> \- John Templeton



Source: Stepstone Group, Bloomberg**

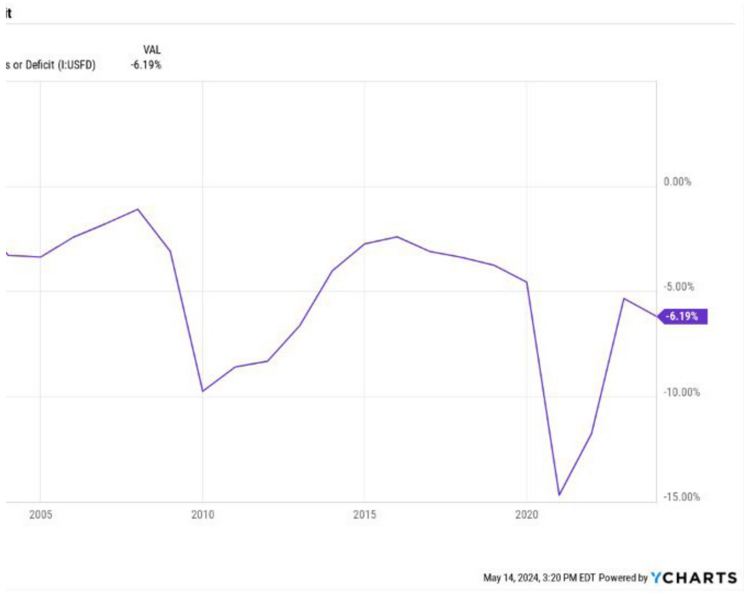
Inflation

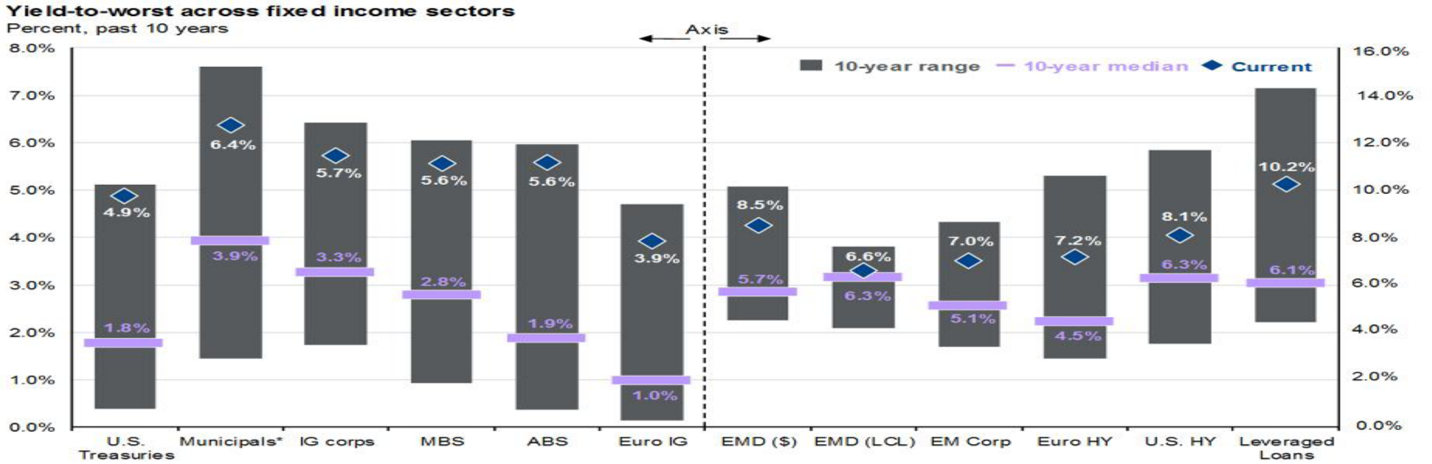
Progress Made, Challenges Remain: Navigating Housing Hurdles and Policy Push-Pull

While significant progress has been made on inflation over the past two years, the final 1.5% above the Fed's target of 2% has proven stubborn. At this point, more than half of the remaining inflation is related to shelter costs. The Zillow Rent Index, which is a more contemporary indicator of shelter costs than CPI, shows signs that rent pressures may be easing.

Longer term, housing costs are likely to remain pressured due to a shortage of housing supply. A contributer to the supply problem is the path of interest rates. At the end of 2023, about 70% of homeowners with mortgages had a rate that is more than 3% below the current average mortgage rate, disincentivizing existing homeowners from selling.

While the Fed has made considerable efforts to increase the restrictiveness of their policy, the Federal Government has been doing the opposite. Deficits have recovered somewhat from the levels seen a few years ago but fiscal policy remains expansionary. This seems unlikely to change in the near term given the divided state of government. Furthermore, about 60% of Federal spending is non-discretionary, consisting of interest payments and entitlements. The Fed will likely have to remain restrictive for a longer period to counteract the impact of expansionary fiscal policy.





