July 29, 2024

"You only see what she wants you to see
And before you really know it always seems to go
Back & forth, back & forth …"

- Cameo, Back and Forth

Dear Client,

While global financial markets continue to trend positively on a quarterly basis, monthly movement has become more volatile. Key indicators of growth and inflation are still resetting from the 2020 pandemic. Government involvement in markets continues to increase. Market structure has evolved to be increasingly dominated by non-discretionary actors. An indicator flips from good to bad (or vice versa), existing market setup determines the initial direction of reaction (sometimes good means bad and bad means good). Then, systematic programs amplify that initial market reaction. A month later the indicator flips again. Amplification in the opposite direction. Back & forth, back & forth …

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Gold and equities performed well during 2024's second quarter. Commodities were flat and long-dated bonds were down. After accelerating from mid-2023 through the first quarter, economic growth consistently decelerated each month of the second quarter. More on that below, but first, a review of recent performance for "primary" assets[1] and the Grey Owl All-Season strategy.

[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

For the second quarter of 2024, US equities were +4.4%. Global equities were +2.9%. Gold was the best performing primary asset class, up +7.6%. Commodities were barely positive +0.4%. Like the first quarter, safe-haven, long-dated US Treasury Bonds were the lone poor-performer down -2.0%.

During the first quarter of 2024, the Grey Owl All-Season strategy returned +4.3% versus the 60/40 index[2] return of +4.5%. During the second quarter, the Grey Owl All-Season strategy outperformed during April when US equity indices were down mid-single digits and trailed during May and June when the US equity rally returned via very-narrow, mega-capitalization dominance. (The Grey Owl All-Season strategy has similarly outperformed in the first few weeks of the third quarter as large-capitalization equity indices have sold off.) For the full second quarter, the Grey Owl All-Seasons strategy returned +0.6% compared to +1.8% for the 60/40 index.

Throughout the quarter, the Grey Owl All-Season[3] strategy mostly maintained the more aggressive posture which began in the later portion of 2023. Equity exposure remained diversified across global equities with an overweighting toward the Indian market.

The most significant portfolio change was to increase fixed income exposure as both inflation and growth slowed throughout the quarter. Looking forward, last year's inflation numbers continue to provide easy comparisons for the next few months – i.e. inflation is likely to continue to decelerate. But, towards the end of the year and into 2025 the comparisons become much more difficult, and it would not be a surprise if inflation picked back up. With that backdrop, bond positions need to be managed dynamically.

Economic Growth

The manufacturing sector growth that persisted for nine months through March 2024 has now slowed for three consecutive months. In addition, after barely reaching expansionary territory (>50) in March, it is back to mild contraction.

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

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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.

[2] 60/40 index refers to 60% MSCI ACWI Index (equity) and 40% Barclays Aggregate Bond Index (bonds).

[3] 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.

plan to acquire more or less inventory next month compared to this month) and are thus a leading indicator of economic activity.

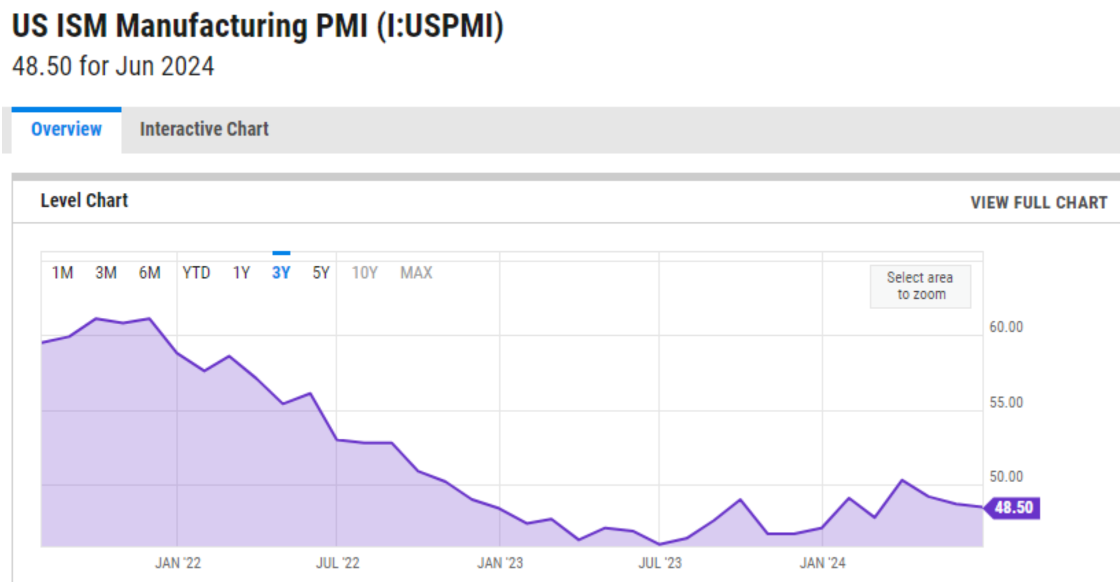

Figure 1 – US ISM Manufacturing PMI monthly
https://ycharts.com/indicators/us_pmi

Further, after never experiencing a post-2020 contraction, the service sector is now both decelerating and in contraction.

