Investor Insights & Outlook

April 2024 2nd Quarter Concorde Investment Management

Domestic Economic Overview

A Message from Concorde Investment Management

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Not dissimilar to our last quarter's discussion on the domestic economy, there are arguments both for robust economic growth and concerns about the future. What economists are starting to point out regarding the US versus other developed countries is that the reason for our growth is due to government spending. 17.4% of our nominal GDP, or $5 trillion USD, is government related spending. The US federal deficit spending amounts to 6% of GDP, which is higher than any time in history outside of the great financial crisis and the covid-19 pandemic. The spending is bipartisan and the US is currently without an adult in the room as it relates to getting spending under control.

The question is 'Does it matter'? In our recent history, our excess spending has not impacted the US government or the consumer given we have had suppressed interest rates for over 15 years (and in many ways it was a benefit). What is concerning at this point is that higher interest rates for the government are here to stay and those higher rates impact the US annual interest cost on outstanding debt which further adds to the annual deficit and total debt load. As discussed in this quarter's fixed income section, these higher rates are normalized. Money should not be free and there should be a cost to borrowing.

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Domestic Economic Overview (continued)

The 'real yield' (nominal 10-year yields less inflation) is currently 0.44%. The historical average since the late 1950's is 1.94%. So the US could have another 1.5% of higher rates to get to the average. That would put the 10-year at 6%. The consumer, as we stated in the last letter, has been shielded thus far from rates given 90+% of homeowners have mortgages below anything resembling the current rates. The government, however, has a wall of debt maturing this year that it needs to refinance in addition to the annual deficit spending which will keep rates higher for longer.

The lag effects of rates have yet to be really felt however delinquencies in auto and credit card debt have been on the rise since 2022 and they currently sit at 7.7% and 8.5% respectively, up from 5% and 4% at the lows in mid-2021. Regardless, the US Consumer continues to power through any concerns. Savings rates remain positive and consumer spending remains 11% above its pre-covid trend line.

International Economic Overview

In general, global macro events tend to put a chill on economic activity. Currently all of the developed world economies, with the only exception being the US, are either in or near a technical recession. This would suggest that the developed world will seek to reflate their economies while the US is still fighting to get inflation down. How do businesses plan for the future given all of the potential conflicts occurring across the globe? Listing out the current conflicts and their escalatory nature adds to our concern about global economic activity. Inflation expectations across the globe are increasing given every activity has inflationary characteristics. The rewiring of international trade, which we've written about in the past, is inflationary. The re-militarization of developed countries is inflationary.

Interestingly, when the Russia/Ukraine war began, Germany only had 2 days worth of ammunition inventory. They, along with every country in the EU, are rearming.

We've discussed China and our concerns about their debt loads and demographics, which remain and will not change. What is interesting is in their Q4 2023 data on economic growth, consumption grew at 4.3% which was in comparison to 1% in 2022. There are economists out there that believe the international economies, both developed and emerging, are primed for growth. If the globe gets a rearming of military combined with cooling conflict tensions, we could see a global economic rebound by other countries that would mirror the US.

Fixed Income

Domestic bond yields moved steadily higher during Q1 2024, heading back toward the recent highs reached in October for short to medium term Treasuries. For example, 5-year Treasury yields moved from 3.84% to 4.22% at quarter end and standing at 4.65% currently in mid-April. Likely fundamentals behind this strength are persistently strong inflation and economic reports along with ongoing Treasury funding supply. Our thoughts continue to be that the range of yields reached over the last year represent more normalized levels compared to the suppressed rates experienced for many years after the 2007-2009 financial markets turmoil.

Spreads to base Treasury yields for most credit sectors except mortgages are relatively narrow, reflecting little concern over potential economic weakness. Mortgage spreads, historically wide, likely reflect abundant supply from traditional market investors, including bank and mutual fund net selling and ongoing government quantitative tightening – runoff of balance sheet mortgage holdings. The residential mortgage market, high in quality, does represent good value despite rising yields and we are participating. In addition, short-term investment grade corporate issues, floating rate preferred stocks, select callable municipals and convertible arbitrage strategies continue to be investable income-oriented themes we participate in and have tended to outperform in the recent rising yield environment. Although how high bond yields may go in the current cycle is guesswork, we do not anticipate rates going back to 2010-2019 levels unless there is dramatic economic weakness, we are positioning our investments in fixed income to capture the available higher current income without risking significant principal if yields move even higher.

Equity Markets

The domestic equity market continued the rally that began last October as investor's belief in sustained economic strength persisted. The breadth of good performing sectors that began to widen in Q4 continued as many stocks in the energy, financial, materials and industrial sectors produced double digit gains and performance in the mega cap technology and communication services sectors, which had been the narrow driver of index performance for most of 2023, continued to rise but at a more modest pace. The S&P 500 (still heavily skewed toward mega cap stocks) rose 10.6%, but large cap value equities rose 9.0% and mid cap stocks of all styles rose between 8.2% and 9.5%. Overall, stocks clearly were able to rise despite higher interest rates, however at some point we will observe the limit of this relationship. We believe that most fundamentally oriented equity investors are incorporating 4-5% risk free rates in their analysis, reflecting what appears to be the normalizing of market yields.

Going forward, overall valuations are still within fair value as earnings have generally risen during 2023 and for the first quarter this year. The risk of rising yields, especially to consumers in the lower half of the income and wealth distribution, is starting to become apparent in some spending reports and credit payment statistics. Some caution is warranted in stock selection and overall equity exposure as a result, and the key will be the state of the labor market. So far that market has remained strong but should be monitored closely. We are still holding a small underweight in our equity allocation compared to long-term averages, but the divergence in individual valuations provides many good purchase and hold opportunities.