MH & ASSOCIATES • SECURITIES MANAGEMENT CORPORATION

INVESTMENT VIEWS

JANUARY 31, 2025

NAVIGATING THE INTEREST RATE ENVIRONMENT

Since 2021, interest rates have been on the rise as inflation and government spending deficits have been quite high. Interest rates, most notably the 10-year US Treasury, play a central role on financial markets, including influencing rates for mortgages and auto loans, the viability of capital expenditures for businesses and determining stock market valuations. Higher rates are headwinds to all of these items listed above and it is our conclusion that interest rates are headed higher over the long run due to stubborn inflation and government spending. Ideally this comes as a smooth and gradual rise, avoiding sudden spikes that could catch markets off guard. However, it is unlikely that those sudden spikes can be completely avoided.

As foreboding as this might seem, we believe that this unfolding paradigm has many opportunities as well. First, investors must pay more attention to valuations as higher valued stocks may be more vulnerable to episodic volatility. Profits should be taken and overall exposure managed in a careful manner. By the same token, there could be more opportunity in companies that have suffered from chronic low valuations. Often these companies deal in commodities and other capital goods. Higher interest rates often are good for these companies as it makes financing competition more expensive. Additionally, having plenty of cash on hand allows an investor to take advantage of the volatility, buying issues once they have reached more attractive levels. Alternative investments, such as precious metals and commodities also have an important diversifying effect.

Lastly, an investor would want to have a decent stream of income from dividends and interest coming in to help smooth out some of the anticipated ups and downs. Though we must add that given a continued rise in interest rates, we prefer to stick to shorter term bonds and dividend rates well above the 10-year US Treasury.

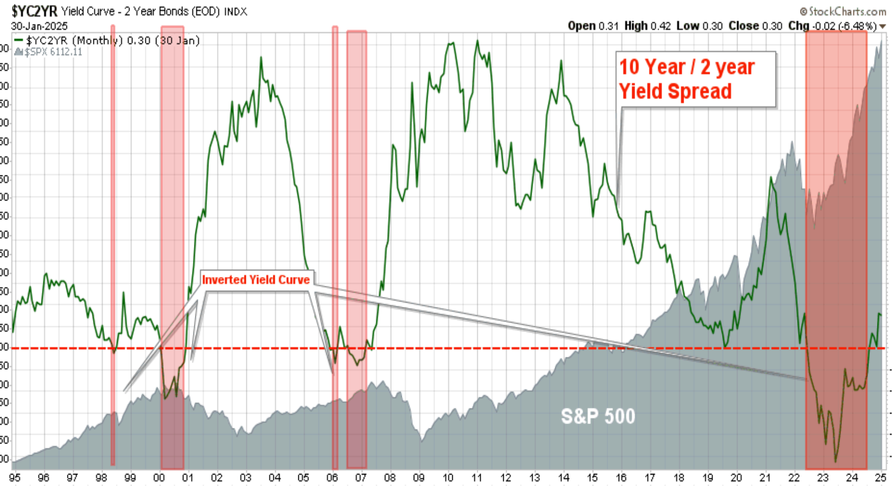
To conclude, over the past two years a new paradigm has emerged in financial markets: higher interest rates and higher volatility. Investors need to embrace this change and make adjustments to successfully navigate this time.

DEEPSEEK SINKS THE MARKET....TEMPORARILY

Right on the tails of the new administration announcing a big spending plan on U.S. data centers and AI infrastructure, a Chinese company unveiled Deepseek, an AI model they claim was built for just under $6 million and can perform on par with the newest models from OpenAi (the current leader in the space). While Deepseek is open sourced (i.e. more transparent), the low level of cost in building/programing it are well up for debate. Regardless, the market panicked and shares of equipment and energy suppliers to data centers and AI infrastructure crashed.

Deepseek is not a revolutionary product, but rather just an evolution in the way that AI models can operate. During a recent conference call with investors, leading semiconductor chip manufacturer ASML said that even if large language models can be made with less computing power, it still requires powerful chips to run the AI applications. Our companies are now asking themselves, if the Chinese can do this with inferior chips, then imagine what we can do with the most advanced chips. While Deepseek is playing catchup, computing giants in the U.S. are focused on the next level of AI called artificial general intelligence. So fears around companies pulling back spending on infrastructure are likely overblown and very recent comments indicate that they will keep their foot on the gas. If costs do indeed come down, then this will likely increase usage of AI as improved economics will drive increased demand.

YIELD CURVE REINVERSION



In general it is believed that when the yield curve "inverts" (i.e. shorter yields are higher than longer yields), a recession will commence in a year or so. Periods where the spread between the 10-Yr yield and the 2-yr yield is below zero are indicated in red. As you can see though, the market (in grey) generally (but not always) does not start its decline until after the curve "re-inverts", which is did at the end of last year. So just another red flag to add to the wall of worry the market usually has to climb.

TARIFFS AND THE U.S. DOLLAR

The new administration has made trade policy and global currencies one of their top priorities. Scott Bessent, the Treasury Secretary has set some concrete goals for the country, including ensuring a strong manufacturing revival, which will likely be fueled by some mix of tariffs and a weaker US dollar. Getting the right balance and negotiating with global players on how to redo the trade flows with the US and setting a currency level that works is not an easy task. A weaker US dollar means stronger currencies in other nations, which will be difficult for those nations to accept.

Nevertheless, the current administration will pursue tariffs and a weaker dollar to help the US economy "reindustrialize" and revive much of the former rust belt. This is likely the beginning of a longer-term trend and will play out over several years to come. Implications for investors include higher prices for commodities and precious metals as well as higher stock prices for certain companies that will benefit from tariff protection and expanded exports.

THE JANUARY BAROMETER

An old market adage is that "as goes January, so goes the rest of the year". Since 1950, January has correctly predicted the return for the year 85% of the time. Post election Januarys tend to be modestly weaker than usual and this year was no exception. They do, however, still maintain a positive performance on average for the rest of the year.

Another positive aspect of the trading this month is that this January will be what is referred to as an "outside month". This occurs when the current month has a higher high and a lower low than the preceding month. When an "outside" January closes positive, it has never closed lower twelve months later. While a small sample size, this will mark on the eighth time this has occurred since 1967.

On the flip side was the lack of a Santa Claus Rally, which comprises the last five trading days of the year and the first two of the new year. Failure to have a rally has occurred 16 times since 1950 (not including this year) and has proceeded bear markets in 9 of those years. But there have been plenty of outstanding returns in years where Santa failed to show up.

In conclusion, these studies are used as anecdotes and best to not get too bogged down in them and definitely don't make investment decisions because of them. We prefer to use a weight of the evidence approach and right now the market is still bullish.

Recommendation List: A list of all previous specific investment discussions published over the past 12 months will be provided upon request. Please email lara@mhandassociates.com or call our office for this list.

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