2024: A New Cycle Begins

The market is transitioning from an environment of interest rate hikes to an environment of interest rate cuts. There is a specific portfolio to own when rates are rising and an entirely distinct portfolio when rates are declining.

1) The rate of change for future rate hikes has materially changed. The market is pricing in a higher probability of rate cuts compared to an incremental rate hike. This inherently translates into a new market cycle and hence a different portfolio construct.

2) The US earnings recession is now over. With 98% of companies reporting actual results, the blended year over year earnings growth for Q3 2023 is 4.8%, well ahead of the -0.3% estimate as of September 30th. As the prior three quarters saw declines, this will mark the first quarter of positive growth since Q3 2022.

3) Investors seem to have thrown in the towel on the recession call. Q3 2023 GDP printed a 5.2% handle per the second estimate, even higher than the original 4.9%. In fact, we had an economic expansion amid an earnings recession in 2023. This is quite rare.

Because of items 1, 2, and 3, investors should consider moving beyond T-Bills, rolling, and waiting an entire year to accrue 5%. We believe this won't cut it in the new cycle. While those T-Bill yields were attractive, just remember there is an opportunity cost of missing out on larger potential equity gains/fixed income price appreciation if the underlying macro picture continues to improve in 2024. Moreover, investors should ask themselves if it's prudent to keep buying seven US stocks while ignoring the rest of the world. A broadening out of the market is likely to occur at some point while we transition to a new cycle.

We've had the fastest rate hiking cycle in nearly half a century, but we've had an economic expansion in 2023. Sure, it's possible that tightening effects materialize in 2024 and the US experiences worse than expected growth, or even negative growth. But what's going to happen to growth if the Fed cuts rates in the mid to later part of next year? Stocks are forward looking, and after two years of subdued returns for the average stock globally, it seems risks would be skewed towards the upside in this scenario.

We think five rate cuts is far too aggressive and is likely the market getting ahead of itself. With that said, even the potential end of Fed rate hikes is enough for stock market investors to cheer – see the 9.1% rally in the S&P 500 Index for the month of November.

Astoria believes that the past twelve to eighteen months were mired in a cycle which consisted of:

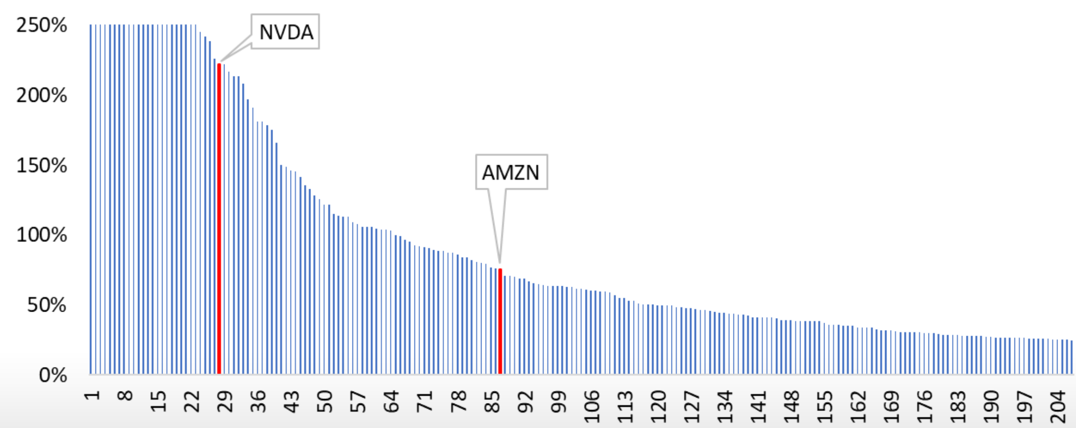
- Rampant inflation fears
- Aggressive and violent Fed rate hikes
- Low to negative real rates
- A bear market which mauled over unprofitable technology, crypto, and long duration assets
- Corporate fear mongering over a pending recession which hasn't/may not materialize
- A US earnings recession
- A "T-Bill and Chill" complacent attitude towards portfolio construction

