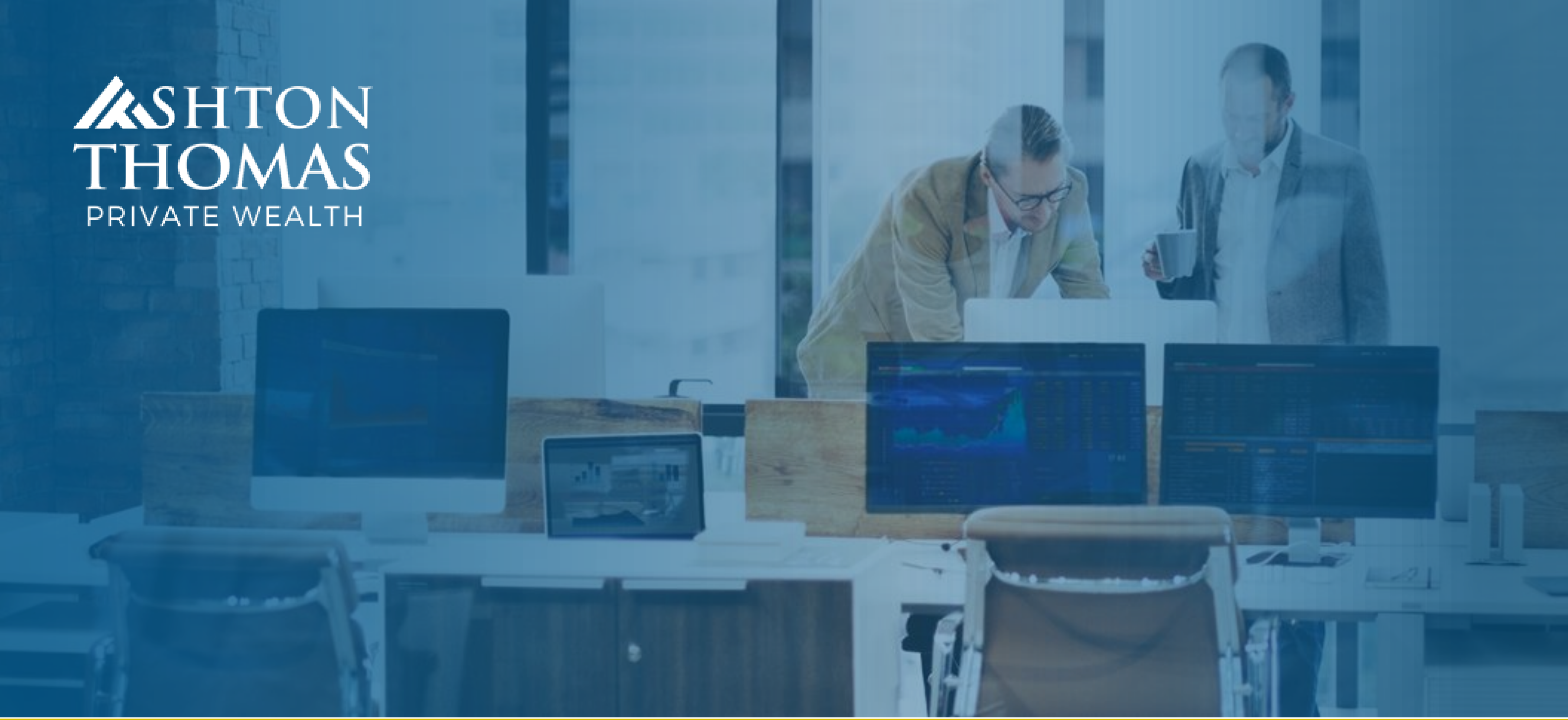

ASSET ALLOCATION PLAYBOOK

Annual Outlook 2024

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Growth, Inflation, Interest Rates and Optimism

The economy is defying many economists' dower predictions, as it refuses to go into full recession. This report will look into the economy through the eyes of Federal Reserve Governors and will provide some conclusions based on their perspectives.

Since the beginning of 2021, the Fed has communicated to the markets that the general levels of inflation were no longer considered transitory, and they have since been in full inflation fighting mode.[1]

During this time, we have seen unprecedented speed and magnitude of policy rate (those which the central bank can influence) increases.[2]

Unfortunately, there have been casualties of rising rates, such as local and regional banks, and borrowers relying on low interest rates may now have to finance or refinance at higher rates.

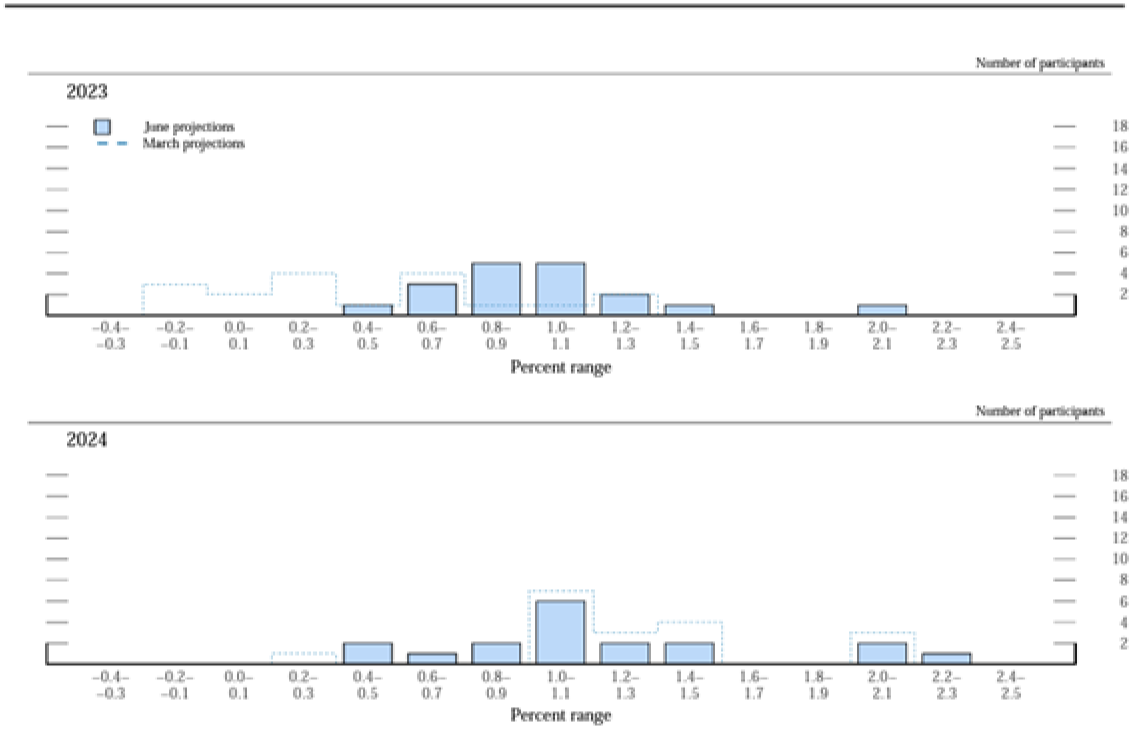
Post Fed meetings, the Federal Open Market Committee (FOMC) publishes a Summary of Economic Projections which summarizes participants projections of GDP, the unemployment rate, and inflation for the next couple of years. As with any economic projections, these do move quite a bit. However, we will use these projections published on June 14th to get some insight into what the committee is seeing.[3]

