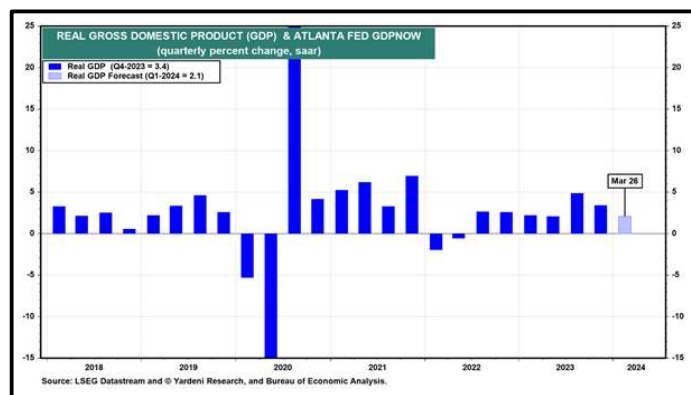


Quarter-In-Review – Global stock markets generally got off to a strong start in 2024 with most major indexes finishing in the black for the three months. The S&P 500 stands out once again with a +10.5% gain, its best first quarter advance since 2019, when it rallied +13.1%. The Magnificent 7 turned into the Magnificent 5 as Apple and Tesla lost ground, but in general tech stocks performed well. Encouragingly, the rally broadened out. Financial stocks picked up +12.4% for the quarter while equities linked to energy were up +13.5%. It’s worth noting that small-caps and international lagged large-cap U.S. again, and emerging equities were particularly disappointing, posting a gain of just +1.9%. Real estate stocks continue to struggle, losing -1.2% in the first three months of the year.

What drove investor’s buoyant mood? We will explore in more detail below, but basically it is the combination of optimism that economic growth will remain solid at the same time that inflation will continue to moderate. This is the so-called soft-landing scenario we detailed in our year-end report three months ago, although it is looking more and more likely that we are going to see fewer rate cuts in 2024 than originally thought.

This last point is proving a challenge for the bond market. Both short-term and long-term rates moved meaningfully higher in the first quarter, with the yield on the 10-year closing at 4.20%. Despite this increase, short-term Treasury bonds gained fractionally for the quarter (+0.3%) because the coupon yield offset the decline in principal value. But intermediate and long-term Treasury bonds lost -1.3% and -3.7% respectively due to their greater sensitivity to interest rate movements.

What’s Not to Like? – There’s been a lot of debate the last few months about whether the U.S. economy would achieve the fabled soft-landing or not. On one side of the discussion were those arguing for recession. After all, the thinking went, how could we not avoid recession when interest rates have gone up so quickly? On the other side were those saying that growth might certainly slow from the heady levels of last year, but a recession was



Market Benchmarks			
Market Indices	1Q24	3-Yr An	5-Yr An
Global Equities	+7.8%	+6.6%	+10.9%
S&P 500 Index	+10.5%	+11.4%	+14.9%
Russell 2000	+5.0%	-0.3%	+8.0%
Int'l Index (EAFE)	+6.0%	+4.8%	+7.3%
Emerging Mkts	+1.9%	-3.9%	+2.7%
Other Indicators			
	3/31/24	12/31/23	12/31/22
Fed Funds Rate	5.25%-5.5%	5.25%-5.5%	4.25%-4.50%
2-Year Treasury	4.62%	4.25%	4.43%
10-Year Treasury	4.20%	3.88%	3.88%
S&P 500 P/E Ratio*	21.0	19.5	16.7
Crude Oil	\$82.99	\$71.31	\$80.35
Core Inflation	2.8%	3.2%	4.7%

*Forward 12-month operating earnings per S&P

unlikely given that consumers in general are still employed and seeing wage growth.

