AEQUITAS INVESTMENT ADVISORS

QUARTERLY LETTER – MARCH 31, 2024

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From: Aequitas Investment Advisors

Warner & Your Team!

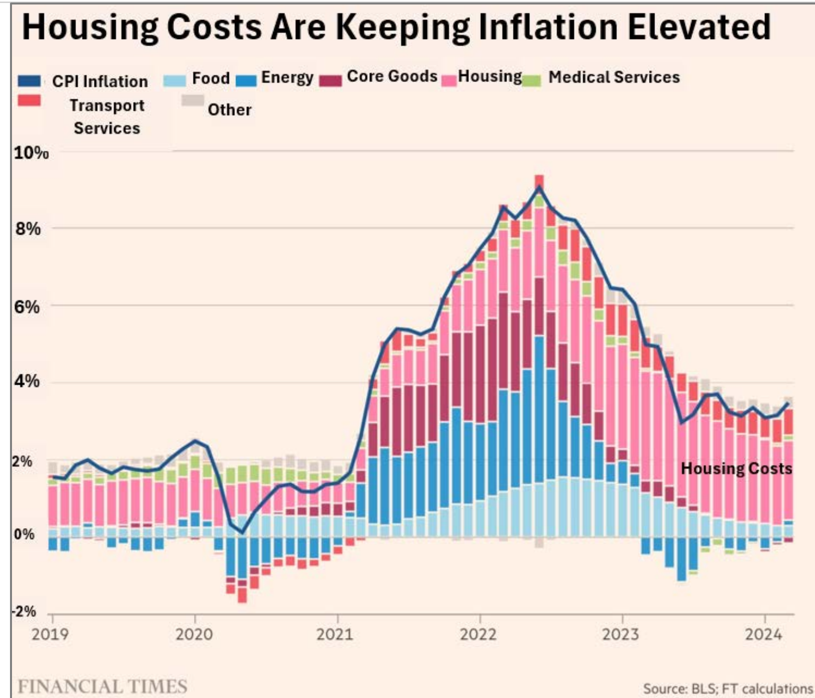
Re: The Best of Times, the Worst of Times

Charles Dickens opened his historical novel, *A Tale of Two Cities,* with "It was the best of times, it was the worst of times….it was the season of light, it was the season of darkness…" While Dickens was pointing out the social and economic contradictions and injustices in the nineteenth century, one might aptly use his words to describe the current situation in the U.S. and around the globe. On the one hand, in the United States we have an economy which is surprisingly strong with unemployment at its lowest level in more than 50 years and consumers spending at record levels, while on the other hand, and seemingly contradictory, consumer confidence remains well below pre-pandemic levels with many Americans continuing to feel the negative effects of inflated prices. And from a global perspective, while most the world's population is benefiting from the eradication of diseases, greater prosperity and greater freedoms of information, the world is also beset by human suffering with the ongoing wars between Russia and Ukraine where more than half a million people have died, and between Israel and Hamas where tens of thousands have lost their lives. And from a political perspective, our nation seems more polarized than ever with little apparent appetite for moderation and compromise.

From an investment perspective, one can look at today's favorable economic data and build a bullish case for investing in bonds and stocks in the future, or one might look at some of our long-term fiscal and environmental challenges and build a more bearish outlook. Our view is one of cautious optimism given the investment opportunities we see today as well as our belief that human ingenuity, combined with the laws of economics, are powerful forces which can overcome significant challenges.

Inflation Update

Last week, the Bureau of Labor Statistics reported that on a year-over-year (YoY) basis inflation rose in March by 3.5% compared to a 3.2% YoY increase in February. While this represents a modest increase, the markets were expecting that inflation would continue its downward trend thereby encouraging the Federal Reserve to begin lowering interest rates, perhaps as early as June. However, with the surprise inflation uptick, bond yields have risen (sending bond prices lower) and stock prices are slumping (the MSCI All Country Stock Index is down by close to 5% since the surprise inflation report). The primary culprits for the inflation uptick were energy prices and housing costs (housing includes rents and homeowners' equivalent rent). Auto insurance premiums, included in the transport services component, also continued trending higher and have risen by more than 20% over the past year. Despite the recent uptick, most economists expect inflation to continue trending downward by the end of the year, though it may take longer for the Fed to reach its 2% target. Rather than beginning to lower rates in June, as the optimists had hoped, the consensus now is that the Fed might not begin lowering rates until December.



