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Happy New Year

January 19, 2024

Dear Friends,

Happy New Year and my best wishes for a healthy and prosperous 2024! Gretchen and I were fortunate enough to get the whole family up to Lake Tahoe for Christmas and had a great time. Mostly relaxing, however, my third son turned 21 on Christmas Eve. Of course, everyone wanted him to celebrate in a casino and everyone wanted to be involved. So, off we went to Stateline to roll some dice. After that he played some slots and quickly lost a hundred dollars. That was it for him. Hopefully in the long run he learned a cheap lesson on the dangers of gambling and uncalculated risks. Nevertheless, it was good to have everyone under one roof and to be able to check out for a few days.

2023 was a year that gave us plenty to fear. A continued war between Russia and Ukraine, then we had a banking scare (remember First Republic Bank?), the Federal Reserve was continuing to hike interest rates, and finally the October 7 Hamas attack in Israel. And yet, somehow the market continued to climb throughout the year despite these issues. In hindsight, the October 7 attack seemed to have the effect of getting anyone considering selling to sell. With no sellers left, the market took off and had a banner November/December.

Speaking of fear, I had an interesting talk with an old friend in the investment business who recently visited the 6th Floor Museum at the Dallas School Book Depository in Dealey Plaza. He told me that, before entering the museum, there's an exhibit showing national headlines for the weeks before Kennedy's assassination, from the major newspapers of the time. Interestingly, he said the headlines strongly resembled the types of things we hear today. Natural disasters, geopolitical, economic, social and political problems have always been the case. Today, and because of social media, they are just easier to see.

Here is something you don't see: The economy has been doing great. We don't hear about this in the media because no one would watch. Growth in the 3rd quarter came in strong, the Federal Reserve is mentioning rate cuts, unemployment is below 4%, I don't know anyone out of a job or losing their home, and people are spending money. Yes, prices are still high, but they are no longer increasing at the pace they were. This is great news but it's in the past. What matters is what happens over the next 4 quarters. Here's what I'm paying attention to:

In short, the Federal Reserve recently said the November annualized rate of inflation is about 2.5% and over the long run they would like to get rates to neutral. Neutral implies interest rates at 2.5%. The stock and bond market took that to mean interest rates would be cut to 2.5% sometime in 2024. My concern is that aggressive rate cuts in 2024 imply that the economy would be quite weak. I see little incentive for the Fed to cut rates with unemployment under 4%, especially given the strength of recent economic growth. If the rate cuts don't materialize, the stock market could be disappointed. If we do get aggressive rate cuts, then why? What's in store for the economy? Is it slowing that fast?

In last quarter's letter, I said the market was due for "some kind of bounce" and I hoped it would "turn into something more." Well, the November/December bounce did turn into something more. In fact, the Dow Jones Industrials made a new all-time high. Now, once again, the market needs to pause and refresh. Don't be alarmed if we see it pulling back a little bit.

For now, I think I've gone on long enough. Enclosed, find a short and succinct piece by the astute people at Guggenheim Partners. They also seem to feel that there are quite a few rate cuts coming in '24.

Again, wishing you a healthy and prosperous new year.
Sincerely,

Antone Mercurio CFP®

Macroeconomic Update

The Economy Is Not Immune to the Effect of Tight Monetary Policy

Recency bias hits the market's economic outlook.

Faced with a series of strong economic data releases, the market has increasingly come to the conclusion that the economy is structurally better able to withstand higher interest rates. This dynamic can be seen by decomposing the move in Treasury yields, with the selloff almost entirely due to real yields rather than inflation expectations, and most pronounced at the back end of the yield curve. Digging further, we can see that a large portion of this shift is due to a rising term premium, indicating greater uncertainty about the outlook. We agree with the view that the neutral rate for the economy has moved higher, but we think the magnitude of the move in the market is overdone. It is a mistake to think strong economic data will continue and that the impact from monetary tightening is behind us.

Many forecasters are extrapolating this year's economic strength without recognizing growth has benefited from a number of factors this year that are unlikely to be repeated, namely a huge expansion of the fiscal deficit, a major slowdown in inflation, and a rebound in labor supply. As these factors fade, the headwinds from tight

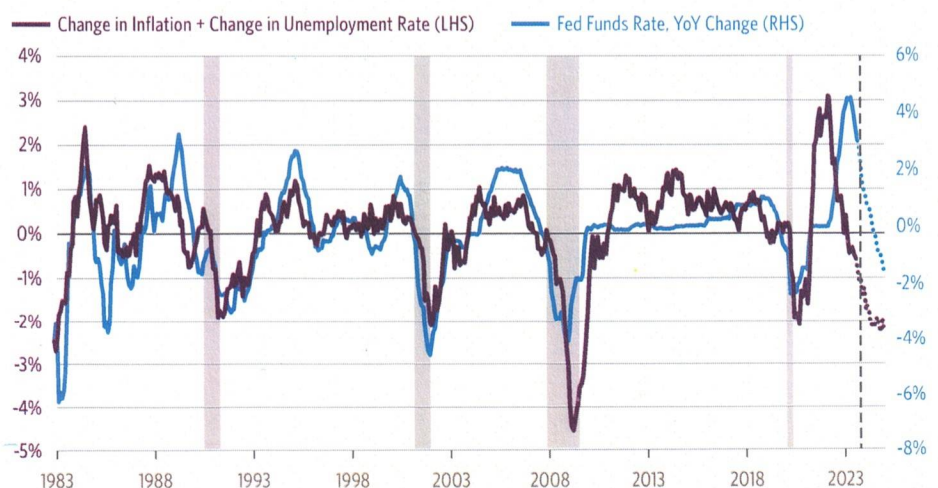
monetary policy will be more apparent—headwinds that will only grow in strength. And the longer monetary conditions stay tight, the greater the risk of something breaking (regional banks and commercial office real estate remain key risks). All this means that the recent economic trajectory cannot be assumed to continue, especially given the substantial restraint that will be imposed by the recent rise in long-term borrowing costs.

Uncertainty is elevated, and rightfully so given the diverging signals in the data and many traditional economic models not "working" as they should. This uncertainty extends to the Fed, which looks set to hold off on further rate hikes while waiting to see if the data start to align better with the softening conditions reflected in their Beige Book reporting. We continue to think the gravitational pull of tight money and credit conditions will slow the economy and cool inflation over the next year, paving the way for more rate cuts than the market expects.

By Matt Bush and Maria Giraldo

The gravitational pull of tight money and credit conditions will slow the economy and cool inflation over the next year, paving the way for more rate cuts than the market expects.

Weaker 2024 Economy Should Pave the Way for Rate Cuts



Source: Guggenheim Investments, Haver Analytics. Actual data as of 9.30.2023. Change in inflation measured as six-month change in YoY% core PCE price index, change in unemployment rate measured as YoY change. Shaded areas represent recession.

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