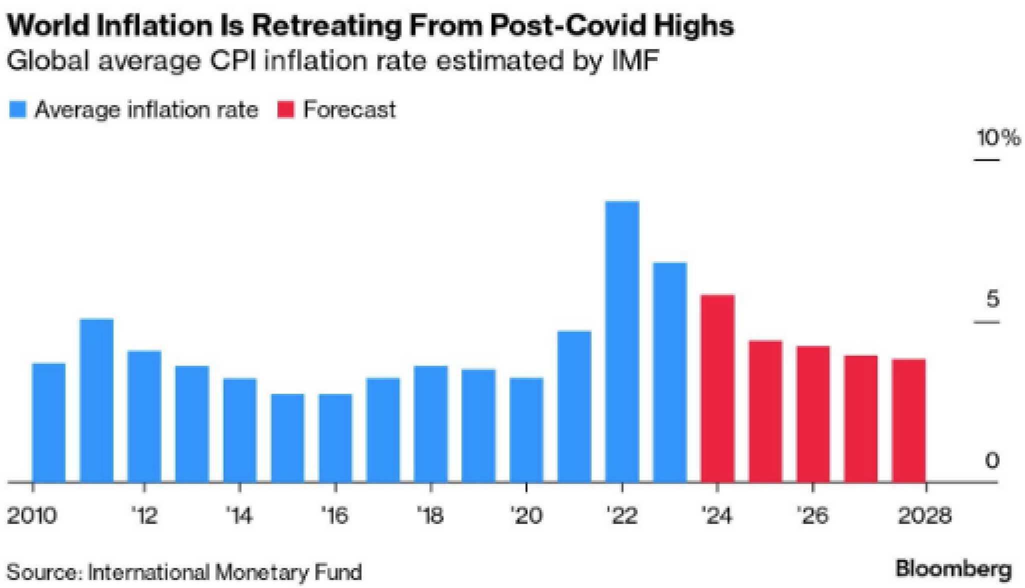
February 2024

From Bloomberg's Weekend Reading:

For those holding out hope the US Federal Reserve would start dropping interest rates later this month, the most recent inflation data surely dashed those expectations. The Fed's preferred gauge of underlying inflation rose in January (0.6% from December) at the fastest pace in almost a year. ("With So Many Flavors of Inflation, Which Should We Care About?" from the NYT's Peter Coy: https://www.nytimes.com/2024/03/01/opinion/inflation-supercore-federal-reserve.html) The uptick highlights the bumpy road to fully containing price pressures, especially amid the backdrop of a robust labor market, strong growth and a resilient American consumer. It also underscores the central bank's oft-repeated stance that it's in no rush to drop rates, concerned that loosening policy too soon could reignite some price pressures. The situation is similar in other countries and regions including Europe, where inflation eased less than anticipated last month and officials also exhibited a cautious approach to rate cuts.



Still, it's important to take a moment and reflect on the economic hurdles the world has had to overcome or continues to endure—from the pandemic to war—and the progress made. Most central banks have walked a fine line of pushing rates higher to bring down inflation—but not so high as to trigger a recession. Finance chiefs from the G20 this week cited a growing chance of a soft landing for the global economy as inflation comes to heel, a powerhouse US underpins growth and fiscal stimulus flows in China. Of course, plenty of risks remain, from fear of deflationary malaise to a widening conflict in the Middle East.

BCA Research's Global Investment Strategy developed a quantitative model which is published monthly. From Feb. 29th's:

MacroQuant Model Update: Still Dancing

1. Overview

After a brief sojourn into neutral territory in January, MacroQuant upgraded equities to overweight in February on a tactical short-term (1-to-3 month) horizon. It continues to see downside risks to stocks on a medium-term (12-month) horizon.

As was the case in January, the model ranked the US as its favorite equity region and tech as its favorite equity sector.

Consistent with the model's relatively somber medium-term growth outlook, it sees more downside for bond yields on a 12-month horizon than on a 1-to-3 month horizon.

The model is neutral on the near-term direction of the US dollar. It is modestly bullish on copper, neutral on oil, and slightly negative on gold.

