April 24, 2024

“To Infinity and Beyond!”

- Buzz Lightyear, Toy Story

Dear Client,

Was Buzz Lightyear referring to the US national debt or Bitcoin?

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Risk assets had another good quarter to start 2024. On the economic front, broad indicators continued the improvement that began in late 2023. More on that below, but first, a review of recent performance for “primary” assets[1] and the Grey Owl All-Season strategy.

Recall that in 2023, economic growth was modest in the US, decelerated significantly in China, and was near zero in the Eurozone. Amidst this backdrop, US equity indices performed very well, gold was strong, and even bonds showed modest gains following two of the worst years in the last century. Commodities were down in 2023 reflective of global economic stagnation and manufacturing contraction. Now, with easy compares, US and global growth is (modestly) accelerating. Inflation is too.

For the first quarter of 2024, US equities were +10.4%. Global equities closely followed, up +8.2%. Gold was up +7.6% and Commodities reversed their negative 2023 for a +10% return.

[1] We refer to US equities, long-dated US Treasury bonds, gold, and commodities as “primary” asset classes borrowing the language of HCWE & Company. The idea is that these four assets best capture two variables that explain a significant amount of asset price movement: global growth (explained by investor risk sentiment) and inflation. This framework is the basis for a permanent portfolio, an “all-season” portfolio, risk-parity, etc. US equities and commodities are “risk” assets, while US Treasury bonds and gold are “haven” assets. The market (or asset class) returns are measured on a total return basis using index exchange traded funds (ETFs): SPY for the S&P 500, ACWI for the MSCI All-Country World Index, GSG for the S&P GSCI Commodity Index, TLT for 20+ Year Treasury Bond index (i.e. “long-dated” US Treasury bonds), and GLD for gold.

Safe-haven, long-dated US Treasury Bonds were the lone poor-performer down -3.7% as growth returned and inflation stopped declining.

As global economic conditions appeared to bottom in late 2023 and financial market internals continued to improve, the Grey Owl All-Season[2] strategy took a gradually more aggressive posture. We added equity exposure across multiple global markets and diversified amongst commodities including gold, energy, and Bitcoin.

Through the first quarter of 2024, the Grey Owl All-Season strategy returned +4.3% versus the 60/40 index[3] return of +4.5%. In the three weeks following the end of the quarter, the S&P 500 lost -5.3%. With a much broader portfolio with significant global and commodity-related investment exposure, the Grey Owl All-Season strategy has outperformed during this (so far) short equity-market contraction. Year-to-date, through April 19, 2024, the Grey Owl All-Season strategy is +3.2% compared to +0.4% for the 60/40 index.

Economic Growth

Economic growth is back. For the last few letters, we have noted that the PMI decelerated between March of 2021 and June 2023 where it made a low of 46. It first entered contractionary territory (below 50) in November 2022. Now it is accelerating and just entered expansionary territory. There was a blip in December, but in January through March, the PMI continued re-accelerate. March was greater than 50 which means economic expansion (in addition to acceleration). The acceleration has now persisted for nine months.

Recall that the (PMI) summarizes in a single data point the state of the US economy. The PMI is a “diffusion index” which aggregates survey data from decision makers throughout the manufacturing economy. The questions are around the managers’ expectations (e.g. “do you plan to acquire more or less inventory next month compared to this month) and are thus a leading indicator of economic activity.

[2] Despite the generic and frequent use of the term, we renamed our strategy Grey Owl All-Season after Bridgewater Associates requested we do so claiming it conflicted with a strategy they call All-Weather.
[3] 60/40 index refers to 60% MSCI ACWI Index (equity) and 40% Barclays Aggregate Bond Index (bonds).