1 https://www.foxbusiness.com/politics/powell-fed-wrong-inflation-not-transitory
2 https://www.visualcapitalist.com/interest-rate-hikes-1988-2023/
3 https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20230614.pdf

Macro Comments

Starting with GDP, we can see that no committee member is predicting recession as of this June report. In fact, a number have raised their prediction to moderate real growth. From this, we may conclude two things: First, there appears to be enough strength in the economy such that substantial further interest rate increases are not likely to be needed at this point in the cycle. Second, because of the economic strength in the U.S., the Fed appears to have more leeway to raise rates somewhat to combat inflation without completely dismantling job opportunities. This was confirmed recently, as first quarter GDP was revised up from a 1.3% annual rate to 2.0%, as illustrated here.

Figure 3.A. Distribution of participants' projections for the change in real GDP, 2023–25 and over the longer run

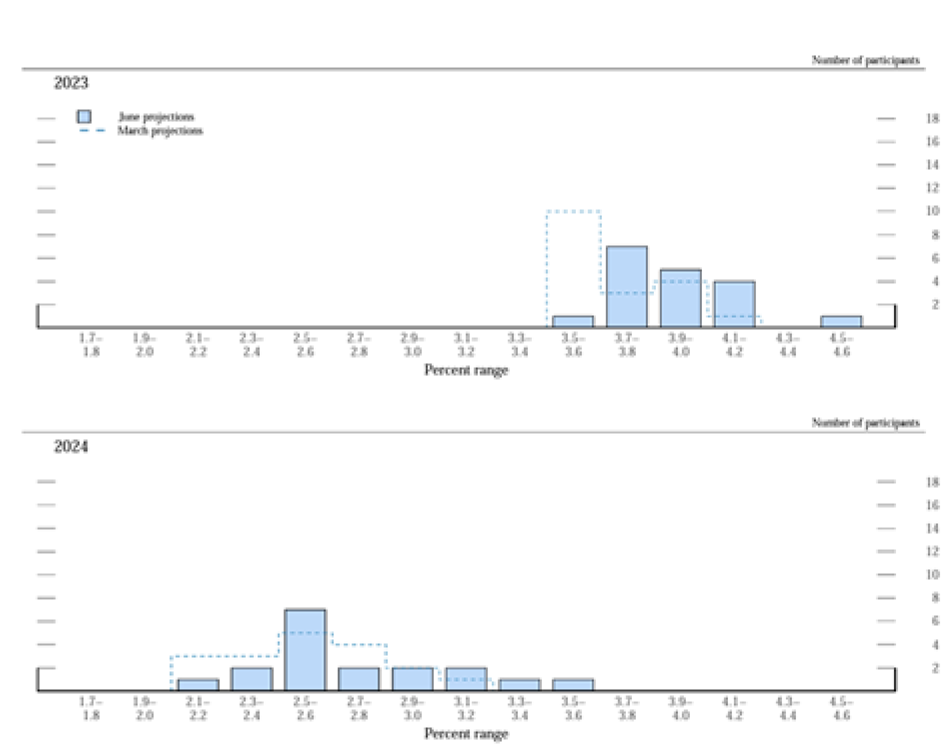


Source: https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20230614.pdf

Macro Comments

Looking at the committee's projection for inflation as measured by Personal Consumption Expenditures (PCE), it tells us a somewhat different story. Although the economy is still moving along, so are inflation expectations, especially for 2023. Taking the revisions from March to June into consideration, we see members have adjusted forecasts upward. In contrast, the 2024 projections have been brought down. So, although the trend is moving down and in the desired direction, FOMC members seem to be looking at this as a job that is "not yet finished."

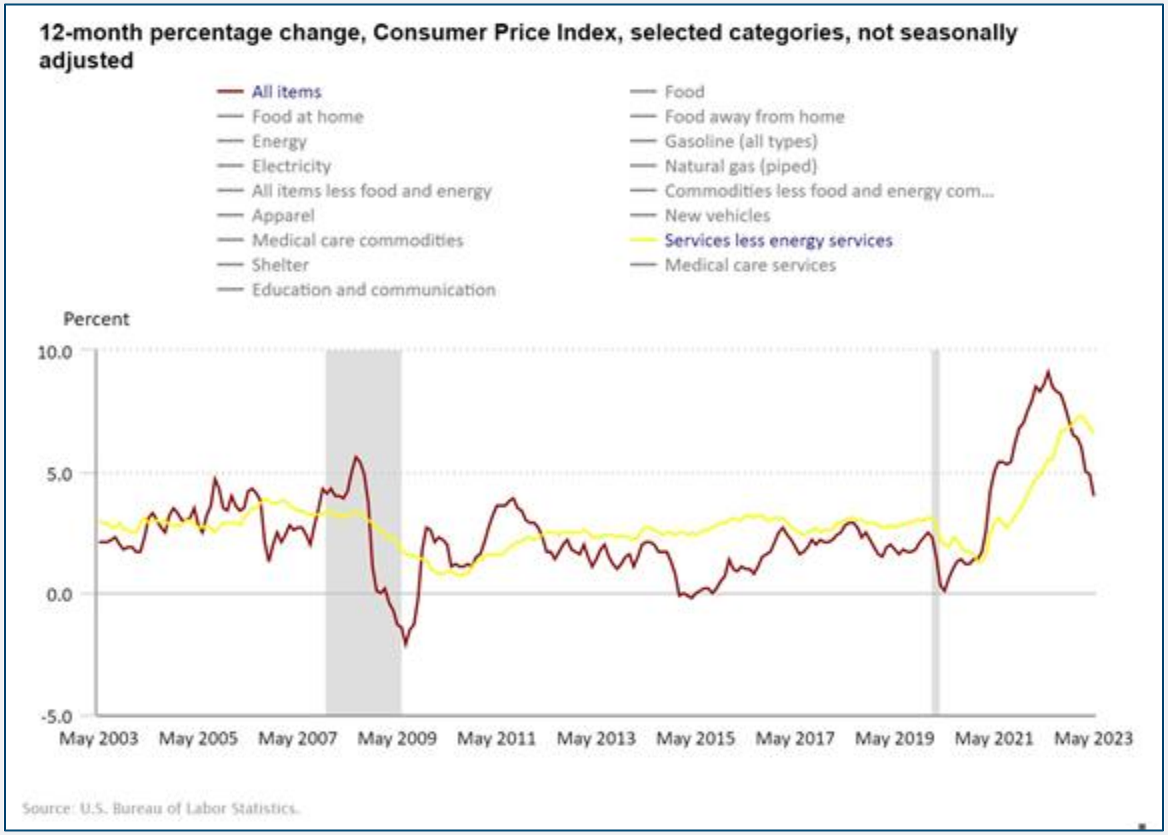
Figure 3.D. Distribution of participants' projections for core PCE inflation, 2023–25



