Strengthening Our Clients' Financial Lives

Forza Investment Advisory, LLC

FROM THE DESK OF BOB CENTRELLA, CFA **April 8, 2024**

We just returned from a short "spur of the moment" trip to Italy a few weeks ago and I still have food and wine depression. Rome was buzzing before Easter and if this was any indication, travel this summer will be strong, especially to Italia. On a fun note, we went to a new area just below Rome called the Castelli Romani and tasted some interesting wines. **You must read on to get to my Italian wine tips and a food idea!**

The market had a great start to 2024 and the first quarter is in the books. The strong Q1 bodes well for the rest of 2024 based on history. More on that later. Presently we see inflation moderating, employment holding steady and the economy continuing to grow as the possibility of a never-achieved "soft-landing" remains in the cards. We entered 2024 after a strong year for stocks led by the coming Artificial Intelligence (AI) revolution and MegaCap growth stocks or the "trillionaire's club" of Apple, Amazon, Alphabet, Meta, Microsoft and Nvidia. These stocks plus Tesla constituted the "Magnificent 7" (stupid name imo) which provided the bulk of last year's 26% gain in the S&P 500. In Q1-24, large growth again paced stocks in the first quarter although we did finally get some participation from the rest of the market . The S&P 500 price gain was 10.2%, eclipsing many strategists targets for the full year. This was only the 4th time this millennium it gained more than 8% in the first quarter. This was despite bond yields rising, with the 10-Yr UST yield climbing from 3.89% at the end of 2023 to 4.21% leading to a loss of -1.0% for the Barclays Bond Agg Index.

Below is a table of price returns for various assets in Q1-24.

ASSET	% RTN	ASSET	% RTN	ASSET	% RTN
Cocoa	132.8%	Nasdaq Comp	9.3	Vang Int'l Bond	-.35
Bitcoin	66.6	S&P 100 Eq Weight	8.9	I-share Nat Muni Bond	-.75
Ethereum	58.5	CAC France	8.8	Barclay Bond Agg	-1.0
Nikkei 225	20.6	Comex Gold	7.5	S&P 500 Real Estate	-1.4
FTSE MIB Italy	14.5	Dow Jones Industrials	5.6	UST 7-10 Yr Bond	-1.8
DAX Germany	10.4	Russell 2000	4.8	Euro	-2.2
S&P 500	10.2	Comex Silver	3.96%	Hang Seng	-2.97
Euro Stoxx	9.7	FTSE 100	2.8	Ish 20+ UST Bond	-4.3
IBEX 35 Spain	9.6	Shanghai	2.2	Japan Yen	-6.8
S&P Midcap 400	9.5	S&P Small Cap 600	2.0	Nymex Nat Gas	-29.9

Cocoa was the big gainer in the quarter up 133% - bad news for us chocolate lovers! The crypto currency Bitcoin had a big quarter after Bitcoin ETF's were approved by the SEC. Bitcoin gained 66.6% while its cousin Ether gained 58.5%. The Nikkei 225 led the countries with a 20.6% gain followed by Italy +14.5% and Germany DAX up 10.4%. The US Nasdaq gained 9.3% while lagging was the China Hang Seng -2.97%. Gold continued its impressive run up 7.5% to $2238/oz while silver rose 3.2%. On the bond front, rising rates caused bonds to fall with the Barclays Bond Agg declining 1.0% and the UST 7-10 Year down 1.8%. The 20+ UST Bond fell 4.3%. Finally, the big loser (but good for consumers) was Nat Gas which dropped 29.9% in the quarter with warmer weather across the East.

Among cap sizes and styles, Growth outperformed Value across the board. Midcap Growth was the best group at a 15.5% gain, while Large Growth returned 12.6%. Large Cap +10.4% slightly outperformed Midcap +9.6% while overall Small Caps lagged with a SC 600 gain of 2.3%

Index	% Rtn	Index	% Rtn	Index	% Rtn
S&P 500 Growth	12.6%	S&P MC 400 Growth	15.5%	S&P SC 600 Growth	4.5%
S&P 500 Value	8.0%	S&P MC 400 Value	4.2%	S&P SC 600 Value	-.09
S&P 500	10.4%	S&P MC 400	9.6%	S&P SC 600	2.3

Finally on a sector basis, Technology again led with a 12.5% gain followed by Communication Service +10.7%, Financials up 10.4%, Industrials +9.8%. All the other sectors were positive except Real Estate which was down 2.1%.

