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Q2 2024 Outlook

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Economy: Economic growth continues to track as expected with rates of both GDP growth and inflation slowly moving back down to longer-term trends as Fed policy remains restrictive for the time being.

- For the moment, it appears the Fed has used their policy to navigate the economy into a "Goldilocks" environment. It feels as though the hard-landing vs. soft-landing debate that pervaded 2023 is now a distant memory. The economy is currently characterized by strong, but not too hot, GDP growth and slowly declining rates of inflation. This environment usually results in some of the best conditions for risk asset appreciation, and, sure enough, public market risk assets have performed accordingly since October. With Q1 GDP forecasts looking to continue this pattern, we don't see a clear catalyst for change.

- Most industries and sectors that have exhibited recessionary characteristics over the past couple of years appear to be in recovery. One example, despite persistently high mortgage rates, is the housing market. A lack of supply amongst existing homes has led to moderate price gains and a strong environment for builders. One area that still appears challenged is the tech market and employment tied to that sector. The liquidity-driven excesses of 2021 may take longer to correct themselves in tech, especially with labor demands for highly specialized skills sets. The job market as a whole is still very healthy and has trended to a more neutral position relative to the tightness of the past couple years, allowing the Fed to sit back and be patient.

- While current Fed policy actively seeks to withdraw liquidity from the system through high rates on the short end of the yield curve and a declining Fed balance sheet, the Fed's communication of late has been surprisingly accommodative to markets. Despite concerns over inflation not coming down quickly and smoothly enough, the Fed continues to signal their intention to lower rates and begin tapering their balance sheet run off. This has supported gains in the stock market and has in many ways been counter-productive to their tightening efforts.

- Inflation data has been lumpy, with inconsistency amongst its various components. We still see flat to declining market rents in housing, while inflation has been stickier in other areas. The unevenness of this disinflation creates a definite risk that the Fed may not follow through on their signals for rate reductions. Alternatively, we do see a meaningful chance inflation could return, along with too-hot economic growth, if the Fed eases policy prematurely.

- While public, liquid markets charge ahead as we exit Q1 2024, we still see anecdotal evidence of the Fed's policies having been successful in reducing liquidity. Many private markets have essentially been "frozen" for several quarters. Bid-ask spreads remain wide, with sellers demanding high prices to transact and buyers exhibiting risk aversion, valuation sensitivity and concern that prices could pull back if distress begins to unfold, particularly in commercial real estate debt markets. Headlines started to appear late in Q1 indicating this freeze may have begun to thaw as we saw news of M&A in tech, a couple of notable IPOs and an uptick in buyer interest in commercial real estate. With so little transactional volume of late in these markets causing uncertainty amongst buyers about where assets should really be valued, an uptick in activity and the associated price discovery would be a welcome development.

Stocks: The S&P 500 ended the first quarter of 2024 making a new all-time high at 5,254, up over 10.2% in price year to date.

- The rally that began at the end of October 2023 has been notable in its lack of volatility. The VIX, an index that quantifies volatility through option premium pricing, sits near multi-year lows. The ascent of the major indices has been uninterrupted by any sort of meaningful pullback. Sentiment, an ineffective indicator for timing the market, has been very strong and could stay that way. The momentum of the market is currently strong and must be respected.

- Valuation has also become less of a reason for concern. Although multiples are relatively high, they are not at unsustainable levels in our view. Importantly, the strength of economic growth means that the Earnings piece of P/E multiples is more likely to support higher prices as the requisite discount for a hard-landing outcome has faded.

- Breadth is another improving characteristic of the current market. More and more sectors and sub-industries have begun to participate, and we have observed some healthy rotation. We gauge breadth through many indicators, but one of the easiest to observe is the price action of the Russell 2000 index, which focuses on small caps and excludes the mega cap tech stocks that skew the other major market indices. It ended the quarter on highs and at levels not seen since early 2022 while having moved above a trading range that was in place well over a year.

- Hollencrest has been judiciously increasing exposure to the stock market as the year has progressed. We have carefully utilized leveraged products to increase exposure while still benefiting from the high interest rate environment. We have also employed active trading strategies, moving to more conservative positioning at times when the market has been especially overbought. We look to further increase exposure in this manner as we enter Q2.

Bonds and Rates: Treasury yields spent Q1 in a trading range. After falling to 3.88% at the end of the year, the 10-year's yield made its way back to 4.35% before ending the quarter at 4.20%

- We are confident the Fed is done raising rates, although we are curious what, exactly, will catalyze their first rate cut. We haven't yet seen the necessary success in returning inflation to target levels, nor have we seen the weakness in economic growth or the job market that would force their hand. In the absence of a negative trigger, we suspect the Fed will focus on the level of real interest rates - the increasingly large spread between the rate of inflation and Fed Funds. Currently, we estimate real rates at approximately 2.5%. If inflation were to fall back to target levels, that real interest rate would approach 3.5% and be at a level the Fed would consider exceedingly restrictive, causing them to cut. We are not convinced that will occur by June, but perhaps they feel the current level of real rates is already too high. For context, we assume real rates of approximately 1% to be the long-term average and the eventual target.

- We expect the long end of the yield curve to stay in it's approximate trading range, although we are cautious that the general trend has been towards higher yields this year. Fresh concerns in recent weeks over inflation's trajectory, along with accompanying concerns that the Fed may exacerbate supply imbalances by selling more bonds into the market for longer, have combined with trading momentum to expand the upper bound of this potential trading range. On the other hand, longer term inflation expectations should keep the long end's yields anchored, with a move below the existing trading range possible on any sort of deceleration in economic growth, a quick decline in inflation, or the Fed suspending the shrinking of their balance sheet through the sale of bonds.

- Corporate credit spreads remain notably tight and continue to give assurance that we are far from any sort of credit crunch that could trigger a default cycle that would lead to a wider financial crisis and mass job loss. Investing in credit remains a challenge at these spread levels and we expect to continue to focus on government securities and mortgages with a view that we may build positions in these assets opportunistically when risk adjusted return prospects look strong.