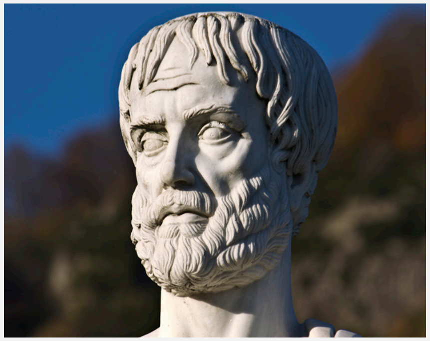
Economic & Market Commentary

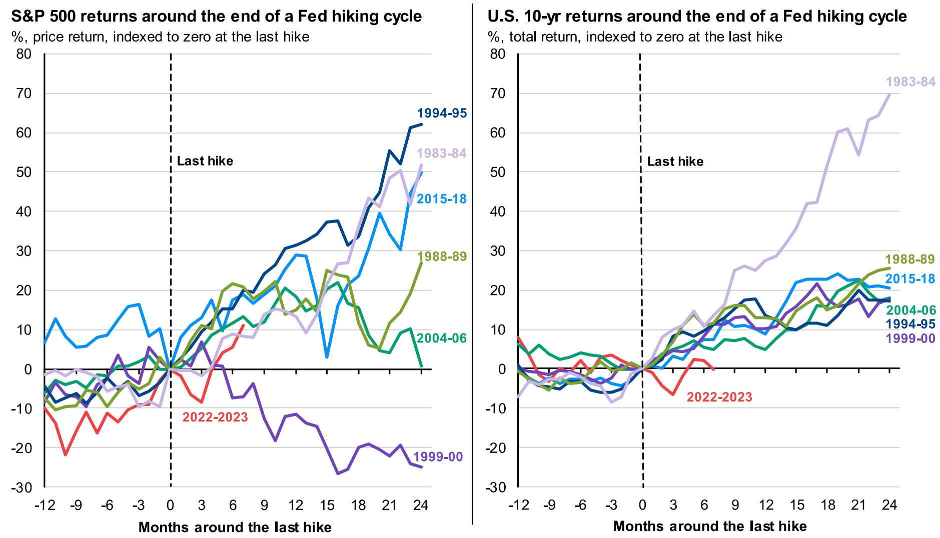
Spring 2024

The Wisdom of Crowds

We often read that following the crowd is a sure path to investment disaster. In 1841, Charles Mackay published *Extraordinary Popular Delusions and the Madness of Crowds*. It explained the psychology surrounding, among other things, the Dutch tulip bulb and South Seas investment manias. Fortunes were made and quickly lost as speculators abandoned rigorous analysis and followed the emotions of the crowd.



Conversely, Aristotle's treatise *Politics* suggests collective wisdom can be superior to that of any one individual. There will always be outliers (ahem…Warren Buffet). But, in theory, the collective opinion of a large and diverse group often produces better decisions than that of any single expert. Read *The Wisdom of Crowds* by James Surowiecki for more in this topic.



Source: FactSet, Federal Reserve, S&P Global, LSEG Datastream, J.P. Morgan Asset Management. The 2022-2023 cycle assumes that the last hike of the cycle was in July 2023. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of March 19, 2024.

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Theory to Reality

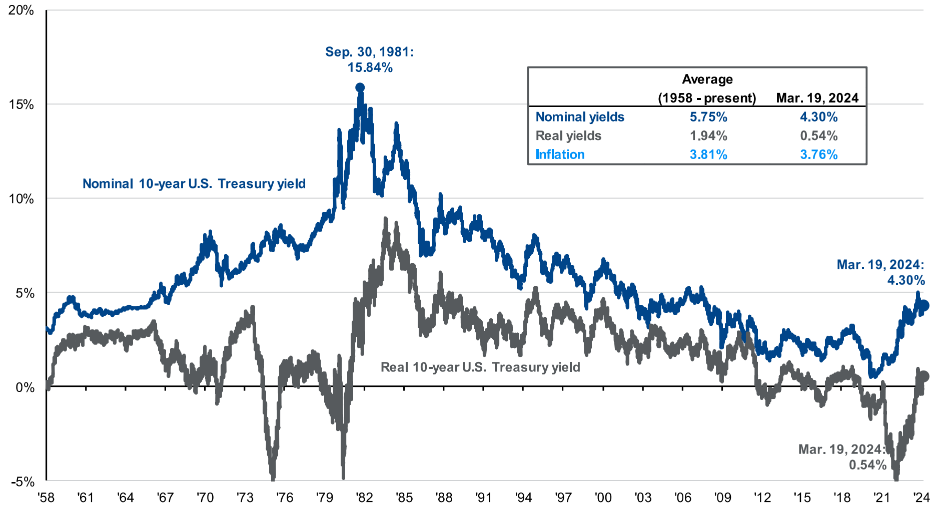
There are few entities that better reflect the 'large and diverse group' description than participants in the financial markets. Millions of investors express their opinions – informed or not – in actions backed up by their financial resources. As it turns out, the wisdom of the crowd has a pretty good track record. While headlines focus on reading the tea leaves of the Federal Reserve, investors as a whole tend to move in the right direction.

