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Capital Creek Partners

Monthly Market Update

January 2024

Strategy Headlines for January 2024

- The Fed's pivot toward an overt easing bias on 12/13/2023 was the biggest single event in markets over the last month.
- US economic data have been weaker than economists estimates since August of last year. We expect this trend to continue throughout the first half of 2024. We view this as bullish for risk assets as weaker data may result in lower inflation and greater Fed accomodation.
- Geopolitical risks continue to mount into the early stages of 2024, and risk assets have gotten off to a choppy and cautious start to the New Year.
- Asset allocation models and leading indicators continue to struggle to predict the post-pandemic economic and market landscape.
- Our Cycle Monitor puts the US economy in mid-to-late cycle territory, not on the cusp of a recession.
- We expect liquidity conditions to continue to improve and inflation to continue to decline cyclically.
- As we enter 2024, we have strategically downgraded cash to neutral while upgrading fixed income and equities to overweight.
- We maintain strategic and tactical underweights to public credit and the US dollar. We much prefer private credit to public credit. We also prefer gold, Japanese Yen, and Bitcoin as alternatives to the dollar.

Market Overview - *Highlights*

- **Ferocious Risk Rally to Close 2023:** The risk rally that began in late October was among the strongest in modern history. In our view, the rally was driven by the sustained fall in the rate of inflation, which triggered a collapse in US Treasury yields and a policy pivot by the US Federal Reserve. Portfolio managers were caught offsides and under positioned. We exited 2023 with both bonds and equities in bull markets. However, bonds and stocks were very impulsive to the upside into year end and Sharpe ratios (returns/volatility) were unsustainable.

- **Historic Fed Pivot:** After executing the most dramatic tightening campaign in modern history, on December 13th, the Fed overtly pivoted from a tightening bias to an easing bias. The Fed "dots" are now forecasting significant policy easing in 2024. This apparent policy shift was made with core PCE inflation well above the Fed's 2% target. The Fed and the market are anticipating that inflation will continue to fall in 2024. We tacitly agree with this forecast, but the risks of a reacceleration in inflation in the second half of 2024 is perhaps the greatest risk the markets face as we look ahead.

- **Cautious Start to New Year:** Both equities and Treasury bonds have gotten off to poor starts in the first several days of trading in the New Year. It is still too early to tell if the early price action is problematic. Market lore is that "as January goes, so goes the year." Empirical evidence suggests that years beginning with negative January performance tend to produce below average returns for equities. We think the sputtering start to 2024 is driven by extremely positive sentiment and heavy long positioning into year-end. Some price give back is appropriate and healthy in our view.

- **Softer Data Abound:** The long and variable policy lags associated with 525 basis points of tightening over 16 months, plus the onslaught of quantitative tightening are beginning to bite and show up in the data. At the margin, the US economic data have been consistently missing estimates to the downside since last October. Bad news has been good news because it has kept downward pressure on inflation and allowed the Fed to pivot. During this time, employment has held up and GDP has continued to run above trend. This is the essence of a soft landing for the US economy. Our concern is that the odds of a "growth scare" to the downside are mounting. This is a core reason we are bullish Treasury bonds as we enter the New Year.

- **Middle East War Risks Rising:** Houthi pirates effectively closing the Red Sea, Hezbollah attacks on Israel increasing, guerilla-style attacks on US Middle East positions, all of these are being orchestrated by Iran. The longer the Israeli/Hamas war drags on, the greater the risk of a wider war in the Middle East. The US Administration knows this, and it's why they are trying so hard to quell the fighting. Iran also knows this, and it's why they are taking advantage to hit the US and Israel via proxies. Our central case remains that the war will not expand, directly bringing the US and Iran into an open conflict. There is simply too much to lose for all parties, but accidents can still happen.

- **US Political Calendar Heavy, Risks Rising:** The Iowa Republican Presidential Caucuses will be held on January 15th, 2024. This will officially kick off the Presidential election cycle in the USA. Most voters are filled with dread over the prospects of a brutal rematch between two aged and unpopular candidates. This is an unusual Presidential election cycle and could be filled with surprises along the way. In our view, the election cycle will be a headwind for equities through September. Our central case is a much more benign outcome than the consensus. We don't think the equity market really cares who wins, it just abhors the uncertainty that the whole process engenders.