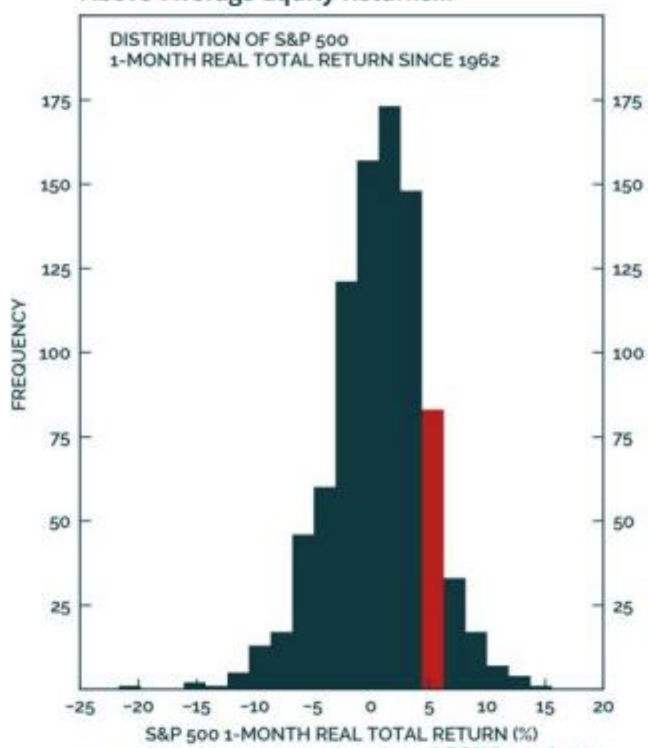
2. Model Components

A. US Equities: Blow-Off Phase

MacroQuant's US equity model, Stock Coach, has become more bullish on the near-term prospects for the S&P 500. Its short-term (1-to-3 month) equity score improved over the course of February, finishing the month at the 86th percentile of its historic distribution, up from the 57th percentile at the end of January. Such a score is consistent with significantly above-average returns (**Chart 2**). The model's equity score has stayed above the 50th percentile for 12 straight months.

The jump in the equity score in February was largely driven by better economic data (**Chart 3**). Among other things, economic surprise indices have improved, manufacturing new orders have risen, initial unemployment claims have dipped, survey-based recession odds have fallen, and several housing-related indicators have turned up.

CHART 2
Stock Coach Expects Significantly Above-Average Equity Returns...



SOURCE: MACROQUANT 2.0 (STOCK COACH).
NOTE: RED SHADING INDICATES THE BAR CONTAINING THE 86TH PERCENTILE OF MONTHLY S&P 500 REAL TOTAL RETURNS SINCE 1962.