The above charts show the paths of equities (left) and bonds (right) before and after the final hike in past Federal Reserve cycles. Since the Fed does not announce a contemporaneous end of its efforts when the last rate increase is announced, it is up to the investment community to decide and act. With only a couple of exceptions, investors were correct in pushing the 'buy' button despite uncertainty over the Fed's next step. A definition of success is the ability to make correct decisions based on incomplete information; the Aristotelian view of collective wisdom is certainly applicable to the financial markets.

Fixed Income (at Last) is Beating Inflation

Real (inflation-adjusted) interest rates were negative more often than not for the last decade. Fixed income investors lost purchasing power with their holdings – without factoring in taxes paid on income received. The recent combination of moderating inflation and restrictive monetary policies pushed real interest rates to positive territory. Not by much, but it's a start.

Nominal and real U.S. 10-year Treasury yields



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month. For the current month, we use the prior month's core CPI figures until the latest data are available.
Guide to the Markets-U.S. Data are as of March 12, 2024.

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We do not expect either nominal or real interest rates to return to the levels of the late '70s – early '80s. As such, the real level of rates will likely not reach its historic average. That said, opportunities going forward will be better than those of the last several years. Three considerations lead us to this conclusion.

First, barring supply shocks, inflation should continue its moderate path toward the Federal Reserve's target, even with reasonably strong economic progress. Second, we take the Fed at its word that policy will remain firm for most of 2024. This does not preclude cuts later in the year, but it does suggest a measured pace in moving toward accommodation. Finally, and most important, the failure of Washington to control budget deficits suggests that longer term interest rates will stay 'higher for longer' as markets are forced to absorb massive debt issuance to finance spending.

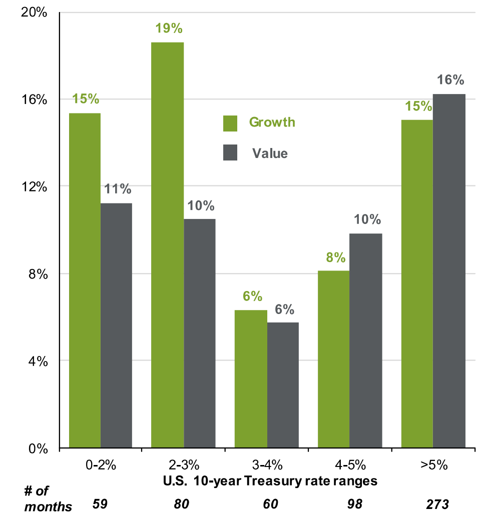
How to position for this outcome and minimize the risk of being wrong? Stay with short- to intermediate-term maturities (an average maturity of three to five years). Maintain high credit quality (this doesn't exclude high-yield product, but only in moderation). And, as always, build in broad diversification (including exposure to international and non-traditional debt). We expect positive outcomes from such a fixed income portfolio – conservatively structured, flexible, and income-sensitive. This has been, and will continue as, our core strategy.

An Equity Style Shift is Near

Value-oriented investors have generally trailed the growth-dominated S&P 500 in recent years. Historically, growth outperforms value in low interest rate environments, not just recently but generally over the last several decades. Recent experience was in line with this pattern.

Our past writings focused on the performance gap between growth and value themes in equity markets, both here and abroad. The difference over the last few years – in a record low interest rate environment – is as wide as any time since the technology bubble of the late 1990s. We believe a 'reversion to the mean' is starting. First, the U.S. economy is heading toward a soft landing – cyclical sectors and consumer themes will produce better-than-expected results. This will draw capital from the last cycle's technology and AI-related themes toward stronger, lower-valuation alternatives.

Value vs. Growth in different interest rate environments
Annualized total return by 10-year Treasury rate ranges, 1979- present



Source: FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management.
Growth is represented by the Russell 1000 Growth Index and Value is represented by the Russell 1000 Value Index. Returns are calculated by annualizing the average monthly performance during each interest rate range.
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The second and more compelling argument is related to the macro interest rate environment. As discussed in the previous section, we expect longer term interest rates to remain elevated regardless of when and how far the Federal Reserve reduces shorter term rates. The federal deficit must be financed, and there is little chance that current projections of future deficits and debt loads will prove too conservative. In investment math, higher long term interest rates produce higher implied discount rates for future cash flows. Lower-multiple, dividend-oriented themes are favored in a more normal, upward-sloping yield curve environment. The valuation gap will close to the benefit of conservative portfolio structures.

Where We Stand

Our strategies are built to provide broad diversification in the context of a risk-conscious structure. We see our role as not to *make* fortunes, but to *protect* and *build upon* the wealth entrusted to our management. We believe our conservative, value- and quality-oriented portfolio practices are ideally suited to the challenges and opportunities ahead. Your safety and success matter to us.

Economic & Market Commentary is written by the Investment Services Department at Security National Wealth Management.