January 24, 2025

"If the new administration [de] regulates, [cuts/increases] spending, [deftly/poorly] manages tariffs, the US dollar will [continue higher/crash], interest rates will [increase/stabilize], commodity prices will [increase/stabilize], and equity markets will [continue higher/crash]."

- Quasi-Quotation

Dear Client,

We began our last letter "inflation is set to reaccelerate." It has and will likely continue to do so through the first half of 2025. This was a contrary idea in September; less so now. Real growth remained positive at the end of 2024 but slowed from earlier in the year. Base effects[1] anticipate real growth will zigzag between modest acceleration and deceleration into the summer. The economy is moving from stagflation to quasi-stagflation. High nominal growth means a recession is unlikely, but increasing inflation has already put significant pressure on interest rates, and the zigzag of real growth could introduce additional financial market volatility regardless of the economy's resilience. Much of the inflation and growth expectations are "baked in the cake" based on historical comparables. Some of this will depend on the actions of the new administration in Washington, DC, reactions from the rest of the world, and investor perceptions. A templates exists, but much remains unknown. More on the outlook below, but first, a review of recent performance for "primary" assets[2] and the Grey Owl All-Season strategy.

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[1] "Base effects" refer to the impact of a comparison point (base) in the previous period on the current period's growth rate.

[2] We refer to US equities, long-dated US Treasury bonds, gold, and commodities as "primary" asset classes borrowing the language of HCWE & Company. These four assets best capture two variables that explain a significant amount of asset price movement: global growth 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

For the fourth quarter of 2024, commodities were the best performing asset +3.7%. US equities were +2.5%. Global equities were -0.9%. Gold was down modestly, -0.4%. Long-dated US Treasury Bonds were down a meaningful -9.7%. This followed the third quarter when long-dated US Treasury Bonds increased for the first time in 2024, gaining +7.9%. That is a significant amount of volatility for a supposedly "safe" asset. Investors were clearly surprised by inflation's reversal and/or programmatic trading levels were triggered.

During this period, the Grey Owl All-Season strategy returned -1.6% versus the 60/40 index[3] return of -1.4%. For the full year, the Grey Owl All-Season strategy finished up +6.7% compared to the 60/40 index return of +11%. For 2025 through Friday, January 17th, the Grey Owl All-Season strategy is up approximately +2.5% while the 60/40 index is up +1.1%.

Economic Growth

Representative of the economic fits and starts described above, the PMI appears to have bottomed in October and has begun to reaccelerate. As of December, it is still below 50, but just barely (i.e. only very slightly contractionary).

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.

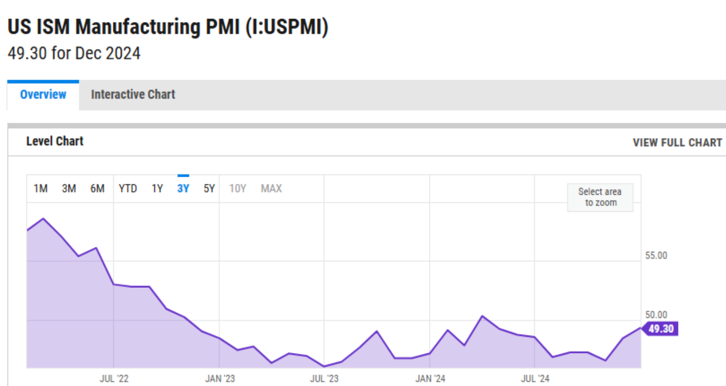

Figure 1 – US ISM Manufacturing PMI monthly
https://ycharts.com/indicators/us_pmi

US Treasury bonds and gold are "haven" assets. 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.
[3] 60/40 index refers to 60% MSCI ACWI Index (equity) and 40% Barclays Aggregate Bond Index (bonds).

The Services PMI remains well above 50.

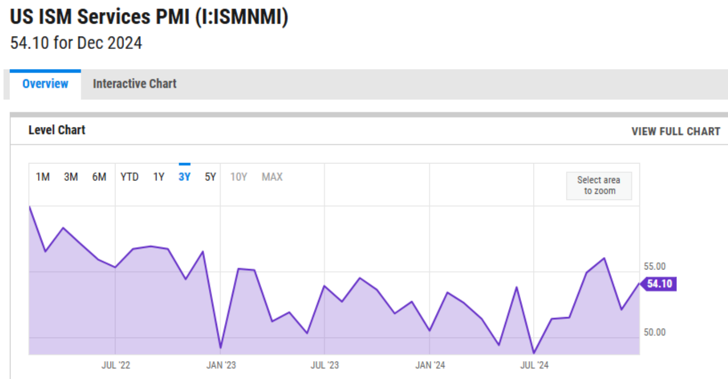

Figure 2 – US ISM Services PMI monthly
https://ycharts.com/indicators/us_ism_non_manufacturing_index

And, small business optimism is surging higher.