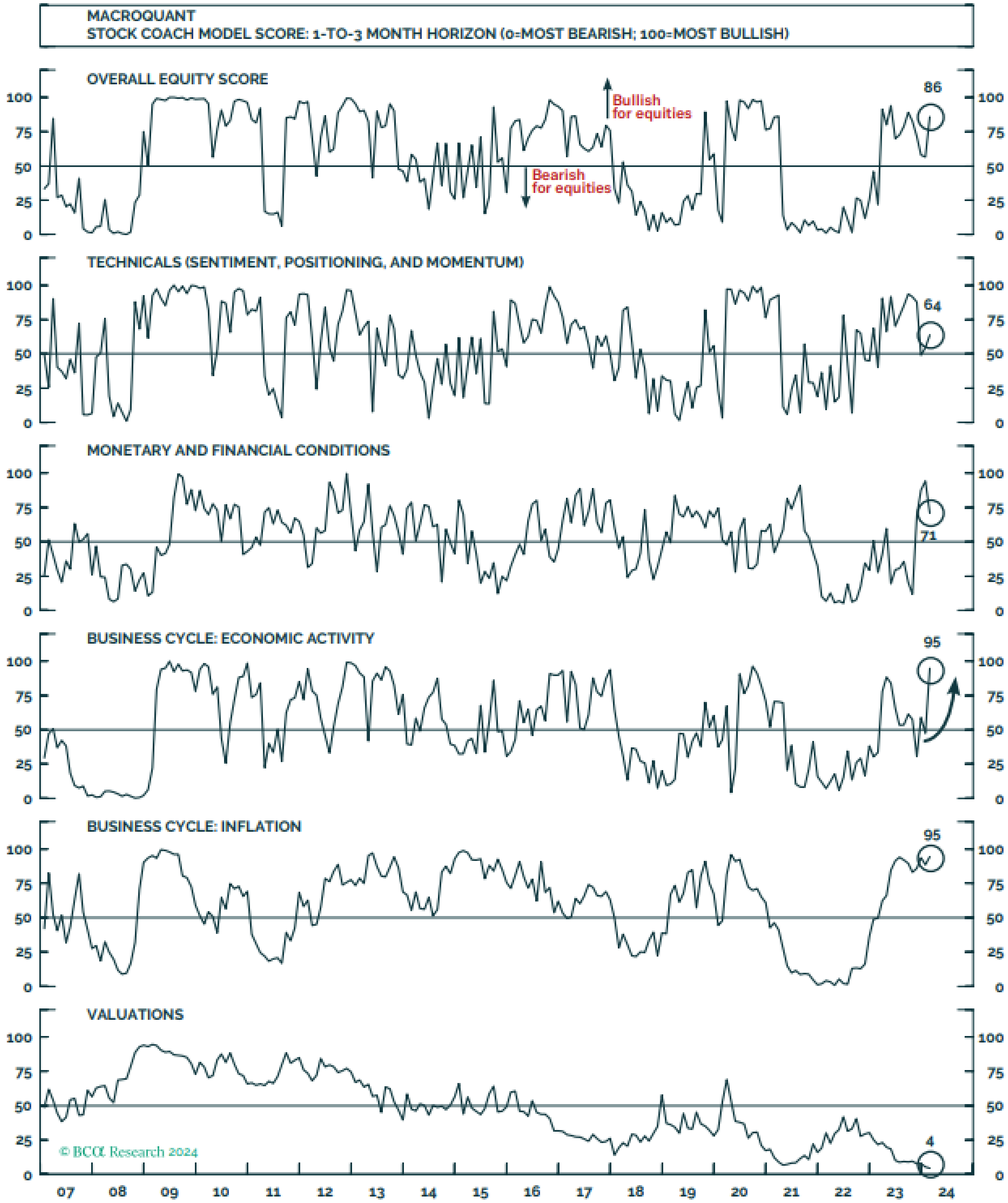
Not all is rosy, however. While the model's medium-term (12-month) equity score did move up in February, it stands at only the 39th percentile, consistent with subpar returns.

Large divergences between the short-term and medium-term equity scores are fairly rare and have typically occurred only near market tops. This suggests that US equities are in a blow-off phase that could end as early as this spring.

The model sees the US economy as being in the late stages of the expansion, as evidenced by a very low unemployment rate. Historically, a low unemployment rate has been associated with below-average subsequent equity returns (**Chart 5**). This is mainly because the unemployment rate is a highly mean-reverting series and typically starts rising within two years of bottoming.