Source: https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20230614.pdf

Macro Comments

As inflation is not a homogeneous statistic, the FOMC will look further into the numbers to find the "most onerous" component. Over many inflation cycles, wage inflation seems to have proven the most stubborn. Once it becomes "part of the system," it is generally difficult to remove. The chart below shows the general level of inflation and separates services (less energy) to give us a proxy for wage inflation. It is clearly above the general level, but seems to be falling. The cause of wage inflation in this cycle emanates from the labor shortage: not enough available workers to meet current job demand.[4]



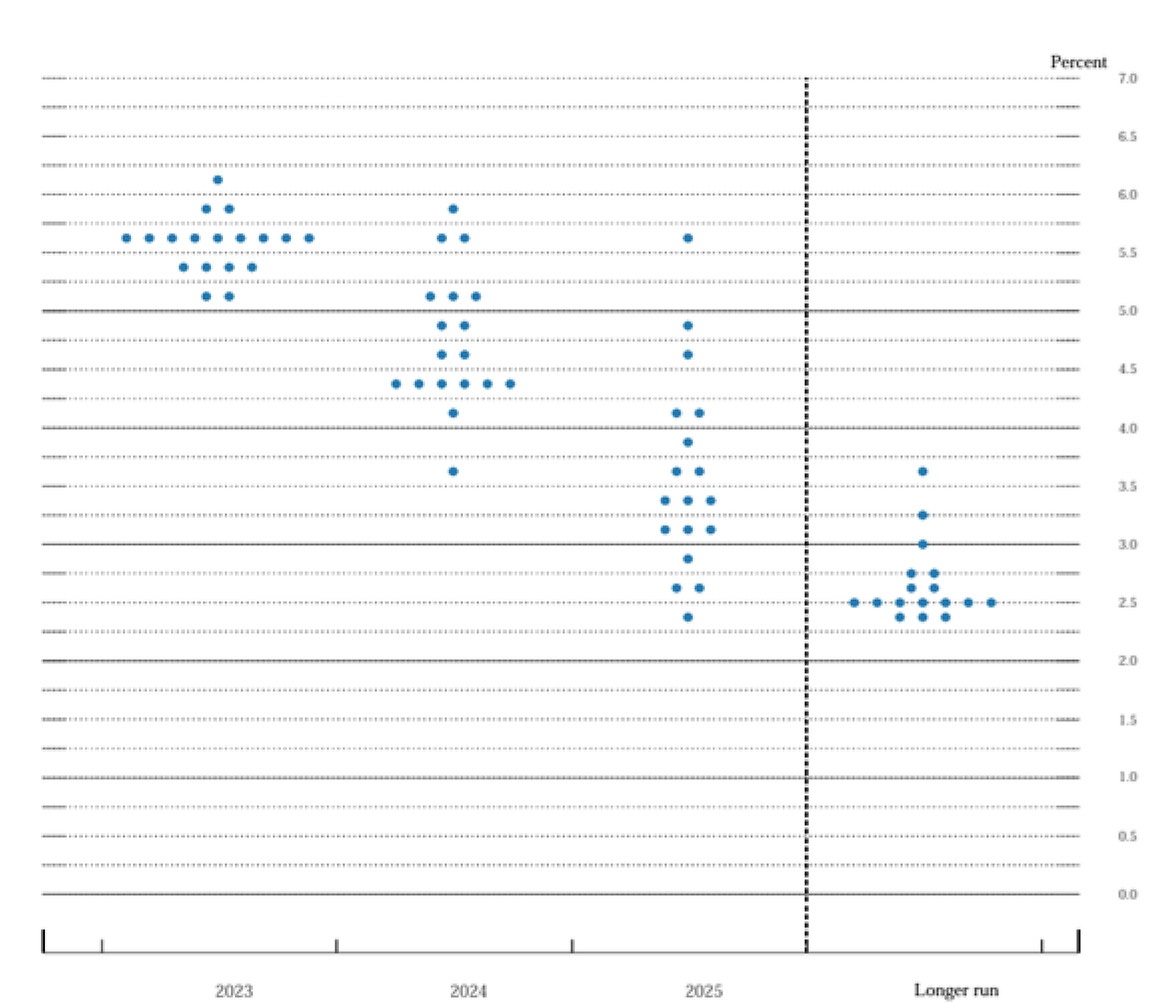
Source: https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.htm

4 https://www.usbank.com/investing/financial-perspectives/market-news/effect-of-job-market-on-the-economy.html#:~:text=Fed%20officials%20have%20clarified%20that,could%20contribute%20to%20higher%20inflation.

Macro Comments

Some of the information the Fed uses is made public. Among this publicly available data in their report, we find the Dot Chart. Each governor is polled as to their policy rate forecast and the answers are graphed. The conclusions are that
1) their views are divergent, 2) the farther the time frame the more divergent they become, and 3) the consensus is that policy rates should peak this year absent any unforecastable event. As this is a poll among economists (who rarely agree with each other in general), one must not take this literally
and understand the inherent inaccuracies of forecasting no matter who is doing it. It seems the consensus is that rates in 2024 and 2025 will fall.

