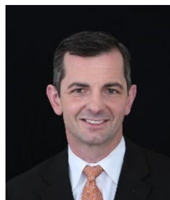


"The best way to predict the future is to create it"

~ Peter Drucker

March Madness. Every year the NCAA tournament captures our attention with drama, sportsmanship, and its famous by-product: brackets. There are some interesting parallels between March Madness brackets and the stock market. Basketball is a sport where skill, more than chance, is most important to the outcome, even though some unusual upsets are still possible. Thus, the winner of each game is more likely to be the team with the most skills, something easily measurable with all the statistics available on teams and individual players. Now, imagine a stock market where prices move up or down solely based on a company's current financial results, without any speculation about future results. Even better – imagine that all contributions to the results of the company would be happening live in front of you in the span of a few hours (while all bets would be locked). That would truly be a more predictable stock market with no participant having superior information.

Despite all available basketball data making predictions easier, I often see our most avid basketball fans in the bottom half of our office bracket pool while the top half of the bracket pool is populated with participants with little day-to-day basketball enthusiasm.

What this illustrates is the difficulty of making predictions while attempting to overcome your biases at the same time (favoring your home team versus the better teams) despite the existence of data which should make predictions easier. Similarly, this is a reminder that when making long-term financial investments, managing your emotions will continue to be a part of the journey.

My personal objective is three-fold when indulging in bracketology: to have more than 50% of my predictions proven correct (an improvement on random selections), to score in the top half of the bracket pool (be better than the average participant) and repeat this modest feat each year (consistency) while having fun. Given my approach and modest goals, you may not be surprised to learn that my annual bracketology exercises have been successful every year to date.

In summary, when presented with the challenge of financial growth (or picking March Madness brackets), it's important to keep a clear and realistic objective (a quantifiable goal), use a systematic approach (skill data), diversify-diversify-diversify (seeding order, favorites ranking, variety of metrics), and maintain a long-term attitude (big picture thinking).

As we move into the second quarter and reflect on the difficulty of making investment predictions, we are reminded of these lessons: establish a realistic objective, diversify your portfolio, follow a systematic approach, and stick with the plan during episodes of volatility.

Our goal is always to provide you with innovative solutions adapted to the uncertainty of investing, guiding you through an optimal allocation according to your financial goals and risk tolerance. Now for my view on the topics affecting your investments.

A CIO's View

These events are monitored daily by our models. We also regularly cover these topics in our monthly Navigator and quarterly Fixed Income Commentary.

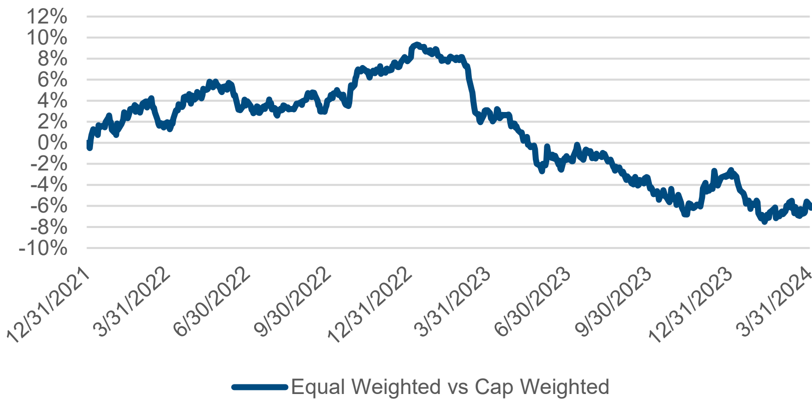
Market Return: A broadening rally more conducive to stock picking

We had mentioned in a previous newsletter the magnitude of the distortion of index returns caused by the run-up in the "Magnificent 7" stocks in the S&P 500. Looking back at this quarter, the cohort started going its separate ways and looking more like the "Magnificent 2" with Nvidia shares up 82.5%, Meta up 37%, Amazon up 18.7%, Microsoft up 12.1%, and (barely beating the S&P 500) Alphabet up 8.05%, with Apple down 10.8% and Tesla down 29.2%. The Artificial Intelligence gold rush seems to be tapering and the 10.4% rally of the first quarter is much less concentrated than that of last year. Case in point the highest performing sector year-to-date is communication services lead by Meta, Disney, Netflix, and Verizon. Close behind is the energy sector with Marathon Petroleum, Valero Energy, Diamond Back Energy and Targa resources all displaying gains of 30% or

more. A few other notable names in non-technology sectors: Progressive Corporation, Hartford Financial, General Electric, Eli Lilly, Davita Inc, Ralph Lauren, Tapestry, Constellation Energy and NRG Energy were also up 30% or more.