CHART 3

... Following Strong Economic Data

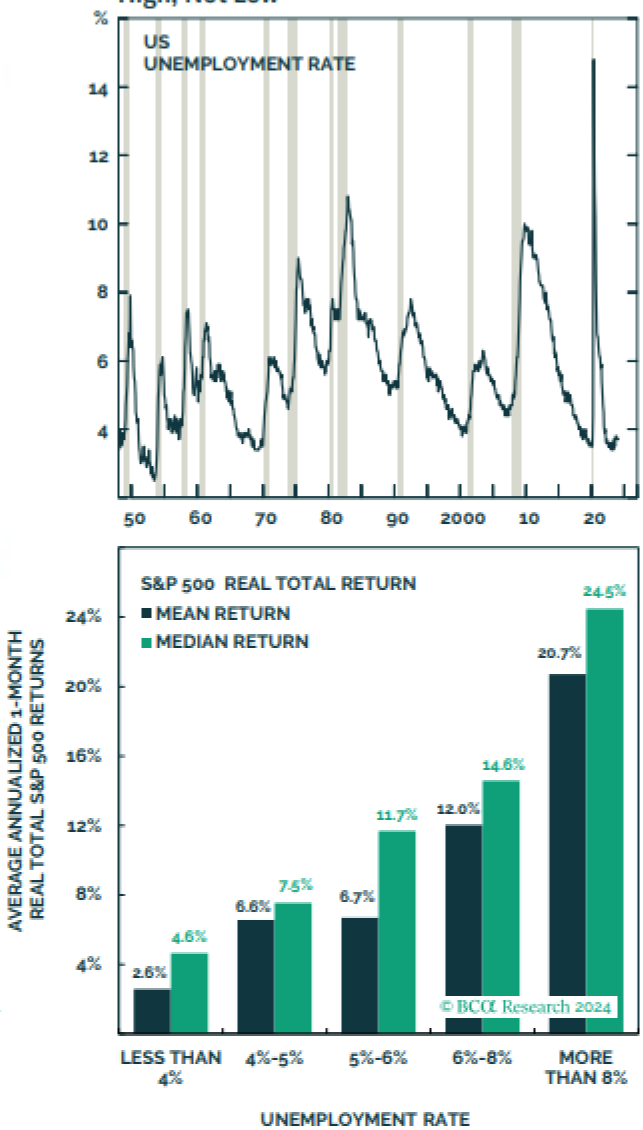


SOURCE: MACROQUANT 2.0 (STOCK COACH).

Adding to the worries are valuations. The S&P 500 currently trades at 20.6-times forward earnings, compared with 16.9-times between 2016 and 2019. Against the backdrop of real long-term Treasury yields in excess of 2%, the model sees the S&P 500 as being 42% overvalued relative to expected future cash flows – the most extreme level of overvaluation since September 2000 (**Chart 6**).

CHART 5

Stocks Do Best When Unemployment Is High, Not Low



NOTE: SHADED AREAS IN THE TOP PANEL DENOTE NBER-DESIGNATED RECESSIONS. BOTTOM PANEL CALCULATIONS ARE BASED ON UNEMPLOYMENT RATE FROM JANUARY 1950 TO DECEMBER 2023.

Admittedly, the S&P 500 would trade at "only" 18.5-times forward earnings if one were to exclude Alphabet, Amazon, Apple, Meta, Microsoft, and Nvidia from the index (**Chart 7**). However, the remaining 494 stocks saw their earnings contract by 10.5% in 2023. Thus, while the rest of the index is relatively cheap, it is cheap for a reason. In general, our backtests reveal that rising concentration – to the extent that it is associated with positive price momentum – is good for stocks in the near term, but bad for stocks over the long haul.

As a reminder, the Global Investment Strategy team uses the MacroQuant model as one of several inputs into its decision-making process. We are currently neutral on global equities on a 6-to-12 month horizon.

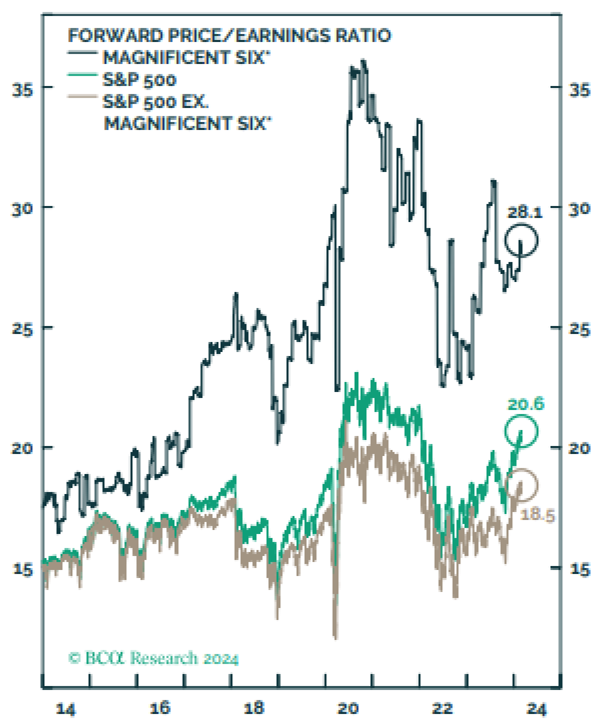
CHART 6

MacroQuant Sees Equities As Very Overvalued

* BASED ON PRESENT VALUE OF EXPECTED EARNINGS.
SOURCE: MACROQUANT 2.0 (STOCK COACH)

CHART 7

The Magnificent Six Trade At A Considerable Premium Over The Rest Of The Market



* INCLUDES AAPL, AMZN, GOOGL, META, MSFT, AND NVDA.
SOURCE: REFINITIV / IBES.

