

FORTITUDE CAPITAL MANAGEMENT

Independence · Integrity · Insight

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“The easiest way to solve a problem is to deny it exists.” – Isaac Asimov

“To know what you know and what you do not know, that is true knowledge.” – Confucius

Fellow Investors:

The equity markets seemingly moved into 2024 in a higher gear, as the S&P 500 followed up last year’s 26.3% return with a 10.6% return in the first quarter of 2024. While we would hope for more dispersion of returns across the index, there was still a significant degree of concentration. The Magnificent Seven became the Fantastic Five as both AAPL and TSLA saw sharp pullbacks. The other top five contributors for the index (MSFT, NVDA, AMZN, META, GOOGL/GOOG) accounted for approximately 7.1% of the total return. However, the combined negative returns of AAPL and TSLA pulled the index down a full 2.6% themselves. Taking the Mag 7 as a whole, they accounted for 4.6% of the 10.6% gain in the S&P 500 for the quarter, so perhaps we have better contribution from the other 493 companies than might first appear. Contrast that to the full year 2023, when the S&P returned 26.3% and the non-Mag 7 stocks returned only 8% for the year.

In other equity markets, positive results were the rule with strong quarterly results in developed markets (MSCI EAFE) and small caps (Russell 2000). Emerging markets (MSCI EME) were somewhat weaker although still positive. Bonds on the other hand continued to struggle with interest rate uncertainty and persistent inflation resisting the Fed’s efforts to reach its target of 2%. The second quarter is off to a down start for equities and higher interest rates reflecting the sustained inflation concerns.

The yield curve remained inverted as both short-term rates and longer-term rates increased over the quarter. The two-year treasury rate finished 2023 at 4.23% and ended the first quarter of 2024 at 4.59%. The ten-year treasury rate went from 3.88% to 4.20% over the same period. This upward shift in rates may reflect the market’s view of inflation’s staying power and the rising federal debt. At the beginning of the year, the markets expected as many as six interest rate cuts by the Federal Reserve in 2024. That degree of rate reduction is now looking very unlikely. The messaging by the Fed indicates perhaps three rate cuts (maybe fewer) at this point and the markets seem to agree, although there is a wide range of opinions/predictions, and some market commentators doubt we will see a rate cut until 2025. The coming election adds a complication to the Fed’s strategy as they will be hesitant to cut rates too close to the election to avoid appearing political. That may lead them to make a cut earlier than the immediate data would suggest if they believe a move or two in 2024 is inevitable. Reaching the Fed’s 2.0% inflation target increasingly appears to be farther off than originally thought. Recent readings have ticked up and recent energy costs, grocery prices, and insurance premiums do not bode well for upcoming readings.

While the Fed’s inflation target is 2.0%, the current rate of 3.48% (as of March 2024) is not a high level when looking at historic inflation rates going back as far as 1985 (see chart). Recency bias is something that we investors need to watch

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out for with our portfolios and it may also be affecting the Fed's target. Yes, we had a period of exceptionally low inflation for a ten-year period, but the longer-term norm is higher. It is no secret that current federal spending and deficits are at records, making the fight against inflation an uphill battle. Some calculations show that quarterly GDP increases are less than increases in federal debt. That is not a good relationship. You cannot borrow economic growth for long. With inflation being within the historic norm at current levels (acknowledging that the peak of over 9% year over year reached in mid-2022 is not the norm), how do current interest rates stack up? The two-year treasury rate is not out of a normal range for the period 1976 to 2007 (before the GFC) and the ten-year is not out of a normal range for the period 1970 to 2007. Other than the inverted yield curve, perhaps we should view current rates as closer to "normal" than advertised. At current levels the "real" rate on the ten-year treasury (nominal rate less inflation) is just under 1%. Eventually the yield curve will return to upward sloping, but we may not see much downward movement at longer maturities. For now, short-term bonds are paying well giving those wanting to be cautious a decent yield while they wait.