We like to measure this breadth factually by comparing the performance of the equal-weighted S&P 500 Index versus the cap-weighted index performance. You can see below that after a difficult 2023, the race between those two indices has been quite even over the past few months. (Exhibit 1)

Exhibit 1: S&P500 Cap-Weighted vs. Equal-Weighted Performance



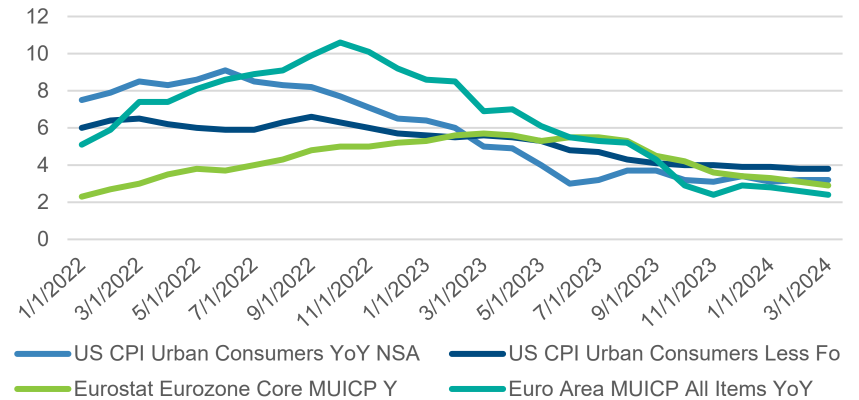
Source: Bloomberg.

Inflation: Improvements so far but resilience ahead

Core inflation has continued to abate but is now doing so slower (Exhibit 2). Core inflation now stands at 3.8%, while headline inflation barely inched down to 3.5%. While the trend continues to be in the right direction, the pace in inflation moderation is slower than last quarter and slower than the market anticipated. We have highlighted in our previous commentaries that possibility and see it becoming the base case for the moment.

Core inflation above 3% for the remainder of 2024 is a scenario which would trigger hawkish actions from the Federal Reserve such as a delay in interest rate cuts (or no cuts in 2024) as inflation could be more persistent than predicted.

Exhibit 2: US/Europe Core Inflation Rates

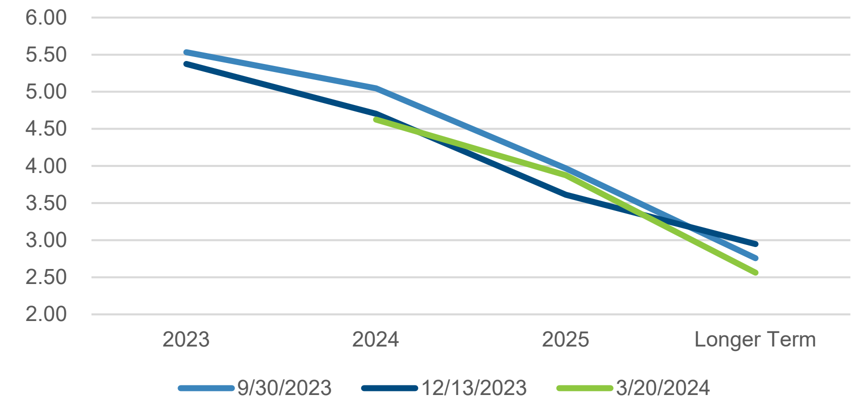


Source: Bloomberg.

Federal Reserve actions: Wait-and-see

In March, the FOMC continued to pause and maintain its policy rate within 5.25% and 5.5%. The tone was to pause while assessing more data, pointing to the strength of the economy and resilience of the inflation, further indicating that the Fed is unlikely to reduce rates at their next meeting, thus maybe leaving on the table a first cut in June at best. The dot plot is now higher than the last one for 2025 (Exhibit 3).