B. US Sectors: Tech Remains on Top

As was the case last month, MacroQuant's US equity sector model, Sector Selector, has ranked IT as its favorite sector. Strong sales and earnings momentum, rising orders for tech equipment, and positive inflows into tech funds all helped IT maintain the top spot. The tech-heavy communication services remains the second-highest ranked sector.

Sector Selector kept financials at neutral in February, although the score is now just a whisker from being overweight. While this sector is benefiting from cheap valuations and a moderation in the pace at which banks are tightening lending standards, it is being hampered by rising loan delinquency rates and slowing credit growth.

The model downgraded materials to underweight, partly due to continued uncertainty over China's growth outlook. It remains negative on energy, where earnings estimates have fallen for three straight months.

As in January, the model is underweight health care, consumer staples, utilities, and real estate. Subjectively, the GIS team has less of a procyclical bias than Sector Selector. The biggest divergence in views is with regards to health care. We see scope for health care stocks to outperform over a 6-to-12 month horizon given their defensive nature, favorable valuations, and room for increased pricing power.

C. Equity Regions: Overweight the US

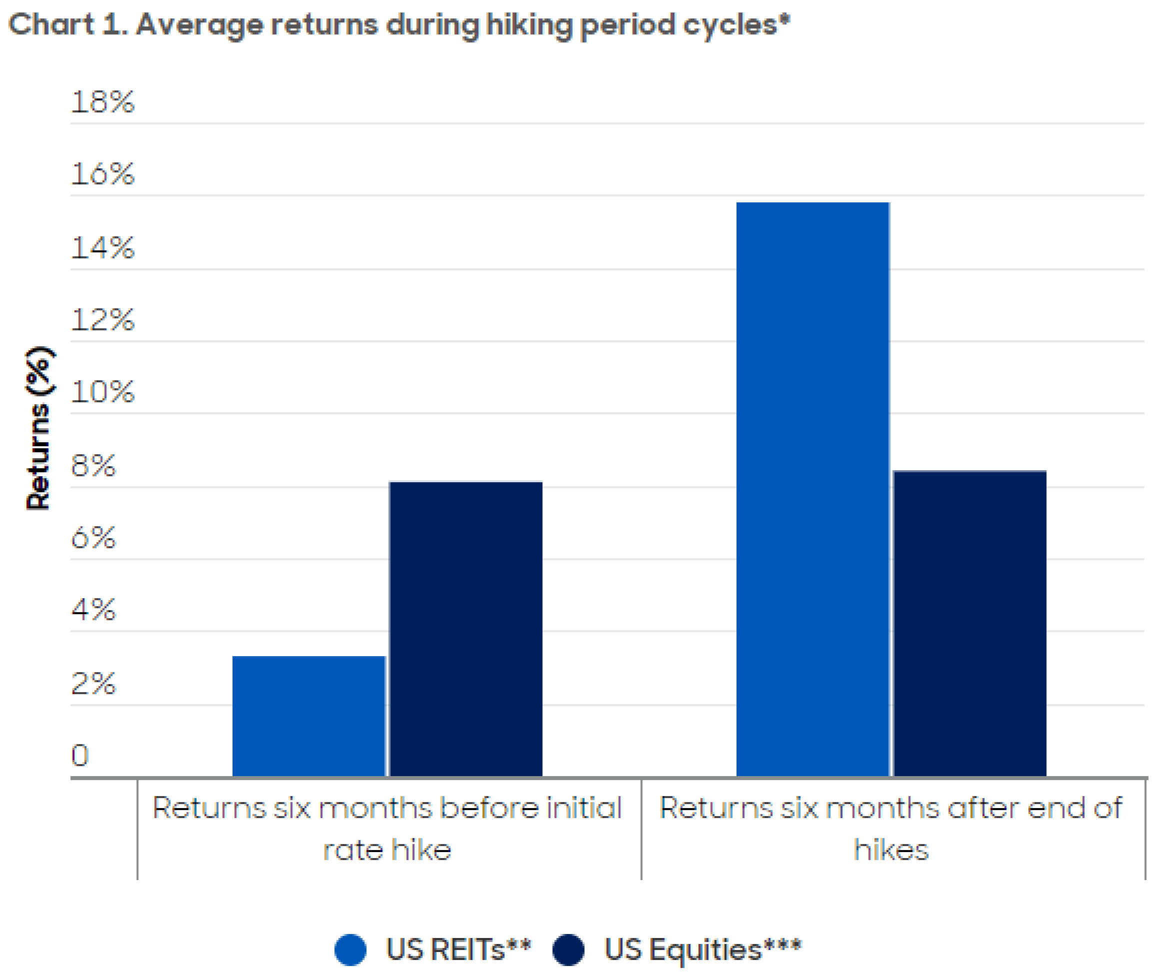
As was the case in January, MacroQuant's regional equity model, Region Rumble, awarded the US the top spot. US equities benefit from superior relative earnings and sales revisions, stronger buyback activity, and a more favorable sector mix (with tech overrepresented in the US). US growth has also handily outpaced growth in the rest of the world. Only relatively stretched valuations represent a black mark against US stocks.