Sector	% Rtn	Sector	% Rtn
Technology	12.5%	Cons Defensive	6.1%
Comm Svcs	10.7	Cons Cyclical	5.0
Financials	10.4	Basic Materials	2.95
Industrials	9.8	Utilities	2.8
Energy	8.7	Real Estate	-2.1
Healthcare	8.1		

KEY TAKEAWAYS AND LOOKING AHEAD

We entered 2024 with the consensus expecting a soft-landing to be engineered by the Fed for the economy, with up to 6 rate cuts during the year. Personally, I was looking for 3 rate cuts, but even that is now suspect. Here are some takeaways from the quarter and what to expect ahead.

1. Remember that 2024 is an election year. **The average annual return in an election year since the 1920's is 11.2%.** So, theoretically we don't have much to go. But… history suggest more gains to come. Since 1950, the market has gained over 8% in the first quarter 16 times. Of those 16 times, only once, 1987's crash, did the index lose ground the rest of the year. In fact, for the other 15 times, the index gained an average of 9.7% more during the subsequent 3 quarters. So, going back 75 years, that's a 94% chance of more gains to come.
2. Inflation remains stubborn and has averaged around 3% the last 2 months. The Fed target remains 2% but with oil prices rising now above $90 and other commodities rallying, further drops in inflation will be hard to come by.
3. The Fed is on hold and not ready to decrease rates. Fed Chair Powell recently said that the Fed would lower rates at some point, but would continue to be data dependent. The latest Fed estimates had forecasted 3 rate decreases but recent reports such as strong employment and inflation above 3% may put those on hold. Plus given the election year, the Fed's window to decrease rates probably closes around September.
4. Corporate profit reports are coming over the rest of April. The next few weeks will be influential on stocks as companies report Q1 earnings and give guidance. Estimates call for 3% earnings gain overall in Q1. As the year progresses, quarterly comps should get easier. Earnings gains are projected to be 9.4%. 8.5% and 17.5% for the following 3 quarters for a total increase of 10.9% for 2024. The Mag-7 stocks provided almost all the earnings growth in 2023 for the S&P 500. Can the rest of the market provide earnings growth?
5. Stocks are still valued above average. The S&P 500 currently trades at a forward PE ratio of 20.5x EPS compared to the 5-yr average of 19.1x and the 10-yr average of 17.7x. Earnings growth will be key now that PE multiples are above average. Higher earnings growth can move the market higher, but if lower than expected…
6. Bond yields remain above 5% out to a year and above 4% beyond out to 30 years. **The yield curve has been inverted now a record 639 days and counting**. On average it is usually ½ of that. What gives? The inversion reflects concerns about the long-term economic outlook with a recession predicted within 1-2 years. If the Fed

only cuts rates 2-3 times this year, the inversion will persist. Is this the new normal? Short rates need to drop 1% all else being stable for the inversion to start normalizing.

7. Geopolitical risks seem to be increasing in the Israel/Hamas war and the Ukraine/Russia war wages on. There is concern that the conflict can spread further in the Mideast. What's the next geopolitical event to occur?
8. It's "Sell in May and Go Away" season. It's coming up on a seasonally slow period for stocks. Is a market correction in the cards? **Stocks have been on a tear since November having risen 29%** at as of March 31st since they bottomed from the 11% correction that started in August '23. At some point we are likely to get tested this year. With the election looming, the market skittish about inflation and interest rates, valuations above average, and geopolitical risks rising I would not be surprised to see a period of weakness occur. So what should you do with stocks, is it sell and hibernate time? Here's a look at the S&P for the last year.

If we do get a correction, I would expect any weakness to be a normal -5% to -7% pause over a few months which would be short-lived and eventually met with buying. This would more likely be if the Fed signals they won't be cutting rates by June, or things worsen in the Mid-East. And if the Fed does lower rates, don't fight the Fed! Buy stocks. So, we advise holding on, raising a little extra cash and looking for good opportunities.

BONDS

Short yields above 5% and medium to long yields above 4% still offer some decent returns. Given the yield curve inversion, I still don't see longer term bonds earning much more than their current yield. My strategy remains in place of a barbell and laddering approach coupling short and intermediate bonds with a combined yield in the 4.5% range. With rates moving up since year-end I now see a smaller trading range of 25 basis points up or down from current levels until the Fed signals a cut. Preferred stocks and convertible bonds also offer a decent return opportunity if rates don't move much higher. Cash Money Market yields will decline but should still stay above 4.5%.

EQUITIES

In the first quarter growth stocks continued leading but the breadth broadened with Value and mid-caps also performing decently. Small-caps are still lagging and may continue to until rates decline as their cost of debt is higher. I continue to like the equal-weighted index approach but with higher than average exposure to the mega-caps. As I mentioned in my prior letter, when the Fed starts lowering rates, Value stocks could gain an upper hand over Growth and small-caps should catch a bid. So, I continue to want to allocate money to these areas. On the international front, Europe is doing better, and stocks are reflecting this with nice gains. I like some exposure to international stocks but prefer developed markets. I'd steer clear of China. My sector approach is to stay diversified, but I look for attractive valuations and stories among individual companies. Technology, Comm Services and Industrials will have the best EPS growth.

SUMMARY AND CONCLUSION

Coming into 2024 my base case forecast was for a nice up year for stocks and a collect-the-coupon year for bonds. Here are my scenarios I presented 3 months ago with current updates:

- My highest probability and base case remains that the Fed pulls off a soft landing and we do not have a recession. I do see market volatility with up and down months remaining and a possible correction of 5% or more. I don't see the Fed lowering rates until after June as it continues to be data dependent. Investors have adjusted their expectations (to where I was) to 3 rate cuts at most given stubborn above average inflation and a solid labor market. I was forecasting stock returns of 10%-13% coinciding with S&P earnings growth. The S&P 500 target at that level would be 5300 – 5450. As an update, I am moving my target to 12% to 16% return and 5400 – 5600. I believe earnings growth could be a little better assuming economic growth is around 2.5%. For Bonds, I was forecasting returns in the 4%-5% range for the Bond aggregate. I now see that return for bonds in the 1–2-year maturity range. I think the bond aggregate may return only 1% to 3%. I assign an 85% probability to this base scenario with returns in the 10% to 16% range for the year.
- My bear case scenario is that the Fed can't cut rates because inflation lingers and drives us to a mild recession where the Fed must then eventually lower rates. Corporate profits could decline 5% or more and stocks drop 10%+ until rebounding late in the year after the election but still remain in the red. I assign a 15% probability of this case or a more bearish scenario than my base case.
- My best-case scenario of 5-6 rate cuts is highly unlikely at this point, so I am removing it. I had only given it a 15-20% probability.

In sum, I think equities outperform bonds, but ST bonds should be held for income and protection in balanced accounts and should produce positive returns. I continue to favor a diversified large cap equity portfolio with some exposure to mid, small, and international stocks as well. Stock-picking will be key.

Feel free to contact me with any comments. Cheers!

Bob

Forza Wine Tip:

As I mentioned, we were in the Castelli Romani region just 30+ minutes south of Rome. This is where the Castello Gandolfo Pope's summer palace is located and there are frequent daytrips from Rome. We stayed a few nights. We visited 2 local producers and had wonderful experiences. The 2 important wines from this area are White Frascati and the Red Cesanese wines. The Frascati wine is made from the Malvasia (Mal-va-See-ya) grape and is a dry white wine. It is very refreshing with citrus and mineral notes. The red wine called Cesanese (Chae-sah-NAE-say) is an ancient Roman wine. It is not well known outside of the Lazio/Rome area but is cost friendly and tasty. This dry red wine is somewhat tannic at first but fruity and medium bodied. Generally, it is aged in either large or small oak. It was served with various kinds of ham and porchetta although my daughter is Vegan and enjoyed it with bread, veggies and jam. These wines might not be as easy to find but if you see them give them a try!

Fun Food to try:

While in the Jewish Ghetto area of Rome we had the Jewish Artichokes known as Carciofi alla Giudia. These are deep-fried globe artichokes and fun to eat. The leaves are crispy like chips and the inside soft. You can find recipes online if you want to try them. Of course, getting the wonderful large artichokes would be the first requirement!