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Doug Kass: My 2024 Market Outlook

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There is now a near-universal view -- after a rapid rise in the markets, especially of a Nasdaq-kind -- that stocks are headed higher over the near term and for the full 2024 year.

However, it is important to observe how wrong the confident consensus has been in each of the last two years:

* At the end of 2021, the herd was optimistic. 2022 was a disaster in both the fixed income and equity markets.

* With such a bad experience in 2022, the consensus ended the year wildly confident but this time bearish -- especially on mega tech. And that could not have been further off market as not only did the market rip higher, but tech materially led the way.

* Today the consensus, following the momentum built up in the last three months, is exceedingly bullish -- nary a bear can be found. This is consistent with market technician Helene Meisler's wonderful quote that *"price has way of changing sentiment."*

There is no more reason to expect the herd's optimistic market calls for 2024 to be closer to the mark than those of 2022 or 2023. While the "*group stink*" feeding these forecasts may not qualify as a leading contrary indicator of what we should expect this year, the upbeat consensus forecasts should definitely be taken with a grain of salt.

Count my hedge fund, Seabreeze, today, as we were at the beginning of 2023 -- when we were more upbeat than most -- to be outside the consensus, again. This time we are downbeat when almost everyone else is upbeat.

I see a vast array of unexpected political, geopolitical, economic and market surprises that could be on tap for the New Year.

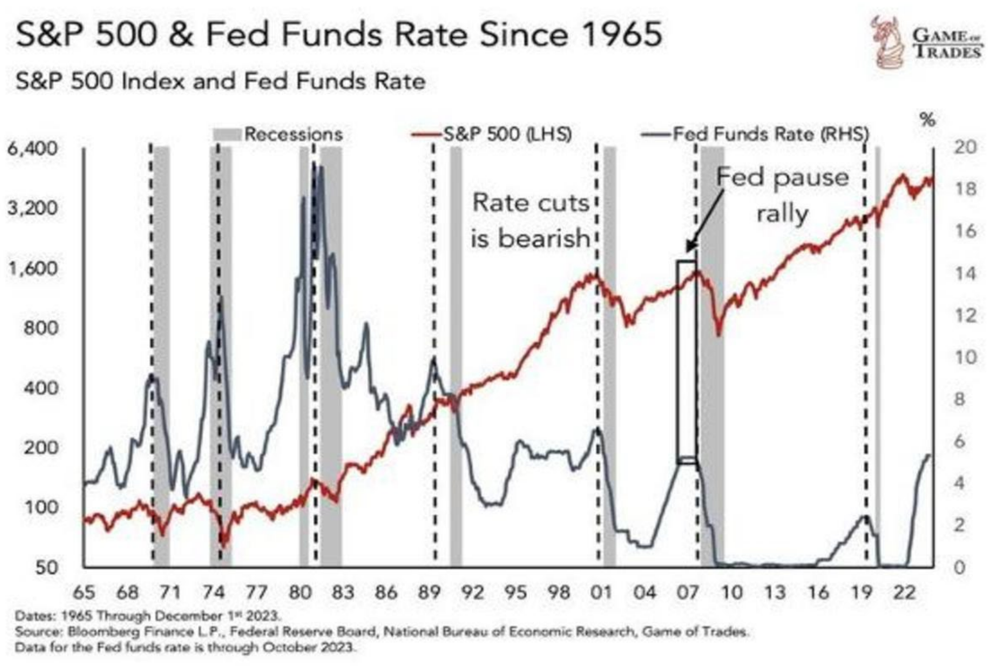
Here are some of my principal concerns:

Equity Risk Premium: Despite the enormity of the drop in yields, the equity risk premium (the S&P earnings yield divided by the risk-free return) is still paper thin - and, historically, this is a reasonable predictor of weak markets. The move higher in stocks in 2023 was mostly a valuation reset - and the specific move in the last two months has entirely been a reset of multiples as the 4Q2023 S&P EPS projections are down -6% from the beginning of the fourth quarter and 2024 S&P EPS forecasts are down by -1% to -2% in the same timeframe.