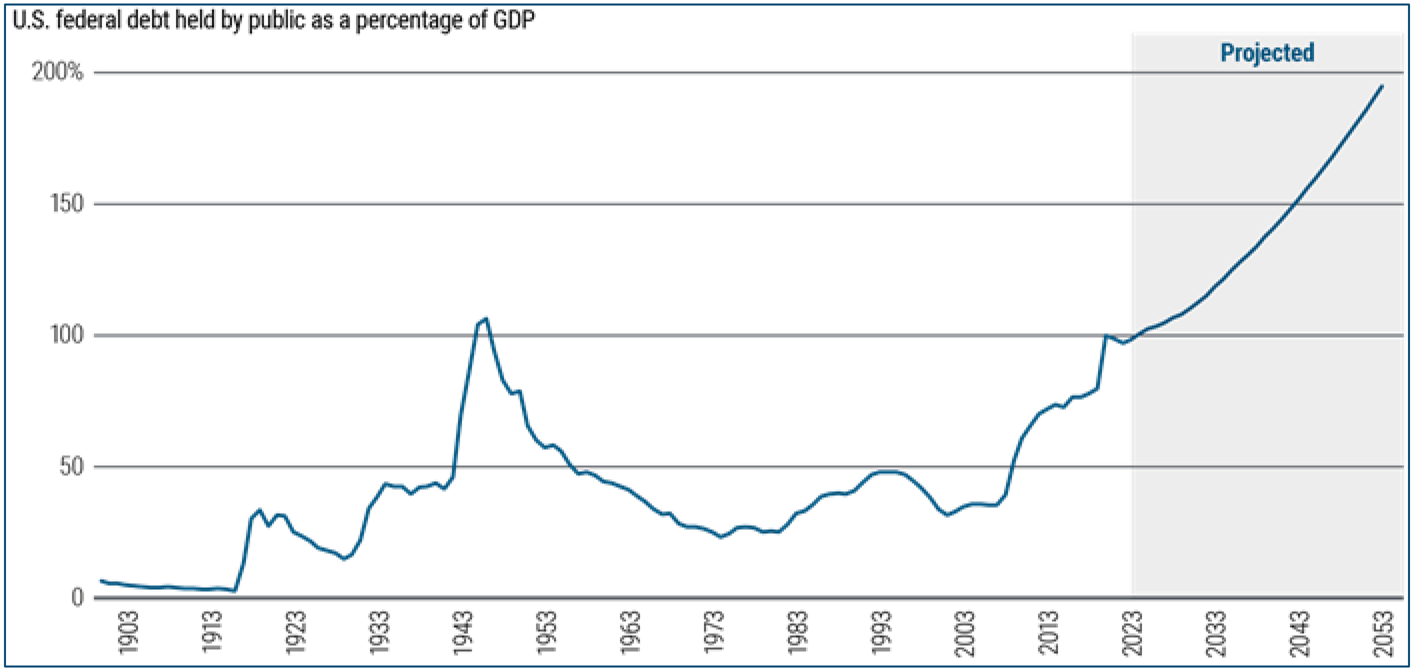
Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Source: https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20230614.pdf

Macro Comments

So, in this “rosy” economic situation where rates fall slowly, what are the risks? Some economists have, for many years, espoused the theory of “crowding out.” This theory suggests the supply of government debt can rise to the point where interest rates cause issues in the private sector, as borrowers compete for bond investors’ capital, driving up rates even further. The crowding out risk has been discussed for decades, but seems to be closer to reality in the current environment.[5] Although the recent debt ceiling “crises” was averted, the U.S. Congressional Budget Office (CBO) published the follow chart, which shows the potential increase in debt-to-U.S.-GDP. As the government continues to spend upcoming generations’ wealth, some price will have to be paid at some point.



Source: https://www.pimco.com/en-us/insights/economic-and-market-commentary/secular-outlook/the-aftershock-economy/

5 https://www.investopedia.com/terms/c/crowdingouteffect.asp

Macro Comments

On one hand, we can foresee an environment where we go into a shallow and short recession (or even a soft landing), and then move on to the next cycle. Policy rates would fall and risk assets would perform to their historical averages. That is the optimistic scenario. The (very) long awakening to the magnitude of government spending and increasing debt does put a damper on our optimism. Until this point, “crowding out” has been mostly hypothetical and has not actually moved interest rates to the point that borrowing has become onerous. However, should the CBO predictions become reality, the corresponding increase in debt and rise in rates could damper traditional investment returns.

These exogenous factors make predictions even harder for the Fed, especially as we are close to an election year. Market participants will begin to look at any Fed decisions or forecasts as potentially being politically motivated. The incumbent party would always like to delay any recession and inflation fight until after the election. The competing party will generally highlight the need to fight inflation regardless of the risk of recession. We hope that neither becomes an input to the FOMC’s decision-making process and that inflation returns to a reasonable level without dowsing economic growth.

The Magnificent Seven

For those investors who measure success as "beating an index" rather than managing wealth to client expectations, 2023 has been a perplexing year at best. 2022 saw low-duration, dividend-paying value stocks dominate. Almost exactly at the beginning of 2023, there was a paradigm shift in equities, with leadership changing. This shift was not just to technology and artificial intelligence, but specifically to the largest seven stocks in the S&P 500. To date, these companies (Meta, Amazon, Apple, Microsoft, Alphabet, Tesla, and Nvidia) account for most of the market cap and return. If we add in the next three largest companies, these statistics are historically relevant, as the table from Strategas (which we have published in prior months) shows.

Annual S&P 500 Contribution of 10 Largest Weights During Positive Performance Years

Year	Top 10 as % of Total	S&P 500 % Perf.
2023 YTD	**85.8%**	**12.7%**
2007	78.7%	3.5%
2020	58.9%	16.3%
1999	54.5%	19.5%
2021	45.0%	26.9%
1998	36.8%	26.7%
1996	33.9%	20.3%
2017	33.3%	19.4%
2019	32.8%	28.9%
1991	28.6%	26.3%
2006	27.6%	13.6%
2016	26.6%	9.5%
2003	23.6%	26.4%
1995	22.3%	34.1%
2014	22.2%	11.4%
2004	21.1%	9.0%
2005	20.5%	3.0%
2010	19.6%	12.8%
2012	19.2%	13.4%
1997	19.1%	31.0%
2013	17.6%	29.6%
2009	15.5%	23.5%
1992	14.9%	4.5%
1993	12.2%	7.1%

Source: Strategas

Year-to-date, there has been no other era where the top 10 stocks comprised more than 79% of the S&P 500's market cap. Today, it stands at 85.8% of S&P 500 market cap and accounts for 12.7% of the index's return.

Equity investors should ask what is driving this. We cite "Mega-Cap P/E Expansion," although not all the seven companies are the same in that regard. Apple's market cap is approximately equal to the *entire* Russell 2000 Small Cap Index. The difference is in valuation. Nvidia, Apple, and Microsoft are trading at near-highs of their historical ranges. The others are not.

Looking forward at Nvidia and Meta, we could use earnings expectations to somewhat justify their rise. For the others, it appears to be more problematic.