2024 will likely begin a new cycle which consists of:

- Fed rate cuts
- Positive and structurally higher real rates
- Stubborn inflation
- A change in market leadership
- A transition away from "T-Bill and Chill"
- Lower rates that will alleviate funding pressures

Lower rates will help the housing sector, small businesses, and the mounting credit card delinquencies. In particular, the state of the housing market is crucial. No bull market is likely to commence without a recovery in housing market. From October 27th through December 5th, the SPDR S&P Homebuilders ETF (XHB) is up 23%. Also, it's worth pointing out that investors no longer need to crowd into defensive mega-cap growth stocks. Going down the market cap range, there are attractive opportunities across other cheaply valued US stocks with appealing growth potential. For instance, when analyzing 900 constituents in the S&P 900 Index, 207 companies saw earnings growth greater than 25% over the last twelve months. More interestingly, only two of the "Magnificent Seven" stocks (NVDA & AMZN) make that list.

S&P 900 Stocks with >25% 12M EPS Growth



Source: FactSet, Astoria Portfolio Advisors. Data as of November 30, 2023. Trailing EPS growth calculations use quarterly last twelve months reporting basis.

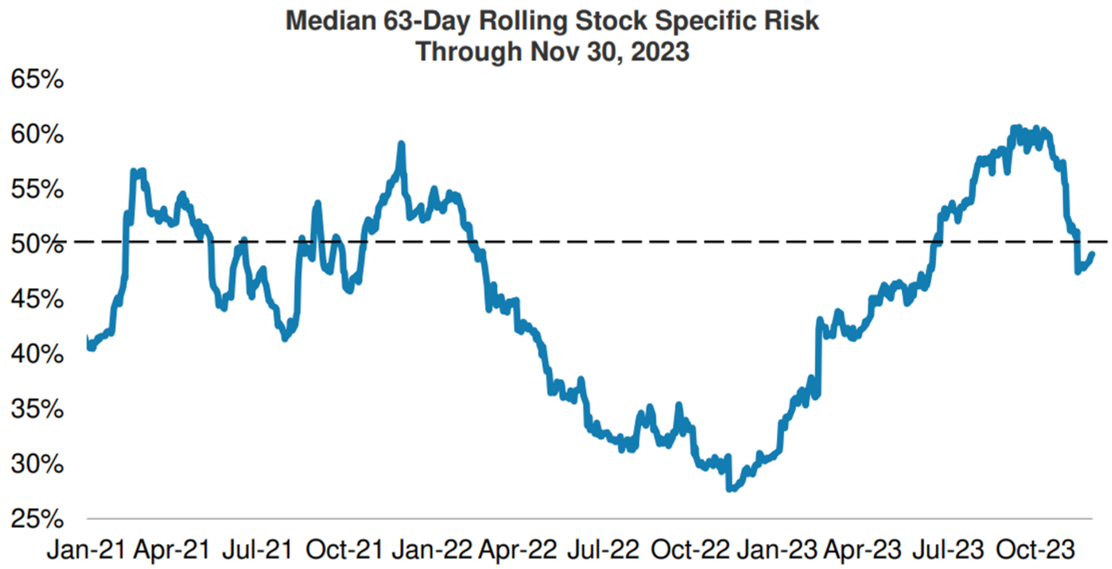
In 2023, we were constructive on bonds evidenced by our 10 ETFs for 2023 publication (click here). As the potential peak of the Fed's tightening cycle is priced in, money market funds and short duration bonds likely won't be able to keep up in 2024 if rates decline. For those that bought T-Bills in January 2023 and rolled ahead, you tied up your money for twelve months waiting to accrue a 5% yield. Meanwhile, investment grade corporate bonds via the iShares iBoxx $ Inv Grade Corporate Bond ETF (LQD) rallied 7.6% in November.

The biggest risk for 2024 is that the Fed lowers rates and demand inflation resurfaces, creating another 2022 feedback loop.