Given that the US constitutes 64% of global stock market capitalization, an overweight on the US will invariably push other stock markets far down the leaderboard. As such, the euro area, UK, Canada, and Australia all registered underweights.

Japan also registered an underweight, partly on the back of recent growth disappointments. It is important to stress that the model aims to predict relative equity performance in common-currency terms. While the weak yen has boosted the Nikkei, it has hurt the stock market in dollar terms. ...

From yesterday's High Dividend Opportunities:

Reviewing past rate cycles shows that REITs outperform equities after rate hikes. After the 1973 bear market and a pivot from the Fed in December 1974, listed REITS returned 59% in the following 12 months compared to 36% for the broader equity market. Similarly, in the 12 months after the GFC, REITS soared 74%, compared with 49% for equities. Current market conditions indicate similar, if not better, returns for the REIT sector due to their better positioning regarding balance sheet quality, FFO growth, and dividend coverage.



Follow-ups

As we opined last month. From NYT:

Another Wall Street fad has imploded. Not before it claimed its victims.

By Adam Lashinsky

February 20, 2024

Yet another Wall Street investment fad has crumbled, this time a dodgy technique for taking companies public called SPACs, or special purpose acquisition companies. As is often the case, regular investors and rank-and-file employees are the losers; hedge fund managers and investment bankers are the winners. Not for the last time, regulators are stepping in to quash snake-oil schemes they didn't do enough to stop when it might have made a difference.

It's worth taking note of this debacle now because it won't be the last time Wall Street hustlers separate unsuspecting investors from their savings. It's just the latest.

If you only started paying attention to SPACs a few years ago, you'd be forgiven for thinking they were a new financial elixir. In 2021, nearly 200 companies completed SPAC deals, up more than threefold from the year before. These deals were worth close to $500 billion, a fivefold increase.

But SPACs have been around for decades. Before a few years ago, however, only unsavory, little-known companies attempted to enter the public markets using this device. The transaction involves a financial player raising money from a pool of public investors to merge with a not-yet-identified company at a later date. SPACs had long been a back-door path to an initial public offering that only a company that couldn't do it the respectable way would pursue.

Perhaps that's why the SPAC craze of the early 2020s was such a magnet for a new crop of unlikely start-ups in capital-intensive industries such as electric cars and flying taxis. A speculative frenzy ensued that sucked in all sorts of prominent if shaky companies. Today, many are limping along — or worse.

Late last year, Bloomberg counted more than 20 companies that had gone public by SPAC only to declare bankruptcy relatively shortly afterward. One of these was WeWork, the shared workspace real estate company. WeWork's backdoor IPO occurred well after company founder Adam Neumann had departed in a cloud of scandal. (Neumann reportedly is trying to take back control of WeWork, an effort that doesn't seem to be going anywhere.)