Mega-cap stock YTD results

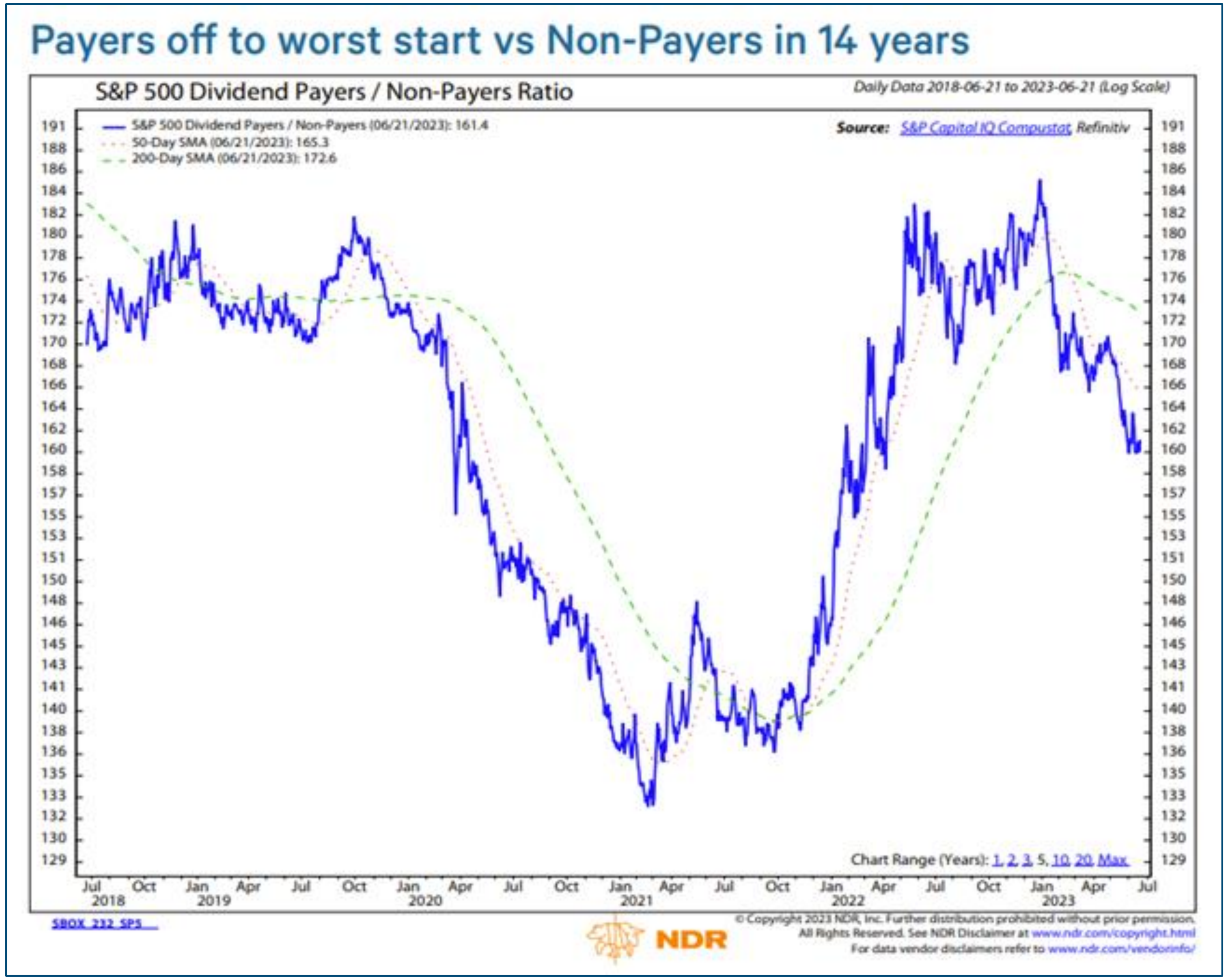
	NVDA	META	AMZN	GOOGL	MSFT	AAPL	TSLA
YTD return	181%	125%	51%	40%	40%	41%	110%
Jan 2023 Fwd P/E multiple	38x	13x	32x	15x	24x	21x	25x
Current Fwd P/E multiple	44x	18x	38x	20x	31x	28x	55x
Percentile rank of current Fwd P/E, 2013 - 2023	79%	17%	6%	28%	85%	93%	14%

Source: Bloomberg, JPMAM. May 2023.

JPM Source: https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/insights/eye-on-the-market/letters-to-the-editor-amv.pdf

JPM Source: https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/insights/eye-on-the-market/letters-to-the-editor-amv.pdf

A casualty of this mega-cap trend has been dividend-paying stocks. As the following chart shows, the relative performance of dividend-paying stocks versus non-payers has not been this pronounced for 14 years.

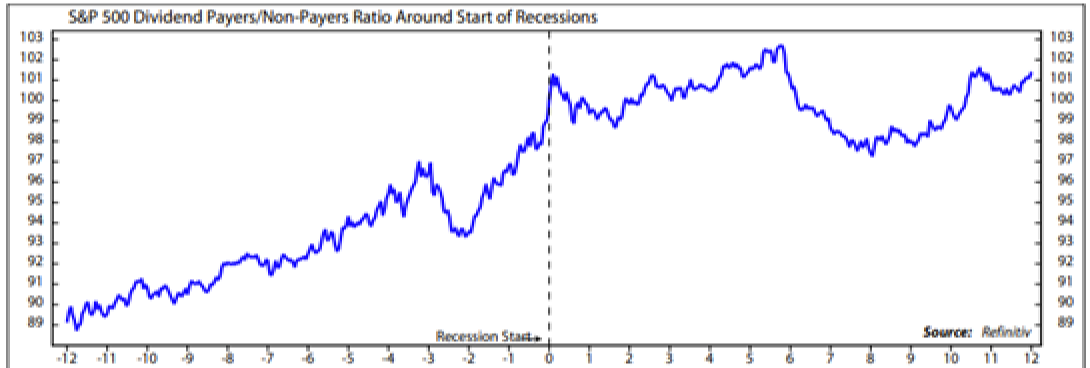


Source: Ned Davis Research

The macro factors which have led to this outperformance are 1) a positive trend, 2) general positive economic news, and 3) decreased Fed tightening in both speed and magnitude. For dividend payers to again outperform, we would need a reversal in all three trends.

So why would investors stay with dividend payers moving forward? Certainly, current valuations for alternative growth stocks warrant consideration. However, if in fact we do enter recession, dividend payers have historically outperformed, at least since 1973 (see chart at right).