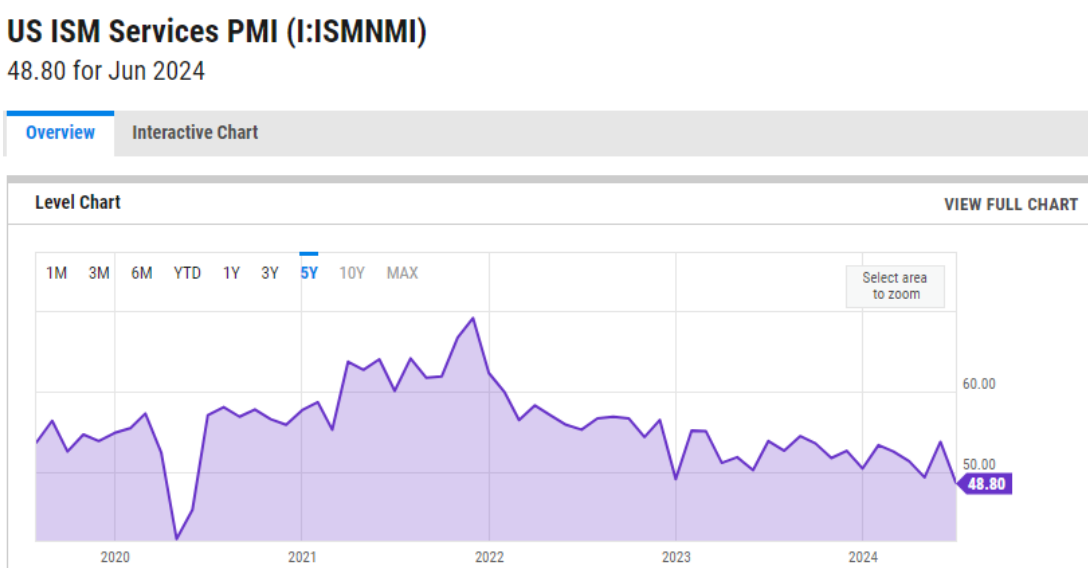

Figure 2 – US ISM Services PMI monthly
https://ycharts.com/indicators/us_ism_non_manufacturing_index

As we wrote last quarter, "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]"

The trend in weekly initial jobless claims amplifies this point. They have begun to climb. We are still a ways from the 300k "threshold," but this trend bears watching.

Figure 3 – US Initial Jobless Claims (Weekly)
https://www.tradingview.com

[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

Different inflation indicators are currently providing distinct outlooks on inflation. 5-Year Breakevens[5] imply inflation that is "sticky-high" but neither accelerating nor decelerating.

Figure 4 -5-Year Breakeven www.tradingview.com

On the other hand, recent commodity price movements forecast a modest deceleration. While a shorter trend (at this point), it is consistent with the year-over-year, rate-of-change comparisons that set up for flat to slower growth and disinflation.

Figure 5 – GS Commodity Index ETF www.tradingview.com

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[5] From YCharts: "The 5 Year TIPS/Treasury Breakeven Rate is calculated as the difference between the 5 year treasury rate and the 5 year treasury inflation-indexed security rate. Market participants use this value as what they believe the expected inflation should be in the next 5 years, on average."

Finally, and most importantly, the forward-gold price (a concept created by David Ranson at HCWE[6]), a longer-term indicator, continue to point toward increasing inflation.

Figure 6 – Forward Gold www.tradingview.com

Given the setup of year-over-year comparisons for the next few months, we conclude inflation is likely to show modest deceleration for a quarter or so before reaccelerating as suggested by the forward-gold price.

Market Signals

In the US, 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. Despite the mega-capitalization selloff of the last few weeks, internal strength persists. Market internals remain constructive as summarized by the positive spread between buying power and selling pressure via CFRA Lowry Research depicted in the chart below.

[6] Ranson's theory is that gold has both a flight-to-safety and monetary (inflation) component. If you divide gold by long-dated Treasury bonds, you isolate the forward price markets are willing to pay for the more pure inflation component.