As one might suspect when looking at the market performance in the first quarter, the optimists are carrying the day so far. The chart below shows that broad growth in the U.S. certainly slowed modestly in the fourth quarter of last year and is projected to be a touch softer in the first quarter of 2024, but headline growth of roughly 2.5% is solid. But there’s always something to fret about. Could growth actually be too strong? Could the battle against inflation not be over? The bond market is certainly telling us that investors were definitely well over their skis at the beginning of the year expecting seven rate cuts. Could we actually see rate hikes later this year?

From Soft Landing to No Landing? – Recessions don’t just come out of nowhere. The U.S. economy is the proverbial oil tanker – once it’s on a course it takes a lot of energy to move it in one direction or another. As things now stand, that course is one of modest growth. Consumers continue to increase their spending, upending forecasts that the dwindling of their pandemic-related excess saving and the resumption of student loan payments would force them to retrench. We’ve also learned that consumers today aren’t particularly rate sensitive. Those who own homes have locked in mortgage rates at relatively low levels. And while credit card and car loan

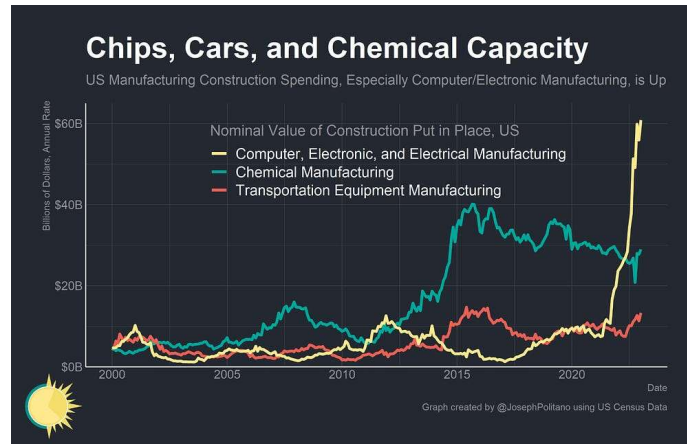
delinquencies have hooked higher, this doesn't appear to be an existential threat. And critically, the job market remains tight. The latest payrolls report shows robust job growth and a continued low unemployment rate.

Spending on private capital and public infrastructure also continues to help. Fiscal policy remains stimulative and should continue to be so this year given the government's tax incentives and grants to boost onshoring of manufacturing and ongoing work to improve public infrastructure. The chart to the right shows construction spending in the U.S. and it is startling how much has gone towards electrical manufacturing thanks largely to the CHIPS Act.

If there is a dark spot in the U.S. economy it relates to commercial real estate. Downtown offices and apartments in certain regions have been hit hard by higher financing costs and new work habits. We are finding out that for offices, in particular, there's a lot of excess capacity. Investors and bankers are taking losses on their investments, but so far this issue isn't proving to be systemic. Bank's exposure to troubled commercial real estate appears to be relatively modest, and the write-downs are not impacting overall credit availability as of yet.

Inflation - A Higher Plateau? – We doubt there is much in the discussion about growth that surprises many people. Our day-to-day anecdotal experience confirms that home prices have been relatively stable, restaurants seem busy, and commutes are as unenjoyable as they were pre-COVID. But the popular view is that inflation is far more severe than the data would suggest. The chart at the bottom of the page shows both headline and core inflation through the end of February. What jumps out is how much the rate of change in prices has come down. Core inflation is running at just below +3% year-over-year, while headline inflation is up +2.5%. Both are hotter than the Fed's target of +2%, but not dramatically so.

What's become notable in the last couple months, though, is that the improvements have ground to a halt. It's becoming more and more evident that the economy is running hotter in the post-COVID world than it did at the same pace of growth pre-COVID. Just eyeballing the same chart, it's pretty clear