There is to me, a single-minded preoccupation with lower yields and disinflation. To me Treasury yields are still high relative to the lowly S&P dividend yield (at only 1.45%). Moreover, the S&P dividend yield compares unfavorably to the one-year Treasury bill yielding 4.80% and a three-month Treasury note yielding 5.40% - the gap between the S&P dividend yield and Treasuries is at a multi decade wide.

In other words, a reasonable risk free, nonvolatile, and equity-like return can be achieved in short term Treasuries today. If one goes out further to somewhat more risky credit, fixed income returns are in excess of historic equity returns.

Fed Rate Cuts Are Typically Bearish: It is clear that the Fed's tightening cycle is over. But, as seen in the following chart, it is important to recognize that, over time, policy loosening and interest rate cuts are typically equity market unfriendly:



Geopolitical: As I have cautioned the world is no safer than it was three months ago, six months ago or one year ago. Arguably it is less safe. The *Black Swans of Geopolitics* are being largely ignored despite the danger being equal in my view to just before both World Wars. Indeed, the similarities to 1914 and 1938 are very scary.

Political: Politically we are also in worse shape with an aging President leading the Democratic Party and a multiple times indicted ex-President (likely to represent the Republican Party) contributing to a toxic Washington that has never been more partisan and unequipped or unlikely to compromise in important legislative matters.

Deficit/Debt: On that score the burgeoning U.S. and a $300 trillion global debt crisis are being ignored. Our nation's growing annual deficit and the accumulated debt load (of more than $34 trillion, +500% since 2000) will suppress economic growth:

US National Debt - History (1981 - Today)

National Debt (Trillions $)	% Change Between Milestone	# Days Between Milestone	Date
34	3.0%	105	12/29/2023
33	3.1%	92	9/15/2023
32	3.2%	255	6/15/2023
31	3.3%	245	10/3/2022
30	3.4%	46	1/31/2022
29	3.6%	290	12/16/2021
28	3.7%	151	3/1/2021
27	3.8%	114	10/1/2020
26	4.0%	35	6/9/2020
25	4.2%	28	5/5/2020
24	4.3%	159	4/7/2020
23	4.5%	262	10/31/2019
22	4.8%	333	2/11/2019
21	5.0%	188	3/15/2018
20	5.3%	588	9/8/2017
19	5.6%	427	1/29/2016
18	5.9%	407	11/28/2014
17	6.3%	412	10/17/2013
16	6.7%	290	8/31/2012
15	7.1%	319	11/15/2011
14	7.7%	213	12/31/2010
13	8.3%	197	6/1/2010
12	9.1%	245	11/16/2009
11	10.0%	167	3/16/2009
10	11.1%	396	9/30/2008
9	12.5%	682	8/31/2007
8	14.3%	642	10/18/2005
7	16.7%	688	1/15/2004
6	20.0%	2,195	2/26/2002
5	25.0%	1,241	2/23/1996
4	33.3%	914	9/30/1992
3	50.0%	1,370	3/31/1990
2	100.0%	1,642	6/30/1986
1			12/31/1981

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The rapidly expanding U.S. debt bill (observed above)- impacted by unprecedented political partisanship and our government's uncompromising policy - is being ignored by both parties as reflected in the expansive, unfocused and undisciplined fiscal policies maintained in the last decade. But, this is an obligation that must be paid.

With global debt growth accelerating at an alarming rate, markets are rallying on expectations of lower interest rates, lower inflation, and strong economic growth, a jigsaw puzzle whose pieces fundamentally don't fit together. Lower inflation and lower interest rates point to slowing economic growth and lower corporate profits which are inconsistent with forecasts for new stock market highs. But a foolish consistency is the hobgoblin of little minds in the ZIRP/QE era, and having crossed the Rubicon into that era, we can never cross back.