- Markets typically trade on the margin, and the rate of change is what drives risk assets. Stocks are forward looking, discounting instruments and are rallying because five rate cuts are currently priced in for 2024, there is an acknowledgement that inflation is no longer the primary risk for stocks, and the US earnings recession is over.

- The biggest risk we see is that lower rates shift back demand curves and re-ignite the inflation trade, leading to incremental rate hikes once again. We argued in 2020 that inflation would be a sticky problem lasting for many years. This is a key reason why we are saying investors should always carry inflation protection. The irony of this call is that inflation-linked assets have low correlation to US index beta, carry well in a multi-asset portfolio, and trade at a 40-45% discount to the S&P 500 Index. This has been a no brainer for us.

- While the profits recession may be over, corporates are not out of the woodwork. With wage growth expected to decline and hiring to be sluggish, earnings and fundamentals may be of focus when it comes to selecting stocks. Stock-specific has increased in 2023, and we believe it should rise further in 2024 as macro variables become of less importance while corporate earnings take center stage.



Source: Compustat, Morgan Stanley Research. Data as of November 30, 2023.

Investing is about looking to the future. Many put together portfolios while looking in the rear-view mirror. As an OCIO and subadvisor for financial advisors, we have reviewed thousands of portfolios and the majority are still tilted towards the winners of the past decade, which consisted of:

- Deflation winners
- Lower interest rate beneficiaries
- Globalization themes
- US mega-cap technology stocks
- Nominal bonds

We've argued for over two years that portfolios need to be prepared for the next new cycle. We believe this consists of:

Inflation sensitive assets	Higher interest rate beneficiaries
Deglobalization winners	A shift towards small/mid-caps (SMID), GARP (growth at a reasonable price), and other factors beyond beta

It may be difficult to part way with winners, but one should consider this as nothing likely goes up (or stays up) forever.

Amongst our peers, Astoria was arguably one of the first and biggest inflation hawks. We had the fastest rate hiking cycle in half a century, and we are still way above the Fed's inflation target. Hence, the inflation trade is not over.

We believe there's north of 75% probability inflation will stay above 2% throughout 2024. We've had nearly 500bps of tightening and October annualized Core PCE is still at 3.5%, 1.75x the Fed's 2% target. With 2024 being an election year, it is our view that the Fed backs off on aggressive monetary policy to let the political cycle run its course.

Our bottom line is that the inflation problem is now more anchored on the supply side, which is tricky and takes years to shift. As mentioned in numerous posts, Apple is not going to shift its supply chains from Asia to the United States anytime soon.

How should investors position their portfolios in 2024?

- **Increase your equity beta and be overweight equities.** Barbell your portfolio risk by owning cyclical growth, transition away from market cap weighted strategies, overweight inflation sensitive assets, nibble on international developed markets, and diversify away from US large-cap index beta (we like GARP and US mid-caps). A new cycle usually signals a change in market leadership.

- **Say sayonara to those T-Bills.** If the underlying macro improves in 2024 and market leadership broadens, the opportunity cost of sitting in money market/T-Bills as yields decline could cause one to miss out on larger potential equity gains/fixed income price appreciation. Deploy that cash in the above equity cohorts or in fixed income via extending duration and increasing exposure to investment grade, high quality corporates and municipal bonds. Why? Given the level of starting yields, hypothetical forward returns for bonds look appealing. For instance, a 50bps decrease in interest rates would cause the Bloomberg US Treasury Index to gain over 8% in the next twelve months. As the bond indices in the table below are high in quality, some may refer to this as a possibility to earn equity-like returns without equity-like risks.

