KENSINGTON
Asset Management

Monthly Commentary
April 2024

About Kensington

Kensington Asset Management specializes in data-driven, quantitative investment solutions spanning across the global investment landscape. Our focus is to help provide investors with confidence through quantitative analytics, by attempting to participate in rising markets, while taking steps to help avoid exposure during times of market decline or volatility. Kensington Asset Management was founded by Bruce P. DeLaurentis, a quantitative pioneer with over 40 years of trading experience through numerous market cycles.

Investment Philosophy

Kensington believes that the best way to generate steady, above average positive returns is to employ an investment methodology that has the potential to recognize and measure consistent and repeating behavioral patterns in the financial markets. With that goal in mind, Kensington has developed clearly defined quantitative decision models that strive to minimize subjectivity in this decision-making process. The overarching goal is to capture sufficient returns in positive market conditions, while protecting capital, with rigorous mitigation during down markets.

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Geopolitics: Tensions between the US and China remain elevated and are likely to continue as we move into the election season. The Biden Administration recently revoked export licenses that allow Intel and Qualcomm to supply semiconductors to Huawei, China's telecommunications and consumer electronics giant, and also announced it would quadruple tariffs on Chinese electric vehicles and sharply increase levies on other industries directly affected by cheap Chinese imports. (May 14, 2024)

The issue of unfair competition from Chinese state-sponsored or supported companies has been a political hot button in the US for decades, but increasingly less tolerated on both sides of the political aisle as China has now grown into an economic superpower.

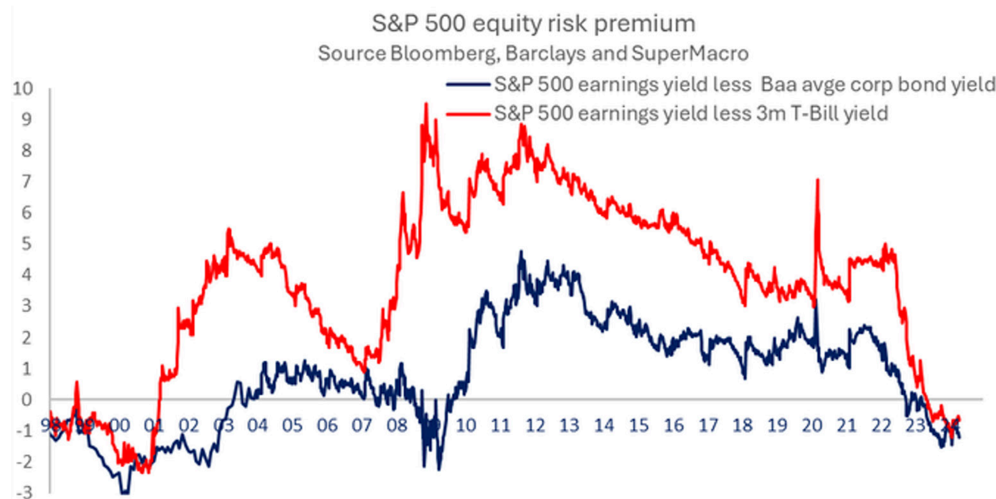
The real conflict lies in the nature of each country's economic system and beliefs. China has been able to grow and thrive principally by means of a mercantilist approach, relying on export markets to buy its goods. This benefitted both China and the West for years following China's entrance in the WTO in 2003 as Western consumers were able to purchase an array of increasingly sophisticated products at cheap prices, while China was able to transform itself from a rural, agrarian society into a modern industrial juggernaut.

But as China's economic expansion reached a point where it started competing with the US, conflict between the two was inevitable due in large part to China's reticence to play by America's rules. The intransigence on China's part is philosophical but also based on its inability or unwillingness to pivot from a mercantilist economy to a more balanced one, where growth is more evenly driven by both internal and external demand.

The Chinese consumer, unlike its American counterpart, has historically saved at a much higher rate which has supported the country's decades long investment boom. A transition in China to a more consumer oriented economic system would help reduce that tension, but whether the Communist Party's leadership is up to this monumental task will be a critical factor in how West and East come to terms with China's ascendancy in the years ahead.

Stock Market: April was a difficult month for risk assets with nearly all major equity and bond indices showing losses. The S&P 500 Index declined -4.16%, the NASDAQ 100 fell -4.46%, while the small-cap Russell 2000 Index lost -7.09%. Overseas exchanges performed far better on a relative basis with the Euro Stoxx 50 Index falling -3.19%, the MSCI EAFE Index down -0.87% and the MSCI Emerging Markets Index up 1.40%. For the year, domestic indices remain comfortably in the black with the exception of the small-cap Russell 2000 Index, which continues to lag, down -2.62% YTD.

