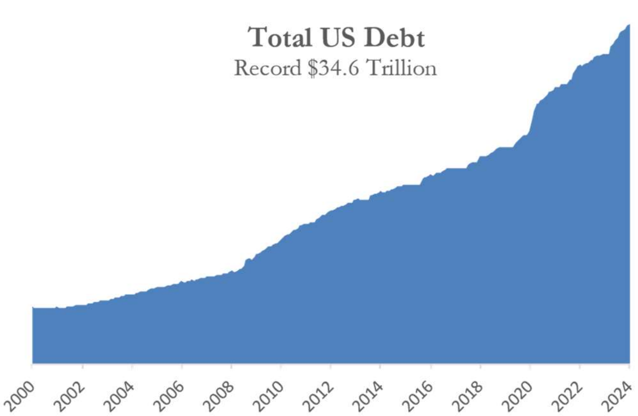
1Q2024

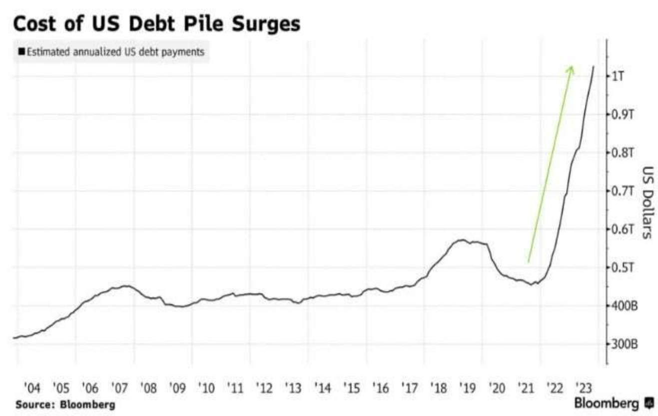
> "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance." Chuck Prince, former CEO of Citigroup, 2007

I'm a terrible dancer. That's actually not true but making a statement about my skills on the dancefloor would only elicit taunts from a few of you to prove my moves. Experience, along with a healthy dose of sobriety, has taught me there is little to be gained by making a spectacle of myself and my dance partner. I prefer to stay firmly planted in my seat while others show their stuff.

The dance floor for U.S financial markets is jammed packed, and participants are working themselves up into a heated frenzy. Profligate government spending, massive deficits, an election year, and momentum market sectors have been the makings for one heck of fun party. I wish I were a young person again, with little responsibilities and relatively insignificant dollars at risk. There would be no reason not to request another song and party late into the evening. Unfortunately, the music must always end, intentionally or not, and the unpleasant results of the fun are generally commensurate with how hard you partied.

At the end of the first quarter, the total U.S. debt hit another new record of $34.6 Trillion dollars. This figure has been rising by $1 Trillion approximately every three months, or every 100 days. The amount itself is hard to fathom, but equally important is the financial commitment the U.S. government owes its creditors. It was notable last quarter when the U.S.'s debt interest surpassed $1 Trillion dollars. A figure larger than our defense budget. We have already added an additional $100 Billion to that figure in 2024 and now sit at $1.1 Trillion in debt service, growing by $100 Billion every four months! Is it any wonder that the borrow and spend mentality of our political elite will result in higher taxation of the masses (not just the wealthy) in an effort to pay for all this fun.



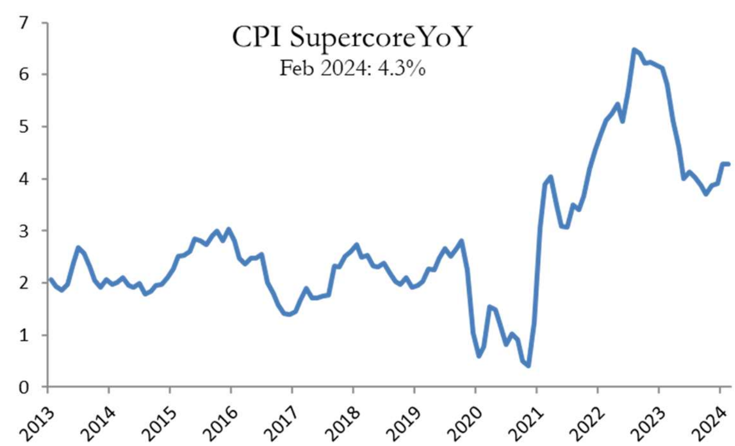


According to a recent report from the Congressional Budget Office, "such large and growing debt would slow economic growth, push up interest payments to foreign holders of U.S. debt, and pose significant risks to the fiscal and economic outlook. It could also cause lawmakers to feel more constrained in their policy choices." The last comment about political constraint is the only positive I see resulting from our ballooning debt balances!

Reforms will be difficult and likely very painful, making them nearly impossible to implement. Does anyone remember the incredibly short tenure of Liz Truss, the former Prime Minister of the United Kingdom? Citing her nation's "unprecedented" fiscal trajectory, she attempted to impose fiscal and monetary reforms that would slowly return the country to a more stable footing. Her comments had an instantaneous effect and sent bond yields soaring, sparked a run on the British pound, led to an immediate restart of quantitative easing by the bank of England and a bailout of various pension funds. Her resignation was almost as immediate and cemented the example for other nations of what to expect if considering similar reforms. Would any elected political figure in this country weather the financial firestorm necessary to direct us towards more responsible fiscal and monetary policies?

In the meantime, we are left to ponder the near constant commentary coming from Federal Reserve officials about each of their opinions as to when conditions will be ripe enough for the Fed to begin easing their monetary policy stance. At the end of 2023, Chair Powell made a very clear decision to change his messaging to financial markets that the conditions were suddenly, and miraculously, ripe for the consideration of interest rate cuts. The now termed "Fed Pivot" was the signal to investors to embrace risk assets once again. The market has responded and at the time of this writing the S&P 500 has returned nearly 13% from the pivot date on December 13th. The year end rally in 2023 culminated with a dot plot view on future interest rate cuts pricing in a total of six for calendar year 2024. We questioned the sensibility of that expectation in our year-end letter as being overly positive and a scenario that would only take place if financial conditions deteriorated quickly and sharply.

Fast forward to the end of 1Q, and market expectations have adjusted markedly with economic data points pointing to a higher sustained and more persistent level of inflation along with commentary from Fed officials painting a much more hawkish tone towards the timing and totality of rate cuts. In fact, as I sit and write these thoughts, Atlanta Fed president Bostic is on the news wire stating that a single rate cut in 2024 during the fourth quarter is his reasonable expectation. We have come full circle in the rate cut discussion for the current year with some economists questioning whether or not the next move will be a rise in interest rates as inflation begins to percolate higher because of the strong underlying economy. The Fed's newly favorite gauge, a stripped-down version of the Consumer Price Index known as the Supercore estimate measures core services prices where energy, food, and shelter are removed (because those don't matter!). It has witnessed a rebound in recent months as the economy continues to expand. A free fall of inflation back to the 2% target is beginning to prove more difficult as the initial impact of higher rates has worn off and labor markets remain resilient. According to the S&P Global economic team:



> *"Average selling prices charged by producers rose at the fastest rate for 11 months in March as factories passed higher costs on to customers, with the rate of inflation running well above the average recorded prior to the pandemic. Most notable was an especially steep rise in prices charged for consumer goods, which rose at a pace not seen for 16 months, underscoring the likely bumpy path in bringing inflation down to the Fed's 2% target."*

The only area not to adjust to the higher-for-longer rate outlook is the broader equity market that pulled prices forward in expectation of a series of more timely cuts yet has held on to those gains even as the outlook for multiple rate cuts this year has diminished. The Fed is in a difficult position, attempting to stick to their dual mandate while also compelling market participants to assume more risk and drive markets higher, promoting the perception that all is good. Some have questioned if their mixed messaging is a political maneuver, despite their assurance to the contrary.

At the portfolio level, our Strategic Value holdings performed well considering our defensive stance by returning 10.8% after fees at the composite level for the quarter. This was 180 bps ahead of the Russell 1000 Value index and slightly ahead of the S&P 500 while carrying less risk per unit of exposure given both positioning and cash balances. The portfolio's top performing positions were securities in both the Energy and Utility sectors and both were up approximately 35% for the quarter. These sectors are two of the least represented in the S&P 500 yet offer some of the most compelling valuations along with some of the highest total yields (dividends + share buybacks). For some context, Microsoft alone represents over 7.1% of the S&P 500 by market capitalization. The entire Energy and Utility sectors combined represent less than 6% of the entire S&P yet are responsible for a significant portion of the earnings within the index. Sectors and specific companies have been overlooked as large institutions and passive investors funnel dollars into the largest and most liquid technology business with the promise of ample returns with anything related to artificial intelligence.

We continue to opt for a $1 of earnings priced at 7-10x rather than the same $1 priced at 30-40x or higher. While we can't control or predict market cycles, we can control our approach to investing in businesses that meet our fundamental standards and provide a significant prospect of return over time.

I appreciate your friendship and confidence. Please feel free to reach out if I can be helpful with any investing needs you, a family member, or a friend might have.

Drew
Hourglass Capital, LLC