Market Overview – *Market Indicators*

- **Models:** Our equity model (TES) is bullish for the first time in memory. The model turned more positive based on a positive breadth thrust, an upturn in our earnings growth leading indicator, positive investment flows, a big improvement in our model composite, and a dramatic easing in financial conditions. Our tactical asset allocation model (TAA) remains bearish toward equities, bonds, credit, and commodities. The TAA model continues to overweight cash.
- **Leading Indicators:** US Leading Economic Indicators from the Conference Board and the OECD still point to the high probability of recession over the next four quarters. However, exceptionally strong fiscal spending along with the new realities of the post-Covid economy have lowered our confidence in the predictive capability of leading indicators in this cycle.
- **Cycle Monitor:** Our Cycle Monitor (see page 6) is now in mid-to-late cycle territory. This underscores how the probabilities have shifted away from recession to a more extended cycle. The Monitor underscores our belief in slower growth but no recession in 2024.
- **Inflation:** Inflation continues to trend lower and has beaten estimates to the downside by small margins in recent months. The inflation narrative for bonds and stocks shifted from a headwind to a tailwind. The average of Core PCE and "Supercore inflation" remain around 3.5% on a YOY basis—too high for Fed comfort. The lagged downturn in Owners Equivalent Rent (OER) is a major depressing factor for inflation for months to come and reinforces the disinflationary trend.
- **Volatility:** Equity volatility has fallen persistently since the end of October and remains near the lowest levels of the last two years. The fixed income volatility gauge, MOVE Index, has also been falling along with Treasury yields but remains around the average levels of the last two years of the bond bear market. In our mind, volatility is underpriced given the prevailing economic and geopolitical risks on the horizon.
- **Policy:** Monetary policy has pivoted from a tightening bias to an easing bias. Fiscal policy remains historically stimulative especially during an economic expansion. The Biden Administration has proven to be highly skilled at using its legislative and non-legislative levers to over deliver fiscal stimulus to the US economy. We expect more of this in a Presidential election year to "goose" the economy ahead of voting. Think Nixon in 1972.
- **Liquidity:** Liquidity remains constrained due to global central banks hiking rates and quantitative tightening policies. U.S. M2 growth remains moribund. The Fed and ECB balance sheets continue to contract. However, global policy rates have likely peaked, China is now stimulating, and Bitcoin, a leading indicator of liquidity, has put in a sustained rally. Risk assets are rallying on improving liquidity at the margin. Treasury Secretary Yellen has been adroit at using less obvious tools such as the General Treasury account and shortening government term funding to manufacture greater liquidity.
- **Credit:** Credit availability remains constrained at the margin. The October Senior Loan Officer Survey (SLOOS) showed that banks continue to tighten credit standards across the board. However, market-based credit spreads remain remarkably well behaved, showing little to no stress. Consumer loan default rates continue to rise from historically low levels, and corporate defaults continue to rise gradually.
- **U.S. Dollar:** We believe the next leg of the dollar bear market could be underway as risk is bid and yields trend lower. Fed policy support for the dollar has diminished in the wake of the recent policy pivot. The structurally negative dollar fundamentals of massive budget and trade deficits combined with the longer-term thrust of "de-dollarization" may crystalize in the coming election year. We prefer gold, Japanese Yen, and Bitcoin as alternatives to the US dollar.

CCP Capital Markets Framework

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2024E Economic Assumptions

Cycle Scoring	Mid-to-Late Cycle	Fed Policy:	Easing Bias
Headwinds / Tailwinds	Trending to Headwinds	Fed Funds Rate Est:	4.5%
Real GDP:	1.5% to 2.5%	Debt Levels / Spreads:	High / Tight
Inflation (Core PCE):	2.5% to 3.5% (2024) / 2% to 4% (Long-Term)	Volatility:	Moderate/Falling
Unemployment:	3.5% to 5.0%	Earnings:	2023--$220 / 2024--$235/2025--$247
Consumer Spending & Confidence:	Neutral	Equity Valuations:	Expensive relative to history