So far in 2024, the S&P 500 has recorded 22 all-time highs and we have not had a daily decline of more than 2% in over a year. This is an unusual streak occurring only 6 times since 1965. With equities doing so well over the last year and a quarter, how are valuations? Using the price to earnings (P/E)¹ ratio as a measure, US equities appear overvalued to differing degrees. The P/E ratios for small-cap value stocks are very close to the 20-year average and large-cap growth stocks are the farthest from the 20-year average at 147%, again with a heavy influence from the Mag 7. Since

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theoretical equity valuations are the present value of future earnings allocated to shareholders, it is expected that growth companies that are expected to have increasing earnings should sport a higher P/E. The current weight carried by the largest companies in the index distorts overall performance and encourages unwise portfolio concentration. We continue to emphasize prudent portfolio allocation and balance as concentrations that award on the way up can sting on the way down as metrics gravitate toward the mean.

When dissecting what is behind total returns, P/E expansion has been the largest contributor in the US (as well as other developed markets) in 2023 and YTD 2024. Earnings and dividends have taken a back seat. Historically earnings have been the major contributor. With consensus forecasts calling for earnings growth into 2024, equities very well may earn their way into their inflated P/E ratios. The Fed cutting rates would only add to this. As mentioned above, we are seeing signs of more dispersion of returns across the markets.

At this point we want to add a note on recent economic statistics. The March jobs report is being touted as a “robust” 330,000 new jobs. However, 71,000 of that number were government jobs and another 81,000 were in the healthcare field, neither are arguably adding to the productivity of the overall economy. The report was also the fourth month in a row where part-time jobs created exceeded full-time jobs. So, are more people getting jobs or are more people getting a second (or third) job? Before we take top line statistics as evidence of economic success, it pays to look under the hood which may explain the general mood of the public toward the current state of things. According to an NFIB survey, the small business optimism index is at its lowest since 2012.

One theme that is a recurrent headline in the market is the artificial intelligence (AI) “boom”. Clearly having the potential to be transformative, its full potential is currently only guesswork. While a major factor behind the outsized returns of the Mag 7, how it filters down through the rest of the economy is yet to be seen. Predictions are very positive. A key element of economic growth and equity performance is improving productivity, which is the area that AI will have its greatest effect. The question on everyone’s mind is will it end like the internet bubble where the hype got way ahead of reality (although reality did eventually catch up after much carnage), or can the hype stay contained to match reality as AI applications filter into the economy. From our perspective it seems like the hype remains contained. The Mag 7 clearly has a lot to gain from AI and perhaps we are seeing that in how the market currently values them, but the effect on the remaining companies appears to be more wait and see.

Finally, we come to the elephant in the room, or in this case the elephant and the donkey. We are embarking on the longest presidential election cycle in history with two major party candidates with known track records determined very early in the cycle. Historically, the equity markets have underperformed in presidential election years until the candidates are determined and then overperformed until the actual election with a slight pullback once the election is over and the result is known. Perhaps the robust first quarter results are partially attributable to the candidates being known so early. We maintain that trying to do anything except staying the course is counterproductive as time has proven that timing tends to work consistently well only in hindsight.

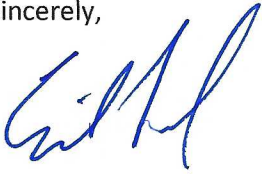
It should be an interesting year between the election, the Fed’s dilemma, AI, international conflicts, etc., but you can say that about any year. We can even add in an earthquake in New York City, volcano eruptions and a total eclipse of the

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sun. We even have two broods of cicadas to look forward to. To quote the Saturday Night Live character Rosanna Rosanna Danna, "it's always something". And frequently something comes from off our radar screens.

Sincerely,



Erik Ford



Jason Marrs

¹The price-to-earnings (P/E) ratio measures a company's share price relative to its earnings per share (EPS). Often called the price or earnings multiple, the P/E ratio helps assess the relative value of a company's stock. It's handy for comparing a company's valuation against its historical performance, against other firms within its industry, or the overall market. P/E can be estimated on a trailing (backward-looking) or forward (projected) basis. The figures cited above are forward looking.

The S&P 500 Index, or the Standard & Poor's 500 Index, is a market-capitalization-weighted index of the 500 largest publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

The term Russell 2000 Index refers to a stock market index that measures the performance of the 2,000 smaller companies included in the Russell 3000 Index. The Russell 3000 is a capitalization weighted index representing approximately 96% of the investable U.S. equity market.

The MSCI EAFE Index serves as a performance benchmark for the major international equity markets and includes companies in 21 countries in Europe, Australasia, and the Far East (East Asia).

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries. With 1,376 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.