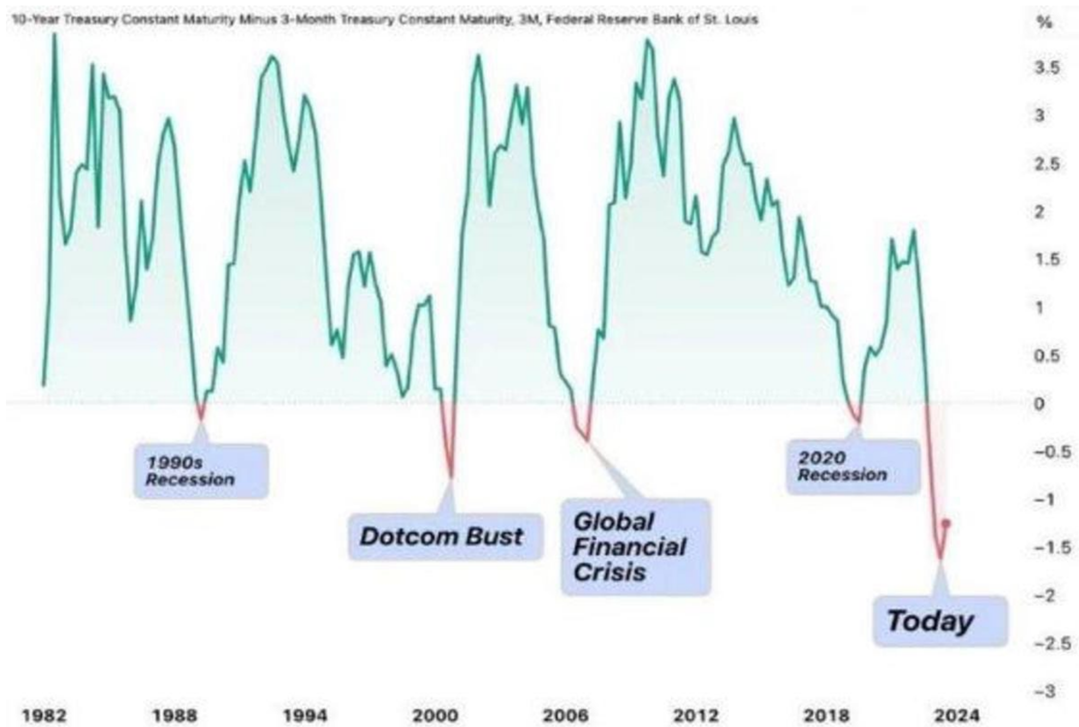
The world's debt load represents an existential threat to the global economy. That debt can never be repaid in constant dollars - it can only be addressed by defaults, inflation, and currency devaluation. The day of reckoning for this intensifying crisis is moving closer due to the exponential nature of debt. Investors who ignore this looming threat will suffer terrible consequences in the future; those who factor it into their investment decisions will better protect themselves and even prosper. But make no mistake about it - there is no way to avoid the debt crisis. Ignoring it is not an option and is the equivalent of financial suicide for anyone who sticks his or her head in the sand.

Economic And Corporate Profit Growth Expectations Are Inflated And Inflation Will Remain Sticky: As it relates to a consumer-driven domestic economy, the stacked or cumulative rise of well over 20% in prices since 2020 will likely weigh on both economic and corporate profit growth over the next several years. We are less concerned about a recession this year than an extended period of market unfriendly *slugflation* (sluggish economic growth and sticky inflation).

The likely future condition of *slugflation* could deliver a sustained period of higher interest rates than expected - providing both fundamental (debt rollover challenges) and valuation headwinds. (See Howard Marks' explanation of this "Sea Change" later on in our commentary.)

Meanwhile, back to the current situation in which the lingering period of curve inversion (in which short term interest rates have been above long-term interest rates since early 2023) represents a noteworthy valuation threat to equities - that has been dismissed by many.