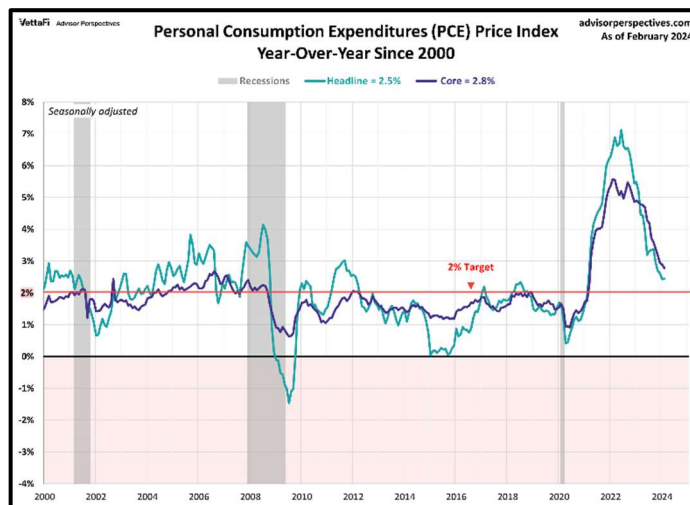


It's easy to get lost in the weeds when tackling the inflation question, but we think when everything shakes out, the steady state for inflation in the U.S. is going to be in the +2.5% to +3.5% range. Not the end of the world, and what really matters for the markets is how do policy makers respond to this new dynamic. Do they try to force price inflation down to the +2% target through even tighter monetary policy, or do they in essence move the goal posts?

Will the Fed Declare Victory and Go Home? – Coming into 2024 investors were almost giddy in anticipation of rate cuts in the months to come. Almost seven quarter-point reductions were priced into expectations in early January, four more than the Fed itself was expecting. The narrative of rapidly slowing inflation leading to monetary easing was fully priced into fixed income securities especially. But as we noted earlier, the inflation data in the first quarter failed to cooperate. The prospects of a new higher inflation plateau led investors to revise their rate outlook, and now they basically agree with the Fed's view of three quarter-point cuts this year.

Much of the sell-off in bonds can be traced to this change in expectations, but stocks have shrugged it off. Why? An important reason can be traced to optimism about future earnings growth. But another driver is the fact that the Fed is signaling that they aren't too worried about the new higher inflation plateau. Chairman Powell and the Fed

governors have been given every opportunity to tell the market they are second guessing their rate view, but they appear to want to ease at least a couple times in 2024. At the end of the day the model the Fed is using is pretty simple, and is captured in the chart at the top of the next page. It shows the so-called real fed funds rate (after stripping out inflation) over time. Essentially, the real rate is relatively high



today. The Fed looks at this and thinks that even if inflation stabilizes above their +2% target, they have room to cut because real rates are in what's been historically restrictive territory.

But there's possibly something more fundamental at play. Let's try and answer the question of what would be the personal and economic costs in getting inflation down to +2%? Say it took another six quarter-point rate hikes. This almost certainly would pull growth lower and lead to higher unemployment. How much higher? Even if it was just 0.5% of the work force, that would total roughly 750K people. If the unemployment rate were to go up a full percent to 4.8% (still a historically low level), you'd be talking about 1.5mm more unemployed people. We suspect the Fed is making the calculation that getting to +2% inflation isn't worth the human and political cost.

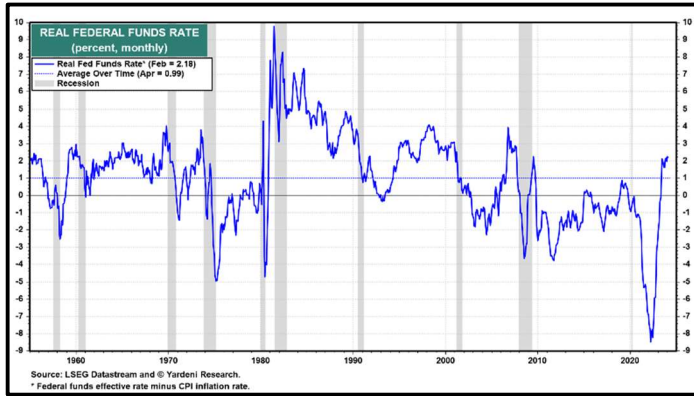
And politics matters. For all the talk of Fed independence, they are still a political animal. And we suspect their read of the political room is that things have changed post-COVID. Just as attitudes have swung away from the fiscal austerity narrative of the post financial crisis period, we suspect a majority of both voters and congress would not support the idea of running subpar growth and higher unemployment simply to get inflation down a half point.