Directional Views

Strategic (Long-Term) and Tactical (6-12 month) Views on Broad Asset Classes

Asset	Strategic View	Tactical View	Commentary
Cash Strategies	Neutral	Neutral	Cash is no longer as compelling with the Fed poised to reduce policy rates later In 2024. It makes more sense to move out the curve into 2-year notes to lock in solid yields for longer. We are tactically and strategically neutral cash as we believe now is an attractive time to redeploy into higher returning opportunities in private markets and equities.
Fixed Income	+1	+1	Fixed Income has an opportunity to produce positive returns in 2024, recovering from deep losses experienced in 2021-2023 due to high inflation. Inflation is on a glidepath lower for the first half of 2024 and the Fed will be cutting rates, both are supportive for more gains in the Treasury market.
Credit	-1	-1	We are strategically underweight public credit as spreads are tight and a credit downcycle is underway. Tactically, we are underweight, seeing little value and potential vulnerability as the credit cycle downturn matures. Our view is that private credit is much more attractive than public credit.
Equities	+1	+1	We are strategically and tactically overweight equities early in 2024. Our Tactical Equity Strategy (TES) model has turned bullish for the first time since 2021. We believe equity returns in 2024 will be driven by improving market breadth, improving liquidity, and a sustained rally in small and mid-cap equities.
US Dollar	-1	-1	We are strategically and tactically underweight the US dollar as the Fed pivots toward an easing cycle, the expansion continues, and massive structural deficits exert downward pressure on the currency. We continue to be concerned about the long-term trend toward "de-dollarization."
Private Markets	+1	+1	We believe non-traditional return streams offer substantial upside opportunities along with diversification benefits. Our 2024 forecast for moderate growth and declining inflation are also supportive for private markets.

Underweight | Neutral | Overweight

Cycle Monitor – Mid-to-Late Cycle

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	Metric	Early Cycle	Middle Cycle	Late Cycle	Recession
Economic Metrics	**Overall Economic Output**	Below potential, rising	Near potential, rising	**Above potential, rising**	Contracting
	Consumption	Low, lagging income	Recovering	**High, ahead of income**	Falling
	Capital Investment	Low as % of GDP	Rising moderate as % of GDP	**High as % of GDP**	Falling
	Residential Investment	**Low as % of GDP**	Rising moderate as % of GDP	High as % of GDP	Contracting
	Vehicle Sales	Low	**Moderate, rising**	Peaking, high	Past peak, falling
	Price Inflation	Below central bank target, stable	Below CB target, rising	**At/Above CB target**	Falling
	Wage Inflation	Low, stable	Moderate, rising	High	**Falling**
	Private Credit Formation	Low, starting to rise	Rising in line with output	Rising faster than output	**Falling**
	ISM New Orders (Manufact.)	Improving	Mid 50s / Moderate	Past peak, falling	**Below 50, falling**
	Personal Savings Rates	High relative to income	Starting to decline	**Low relative to income**	Rising vs. income
	Unemployment Rate	Well above NAIRU	Above NAIRU	**Above or Below NAIRU**	Rising sharply
	Unemployment Claims	Past peak	Falling Sharply	**Trending lower / Stable**	Rising
	Consumer Confidence	Low	**Moderate**	Exuberent	Falling

	Metric	Early Cycle	Middle Cycle	Late Cycle	Recession
Asset Mkt. Metrics	**EPS Revision Ratios**	Downgrade cycle, improving trend	**Upgrade cycle, improving trend**	Second derivative falling	Downgrade cycle, falling trend
	Corporate Margins	High	**High/Peaking**	Declining	Low
	Credit Spreads	Wide, contracting	**Tight, stable**	Past cyclical trough	Wide, unstable
	Aggressive Issuance	**Low as share of total**	Moderate as share of total	High as share of total	Nonexistent
	M&A Activity	Low	**Moderate**	High as share of total	Nonexistent
	Yield Curve	Rates low, curve steep	Rates rising, curve flattening	**Rates high, curve inverted**	Rates falling, curve steepening
	Volatility (Implied)	Vol high, skew falling	**Vol low, skew high**	Vol starting to rise, skew rising	Vol high, skew high

Implied Cycle	**Current macro indicators suggest the market is between a mid-to-late cycle**