The British electric-vehicle maker Arrival, which hit the capital markets with backing from South Korean carmaker Hyundai, even tried doing a SPAC deal twice, the second time falling apart before it could happen. The fledgling company was worth $15 billion when it first went public, despite not yet having produced a vehicle. Arrival already has departed: Its shares have been delisted from the Nasdaq stock market, and the company declared bankruptcy.

The SPAC-splat list goes on: Blade Air Mobility, a firm that flies the Ferragamo-favoring, Air Mail-reading set on helicopters from Manhattan to the Hamptons and other locations, has seen its post-SPAC share price fall from $15 in 2021 to $3 today. Shares in BuzzFeed, a onetime media darling, trade for 20 cents. That's even worse than the spit-test DNA start-up 23andMe, whose shares hover just below a dollar.

It will likely surprise no one that Donald Trump has been working to cash in on the SPAC game, too. The company that owns his Truth Social media platform has been trying for more than two years to go public by merging with a SPAC named Digital World Acquisition Corp. (SPAC creators love anodyne names like this.) Stymied by various Securities and Exchange Commission investigations, Digital World Acquisition last year returned $1 billion to investors that had been earmarked to buy Truth Social. Yet just last week, the SEC granted its approval for the merger to move forward.

What happened to make all these SPACs go bust? Think of the SPAC debacle as the last gasp of the low-interest-rate era. When money was nearly free, Wall Streeters could compete with each other to conjure novel ways to raise and deploy capital. As rates rose, it became harder for cheap money to chase bad ideas, forcing companies to actually have profitable business models to attract financing. Last year, there were just 98 SPAC deals on Wall Street, about half the level in 2021.

It is important to tell this story now because another crazy financing vehicle will come along soon. That immature or money-losing companies were able to raise big bucks so easily was as predictable as it was tragic for investors who got caught on the wrong side of the trade. It was no different from the "prerevenue" companies that did traditional IPOs during the dot-com boom of the late 1990s. Everyone knew there'd be a bust. They just didn't know when.

Just as predictably, the SEC recently promulgated new rules tightening listing requirements for SPACs, a good example of closing the barn door after the horses have fled. Among other measures, regulators will make it more difficult for SPACs to make rosy projections, a marketing ploy long denied traditional IPOs. "Just because a company uses an alternative method to go public does not mean that its investors are any less deserving of time-tested investor protections," SEC Chair Gary Gensler wrote in a statement.

Here's a better idea for the SEC: Start thinking now about the next, rather than the last, get-rich-quick scheme that's likely to snooker the investors your agency is supposed to be protecting.

Adam Lashinsky is former executive editor of Fortune magazine and the author of "Inside Apple: How America's Most Admired — and Secretive — Company Really Works."

Our view on Crypto hasn't changed. It is a speculative vehicle with no intrinsic value. From the front page of February 5th's WSJ:

Financial Giants Race to Lure Investors Into Cryptocurrencies

BY ALEXANDER OSIPOVICH

Listen to firms on Wall Street these days, and you might think you are knocking down beers with a gaggle of crypto bros.

Larry Fink, chief executive of BlackRock, the world's largest asset manager, told CNBC last month that he was a big believer in bitcoin. A few days later, Howard Lutnick, the CEO of financial-services firm Cantor Fitzgerald, predicted that bitcoin would rally this year. He also praised Tether Holdings, the firm behind the widely used stablecoin tether.

"Holding a dollar in a token is amazing," Lutnick, whose firm manages much of Tether's bond portfolio, said in a televised interview from Davos, Switzerland. In 2021, Tether's creators reached a $41 million settlement with U.S. regulators over allegations that they misled investors about whether the coin was fully backed by dollars. Tether didn't admit wrongdoing.

After years of tiptoeing around the world of cryptocurrencies, huge financial firms are racing to lure Main Street investors into these mostly unregulated markets, seeking a fresh source of revenue. The stampede has been prompted largely by January's heavily anticipated launch of exchange traded funds that directly hold bitcoin.