In several of our past quarterly letters, we've discussed the Federal Reserve's goal of achieving a "soft landing" scenario as the ideal outcome in its battle against inflation, i.e., keeping interest rates sufficiently restrictive to slow the economy while gradually bringing down inflation and avoiding a hard landing recession. Given the surprising strength of the U.S. economy, further bolstered by an improving global economic outlook, the outcome might end up becoming a "no landing" scenario which might lead to the Fed keeping rates higher for longer to bring inflation down to its 2% target. Following the strong retail sales report in

March, the Atlanta Fed's tracking model shows real U.S. GDP rising faster than expected largely driven by strong consumer spending which accounts for close to 80% the nation's GDP growth. According to economist Ed Yardeni, "The U.S. is still flying high. That's because consumers didn't get the recession memo. They keep spending because real disposable income is rising, more Americans are retiring and have the means to do so comfortably, and six million or more 'newcomers' are consuming here rather than south of the border." [A few more words on immigration later in this report.]

Escalating War in the Middle East

In addition to being buffeted by the surprise uptick in inflation, the stock market has also been negatively impacted by the escalation in the war between Israel and Hamas which now includes direct engagement with Iran. In retaliation for what Iran believed to be an Israeli airstrike on their consulate in Syria on April 1st which killed senior Iranian commanders, Iran recently launched a barrage of missiles and drones into Israel which were successfully blocked by Israel's air defenses. As of this writing, Israel carried out a limited retaliatory strike on Iranian military targets which appears to have been designed to send a strong message about Israel's capabilities. The U.S. and most world leaders are urging restraint lest this conflict escalate further. Unfortunately, conflict and war in the Middle East are nothing new as the region has been the most volatile part of the world since the mid-20th century. In the chart below, we've listed some of the major events which have occurred in the Middle East beginning with the 1967 Six-Day War between Israel and a coalition of five Arab states. (We added the Russian invasion of Ukraine to the list given its relevance today.) Note that the average stock market return following the five major events was only slightly negative with an average loss of less than 3% after twelve months. The subsequent 12-month returns were positive following three of the events, and negative following two, with the combined Yom Kippur War and Oil Embargo of 1973 being the worst.

S&P 500 Index Performance After Major Geopolitical Events in the Middle East and Ukraine

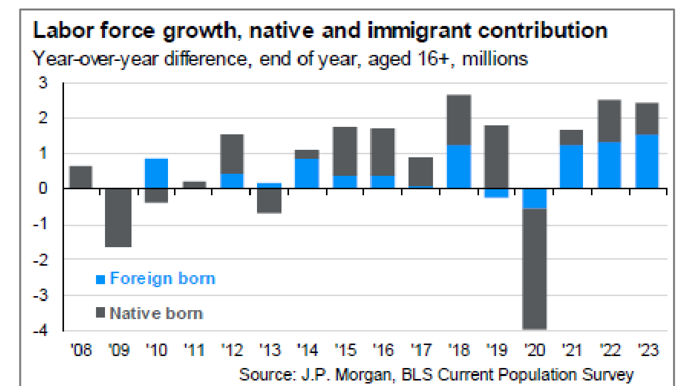
	Months Following the Event			
Market Event	1 Month	3 Months	6 Months	12 Months
Six-Day War: Israel vs 5 Arab States (6/1967)	3.3%	5.9%	7.5%	13.5%
Yom Kippur War & Oil Embargo (10/1973)	-3.9%	-10.7%	-15.3%	-43.2%
Iraq's Invastion of Kuwait (8/1990)	-8.2%	-13.5%	-2.1%	10.1%
U.S. Bombing of Syria (4/2017)	1.8%	3.1%	7.6%	12.8%
Russia Invades Ukraine (2/2022)	5.9%	-7.2%	-2.1%	-7.1%
Average	-0.2%	-4.5%	-0.9%	-2.8%

