

## QUARTERLY REVIEW

December 31, 2023

# Q4 Economic and Market Commentary

The fourth quarter was a strong one for equity returns, with the S&P 500 gaining 11.69% in the period, and a robust 26.3% for the full year. The full year return is impressive given that corporate eps over the last year are essentially flat, and the yield on the 10-year US Treasury rose 120 basis points in the first 10 months of the year. The quarter had a less than stellar start with the market declining by just over 2% in October. This was preceded by losses in both August and September, causing investors to become anxious. **The market officially entered correction territory on October 27th by declining just over 10% from its July 31 high.** There were plenty of worries with tightening financial conditions, persistent inflation, geopolitical tensions, and a mixed earnings outlook. With interest rates rising, the 10-year US Treasury bond topped 5% for the first time in 16 years in October, creating losses in fixed income portfolios. On the earnings front, both Alphabet and Chevron saw double digit price declines as earnings disappointed. And Brent crude was above \$88 with concerns that the commodity could surpass \$100/barrel if Mideast regional tensions broadened, perhaps giving back some of the gains that had previously been won on inflation. However, **the market seemed to turn on a dime as the Fed opted to hold rates steady at their November 1 meeting** and Chair Powell acknowledged the impact the recent surge in bond yields could have on the economy. The market interpreted this as an indication that the Fed was done with its rate hikes and Treasury yields began to tumble. **Perhaps the Fed was on the cusp of being able to achieve the illusive “soft landing”.** In fact, the 3rd quarter GDP came in at a better than “soft” rate of 4.9% growth, driven by strong consumer spending and inventory investment. With that backdrop the market had its best month of the year, and best month since July 2022 with the S&P jumping 9% and Nasdaq climbing 10.7%. The good news of November seemed to be confirmed in December as the Fed’s preferred inflation gauge (Core Personal Consumption Expenditure Index) rose at a 3.2% year over year rate, and on a 6-month basis was up just 1.9% (below the Fed’s target), likely providing confirmation for their move toward lower rates. In addition, December got off to a good start as Black Friday sales results showed consumer spending up 8.5% online, and in store sales up 1% over 2022. Fears of a tepid holiday spending season were again over done. As we have stated before, if jobs are plentiful the US consumer is inclined to spend. This was reinforced with the November jobs report showing 199,000 new jobs being added, and the unemployment rate dropping to 3.7% from 3.9%. **The recession that we had all expected at some point in 2023 never materialized.**

# The Economy – It's Still About the Fed and Inflation: :

**The Economy – It's Still About the Fed and Inflation:** We all believe that markets should find their own price levels without interference from non-market forces. Yet as the Fed is in the process of normalizing interest rates and hopefully ending years of alphabet soup lending facilities, and experiments with quantitative easing and tightening, the final unwind is still far from done. **The stock market for now has bought into a scenario that the Fed will cut interest rates multiple times in 2024 (the Fed's recently released Summary of Economic Projections shows 3 cuts).** Yet Fed Funds futures are currently forecasting 5 cuts in 2024! If rates are cut 4 or more times in 2024, we would either expect that inflation will fall faster, the economy prints a negative GDP number, or jobs go negative. Some cuts are good for equity prices and are reflected in current market strength, while we would argue that too many cuts portend a problem in the economy, and would ultimately weigh on corporate earnings, and be negative for equity prices. **Progress has been made on inflation, but there is more to be done. Average Hourly Earnings are still growing at a rate of 4% and shelter costs (just over 40% of core CPI) are still up 6.5% year over year.** The economy is at full employment, so unless productivity increases, or unemployment rises, it's hard to see much further relief on wages. The Fed doesn't expect Core PCE inflation to be at 2% on an annualized basis until 2026. **We are also optimistic that the Fed has most likely entered the phase from pausing rate hikes to pivoting toward rate cuts next year,** but the road to the final goal of 2% remains long and we would expect some volatility along the way. Employment has fared much better than anticipated in 2023. Many banks used internal forecasts of unemployment at 5% by year end 2023 in predicting loan losses, yet we will close the year at 3.7%. The number of job openings has declined from almost 10.5 million in October of 2022 to 8.7 million currently. The Labor Force Participation Rate fell back to 62.5% in December from November's 62.8%, and remains well below the January 2020 level of 63.3%. The Fed's outlook has the unemployment rate increasing to just 4.1% in 2024 and maintaining that level through 2026. **So, while the labor market is cooling, it is still far from weak. It would likely take a recession to cool jobs and wages by a more significant degree.** We do expect GDP to grow at a slower pace in 2024, and forecasts range from 1.3% to 2%. With a major election looming in 2024 don't be surprised to see fiscal stimulus being applied wherever possible (Employee Retention Tax Credit, student loan forgiveness, Child Tax Credit) which should help in putting a floor beneath the economy. We will also see spending related to the Chips Act, infrastructure and green energy. The first half of 2024 is likely to be the weakest part of the year due to the lingering impacts of higher rates, but with the last Fed hike being in July of 2023 that impact will dissipate by mid-year. The second half of 2024 will be focused on whether a second inflation wave develops as inflation comparisons in the second half will be more difficult. **For now, inflation expectations seem to be anchored with the University of Michigan consumer data expecting long run inflation at 2.9%.** The US consumer is in good shape with savings and checking balances exceeding 2019 levels. Debt service as a percentage of disposable income did increase in 2023 to 9.78% but is still below the long-term average of 11% due to low fixed rate mortgages. However, the recent jump in credit card debt and the attached higher interest rates will cause debt service to increase in 2024 and is likely related to the Personal Savings Rate declining from 5.3% in May to 4.1%. Keep an eye on this as a possible dampener on spending as the year progresses.