Payers > Non-Payers entering recession, on average



Months Prior: -6 **-12** -24 -36

Months Post: 6 **12** 24 36

Remove Stats

Event Date	-12 Months	-6 Months	-3 Months	-1 Month	1 Month	3 Months	6 Months	12 Months
1973-11-30	N/A	4.44	4.74	6.56	3.87	-7.30	-7.40	-1.94
1980-01-31	3.24	4.28	-0.19	-0.09	-0.04	6.31	2.68	3.53
1981-07-31	0.91	0.08	3.13	1.50	2.95	7.70	9.29	2.11
1990-07-31	15.53	4.35	5.79	4.34	3.93	10.82	5.58	8.61
2001-04-02	53.91	38.25	10.27	9.67	-12.04	-8.04	12.30	12.15
2007-12-31	1.18	2.53	2.06	2.06	1.81	2.65	-1.61	6.65
2020-03-02	-1.58	-3.66	-1.73	-0.64	-5.08	-10.44	-14.08	-21.27
Median	2.21	4.28	3.13	2.06	1.81	2.65	2.68	3.53
Average	12.20	7.18	3.44	3.34	-0.66	0.24	0.97	1.41
% Positive	83.33	85.71	71.43	71.43	57.14	57.14	57.14	71.43

SBOX_395A_C

NDR

Source: Ned Davis Research

Equities

One cannot write any type of mid-year report without addressing the figurative elephant in the room, namely artificial intelligence (AI). Although the commercial applications for AI are still in their infancy, we believe that, much like the dot com revolution over 20 years ago, AI should enhance corporate productivity and appears to be a long-term positive trend. However, like the dot.com revolution and subsequent bust, trends in the short and intermediate term could change quickly and dramatically, as some of today's "winners" may not exist at some point in the future. Keeping in mind there will be losers and winners, we believe it is too early to call what, how, and whom specifically. The AI "hype machine" is taking over the markets at this point, but what type of productivity enhancement AI will actually provide is impossible to predict today.

As to whether or not AI will be able to pull the present market and economy out of its malaise is also yet to be seen. We continue to remain cautious on both the economy and markets for the next twelve months. We see some prognosticators shifting views and becoming more optimistic. Within equities, we continue to stay fully invested to slightly underweighted across our models.

Fixed Income

The first half of 2023 saw nearly unprecedented volatility in the fixed income markets, but this volatility eventually subsided. During the first half of the year, inflation prints and expectations started to wane. Expectations of a pause in rate hikes from The Fed increased, as both Consumer Price Index (CPI) and Producer Price Index (PPI) figures began to print lower. However, some evidence of inflation remaining sticky to the upside persisted, especially in Services and Wages. And although the FOMC chose to "pause" rate hikes temporarily in June, their hawkish commentary pointed at least two more hikes before a more lasting pause.[1]

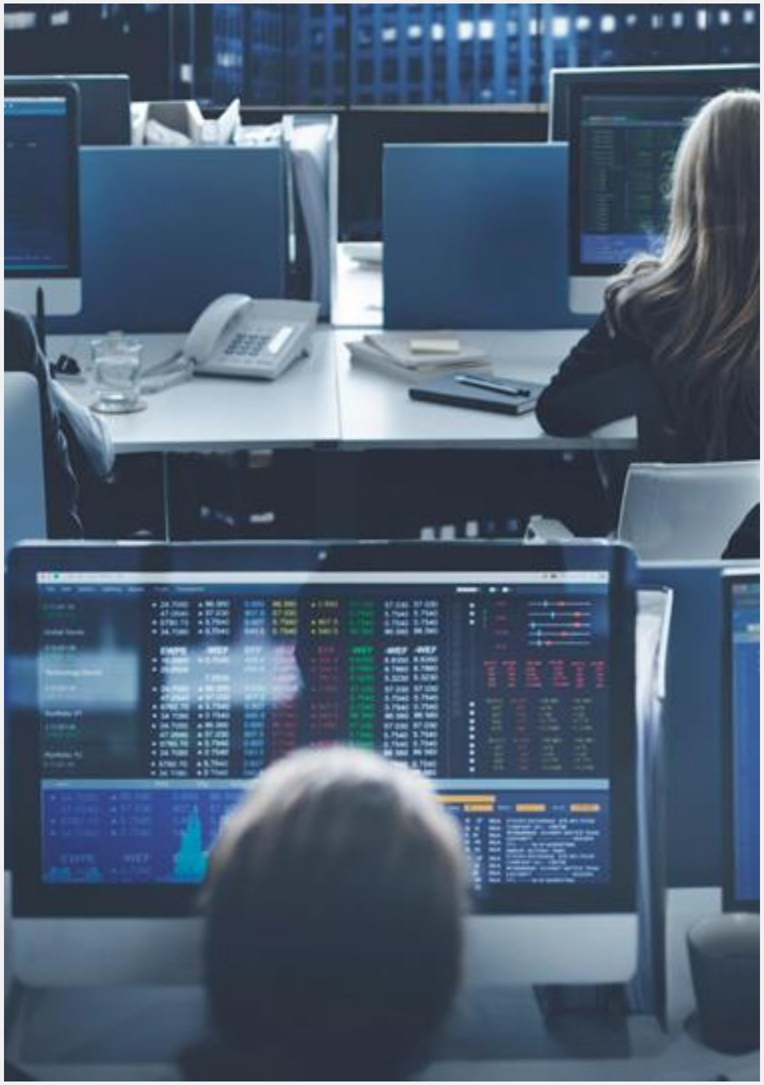
Inflation worries seemed to subside quite a bit, as both the CPI and PPI continued to print lower and below consensus expectations. June CPI printed at a somewhat tame 4.0% year-over-year and PPI printed at a very low 1.1% year-over-year. As both figures showed less inflation pressure, it was enough to convince the fixed income market that a June rate hike was not in the cards. The FOMC rewarded the market's expectations with a "pause" in June. Additional data coming in showed slight easing in inflationary pressures in the employment market and a jump in the unemployment rate (up to 3.7%, from 3.5%). As a result, the Fed was provided with enough "ammo" to pause in June without surprising the markets. Although wage pressures continue to weigh on inflation–with Average Hourly earnings printing up 0.3% month-over-month and up 4.3% year-over-year–our view is that hikes will resume in July and possibly August, as inflation is far from defeated, either domestically or globally. This was particularly evident when the Bank of England surprised markets with an inter-meeting hike of 50 basis points on June 22. Other central banks also came back to the table with hikes after their pauses, including Australia and Switzerland.[2, 3]

1 https://www.cnbc.com/2023/06/14/fed-rate-decision-june-2023.html

2 BOE: https://www.reuters.com/markets/rates-bonds/bank-england-hikes-rates-5-surprise-move-tackle-stubborn-inflation-2023-06-22/#:~:text=The%20BoE's%20Monetary%20Policy%20Committee,policymakers%20last%20met%20in%20May

3 SNB: https://www.cnbc.com/2023/06/22/swiss-national-bank-opts-for-smaller-rate-hike-but-says-more-are-likely.html#:~:text=The%20SNB%20announced%20a%2025,75%2Dbasis%2Dpoint%20rises]

Fixed Income



The GDP data released in June showed a noticeable uptick in economic growth, printing at a 2% quarter-over-quarter, which was higher than the 1.4% surveyed. The increase was led by significant gains in new home purchases. Sentiment has been steadily improving, especially as measured by the University of Michigan survey, showing renewed optimism and easing inflation expectations. Many respondents note the stability that the debt ceiling agreement has brought and the continued strength of the consumer. Consumer Sentiment, Expectations, and the Current Economic Conditions Index all rose, as respondents seemed confident the Fed has inflation at least partially under control. We do want to note that optimism may be somewhat short-lived, as student-debt repayments are set to begin shortly, causing retailers to predict a cautious consumer environment for the next three to six months.[4]

Some of this renewed positive sentiment is certainly due to less inflationary pressure. However, we wonder how much of that is "euphoria" from the S&P 500 being up 16.8% year-to-date and the NASDAQ 100 increasing 39.3% year-to-date (both as of 06/30/2023).