Source: Capital Creek Partners Research

Market Dashboard – as of December 31, 2023

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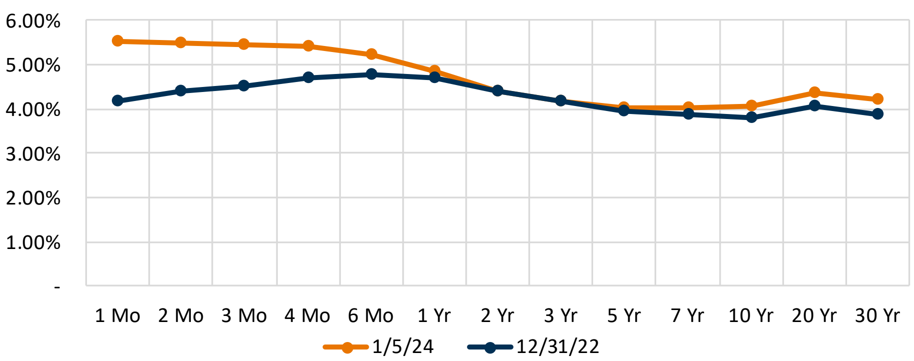
U.S. Equities	Current	MTD	QTD	YTD	LTM
Dow Jones Industrials (DJIA)	37,689.54	4.8%	12.5%	13.7%	13.7%
S&P 500 (SPX)	4,769.83	4.4%	11.2%	24.2%	24.2%
NASDAQ 100 (NDX)	16,825.93	5.5%	14.3%	53.8%	53.8%
S&P Mid-Cap 400 (MID)	2,781.54	8.5%	11.2%	14.4%	14.4%
S&P Small-Cap 600 (SML)	1,318.26	12.6%	14.5%	13.9%	13.9%
Volatility Index (VIX)	12.45	(3.6%)	(28.9%)	(42.5%)	(42.5%)

International Equities	Current	MTD	QTD	YTD	LTM
Developed Markets (EFA)	75.35	5.4%	10.7%	18.4%	18.4%
Emerging Markets (VWO)	41.10	3.3%	7.1%	9.3%	9.3%
Japan (EWJ)	64.14	3.9%	7.9%	20.3%	20.3%

U.S. Industry Sectors	Current	MTD	QTD	YTD	LTM
Communications (XLC)	72.66	4.4%	11.1%	52.8%	52.8%
Consumer Discretionary (XLY)	178.81	6.1%	11.3%	39.6%	39.6%
Consumer Staples (XLP)	72.03	2.7%	5.5%	(0.8%)	(0.8%)
Energy (XLE)	83.84	0.1%	(6.4%)	(0.6%)	(0.6%)
Financials (XLF)	37.60	5.3%	13.9%	12.0%	12.0%
Health Care (XLV)	136.38	4.3%	6.4%	2.1%	2.1%
Industrials (XLI)	113.99	7.1%	13.1%	18.1%	18.1%
Materials (XLB)	85.54	4.5%	9.7%	12.5%	12.5%
Real Estate (XLRE)	40.06	8.7%	18.8%	12.4%	12.4%
Technology (XLK)	192.48	4.2%	17.7%	56.0%	56.0%
Utilities (XLU)	63.33	1.9%	8.5%	(7.2%)	(7.2%)

Fixed Income	Current	MTD	QTD	YTD	LTM
Bloomberg Dollar Index (BBDXY)	1,212.89	(2.1%)	(4.2%)	(2.7%)	(2.7%)
7-10 Year Treasury Bonds (IEF)	96.39	3.8%	6.4%	3.6%	3.6%
US Inflation Linked Bonds (TIP)	107.49	2.4%	4.5%	3.8%	3.8%
Municipal Bonds (MUB)	108.41	2.3%	6.7%	5.6%	5.6%
Corporate Bonds (LQD)	110.66	4.9%	10.1%	9.4%	9.4%
High-Yield Bonds (HYG)	77.39	3.2%	7.1%	11.5%	11.5%

U.S. Treasury Yield Curve



Commodities	Current	MTD	QTD	YTD	LTM
BBG Commodity Index (BCOMTR)	226.43	(3.2%)	(4.6%)	(7.9%)	(7.9%)
Crude Oil (Brent)	77.04	(7.0%)	(19.2%)	(10.3%)	(10.3%)
Natural Gas (Henry Hub)	2.51	(10.3%)	(14.2%)	(43.8%)	(43.8%)
Gold (CMX)	2,062.40	1.2%	11.6%	13.3%	13.3%
Copper (LME)	3.88	1.3%	4.1%	2.0%	2.0%
Bitcoin	42,099.40	11.6%	56.4%	153.6%	153.6%