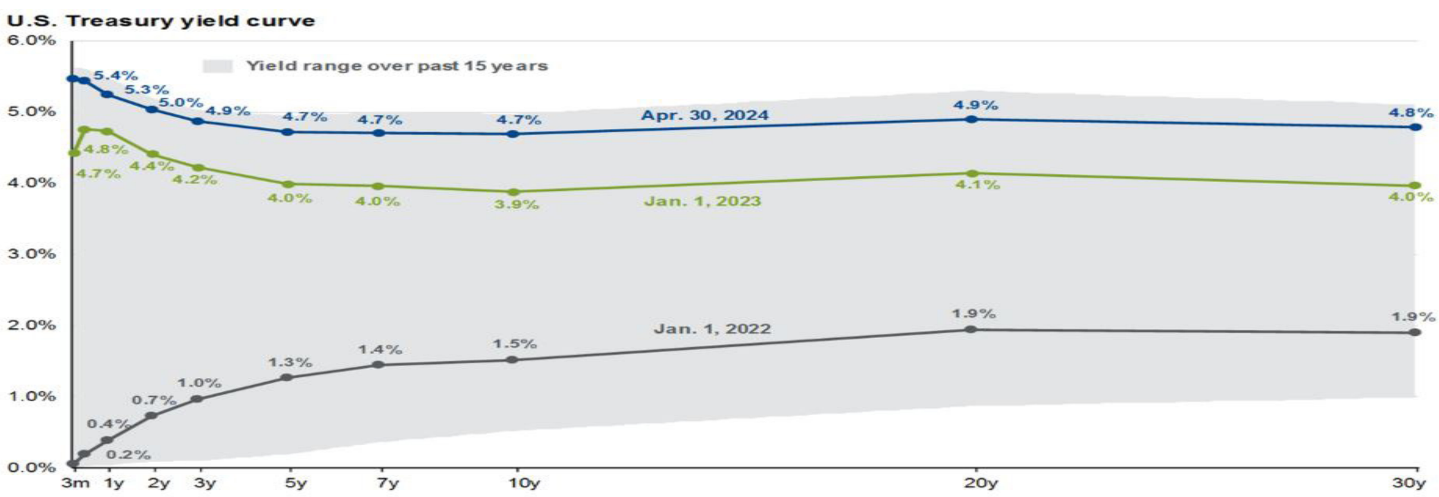
Source: JP Morgan

The Fed & Fixed Income

While the path for rates remains uncertain, most agree that the longer-term trend for short-term rates is downward. Yields have crept back up since the beginning of the year as market participants have reduced their expectations of how quickly and how drastically the Fed will cut rates. Currently, futures markets are pricing in 1-2 cuts this year but that may get pushed out further if inflation is slow to normalize.

Larger treasury issuance and the Fed's commitment to balance sheet reduction will likely keep long-term rates higher than those we've seen in the recent past, regardless of the Fed's efforts to manipulate rates at the short end of the curve. Yields have pulled back slightly since the fall, yet we consider current levels to be an attractive entry point for long-term fixed income investors.

It's easy to fixate on attractive money market yields. However, these rates typically fall quickly once the Fed begins cutting rates. Fixed income has historically outperformed cash equivalents by a substantial margin in the years following a Fed hiking cycle. Currently, core fixed income assets offer similar, if not better yields than money market funds, so there isn't a yield sacrifice to extend duration. While cash and money market funds bear low levels of market and interest rate risk, they leave investors exposed to reinvestment risk. If you have dollars sitting on the sidelines that are earmarked for fixed income, why not lock in current higher rates for the long term by extending duration?



Source: JP Morgan

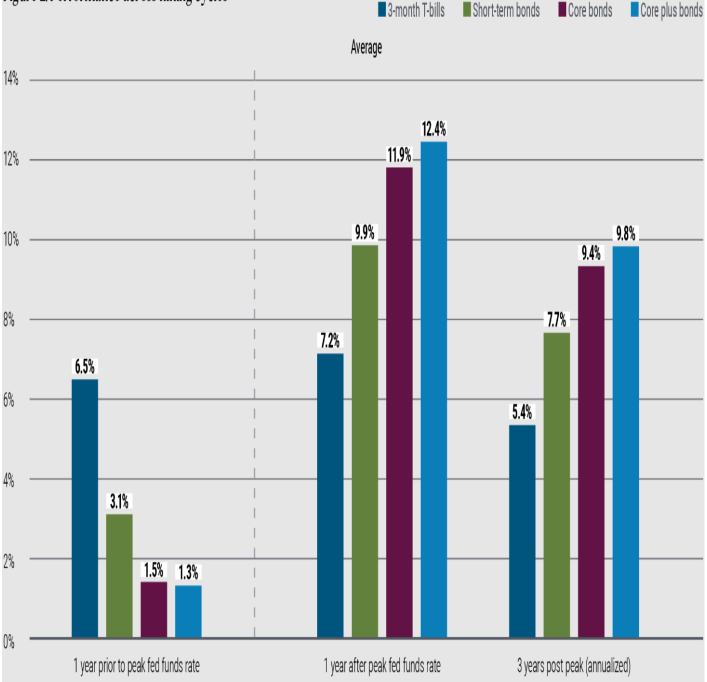
Timing The Fed: A Fool's Errand?