The last four times the Ten-Year Treasury note yield minus the Three-Month Treasury bill yield inverted, it led to the 1990s recession, the Dotcom Bust, the Global Financial Crisis and the 2020 Recession:



Market Structure: The action in the last three months is proof positive that markets no longer move based on fundamental economic logic. Instead, they are driven by liquidity, flows, momentum and an extremely short-term oriented psychology which is reflected in the popularity of ODTE (zero days to expiration options) that today account for more than 60% of total options trading activity daily. Macro rules markets but not in the sense of traditional macroeconomics but the new macro-structure of markets.

A Sea Change

Back last year, my friend Oaktree Capital's Howard Marks reflected upon an economic *"sea change"* he expected in the next decade. We agree with his thesis (which has bearing on our investing strategy and tactics), the upshot of which is:

> *- The period from 1980 through 2021 was generally one of declining and/or ultra- low interest rates.*
>
> *- This had profound ramifications in many areas, including determining which investment strategies would be the winners and losers.*
>
> *- That changed in 2022, when the Fed was forced to begin raising interest rates to combat inflation.*
>
> *- We're unlikely to go back to such easy money conditions, other than temporarily in response to recessions.*

- Therefore, the investment environment in the coming years will feature higher interest rates than those we saw in 2009-21.

- Different strategies will outperform in the period ahead, and thus a different asset allocation is called for.

Where I Erred

Since I have been directionally wrong over the last sixty days, I would be remiss (and it would be arrogant of us) if I didn't review why I have been wrong directionally and what I might have missed over the last sixty days:

* I underestimated the animal spirits and price momentum that accumulated during November and December.

* I underestimated the power of the herd - as the pressure to the upside intensified, so did FOMO (the fear of missing out).

* I underestimated the contribution that market structure would have in terms of intensifying the upside to equities - specifically, quant strategies that worship at the altar of price momentum catalyzed the market advance. Active managers came along for the ride. In essence, we live in a world where *buyers live higher, and sellers live lower.*

* The same applies to interest rates, as the momentum of yields to the downside accelerated, there was more and more buying (and lower yields) on fixed income products.

* I thought interest rates would decline but we underestimated the valuation reset higher in equities even in the face of weakening high frequency economic data.

* I overestimated the concerns that would accompany lower interest rates and did not anticipate the possibility that price earnings multiples would expand to the degree they did.

Nonetheless, given the headwinds cited in this commentary, it is my strong (and non-consensus) conviction that the market's upside reward is now likely dwarfed by the downside risk.

Summary

Christmas came early to Wall Street in 2023, but a New Year's Eve hangover may lie ahead.

Currently the S&P Index is near a record high and "Goldilocks" thinking has been embraced by many market participants as a number of consequential market headwinds are being materially ignored.

I have often seen the acceptance of "Goldilocks" played out many times over the course of my investing career. But "Goldilocks" and a perfect outcome are rarely sustained for very long as ideal scenarios often fail to emerge.

More significantly one important effect of "Goldilocks" is that it leads to high investor expectations and room for potential disappointment and losses.

FT Unhedged recently expressed a similar view:

> *Yesterday's letter suggested that we think the market's current expectation of solid growth and six rate cuts seemed likely to be wrong in one direction or the other: either strong growth will limit the Fed to close to the three rate cuts it currently forecasts, or growth will be weak and there will be as many cuts as the market expects. In this sense, the market does look to be pricing in too much good news.*

There are two important things to keep in mind with respect to market and economic forecasts:

* There is often an inverse relationship between the degree of confidence with which a forecast is delivered and the ultimate accuracy of that forecast.