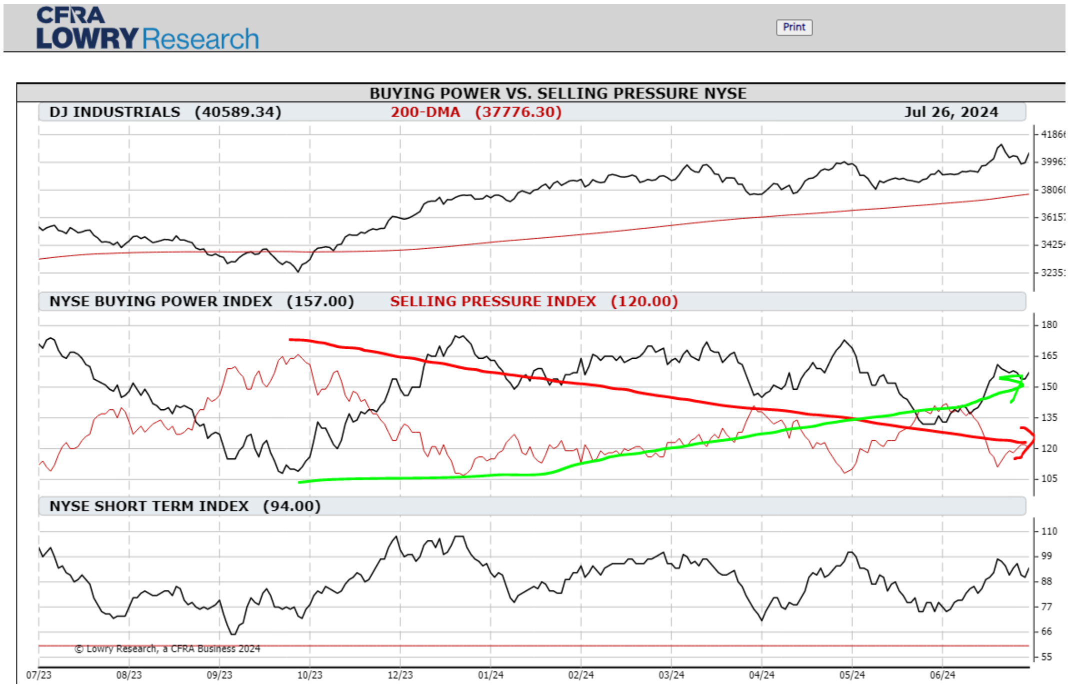

Figure 7 – https://www2.lowryondemand.com/members/markets/marketchart.cfm

India

Globally, India continues to outperform economically and via financial markets. While the US PMIs are just below 50 (contractionary), India's PMI composite is at 61 and continues to accelerate.

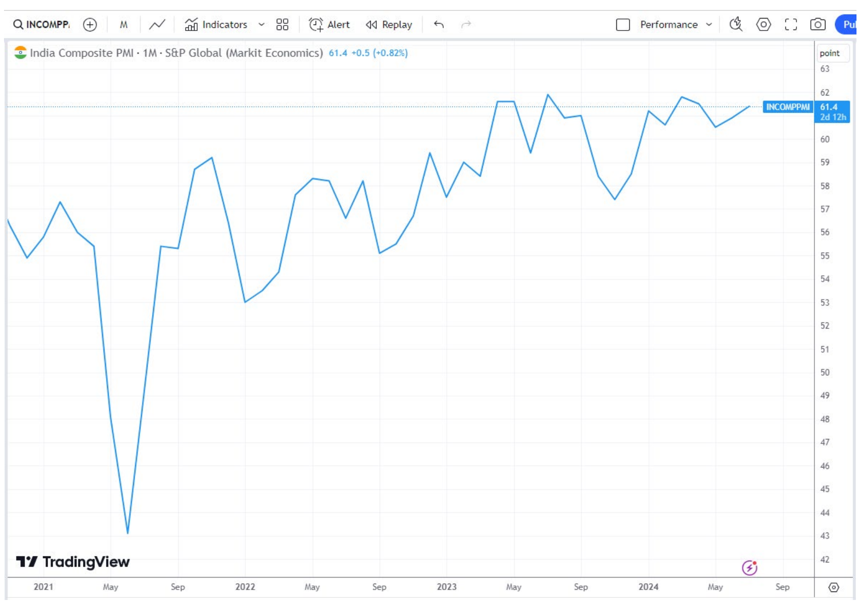

Figure 8 – India PMI Composite [**www.tradingview.com**](http://www.tradingview.com)

India's stock market has followed suit.

Figure 9 – Indian Equity Market ETF www.tradingview.com

Current Positioning

Our current positioning remains constructive. We have exposure to idiosyncratic risk-assets including gold, India, insurance, momentum, and emerging markets. Over the last quarter, we increased exposure to fixed income (domestic and global), as well as, rate sensitive assets such as utilities. We have pared back some exposure to the most cyclical equities and increased exposure to lower-volatility sectors such as healthcare. Our cash position remains relatively low. And what cash we hold continues to provide a meaningful yield. Cash should now be considered a portion of the 40% bond allocation in our 60/40 benchmark. This position today yields approximately 5% annually. 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. That said, we are seeing increasing volatility from month to month as the economy continues to digest the fallout of the 2020 pandemic and the subsequent government interventions. This volatility (the back and forth) demands more active management and monitoring for a trend shift. We need to see more than what the headlines want us to see.

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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

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