While the events in the Middle East (and Ukraine) might not have been the primary cause of the stock market's subsequent performance, they were certainly contributing factors. Following the Yom Kippur War and Oil Embargo of 1973, oil prices skyrocketed by 400% which were factors leading to a severe global recession accompanied by double-digit inflation. One significant difference in today's global oil supply is that the United States is energy independent and is a net exporter of oil and petroleum products, whereas in 1973 we were largely dependent upon imported oil from the Middle East. On the other hand, we are not independent when it comes to the price of oil as it is largely determined by global supply and demand. Given that the Middle East accounts for about 30% of the global oil production, and more than 10% of global shipping passes through the Red Sea, war and conflict in that region will still have a significant impact on the global economy, at least in the short term.

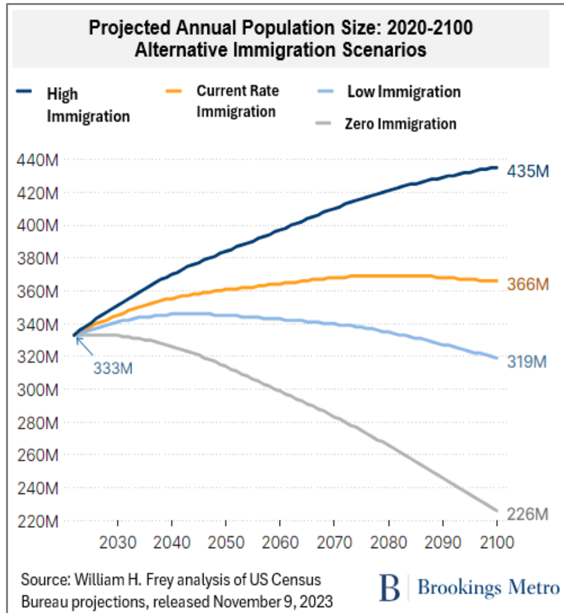
Immigration – a Story of Two Tales

Since the last comprehensive immigration reform legislation was enacted in 1984, there have been numerous attempts to enact additional reforms, but they have all failed due to political polarization. In February, a group of U.S. Senators crafted a bipartisan bill for border security and immigration reform which was abruptly shot down by a few Republicans in the House and Senate after the presumed Republican presidential nominee voiced his objection. This outcome was unfortunate given that close to 60% of voters, according to a recent Wall Street Journal survey, said they supported the bi-partisan Senate compromise with roughly equal support from both Democrats and Republicans. The same survey found that 74% of voters support creating a "pathway to citizenship for undocumented immigrants who have been in the country for many years and pass a background check."

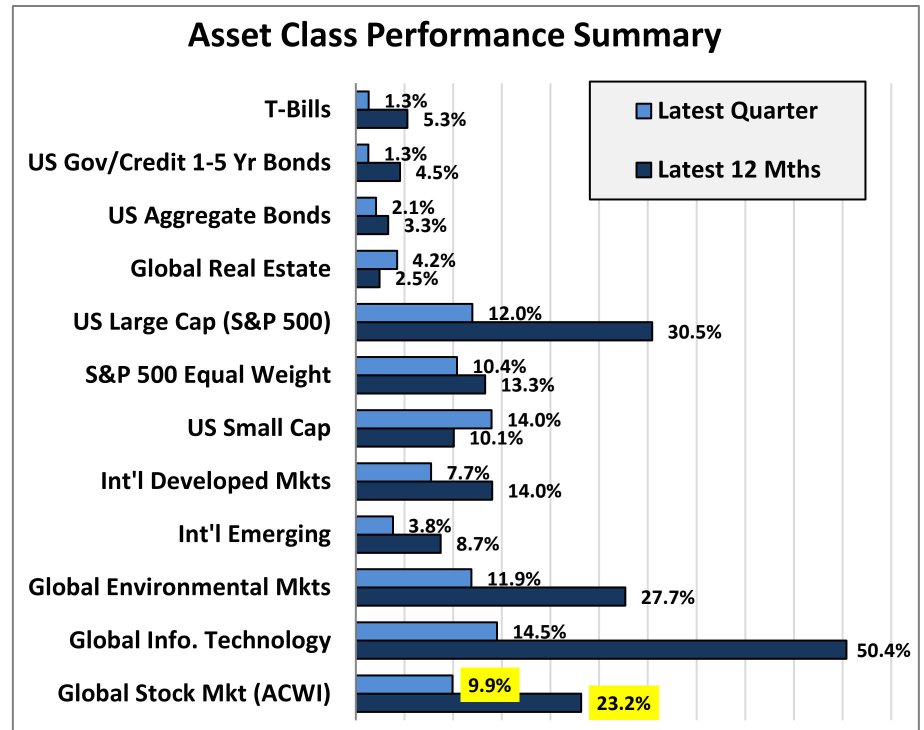
From an economic standpoint, immigration is additive to our nation's labor supply and economic growth. In the bar chart below, note that immigrants have made up more than half of the growth in our labor force in recent years (the blue portion of the bars). In total, foreign-born workers in the U.S. represent close to 20% of the civilian labor force, according to the U.S. Bureau of Labor Statistics.