Note: All numbers are estimates. The data reflect total returns. Data reflect adjusted share price including dividends, splits, and fees. Please use statements as final value.
Source: Capital Creek Partners Research, Bloomberg

10 Year US Treasury Bond yields appear to have peaked for the cycle

Source: Capital Creek Partners, Bloomberg

This SPX trading channel has caught every turn since the 10/22 lows

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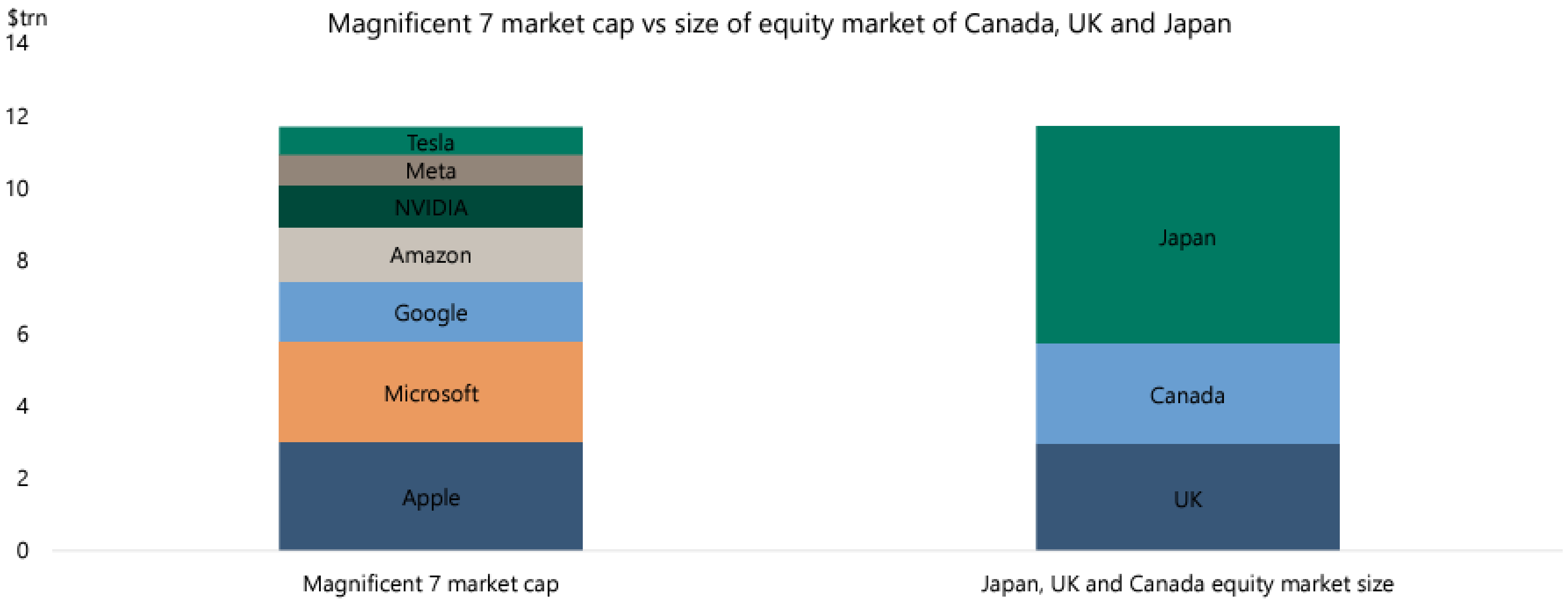
Source: Capital Creek Research, Bloomberg

The S&P 500 Index has become historically top heavy

Market cap of the Magnificent Seven is the same as the combined market cap of the stock markets in the UK, Canada, and Japan



Source: Bloomberg, Apollo Chief Economist

The Citi Econ Surprise Index has been weakening since last August as monetary policy bites

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Source: Bloomberg, Citigroup

Disclaimers

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