Market & Portfolio Commentary

Q1 2024

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First Quarter Market Review and Commentary

The market rally continues and broadens as multiple expansion drives gains despite stubborn inflation and attention remaining focused on the Fed's actions.

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Wall Street is having a strong start to the year as optimism about a soft landing for the U.S. economy fuels bullish sentiment. Resilient corporate profits, enthusiasm around artificial intelligence developments, and the hopes that the Federal Reserve is on track to begin cutting rates are some of the reasons for the strong start. The S&P 500 index surged 10.2% during the first quarter, its best start since 2019 and the 14th-best start to the year in history. The Nasdaq index wasn't far behind, advancing 9.3%, and the Dow Jones Industrial Average ended the quarter up 5.5%. Small caps, measured by the Russell 2000 Index, finished the quarter up 4.3%

Unlike last year's stock market performance, which was mostly fueled by the stocks of seven large companies, this quarter's market strength was broad. All but one of the 11 sectors of the S&P 500 have risen, and more than half of the stocks in the S&P 500 have reached 52-week highs. The dominance of the "Magnificent Seven" (Alphabet, Meta, Microsoft, Amazon, Nvidia, Apple, and Tesla) faded with steep pullbacks in Tesla and Apple during the quarter.

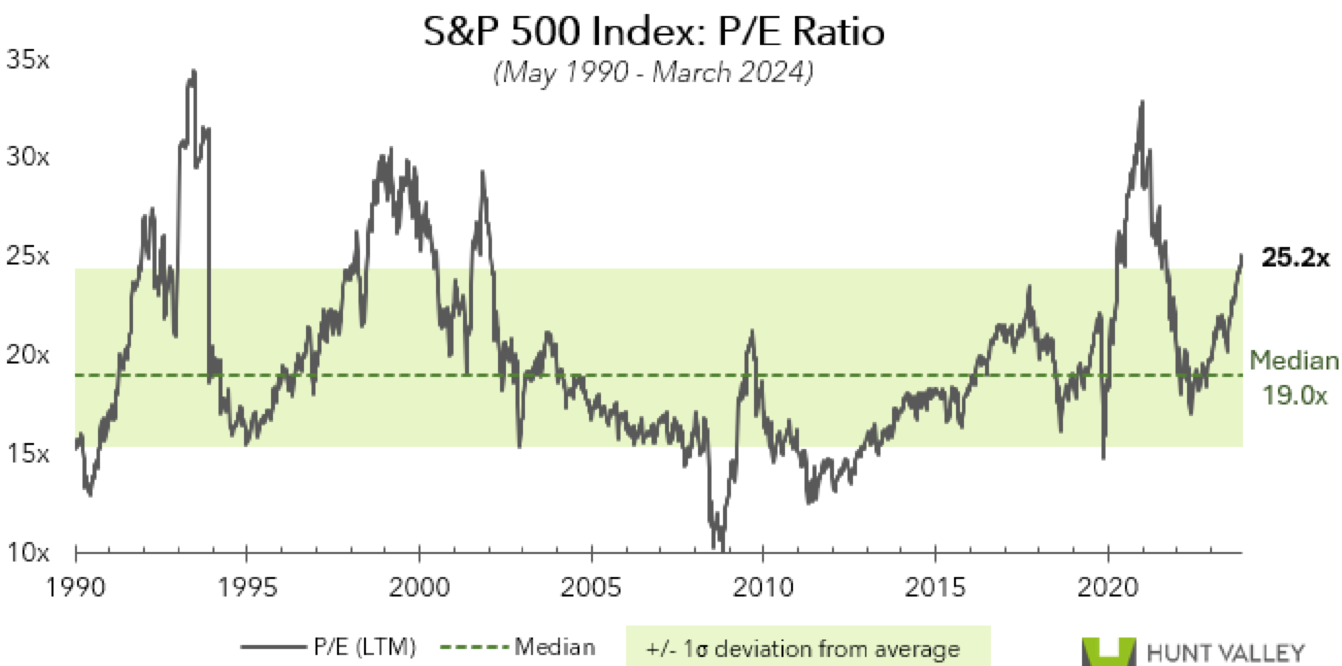
The market strength has come despite inflation readings remaining stubbornly high. This has pushed back and reduced expectations for Federal Reserve interest rate cuts. The Fed Chair Jerome Powell believes inflation is in a downward trend despite a recent spell of hotter-than-expected price reports.

At the beginning of the year, investors expected the Fed to cut its benchmark short-term rate six times in 2024. That turned out to be overly optimistic. For now, most Fed officials are penciling in three rate cuts this year.

While the stock market was able to weather the diminished expectations for Fed rate cuts, the higher-for-longer landscape took the wind out of the bond market sails. After a huge rally in the fourth quarter, bond prices fell, and yields rose. The U.S. Corporate Bond Index fell 0.8% for the quarter, while U.S. Treasury bonds overall dropped 0.9%.

It appears that the Federal Reserve is walking a tightrope when it comes to monetary policy. Senior officials don't want to cut rates too prematurely and risk seeing inflation pick up again. However, they also want to avoid pushing the economy into recession by keeping monetary policy too restrictive.

With the rise in stock prices, valuation multiples have also risen. The aggregate price multiple of the S&P 500 index currently sits above 25 times, roughly 33% higher than its historical median of 19.0 going back to 1990.



Sources: Bloomberg Data and Hunt Valley Wealth calculations

While stocks are expensive by historical means, they certainly don't appear to be in "bubble territory." However, if progress on inflation stalls and the Fed continues to wait to cut rates, the market could see a pullback from these levels. Investors will need other reasons to keep buying, and as we enter earnings season in April, corporate profits could underpin the next leg.

Our investment methodology does not involve making economic or market predictions. As we've written before, these predictions are usually wrong and end up being very costly to investors. While macro conditions drive short-term market moves, individual stock fundamentals historically dictate long-term investor outcomes. This is why we keep our focus and seek great businesses and reasonable prices.

Artificial Intelligence

Matthew Holman, CFA
Portfolio Manager

It is probably safe to assume that you have heard the term artificial intelligence or AI over the last year or two. It is undoubtedly today's hottest buzzword, but what does it mean, and what should we do about it? If we dig into the details, this can quickly read more like a science-fiction screenplay than an investment discussion. So, we will keep things high-level and start with a brief primer for those less familiar with artificial intelligence.

Artificial Intelligence Explained

What is AI? Think of AI as a computer system capable of performing tasks that traditionally require human cognitive functions. More simplified systems use machine learning to process large amounts of data, look for patterns, and make informed predictions. Newer AI systems analyze even more data and incorporate neural networks to create progressive learning algorithms – effectively training them to process the data how a human brain would.

How can this be used? *Generative AI* systems focus on creating new content, such as computer code, images, and videos. It can be used for tasks like generating marketing material or even creating a newsletter like this one (don't worry, this is our work).

Predictive AI systems are used to streamline a company's largest-scale operations. These strive to predict the inherently unpredictable, such as human behavior. Some use case examples include:

- Forecasting sales and demand trends
- Targeted advertisements
- Risk management uses such as detecting fraud, pricing insurance policies, and assessing a borrower's creditworthiness.

Why does this matter? AI is neither inherently good nor bad but has its benefits and drawbacks. On the plus side, it potentially offers faster, more accurate, and unbiased decision-making. It is also scalable, available 24/7, and creates opportunities for more customization and personalized user experiences.

AI shines when working with rote processes. However, in its current form, it cannot capture human emotion and creativity and has a limited ability to learn and improve from experience. It is also costly – both monetarily and in its environmental impact. There are also ethical and privacy concerns and questions about how much autonomy AI should be given.

Future of AI? Currently, all of the AI in use would be classified as *Narrow AI*, meaning it has a limited range of competencies and relies on human intervention.

The next iteration, *Strong AI,* will incorporate the ability to learn, perceive, understand, and be as smart as humans.

The third phase is *Superintelligence* – where AI will be superior to humans, with an added layer of self-awareness, the ability to sense and evoke emotions and influence its decisions.

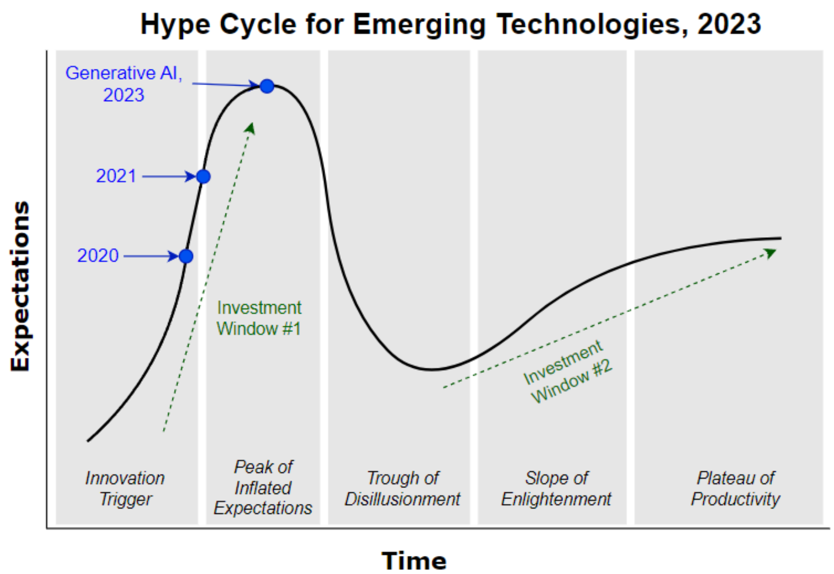
Is this the next big thing?

New innovations emerge each year. Some are revolutionary and change the world, while others are forgotten as quickly as they arrived. The key is discerning between the two – which is exceedingly more difficult than most are willing to admit.

We can look to Gartner's annual Hype Cycle of Emerging Technologies as a cursory guide to the history of innovative technologies. The study is not perfect, and most fail to follow this path as designed – which is part of the reason for its inclusion here. However, it does reflect an industry consensus and distills over 2,000 trends into a succinct set of "must-know" emerging technologies.

The study provides the following graphic (right), which is a conceptual tool that assesses the maturity and adoption level of the top tech trends. We are not looking for absolute precision here but to use its shape as more of an intuitive guide. We isolated Generative AI to keep things simple.

After reviewing the trends of this study since its inception in 1995, our main takeaway is that collectively, people have historically been pretty bad at making predictions about early-stage technologies. Hundreds of unique and innovative technologies have appeared in this study. However, only a handful navigated the entire cycle, and are still widely used today.



Source: Gartner Hype Cycles 2020-23 and Hunt Valley Wealth annotations

This is because many get stuck or fail at various points along the way. Perhaps they struggled to solve a core issue, or maybe the market just wasn't ready for their product yet. Stalled projects sometimes get picked up by future innovators, but many outright fail due to obsolescence or irreconcilable issues.

How are we thinking about AI?

For someone looking to invest directly in this space, there are generally two investment windows:

- Window #1: Buy early and sell into the hype
- Window #2: Allow things to develop, identify key players, and invest in the strongest companies

The early window is more exciting because the upside is tremendous. However, this assumes you can (1) identify the right trend, (2) pick the right company, and (3 and 4) time your purchases and sales. That is a lot to get right; a mistake at any step can derail the entire investment.

This option doesn't generally align with our investment philosophy. Companies at this stage trade more based on sentiment than fundamentals, leading to drastic disconnections between price and value. In the case of AI, the assumptions needed to justify current market prices have become unrealistic. But the hype is strong enough to convince traders to buy at any price for fear of missing out on the next big thing.

That said, we acknowledge the power of AI and believe it will likely change the future. However, this is a fitting time for a reminder that not every revolutionary product is inherently a good investment. We have questions that haven't been answered yet. To feel comfortable investing, we would want to know: How profitable will AI be? What future investment will be needed? How will the industry landscape develop? How will the tech be regulated?

Our preference is to wait for that second window when we can answer some of these questions. If these businesses show earning power and develop economic moats, the upside can be just as lucrative in the long run.

Some of our current companies are at the forefront and considered AI leaders at this stage. This may not be why we initially invested, but it is a great example of unlocking upside potential via *optionality*.

There are use cases for AI in every industry, with virtually endless opportunities for more. Companies that adopt the technology will also benefit from this boom, providing a third method to invest in this trend.

In summary, we don't necessarily need to chase the hottest AI companies to participate in the upside. There are multiple ways to gain exposure to this burgeoning trend without a pure-play investment. They may not all have as high of a ceiling but will likely have a narrower and more defined range of potential outcomes.

Company Spotlight

Q1-2024

Louis Foxwell, CFA
Portfolio Manager

Brookfield (BN) is an investment firm that operates three core businesses: asset management, insurance solutions, and a portfolio of operating companies.

Brookfield Asset Management (BAM) is the largest of the three core businesses, forming the backbone of the company's business model. BAM invests capital on behalf of institutions, private investors, and sovereigns in private equity, credit, and "real assets" like infrastructure, energy transition, and real estate. The asset management business generates predictable revenue streams, with the company earning a fee as a percentage of managed assets. It also provides upside through carried interest, which is dependent on fund performance. BAM is one of the largest alternative asset managers in the world, giving it access to sizeable deals that very few other organizations can finance. This augments its sticky relationships with pension funds, foundations, endowments, and financial institutions, making BAM very efficient in raising capital for emerging opportunities.

Brookfield also invests its own capital in the funds that BAM manages for clients. This enables it to "double dip" when it achieves superior investment performance. This co-investment has resulted in BN owning stakes in numerous operating businesses, with assets in real estate, private equity, renewable energy, and infrastructure. We like businesses that can generate high returns on invested capital and have opportunities for reinvesting back into the business. This is how compounders operate. Brookfield meets this criterion through its unique business structure.

The third core business is insurance solutions, which primarily sells annuities and life insurance. Brookfield's goal is to generate predictable long-duration liabilities through this segment, and then leverage its investment expertise to generate an adequate "spread" over a low cost of capital. This is a fast-growing business, and we believe it has many synergies with existing operations.

We believe Brookfield shares have been undervalued for some time now. In our view, the market is overly concerned about Brookfield's commercial real estate exposure, which contains numerous high-quality trophy assets that are masked by lesser-quality ones. One of the benefits of BN's corporate structure is that much of the debt across the ecosystem, including the commercial real estate portfolio, is non-recourse to the parent company. This insulates the company from individual loan defaults, creating asymmetric upside and downside protection in our view.

Another underrated attribute of Brookfield is that most of its assets are publicly traded. This gives management flexibility and a liquid "currency" to make optimal capital allocation decisions. For example, the company recently offered to acquire American Equity Investment Life with BAM shares. Management's track record and close alignment with shareholders through equity ownership gives us confidence that they will continue to take advantage of this unique and flexible structure.

Lastly, we think it is important to highlight that Brookfield gives us exposure to assets that we normally would not be able to invest in via the stock market. Infrastructure, energy transition, real estate, and private equity are generally all illiquid assets, but ownership through a liquid stock is an optimal way to diversify client portfolios in our view. We view Brookfield as a potential long-term core holding due to the many attributes listed above, and we continue to purchase shares when they trade at a discount to our estimate of intrinsic value.

Financial Planning Corner

Your Tax Planning Team

Dani Ryan, CFP®, CDFA®
Senior Wealth Advisor

We have yet to meet a client who wants to pay more taxes than they need to. Tax planning and tax preparation are critical components of managing your finances and often times not done in coordination. While tax planning involves implementing a proactive strategy to minimize tax liabilities and optimize financial outcomes not just for the current year but for years to come. Tax preparation, on the other hand, focuses on the organization and filing of tax returns for the prior year to ensure compliance with relevant laws and regulations.

Having a tax planning team ensures comprehensive expertise and collaboration, leading to minimizing tax liabilities and maximizing financial opportunities. A dynamic tax planning team is comprised of a seasoned wealth advisor and a meticulous tax advisor.

Here are the areas where your wealth advisor can offer perspective and how your tax advisor can help:

Your Wealth Advisor

1. Evaluating and minimizing capital gain implications
2. Evaluating family gifting strategies
3. Charitably gifting tactics
4. Weighing difference between lump sum and annuity options
5. Reviewing social security options
6. Evaluating benefits of Roth conversions

Your Tax Advisor

1. Review estimated tax withholding
2. Manage state and local income tax deductions
3. Recognition and timing of income

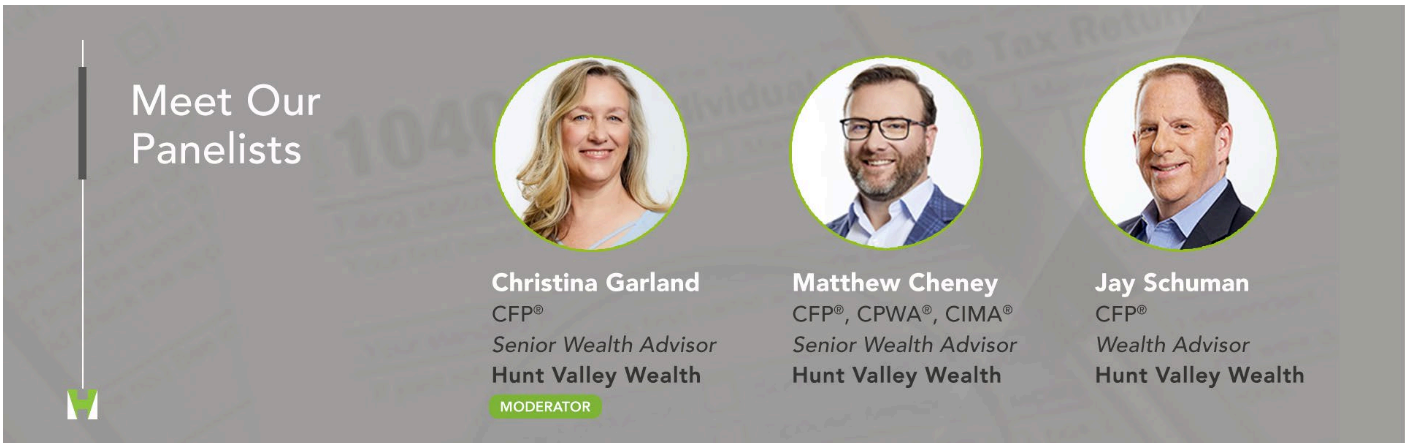
As wealth advisors, we play a crucial role in assisting individuals and businesses with tax planning strategies to optimize their tax situations. Together, with your tax advisor, we can craft holistic strategies tailored to clients' specific circumstances. This team effort ensures that tax planning efforts are aligned with broader financial objectives.

Tune into our webinar on April 24th at 2 pm for more information on tax planning and how to make the most of your tax return.

Hunt Valley Wealth: Upcoming Webinar

Join us and learn the necessary strategies to utilize your tax return as a blueprint towards financial success.

[Upcoming Webinar]
Tax Planning: 5 Ways to Make the Most of Your Tax Return
When: Wednesday, April 24, 2024 at 2:00 pm - 2:45 pm E.T.



During this discussion, we'll explore five essential areas:

1. Revisiting the fundamentals of prudent saving habits
2. Understanding tax-aware investing to maximize returns
3. Exploring techniques to maximize cash flow and minimize income taxes
4. Harnessing the power of charitable giving as a strategic tax planning tool
5. Leveraging Roth conversions to enhance your financial portfolio

Register now and discover actionable ways to optimize your financial outcomes.

Scan To Register

REGISTER HERE

We are here to support you and your wealth management objectives.

Especially now, we invite you to connect with your advisory team to discuss the markets, inflation, or your personalized wealth management strategy. We remain committed to your goals, both near and long-term.

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