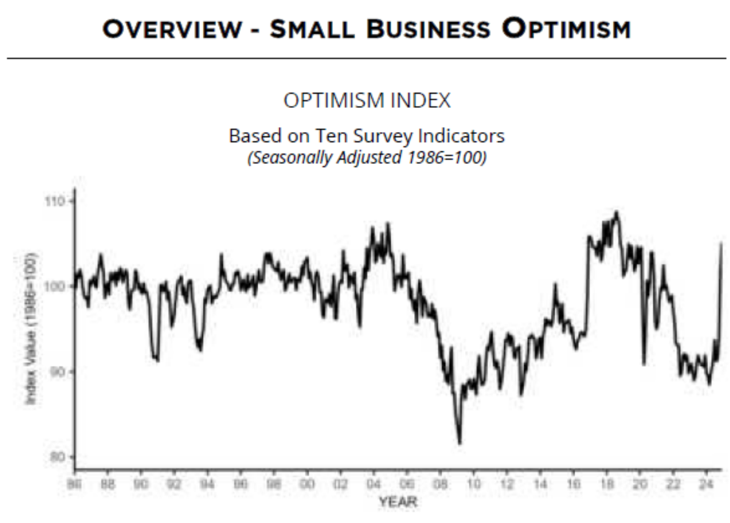

Figure 3 - Small Business Optimism
https://www.nfib.com/news-article/monthly_report/sbet/

Overall, the outlook is for continued growth.

Inflation

The 5-Year Breakeven[4] rate is still pointing higher, but the spike in the early fall has receded. The threat of returning runaway inflation has decreased.

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

On the other hand, Hedgeye's more short-term oriented, Monthly Inflation Nowcast forecasts continued higher consumer price inflation through January after accurately calling the September bottom well ahead of the market.

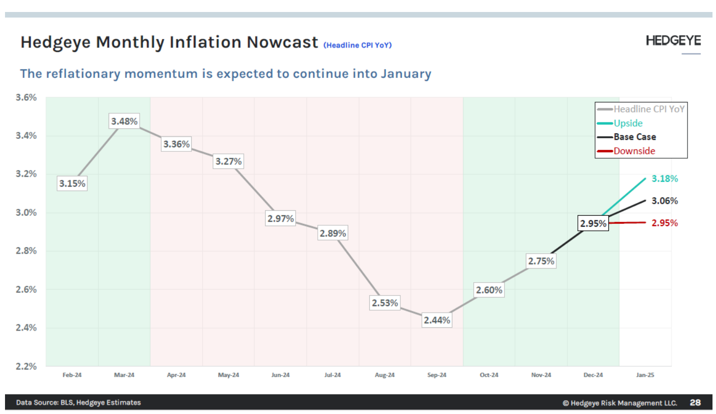

Figure 5 – Monthly Inflation Nowcast (www.hedgeye.com)

Modestly increasing inflation looks likely for the next few quarters.

[4] From TradingView: "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."

Market Signals

Market internals became mixed during the fourth quarter and into the US election both reflecting and contributing to the volatility in multiple financial assets classes (e.g. Treasury bonds). More recently, market internals have rebounded in a significantly positive way. This likely reflects the outlook for modest real economic growth, accelerating (but contained) inflation, and an optimism (how long will it last?) for a more business friendly regime in Washington.

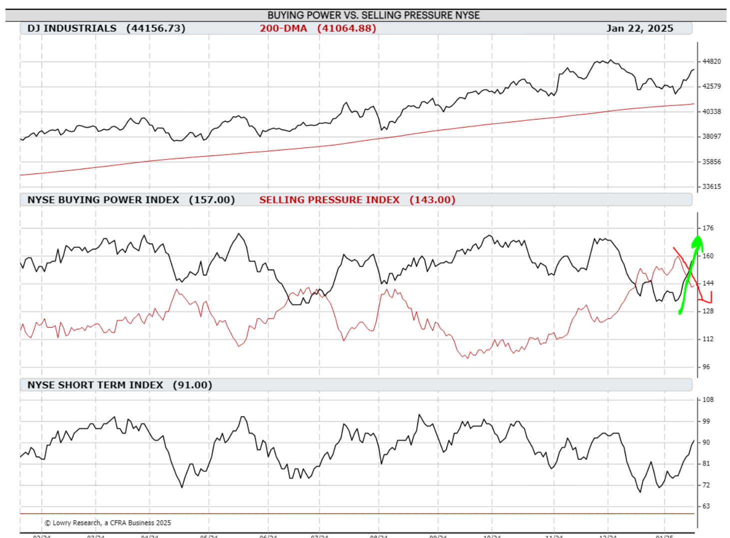

Figure 6 – https://www2.lowryondemand.com/members/markets/marketchart.cfm

Current Positioning

Our current positioning remains constructive. We have exposure to idiosyncratic risk-assets including large capitalization US growth and momentum equities, commodities (including crypto), and commodity equities. Given the ongoing strength in the US dollar, our foreign equity exposure is limited to countries with little US dollar denominated debt and accelerating economies. We decreased exposure to fixed income during the third quarter of 2024, but with rates now much higher and nominal growth strong, we added high-yield debt. Our cash position is low.

It's worth repeating a portion of our closing lines from our last letter: “The US economy has held up better and longer than most believed possible. While the evidence points to unsustainable government borrowing as the most likely explanation, it is impossible to say when it would truly become unsustainable.” Markets appear to be watching the incoming administration closely. If efforts such as the Department of Government Efficiency (DOGE) appear serious, bond markets would likely react positively (yields stop moving higher). That could put some pressure on the economy as resources take time to reallocate to the more efficient private sector. Or, the profligacy continues and rates move dangerously higher. For the very short term, sentiment and fundamentals are bullish. But, it would be unsurprising if volatility returned.

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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