JSB Capital Management, LLC

Pro-active Wealth Management

Outlook 2024

The most important thing to remember is that inflation is not an act of God, that inflation is not a catastrophe of the elements or a disease that comes like the plague. Inflation is a policy.

Ludwig von Mises, (2006). "Economic Policy: Thoughts for Today and Tomorrow"

One year ago, we published our annual review of the previous year (2022) and detailed our forecast for the full year of 2023. Here's what we said back then (in *black italics*):

> *2022: The Worst Year for Both Stocks and Bonds in History*
>
> *Last year was the S&P 500's worst year versus the Dow since the S&P 500 was introduced as a broader stock market index in 1957. In terms of total returns (price action plus dividends paid) the S&P 500 index experienced its fourth-worst year since 1957 (it was down 38% in 2008 by comparison).*
>
> *Perceived as a "safe heaven" during stock market declines, the overall bond market lost 30.2% in 2022 marking the worst annual return in U.S. bond market history.*

Regarding inflation which was picking up rapidly in mid-2022:

> *<u>Inflation Rears Its Ugly Head in 2022</u>*
>
> *Years of near-zero interest rates produced the predictable effect of skyrocketing inflation last year. The most well-known gauge of inflation, the Consumer Price Index (CPI), hit 9.1% in June and slowly eased downward to finish the year at an annual rate of just over 8%.*

With inflation on the forefront of the economy, we articulated the role of the Federal Reserve Bank:

> *The Federal Reserve Bank aggressively raised their short-term, administered rate (Fed Funds Rate) to a point where it finished the year at just under 5%. Most analysts agree that the Fed will continue to raise this rate at their next several meetings until the effective rate is around 5.5%. This contributed greatly to the slump in stock prices and will continue to influence stock prices lower in 2023. It is likely that the stock market as measured by the S&P 500 Index will find a bottom in late spring to early summer somewhere about 15-20% lower than it began this year.*

The above description is exactly what came to pass. The Fed Funds rate is in fact around 5.5% with the stock markets (as measured by the S&P 500 Index) reaching their lows for the year in October.

And finally, we concluded our forecast for 2023 with the following:

> *Various factors are stacked against investors this time. As the war in Ukraine shows no sign of ending, Covid-19 continues to disrupt the increasingly influential Chinese economy and the Federal Reserve is all but certain to keep raising interest rates in the face of persistent inflation, consumer spending and corporate earnings both will be negatively impacted which will likely send stock prices even further down at least for the first half of this year.*

At the beginning of 2023 we outlined the strategy for the entire year:

1. *Continuing the program of buying high paying U.S. Treasury bills of the 3, 6 and 9-month maturities (currently averaging about 4.75% interest annualized),*
2. *Continuing to hold and augment, when possible, an exchange traded fund that protects the portfolios from precipitous stock market declines,*
3. *Holding and adding to several preferred stock holdings that are relatively stable in price (historically) and that pay 7% plus dividends, particularly those preferreds that have an adjustment mechanism to higher interest rates,*
4. *Hold high quality exchange traded funds (ETFs) that pay high single-digit annual dividends and that also offer some downside protection with provisions for adjustments in dividends with higher interest rates,*
5. *Maintain an allocation to precious metals and possibly increase that percentage,*

6. *Selectively purchase or hold high quality, blue-chip companies that also pay above market dividends.*

The strategy outlined above proved to be very profitable as the portfolios were protected from the stock market lows reached in the fall and then were advantaged by the historically high interest rates (5.5% as an average) on short-term U.S. Treasury debt that we successfully locked in early in 2023. We continued to lock in those rates throughout the year.

The preferred stock investments had high single-digit annual payouts (dividends) and then their price levels rose as the Fed completed their interest rate hikes toward the end of the year. The preferred stocks were excellent performers in 2023 and will continue to perform well this year.

The high-quality exchange traded funds (ETFs) paying above market dividends continued to provide consistent income while providing some downside protection as well, as many of their holdings contained adjustable-rate bonds that increased their yields upward with higher interest rates.

The Outlook for 2024

Since hitting annual lows back in October 2023, the domestic stock markets, which became heavily oversold, rallied sharply into the end of the year. As 2024 got started, the markets experienced a brief lull in the first week of the year and then resumed their upward trajectories led by many of the same names that lifted the stock market averages in late 2023.

The primary driver of investor optimism was derived from the very “bullish” comments by the Chairman of the Federal Reserve Bank, Mr. Jerome Powell, who poured gasoline on the flames of optimism when he strongly suggested that he and the other voting members of the Federal Open Market Committee (FOMC) were considering interest rate cuts in 2024.

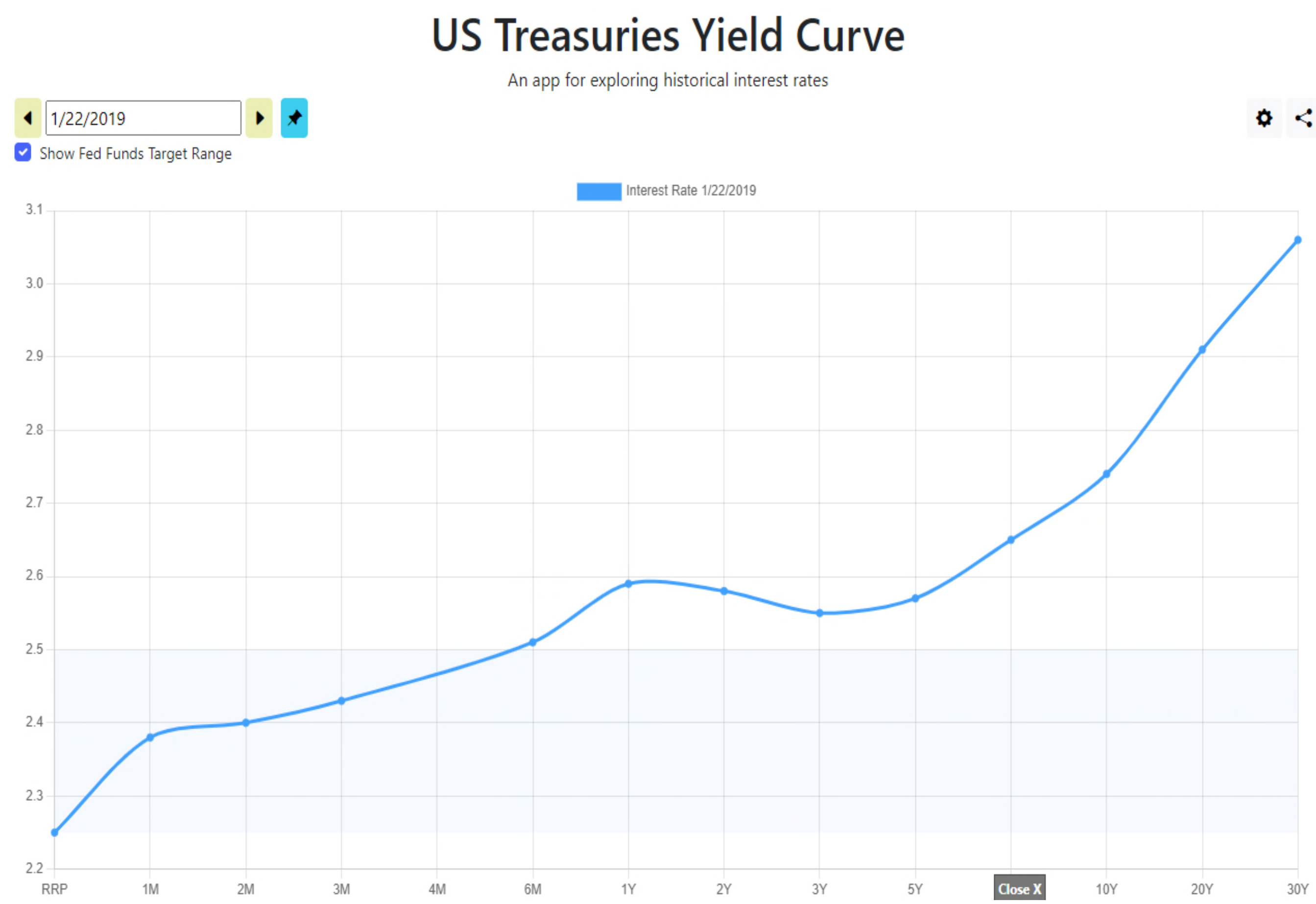
The FOMC in their last meeting of 2023 telegraphed the potential for three, one-quarter point interest rate cuts possibly beginning in March of 2024.

Many investors look to the futures market in bonds as an indicator of future interest rate levels and many in late 2023 saw the potential for as many as **six** quarter-point cuts.

Stock market traders, hedge funds, and algorithm-based trading devices pounced on the bullish rate cut "news" and sent the stock market indexes to all-time highs in early January of this year.

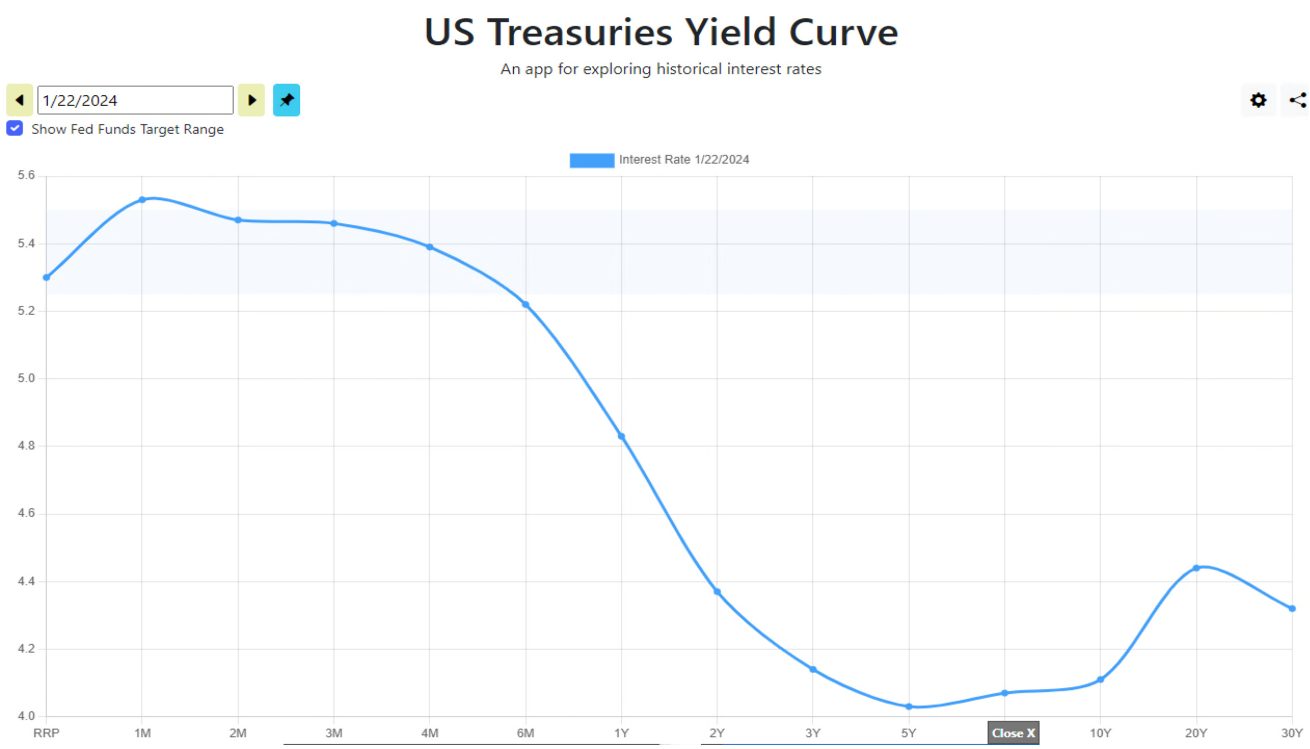
Besides Fed Rate Cuts, What Other Economic Influencers Might Impact Markets?

A. The general level of interest rates will start their gradual drift back to more "normalized" levels beginning mid-year or so when the Fed clearly indicates the start of its rate cutting program. Historically, the cost of borrowing has been characterized by the "Yield Curve" or the historical relationship between short-term borrowing costs to long-term costs (in this case represented by the return or "yields" on U.S. Treasury debt). This is depicted in a historical representation of short-to-long costs with a gradually inclining interest rate curve as shown below:



This is the relationship from **5 years ago**, and it is the case around 90+% of the time. Notice that five years ago the yield or return on less than one-year maturing Treasury debt was around 2.4% and the yield on 10 to 20-year debt was just under 2.9%. Today, those returns are "inverted," with short-term debt yielding over 5% and the 10-year debt is returning less than 4%.

For the last nearly three years, once the Fed aggressively began its interest rate raising onslaught, the curve has been **inverted** as it is today.



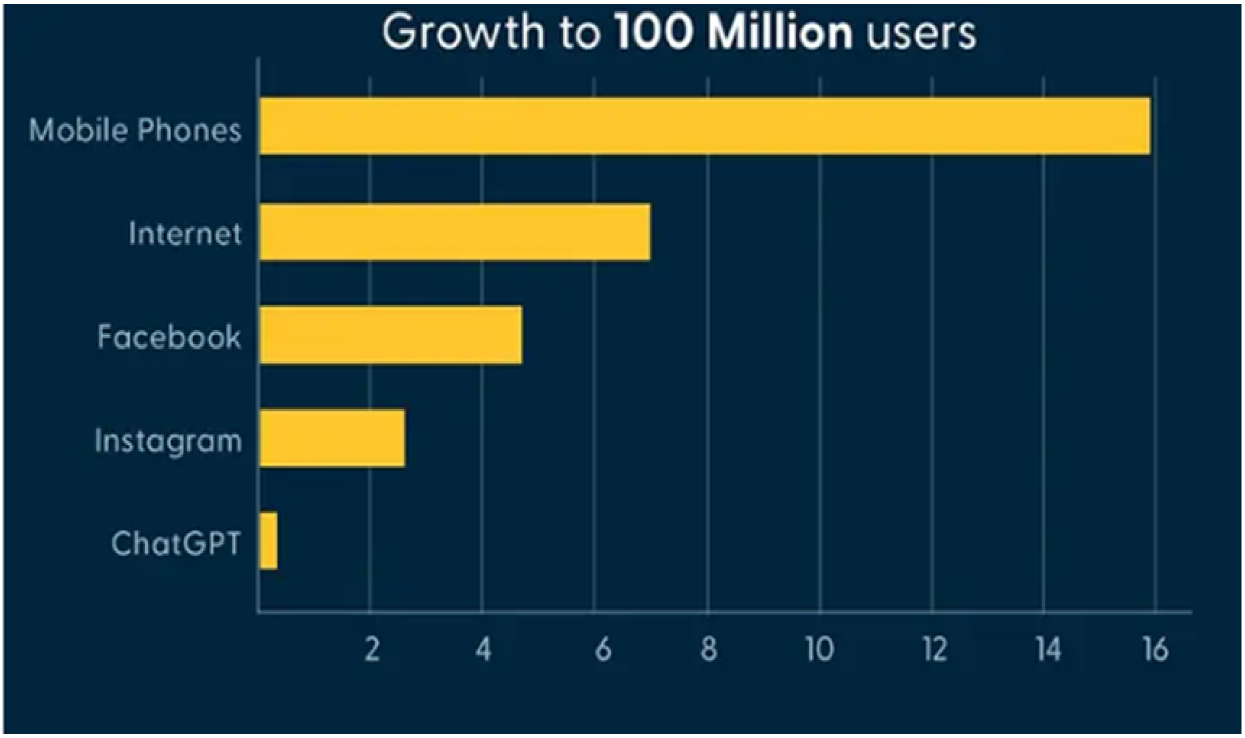
FOMC rate cuts will likely bring the short-term rates down (from above 5% as they are now) to something that will begin to "flatten" the yield curve and then gradually return to the more normal, slightly inclining interest rate ("yield curve") relationship.

B. American households are amazingly liquid and relatively well off. At the end of last year American households totaled a record-high $151 TRILLION with another record $6 TRILLION in money market funds alone. Commercial bank deposits (mostly business deposits) totaled $17.3 trillion as of December 2023. There are 86 million U.S. households who own their own homes, with 40% of them mortgage-free. Also, many of the existing mortgages took advantage of the "zero interest rate" years and refinanced at very low, single-digit rates.
This level of liquidity and low interest rate debt gives consumers purchasing power and that will drive the economy significantly this year. Gross Domestic Product (GDP) calculations include just under 70% in consumer spending which will likely support a buoyant economy and higher corporate earnings.

C. Corporations are experiencing a record high $3.4 trillion cash flow in the recent quarter. That money will go toward more hiring (there are still 8.6 million job openings available to be filled) and more spending in infrastructure, including massive technology upgrades. Corporate spending accounts for around 17% of

GDP. This spending encompasses all investments businesses make in things like machinery, equipment, construction, research and development, etc. It's a major driver of productivity and growth.

D. The most important investment theme of 2024 will be the rapid and extensive proliferation of Artificial Intelligence based systems. What began in 2022 with the introduction of a system from Open AI known as “Chat GPT,” has grown faster than any technology in history. ChatGPT hit 100 million users in just under two months, the fastest-growing technology of all time:



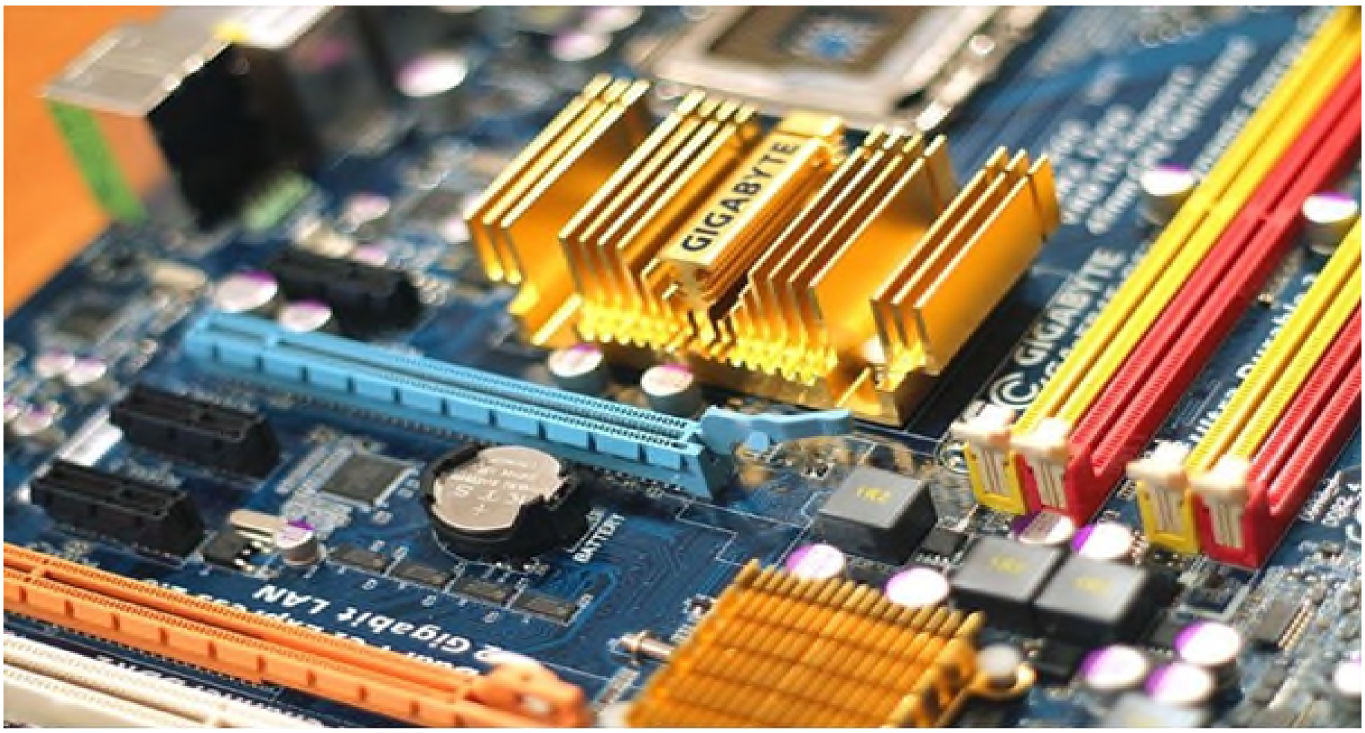
The explosive surge in Chat GPT’s users was 4.5 times faster than TikTok’s and 15 times faster than Instagram’s. Microsoft invested $10 billion into OpenAI, the startup behind ChatGPT.

ChatGPT is just scratching the surface of what generative AI can do. New ways of using AI and new, improved versions of AI are hitting the market every day. Corporations are using artificial intelligence to cut costs from the factory floor to the Executive Suite. AI is taking orders at McDonald’s. The military is studying AI programs that can fly multiple planes at once. Chat GPT aced the bar exam and the CPA exam.

For better or worse, AI is supplanting older technologies and labor. When new technology can reduce labor costs, if revenue is just held stagnant, then profit margins go up. When corporations substitute physical assets with less expensive technology

(AI), then returns on assets go up. Virtually every company in the U.S. is focused on these principles and AI will proliferate rapidly.