Hypothetical 12M Forward Returns — Scenario Analysis

Index	Change in Interest Rates & Return Forecasts				
	-1.0%	-0.5%	No Change	+0.5%	+1.0%
Bloomberg US Aggregate Bond Index	12.4%	9.5%	5.2%	3.8%	1.0%
Bloomberg MBS Index	13.2%	10.3%	5.4%	4.5%	1.6%
Bloomberg US Treasury Index	11.4%	8.6%	4.7%	3.1%	0.4%
Bloomberg US Corporate Index	13.7%	10.5%	5.8%	4.2%	1.0%
Bloomberg Intermediate Corporate Index	10.0%	8.2%	5.8%	4.7%	2.9%

Source: LPL Financial. Data as of November 20, 2023. Return forecasts are hypothetical and based on a twelve-month forward horizon.

- **Play convexity in the rates market.** One of our best ideas for 2024 is to use fixed income strategies that benefit from declining rates at the intermediate and back end of the curve. Though the twelve-month forward return forecasts in the table below are from October and rates have come down since, it can be observed that the risk/reward for duration is attractive.

Hypothetical 12M Forward Returns — Scenario Analysis

Term	Change in Interest Rates & Return Forecasts					
	-3.0%	-1.5%	-0.5%	+0.5%	+1.5%	+3.0%
2-year Treasury	7.9%	6.5%	5.5%	4.6%	3.7%	2.3%
5-year Treasury	16.1%	10.2%	6.5%	2.9%	-0.6%	-5.5%
10-year Treasury	29.8%	16.4%	8.3%	1.0%	-5.8%	-14.9%
20-year Treasury	53.2%	26.0%	11.4%	-1.1%	-11.6%	-24.7%
30-year Treasury	74.7%	33.5%	13.2%	-2.9%	-15.7%	-30.4%

Source: F/m Investments, Bloomberg. Data as of October 2023. Return forecasts are hypothetical and based on a twelve-month forward horizon.

- **Find alternatives which give equity-like returns but lower volatility.** This is crucial. Fund your alternatives by being underweight bonds.

- **Overweight inflation-linked assets such as energy, industrials, commodity equities, and physical commodities.** As the table below shows, various commodities have produced positive returns with a high hit rate during prior inflationary regimes. When the profit cycle recovers, value centric stocks have historically performed well and many currently trade at a discount to the S&P 500 Inex. These opportunities will likely not last forever.

	Specific Inflation Regimes								Combined Regimes				
	US Enters WW2	End of WW2	Korean War	Ending of Bretton Woods	OPEC Oil Embargo	Iranian Revolution	Reagan's Boom	China Demand Boom	Inflation (19%)	Other (81%)	All (100%)	Hit Rate	t-stat
Start Month	April 1941	Mar 1946	Aug 1950	Feb 1966	Jul 1972	Feb 1977	Feb 1987	Sep 2007					
End Month	May 1942	Mar 1947	Feb 1951	Jan 1970	Dec 1974	Mar 1980	Nov 1990	Jul 2008					
Total Price Level Change	15%	21%	7%	19%	24%	37%	20%	6%					
Strategy				**Real Return (Total)**						**Real Return (Annualized)**			
Industrials				115%	38%	-6%	306%	3%	19%	4%	7%	80%	1.7
Precious				28%	29%	185%	-27%	33%	11%	-2%	1%	80%	1.7
Agris		12%	6%	-23%	197%	-21%	6%	33%	7%	-3%	0%	71%	1.8
Softs				-41%	243%	15%	11%	15%	8%	-3%	-1%	80%	1.6
Livestock				69%	-21%	35%	97%	-23%	7%	1%	2%	60%	1.1
Energies	*-3%*	*2%*	*-6%*	*-16%*	*264%*	*57%*	201%	68%	41%	-1%	3%	100%	1.7
Gold					*166%*	154%	-18%	27%	13%	-1%	1%	67%	1.6
Silver				9%	99%	210%	-41%	36%	12%	-5%	0%	80%	1.8
Commodities Aggregate		12%	6%	26%	85%	38%	84%	21%	14%	1%	4%	100%	3.1 *

