Invest Smarter. Live Better.

To Cut or Not to Cut

Better than expected economic growth, strong employment, and improving earnings propelled most asset classes higher in the first quarter of 2024. Still, inflation remains sticky after falling sharply since late 2022. Now in the 18th month of recovery since the dark days of 2022, the focus for investors centers on the Federal Reserve, the prospects for future interest rate policy, and the implications for asset class returns going forward. To cut or not to cut? That is the question.

Avalon client portfolios had solidly positive returns in the first quarter, driven by strong performance across the equity and natural resource categories. In US equities, the strong momentum from the last two months of 2023 carried into 2024, as the NASDAQ and the S&P 500 had their best first quarter in years. For the quarter, growth outperformed value-oriented stocks, but dividend value trended up in March to end strong as well.

Asset Class Returns for Q1 2024

International stocks rose as well, with developed markets outpacing emerging markets. Japan outpaced Europe and finally eclipsed its all-time high from 1989. India led emerging markets and China continued to lag even as new government policies attempt to shore up support. In the real asset segments of the market, gold and natural resources were strong, while real estate lagged. Energy, a leader in 2022 and among the worst-performing sectors in 2023, moved into the top position in Q1, staging a strong comeback in March as oil prices rallied partly in response to Middle East tensions.

The Long-Term Treasury Bond index fell by over 3% in the first quarter. Prices dropped amid changing expectations for the Fed, which declined to cut interest rates in the face of persistent inflation and strong economic growth. Bonds and stocks have historically rallied into an initial rate cut. While some stocks trade near all-time highs, long bonds still trade nearly 50% below the high-water level reached during the COVID crash in 2022, when 30-year interest rates traded below 1%. While value is being restored with long rates near 4.5%, until a definitive peak is evident, shorter duration bonds and cash are a better bet, paying closer to 5%.

Real estate continues to show poor performance, influenced by the current interest rate environment and high mortgage rates. The post-pandemic shift to remote work also continues to create challenges for the retail and office space segments. On the bright side, residential demand remains persistent, supporting strength in homebuilders. Another bright spot, data centers, have extended their advance as part of the tech and AI leadership.

Avalon Market Observations

Investors are torn between wanting the benefits of easy money via a rate cut and seeking protection from higher inflation by keeping rates high. In an effort to drag inflation back down toward its 2% target, the Fed has hiked interest rates 11 times in total over the last few years to a target range of 5.25%-5.5% — the highest level in more than 22 years. The expectations that they would cut rates six times in 2024 have shifted to only three cuts, possibly starting in June. Even so, one by one, the chorus of Fed participants is casting doubt on the timing and necessity of rate cuts at all.

The consensus market view remains bullish, predicting a “soft landing” as opposed to a recessionary response to the rising interest rate environment. We believe it is still prudent to exercise caution around a further overweighting of US equities as corporate valuations continue to rise and equity market sentiment remains elevated. With fiscal stimulus fading and personal savings dwindling, equities could face some headwinds. If the Fed does not cut rates in June, equities may see further correction as expectations adjust.

It is also important to remember that even without the dilemma facing the FED, a pause in the uptrend would not be surprising based on historical behavior in an election year.

Historically, the stock market posted stronger gains when the incumbent party retained the White House, reflecting good economic conditions and less uncertainty. Complicating any predictions in this election cycle are the many unprecedented factors in modern history. It is too soon for markets to start anticipating the outcome, but as the following exhibit shows, in an election year, a pause or slight decline in Q2 is not unusual.

