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The Hudson River Group at Morgan Stanley

80 State Street, 12th Fl • Albany, NY 12207 • 518-463-4111 / 800-541-0601
https://advisor.morganstanley.com/the-hudson-river-group

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"When you come to a fork in the road, take it"

-Yogi Berra

Spring is in the air meaning it's baseball time. No better way to honor the start to the season than by donning this letter with a "Yogi-ism"; a unique saying from the legendary, Hall of Fame Yankee's catcher. The story goes that these were the exact directions he gave his friend and fellow catcher Joe Garagiola to his house in Montclair, NJ. It so just happened that both paths ironically led to his house. Unlike the Berra's residence, the fork in the road for the markets post the Federal Reserve's tightening campaign in 2022-2023 was expected to have two very different possible paths: soft landing or hard landing. Soft landing was the guess that the FOMC raised rates enough to lower inflation while also slowing the economy just enough to avoid a recession. Think of a plane landing smoothly after a choppy descent. A hard landing would be the opposite ending, turbulence followed by an emergency landing or pronounced decline in economic activity. Entering 2023, based on the current economic data of that time and historical patterns we saw a greater probability of the latter. We were of course wrong.

We now understand what we overlooked. Private credit being a large lender while traditional banks slowed. Excess Covid savings plus assets appreciation lasting much longer than we would have guessed buoying the consumer. Less sensitivity to higher rates due to both individuals and corporations locking in lower rates via their respective mortgage/ corporate debt and the dynamics immigration have had in the labor market. Looking ahead the biggest question now is what happens if there is no landing? Economic growth stays strong with no large upward movement in unemployment while inflation stays above the Federal Reserve's 2% target. This economic fork now has three prongs versus Yogi's two.

The markets started to discount this possible path during the first quarter. Entering the year, the number of implied policy cuts were seven[1]. By the end of February that fell to roughly four cuts[2]. By the end of March, it was closer to three and a half[3]. Risk assets digested this rapid repricing without a glitch and the post Halloween rally continued while the 10yr US Treasury increased by roughly 30bps[4]. The five-month move in the broader market; as defined by the S&P 500, from November to March ending up being historic notching a 25% gain[5]. This was the seventh best five month stretch in over 70 years. As the table on the next page highlights prior rallies tended to have staying power with some notable events further down the road (1987 crash, dotcom bubble busting).

		S&P 500 forward total return		
Date of Signal	5-month price return	3 months	6 months	12 months
02/1975	28.4%	12.9%	5.3%	27.3%
11/1982	26.4%	8.1%	19.9%	25.6%
03/1986	25.9%	5.9%	-1.5%	26.2%
01/1999	33.7%	4.7%	4.5%	16.2%
07/2009	34.3%	5.5%	9.9%	13.8%
08/2020	35.4%	3.9%	9.9%	13.8%
03/2024	25.3%	??	??	??

Source: Bloomberg

It was not until the quarter ended that the bond market started to play catchup as economic data stayed hot and the 10yr US Treasury reacted by adding another 40bps in a few weeks on top of the 30bps during the first quarter[6]. This meaningful delta/rate of change along with a rise in tensions in the Middle East was enough to stoke fear putting an end to the rally. The first "pothole" of 2024.

Potholes should be expected when you are an investor. What we witnessed from November-March is the outlier. The median intra-year decline/drawdown post WWII is 10.8%[7]. Our generic pothole playbook has the following rules (Note these are generic. Individual recommendations will be made based on your respective goals and level of risk tolerance):

- Do not try to avoid the pothole. Market timing in and out during a relatively short window is extremely difficult. While a broken clock is right twice a day doing this constantly is a fool's errand in our opinion.
- Long term investors with a higher level of risk tolerance should add to risk assets particularly if underweight and/or have excess cash.
- Ensure your portfolio is behaving as you would expect while driving through the pothole. Your portfolio's asset allocation should match your goals and risk tolerance. There is no better checks and balances than a drawdown.

What happens over the next three quarters is anyone's guess. Economic predictions of rate cuts are a prime example of why the guessing game is difficult. The "known-knowns" of this marketplace have all been well publicized:

- The Federal Reserve will continue to be data dependent and inflation is sticky. Forget about the definition of CPI (consumer prince index) or the Fed's favorite PCE (Personal Consumption Expenditure) for now. Grocery bills are still high. Filling up your tank is more expensive. Car insurance has had a large jump. Housing prices have yet to correct.
- Market concentration is at an extreme: The top largest companies represent over 30% of the S&P 500 a level not seen since the early 1970's[8].
- Equity risk premiums: the excess return that investing in stock market provides over a risk-free rate is the lowest since 2002[9].

- The trend for a while now has been US over international, growth over value and large over small. Owning the relative laggards have been frustrating though that is the give and take with diversification.

S&P 500 relative to MSCI World ex US (1970-present)

Russel 1000 Growth relative to Russell 1000 Value (1991-present)

S&P 500 relative to Russell 3000 (late 1970's – present)

Over the course of the next four to six quarter we would expect to see changes which will most likely provide times of fear, greed, hope and despair. Though the Fed's first cut is being pushed out; it will happen at some juncture either proactively or reactively (the latter would not be a shock). It would be difficult for us to imagine unemployment staying this low for much longer. While immigration has been a large variable to keep the US at full employment; it will most likely also be the cause of a large jump in unemployment when labor demand declines.

Whatever is conjured up for the future will not alter our goal of investing and/or making investment recommendations that we see as prudent based on your goals and risk tolerance while keeping a high level of service and transparency.

The Hudson River Group

Brian Schlaks, CMT
Senior Vice President
Financial Advisor
Portfolio Management Director
NMLS# 1252940

Bert Trombly
Senior Vice President
Financial Advisor
Portfolio Management Director
NMLS # 1272995

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For index, indicator and survey definition referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

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[1] Bloomberg: Number of Hikes/Cuts Priced in as of 12/31/23: -6.95

[2] Bloomberg: Number of Hikes/Cuts Priced in as of 2/29/24: -3.95

[3] Bloomberg: Number of Hikes/Cuts Priced in as of 3/31/24: -3.42

[4] Bloomberg: Ten Year US Treasury Yield 12/31/23 to 3/31/24: 3.87% to 4.21%

[5] Bloomberg: S&P 500 total return 10/31/23-03/31/24: 26.1%

[6] Bloomberg: Ten Year US Treasury Yield 3/31/24 to 4/18/2024: 4.21% to 4.65%

[7] Morgan Stanley: Intra-Year Declines and Rises. Monthly Data from December 1944 to March 2024

[8] Market Concentration And The Magnificent Seven: Where Next? | Russell Investments

[9] Morgan Stanley Equity Risk Premium – S&P 500

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