E. The CHIPS and Science Act is a law passed a little over a year ago that provides over $280 billion in funding specifically targeted to strengthen U.S. leadership in critical technologies like semiconductors and artificial intelligence. It directly increases AI research and development funding support for academia, government labs, and industry partners as well as tax incentives to spur private AI innovation. Combined with chip investments, it aims to strengthen the U.S. AI ecosystem for global technology leadership. The majority of this funding is going to be spent in 2024.



F. So far at least, the conflicts in Ukraine and Gaza have been contained to those regions and the markets have taken the fighting in stride. The disruptions to the supply chains and the spike in commodity prices have abated (for example, corn prices declined 30% in 2023 despite the fact that Ukraine is a major supplier). China is experiencing a significant economic slump, and their GDP growth is expected to be 3% or less this year for the first time in decades. Their stock market is in a bear market, being down over 30% from its high and their housing and commercial office markets are in shambles. This makes their threats to invade Taiwan less credible and potentially less imminent. In fact, China is likely to be a major disinflationary global force this year alone.

G. U.S. demographics will probably play an outsized role in 2024 and beyond. For the first time in history, there will be more people over the age of 65 than there are under the age of 15. This will manifest itself in the healthcare industry most significantly. Drug developers and healthcare providers will benefit from greater demand and as mentioned earlier, AI will rapidly improve the ability to develop groundbreaking drugs especially in the areas of Alzheimer's, Parkinsons, heart diseases and weight loss. Healthcare innovation is already powered by genomics research breakthroughs and AI will multiply that innovation even more rapidly.

H. Historically speaking, Presidential election years have been good for stock market prices. With the notable exception of the Great Recession year of 2008, every year in the last 20 years has seen a double-digit annual return for the stock market as measured by the S&P 500 Index:

Election Year	S&P 500 Return
2004	11%
2008	-37%
2012	16%
2016	12%
2020	18%
2024	???

The reason for the negative performance of stocks in 2008 was the collapse of the residential housing market bubble which caused banks and mortgage debt holders to suffer catastrophic losses. The situation in 2024 is much different owing to the existence of very low mortgage rates for most borrowers (even today, a typical mortgage loan is running around a reasonable 6.5%) and the eradication of the prime cause of the Great Recession - the existence of Collateralized Debt Obligations (CDOs) that were almost completely comprised of "liar loans" and derivatives which were not actual mortgages.

By the way, 1996 was a very strong +22% and 1994 was also a positive return. The Presidential election year 2000 was down 9%, but that was also the "dot com" bust year when the newly minted dot com tech stocks eventually took everything down. We are nowhere near the kind of “tech bubble” that existed in 2000 as the leaders in that area today are real companies with real (and very rapidly increasing) revenues and earnings (companies that are collectively known as “the Magnificent Seven”).

The Strategy for 2024

1. Continue to lock in above 5% annualized returns on the safest investment on the planet, U.S. Treasury bills. It is reasonable to expect that these very attractive yields will continue to be available for at least the first half of the year. If the Fed begins to cut their short-term interest rate, known as the Federal Funds rate, sometime in the summer, it is inevitable that the Treasury debt that is also short-term in maturity will follow that rate cut down. Until then we’ll continue to reap the benefit of this risk-free return.
2. The preferred stocks and ETFs that are already in the portfolios will prosper and deliver a great return in 2024. There will likely be some additions to this asset class as opportunities present themselves. Also, most preferreds have a maturity date and those will be replaced with other preferreds as needed.
3. AI is a dominant theme and we have already begun to add investments to the portfolios that will prosper directly from advances in chip technology, cloud storage, cyber security and software-as-a-service (SAAS) innovations. There will be additional investments, most likely in the ETF area that will focus directly on the AI boom.
4. Healthcare is also going to be an important theme beginning in 2024 and there will be a significant allocation to this industry.
5. The likelihood of a reasonably well-behaved stock market overall means the investments that were oriented to aggressively protecting against major market downturns have been liquidated and the themes for this year are being increased in allocation.
6. At some point the overall markets might become vulnerable to a correction and we will be prepared to lessen the impact of that correction on the portfolios. The risk of a geo-political event that would impact the markets is elevated, but nothing has materially impacted the U.S. economy or corporate profits, which is the main driver of stock market pricing.