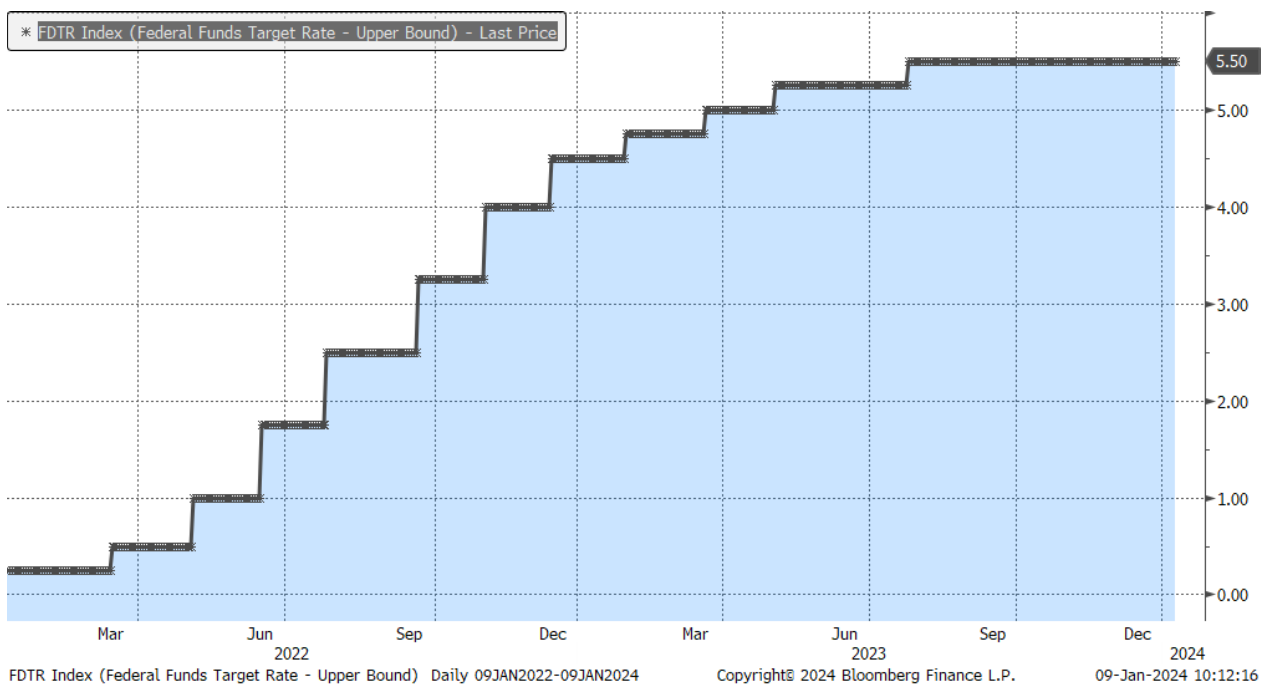
Be Alert and Adaptable in 2024

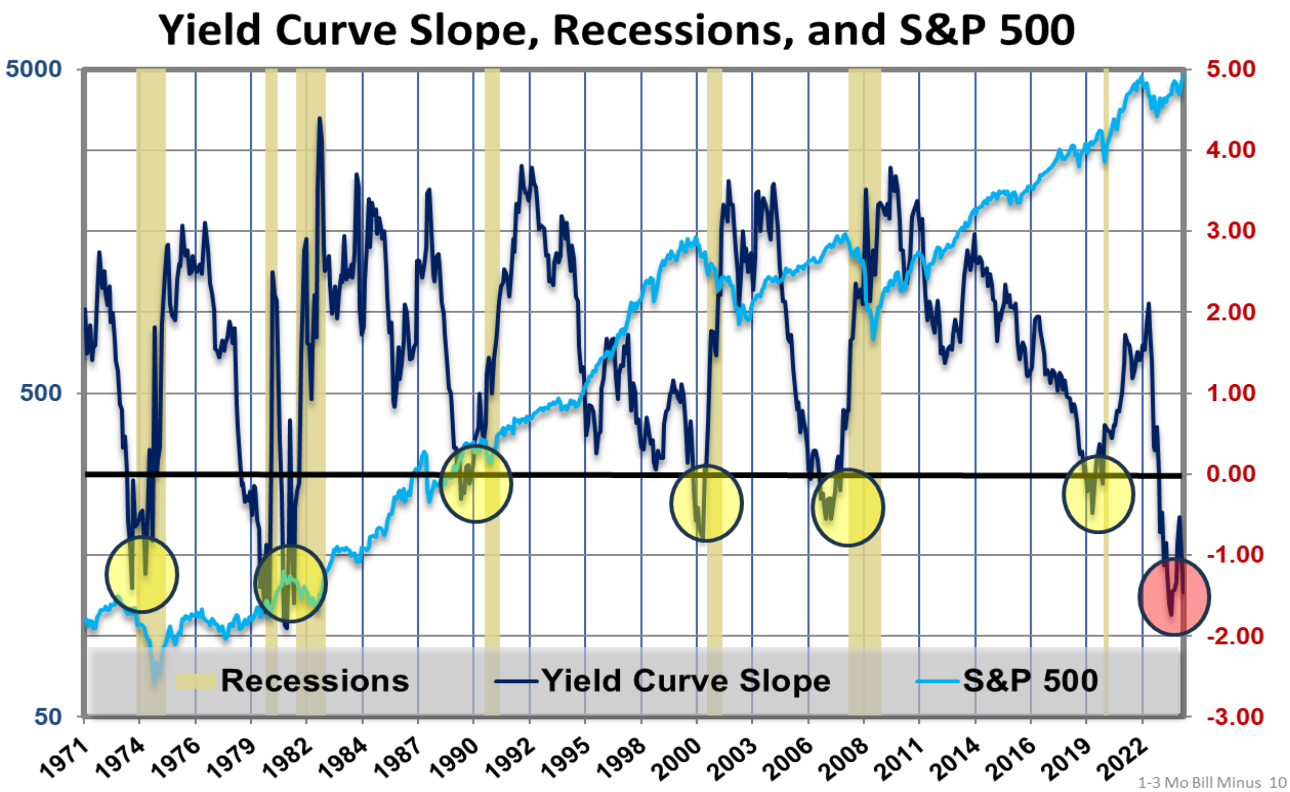
To combat inflation, the Federal Reserve aggressively raised the Fed Funds rate 11 times, from essentially 0.00% in March 2022 to 5.50% in July 2023. The San Francisco Federal Reserve Bank's proxy Fed Funds rate, adjusted for quantitative tightening (QT), is a highly restrictive 6.3%. The Fed is still trimming its $7.7 trillion balance sheet, already down approximately $1.3 trillion from its peak in 2022, sharply reducing the money supply. We believe it is done hiking interest rates and will likely start cutting the Fed Funds rate some time in 2024. It is not clear when it will stop shrinking the balance sheet.

These policy shifts have already had a marked impact on interest rates and the stock market. The ten-year Treasury bond peaked at 5% on October 19 and has since declined 100 basis points to about 4%. This sharp drop in interest rates also sparked a strong stock market rally of about 16% from late October to year-end. However, it is unlikely that longer-term interest rates will continue to decrease at their recent pace, and we also doubt that the stock market rally can maintain its recent momentum.

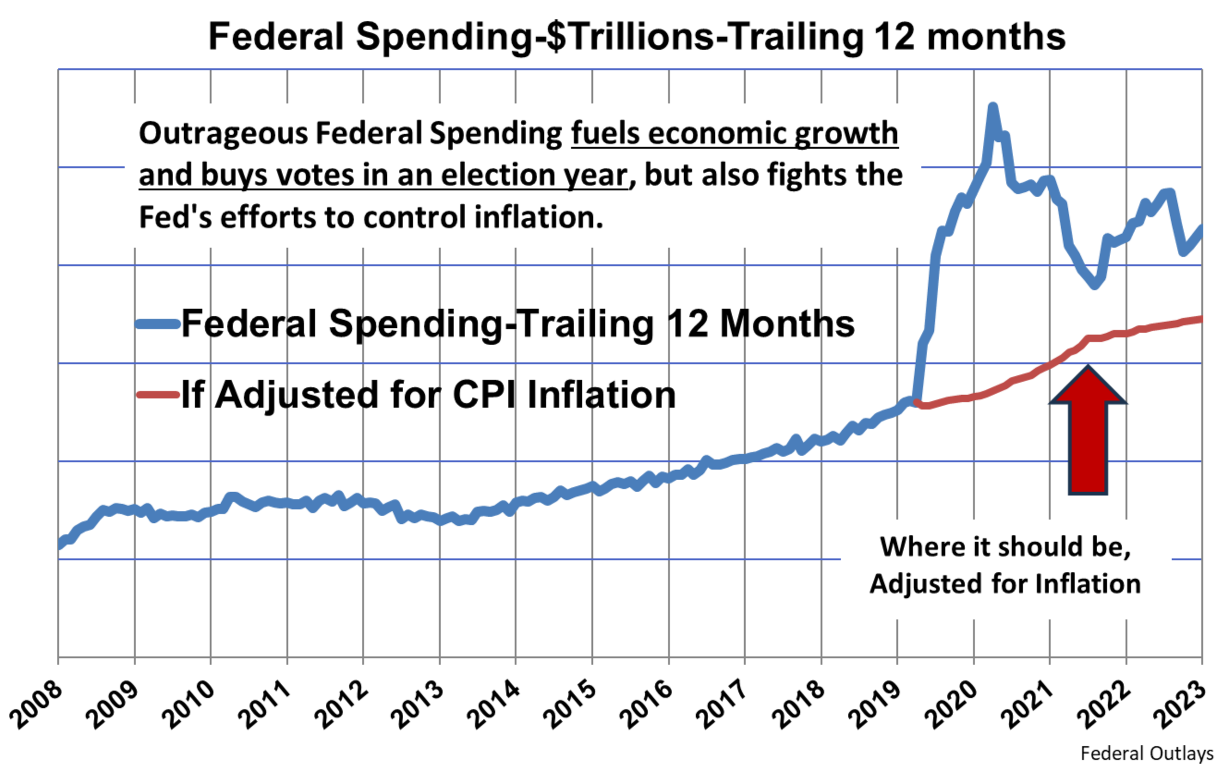
Geopolitical politics, the conflicts in Ukraine and the Middle East, and the U.S. Presidential election make it hard to predict outcomes. Overall, 2024 is shaping up to be a year of significant political, economic, and market transition, creating risks and uncertainties as well as opportunities for investors to evaluate, adapt, adjust, and potentially prosper as 2024 unfolds.

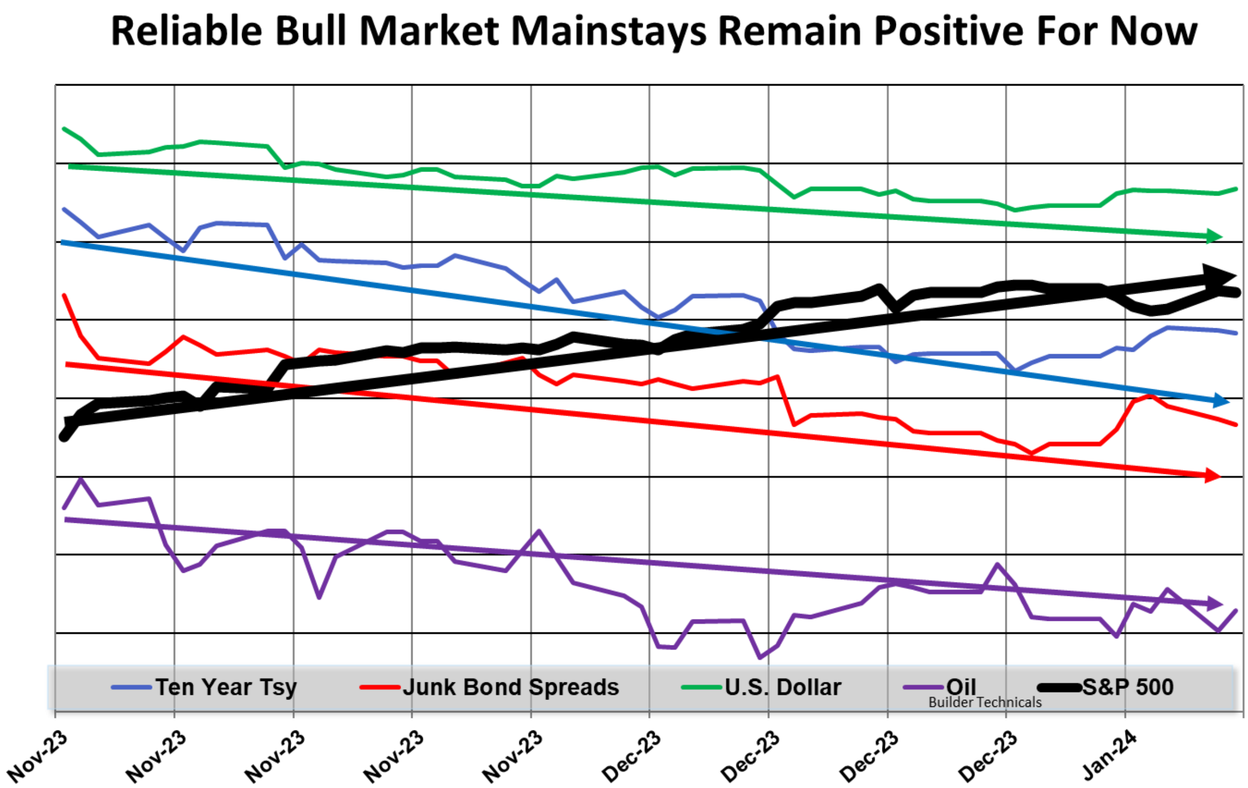
The Fed funds rate has remained at 5.5% since July 2023, possibly marking a peak for this tightening cycle. Fed officials have hinted they will pivot to rate cuts in 2024 (see exhibit below).



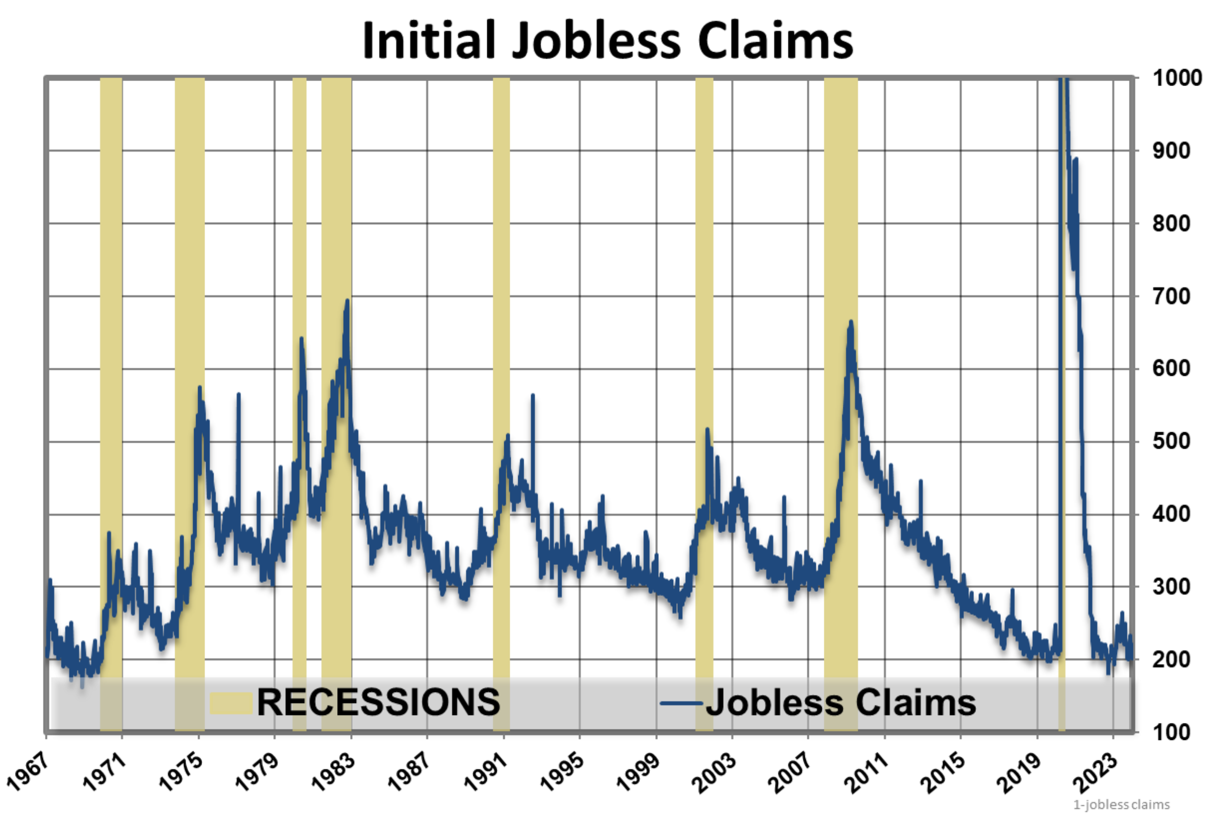


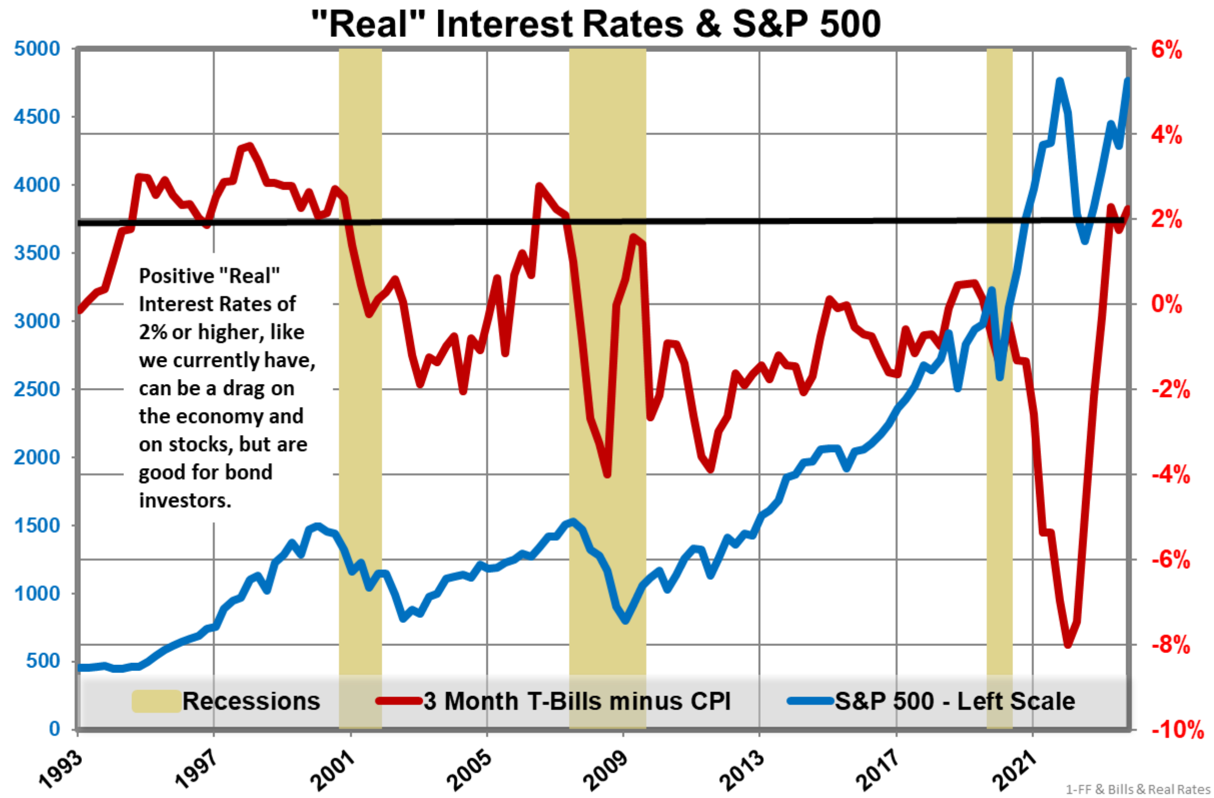
While inflationary federal outlays in this election year may postpone a recession for a while (see exhibit below), history tells us, with 100% certainty going back to 1970, that one is on the horizon, possibly in late 2024 (see exhibit above).



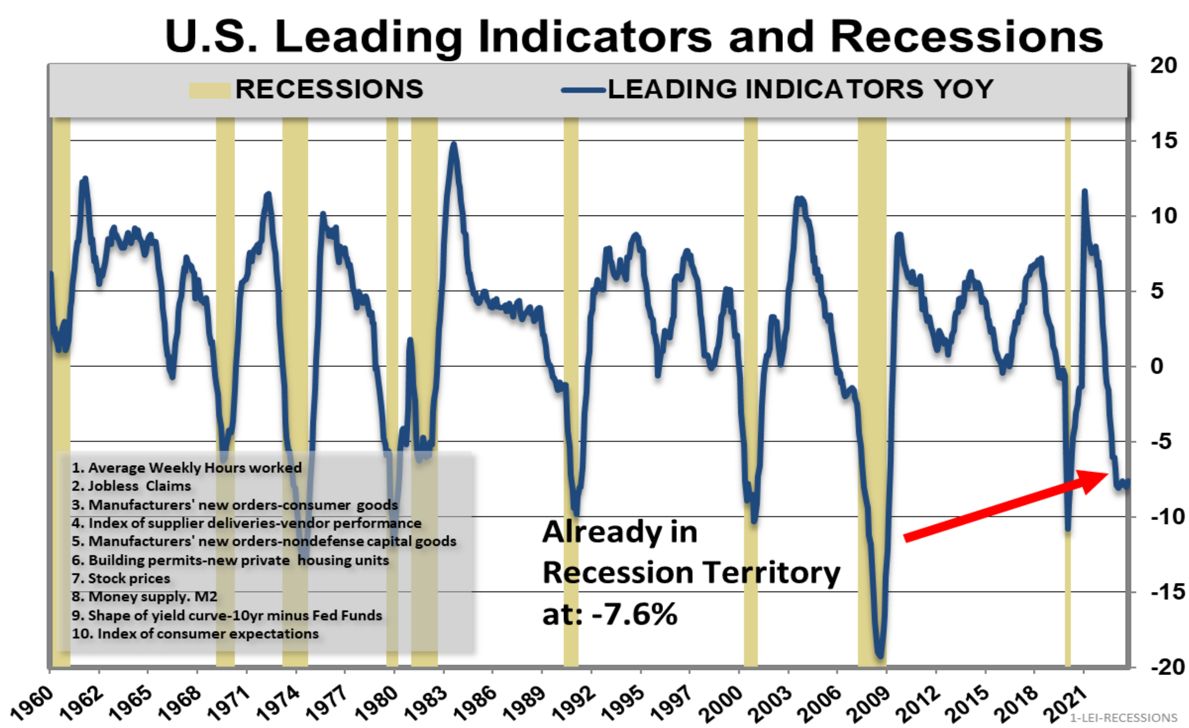


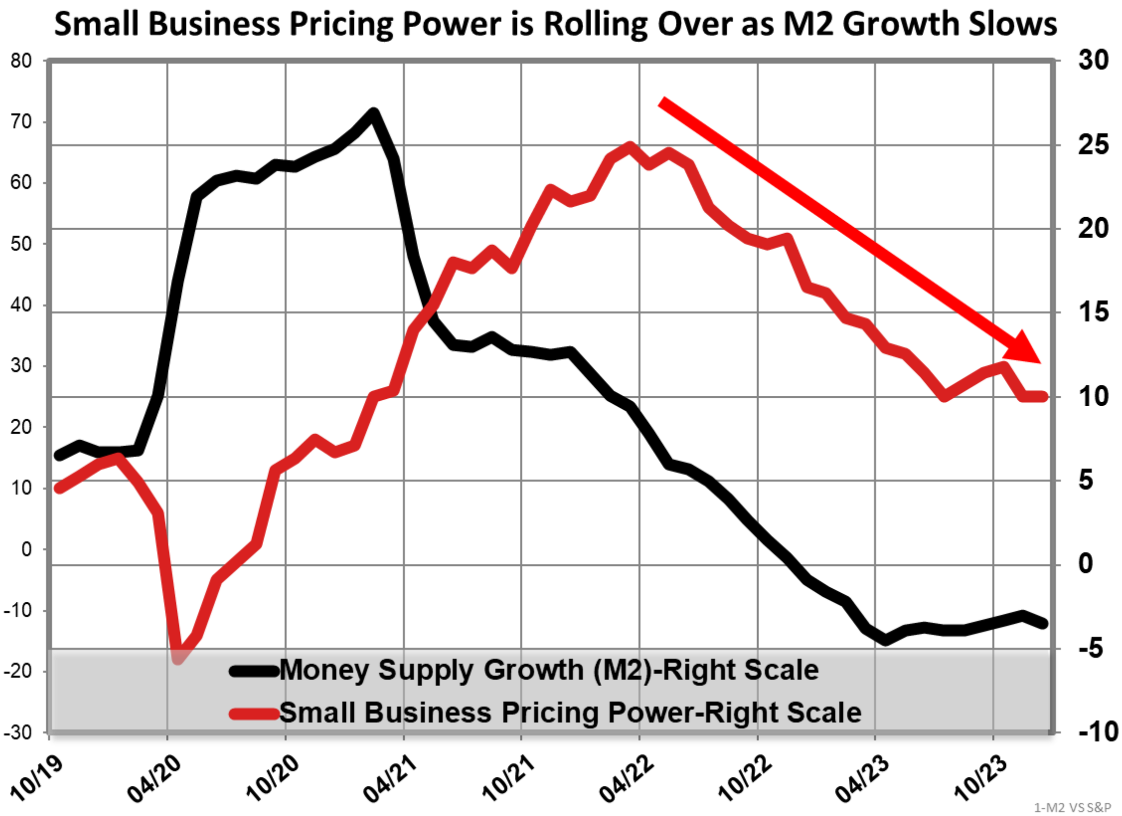
Reliable bull market mainstays (see exhibit above) and historically low jobless claims have a positive correlation with an appreciating stock market and robust economy (see exhibit below).



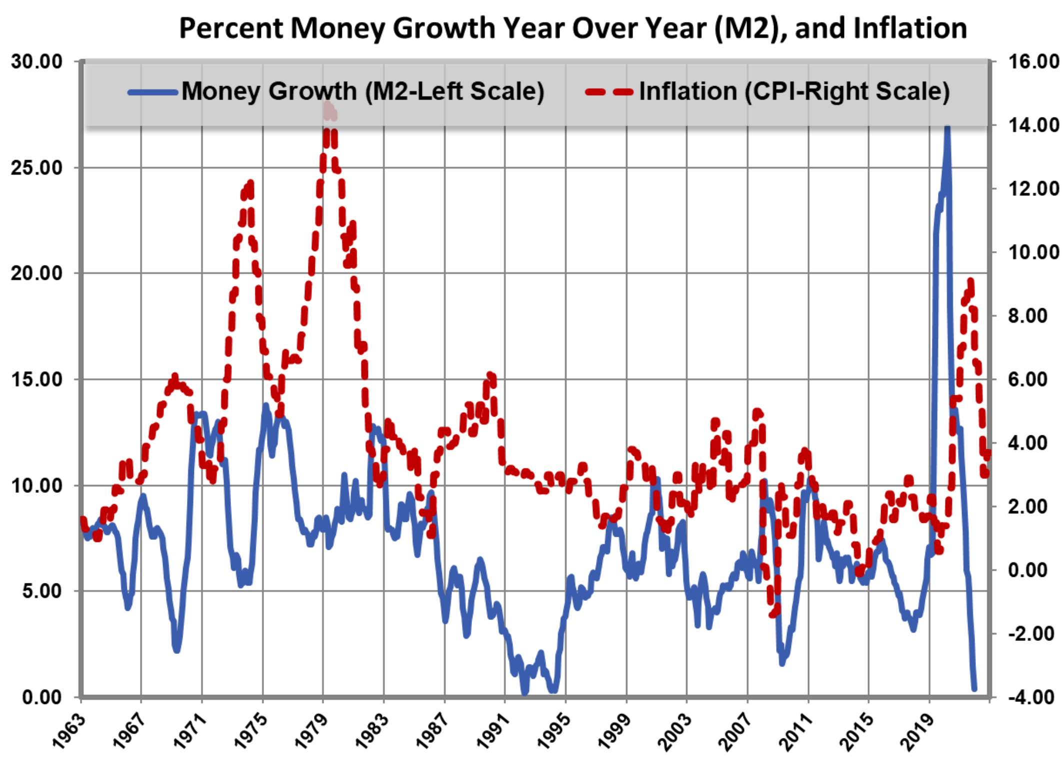


But positive "real" interest rates (which are good for bond investors, but negative for borrowers and the economy-see exhibit above) and Leading Indicators (see exhibit below) both point towards an economic slowdown.





Quantitative tightening reduces the amount of money circulating in the economy, lowering inflation but also making it harder for consumers to borrow and spend (see exhibit below). This can dampen demand, making it tough for businesses to raise prices (see exhibit above).



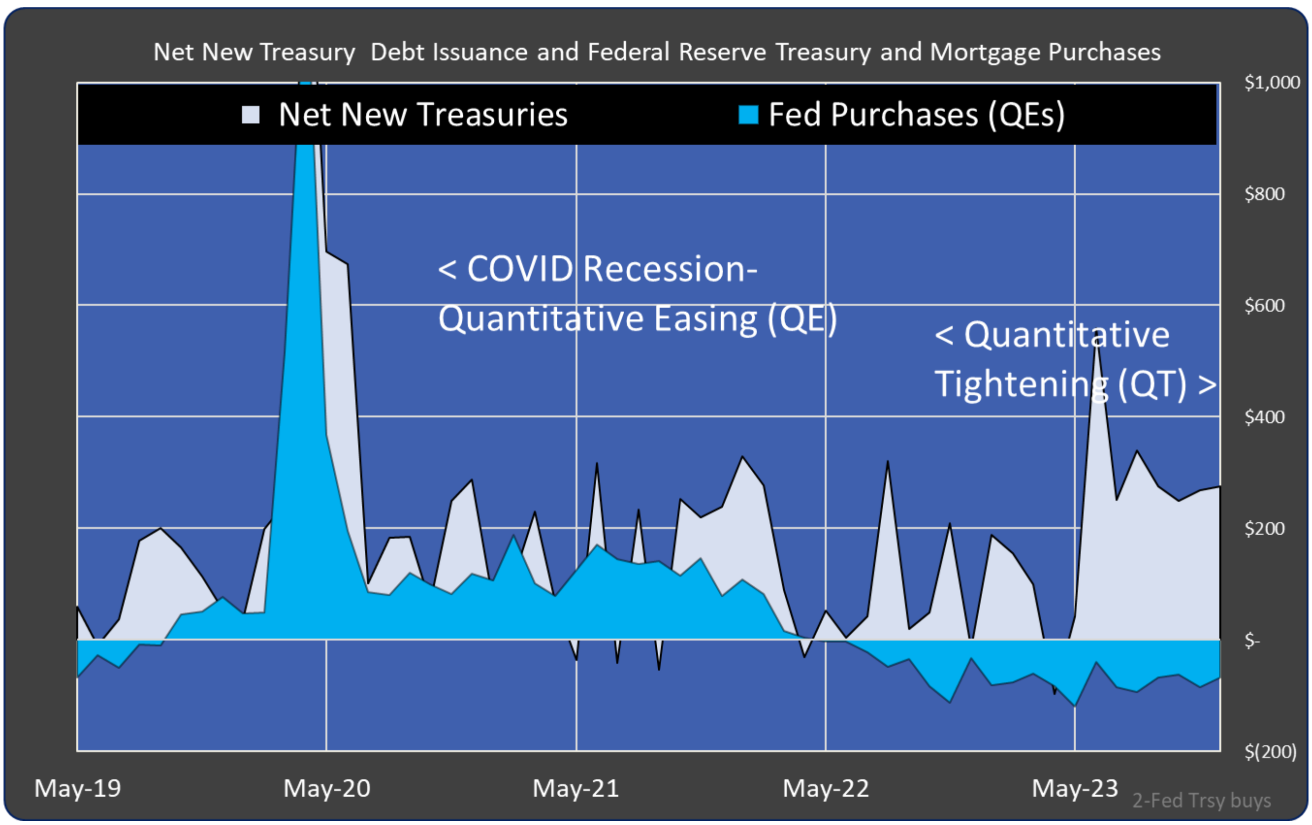
Our Advice: Bolster Portfolios With Still Attractively Priced, Carefully Selected Bonds

Bonds offer a <u>certain return</u> and can be a wise investment in <u>uncertain times</u>. Bonds are typically less volatile than stocks, and they can provide a guaranteed return, as well as a steady stream of income. However, it is important to choose the right types of bonds that match your investment goals and risk tolerance.