We will conclude by focusing on the continued inversion of the yield curve and its potential impact. The 2-year/10-year spread finished the month of June the most inverted in its history, at approximately 106 basis points. As well as the equity markets have performed year-to-date, bonds are still indicating that we are not out of the woods yet. Add to this the fact that retail is starting to slow and that Chairman Powell has hinted at two more potential rate hikes in 2023, and it sets the stage for a terminal Fed Funds rate of 5.625% or higher.[1] We believe that, had the regional banking crisis not happened in late March, Fed Funds would already be at 5.625% or higher, making our earlier prediction of a 6% or higher Fed Funds rate within range. As noted in previous Playbooks, in order to stop inflation in its tracks, it is widely believed the Fed Funds rate needs to be about 200 basis points above CPI. We could certainly get there with a few more "tame" CPI prints and another rate hike or two from the FOMC. In fact, Fed Funds Futures are pricing in an 81% chance of a 25-basis-point hike at the July 26 meeting and imply that a rate cut is not likely until at least March of 2024.

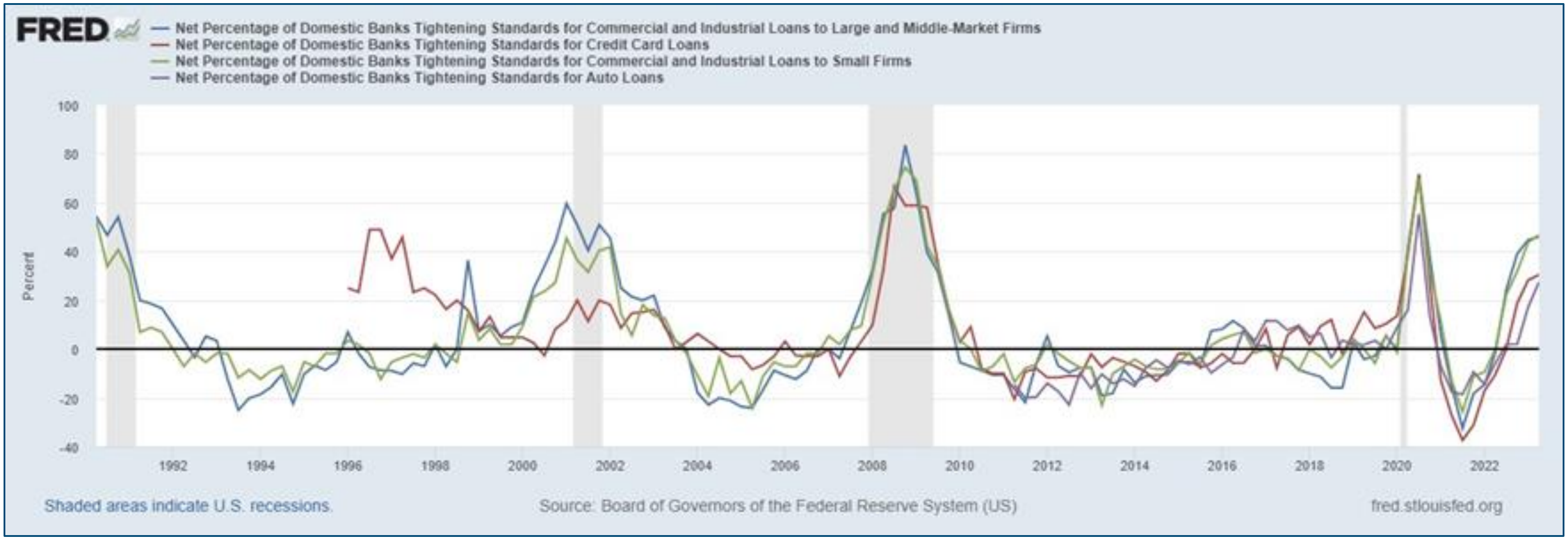
4 https://studentaid.gov/announcements-events/covid-19
1 https://www.cnbc.com/2023/06/14/fed-rate-decision-june-2023.html

Fixed Income

What to expect:

- Lower volatility (but certainly more than usual) – Markets hate uncertainty and love predictability, and the Fed has been working hard to reduce the former and increase the latter. All of this is predicated on the assumption that two more rate hikes will not "break" anything else, like they did the regional banks in in the first quarter. But that is never a certainty. Additional swings in rates and rate decisions are likely to be very much data dependent, especially in regard to CPI, PPI, PCE and Employment.

- Greater probability of recession and significantly tighter lending standards – Although the Fed has certainly pumped the brakes on Quantitative Tightening, in reality, the banking sector is already doing the "heavy lifting" for them. Banks have consistently raised lending standards since the Fed began tightening–and significantly so in the second quarter of 2023–as evidenced by the rise in Private Equity financing and non-traditional lenders originating more loans where banks have said "no" recently.[5] If this trend continues, and we think it will, banks will continue to reduce the velocity of money. That should naturally lead to economic slowdown, i.e., less borrowing, less spending, less consumption, and muted expansion.