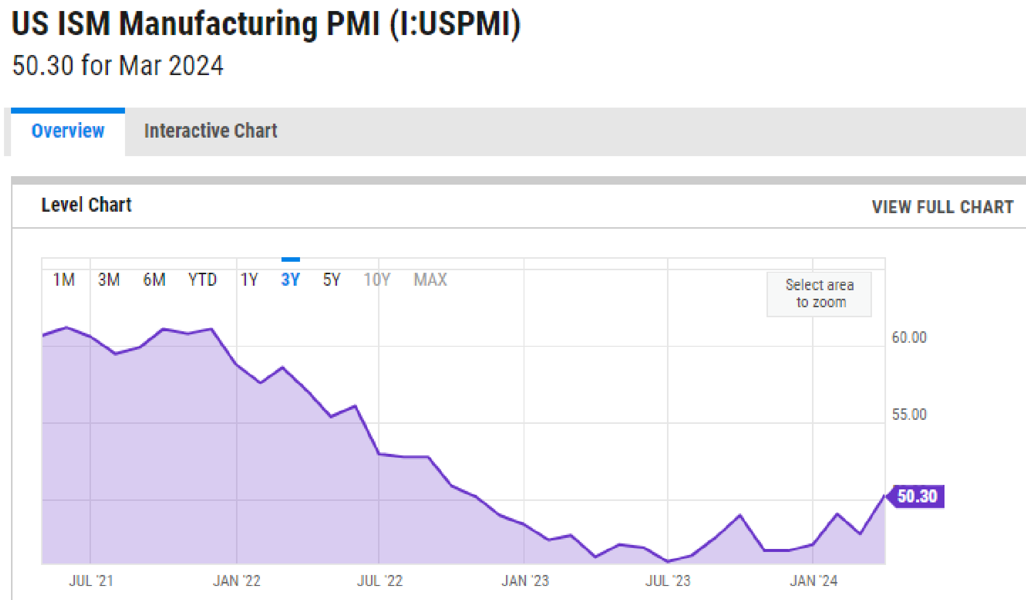

Figure 1 – US ISM Manufacturing PMI monthly
https://ycharts.com/indicators/us_pmi

The services sector never experienced a contraction. (It technically went below 50 at 49.2 for one month in January 2023.) Yet, now it is moving sideways rather than accelerating. While not a warning sign, this is a reminder that though currently growing and with several prospective quarters of easy compares, this is still not a stellar economy.

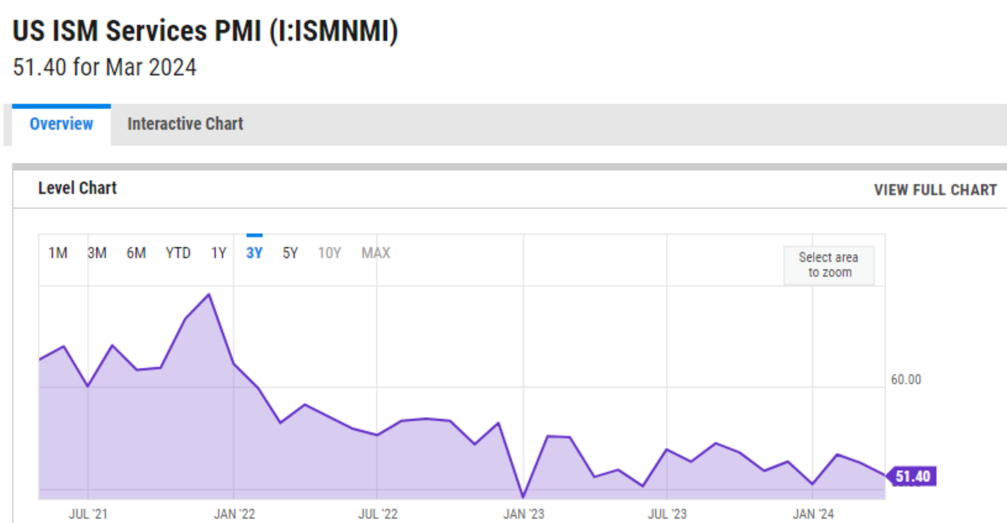

Figure 2 – US ISM Services PMI monthly
https://ycharts.com/indicators/us_ism_non_manufacturing_index

Did the economy experience a "soft landing?" It sure seems like it did. Though, it is likely only because it was propped up by government spending that is now at unprecedented levels. Again, there is a path to several quarters of economic growth, but we are in a "stable disequilibrium."[4]

Borrowing to Spending

Federal government spending modestly contracted after Covid. Then it continued growing. It is currently almost 50% greater than pre-Covid levels.

