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2023 Q4 Outlook

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Economy: Hollencrest expects moderate economic growth into year-end driven by consumption and fiscal spending. The investment management team continues to monitor potential recession triggers as we move into 2024.

- Despite continued economic growth, signs of liquidity evaporating from the US financial system are beginning to show. Bid-ask spreads are wide in certain asset classes, making transactions unfeasible. The Fed has successfully begun to shrink the supply of money. Banks and other lenders have become much more conservative and far less willing to extend credit. Cash flow has plunged on levered assets as increases in cost of capital have far outpaced growth in yields. As these issues become more problematic, the importance of holding cash and liquidity will increase.

- At the same time, the mystery of the 2023 recession-that-never-arrived continues to puzzle markets. The reality is that most of the drivers of that forecasted recession have always been more likely to cause a pullback in 2024. Fiscal spending has combined with significant excess savings and discretionary income amongst the socioeconomic cohort that drives US consumption to overcome the early effects of higher rates and declining liquidity, promoting continued expansion of the economy. We believe the benefit of having locked in 2% to 3% mortgage rates for 30-years across a generation has been underestimated by economists and markets. This permanently low cost of shelter creates excess discretionary income for those consumers and has kept economic output growing at a greater rate than Fed policy would dictate. However, with history as a guide, we see a meaningful risk that restrictive Fed policy and reduced liquidity will eventually prevail, creating this risk of recession.

- The rate of inflation has drastically declined from its peak, but it is not completely under control. Certain areas, like energy (gas prices) and insurance, have seen renewed or unabating inflationary pressure, while other areas, like used cars and food costs, have begun to show disinflationary characteristics. We question the Fed's ability to monitor inflation in shelter costs as the data they use is backward-looking and does not fully illustrate what is going on in the market today, creating the risk the Fed will fall behind or overshoot once again. Additionally, their policies have had the opposite of intended effect on housing prices as the quick surge in mortgage rates made it unpalatable for anyone to sell their house and give up their low mortgage payment, creating a supply-demand imbalance and sending housing prices higher. Employment remains strong as well, putting continued inflationary pressure on wages.

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Stocks: The S&P 500 ended Q3 at 4,288, well off highs seen in late July but still up over 11% for the year. Our outlook has become more cautious, and positioning slightly more conservative, entering the end of the quarter as the correction we now find ourselves in could evolve into a more significant downtrend. However, seasonality points to the possibility of a decent rally into the end of the year if this correction resolves itself with limited further damage.

- Valuation relative to risk free rates has returned as a headwind that puts a ceiling on the market's potential to break out to higher levels. As the 10-year Treasury's yield has climbed throughout the past quarter, the equity risk premium indicated by the S&P's earning's yield has crept closer and closer to 0. Stocks must fall further to create appropriate relative value with yields moving higher.

- Market internals, namely breadth, continue to call the rally from October 2022's lows into question. For only brief periods have a large majority of stocks participated in this rally, keeping Hollencrest from shifting to more aggressive positioning. Instead, the recent pullback has caused breadth readings to turn negative very quickly, causing us to reduce equity exposure. The market's seasonality points towards a low sometime in October with a renewal of the rally into year end. However, both the probability and magnitude of such a rally are highly variable, leaving us unlikely to reposition for that kind of bounce unless valuations get more attractive and technicals improve.

Bonds and Rates: Treasury yields continued their ascent during Q3 with the 10-year's yield rising from about 3.8% to nearly 4.6%.

- We expect the Fed will follow through on their guidance and move Fed Funds to 5.50%-5.75%. Unless the economy shows signs of cracking in mid-2024, the Fed will hold rates there for an extended period.

- The recent rise in yields is likely a combination of reduced concern in the bond market about an imminent recession and greatly increased concern in the bond market over runaway fiscal spending and deficits. Our valued economist Dr. Ed Yardeni has coined the term "Bond Vigilantes" to describe the bond market's revolt when it becomes disenchanted with fiscal policy. At some point, as yields move even higher, the "risk-free" (now "low-risk" as rating agencies continue to call US creditworthiness into question) returns that can be made will attract buyers, putting a cap on how high yields can go. The upper bound on long-term yields, however, could be 5% or more. At that level, we would expect to see reallocations begin to occur. It is looking more and more like the dis-inversion of the yield curve could come through the long end rising in yield instead of the Fed pushing the short end down, which will likely come as a surprise to most market participants.

- Corporate credit spreads remain stubbornly low, flying in the face of the illiquidity issues outlined earlier in this note. However, we have observed that mortgage spreads have remained wide throughout this rising rate cycle. This is an area under consideration for longer-duration investment to take advantage of this higher rate environment once peak rates appear to be more certain.

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