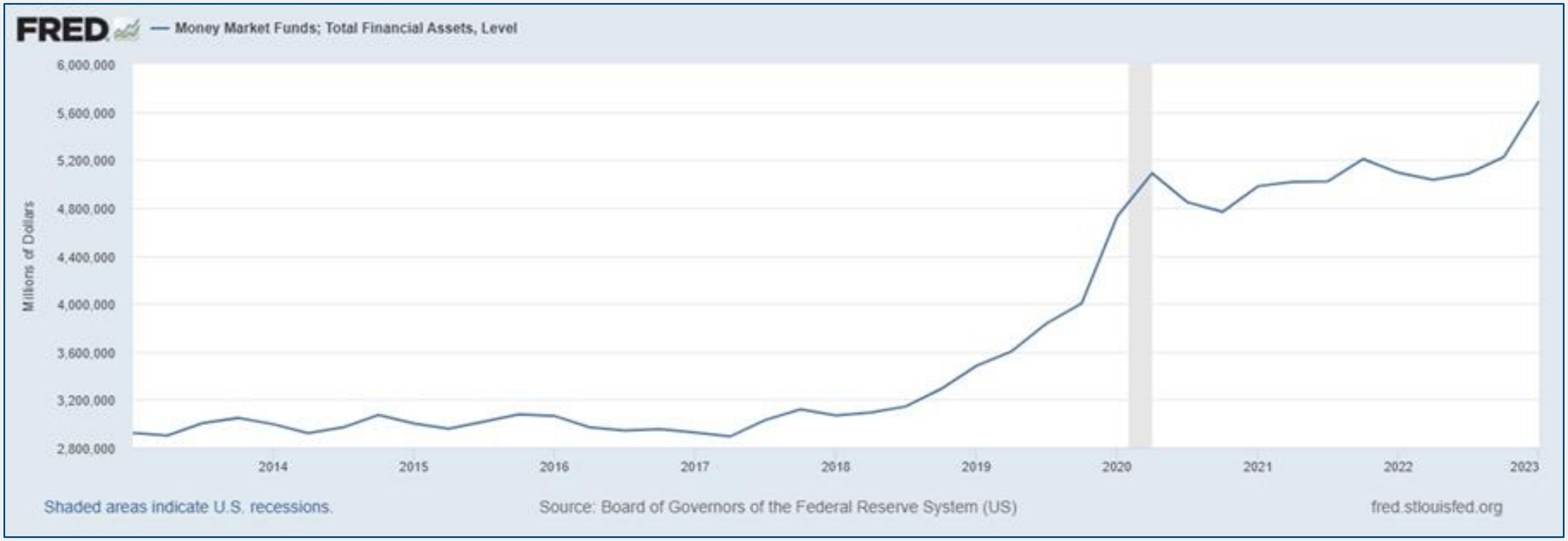


Source: FRED - Board of Governors of the Federal Reserve System

5 https://www.forbes.com/sites/rohitarora/2023/02/24/high-interest-rates-at-banks-make-alternative-lenders-more-attractive-for-small-business-borrowers/?sh=2aaaa0eb2cb9

Fixed Income

Continued utilization of Money Market Funds and quasi-Treasury proxies – Many depositors and/or investors holding cash continue to shift out money out of "Sweep" accounts paying 0.40% or 0.45% and into Money Markets, Treasuries, and CDs, most of which are paying north of 4.75% in the Taxable space at present. We expect to see further flight into high-quality cash instruments and/or Treasury proxies.



Source: FRED - Board of Governors of the Federal Reserve System

Fixed Income

- We believe fixed income investors should stay nimble and act opportunistically – We continue to lengthen duration into the 3-year to 5-year range for fixed income portfolios (where appropriate) to take advantage of rates as they rise. We will be especially active if/when the 2-year Treasury-Note touches 5% or above and the 3-year Treasury-Note touches 4.75% or more, taking the opportunity to lock in higher rates before the market starts to price in rate cuts in 2024.
- In the Corporate space – We continue to watch several sectors, including Banking and lower rated Consumer Discretionary names, that need financing. We are still actively staying away from Commercial Real Estate exposure, as it is the most shorted segment of the market right now. We would add that, while we may no longer be seeing a run on the banks, we are still witnessing assets slowly "walking away from" regional banks into money market funds. This remains true even though money markets are starting to see weekly outflows, as investors continue to chase the red-hot tech sector. If considering Consumer Discretionary debt, be mindful that the end of the student loan debt jubilee is near and is likely to have a negative impact on consumer purchasing power.
- In the Muni space – We still favor quality names and extending duration into the 3-year to 10-year space. We believe there are attractive opportunities available for yield pick-up, especially with continued volatility across the curve. We are actively staying away from Hospital and University paper, unless they are of superior quality and offer credit support. We continue to see very low new-issue volume, leading to slightly elevated prices from the lack oF inventory.
- We believe that issuers will take advantage of any dip in rates – Issuers are likely to come back to the market to issue debt at lower rates, especially in the supply-starved Muni market, and we will be looking for attractive opportunities there. We continue to favor issuers that have strong balance sheets, low borrowing needs, and higher amounts of available cash, which can provide a cushion in a potential recession, especially if it is more severe than predicted.

Asset Allocation Playbook

Supporting Your Wealth Advisor

Our Commitment

For more than a decade, we have served wealth management clients and their advisors with an unwavering commitment to our CREDO. As Ashton Thomas continues to grow and innovate, these principles will remain in focus for our team members and all parties serving your wealth management needs.

COMMUNITY
RESPECT
EXCELLENCE
DISCIPLINE
OPPORTUNITY

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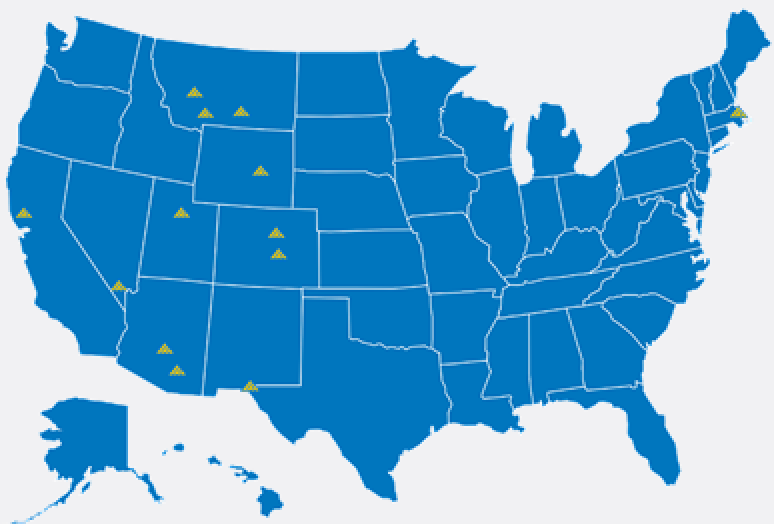

Asset Allocation Team

Our experienced Asset Allocation Team works with your advisor to keep your financial goals in view and your investments on track for the long term.

From investment research and due diligence to portfolio construction to trade execution and support, our team is focused on providing investment solutions which are tailored to meet your ongoing needs.

Mike Serio, CFA®, CAIA®, MBA
Chief Investment Strategist

Claudiu Barbos
Director of Investments and Trading

Ron Piccinini, Ph.D.
Director, Head of Investment Research

Brandon Cromer
Portfolio Manager, Associate Director of Investments and Trading

Kodi Thruston
Investment Analyst

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