Bitcoin proponents hope the ETFs will boost the price of the digital currency by opening it to a wider investor base, but many outsiders question whether these highly speculative assets belong in the average individual's portfolio.

Some asset managers backing the new ETFs have flaunted their bitcoin bona fides on social media, dropping memes and lingo familiar to the crypto community, though perhaps obscure to others.

For example, you might not know that Jan. 3 was the 15th anniversary of the first bitcoin transaction, but Invesco made it clear that it did: The $1.6 trillion asset manager wished bitcoin a happy birthday on its official X account.

“BOOORN TO BITCOIN,” investment- management firm VanEck tweeted on Jan. 16. The fund manager later tweeted at Merriam-Webster, asking why its dictionary didn’t include “HODL,” a term used by bitcoin investors to mean never selling one’s coins despite wild volatility.

Franklin Templeton, a 77year-old asset-management company, was named after Benjamin Franklin because he “epitomized the ideas of frugality and prudence,” according to its website. In January, the company, which trades publicly as Franklin Resources, tweaked its official X profile picture to show the U.S. founding father with laser eyes, a meme popular with bitcoin bulls.

“In crypto, speculation is a feature, not a bug,” Franklin Templeton tweeted on Jan. 17, during a roughly 90-minute stunt in which the firm’s digital- assets team took control of the X account.

In other posts, Franklin Templeton cited the “massive potential” of some blockchain networks and circulated a meme that appeared to endorse adding bitcoin to a traditional 60/40 portfolio of stocks and bonds.

“We’re always trying to stay fresh and current,” said Roger Bayston, head of digital assets at Franklin Templeton.

The firm recently removed the laser eyes from Benjamin Franklin’s image on its main X account. It also deleted a crypto-themed post featuring a meme with images of former WWE boss Vince McMahon after an ex-employee filed a lawsuit accusing him of sex trafficking. McMahon has denied the allegations. “Given the allegations at that time, we felt that removing the tweet was the most appropriate course of action,” a Franklin Templeton spokeswoman said.

Some crypto skeptics said Wall Street’s embrace of bitcoin rang hollow, calling it a thinly disguised attempt to cash in on an emerging asset class.

“Fee revenue is the name of the game on Wall Street. This is a new opportunity to get fees,” said Lee Reiners, a lecturing fellow in economics at Duke University.

Some of the biggest players in traditional finance are still wary. Vanguard Group has refused to provide access to bitcoin ETFs via its brokerage platform, saying they don’t align with its philosophy of enabling long-term, buy-and-hold investing. Jamie Dimon, CEO of JPMorgan Chase, has maintained his personal skepticism of bitcoin even as the bank has agreed to facilitate trading in BlackRock’s bitcoin ETF.

Bitcoin is a useless “pet rock,” Dimon told CNBC on Jan. 17. “My personal advice is don’t get involved, but I don’t want to tell any one of you what to do. It’s a free country.”

There are risks for regulated financial firms that get too enthusiastic in marketing crypto. Last month, the Financial Industry Regulatory Authority released the results of a 2022 review of more than 500 crypto-related communications from 11 brokerage firms. More than 70% of the messages were potentially in violation of a Finra rule that prohibits false or exaggerated communications with the public, Finra said. Not long ago, the crypto community viewed Wall Street as an ideological enemy. Bitcoin’s anonymous creator, Satoshi Nakamoto, originally envisioned his invention as a way to make payments without relying on banks, and many early bitcoiners were libertarians bent on creating a financial system outside of government control. In turn, most financial firms kept their distance from the unruly world of digital currencies.

Now, in much the same way that high fashion co-opted rebellious subcultures such as punk and grunge, the financial industry is echoing the messaging of crypto. “Bitcoin may help guard against the government devaluing your money,” VanEck said in a recent television commercial for its new bitcoin ETF. In an interview, CEO Jan van Eck said the firm had a history of offering products to help investors protect against inflation.

Positions

THC - Our IVA Stock Selection System requires Valuation to be in the lowest decile on either PEG, EV/EBITDA, or EV/EBIT, in that order of preference. As detailed on our website, we will usually sell when the stock becomes fully valued. We sold THC on 2/21 for 4 clients @ 90.98: