Episode 83

FireSide: Market Madness 2024

In celebration of March Madness, the Investment Research team goes head-to-head discussing leading topics set to influence markets this year.

Lara Rhame (00:16):

Welcome back to FireSide, a podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist here at FS, and today we are recording our annual market madness. You guessed it. In honor of the NCAA basketball tournament, we have created a bracket of our 16 ideas that could influence markets over the coming year. Some are obvious, some are here on a repeat appearance, and some are long shots, right? Like any good tournament. Let's introduce the other folks on our panel before we really get into the competition. I'm joined by our Head of Private Wealth Solutions, Rob Hoffman. Rob, are you ready to go today?

Rob Hoffman (00:59):

Hello, I am super excited.

Lara Rhame (01:01):

Also, here is Andrew Korz, an Executive Director on the team who's our thought leader on commercial real estate and equity markets in general. Andrew, welcome.

Andrew Korz (01:09):

Hey Lara. I got some shots up pre-game. I'm excited to go.

Lara Rhame (01:13):

I hope we've all gotten up for the game. I have. I know I have. Finally making his FS FireSide debut and rounding out our panel is Alan Flannigan. Alan is not only a terrific new addition to our team, but he's also co-authored a white paper recently on private equity secondaries. It's some of the smartest education around on this topic. So do yourselves a favor and look it up. And there's another reason Alan's here. He was in the NCAA tournament for Lafayette in 2015. So while his market insights are going to be valuable, I'm hoping he'll give us a little peek into the intensity of that experience. And Alan, welcome to the podcast.

Alan Flannigan (01:53):

Thanks Lara. It's a pleasure to be here. I didn't realize I'd still be rehashing my college basketball exploit this many years later, but glad that it's paid off here. So privileged to be here.

Lara Rhame (02:03):

Alright, let's talk about the tournament, the brackets as we record today. The bracket isn't out yet. We're recording on March 13, the brackets coming out this coming weekend.

Alan Flannigan (02:17):

Selection Sunday.

Lara Rhame (02:18):

Yeah. Selection Sunday. Andrew, you as anybody who's been a frequent visitor of this podcast recognizes Andrew is a rabid Villanova fan. Are you guys in this year by chance?

Andrew Korz (02:29):

Well, we'll see. I'm not sure when this podcast will come out, but as of now, I would say we're firmly on the bubble, which means that time will tell whether we get a bid.

Lara Rhame (02:38):

Not too much time though, because this...

Andrew Korz (02:40):

Yeah, within the next week we'll know. Yeah, next week.

Lara Rhame (02:44):

Alan Lafayette. Any chance?

Alan Flannigan (02:45):

Lafayette is out season is over lost in the conference tournament. So we're one bid league. You don't get that one bid. No chance of the at large bid.

Lara Rhame (02:53):

And do any of you have teams in ?

Rob Hoffman (02:56):

Nebraska?

Lara Rhame (02:57):

Oh, Nebraska

Rob Hoffman (02:58):

for the first time in a decade.

Andrew Korz (03:00):

The corn Huskers

Rob Hoffman (03:01):

Number three in the big 10 double bye in the conference tournament.

Lara Rhame (03:04):

Yes.

Rob Hoffman (03:05):

Super exciting.

Lara Rhame (03:07):

So that’s who we'll all root for. That'll be our team teams this year.

Rob Hoffman (03:10):

This will be their chance to get their first win ever in the tournament. That being said, it's like a 99.7% chance they're in when you look at the prognosticators. But

Lara Rhame (03:20):

We'll find out. They have a good coach?

Rob Hoffman (03:22):

Yeah, coach of the year in the Big 10. That's awesome.

Lara Rhame (03:25):

Excited. That's awesome. Are you going to be able to go to any of the games or are you that big of a fan or are you just going to have a viewing party at your house?

Rob Hoffman (03:33):

I mean, we'll see where they're playing, but it might be a little bit difficult to make it to the game, but we'll see. You're on the

Lara Rhame (03:41):

Road a lot. You never know. Stars align.

Rob Hoffman (03:42):

I love watching 'em on TV and seeing my parents sitting in their seat kind of behind the hoot. That's awesome. That's pointing out the grandparents for the kids when they're on Tv. It's a lot of fun.

Lara Rhame (03:51):

So It's a family institution.

Rob Hoffman (03:53):

I've been going my whole life

Andrew Korz (03:54):

For a football school. It's pretty cool to get basketball in line right there.

Lara Rhame (03:59):

Alright, good stuff. Well I know we'll all be making good use of the time to enjoy the tournament and do that. Alright, so let me explain what we're doing today with our Market Madness, which is a bracket of our 16 top ideas that we think could influence markets over the next year and the brackets online. So I hope that you'll have an opportunity to just sneak a peek at it and kind of frame out the conversation. I think we're going to go region by region first. Does that sound like a good plan to everybody? Alright, so our first region, our number one seed is inflation up against crypto resurgence. That's our dark horse. And then we're going to have another game between China devaluation and CRE refi meltdown that sounds like a terrible team to root for and yet it keeps coming up as something that could influence markets over the next year. That's the way that we're framing this conversation.

Andrew Korz (05:00):

I'm glad I was assigned to that team.

Lara Rhame (05:02):

Well, even if the team is bad, the idea is that if it is going to be a really dominant influence, that could be one way.

Andrew Korz (05:09):

Some teams have won ugly in the past and that's certainly possible.

Lara Rhame (05:14):

I love that phrase. Alright, so I'll start us off inflation and I will pass off crypto resurgence to Alan.

Alan Flannigan (05:22):

Excited to take it. The underdog

Lara Rhame (05:24):

Lucky underdog. Right. Let's make your case for why you think crypto resurgence is going to be the dominant influence in markets for the next year.

Alan Flannigan (05:32):

Sure. So I mean I'm used to being in the underdog position in the tournament. When we were there we were 16 C going up against the Villanova Wildcats as the one Andrew's beloved franchise. Great college program.

Lara Rhame (05:44):

Andrew, were you at Villanova

Andrew Korz (05:45):

Then? I was a senior, yeah.

Lara Rhame (05:47):

And you were both seniors at the same time? We were. That's where were, for me, he was on the court and

Andrew Korz (05:51):

I was in my tiny little living room.

Alan Flannigan (05:55):

But in any event, hopefully, but I enjoyed the game more than

Andrew Korz (05:56):

Allen did, I think. Yeah,

Lara Rhame (05:57):

I

Alan Flannigan (05:57):

Think so too. And I'll make my best effort here for crypto resurgence to do better than my beloved leopards did that day. So here we go. So crypto resurgence, let's focus on Bitcoin to start. It's the oldest most established of the cryptocurrencies. It really serves as a proxy for the market. And with the runup to start this year, it's now at a $1.4 trillion market cap. And this is on the back of news of Spot ETFs being approved in January, which have attracted pretty considerable flows. I mean BlackRock's attracted 15.4 billion, fidelity, 9.2 billion, and the grayscale Bitcoin trust kind of the longest lasting. Now ETF as of two months ago in the space is up to 27.7 billion. So meaningful money going into this space and the returns have been very strong on the back of this. If you think about last year, maybe a little bit of a crypto winter, but now we're in the spring and spring has certainly sprung across this space.

(06:54):

So year to date returns of over 72% for Bitcoin. A one year returns in excess of 200%. And if you go back five years, you've had an annualized return of 80% eye-popping results. But certainly it's something where volatility along the way is integral to the story. As we approach the HAL cycle for Bitcoin here in the next month or so, expected to be in April according to Coinbase, that's an event that Bitcoin enthusiasts have been marking on their calendars for years. Much like we do the tournament every year they mark that HAL cycle. And with that, this is something that increases the deflationary aspect of Bitcoin into something that Bitcoin enthusiasts point to is providing a lot of price support.

Lara Rhame (07:34):

Awesome. Well that was a very strong case for crypto. I think the question is does it influence other markets significantly? That's the issue, right? Because here I am, and I'm not going to lie, inflation has been my top pick not just this round, but prior last year in the tournament was because I see inflation as really at the center of the dynamic striving interest rates higher all else SQL equity markets, which are responding a lot to CPI data and other wage data to even clearly real estate markets. Things that there are many different markets that are really taking inflation, which leads to fed expectations and running with that. So inflation today, yesterday we got the February CPI report with inflation at 3.2% year over year was a second upside surprise in a row. And CPI has really been flattened above 3% now since June of last year. I will actually say it hasn't influenced Marcus as much as I would've thought over the last year, but I think over the coming year it's going to be a pretty big influence. So what do you think guys? Do you think I won that round or

Rob Hoffman (08:55):

No? The thing crypto, it's had multiple crypto winters, right? It happens and it's crazy volatile, but it doesn't seem to really spread beyond crypto.

Andrew Korz (09:07):

And it also, I mean to simplify things kind of feels like just a levered play on speculative tech. It seems to trade with the nasdaq and I'm not sure crypto is necessarily the one driving the market. It's kind of the market driving crypto performance. Great way to put it.

Lara Rhame (09:26):

Alright Alan, great case. I think we're going to advance inflation. Try to

Andrew Korz (09:30):

Make my most passionate argument, maybe

Lara Rhame (09:32):

The most

Andrew Korz (09:32):

Passionate argument I've ever made

Lara Rhame (09:34):

For Bitcoin. I heard it. It was in the room. Alright, the next head to head is CRE refi meltdown. Andrew. Clearly that is the one that you are going to be talking us through that team's chances.

Andrew Korz (09:46):

Yeah, absolutely.

Lara Rhame (09:47):

I've given myself one that has come up. I'm going to channel my old foreign exchange days because China and the risk of devaluing the Ren mibi is something that I think is starting to bubble up. Why don't you take us through your CRE refi meltdown and why you think that could be a big influence in markets over the

Andrew Korz (10:09):

Next year? Sure. So I'm going to take some liberties here because there are no rules in market madness. No rules at all. There's

Lara Rhame (10:15):

No referee

Andrew Korz (10:16):

Here. There's no referee here at all. It's anarchy only madness. So I think taking the word meltdown out of this, I do think this team has a decent chance of advancing here. Look, I think the reality is there are about six to $800 billion of CA debt outstanding that needs to be refinanced in the next year. That is a fact. A lot of these other factors are uncertain as to whether they'll happen at all. We know that there is this refinancing wave in the commercial real estate debt markets. Again, six to 800 billion over the next year, about $2 trillion over the next three years. That's significant, right? Sure. Lots of borrowers, lots of property owners are going to see their and

Lara Rhame (10:56):

It comes up all the time.

Andrew Korz (10:57):

It does, it does, absolutely. And you hear refi wall, I prefer refi wave, but lots of borrowers are going to have three refinance into this environment where interest rates have really more than doubled in terms of CRE mortgage rates. So the interest expense for these borrowers is going to increase significantly. Again, as we've talked about, the good news is fundamentals outside the office sector are really strong and most of these borrowers are sitting on assets that they want to continue to support. The issue is going to be that they're going to have to inject new equity into these properties to continue to support them and to meet the refinancing needs of these lenders. Are there going to be some issues in the office sector? Are there going to be some issues at certain banks that are overexposed to parts of the market? I think yes, and the Fed has sort of put out some statements about concerns around the office sector, but I think as we go throughout the year, there's going to be more news mostly around the office sector here. But the other thing is it presents a massive opportunity for lenders in the market, right? Sure. We've talked about and CMBS market, having stepped back a bit, there are these alternative lenders that can come into the market and meet this big need. So I think when you think about an issue like this where we definitely have to address it, there could be some risks along the way and it presents a massive investment opportunity as well. I think that that presents a pretty strong case for this being a big market factor over the next

Lara Rhame (12:14):

Year. Yeah, sure. And I think I'm going to talk a second about China because when you look at the globe and the global economy, China's slowdown has certainly I think is really notable. It's really obvious that it's getting a lot of attention. The reason why I think China's the possibility of China devaluing their currency is coming up is because it's a potential release valve that could further accelerate their export machine, their domestic export machine. And I put it there because the reality is that while I don't see in and of itself China's weak growth impacting the US economy, I think there's a much greater chance that it impacts financial markets. We've talked about supply chain disruption and that release valve of the currency, it's kind of already slowly happening. I'm going to put on everyone's radar that the Ren MIBI is trading at 7 34 to the dollar that was its high that we hit just in September, 2023. That's the high since they broke their peg back in the mid two thousands and that was only six months ago. And over the last year, call it year and a half, it's fallen 14% versus the dollar. So they're already I think kind of weakening their currency at the margin. It's not a whole scale

Andrew Korz (13:37):

Team valuation and there's only so many levers on growth that China can pull. That's the point. They don't want to reinflate the real estate market that the infrastructure is just going to add more debt to the economy and China, there's not

Lara Rhame (13:49):

Much room for fiscal stimulus

Andrew Korz (13:50):

There and they're never going to stimulate the consumer, they never have.

Lara Rhame (13:53):

The

Andrew Korz (13:54):

Export market is really where the game is at

Lara Rhame (13:56):

And local governments just are tapped out. They don't have the room for the fiscal squeeze. So when I think about what could influence markets, I think we look at the likelihood in the US that it's really a CRE, either anxiety, which I think you and I don't feel is warranted. I think that's got to advance even though I think it's worthwhile having the discussion on China. Yeah,

Rob Hoffman (14:20):

I think that

Andrew Korz (14:21):

Makes sense. I agree

Lara Rhame (14:22):

Certainly. Alright, let's move to the next region and here I'll turn it over to Rob and Alan because it gets very, I think banking related, very credit related, fed rate cuts, more regional bank failures, tight credit spreads and geopolitical tensions. So Rob, why don't you and Alan take those number two and number three seeds, tell us what they are and why you think they're going to influence markets. Yeah,

Rob Hoffman (14:49):

So if I take the two seed tight credit spreads, look, credit markets generally speaking across the board have had a pretty good run following the volatility in 2022. And floating rate credit for that standpoint generally did okay in 22 against a backdrop of falling equity markets. But things rallied really strongly in 2023. This year has been off to a pretty good start. And when we look at spreads across markets like high yield loans, high grade, I mean if you rank things on a percentile basis where they've been in history, high yields 86 percentile loans 50th, high grade 77 CLO, single A, 66 European markets for high yield, almost 80% on a spread basis. Spreads are relatively tight. I think they're tight for a reason. It reflects a lot of the good returns, relatively low default rates. Companies are still in pretty good position. Economic growth is good, it supports that. But I agree, I think from a pure spread perspective, I think a lot of people look at these markets and say, man spreads are kind of tight and does that not pose a challenge that could spread to other parts of the market

Lara Rhame (16:05):

If they

Rob Hoffman (16:05):

Heard to widen and you get some big price moves and these markets start to go down, I think there's a case to be made there that

Lara Rhame (16:12):

It could impact broadly. But my answer too, the concern that it's not a good time to invest in credit because credit spreads aren't wide is like we're now in a world where core interest rates are four to 5% total yield is really, and I think that simple fact is just so lost on so many investors in this space.

Rob Hoffman (16:33):

Well, not to talk against my own position, but I do agree if you look at those same percent aisles on a yield basis, high yields only at 50%. US loans are only at 11%. CLOs only at 12% like on a yield perspective, markets are still exceptionally attractive and I think that's created a lot of demand for credit product combined with, again, the reasonably good economic conditions means companies are generally in good space and yields are super attractive. So yes, spreads are tight, but the yield argument does kind of

Lara Rhame (17:03):

Offset well and we wrote tight credit spreads, but I feel like we could have just written credit spreads. I think that's something that a lot of investors are still watching this day-to-day movement in spreads. And it's like when corn streets were zero, that was all your return was reliant on and now you can kind of just focus back more on fundamentals and let the yield do its work for you. Yeah, it's true. All right. I don't need to sell you a credit fund, you're

Rob Hoffman (17:30):

All

Lara Rhame (17:30):

In. Alan takes us through your team.

Alan Flannigan (17:34):

So I've got geopolitical tensions here as the three seed and this is one that can be an all encompassing topic. You can think about tensions between China and Taiwan, certainly what's going on in the Middle East with Israel and Gaza and the Russian Ukrainian war. And these are all things that have a very human element and a situation where first and foremost you think about the human toll that these conflicts take and certainly thoughts and prayers with all those that have suffered throughout and hoping that the resolution is on the horizon in each of these scenarios, as

Lara Rhame (18:06):

You clear when we say we're rooting for a team to move forward, in no way are we rooting for any sort of geopolitical tension. Correct, exactly. We're simply thinking about what would be the most likely to influence markets.

Alan Flannigan (18:18):

Exactly. So that's our framework by which we're looking at this certainly not advancing these on cheering for an outcome here. So I'll take us through the economic side of things as well too. And here it's helpful to step back a little bit and what is war from an economic perspective? It's a commodity and an inflation story. When the soldiers are off fighting wars, they aren't at home farming or working in factories producing goods that cause supply chain disruptions. You have physical supply chain disruptions as a result of war. And these all cause supply side shocks in terms of inflation dynamics. And speaking specifically about Russian Ukraine, this is a good example because these are two major commodity producers in Europe. And the inflationary results of that is obvious. Everybody knows a story with oil and wheat, but it's also nickel, copper, iron, palladium, platinum, titanium for the aerospace industry. And I remember in the early days of the conflict breaking out, everybody was figuring out, oh neon, 90% of it's produced in Russia and where do they refine it after it's produced in Russia, Ukraine, right? So this is a key ingredient in the semiconductor manufacturing process. And this is an example I think that we've experienced multiple times in the past few years now, be it the covid lockdowns and restrictions, but it's companies having to gain a better understanding of their supply chains.

Lara Rhame (19:41):

And that conflict's already in play. I think this is asking if there're going to be more breaking out, widening, spreading, or do we think it's going to,

Andrew Korz (19:49):

We're seeing it with what's going on in the Middle East, the rerouting from the Red Sea around the horn of Africa. That continues to worse and actually, and it hasn't impacted things too significantly yet, but as shipping rates go up, we could see that sort of flow through to inflation as well.

Lara Rhame (20:05):

Sure. Well, and I think commodity prices haven't moved yet, but to me that's going to be the biggest potential point of intersection with our economy and markets. It seems like oil above a hundred is some sort of place that markets just get really uncomfortable. How many fundamentals break down? Think

Andrew Korz (20:23):

About China, US, the US just passed I think something through Congress looking to ban TikTok. There could be some retribution from TikTok where they're banning Facebook products there. There's all these issues between the US and China where we still don't really know how they're going to end.

Alan Flannigan (20:39):

And so the risk of a broader escalation in the Middle East certainly is a threat. Fortunately with where it's contained right now, there's not a lot of major global economic impact. Obviously shipping routes affected but not major commodity exporters. That's why I give the example of Russian Ukraine to illustrate how an escalation kind of can be a significant market event when it involves these types of producers.

Lara Rhame (21:00):

Alright, well you've talked me into it. I feel like that's the one that advances because I think credit fundamentals now should be more the focus than credit spreads. And so as we look forward to the next year, I think that left hill risk of some bigger event or I really PE economy prices

Rob Hoffman (21:18):

Like financial banking crisis for credit markets to be the thing that moves everything outing else. A lot of

Lara Rhame (21:26):

Times

Rob Hoffman (21:26):

It's these other factors that then impact credit not the other way around. I

Lara Rhame (21:30):

Agree with that. All right, let's move on to, I will briefly mention because I want to move to our third region rate cuts are another number one seed in that second region that we talked about bank failures, it was the number four C they were up against. That is also a left hill risk that should be on all of our radar, but we've already had two and it did not cause a broader market reaction. I think fed rate cuts are still going to be the major focus. Should you agree with that, Andrew? What do

Andrew Korz (22:04):

Think? I mean the Fed reacted pretty strongly to the spring 23 bank failures and I think that knowledge for the market should keep them fairly confident that they know how the Fed will react. If there's more issues,

Lara Rhame (22:17):

I think we can take some confidence in that our next region is going to be, we're going to move through that one quickly. I think Andrew, I want you to give us, and I signed you too because these are both related to equity markets, which of course are I feel like a driving force in overall markets. Equities are really often sort of the guiding sun. And when we think about the big drivers in equity markets, I have given you two pretty tricky ones. Small and mid-cap comeback and an AI reality check.

Andrew Korz (22:54):

Don't call it a comeback.

(22:57):

So the smid. Yeah, so on sids, I mean they've really underperformed markets over the past three years. SID caps have underperformed large caps by 14% the past year, 50% the past three years. Just massive underperformance. Yeah, it's not as dramatic outside the US but it's definitely still there in other markets as well. I think the reality is if you look at this from a fundamental perspective, the gap between just the profitability and the margin dynamics at these large caps, especially the mega cap US companies have just that gap between large and small cap is just really widened. And as we've talked about in other podcasts, the quality of the small and mid cap market in terms of just the pure beta of that market has really degenerated. There's 35 to 40% of those companies don't have any positive earnings. So when you're talking about just the pure market, it's not a very high quality market anymore.

(23:47):

So really it's a valuation sort of play right now where you've got PE ratios that are like 0.75 that of the large cap market. So you're really betting on that valuation. The way we would prefer to play that is more sort of looking for the highest quality names in this mid market that has sort of gotten beat down just because that's the market they're in and that market has underperformed. Sure. But by and large, I am not sure at this point in the cycle you want to be buying broad beta to the small and mid-cap companies. And then on the AI side, I think a little more interesting, probably a broad estimation of how much wealth the AI trade has netted is around $5 trillion just in the US just using sort of an ETF that tracks companies in the AI space.

Rob Hoffman (24:31):

Is that a big number 5 trillion?

Andrew Korz (24:33):

It's

(24:34):

Not small. It's not small.

Lara Rhame (24:35):

Two of a TR trillion.

Andrew Korz (24:37):

The US market's about 45 trillion. So you can say you've added one ninth of the US equity market cap in the past year. Extraordinary just on ai. And 40% of that's Nvidia. So

Lara Rhame (24:48):

Here's the real question though. Is it a bubble, like the tech bubble? Is that what we're seeing again? Yeah,

Andrew Korz (24:53):

It's incredibly exciting and my goal here is not to be a Debbie Downer, but that's the task that I was given here. I think if it is a bubble right now, it wouldn't be more of a fundamental bubble than a valuation one. If you actually look at Nvidia, their PE ratios come way down because earnings expectations have come up so much. But the question is just like will the earnings be as spectacular as people think? Right. NVIDIA's forward earnings have quintupled over the past nine months.

Rob Hoffman (25:21):

Yeah. Wow.

Andrew Korz (25:22):

It's just incredible the surge in profitability that we've actually seen in the reports. It's not just expectations we've seen it. I think as this goes forward though, more issues will arise around political as it takes more jobs from certain industries. Will politicians come in to try to protect their district's regulatory as security issues come up and

Lara Rhame (25:46):

Reality check doesn't have to be negative, it can just be taking the air out the balloon a little bit. It can actually be exactly

Andrew Korz (25:52):

As we look to implement it sustainably in our society. And then of course environmental in terms of the amount of power and electricity and water that's used to make some of these NVIDIA semiconductors that are using these data centers. So I think given how much wealth is being created on the back of that, there's a lot of sort of dynamics that could come into play where it's swinging the market one way or the other. So I think this could really come into play over the next year as sort of society comes to grips with how this is implemented. Yeah,

Rob Hoffman (26:24):

No I think that that makes a lot of sense. I mean to think that Nvidia with the incredible run that it's had, but the PE ratio has gone down, it's

Andrew Korz (26:32):

Come down to like

Rob Hoffman (26:33):

Half. Yeah, it's like

Andrew Korz (26:34):

33 right now or 34 and it was

Rob Hoffman (26:36):

Incredible. Yeah. That's incredible.

Andrew Korz (26:38):

Yeah.

Lara Rhame (26:39):

Alright, so you're advancing, which one are you advancing? I

Andrew Korz (26:42):

Think as much as I would like to go by Smid at the bottom, I think AI reality check, given the wealth that it's created is the winner here.

Lara Rhame (26:51):

AI seems to be the dominant discussion topic every time it's on the way up. It will certainly be if there is some kind of reality check. And I wanted to kind of answer the own question, my own question that I threw out to you, which is something I get a lot, is this a repeat of the tech bubble in the late nineties? And I just think there are lots of reasons why those companies weren't profitable. There were not positive earnings, very different from today. But I think your point is really important, and I don't want to even use the B word, but a reality check can come on fundamentals alone. It doesn't have to come from some sort of

Andrew Korz (27:26):

Radical, A company can be mega profitable

Lara Rhame (27:28):

Today, rational priced,

Andrew Korz (27:29):

But that doesn't mean they're going to be mega profitable in three years.

Lara Rhame (27:31):

Alright. AI reality check. I hope that didn't feel too bearish to you.

Andrew Korz (27:37):

No, I mean I hope I didn't sound too bearish. No.

Lara Rhame (27:42):

Alright Alan, I'm going to give you the next matchup middle market, US middle market versus fiscal outlook.

Alan Flannigan (27:48):

Thanks Laura. So the US middle market will just frame out the discussion in terms of what we mean a bit. So this is a sub-sector within the US economy that involves nearly 200,000 businesses, represents a third of private sector GDP and employs approximately 48 million people. Revenues for these businesses are between 10 million and a hundred billion. And this is a market where we've seen consistent outperformance on the growth side of things. So in 2023 across the segment of the market revenues increased for 83% of middle market companies and an average revenue growth rate of 12.4% over the year, which was an all time high for this segment of the market.

Lara Rhame (28:29):

Does that compare to the s and p 500 or outpaces it?

Alan Flannigan (28:32):

I mean I turned to my equity strategist, Mr Korz is everywhere.

Andrew Korz (28:35):

Earnings were down in 2023 for the s and p outside the mag seven. So I don't think 83% of companies were growing earnings.

Lara Rhame (28:43):

Yeah, that's

Alan Flannigan (28:43):

Great. And this is a market that can help investors address one of the main challenges today, which is everybody needs some allocation to growth in their portfolio. Whether you're in retirement and you're concerned about the possibility about living your assets or whether you're very much still in the wealth and accumulation phase of your life, this is a core fundamental need within a portfolio. When you look at US public equity markets and you say, okay, valuations are pretty high, you're very concentrated in your growth stocks and a few large cap tech platform names externally outside the us there's a lot of reason for skepticism as well too. Valuations are a bit more attractive, but there's many other problems that plague the rest of the world where the US has leadership position that insulated from some of the rest of the world's problems. We're also fairly insular economy and you see that within the US middle market where the main market in which these companies operate is the US where the consumer's still strong and household balance sheets are still adequate.

Lara Rhame (29:37):

And this speaks to one of the discussion points that we just had earlier, like geopolitical tension. This is a place where you are a little more insulated from geopolitics where energy independent food independent, and really unlike the s and p 500, which is a very international index, our economy is quite closed. We trade is only what 15% of

Alan Flannigan (29:58):

The absolutely no

Lara Rhame (29:59):

Currency risk.

Alan Flannigan (30:00):

And as investors think about getting equity and growth exposure within their portfolio, diving down into the US middle market, which is a market that there are becoming more ways to access this part of the market for investors, which is critical because if you look at the cohort of companies there, 87% of US companies with more than a hundred million in revenue are private companies. So if you want to have an equity allocation that gives you exposure to the broad market and you don't have exposure to this part of the market, you're missing out on a significant amount.

Rob Hoffman (30:31):

And it's interesting, not to belabor the point, but the comment that Andrew made on smid, that if you look at the SID market, so publicly traded small and mid-sized companies, you made the comment that they're not particularly high quality today with a lot of 'em that, I mean a lot

Andrew Korz (30:44):

Of whose iPod are companies and biotech and software that don't have positive earnings yet. And a lot of the companies in the other sectors have stayed private.

Rob Hoffman (30:53):

But meanwhile the US middle market, which is largely private, still has really good fundamental characteristics. So absolute to your point Alan, that providing access to, you can't just go buy a smid fund and say, okay, well I've got us midmarket exposure. So many of those companies are not public anymore. It might've been a decade or so that

Lara Rhame (31:12):

Influences other markets because what it's positive fundamentals, the clue they a employ a lot of people in the US and it's

Alan Flannigan (31:20):

A wider opportunity set. It's not just tech software businesses, you can get growth in industrials, healthcare variety of sectors. It's just a more diverse environment from which to pick companies for your growth exposure.

Lara Rhame (31:32):

So I put you up against US fiscal outlook, which is probably not that good, but I mean you say one day, but to me I put it in the bracket because listen, supply side dynamics on treasuries are not great. Where we keep, as the new budget shows, we're not going to do a good job closing the gap anytime soon. And so the fiscal outlook to me is really similar. It's sort of the same side. The other side of the coin is debt dynamics and debt outstanding, which is enormous and I think could have a big influence on markets should we get a failed treasury auction. So

Alan Flannigan (32:09):

It helps that congress has passed a spending bill this past week, avoid shutdown for the near term, but it'll be a topic that comes up again in the fall, particularly in an election season. Let's not being naive that just because there's an election folks won't hold the budget hostage, but the question is impact to the market of the coming year. And I think what we've seen in the past is that yes, there are fits and starts when it comes to budget making occasionally some shorter term ramifications, but long term these are not major black swan events that affect the markets in a significant

Lara Rhame (32:40):

Way. Gotcha. Alright, so it sounds like you're pushing to progress us middle market as a broader sort of ballast for overall markets. Yeah, I

Alan Flannigan (32:49):

Think that's the more compelling story for investors

Rob Hoffman (32:51):

And that, I mean maybe a more near term compelling. I mean I think the big worry is one day the US fiscal outlook, it is a big issue for this economy.

Lara Rhame (33:01):

Yeah, yeah.

(33:02):

No, I agree. When we look at the long run charts sort of one to 10 years, it is really scary, but we want to keep this upbeat, not terrify everybody with the US deficit outlook. Alright, last quadrant, I'm going to take the top one. I have given myself household delinquency rates versus trade policy. And when I think about what could impact the economy, I don't think we can discount, these are kind of maybe two scary things, like household delinquency rates are rising. You look at auto delinquencies, credit card delinquencies, they're both back well above where we were pre pandemic. Remember they all dipped during the pandemic. We couldn't go out and spend our money so we kind of paid down our debt and people got a nice bolus from the government,

Andrew Korz (33:52):

Rates were zero. That helped.

Lara Rhame (33:53):

Right? Totally. So now they have really, I think risen beyond where they were before the pandemic and for both autos and credit cards at the highest is 2011, which was not a good time in the economy. So that is absolutely something to keep our eye on. The outlook for the US consumer remains solid. The unemployment rate has been below 4% for two years now and real income growth is positive. So while excess savings has been eroded, people tend to spend alongside with income. But household delinquencies we need to keep our eye on very closely. And trade policy I think is something that's unlikely to affect our economy this year. I'm going to advance household delinquency, but I'm not going to skip over the fact that trade policy needs to remain at the forefront. The Biden administration continues a lot of the policies actually that Trump put into place and obviously if we get Trump reelected, he is promised significant new tariffs. There's going to be a lot of moving parts on that front and I think that still is something that I keep, while I'm not going to advance it, I think we need to remember it is a left tail possibility for broader markets which are heavily international. Yeah,

Andrew Korz (35:18):

It seems like reversing globalization is becoming more and more bipartisan, so it's more of a question of magnitude than direction.

Lara Rhame (35:24):

Yeah, exactly. Exactly. Alright, for our last matchup, this is going to be a tight competition. I'm going to turn it over to Andrew and Rob to break down the head-to-head competition between managing the magnificent seven, what that's going to look like over the coming year, and rob this idea of cash on the sidelines, which you can explain to us what I mean by that. Yeah, Rob, you want to take it first?

Rob Hoffman (35:50):

Sure. I mean 6 trillion of cash sitting in money market.

Lara Rhame (35:55):

That's also a big number.

Rob Hoffman (35:56):

Yeah, six pretty big there was call it 3,000,000,000,003 years ago or so. Yeah, that's incredible. And look, as sitting here in the seat of working at an asset manager, I mean I think one of the largest sources of competition for anyone who's trying to get investor dollars into a fund is, well how is that going to do relative to cash? If I can earn five plus in cash right now by earning t-bills and money market funds, what's the compelling investment rationale to do almost anything else? And it is certainly a major source of competition. It's interesting in that this

Lara Rhame (36:31):

Is why I remind everyone that inflation's still like 3%. So 5% isn't what you

Rob Hoffman (36:36):

Would

Lara Rhame (36:37):

Think it would be.

Rob Hoffman (36:37):

Absolutely. And what could cause that cash to come off the sidelines and move into markets? I think one of the things that's interesting is as rates have gone up and these yields have become really attractive, I think the relative opportunity in cash versus other things has shrunk. But if we think about the other side of this and what happens if rates decline, the absolute level of yield that someone is going to be able to earn in one of these money market accounts is going to go down and it will go down in a direct relationship to what the Fed does with rates. But when we think about whether it's earnings yields and equities or high yield bonds or private credit or any of these other yield generative asset classes, the actual relative gain in those asset classes becomes even more attractive as rates go down. So could that cause a flood of some of this money to move into these markets as the Fed is cutting rates to provide stimulus to some other sectors? Or is there something else that just causes this cash to come off the sidelines, the AI trade, whatever it is that sort of rerate investors Bitcoin to want to move that money out of a money market Where to your point that the real return is not as good as just the absolute level or the nominal return. It's a lot of money. It flows

Lara Rhame (37:55):

Matter sitting there, flows matter, it's sitting there. I also think that last year gave us a powerful reminder that there's an opportunity cost to sitting on the sidewalk. And I think that's going to think motivate a lot of people to deploy that cash.

Rob Hoffman (38:08):

Yeah, I mean high yield was up 14% and if you were like my dad who is a retiree and oh, if I can earn 5% on my bank cd, I'm not doing anything else. But he just gave up almost 10% worth of return by not investing into the market. Did you tell him that? Yeah, he wouldn't listen to me.

Lara Rhame (38:27):

He's got Nebraska on the mind. He's setting his

Rob Hoffman (38:28):

Waist.

Lara Rhame (38:31):

Alright Andrew, how do you manage the Mag seven? This concentration

Andrew Korz (38:35):

Through the next year? To me, I feel pretty good about this squad. I mean this is the question in global markets today. It is, I mean seven stocks, it's now 30% of the s and p 500. We

Lara Rhame (38:45):

Have all of our eggs in one basket, seven eggs in one basket,

Andrew Korz (38:48):

Seven eggs in one basket. Exactly. Exactly. With 30% of the s and p 500, that's up from 22%.

Lara Rhame (38:53):

What's the basketball corollary? Is this a team with one player and all of our performance is concentrated in that one person? You got to play

Andrew Korz (38:59):

Boxing one against this team I think. Yeah. Yeah, just track 'em around the court. So again, almost a third of the market historically, they've traded very tightly to each other just because they're all growth companies. They all respond similarly to interest rates. Sure. Recently it is interesting, they've kind of split into, I would say trifurcated into three separate groups. You have Nvidia, which is in its own world right now. You've got Microsoft Meta and Amazon, which are all your AI cloud plays that have performed, continue to perform really well. And then you've got your Apple, your Google, and your Tesla, which all have kind of struggled recently for various reasons. Apple, because of stagnating sales of the iPhone issues in China, et cetera.

Lara Rhame (39:44):

And regulatory, regulatory

Andrew Korz (39:45):

In Europe and Google sort of with the absolutely calamitous outlaying of their AI Gemini, which obviously has gotten, I was pilled in the market. And then Tesla, which is down like 40, 45% over the past six months. So you've had this trifurcation again in that market alone. So the group together is still up 12% this year or 12% plus. But really the dispersion between the names has increased pretty significantly this year. So when we think about managing this, you're managing multiple moving parts. Number one, you're managing just sheer concentration, right? It sounds

Lara Rhame (40:21):

Like a nightmare.

Andrew Korz (40:22):

Yeah. I mean you're managing a market and a core allocation that is now really concentrated. I think number two, you're managing, again, rate sensitivity. These stocks are moving in slightly different directions, but they're still all exposed to what the Fed does and what rates do. And that's why it's a big reason why we've seen stock bond correlations rise. You do have this cohort dominating the market. And the third thing again is new. It's like how do you manage the Mag seven, which is now basically its own asset class, right? Do you start to actively manage it? Do you look to overweight the underperforming names like Apple and Google? Do you sort of ride the winners like Nvidia? There's a lot of questions that come up that are going to be really important to portfolio construction the next year.

Lara Rhame (41:03):

Alright, so this is a tough one. Which one do we advance? I know my vote, which is that we should advance the cash on the sidelines because that is one large pool that's going to move in one direction. To your point, flows matter, but I'm open to discussion. What does everyone else think? No,

Alan Flannigan (41:21):

I think Andrew's point on the Mag seven, it's such a narrow set of considerations. I mean there's many considerations, but it's involving such a narrow relationship between these stocks interest rate effect on these stocks. And it's a challenge for investors, but in terms of what moves markets, I tend to think that 6 trillion in cash is a lot. And if that cash does start getting off the sidelines and into the game, Rob,

Rob Hoffman (41:48):

That was the one I was arguing, so

Lara Rhame (41:52):

I

Rob Hoffman (41:52):

Can't complain about that. I got to ride the hot hand.

Lara Rhame (41:53):

Well, and I think to Andrew's point, and this is where we'll get us down to the final four now, the idea that interest rates are also still a key driver of that magnificent seven bundle to me speaks to bringing something more in inflation or fed rate cuts as a bigger presence in driving markets over the next year.

Andrew Korz (42:15):

And one more thing I would add is when you think about managing the MAG seven part of managing it is figuring out how to get exposure to assets that diversify that exposure. And you could argue that folks have a lot of cash sitting on the sidelines right now and they have the ability to sort of step into those types of asset classes that do offer diversification. So I will allow Rob this victory.

Lara Rhame (42:40):

Thank you. Go Nebraska.

(42:43):

Alright, we'll wrap this up with our final four, which is inflation fed rate cuts, the US middle market and cash on the sidelines. I'll take inflation very quickly, which I put right up against Fed rate cuts. And I guess now I found myself sort of arguing against myself because it's the same issue. I have consistently thought inflation's going to be uncomfortably persistent that the Fed is only going to have the room to cut rates surgically two to three times at this second half of the year. That is significantly less than markets expect. I am going to push inflation as the broadest market mover because I think it's going to keep upward pressure on long-term interest rates. I think those upward interest rates are going to force some recalibration of expected returns in equities. And I think that this idea that the economy is solid, but there's no urgency to cut rates. I think that is going to be really the dominant factor in markets.

Rob Hoffman (43:57):

And I think interestingly, and I don't really know why this is, but you've seen this major change in expectations for fed rate cuts this year and the impact to treasury rates and markets has not been that significant. We were looking at this the other day, the fed rate curve and the path for rates is not that different than October of last year when 10 year was at 5%, but this time rates only went from three 80 to four 15. A much more muted impact. Maybe the market is just not as reactionary to changes in fed rate cut expectations right now than it was even for much of the past 24 months.

Lara Rhame (44:37):

Meanwhile, inflation is still impacting the economy, it's still impacting consumer sentiment. And I think for companies it's going to impact their wage costs and a lot of other pricing power factors. Yeah, exactly. Thank you. Pricing power, a lot of other factors that are going to really impact their profitability and performance. So I'm going to stick with inflation. Why don't we break down US middle market, which has also made our final four with cash in the sidelines for Alan

Alan Flannigan (45:05):

And Ron. Yeah, absolutely. And I like how our Final four shaken out because on the one side of the bracket you have inflation and fed rate cuts, which are really out of investors' control. But on this side of the bracket, you have US middle market and cash on the sidelines, which are very much within investors' control. And so as we talk about the US middle market, this is an area where you've got the expanded opportunity of your investment set. You've got 19,000 private companies with annual revenues, over a hundred million. You compare that to public markets, it's just 2,800 public companies with that level of revenue. You've got these companies in the middle market are still growing. They're hiring at fast rates. Over the past year, 59% of middle market firms increased the size of their workforce at a rate of nearly 10%.

Lara Rhame (45:53):

I'm seeing, seeing Rob walk push

Rob Hoffman (45:55):

Back in his argument. No, it's a tough one. I agree. I mean, and these two are kind of interrelated because as we sit here at an alternative investment firm and we just see the flows of capital from investors moving into the middle market, it's sort of interesting like you're talking about cash on the sidelines, but where has been a big source of cash and where has that gone into a lot of private investments that are fueling private equity and private credit in some of these areas where the growth of that part market, they're really targeting the US middle market. So the two are almost kind of intertwined to an extent.

Lara Rhame (46:30):

Well you guys have to pick which one advance.

Andrew Korz (46:32):

I would argue that the US middle market is sort of the proxy for the powerhouse of the US economy, which is by extension the powerhouse of the global economy. So to me, that's the bigger

Lara Rhame (46:44):

Driver that should have

Andrew Korz (46:45):

Been personally

Alan Flannigan (46:45):

Point. While we are patriotic here, that is the economic reality of the situation, just given how robust the growth is within that segment of the market.

Rob Hoffman (46:54):

I think that's fair. You did play the

Andrew Korz (46:55):

Patriot League Allen, right? I

Alan Flannigan (46:57):

Did play the Patriot League. There you go. It all comes back to it.

Rob Hoffman (47:01):

The cash will not flow to the US middle market if the US middle market is not humming along and doing the things that it's been doing. Precise.

Lara Rhame (47:07):

That's exactly right. Yeah. Alright. As we get to our final matchup, we hope that everybody here enjoys watching the tournament. If you're in a bracket, we hope you do. Well, I've always done terribly. I have a terrible track record, so I do better with our market madness bracket than with any bracket I've ever done related to the tournament. So Rob, we'll be cheering for the Huskers. Yes, it'd be great. Absolutely.

Rob Hoffman (47:31):

In the hot hands. Saga draining threes. It's going to be great. Can't

Andrew Korz (47:36):

Wait. He's hopped out. I

Lara Rhame (47:37):

Love it. This is the year he is. I love this. Alright, our final matchup here for us is inflation versus the US middle market. It's a tough one. What is going to impact the markets more in the coming year? Inflation or the US middle market strength?

Rob Hoffman (47:53):

I think, I dunno, I would think it's got to be inflation. It's just, it's on every headline, every newspaper, every day, the middle market,

Lara Rhame (48:04):

Every voter survey of what they're concerned about. It's like

Rob Hoffman (48:07):

The middle mind. We kind of feel it maybe because it employs so many people. It's such a key part of the economy. But in this media driven news cycle that we see markets respond to that we're pounded with inflation and what's happening and

Andrew Korz (48:25):

The implications. And to your point, it does have such an impact on where rates are going to go and what the economy does. And it's such a big factor in the election and consumer sentiment. It is got its tentacles and everything. So I would tend to agree,

Lara Rhame (48:38):

I am still buying groceries. I have one bag of groceries and it's $94 and I'm like how I feel inflation.

Andrew Korz (48:48):

You're just buying too many organic things.

Lara Rhame (48:51):

I do have two teenagers. I buy a lot of groceries

Alan Flannigan (48:54):

And I'll add it on the inflation side as well too. I've argued fervently for the US middle market all along. But this situation where I do think inflation takes the cake here because look, the difference between, in reality, a 2% inflation, a 3% inflation is relatively small on a day-to-day basis. But the reaction function is significant. It affects markets, it affects what rates will do. It affects asset pricing, forward valuations, real returns, real returns from a financial market's perspective. A small change in inflation does have significant effects both in the short and long term. It's not

Andrew Korz (49:32):

Just the level of inflation, it's the uncertainty around inflation I think too.

Lara Rhame (49:34):

Yeah. Well Alan, you brought really good game for the US Middle market really did well. Played

Andrew Korz (49:42):

For his debut. It was an impressive one.

Lara Rhame (49:43):

For Exactly. Alright, well this was fun. Any final thoughts?

Andrew Korz (49:49):

I'm excited to watch some basketball. Yeah, absolutely. That's number one.

Lara Rhame (49:53):

Alright.

Alan Flannigan (49:53):

We hope for a lot of upsets. Not optimistic this year, but we see how it plays out.

Lara Rhame (49:59):

Alright everyone, thanks so much for joining. This is one of my favorite episodes that we do. Thank you so much again and everyone happy viewing. Thanks

Andrew Korz (50:06):

Everyone.

Lara Rhame (50:09):

This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy art. It was produced by the investment research team. It was edited and engineered by Aaron Sherman video, produced by Melissa Vendetti and copy provided by Harrison Beck. Special thanks to show coordinators Ellie Zhang and Lara Coleman. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcasts. Thanks for listening.