HOLLENCREST
CAPITAL MANAGEMENT

100 Bayview Circle, Suite 500
Newport Beach, CA 92660-8903
Main: 949.737.7700
Fax: 949.737.7703
clientcommunication@hollencrest.com

2024 Outlook

January 1st, 2024

Economy: Hollencrest expects economic growth to continue its recent deceleration as we move into 2024, with the Fed's tight policy of the past couple years providing headwinds while inflation moderates back to target levels.

- The hard landing versus soft landing debate remains at the forefront of discussions as we enter 2024. Currently, economic data and market results suggest a hard landing is out of the question. Sentiment has moved firmly into that soft landing, or no landing, camp. Fed messaging in December clarified their willingness to set policy with flexibility, possibly allowing for a shift before overly restrictive policies cause too much damage. This pushed markets and strategists to move forward as they had become impatient waiting for a recession while consumer spending remained resilient and government spending continued to stimulate growth. However, the cautious stance with which Hollencrest has operated for more than a year is still warranted in our view.

- We stop short of an outright hard landing call but continue to monitor our economic indicators for deterioration. By our definition, a hard landing would entail materially negative economic growth rates joined by a negative credit cycle (i.e. a surge in default rates, likely across numerous asset classes) and a significant uptick in unemployment driven by corporate distress. A soft landing could be anything from moderate economic growth to slightly negative growth, but without major corporate defaults and job losses. Despite the strength and confidence of the US consumer, we see ample evidence of liquidity evaporating. Certain markets, particularly slower-to-react private markets, have become relatively inefficient as activity levels and valuations continue to adjust after the rapid increase in interest rates. The reaction functions stemming from the surge in interest rates and declining liquidity have long and varied timelines, which is why we maintain our cautious stance. Until rates begin to align with longer-term inflation expectations and the reduction of liquidity ceases it is not prudent to declare complete victory as most markets seem to have already done. If the consumer runs out of gas, we could see credit markets begin to tighten and trigger a more widespread contraction.

- We recognize positive trends that should boost growth and keep inflation contained, possibly helping the economy avoid the hard landing outcome. Technology-driven productivity advancements are a force that cannot be ignored. The AI-mania seen throughout much of 2023 is an example of how these advancements can impact markets, even if the primary economic effects have not yet been felt. Re-globalization and onshoring of manufacturing are trends impacting the supply side of the economy, triggering investment and growth in the US and abroad while also providing a future deflationary force as supply chains improve.

Stocks: The S&P 500 ended 2023 at 4,770, closing out the year up over 24% in price and over 26% in total return. The index sits less than 30 points below its all-time closing high of 4,797 achieved nearly two years ago.

- We expect a trading range environment could unfold in 2024 with valuations having increased significantly during the most recent run-up in the stock market despite static forward earnings expectations. This creates potential for a pullback driven by multiple reversion, while the earnings growth that could drive a more powerful move higher in the market may be limited by decelerating economic growth. The Fed's most recent shift in its outlook eliminated concerns that rates may move higher and unlocked December's advance in stock prices, however it may take definitive action from the Fed in the form of a first rate cut to allow valuation multiples to move meaningfully higher.

- The Fed's messaging has been a major market driver of late, and, if that dynamic continues, it should result in interest rate sensitive sectors leading or lagging the market according to the Fed's tone. Housing stocks and regional banks are great examples of interest rate sensitive sectors that have seen outsized returns with the Fed's most recent change in stance. To the extent our conviction over one or more of these interest rate sensitive sectors increases in combination with reasonable valuations and technicals, we will look to reposition to take advantage of these moves.

- Breadth, or the participation of more sectors and stocks in the market rally, improved substantially over the last couple of months. This has caused us to become more constructive on equities as we enter 2024. We expect to act on this in accordance with our range-bound view by becoming even more active with a portion of our equity exposure. We recently increased exposure to both small cap and the S&P 500 and sold portions of these investments as they quickly became overbought. We look to increase exposure in early 2024 as overbought conditions abate. We are monitoring small cap closely as it has room for outperformance with the improvement in breadth and its relative underperformance in recent years.

Bonds and Rates: Treasury yields peaked and reversed in Q4 with the 10-year's yield briefly approaching 5% in October before falling back to 3.88% to end the year.

- On the short end of the yield curve, we align with consensus in our view that the Fed is done raising rates. The question now is what pushes the Fed to cut Fed Funds that are now well above core inflation rates? The futures market currently shows an expectation that rate cuts will begin in March and the Fed's pace will be aggressive with cuts likely to occur at each Fed meeting. Given some of the liquidity issues we see and debt issues in certain sectors like commercial real estate and the regional banks that hold that debt, we find it hard to dispute the market's current forecast.

- We also believe rates have peaked on the long end of the yield curve. The volatility in yields during the second half of 2023 appears to have been a brief bond market revolt driven by perceived supply/demand imbalance combined with concerns over runaway fiscal spending. These forces were not enough to sustain rates well above long-term inflation expectations, which remained anchored well below 3% through the volatility. We expect rates will continue to drift lower back towards inflation expectations, particularly if concerns build over economic growth and fears of a credit crunch cause risk-free assets to become more desirable. We have begun to express this view through investments in longer duration Treasuries, either in the form of bonds or unique ETF structures. We are actively managing these positions, as we are with our stock market exposure, and attempting to preserve gains by reducing exposure when these investments get technically overbought and we determine the advance is not likely sustainable in the short term.

- Corporate credit spreads remain stable near long-term averages and indicate no distress in credit markets. We see these spreads as the most important indicator we can closely watch each day that tells us a hard landing is not imminent. A hard landing that includes a corporate default cycle can't occur until credit availability decreases and cost of capital increases demonstrably. We are not investing in corporate credit at the moment as the upside relative to Treasuries appears limited and we expect fixed income returns to be driven by the aforementioned decline in rates. Mortgage spreads remain stubbornly high, however, driven by volatility and uncertainty over the past couple years. We see potential for these spreads to tighten, which could begin to unlock the housing market.