# Market Review Fourth Quarter Equity Market Recap:

The story of Q4 was the Fed pivot and the prospect for rate cuts in 2024. This served to jump start the market as sentiment improved, fear of recession receded, and the market subsequently gained 12.9% from November 1 through year end. As to be expected the most interest sensitive group in the market was the best performing segment in the quarter with Real Estate posting an 18.8% gain on the prospect of lower borrowing costs. Technology continued its strength, adding 17.2% for the quarter. Another interest sensitive sector, Financials, gained 14% as banks showed solid gains reversing many of the losses from the regional banking scare earlier in the year. Lower interest rates will mean lower deposit costs for banks, and smaller losses on their bond portfolios. The only sector to post a decline in the quarter was Energy. The sector fell 6.9% as oil prices declined 20% on worries of weakening demand, growing production in the US, and concerns about OPEC+ unity. The oil market rallied in early October for about 2 weeks following the conflict in the Middle East before surrendering those gains as fears of a wider conflict subsided. In a market that switched to a “risk on” sentiment, it was not surprising to see defensive categories such as Consumer Staples and Healthcare trail the index, as they both gained 5.5% and 6.4% respectively. For the full year the market gain of 26.3% erased the 18% loss suffered in 2022, but as we have noted in previous commentaries this year there have been wide disparities in returns between different market segments. Technology dominated returns for the year on the back of Artificial Intelligence excitement gaining 57.8%, followed closely by Communications Services (Google & Meta) at 55.8%. Consumer Discretionary (+42.4%) was the only other segment to beat the index return, but it also had help from two of the Magnificent 7 stocks that reside in the sector (Amazon +80%, Tesla +101%). **An encouraging sign in the Q4 was a broadening of returns beyond just Technology. The equal weighted S&P index (as opposed to the tech dominated market cap weighted S&P) returned 11.8% in Q4, and the Small Cap Index added 14% in the quarter.** But even with improvement in Q4 returns, the average stock return in 2023 was 17.7% and the median stock return was 12.7%, still well below the S&P return.

## Stock Market Indexes

Market/Index	2023 Close	Sept 30 Close	Quarterly Return	YTD Return
DJIA	37,689.54	33,507.50	13.09%	16.18%
Nasdaq	15011.35	13,219.32	13.84%	44.70%
S&P 500	4,769.83	4,288.05	11.68%	26.26%
Russell 2000	2,027.07	1,785.10	14.02%	16.88%
IEFA	70.35	64.35	10.87%	17.99%



## What to Expect Going Forward:

The mindset entering 2024 seems to be the antithesis of where consensus thinking was going into 2023 of likely recession, aggressive Fed hikes, and worries about earnings. **Today consensus odds on recession are much lower, the '24 outlook for earnings calls for an almost 12% gain, and the Fed should be a tailwind rather than a headwind.** But consensus could not have been more wrong last year. One thing likely not to repeat this year is the extreme outperformance of the largest weighted stocks. In October of 2023 the 10 largest weights accounted for 124% of the S&P return. With the market broadening late in the year, that number declined to a still robust 71%, making it the second largest contribution of the top 10 to performance over the past 30 years. Contrary to conventional thinking, **strong years in the stock market like we just experienced (top quintile trailing 12 month returns) tend to be followed with positive years that average just under 8% returns.** And when the market is trading at above 20X “trailing” earnings (we are currently at 22X trailing earnings), the market gain in the next 12 months averages a more pedestrian 4% gain. A far cry from 2023 returns but still positive, nonetheless. Politics both domestic and international will play a major role in 2024. **National elections will be held in countries that represent 40% of the world’s population and 80% of its stock market capitalization.** As we all know too well, geopolitical events are impossible to forecast but with two wars and numerous major elections around the globe, it would seem the odds of an unexpected event are higher this year. In the US, the presidential election cycle has historically been favorable to investors. The party in power tends to move the levers of fiscal and monetary policy to prime the economic engine. **Since 1944 in the last 16 presidential election cycles, when the incumbent is running for re-election, the market has increased every year!** On the negative side of the balance, it can be argued that the market is already pricing in a soft landing and several rate cuts, and since we are starting from an elevated valuation level (19X forward earnings), any disappointment in earnings, or the timing and pace of rate cuts could send the market lower. **Let’s not forget that most of the 2024 outlook is predicated on inflation continuing to move lower.** It should, but there are obstacles. Energy prices could move higher should the Israeli/Hamas conflict broaden. We must deal with shipping issues in the Red Sea and Panama Canal that could disrupt supply chains. China and Taiwan tensions don’t appear to be easing soon, and with that, companies will continue to near shore or friend shore suppliers which is likely to raise the cost of production over time. And while interest rates will likely come down to some degree, they are not going back to the extremely low levels of 2020 -2021. As a result, **we must face the fact that borrowing costs are higher and will remain higher in the future.**