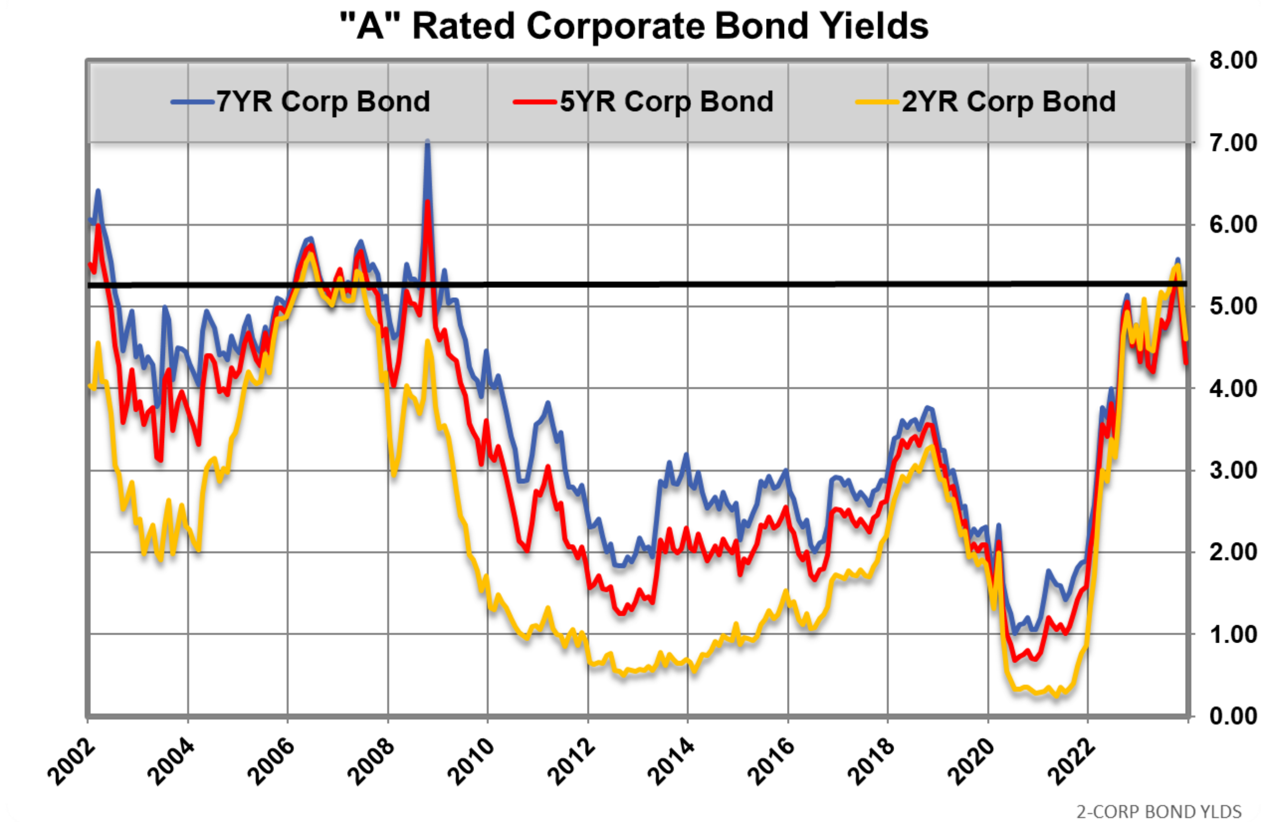
- **Treasury bonds**, issued by the US Government, are the highest quality and most liquid bonds. <u>You do not pay state tax on Treasury bonds, so their after-tax return is often greater than illiquid bank Certificates of Deposit (CD's).</u>

- **Corporate bonds,** issued by companies, can offer a higher yield than Treasury bonds, but they carry more risk. They are also subject to federal and state income tax. Still, they may be a good option for investors in tax-free accounts, such as IRAs and 401(k)s.

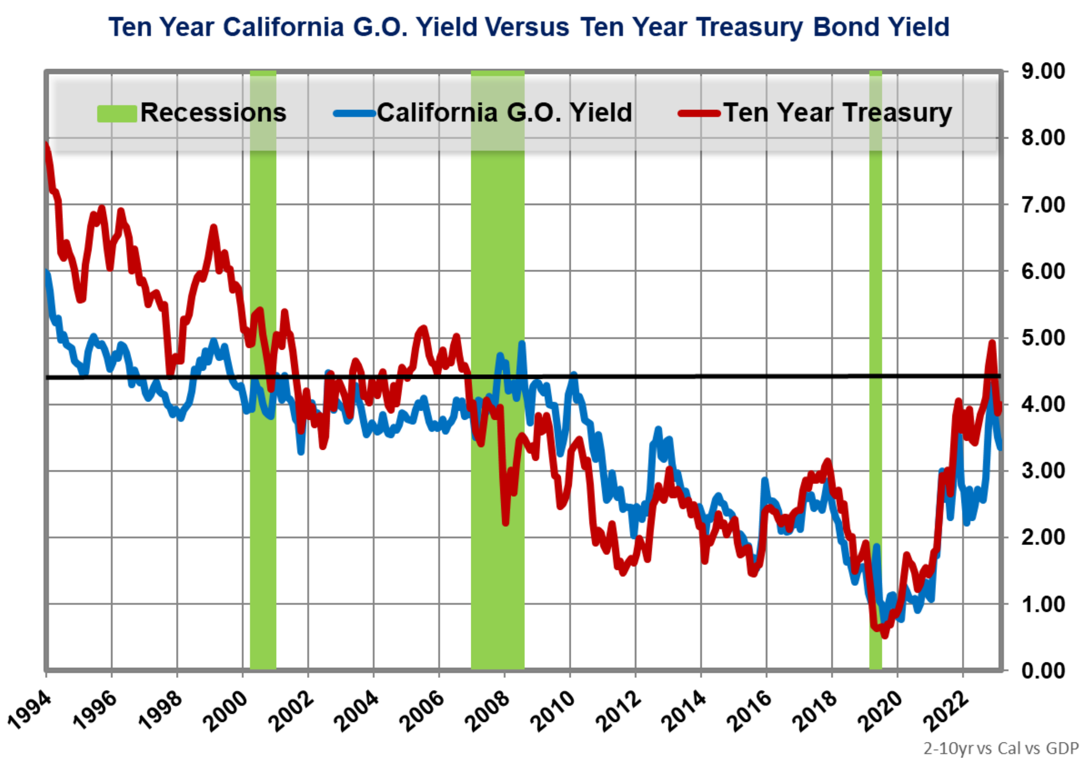
- **Municipal bonds,** issued by state and local governments, and they are exempt from federal and state income tax. For investors in high tax brackets, especially those living in high-tax states, municipal bonds can offer the best after-tax return.