Dow Industrials Four-Year Presidential Cycle

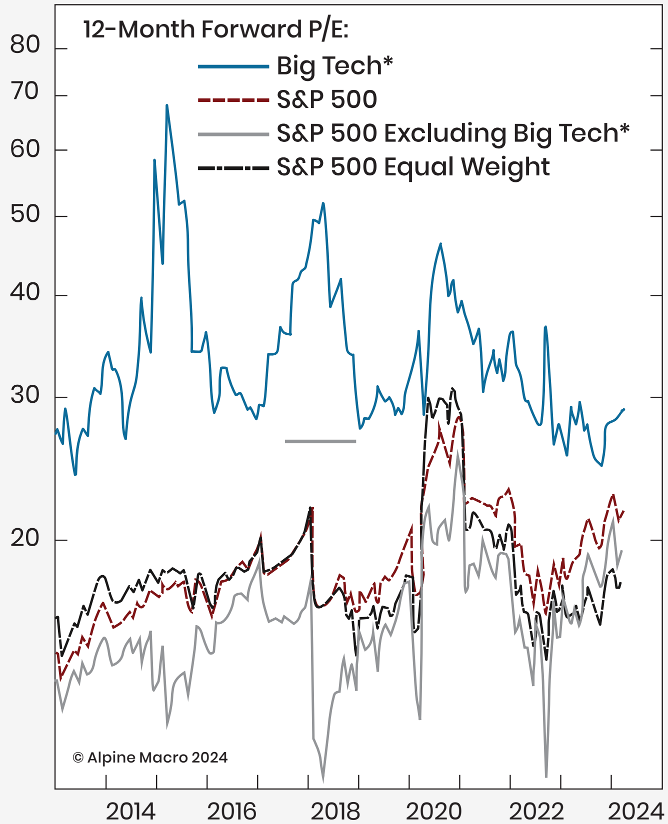
SO1642
Source: Ned Davis Research

NDR

Portfolio Themes

All markets are not equal. As we noted in our fourth quarter letter, the largest capitalization technology stocks ("The Magnificent Seven") dominated strong returns in US equities last year. Among the quality leadership, uptrends are more dispersed as Apple Inc. and Tesla have declined in the first quarter. Even as technology and communication services showed continued strength in 2024 on enthusiasm for artificial intelligence, the rally has broadened to include energy, materials, financials, industrials, and healthcare. Big Tech is still leading, but undervaluation among small and mid-cap stocks is attracting capital. Other select themes like the revival in US manufacturing and advances in diabetes and weight loss treatment via the GLP-1 drugs have been clear market standouts. This is a clear sign that market breadth has continued to improve. Forward P/E ratios for the S&P500 ex Tech remain reasonable. A consolidation among quality leaders and a rotation into more undervalued parts of the market could give equities further room to run later in the year or offer a hiding place as large cap names pause or correct.

P/E dispersion among S&P500 Big Tech and The Average Stock



*Meta, Apple, Amazon, Microsoft, Google and Nvidia

New Leadership Counter Correlated to Equities

One hedge against stocks is commodities. Gold has broken out to new highs above $2,300 per ounce. Persistent demand for gold by central banks seeking an inflation hedge, an overvalued U.S. dollar, and geopolitical tensions continue to bolster the metal. We expect the massive undervaluation gap between precious metals stocks and bullion to narrow, making this one of our favorite themes over the next few years. Conditions are also improving for copper, water, and uranium.

Avalon's recommended asset allocation appears generally well-aligned with recent market performance. The portfolio is overweight US equities and hard assets, while keeping fixed income exposure limited. Any short-term correction in equities may be offset by improving performance in natural resource equities, including precious metals and energy, which are a significant allocation in the portfolios, reflecting our favorable view on commodities and inflation-sensitive assets.

Additional hedges through managed futures have performed well in 2024 and offer a buffer in the pending correction. We maintain a slightly higher cash allocation than the portfolio benchmark as we continue to monitor short-term risks to the bond market. Should economic conditions soften and recession probabilities rise, we would have plenty of liquidity to increase bond duration and provide additional buffers to the downside.

New Additions to the Team

Last quarter we told you we were planning new additions to the team. We are pleased to introduce Senior Consultant Kristina Toland and Wealth Management Associate Charles (Charlie) Hinman. We are confident you will benefit from their many talents.

Kristina provides legal, compliance, and client support for the team at Avalon. Her professional background is in tax and finance. Prior to joining Avalon, she was a Senior Tax Consultant in estate and income tax planning for high net worth individuals and worked in family office and legal consulting services for venture capital firms. Kristina attended UC Berkeley as an undergraduate and holds a JD/MBA from the University of San Francisco.

Charlie has worked in the asset management industry since graduating from Tufts University in 2018. He worked as a Senior Analyst at Fiera Capital Management in Boston. As a member of the Global RFP Management team, Charlie wrote to clients, consultants, and institutional investors about Fiera's equity and fixed income products. Charlie had previously worked at Wellington Capital Management as a Project Coordinator, providing operational support to the firm's retirement, union, and private equity teams. Charlie has a bachelor's degree in International Relations with a concentration in International Security.

Thank you for your ongoing support. We look forward to seeing you to discuss our outlook further.

Clara Basile   Ross Revenaugh

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