While there are unarguably serious problems with the current status of our border security and immigration policies, according to the Congressional Budget Office, the increase in labor supply provided by immigration generates significant benefits for the economy and reduces the fiscal deficit (undocumented immigrants and those with legal status pay billions of dollars in payroll taxes, including Social Security taxes). According to CBO Director Phillip L. Swagel, "In our projections, the [federal] deficit is also smaller than it was last year because economic output is greater, partly as a result of more people working. The labor force in 2033 is [projected to be] larger by 5.2 million people, mostly because of higher net immigration. As a result of those changes in the labor force, we estimate that, from 2023 to 2034, GDP will be greater by about $7 trillion and revenues will be greater by about $1 trillion than they would have been otherwise." Our nation's long-term future economic vitality critically depends on immigrants as illustrated in the chart to the left which projects the U.S. population under four different immigration scenarios. The High Immigration scenario assumes an average of approximately 1.5 million net new immigrants *each year* for the next 75 years, while the Current Rate scenario assumes net new immigration of more than 1 million each year just to maintain our current population level. The Low Immigration scenario is based upon an average of about 500,000 net new immigrants each year.



Whether working in lobster processing plants in Maine, or on dairy farms in Wisconsin, or on our nation's bridges filling potholes, immigrants have always been and will continue to be a vital component of our nation's economy, including the millions of other jobs across the country in both low and high-skilled jobs in such areas as health services, business services, construction, and hospitality. The debate should not be whether immigrants are good for America, but rather, it should be how can we create greater border security while also establishing an immigration process which is just, fair, and expedient.



Asset Class Performance Review

For the trailing twelve months ending March 31st, 2024, all of the asset classes and select sectors listed in the Performance Summary above had positive returns with the Global Stock Market posting a robust gain of 23.2%. Global Information Technology led the way (+50.4%), followed by US Large Caps (+30.5%) and Global Environmental Markets (27.7%). The other stock asset classes had returns ranging from 2.5% (Global Real Estate) to 14% (International Developed Markets). The returns on Fixed Assets were strong, as well, with gains of between 3.3% (US Aggregate Bonds) to 5.3% (US T-Bills).

For the first quarter of 2024, the returns were also strong with a more even distribution of positive returns. The Global Stock Market gained 9.9% while the other stock asset classes and select sectors posted gains ranging from 3.8% (Emerging Markets) to 14.5% (Global Information Technology). The surprise inflation uptick and the escalating turmoil in the Middle East have erased some of the first quarter's gains as the Global Stock Market is up by 4% for the year-to-date through April 16th. We would not be surprised to see a 10% stock market correction as the market adjusts to the likelihood that the Fed will keep interest rates higher for longer, as well as continuing geopolitical concerns.