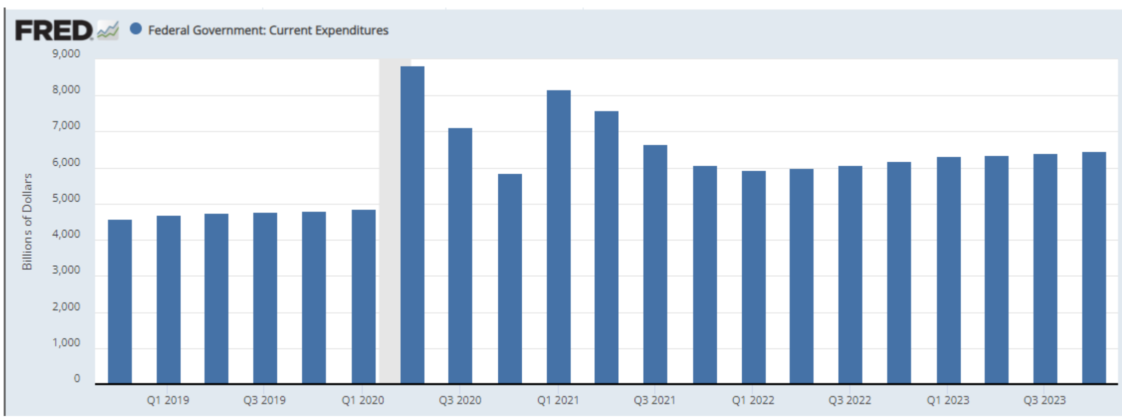

Figure 3 - Federal Government: Current Expenditures, Billions of Dollars, SAAR; https://fred.stlouisfed.org/series/FGEXPND#0

How long can this continue? To infinity and beyond?

[4] This phrase was coined during "The Tens" by PIMCO's Mohamed El-Erian to describe a system of excessive borrowing propping up weak (though positive) economic growth in the short-term at the expense of creating a system that is more and more in disequilibrium thereby ensuring a more violent, eventual return to equilibrium.

Inflation

It looks like the decrease in commodity prices and 5-year breakevens during the last quarter of 2023 was indeed a headfake. The chart below depicts increasing commodity prices (orange) and 5-year Breakeven Inflation Rate (blue). Like growth, inflation compares are now easy for the next few quarters. This increases the likelihood that inflation continues its reacceleration. In addition oil has seen a significant rebound. Oil prices feed into measured inflation (i.e. the consumer price index – CPI) on approximately a one-month lag.

Figure 4 - www.tradingview.com

Market Signals

Equity market performance remains resilient and has broadened significantly since 2023, a period where the capitalization-weighted indices were largely driven higher by the mega-capitalization stocks. The current three-week correction has not done any “technical” damage to the market (yet). The pullback may be a blip, a rotation (into more cyclical, commodity sectors), or a sign the technology-driven bull market is finally over. Only time will tell. For now, market internals remain constructive as summarized by the positive spread between buying power and selling pressure via CFA Lowry Research depicted in the chart below.

Figure 5 – https://www2.lowryondemand.com/members/markets/marketchart.cfm

Positioned for Growth (For Now)

Our current positioning is the most constructive it has been in several years. We have more exposure to idiosyncratic risk-assets including commodity indices, gold, India, insurance, momentum, crypto, uranium, emerging markets, and China. Our cash position is at the lowest level it has been in several years. Cash should now be considered a portion of the 40% bond allocation in our 60/40 benchmark. This <u>position today yields approximately 5% annually.</u> For the first time in fifteen years, it pays to hold cash.

The US economy has held up better and longer than most believed possible. While the evidence points to unsustainable borrowing as the most likely explanation, it is impossible to say when it would truly become unsustainable. While we wait, for both debt and Bitcoin, it's "to infinity and beyond!"

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC