1st Quarter 2024

ACM Journal

The quarterly newsletter of Armbruster Capital Management, Inc.

Portfolio Review

Stocks picked up right where they left off last year by delivering another quarter of strong returns. US large-cap stocks once again led all asset classes as the S&P 500 gained 10.6%, continuing their trend of outperforming small-cap stocks and international stocks, both of which experienced more modest gains. Bonds pulled back slightly after their 6.8% gain in the fourth quarter of last year as longer-term interest rates rose moderately from the start of the year, contributing to a -0.8% loss this quarter.

Factor Returns

Returns for the various factor strategies were mixed in the first quarter. Momentum was the strongest factor, outperforming each of the other factors by a wide margin. That means that stocks that had outperformed throughout 2023 had generally outperformed again in the first quarter, driving the most expensive stocks to even higher levels and creating even more concentration in the S&P 500. For the large-cap momentum fund, this entailed having high exposure to the five "magnificent 7" stocks that gained this quarter, most notably Nvidia, which extended its AI-fueled rally by another 82%. The two "magnificent 7" stocks that large-cap momentum was not exposed to, Tesla and Apple, dropped by -29% and -11% to start the year, so the strategy was positioned remarkably well. Among large-cap stocks, the quality factor also outperformed, while the value and low volatility factors underperformed but still managed to post returns in the mid-to-high single digit range. While we still like all of these factors over the long term, we especially view value and low volatility favorably given their low valuation ratios and tendency to avoid many of the mega-cap stocks during a time when the market is historically concentrated and overvalued.

Rates Edge Higher, Pressure Bond Prices

The fall in long term interest rates that helped spur a bond rally in the fourth quarter of 2023 reversed this quarter and put pressure on bond prices. The 10-year Treasury yield increased from 3.9% to start the year to 4.2% at quarter-end and has continued to rise after quarter-end. Yields on the shorter end of the curve did not move much throughout the quarter, staying within the federal funds target range of 5.25%-5.50% for Treasuries with a maturity ranging from one month to six months. This has provided a nice opportunity to earn fairly high returns on cash holdings for the first time in many years.

The consensus now is that the Fed will not cut interest rates as aggressively as previously believed a couple months ago, and that the first rate cut likely won't occur until the latter half of 2024. The Fed confirmed this change in their view in their latest economic projections. A majority of Fed officials previously believed that three or more rate cuts would occur by the end of the year, but now most are projecting that only three cuts or even less will be needed. The expected federal funds rate by the end of 2025 also shifted from a range of 3.25%-3.50% to 3.75%-4.00% since last December. It makes sense that many believe interest rates will need to stay at their current targets for longer given recent economic data. Headline inflation, as measured by CPI has been stuck above 3% after reaching that mark in June of last year. Core CPI, which excludes volatile food and energy prices, is an even higher 3.8%, far above the Fed's 2% target rate. Meanwhile, economic conditions still appear strong given the low unemployment rate of 3.9% and latest GDP growth rates of 4.9% and 3.4% over the last two quarters. The Fed will have to carefully navigate when and how many rate cuts are necessary, as cutting too quickly or by too much may result in a second wave of inflation and even higher rates needed to get prices under control, which would be a further bane for bonds.

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Last Race

My eldest son, Omar, became serious about endurance sports in high school. He ran track and cross country, but cross-country skiing was his main sport. Cross-country, or Nordic, skiing is a sport that takes years of hard work and discipline to perfect, if it is even possible to perfect the technique. That meant that Omar had to attend summer camps and weekend races in the winter all over the state. That of course meant that I had a lot of driving to do.

In order to make my time more enjoyable on these sojourns, I took my younger son, Amer, along with me. Amer and I would drop Omar and his friends off at a camp in Vermont or the Adirondacks, and then we would go camping and hiking. One year, when Omar qualified for the Junior National ski races in Alaska, I went along to make sure Omar got there safely. Amer joined and we had a great time. While the team trained and raced, Amer and I skied each day, went dog sledding, rode horseback to see a glacier, and generally enjoyed a week of adventuring. In fact, that became our theme. Amer and I were adventure buddies both summer and winter for many years.

Because he was also going to all the weekend races with us in the winter, Amer started competing at a young age. That gave him a real advantage in terms of learning ski technique. More importantly though, he was a part of the Nordic ski community. Weekend ski races are sort of a free-range ordeal for kids, partially because they are so safe, but also because parents are often busy with other jobs like ski waxing and race logistics. Amer made friends with kids from all over the state and hung out with other families. He also learned early on how to get ready for his own races: when to warm up, how to get his heavy clothes off at the start line by himself, how to manage his gear, and most importantly, when to get to the start so you don't miss your race. Some of these lessons were learned the hard way, but he learned a lot about responsibility.

As a freshman in high school, Amer showed real promise as a skier. Unfortunately, his health dealt him a setback as the combination of epilepsy and medication side effects has made it hard for him to compete up to his potential. But impressively, that hasn't phased him. Many of his friends have surpassed him, and his results aren't what he would like, but he has insisted on attending every race, even the optional ones that involve a lot of travel and effort. It would have been easy for him to give up, but on the contrary, Amer was the ringleader among his friends, encouraging them to join him at races they likely would not have done otherwise.

He also helped instill a love for the sport with his friends. He follows the World Cup race circuit avidly and has helped organize a fantasy Nordic ski league (yes, that really exists) that he has pulled his friends into. So, in his way, Amer has also developed some solid leadership skills, even if sometimes that has meant leading from behind.

Because of his setbacks, it was extra meaningful for us all when Amer qualified for the New York State High School Championship races this year. He knew he probably wouldn't be competing for the top spots in the state, but he went along with enthusiasm. He was ultimately right about his race results, but it was touching that he was unanimously chosen for the Sportsmanship Award for being such an ambassador for the sport over his high school career.

I thought States would be end of our season, but Amer asked if we could go to the Eastern High School Championship races in New Hampshire. I was reluctant since it was practically springtime and New York is never competitive against the powerhouses from Vermont and New Hampshire. Nevertheless, Amer wanted to enjoy the fun and community of one last event. So, Amer registered for the races, I volunteered to be one of the New York team coaches, and off we went. The event consisted of four races over three days. I was distracted the first two days by getting skis waxed and kids ready to race. However, once the starting gun went off for the last race on the third day, I was overcome with emotion. I realized it was my last high school race ever with my son.

Amer came in last place for a couple of the Easterns races, but he didn't mind at all. He had a wonderful time and built some great memories. At our end of season banquet, he gave his senior speech and credited me with teaching him how to ski and being his most important coach over the years. It was certainly nice to hear, but I know I learned more and more important lessons from him than he learned from me.

Chris's Corner

Planning for the Sunset

In 2017, then-President Donald Trump passed a series of changes to the tax code, the so-called Tax Cuts and Jobs Act (TCJA). Like just about everything these days, the law was controversial and complicated. One of the more "interesting" components to the law is that there is a sunset provision, meaning many of the changes will revert right back to where they were before the bill was enacted. That sunset will occur on January 1, 2026.

Congress could act to extend the law, but that of course is highly uncertain, particularly with an upcoming election. So, thinking about which rules will change and how to plan for them makes sense while there is still time. The more meaningful provisions that sunset include:

Tax Rates

The TCJA reduced marginal tax brackets to 10%, 12%, 22%, 24%, 32%, 35%, and 37%. After the sunset, the top rate for individuals will revert back to 39.6%.

Standard Deduction

The TCJA raised the standard deduction to almost double the prior level. ($12,000 for single filers and $24,000 for married filing jointly). This meant that relatively few taxpayers itemized deductions. The standard deduction is also indexed for inflation, and currently stands at $14,600 for single filers and $29,200 for married filing jointly). After the sunset, the standard deduction will be roughly cut in half.

Itemized Deductions

The TCJA capped the state and local tax (SALT) deduction at $10,000. Mortgage interest deductions were limited to the first $750,000 of the loan amount and home equity loan interest was generally not allowed as a deduction. Many miscellaneous deductions were eliminated, such as investment fees, legal fees, etc. All of these will revert back in 2026, allowing those of us in high property tax states to increase our itemized deductions, and likely no longer take the standard deduction.

Alternative Minimum Tax

The TCJA decreased the number of taxpayers getting hit with the alternative minimum tax (AMT) as well as the amount owed. After the sunset, the AMT exemption will revert to the surprisingly low pre-TCJA levels. That means AMT will ensnare far more taxpayers.

Estate and Gift Tax

The TCJA doubled the estate and gift tax exclusion from $5,490,000 to $11,180,000. It also indexed that amount for future annual inflation. The 2024 exclusion is $13.61 million per person, but because of portability it comes to $27.22 million for married couples. The estate tax rate maxes out at 40%. With the coming sunset, the estate and gift tax exclusions will be roughly cut in half.

Planning Strategies

If you are in a situation where you may not currently have to worry about estate tax, but will with the sunset, there are some strategies to consider to reduce the value of your taxable estate.

Gifts

Assets can be transferred to family members or charities. If giving gifts to family members, you might consider using stocks or other assets that have the greatest growth potential. Using 529 plans is also a good way to give assets to grandchildren if you want to ensure the money is used for education. Low basis stocks and other securities can be given to charities to avoid the capital gains tax and get a charitable deduction against income. Donor advised funds can be a good option for larger charitable gifts that you may want to disburse over time. As a reminder, the 2024 annual gift tax exclusion is $18,000.

Spousal Lifetime Exemption

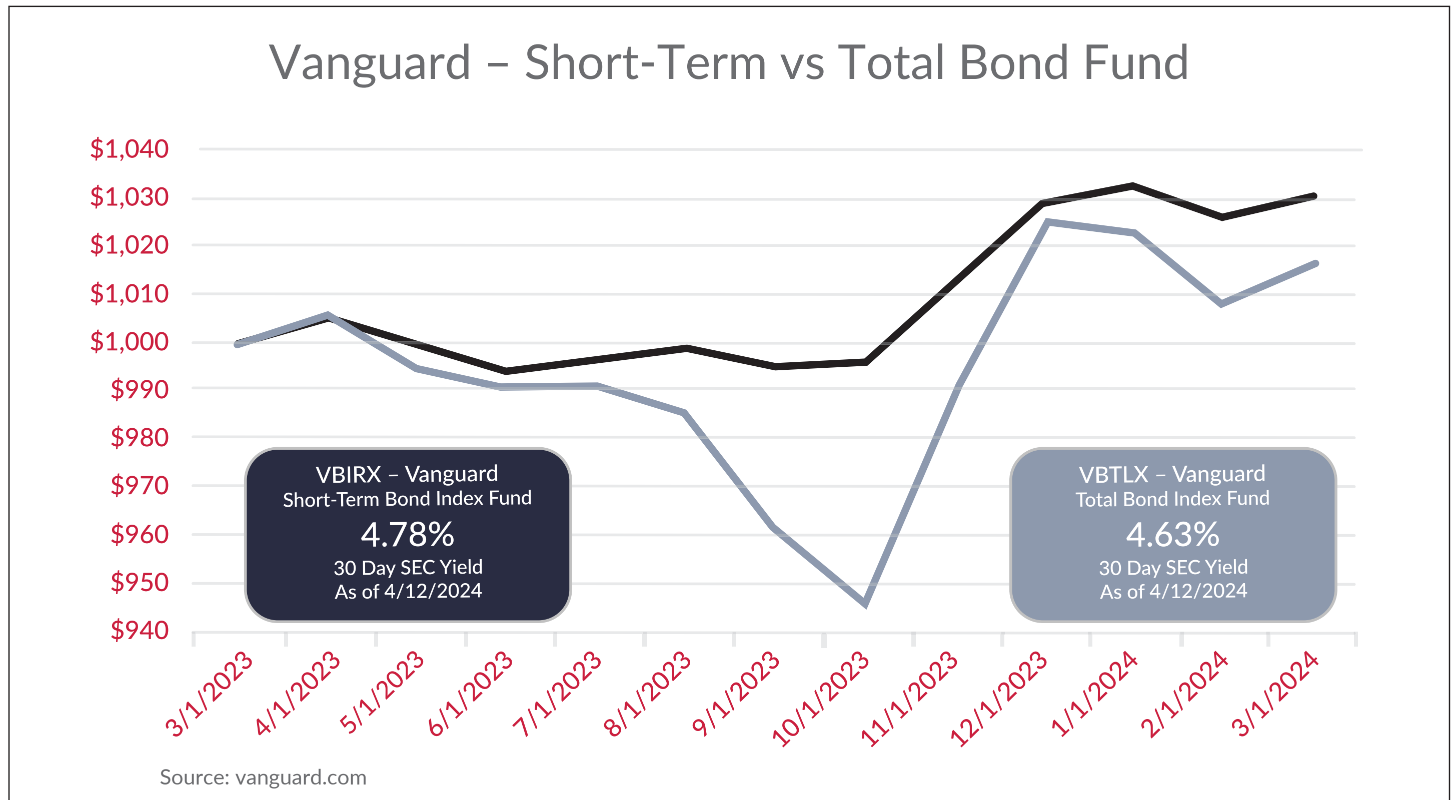
This involves using one spouse's full lifetime exemption ($12.92 million) to make gifts to children or grandchildren but retaining the other spouse's exemption. This allows for significant estate reduction today but ensures that there will be some estate tax exemption accessible later.

Trusts

There are a number of trust structures that can be set up to remove assets from your estate. However, be aware that they all involve giving up some element of control over your assets. Income may be available with some trusts, but it can be difficult to access the principal. Irrevocable trusts can also mean giving up stepped up basis upon your death, and they can be expensive and cumbersome to maintain. Nonetheless, trusts can be very effective in the right situation.

Planning for the sunset now can make sense, particularly if you are considering a trust or other strategy that will include enlisting the help of an attorney. They will likely be jammed up as the sunset approaches. While planning now is prudent, we remain cautiously optimistic that the benefits of the TCJA will be extended and made permanent next year.

Why Everyone is (Probably) Wrong about Bonds



Interest rates have gone up the past few years, by a lot. That could be a bad thing if you're looking to buy a house and need a mortgage. Or it could be positive if you are enjoying a higher interest rate on your bank deposits for the first time in many years. Where interest rates go from here is a topic of hot debate currently, particularly with a presidential election later this year. Many market watchers expect interest rates to come down, and indeed, the Federal Reserve has indicated it expects to cut short-term interest rates in 2024. However, we're not so sure.

If interest rates do come down, we would want to be in longer-term bonds. Interest rates and bond prices move inversely to one another, and long-term bonds are more sensitive to interest rates moves. That means you could potentially generate big returns with long-term bonds if the Fed cuts rates. We currently use short-term bonds since their return hasn't been much different from long-term bonds, and they incur less risk. In fact, by way of example, Vanguard's short-term bond index fund currently has a higher yield and better performance over the past year than the long-term total bond market index fund (see chart).

Many pundits, economists, and Fed watchers are recommending investors lengthen the duration of their bond portfolios to take advantage of the expected rate decline. We disagree. We may miss out on a bit of performance if rates do indeed drop from here, but we're skeptical that rates will come down much, if at all, in both the near and longer term.

That may sound odd since the Fed has been saying it will cut short-term interest rates this year. However, in our view the Fed's credibility isn't what you might like it to be. Last year the Fed told us inflation was "transitory." Inflation is still a problem. In fact, core inflation is almost twice the Fed's target rate, despite coming down quite a bit from last year. There have been studies comparing the Fed's economic forecasts to those of private sector economists, and the Fed has generally fared better. However, that still doesn't instill a lot of confidence when you consider the accuracy of private sector forecasts. Some studies have found that economists, market watchers, and political forecasters were accurate only 47% of the time; less than flipping a coin. So, just because the Fed says it is going to cut interest rates later this year as inflation comes down and the economy remains robust, it doesn't make it so.

Also, even if the Fed does cut interest rates, it doesn't necessarily imply that longer-term interest rates will decline. These are the rates that truly matter for bond market pricing. There has been a strong historical correlation between the short-term Fed Funds rate and the longer-term

10-year Treasury rate, but it isn't perfect and there have been wide divergences in the past. It is certainly conceivable that if the Fed rushes short-term interest rate cuts, it could spur even higher inflation, which could lead to a sell off (and rate rise) in longer-term bonds.

The Fed says it is watching "the data" to determine what it will do in the future. That data includes inflation, GDP growth, unemployment rate, industrial production, and many others. Recently, most of these indicators have shown a strong economy. We can certainly quibble about the quality of the data and whether part-time job creation is the same as full-time job creation, but the full mosaic shows solid economic growth. That means the Fed won't have any true impetus to trim interest rates in the near future.

Longer-term, we don't think the outlook is that bright for continued economic growth, given the huge government debt both in the US and overseas, uncontrolled inflation, unfavorable demographic trends, a declining appetite for Treasury bonds among foreign nations, and what will almost certainly be declining corporate profitability that could lead to larger scale job loss. These things, if they get out of control, could lead the Fed to trim interest rates. However, we're still not convinced that will happen in any meaningful way.

The real problem is that inflation is persistent and doesn't appear likely to abate anytime soon. Inflation seems widespread. Housing prices continue to rise and there is no catalyst for them to decline given a shortage of housing stock and regulations discouraging building in many parts of the country. Commodity prices including oil, copper, and gold have all increased meaningfully in the past few months. And wage increases are finally starting to catch up with core inflation. While inflation has come down from its blistering pace last year, these factors make it less likely that it will fall further, and we wouldn't rule out another spike, just like what happened in the 1970s.

Because of that inflation, and the risk that it could go even higher, we don't think the Fed will be able to meaningfully reduce interest rates any time soon. Moreover, longer-term interest rates have historically trended in long cycles ranging from 25-40 years. It seems we just finished a 40-year cycle of declining interest rates when the 10-year Treasury yield hit 0.5% during the Covid downturn. It won't be a linear rise, but rates could trend higher for the next couple decades or more if history repeats.

There are a host of other risks that could push interest rates higher, such as a significant weakening of the US dollar, even a small decline in demand for Treasury securities as their supply continue to rise with profligate government spending, or on the bright side a further strengthening of economic growth. But there are also forces that could push rates down, including a financial crisis or a politically motivated cut before the election in November.

Just like timing the stock market, it is impossible to know for sure where interest rates will go. But because there is so much risk currently in being wrong, we'll continue to use short-duration, high credit quality bonds. Stocks are in the portfolio for growth, but bonds are there for safety. Even if we give up a little performance in the short term, we'd prefer to keep our bonds extra safe.

Compliance Corner

We are in a highly regulated business, which offers our clients important protections. There are certain disclosures that we are required to make regularly regarding our policies and procedures, including:

The nature of our business requires us to obtain sensitive personal and financial information from our clients. As a registered investment adviser with the United States Securities and Exchange Commission (SEC), we must adopt policies and procedures to protect this nonpublic, personal information. Our policy mandates that ACM employees are prohibited from disclosing nonpublic, personal information to any person or entity outside of our firm, except as authorized by our clients or an appropriate regulatory institution. We also take all reasonable measures to ensure secure transfer and/or disposal of documents containing sensitive information about our clients. You can find our full privacy policy posted on our web site and in the ACM portal. It is also available upon request.

Additionally, registered investment advisors are required to file Form ADV with the SEC or state securities regulators on an annual basis. A copy of our updated Form ADV is available at any time upon request, or it may be downloaded from our website and will be available in the ACM portal.

If you would like a paper copy of either of these documents, please let us know.

Q1 Portfolio Review

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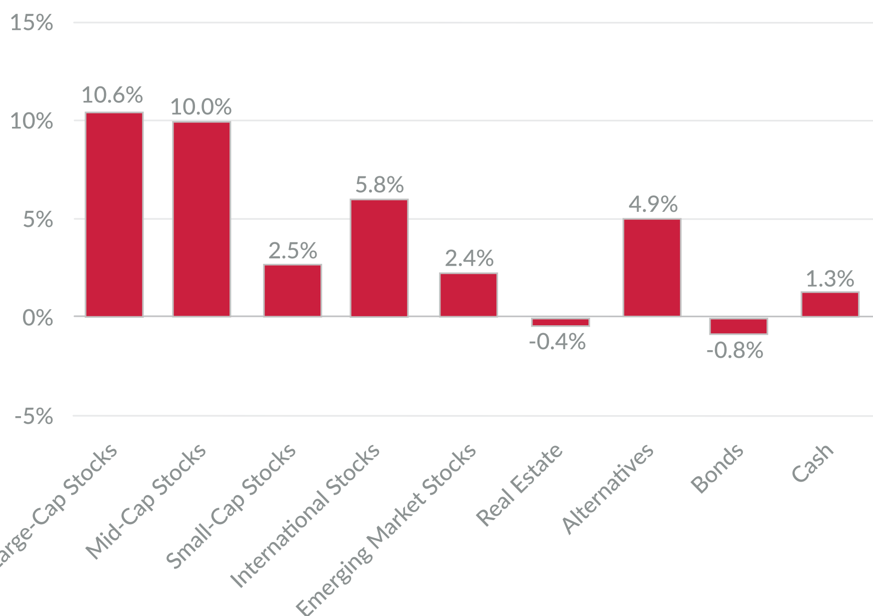
First Quarter 2024 Asset Class Returns



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indices. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones US Select Real Estate Index. Bonds are the Bloomberg U.S. Aggregate Bond Index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Cash is the yield on the 3-month T-Bill.

Alternative Investments Extend Gains

Many of our alternative investment strategies had another exceptional quarter of performance. Leading the way was style premia, which gained nearly 20%. Managed futures also performed well with an 11.5% return. Multi-strategy and reinsurance both gained in the mid-single digits, while alternative lending rose by less than 1%. Since the beginning of the decade, this portfolio consisting of liquid alternative strategies has returned over 10% on an annualized basis, which only slightly trails core stocks at less than a third of the volatility. A portfolio of these alternative funds has also greatly outperformed the Bloomberg Aggregate Bond Index's punitive -0.9% annualized return, again with less volatility. While correlations between stocks and bonds have spiked to over 50% throughout 2020, alternatives have maintained a negative correlation to stocks, making them a better diversifier. Even compared to a shorter-term bond fund which has had lower volatility and better (but still low) returns relative to the aggregate bond index, alternatives still have an advantage on being less correlated to stocks and generating better returns throughout the period.

Given current market conditions, expectations for these strategies still appear favorable. Catastrophe bond premiums remain near record high levels. Loan purchases in the alternative lending space are becoming more attractive in terms of quality and return potential as lending standards tighten. Higher short-term interest rates also benefit many of these strategies by providing a higher collateral return.

We cannot predict what the returns will be for alternatives going forward. However, given these favorable conditions, further gains cannot be ruled out. We do know that the long-term characteristics of the alternative funds we have selected are favorable, especially when used to diversify a more traditional stock and bond portfolio.

The first quarter was generally solid for investors, particularly those taking a riskier approach. While the economic backdrop is still strong, we remain concerned about higher stock market valuations and the potential for increased volatility as the year progresses. Wars around the world and our coming presidential election all pose risks for the next few quarters.