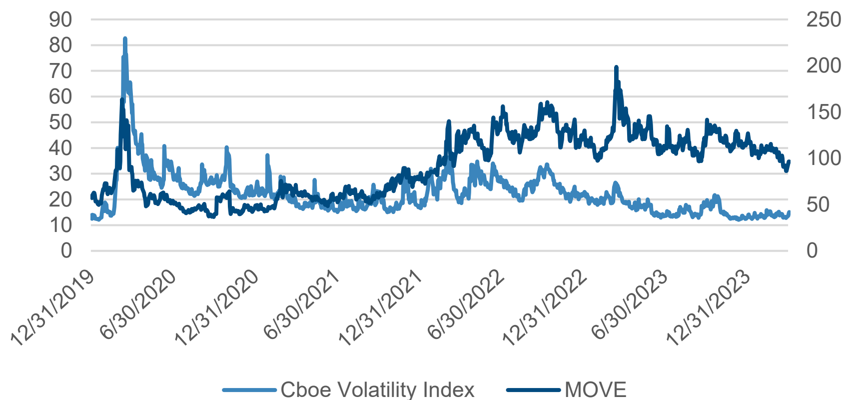
Exhibit 3: FOMC Dot Plots continue to signal high rates for longer



Source: Bloomberg.

The interest rate uncertainty is still high, as can be seen in Exhibit 4: the MOVE Index (implied volatility of a basket of OTC options on US interest rate swaps) illustrates the uncertain environment we are in, with a new positive this quarter: that uncertainty is a little lower than it used to be, conveying that the "higher for longer" scenario might be sinking in. Meanwhile the VIX (Volatility) Index continues at its lows along with tight credit spreads, reflecting the optimism on the economic situation.

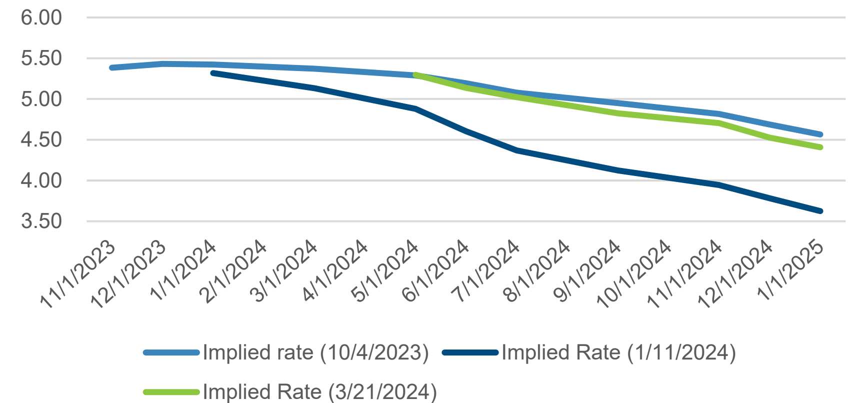
Exhibit 4: The MOVE Index indicate moderating uncertainty in interest rates, while the VIX Index indicates a constructive investment narrative.



Source: Bloomberg.

The rates markets have incorporated this information (Exhibit 5) and are pricing in higher rates for longer, showing an implied rate curve very similar to the one six months ago. With equities trading at multiples of 23X-25X in the US with some signs economic slowdown in combination with resilient inflation, the prudence thesis makes risk assets seem overbought, exposing vulnerabilities in US equities. Noteworthy: 2024 EPS projections keep coming down, potentially indicating that the market is too complacent at this juncture. In contrast, the Euro Stoxx 50 is trading at 14X-15X multiples, the FTSE 100 Index trades at 11X-13X, the S&P TSX Index trades at 16-17X, offering viable competing alternatives to US equities.

Exhibit 5: Implied Rates have significantly decreased in Q1

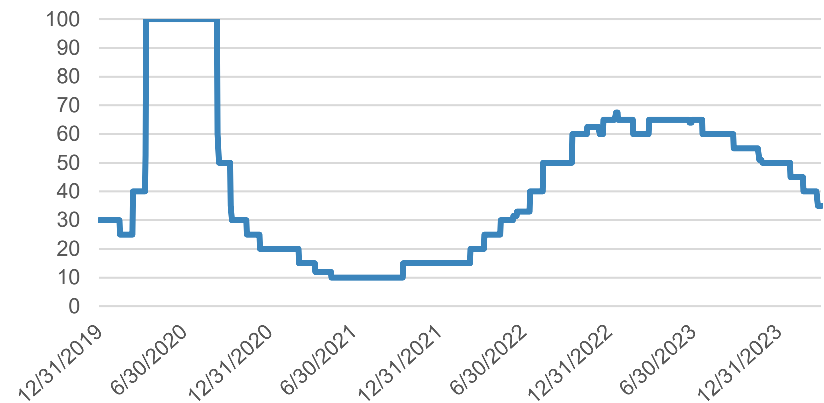


Source: Bloomberg.

Recession: lower risks, but still present

Recession risks have continued to inch lower however more recently recession probability has improved slightly to a moderate 35% (Exhibit 6). Since the economy has shown some resilience with some softening, this may embolden the FOMC to continue its restrictive actions.

Exhibit 6: Probability of a U.S. Recession down to 35%



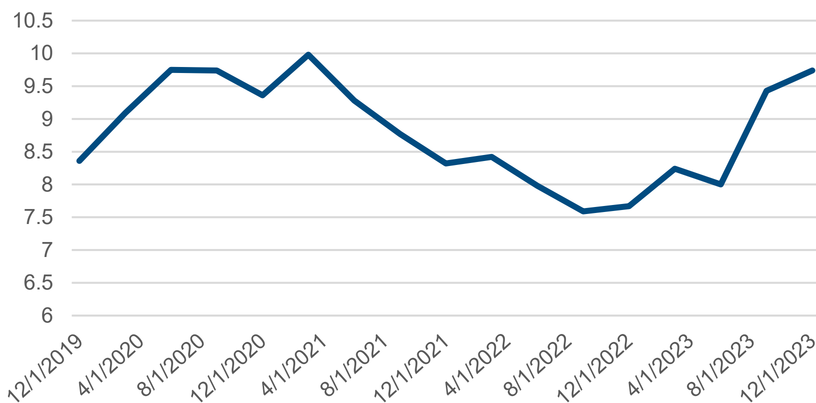
Source: Bloomberg.

Economy: Resilient with a moderate slowdown

For 2024, we are continuing to see some further signs of slowdown which could grow more substantial: personal savings buffers are lower than post-pandemic which could diminish consumer strength, fiscal policy is looking contractionary with the lapsing of past policies, the additional labor participation rate looks more challenging, the delayed impact of variable rate debt is likely to be seen in more corners of the economy, US election uncertainty, and geopolitical tensions in the Middle East could create additional headwinds.

Credit card delinquencies are rising to levels equivalent to the 2020 recession (Exhibit 7). This can be seen as a sign of normalization from the low levels of previous years and a digestion of the riskier lending. Corporate bankruptcies have also been rising and are still below pre-pandemic levels. Commercial real estate does look problematic, but accounts for only 2-3% of bank loan portfolios, which should avoid a repeat of the 2008 episode.

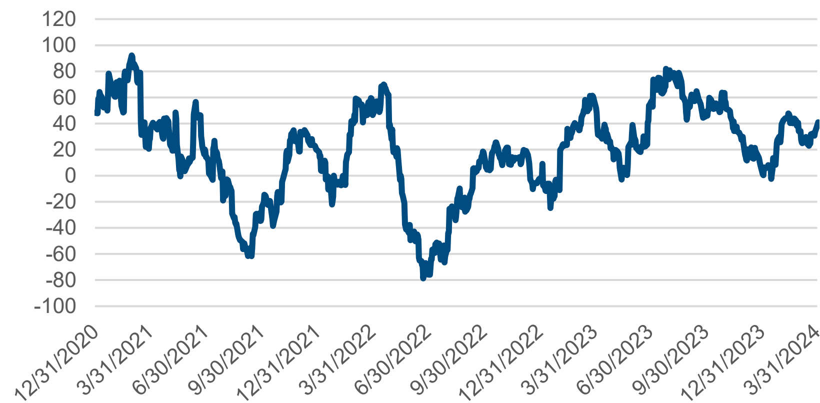
Exhibit 7: Credit Card Delinquencies starting to rise (% of balance delinquent 90+ days)



Source: Bloomberg

Next, the Citigroup Economic Surprise Index has declined over the past quarter, indicating that while still resilient, the US economy is no longer posting as many strong positive surprises as the majority of 2023. While the indicator is in mildly positive territory, it is not displaying a sharply negative trend like the one of 2022. (Exhibit 8).