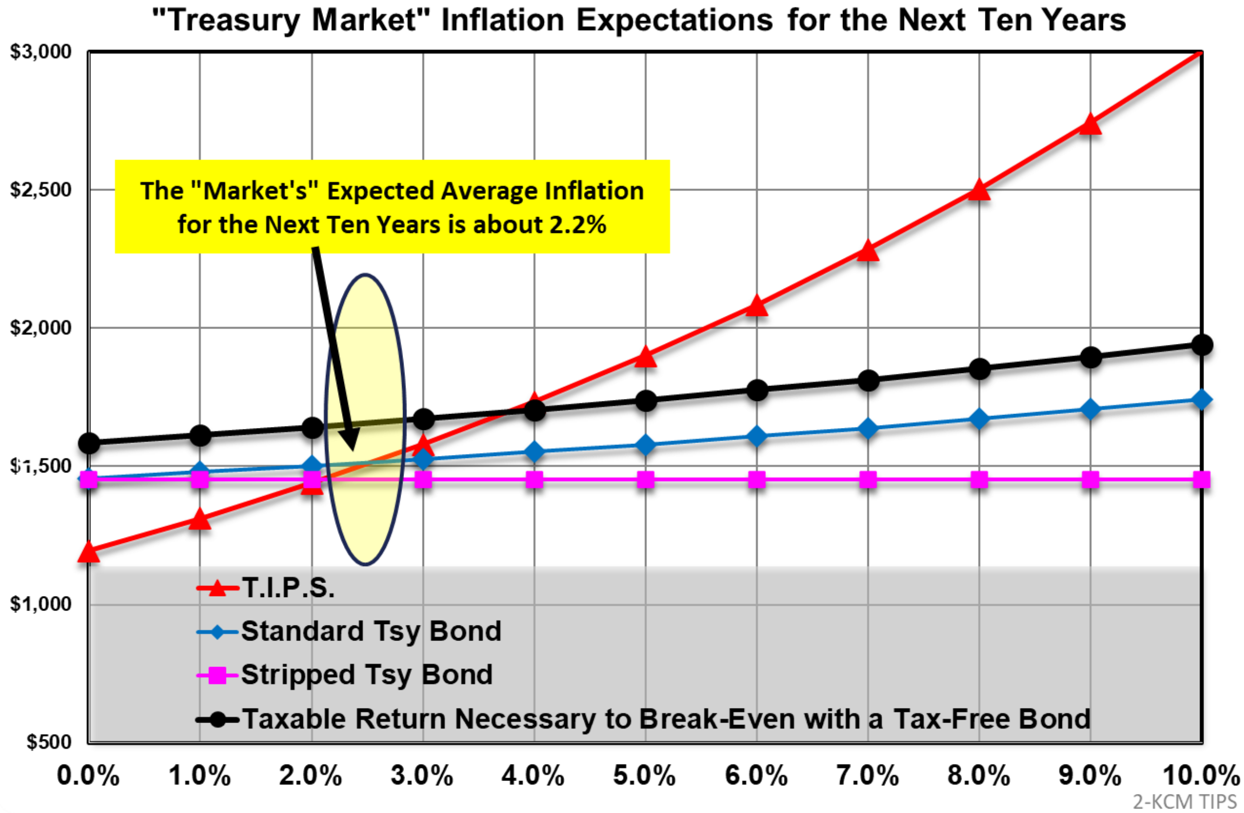


Massive Treasury debt issuance (see exhibit above), combined with the Fed's quantitative tightening (QT), can put upward pressure on bond yields. QT is the Fed's process of both selling assets from its balance sheet and also not reinvesting the proceeds from maturing assets into new Treasury issuance.

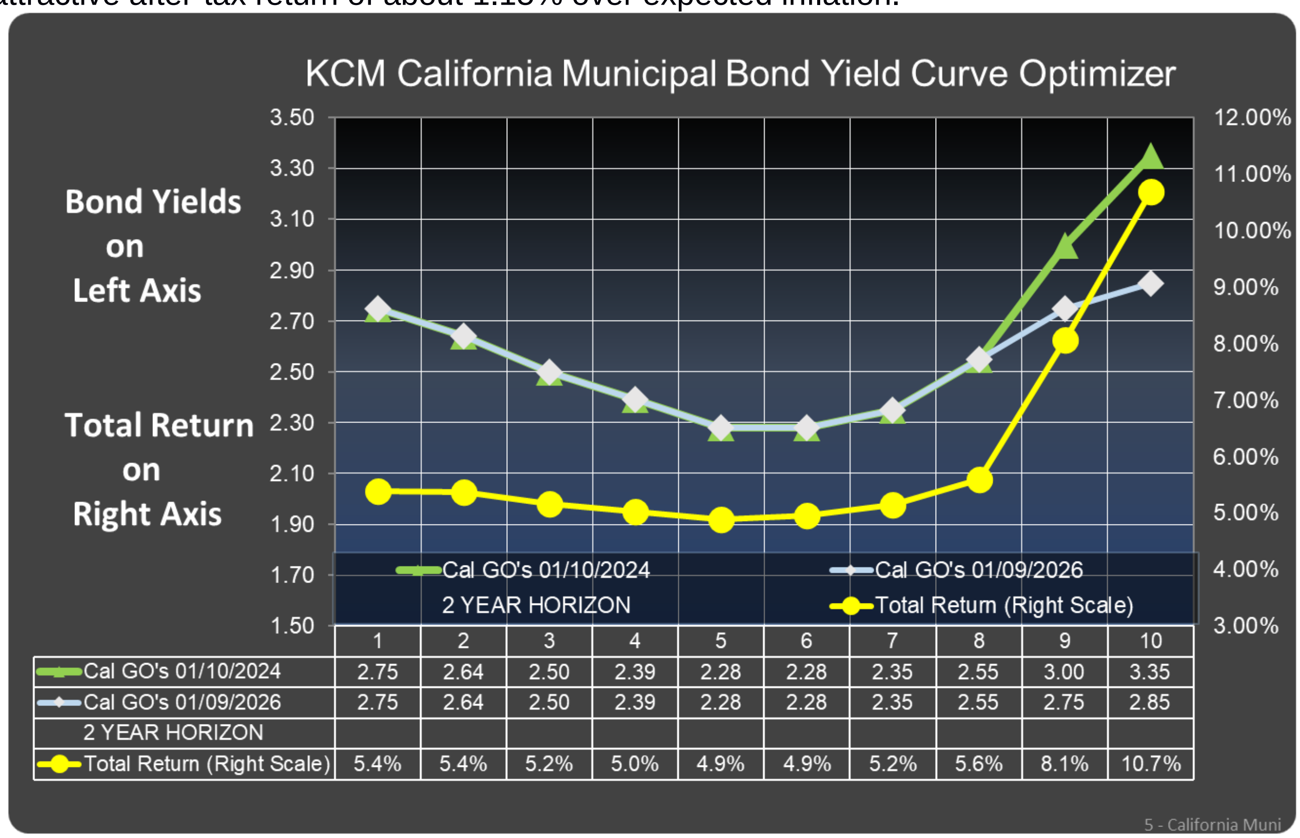


The last time corporate bond yields were at today's level was 2007 (see above), the same year we saw Treasury bond and municipal bond yields as high as they are now (see below).





The market expects about 2.20% annual inflation rates for the next ten years (see exhibit above). Bonds with a 10-year call yield about 3.35% (see exhibit below), giving investors a still attractive after-tax return of about 1.15% over expected inflation.