There is no more pressing example of this than the US debt. We are now running the largest peacetime non-recession deficit in history at 7.5% of GDP. In addition, the interest cost of the debt is now 16% of tax revenues. We may kick this can down road for now, but a time is coming when it must be dealt with responsibly (next deadline is January 19<sup>th</sup>), otherwise we will all face higher inflation and weaker economic prospects. As a result, **we expect 2024 to be a more volatile year, with the economy slowing in the first half of year, and then improving in the back half.** With valuations full or slightly stretched, we would again look to earnings as the primary catalyst for stock prices. If earnings develop as expected, the market should post another year of positive returns, but likely muted relative to 2023. A more volatile year will also lend itself to being disciplined in terms of asset allocation, and emphasizing quality holdings, reflecting good ROE's, strong liquidity and balance sheets – characteristics that we prioritize in our portfolios.

## Fixed Income Recap and Outlook

The conclusion of the year marked a remarkable turnaround for Treasuries, with the 10-year rate retracing from its peak of 5.019% in October. The bond market, initially poised for a historic third consecutive year of losses, experienced a significant rally driven by a series of favorable factors. We witnessed a market rebound on weakening economic data, leading to a late-year surge for bonds that peaked in mid-December when the Federal Reserve surprised investors with signals of potential interest-rate cuts in 2024. Currently, the market is factoring in over 150 basis points of cuts for 2024, with a growing consensus among traders that the first easing might materialize by March. The benchmark 10-year Treasury finished the year at 3.88%, after hitting the lowest level since July.

The Federal Reserve recently held interest rates steady, marking a pivotal shift in its aggressive hiking campaign. The decision to leave the benchmark federal funds rate unchanged at 5.25% to 5.5% signals a departure from the central bank's prior trajectory. The Fed's projections for 2024 indicate an expectation of lowering rates by 75 basis points, a more accelerated pace than previously anticipated.

Notably, the central bank acknowledges a shift in tone, with a commitment to monitor various data and developments before considering any additional policy firming. This change in stance reflects the evolving economic landscape, marked by eased inflation pressures and balanced risks to price growth.

Despite the Fed's acknowledgment of easing inflation and slowing economic growth, the central bank remains cautious. The new dot plot projections show rates at the end of next year at 4.625%, implying three 25bp cuts, compared to two in the September forecasts. The Fed emphasizes a need for sufficient evidence of lower price growth before decisively easing policy.

Throughout the year, the bond market faced skepticism surrounding swelling US deficits and their impact on Treasury prices. While the initial surge in yields above 5% raised concerns about reckless government spending, a subsequent bond rally, triggered by speculation of Fed rate cuts, alleviated some anxieties. However, we believe that deficit concerns will persist and may resurface with added pressure in the bond market in 2024.

As we navigate this complex environment, our investment strategy remains anchored in a comprehensive analysis and a continued focus on relative value opportunities. The Fed's pivot and market dynamics suggest a cautious approach, especially with uncertainties surrounding inflation and rate cuts.

In fixed income, we advocate for a shift towards higher quality and maintain a diversified stance in credit. Opportunities in municipal bonds, agency mortgage backed securities, senior tranches of securitized credit, and higher-quality corporate issuers are preferred. Given current economic data, we think the Federal Reserve has completed its rate hiking cycle and will remain on pause until inflation is closer to 2%. The path to lower interest rates will not be a smooth transition. The dramatic drop in interest rates since October could leave the market vulnerable to snap backs if the Fed doesn't cut fast enough or economic data surprises to the upside. The steep easing in financial conditions during the 4<sup>th</sup> quarter could lead to an unwanted escalation in inflation.

As always are here to assist you in any way and to answer your questions. We appreciate the opportunity to serve you and value the trust and confidence that you have placed in us.