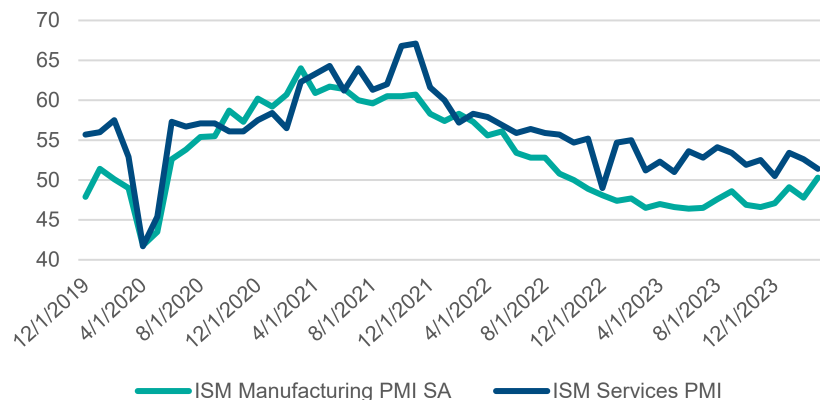
Exhibit 8: The Citigroup Economic Surprise Index indicates how economic data compares with consensus estimates



Source: Bloomberg, Citigroup.

Further signs of a moderate slowdown can be seen in the leading indicators of the PMI ISM surveys (Exhibit 9). Both indices are close to or below the neutral 50 level. While the declines seem to have stabilized, they have not shown any clear signs of improvement over the past six months.

Exhibit 9: ISM Manufacturing and Services Indices are in neutral territory



Source: Bloomberg.

US Elections: More uncertainty later in the year

We continue to monitor the election, with two candidates facing off later in the year. While this aspect is dominating the news, and some uncertainty, we take comfort that it has not yet seemed to impact the markets. One potential explanation is that both leading candidates have been previous Presidents, thus making them more of a known quantity. We anticipate some volatility as the year progresses and the agendas become more clearly defined between the candidates on fiscal, trade, and regulatory policies.

Investment Implications

Looking forward, it seems that the perfect soft landing scenario is dominating the narrative: lower inflation and resilient economic growth and profits, leading to equity multiples appearing overbought in the US. Any evidence of a less than perfect scenario can create vulnerabilities, and some pull back. While we continue to not see any major risks to the upside or the downside, the current return/risk environment does not appear the most favorable, thus our cautious stance and willingness to embrace any trading weaknesses to capitalize on future opportunities.

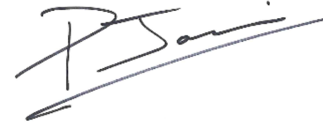
Given the current market conditions we reiterate our recommendations:

- Diversify-Diversify-Diversify: by asset class (bonds, equities, alternatives, options), by investment approach (long, tactical, premium income), by style (active, passive, defined outcome), by benchmark (equal weighted / cap weighted), by geography (US, International …): embrace other scenarios.
- Be realistic and remain cautious and opportunistic in the current environment with active risk management and tactical strategies.
- Follow a systematic and flexible approach and stick with it during episodes of volatility.

Following UConn's victory in the Men's National Championship game on April 8th, my bracket ended up with 38 correct picks out of 63, finishing in the top third of my fellow bracket pool participants. It is important to note that, much like March Madness, forecasting the direction of the markets is an uncertain exercise and embracing several alternative scenarios will more likely result in a positive long-term outcome.

I hope this letter finds you and your family happy, healthy, and enjoying the first taste of spring. If you have any questions about your portfolio or would like to discuss your current positioning, please contact your advisor at any time. Our team always has your interest at heart and stands ready to help meet your goals with the appropriate allocations and proactive financial planning. As always, we thank you for your business.

Warm regards,



Patrick Jamin
President & CIO

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