This is an important positive for the equity market outlook because it means the Fed isn't an enemy. They may not cut three times this year, but the odds of rate hikes are exceptionally low. So, has the Fed moved the goal posts? Is their old +2% inflation target something higher? It's possible. A cynic might argue that the Fed actually wants higher inflation to debase the value of ballooning government debts. But you could also contend that the Fed hasn't moved their objectives, they have been moved for them through a change in public opinion. The Fed is simply adjusting to reality.

A (very) Brief Word on the Election

– We won't pretend we have any great insights on the election. Our suspicion is that the outcome in November will be more gridlock, but we definitely remain open to changing our minds. What's the most likely way for the election to move the markets one way or the other? At the moment three issues jump out:

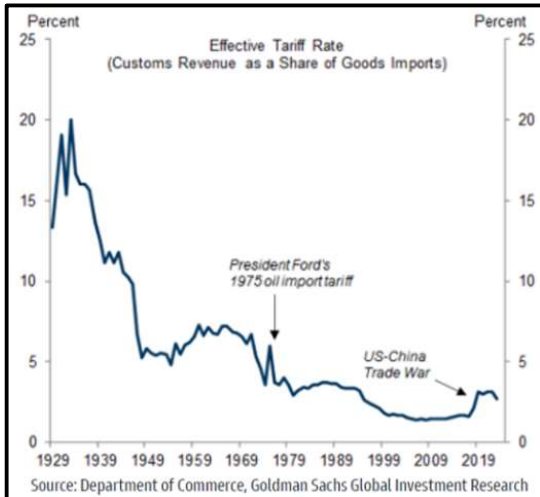
1. Trade policy. The one thing that both sides of the political establishment seem to agree on



is that aggressive trade policy as it relates to China is both a) prudent policy, and b) a vote winner. This means there's a good chance higher tariffs could feed through into consumer price inflation in 2025 and beyond (chart below).

2. Tax policy. Many of the major provisions in the Tax Cut and Jobs Act (passed in 2017) are set to expire at the end of 2025. This single issue is likely to consume much of the time and energy of Congress (such as it is) after the election. If nothing is done the law will automatically impose tax increases and spending cuts that neither party will find palatable.
3. Fiscal sustainability. It's startling how little this matters today. The chart at the top of the next page shows that the U.S. now spends over \$1tn a year on interest on its debt, roughly \$150bn more than it spends on defense and \$250bn more than it spends on Medicare. Depending on where rates go in the months to come, this number could grow dramatically. Will this topic become a hot button issue in 2025? Time will tell.

Bond Strategy In An Uncertain World – Finance types talk of tail risks when they talk about the markets. What they mean with the annoying jargon is basically what low probability/high risk event is being mispriced today. Nassim Taleb's book, *The Black Swan: The Impact of The Highly Improbable*, popularized the concept (as did the crash in the housing market). Tail risks, or black swans, are generally considered to be the bad stuff – wars, pestilence, busting bubbles. But they can also be the unanticipated good things (the right tails). A relatively recent example would be the technology revolution in the 1990's. All the hype around AI today may prove to be something similar (or not!!).



We bring this up because it's worth thinking about what the tail risk is for bond investors today. The right tail (the good scenario) is capped. You earn the coupon and see your principal returned at maturity. Maybe there's a recession in the next three-to-five years and you see the value of your bonds go up, but then you have the challenge of reinvesting at a lower rate. The left tail (the bad stuff) is more interesting. Generally, bond investors lose in two ways:

- Default. Either the borrower misses interest payments or they fail to pay back principal. Typically not an issue for government bonds.
- Loss of purchasing power. This one is more insidious
 - inflation chipping away at the value of the security.

What's the biggest risk today?