	1	2	3	4	5	6	7	8	9	10
Cal GO's 01/10/2024	2.75	2.64	2.50	2.39	2.28	2.28	2.35	2.55	3.00	3.35
Cal GO's 01/09/2026	2.75	2.64	2.50	2.39	2.28	2.28	2.35	2.55	2.75	2.85
2 YEAR HORIZON										
Total Return (Right Scale)	5.4%	5.4%	5.2%	5.0%	4.9%	4.9%	5.2%	5.6%	8.1%	10.7%

Wrapping up: Investors Will Need to Be Alert and Adaptable

The new year is shaping up to be a year of transition. The Fed's shift from aggressive QT to a more neutral or even easing stance would significantly impact market dynamics. Lower interest rates could boost borrowing and investment, potentially revitalizing economic growth. With 2024 being a Presidential election year, another layer of uncertainty is added. Political rhetoric and policy proposals can influence investor sentiment and market movements. The outcome of the election could have wide-ranging economic and regulatory implications. The ongoing conflicts in Ukraine and the Middle East remain potent threats to global stability and supply chains. They can lead to energy price fluctuations, economic disruptions, and heightened market volatility. The unpredictable nature of these conflicts adds to the uncertainty.

As a possibly volatile 2024 unfolds we need to observe, evaluate, adapt, and adjust to changing conditions in order to prosper. The economic outlook is rarely black and white. While the current situation presents both challenges and opportunities, staying informed and adapting our strategies accordingly can help us navigate the uncertainties and potentially thrive in the evolving uncertain economic landscape.

History, Going Back to 1970, Strongly Suggests that a Recession Looms

Inflationary federal outlays may postpone a recession, stimulating the economy by boosting demand for goods and services. This can enhance economic growth, reduce unemployment, and lift wages and stock prices. But they can also lead to higher inflation and interest rates, as government spending fights the Federal Reserve's efforts to reduce inflation by raising interest rates and taking money out of the system. This could force the Fed to raise interest rates and pare the size of its balance sheet more than it might like. Ultimately, whether federal outlays can postpone a likely recession is a matter of debate. There is no guarantee that they will be successful, although they may be able to delay a recession for some time, perhaps until after the 2024 election. What is important to note is that over-the-top federal outlays incur risk.

The Bull Market May Continue for a While

Several reliable bull market mainstays sustained the stock market run-up that extended from the end of third-quarter 2023 through year-end and may continue to support stock prices well into 2024.

- **Falling interest rates.** Lower interest rates make it cheaper for businesses to borrow money and invest. They also make it more attractive for investors to buy stocks and other risk assets.

- **Junk bond Spreads.** Declining junk bond spreads can be a sign of a strong economy. When the economy is doing well, the perceived risk of default for low-quality borrowers diminishes, narrowing the spread between their yields and those of safer alternatives like Treasuries.

- **A weak dollar.** A weak dollar makes U.S. exports more competitive and imports more expensive, which can boost U.S. corporate profits and economic growth.

- **Declining oil prices.** Oil is a major input cost for consumers and most businesses, so falling oil prices can increase consumers' discretionary spending and reduce costs.

- **Historically low jobless claims**. Low jobless claims signify high employment and a healthy economy**.** This means more people are working, contributing to the economy, and earning an income. In turn, this can boost consumer spending, which enhances economic growth.

Good News, Bad News

Positive "real" interest rates mean bond investors will earn returns that outpace inflation, protecting their purchasing power over time. This can be particularly attractive for savers and retirees who rely on fixed income investments. On the other hand, businesses and individuals face higher "real" interest rates on loans, making it more expensive to borrow for investment, expansion, or simply covering expenses. This can dampen economic activity and slow down growth.

We note that U.S. Leading Indicators are already in deep recession territory, possibly portending an economic slowdown some time in 2024.

Quantitative tightening has slashed the money supply, and its growth rate has turned negative. Lower money supply can reduce credit availability and dampen consumption, constraining small business's ability to raise prices.

There is also a good correlation between the money supply and inflation: as the money supply drops, so does inflation.

We Still Say Bonds Are One Way to Go in 2024

A smart investment approach in these uncertain times is to take advantage of bond yields that we last saw 15 years ago by adding attractively priced taxable and tax-free bonds to your portfolios. Bonds are typically less volatile than stocks and offer a guaranteed return. Market expectations for inflation over the next ten years are about 2.20% annually. Ten-year municipal bonds yield about 3.30%, giving investors an attractive after-tax return of about 1.1% over expected inflation.

May 2024 Be a Healthy, Happy and Prosperous Year for You!

As always, we are glad to meet with you to address your questions or concerns, and we thank you for investing with KCM. It is our constant goal to exceed your expectations.

Jay Kellett
Founder and CEO

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- All graphs were produced by KCM using data from Bloomberg.
  Bloomberg is also the source of the stated economic data.

Security Awareness

As you know, protecting your assets and data is priority number one for our firm. Last quarter, we implemented a new secure email protocol here at KCM. Any email your receive from KCM that includes sensitive information about your account will be encrypted. Please see below to learn how to setup your KCM Secure Portal to send and receive encrypted emails or paperless billing going forward. By reviewing this information, maintaining best practices, and exercising caution in your online activities, we can work together to keep your assets safe.

Secure Emails from KCM

KCM has implemented a new secure email protocol to protect your account numbers and other sensitive information. Once you receive your first encrypted email, you will be prompted to setup your username and password for the secure portal. Once established, you can use these credentials to access encrypted emails going forward. Please reach out to us to get started, and/or if you have any questions.

Best Practices

• **Add a Trusted Contact to your Schwab Account(s)**. A Trusted Contact is someone who may be contacted about you and your accounts. For example, a family member or friend. If KCM or Schwab suspects strange activity on your account, we can contact this person in the event we can't reach you. Ask us about completing a Trusted Contact form or login to Schwab Alliance to update your account(s).

• **Keep us informed** regarding changes to your personal information.

• **Be suspicious** of unexpected or unsolicited phone calls, emails, and texts asking you to send money or disclose personal information. If you receive a suspicious call, hang up, then call them back, using a known contact number.

• **Be cautious when receiving money movement instructions via email.** Call the sender at their known number (not a number provided in the email) to verbally validate all instruction details before following instructions or providing your approval.

• **Verify payment requests you receive by phone or email.** Requests for payment using gift cards, prepaid debit cards, or digital currency are frequently associated with fraud or scams.

• **Be cautious when sharing sensitive information** and conducting personal or confidential business via email because it can be compromised and used to facilitate identity theft.

• **Do not disclose on social media** sites personal or sensitive information, such as your birth date, contact information, and mother's maiden name.

If you suspect a scam or a breech of security of any kind, immediately contact our firm at 415-461-7788 or Schwab Alliance at 800-515-2157. We are eager to help you, especially when it comes to your security.