* Forecasts often say more about the forecaster than the object of the forecast. To borrow a phrase from William Butler Yeats' *Among School Children* - we often can't distinguish the dancer from the dance:

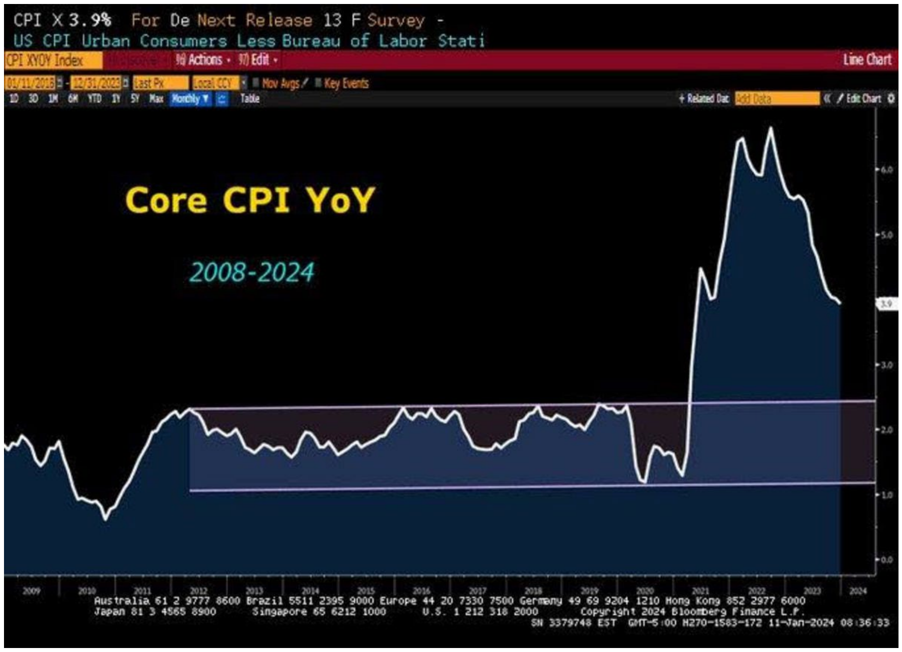
Labour is blossoming or dancing where
The body is not bruised to pleasure soul,
Nor beauty born out of its own despair,
Nor blear-eyed wisdom out of midnight oil.
O chestnut tree, great rooted blossomer,
Are you the leaf, the blossom or the bole?

O body swayed to music, O brightening glance,
How can we know the dancer from the dance?

In a world filled with war, debt and political and geopolitical instability, general uncertainty of economic and profit outcomes and a "sea change" in interest rates -- bullish economic, corporate profit and market forecasts should be strenuously questioned. When those forecasts are almost uniformly bullish, as is the case today, they should be harshly interrogated.

Importantly, the markets are likely underestimating the inflation risks and, therefore, probably overestimating the amount of cutting by the Federal Reserve that is going to take place. Specifically, it is my continued view that wage inflation will likely remain sticky:

Based on the likelihood that wage inflation will remain stubborn (and other factors), we believe inflation will be sticky (literally and figuratively) - and the disinflationary process will get harder from here relative to consensus expectations.



Here are two analogs regarding the difficulty in taming inflation:

* Eradicating inflation is like spilling a cup of coffee on your car's seats. Once it gets in the car seats it's awfully hard to clean up.

* Eradicating inflation is also like trying to diet and lose 20 lbs. The first ten are easy to lose, the next ten are far more difficult. (This might also help to explain why I have been taking Ozempic for the last thirteen months - and, in the process I have lost 50 lbs!)

Regardless, as noted in the body of this letter, rate cuts historically have been bearish for equities.

Finally, valuations are extremely high with most historic metrics (price/book, price/earnings, enterprise/cash flow value, etc.) in over the 90%-tile:

For now, I have a keen eye towards managing capital conservatively, structuring my hedge fund's (Seabreeze) portfolio defensively by positioning mainly in pairs trades and through opportunistic trading - with a net short bias.

Markets don't dictate my exposure - we are dispassionate in the investing process.

Despite the intensity of the market's current momentum to the upside and the emotional unleashing of animal spirits I manage money dispassionately based on the calculus of upside reward v downside risk with an eye towards "margin of safety."

I am disciplined, always seeking value: I don't chase strength solely in order to participate.

It is my continued expectation that we will get a buying opportunity from lower levels sometime this year.