Certainly, if there is a recession in the coming years, corporate defaults will increase and investors in high-yield bonds in particular will take some losses. But investors in government bonds in the developed world are money good. If the financial crisis or COVID taught us anything it's that central banks are the buyer of last resort when it comes to government debt. But if inflation runs hot in the coming years, then the second risk becomes more pronounced. How do bond investors earn a real return after inflation without stepping out on the risk spectrum too much?

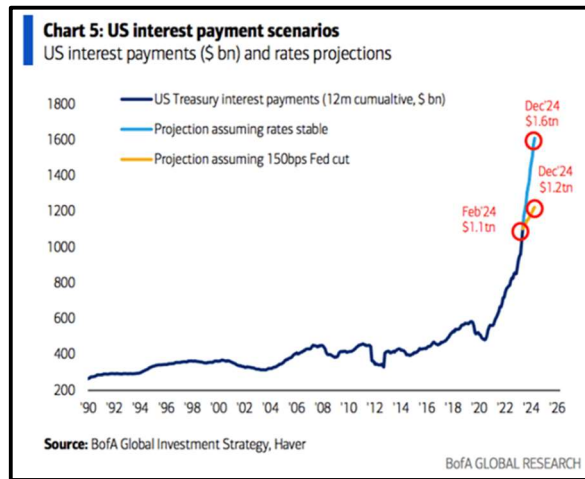
In our mind the best way to address this issue is through a so-called barbell approach. One end of the barbell is comprised of high-quality short-term bonds. Consider the table below:

<u>Treasury Bond</u> <u>Maturity</u>	<u>Yield</u>	<u>Real Yield at</u> <u>4% Inflation</u>
3-Month	5.36%	+1.36%
6-Month	5.32%	+1.32%
2-Year	4.75%	+0.75%
10-Year	4.40%	+0.40%

Source: Bloomberg. As of 4/5/2024

It's noticeable how much higher yields on short-term bonds are relative to 10-year bonds. Granted, short-term bonds present reinvestment risk – if the Fed cuts aggressively in the months to come you'll have to reinvest at lower rates. But in our mind the risks are skewed towards fewer cuts, not more. And if the Fed doesn't cut this year, or even renews rate hikes in 2025, long-term bonds are very exposed to further losses.

At the other end of the barbell are some of the riskier segments of fixed income where we think yields are high



enough to both compensate for possible credit defaults and protect against the loss of purchasing power. For example, higher quality corporate bonds are yielding roughly 5.5%, while lower quality 'junk' bonds are paying close to 8%. We think this is where an active manager can make a lot of sense as they have the ability to build a large, diversified portfolio across a lot of sectors. PIMCO Income, for example, has an average credit rating of A+ and a yield of roughly 6.25%.

We believe a portfolio comprised of a combination of short-term bonds plus some opportunistic riskier securities will generate real returns after inflation without taking too much risk and also providing the added flexibility of being able to deploy capital into longer-term bonds if rates were to increase in the months to come.

Final Thoughts – Returns in global equities almost certainly exceeded most people's expectations in the first quarter. While tech stocks continued to do well, it was encouraging to see the rally broaden out to other sectors such as energy and financial stocks. In general, we think global stocks will continue to beat fixed income as long as earnings continue to grow (which we expect) and the Fed remains on the sidelines. We believe the challenge for bonds will remain the uncertain outlook for inflation and what it means for monetary policy. It is quite possible that inflation will slow somewhat over the coming months, but we think the market is coming around to the view that risks are skewed to the upside when it comes to price pressures over the intermediate term. A solid growth backdrop, a tight labor market, and continued fiscal expansion all argue against a dramatic fall in inflation and significant rate cuts in 2024. The post-COVID world is running hotter inflation wise than it did before, and we suspect popular opinion and the political winds all tilt away from austerity and disinflation. We think central bankers are likely to accommodate this new view for now, but we will have to wait until early next year to see if the political agenda changes in a meaningful way after the election.

Charles Blankley, CFA
Chief Investment Officer

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