Source: Neville, Henry and Draaisma, Teun and Funnell, Ben and Harvey, Campbell R. and van Hemert, Otto, The Best Strategies for Inflationary Times (May 25, 2021). Total returns to six baskets of commodity futures, as well as gold and silver individually, and an equal-weighted, monthly rebalanced basket of all commodities, during the eight US inflation regimes already defined, as well as the annualized return during inflationary, non-inflationary, and all periods. Returns in grey italics are spot returns prior to the existence of a liquid futures contract. These are not included in the aggregate calculations. All other returns are funded. In the final columns, presented is the hit rate (proportion of inflationary periods with positive returns) and the heteroskedasticity-consistent t statistic, which tests whether the returns in inflationary and non-inflationary times are different. *Denotes significance. The starting point for the data varies from 1946 (agris) to 1979 (energies) and runs through to 2020 at monthly periodicity.

- **Diversify away from the "Magnificent Seven."** If you were underweight technology, close the gap by using equal weighted growth/technology/broad market strategies.

- **Investors typically have a home country bias, but we strongly encourage advisors to look at international developed markets. Europe and Japan, specifically, have appealing growth prospects.** Provided the US recession is modest, the rest of the world should benefit.

- **Use active managers for emerging markets as the region is highly nuanced.** High US interest rates have always been an impediment to emerging market investing; 2023 was no different. However, emerging markets are trading at substantial discount to the US and can aid in portfolio diversification. Close your eyes and hold it for ten years or so.

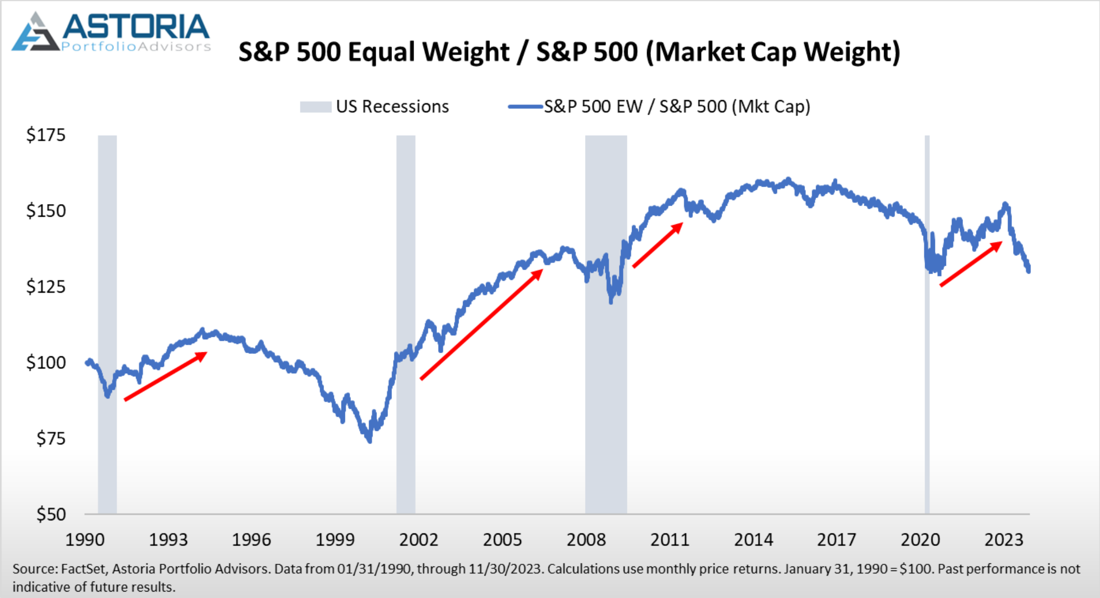
Other Portfolio Construction Thoughts

- **At the end of the day, market performance in 2023 was primarily driven by rates.** Generally speaking, when rates went up, stocks went down. When rates went down, stocks went up. This relationship will be crucial to watch in 2023. Our view is that idiosyncratic and stock specific risk (corporate earnings, margins, etc.) will return in 2024 and macro factors will wane (the Fed, inflation). Back-to-back years of macro driven markets present hardships for any fundamental investor.