Long-Term Forecast

Despite the near-term uncertainties and expected market volatility, we expect that investment returns over the next 10 years will be favorable for two important reasons. First, the expected average annual return for a diversified portfolio of high-quality bonds is more than twice as high it has been over the past 10 years. Second, there are many asset classes within the Global Stock Market where prices are relatively low and expected future returns are high. We believe that a combination of bonds and globally diversified stocks has the potential to deliver comparable returns to what investors experienced over the past 10 years, although the highest returns may come from different asset classes within the portfolio. For the trailing 10-year period ending April 16, 2024, the Global Stock Market (MSCI All Country World Index) generated an average annualized return of 8.4%. The return on a diversified portfolio of high-quality bonds for the same period was just 2.1%. A balanced portfolio invested 40% in bonds and 60% in stock over the past 10 years had an average return of 5.9%. In looking forward over the next 10 years, based upon various assumptions, we would expect a globally diversified stock portfolio to generate an average return of 6.3%, while a diversified portfolio of high-quality bonds is expected to generate an average return of 5.1%. In combining the two, we would expect a 40% bond and 60% stock portfolio to generate an average annual return of about 6% over the next 10 years which is comparable to its trailing 10-year return.

10-Year Future Annual Rate of Return Forecasts

Equities	10 Year "Expected" Return	Risk Level (Standard Deviation)
Emerging Markets	9.7%	20.4%
Non-US Developed Markets	8.9%	16.6%
US Small Cap Value	8.6%	19.3%
Global Equities Mix	**6.3%**	**15.5%**
US Large Cap Value	5.9%	15.5%
US Small Cap Growth	5.0%	22.5%
US Large Cap Growth	2.5%	17.3%
Fixed Assets		
Diversified Bonds	**5.1%**	**3.3%**
Cash (Money Market Funds)	3.5%	0.8%
Balanced Portfolios		
20% Fixed - 80% Equities	6.3%	12.6%
40% Fixed - 60% Equities	6.1%	9.8%
60% Fixed - 40% Equities	5.9%	7.1%
Inflation	2.6%	NA

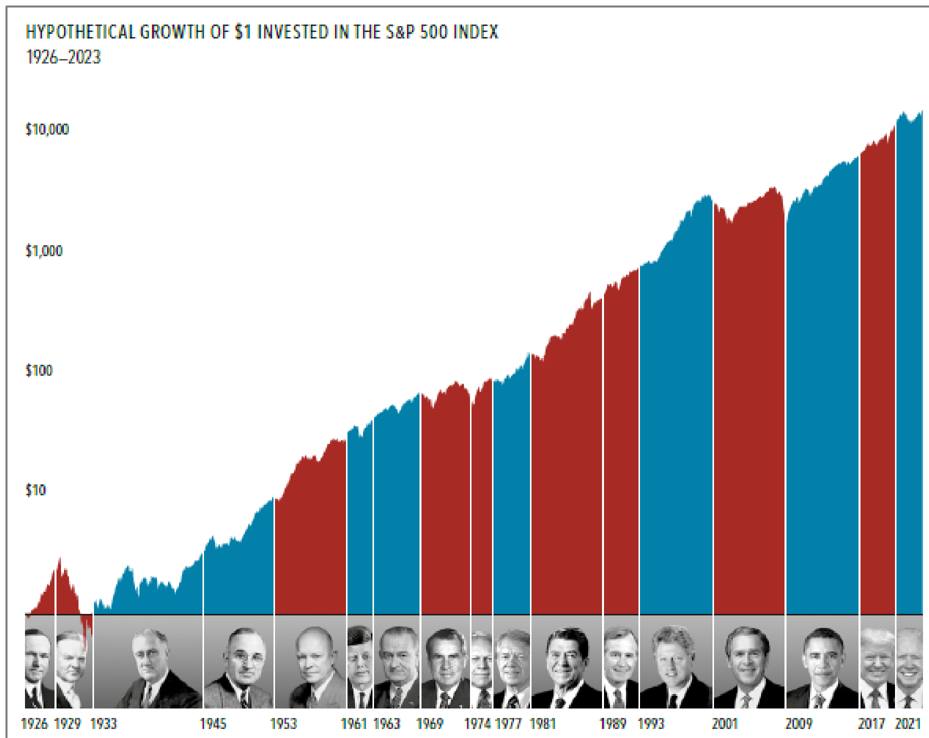
Expectations for future stock market returns are based upon a variety of factors and assumptions about the future, including interest rates, global economic growth, inflation, and current valuations of various stock market asset classes relative to their long-term historic valuation levels. For example, when stocks have high valuations, i.e., when prices are high relative to their projected earnings, their expected 10-year future returns would generally be lower than what they might have been in the past when their prices and valuations were lower. Conversely, when stock prices are low relative to their projected earnings, their expected future returns would generally be higher than they might have been in the past. The underlying concept in forecasting future stock market returns is the assumption that most stock asset classes "revert" to their long-term fair value, or their average historic valuation levels. For bonds, the expected future 10-year returns are based upon where forecasters think interest rates will be on average over the next 10 years. Bear in mind that these expectations are not guarantees, but they represent highly informed estimates based upon historic performance patterns, current valuations, as well as reasonable economic forecasts for the future. One of the measurements utilized in estimating future stock market returns is the Cyclically Adjusted Price-to-Earnings Ratio (CAPE Ratio) developed by Nobel Laureate, Robert Shiller of Yale University, which has proven to be one of the most reliable predictors of long-term future returns (the CAPE Ratio is unreliable in predicting short-term performance).