The financial media spends much of their time speculating on when the Fed will begin to cut rates. From a long-term investor's perspective, trying to guess when the Fed will cut rates is unlikely to be a productive endeavor.

Fixed income performance in the wake of a rate cut has been predictable over past cycles. Whether a recession follows rate cuts or GDP growth continues, fixed income has offered an attractive return profile. In either scenario, fixed income has outperformed cash over both the short and long term. Currently, core fixed income offers yields that are similar or better than yields on money market instruments. As such, there's no reason to wait to make the shift from cash to fixed income if you have excess cash sitting on the sidelines. In addition to the yield parity, fixed income offers the opportunity for capital appreciation if rate cuts occur.

Long-term equity performance depends more on the economic growth outlook (i.e., whether a recession occurs or not) than the Fed's actions. Historically, GDP growth is a far more significant factor in equity performance than the Fed's decisions regarding short-term interest rates. Over the short-term (one-year period), equities typically perform well when the Fed cuts rates and a recession is avoided. When the Fed has cut rates and growth falters, the short-term outlook for equities is weaker. The Fed's actions are likely not the causal factor for equity performance.

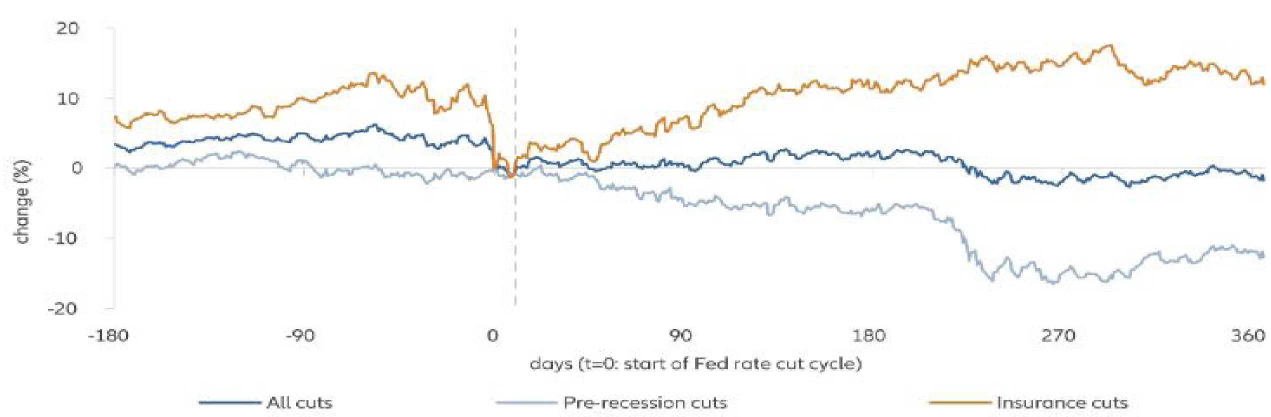
Figure 2: Performance across hiking cycles



As of 31 March 2024. Source: PIMCO, Morningstar, Bloomberg. T-Bills: Citigroup 3-Month US T-Bill Index; Short-Term: Morningstar Short-Term Bond Category; Core Plus: Morningstar Intermediate Core-Plus Category; Core: Morningstar Intermediate Core Category.

Both core bonds and equities have consistently outperformed cash equivalents by a substantial margin in the years following a Fed hiking cycle. Ultimately, while interest rates are an important input for capital markets, the timing of rate cuts is not nearly as critical as creating and maintaining an asset allocation that's aligned with your long-term risk and return goals. Asset allocation is responsible for about 90% of investment returns. Timing, whether it's waiting on the Fed or other factors, has historically explained little of portfolio performance.

S&P 500 excess return vs cash



Source: Allianz Global Investors Global Economics & Strategy, Bloomberg (data as at February 2024)

What's It All Mean...

Inflation, a Slow Battle

Inflation continues to moderate gradually. The Fed's efforts to remain restrictive are being somewhat undermined by stimulative fiscal policy.

The Fed and Fixed Income

Above-target inflation minimizes the likelihood of rate cuts by the Fed in the near term. When considering the reinvestment risk present in cash and somewhat elevated equity valuations, fixed income offers an attractive risk-adjusted opportunity.

Prediction is very difficult, especially if it's about the future.- Niels Bohr

Narrow Markets, Broad Opportunities

US large cap growth equities have driven the bulk of equity returns over the past decade and valuations in the space are elevated relative to historic norms. There are opportunities outside of this narrow neighborhood where equities are reasonably priced. Rebalancing is an integral part of portfolio management. If you haven't rebalanced your portfolio recently, now may be a prudent time to consider doing so.

Don't Wait for the Fed

While the financial media spends a lot of time prognosticating over when the Fed will cut rates, trying to time the Fed's actions is not beneficial for long-term investors. What is important is allocating assets in a way that fits with your long-term financial goals and risk tolerance and sticking to that allocation.