- **The strength of the US consumer may be fading.** High interest rates are now being felt given we're nearly two years into this Fed tightening cycle. While the demand side of the equation may be lower, we still have a supply side problem. This is why we don't think inflation will fall to 2% and hence we still have ways to go in the inflation cycle. Remember, we are still above the Fed's inflation target via Core PCE, and that's with the fastest rate hiking cycle in forty years. It's been our mantra that inflation and rates are to stay higher and for longer which is why we began running a systematic inflation hedging strategy in Q2 2020.

- **We are entering into a world of deglobalization, onshoring, and reshoring.** In this new environment, investors should own real assets and stocks in sectors such as industrial, materials, energy, etc. From the thousands of portfolios we oversee, we still see remnants of the prior decade that are present in most advisors' portfolios. Our view is that portfolios should be readjusted to reflect structurally higher real rates.

- **Equal weight over market cap weight.** It's okay to own the "Magnificent Seven" stocks, but we advocate reducing one's exposure. As seen in the chart below, new market cycles have historically corresponded with equal weight outperforming market cap weight.



- **Equity risk premiums may not be attractive for US large-cap index beta stocks, but they look relatively attractive elsewhere.** Our big view is that investors really need to look at Europe and Japan, US SMID, and cyclically oriented sectors which will likely be the new leaders in a new market cycle that consists of structurally higher real rates and stubborn inflation. The earnings yield for developed Europe is currently hovering around 9-10%.

- **There is some convexity in the back end of the curve that many tried to play and failed in 2023, mainly because rates keep marching up.** That trade is now working because rates have come down. In short, we think equal weighting or slightly overweighting duration makes sense for benchmark-oriented investors. There's still a ton of demand for short duration ETFs, T-Bills, floating rate notes, and senior loans. Those strategies will likely underperform on a relative basis if rates continue to decline.

Conclusion

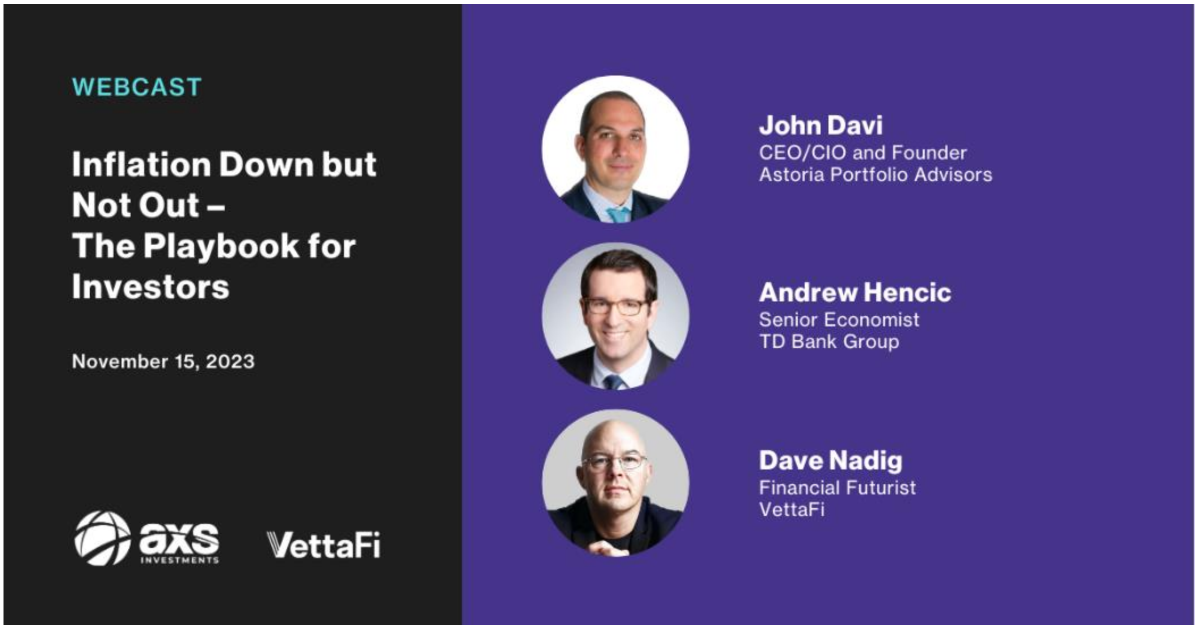
- Forget trying to figure out the next rate hike or rate cut and instead build a portfolio that can sustain in a world of deglobalization, structurally higher real rates, and stubborn inflation.

- **Nothing stays at the top of the index forever**. MSFT wasn't even in the original FANG Index. An equal-weighted basket of high-quality stocks trades at a 25-30% discount to the S&P 500 Index.

- **Remember, we've been in a bear market for 2 years now.** Last year was a bear market for unprofitable technology and long dated bonds, and this year we saw narrow market leadership and significant underperformance again for long duration bonds. As a result of excessive rate hikes, economic growth expectations have fallen, which is exactly why the market is pricing in rate cuts. **We highly doubt we will get five rate cuts next year, but the important point we want to deliver is that your portfolio should evolve in 2024 and look different from the past one to two years.**

- **Stay tuned for our annual 10 ETFs for 2024 report.** Historically, this has been Astoria's most widely read report.

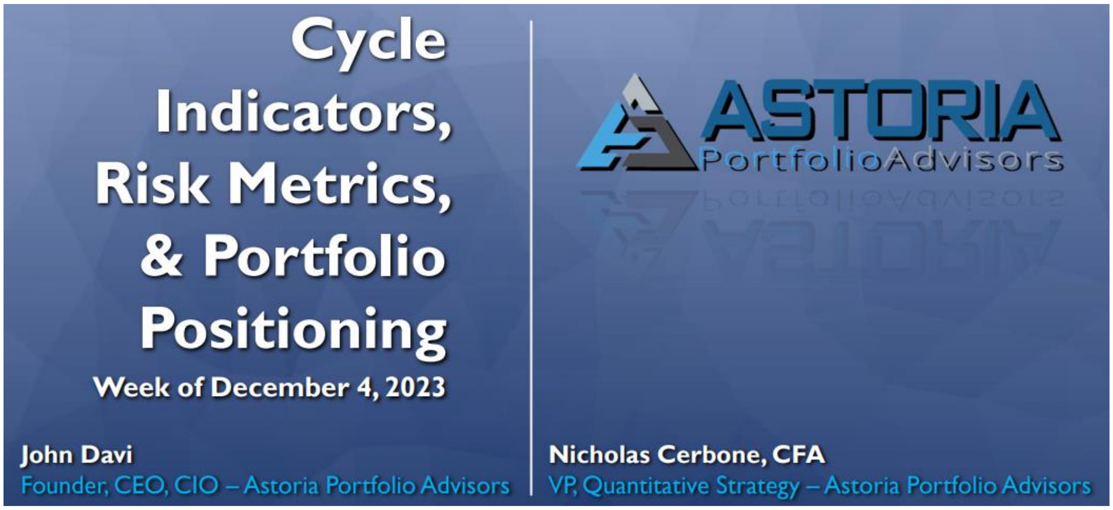
- Below are a few crucial interviews and publications:
    - **Webinar: Inflation Down but Not Out — The Playbook for Investors** (click here) - We explain in detail how to invest in a higher inflation, structurally higher real rate world.



    - **Webinar: 10 Ways an OCIO Can Augment Your RIA Practice** (click here) - We explain how Astoria works with financial advisors.

Webinar: 10 Ways an OCIO Can Augment Your RIA Practice in Under 20 Minutes with Astoria Portfolio Advisors President David Clark

- **Research: Cycle Indicator Deck** (click here for the free version; click here for clients) - We publish all the key indicators we monitor for our portfolio construction process on our website. Please contact Frank Tedesco at ftedesco@astoriaadvisors.com if you would like to receive access.



- **Blog: How to Construct an ETF Model Portfolio? A 5 Step Program** (click here) - Lastly, we published a report almost three years ago on how we construct model portfolios.

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