In the table on the bottom left, we've listed the expected future returns of various asset classes, largely based upon the methodology utilized by Research Affiliates, a highly regarded investment research firm which utilizes the CAPE methodology as one of its primary factors in determining expected future returns. At present, given the fact that non-U.S. stocks are trading at a 34% discount compared to U.S. stocks based on their relative Price-to-Earnings Ratios, their expected future returns are generally higher than U.S. stocks. Within the U.S. stock asset classes, Small Cap Value stocks have comparatively high expected future returns as well. The asset class with the lowest expected return over the next 10 years is U.S. Large Cap Growth which represents stocks of some of the largest and fastest growing companies in the U.S. (Microsoft, Apple, Nvidia and Amazon are the largest stocks within the asset class). While their past returns have been spectacular, their expected future returns are relatively low given that their Price-to-Earnings Ratios are about 50% higher than their 20-year historic average. We continue to recommend that clients own Large Cap Growth stocks, but our guidance is to underweight them in favor of what we believe are more promising areas of the stock market.

A somewhat surprising observation in the 10-Year Future Annual Rate of Return Forecasts table is that the expected return for a 100% Global Equities mix is not significantly higher than the expected return for a 40% Fixed and 60% Equities portfolio. The reason being that the expected 5.1% return on a diversified bond portfolio is much higher than its past 10-year return of 2.1%, and not much lower than the 6.3% expected return on the Global Equities mix. For balanced investors, the good news is that there is now the possibility of earning an attractive rate of return at a lower level of risk.

A Word on the Upcoming Election
(More Words in Future Quarterly Letters)

While it is too early to speculate on the outcome or repercussions of the upcoming presidential election, based upon history, one thing to bear in mind is that the performance of the stock market has generally been positive regardless of who occupies the Oval Office, or which party has control of Congress. In the chart below, created by Dimensional Fund Advisors, the message is that owners of stocks are investing in companies which focus on serving their customers and growing their businesses, regardless of who is in the White House. U.S. presidents may have an impact on stock market returns, depending upon their fiscal policies, but so do many other factors, including geopolitical events, interest rate changes, inflation, consumer spending, and technological advancements. The most practical approach to deal with uncertainty, we believe, is to invest in a balanced portfolio comprised of a healthy allocation to high-quality bonds (where there is safety and where future yields look promising) and an allocation to globally diversified stocks comprised of profitable companies where there is the potential for long-term capital appreciation.



Closing Comment

Referring back to Charles Dickens' *A Tale of Two Cities*, perhaps we are living in a season of light and darkness, but we believe there is the potential for brighter days ahead. And with the advent of spring, here's to renewed hope for a more peaceful and less divided world.