The main cause behind April's poor performance lay in the stronger than forecast labor market and inflation numbers released during the month, which served to reset expectations for Fed rate cuts. The bond market took note with yields on the ten and thirty year tenors rising measurably, serving as stiff resistance for long duration assets such as equities. Adding to headwinds was equity valuations, as measured by equity risk premiums. As shown on the chart below, yields on both three-month Treasury bills and investment grade corporates now exceed the dividend yield of the S&P 500.



As of April 30, 2024

It's difficult to avoid drawing an analogy between today's market enthusiasm for the AI-driven Magnificent 7 and the same sort of internet-driven mania around the turn of the century.

From a shorter-term perspective, though, the outlook is more positive: both Q1 2024 revenues and earnings for the S&P 500 exceeded expectations, with year-over-year revenue growth expected to finalize at ~4%, matching Q3 2023's growth rate. Earnings growth has accelerated, registering 5.4% for the quarter and would have been substantially higher (8.3%) were Bristol Myers Squibb excluded. Perhaps of greatest importance to the market is the continuing robustness of profit margins, with Q1 2024's estimated at 11.7%, above the prior quarter's 11.2%, and the year-ago net profit margin of 11.6%. It was here many strategists feared the market would stumble as companies dealt with higher input costs and higher wages.

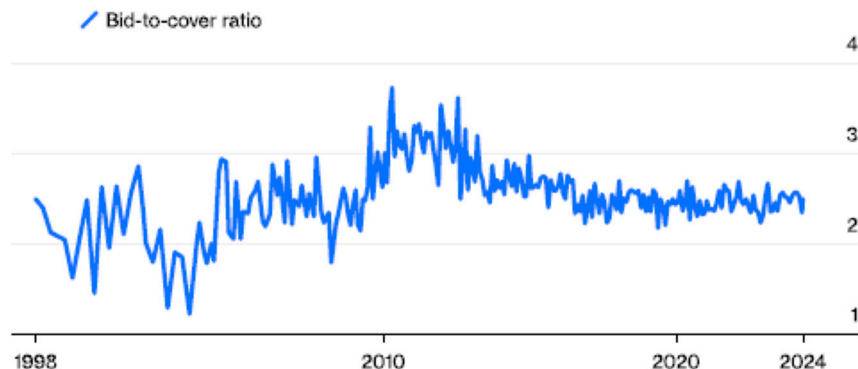
Fixed Income: Bond markets sold off sharply last month, as investors reassessed the Fed's timetable for reducing short term rates. How the market would handle fresh supply also weighed, as investors assessed both the size and composition of the Treasury auctions to be announced at month-end. The pain was mostly felt by longer term, duration sensitive issuance. The 30-year Treasury bond lost -6.50% and the 10-year -3.35% in April, while corporate investment grade bonds fared a bit better, down -2.54%. More credit sensitive high yield issues fell only slightly, down -0.94%.

The ongoing volatility in the Treasury market is not only due to uncertainty around the future path of the economy. Investors are growing increasingly concerned about the enormity of the US's fiscal deficit and Treasury funding stability. As Goldman Sachs' President John Waldron told investors recently at Semafor's World Economic Summit, "The thing that I worry about is the confluence of a political crisis and a lot of leverage in the Treasury system. The more leverage we have, the riskier we make it." (April 18, 2024)

Waldron is well aware how narrowly England avoided disaster in 2022 when former Prime Minister Liv Truss proposed a concurrent series of tax cuts and budget busting spending initiatives that panicked the gilt market, which caused interest rates to skyrocket and the value of government bonds to plummet. The same thing could happen here in the US, according to Waldron, if a political crisis took place and domestic and foreign buyers suddenly lost confidence in the country's ability to manage its financial affairs. With the election coming up in the fall and greater uncertainty about future economic policy, bond investors will be paying close attention to signs of any stress in the Treasury market.

Michael Feroli, chief economist at JPMorgan, recently pointed to a change in how the Treasury market functions that bears watching: the constrained capacity of large banks to house US government debt on its balance sheets, in part due to post-financial crisis regulations. In the event of a severe recession which causes an unexpected spike in government debt issuance, the ability of markets to clear could be tested, prompting a crisis.

To be sure, this is a longer-term story waiting to unfold, as there continues to be plenty of appetite for US debt (chart below). In any event, any such stress will likely first evidence itself in higher rates before the risk of a Treasury auction failing.



Source: US Treasury, Bloomberg
As of December 31, 2023

Federal Reserve and Monetary Policy: Chairman Powell has consistently told the market he intends to stay the course on higher rates until the data tells him otherwise. It then came as no surprise risk assets sold off in April when economic and inflation reports came in stronger than forecast and the FOMC released its meeting statement which read "Recent indicators suggest that economic activity has continued to expand at a solid pace. Job gains have remained strong, and the unemployment rate has remained low. Inflation has eased over the past year, but remains elevated. In recent months, there has been a lack of further progress toward the Committee's 2 percent inflation objective." (May 1, 2024)

What did surprise were two quite dovish actions taken by the Fed: first, it announced it would slow the pace of decline of its securities holdings by reducing the monthly redemption cap on Treasury securities from $60 billion to $25 billion. The second was Powell's own response at his press conference to the question whether there was a risk rates might need to rise further in light of recent data. He firmly responded he did not think the next move in rates would be higher, and in a point of emphasis reiterated "I'd say it's unlikely." (May 1, 2024)

Powell went on to say "I think there's also other paths that the economy could take which would cause us to want to consider rate cuts and those would be, two of those paths would be that we do gain greater confidence, as we've said, if that inflation is moving sustainably down to two percent and another path could be an unexpected weakening in the labor market, for example. So, those are paths in which you could see us cutting rates."

This is quite extraordinary as it inferred the Fed would now tolerate – for a period of time – a higher inflation rate if there was demonstrable evidence of a slowdown in the labor market. In other words, Powell indicated the Fed was willing to move in advance of the data, a stance he hadn't adopted to date.

Unsurprisingly, the market read this as being quite bullish in the short term for risk assets and when non-farm payrolls fell far short of expectations and the unemployment rate ticked higher in early May, markets moved strongly higher. Investor confidence that a slowdown in the labor market was unfolding increased further when unemployment claims surged to 231,000, the highest level since August 2023, and sharply above market expectations of 210,000.

Managed Income Strategy – Manager Commentary

Last month, we mentioned the prospect of the "reflation" trade and its possible impacts on the fixed income market. The March Core CPI rose 3.8% year-over-year, edging out estimates yet again. This has resulted in market participants readjusting their expectations once more regarding the likelihood of rate cuts. Currently, the first possible rate cut is not expected until the September FOMC meeting. Due to the broadening negative trend established during the first half of April, the Managed Income model moved into a Risk-Off position, shifting entirely into cash equivalents and ultra-short-duration Treasuries.

Subsequent to month end, the Managed Income model moved back into a Risk-On posture, ending a three-week defensive period that began in mid-April. The signal change was attributed to a new uptrend established in US High Yield, along with stabilization across equity market indicators and decreased market volatility. Credit spreads remain near cycle lows; therefore, the Portfolio Management team has elected to increase the allocation to senior loan/floating rate debt to supplement core high yield positions. Floating rate has provided stability during times of volatility in US High Yield pricing as of late, while also providing meaningful yield. The senior loan/floating rate positions can also potentially appreciate if interest rates continue to push higher. Our focus is to maximize current yield of the portfolio, while at the same time mitigating risk, should the high yield sector encounter increased volatility.

Dynamic Growth Strategy – Manager Commentary

Volatility returned to equity markets in April, with the CBOE Volatility Index ("VIX") reaching levels not seen since November 2023. As a result, the major indices turned in their first negative month for 2024. The growth sector continued to underperform in April, and based on the increased volatility and loss of positive trend, the Dynamic Growth Strategy migrated to a Risk-Off stance by month end. This ended a 25-week Risk-On streak, which is well above the historical average for the Strategy. Shifting to Risk-Off to end the month allowed the Dynamic Growth Strategy to top both the S&P 500 and Nasdaq for the month of April.

Looking ahead, should volatility abate, we could expect Dynamic Growth to move Risk-On again. In years with low relative volatility, like 2024 has been so far, Risk-On is usually the dominant regime, with intermittent Risk-Off trades lasting for shorter periods of time. However, should conditions deteriorate more quickly from here, the Strategy could shift to a more permanent Risk-Off state. Moving into May, we expect equity market sentiment will remain on inflation-centric metrics, such as CPI and jobs numbers, as well as major earnings reports, to guide equity market sentiment.

Active Advantage Strategy – Manager Commentary

The Active Advantage Strategy began the month of April in a full Risk-On state, with a balanced position between fixed income and equities. Inside the fixed income portfolio, floating rate positions outperformed, while US High Yield underperformed. Equities retreated across the portfolio.

As volatility increased during the month, the Active Advantage Strategy began to de-risk, moving to a position comprised of predominantly cash equivalents, with some growth equities. By month end, the Strategy eliminated these positions as well, moving to a full Risk-Off portfolio.

Defender Strategy – Manager Commentary

The continued positive streak for stocks and various markets came to an end with the first down month since October 2023 as the S&P 500 Index fell -4.16% in April. To compound investor frustration, interest rates also moved higher and bond prices suffered again during the month with the Bloomberg Aggregate Bond Index falling 2.53%. Looming over the markets has been the reacceleration of inflation, further dampening expectations for a near-term Federal Reserve rate cut. For the Kensington Defender Strategy, 5 of the top 6 asset categories with exposure were detractors from performance, with Gold as the only positive attributor for the month. It appears momentum in slowing across the board with a likely decrease in risk exposure on the horizon for the strategy. Overall, the market is still looking to gain certainty on interest rate direction, signals of slowing economic growth, yet strong corporate earnings. This uncertainty may lead to continued short term volatility.

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Certain information contained herein constitutes "forward-looking statements," which can be identified using forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "project," "estimate," "intend," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events, results, or actual performance may differ materially from those reflected or contemplated in such forward-looking statements. Nothing contained herein may be relied upon as a guarantee, promise, assurance, or a representation as to the future.

Advisory services offered through Kensington Asset Management, LLC, Barton Oaks Plaza, Bldg II, 901 S Mopac Expy – Ste 225, Austin, TX 78746.

Managed Income Strategy

Risks specific to the Managed Income Strategy include Management Risk, High-Yield Risk, Fixed-Income Security Risk, Foreign Investment Risk, Loans Risk, Market Risk, Underlying Funds Risk, Non-Diversification Risk, Turnover Risk, U.S. Government Securities Risk, LIBOR Risk, Models and Data Risk.

Dynamic Growth Strategy

Risks specific to the Dynamic Growth Strategy include Management Risk, Equity Securities Risk, Market Risk, Underlying Funds Risk, Non-Diversification Risk, Small and Mid-Capitalization Companies Risk, Turnover Risk, U.S. Government Securities Risk, Models and Data Risk.

Active Advantage Strategy

Risks specific to the Active Advantage Strategy include Management Risk, Equity Securities Risk, High-Yield Risk, Fixed-Income Security Risk, Foreign Investment Risk, Loans Risk, Market Risk, Underlying Funds Risk, Limited History of Operations Risk, Non-Diversification Risk, Small and Mid-Capitalization Companies Risk, Turnover Risk, U.S. Government Securities Risk, LIBOR Risk, Models and Data Risk.

Defender Strategy

Risks specific to the Defender Strategy are detailed in the prospectus and include general market risk, credit risk, interest rate risk, management risk, equity securities risk, fixed-income securities risk, high-yield bond risk, foreign investment risk, emerging markets risk, real estate and REITs risk, commodities risk, currency risk, subsidiary risk, market risk, underlying funds risk, derivatives risk, limited history of operations risk, turnover risk, models and data risk, momentum risk or risk of the portfolio not performing as expected.

Definition:

Bloomberg US Aggregate Bond Index: An unmanaged index comprised of US Investment grade fixed rate bond market securities, including government agency, corporate and mortgage-backed securities. Investors cannot invest directly in an index. It is also known as US Aggregate Bond Index.

Bloomberg US Corporate Investment Grade Bond Index: An unmanaged index comprised of US investment grade fixed rate, taxable corporate bond market.

Euro Stoxx 50 Index: A market capitalization-weighted stock index that represents the 50 largest blue-chip European companies operating within the eurozone nations

MSCI EAFE Index: An international equities market index that consists of large and mid-cap stocks across developed markets in Europe, Australasia, and Far East Asia. Excludes US and Canadian stocks.

MSCI Emerging Markets Index: An international equities market index that consists of large and mid-cap stocks across 24 emerging market countries that include but not limited to Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, South Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

NASDAQ 100: A market index that comprises of the 100 largest, most actively traded companies listed on the Nasdaq stock exchange.

S&P 500: A capitalization weighted index of 500 stocks representing all major domestic industry groups. The S&P 500 TR Index assumes the reinvestment of dividends and capital gains.

Reflation Trade – Trades that reflect anticipated period of economic recovery and raising inflation. It involves positioning investments to benefit from the potential expansionary monetary and fiscal policies implemented by governments and central banks.

Russell 2000 Index: A market index that consists of 2,000 small-cap US companies that are part of the larger Russell 3000 Index.