

Fourth Quarter 2023 Key Takeaways:

In 2023, stock and bond markets were able to shake off a host of uncertainties to post strong gains for the year, much to the surprise of many forecasters.

From an economic perspective, we enter 2024 on solid footing, so a recession is unlikely in the first half of 2024. Factors supporting this: solid economic and corporate earnings growth, while inflation continues to decline.

CPI is at levels near the Fed's goals, which suggests that the Fed's policy has been working, and over time inflation should continue to fall, particularly if shelter continues to decline.

With various sectors of the economy experiencing contractions at different times over the last few years, my expectation is for a mild economic slowdown, not a deep economic downturn across sectors, despite many economists' expectations of a recession in the second half of 2024.

There is growing consensus that a "soft landing" may occur in the U.S. in 2024, though soft landings are quite uncommon, occurring only four times in the last 75 years.

Within the U.S. stock market, performance in 2023 was driven by the handful of mega-cap growth stocks, dubbed the "Magnificent 7" (Apple, Microsoft, Nvidia, Facebook, Alphabet, Netflix, Amazon). Much of the return in these stocks was driven by expanding valuation multiples leaving them vulnerable to a sell-off if investors look to invest in the broader market.

If the recent "broadening out" of equity performance continues, look for it to benefit those areas of the market whose recent performance has lagged, such as small-cap stocks, slow-growth ("value") stocks, and international emerging markets stocks.

Our portfolio equity allocation continues to favor an unloved segment of the market -- foreign stocks. Heading into 2024, the valuation discount for developed international and emerging-market stocks versus the U.S. is the widest it's been in decades.

Extending bond duration -- by investing in longer-maturity bonds, even if their current yields are less than shorter-maturity bonds -- may prove to be a good strategy for investors looking to lock in returns on their "safe" money.

Market Recap

What a difference a year makes. In 2022, high inflation and the Fed's commitment to tame it, led to sharply rising interest rates and negative returns for both stocks and bonds. In 2023, much to the surprise of many forecasters, global stock and bond markets ignored widespread expectations that the economy was headed for a recession and markets were able to shake off a host of uncertainties to post strong gains for the year.

Aided by a powerful year-end rally, U.S. stocks (S&P 500 Index) jumped nearly 12% in the fourth quarter to finish up 26% for the year, and end within a whisper of its all-time high. Smaller-cap stocks (Russell 2000 Index), which lagged their larger counterparts for most of the year, also rallied sharply in the fourth quarter (+14%) to end the year with a respectable gain of 17%.

Developed International and emerging-market stocks also posted solid gains. Developed International stocks (MSCI EAFE) finished the year up 18%, while emerging-market stocks (MSCI EM Index) posted a nearly 10% return.

Bonds also rallied sharply in the fourth quarter aided by a significant drop in Treasury yields. The benchmark 10-year Treasury yield declined over 100 bps in the fourth quarter resulting in a 6.8% return for the Bloomberg U.S. Aggregate Bond Index. Interestingly, despite massive intra-year volatility, the 10-year Treasury yield ended the year exactly where it started. For the year, U.S. core bonds (Bloomberg U.S. Aggregate Bond Index) finished up 5.5%. High yield bonds (ICE BofA High Yield Index) were a standout performer both in the fourth quarter and for the year, earning 7% in the quarter and finishing the year up 13.4%.

Our portfolios generated solid returns across the board, powered by strong relative performance from our international developed, emerging markets equity, and U.S. large company growth allocations. Our U.S. large slow-growth company ("value") allocation had weak relative performance for the year despite stellar longer-term performance.

Investment Outlook and Portfolio Positioning

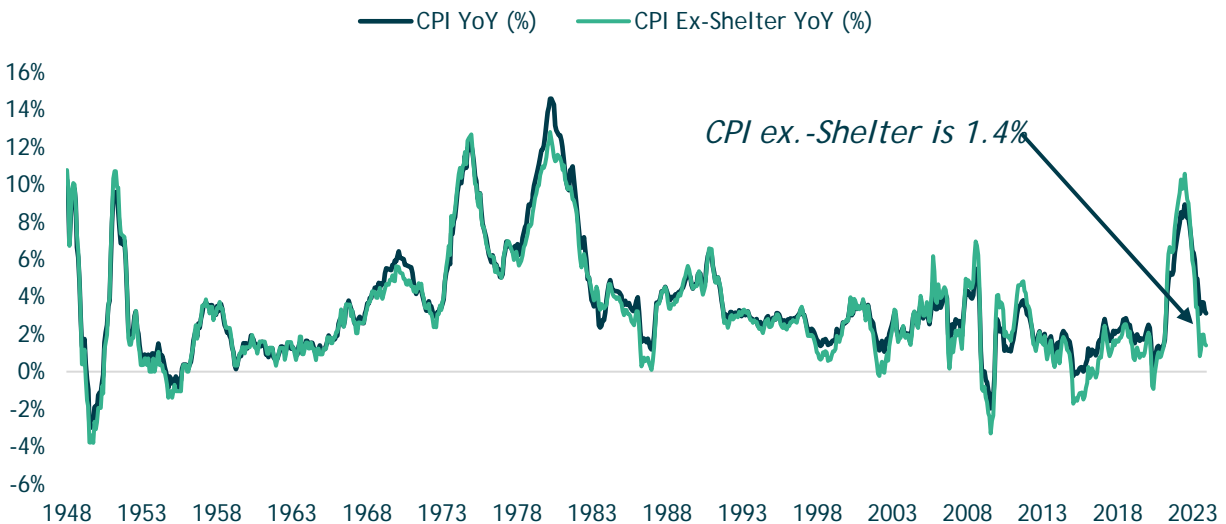
Looking ahead to 2024, all eyes will continue to be on the Fed. When will the Fed start to cut rates, by how much, and why? Will the Fed cut rates enough to meet the markets' lofty expectations? While these questions will be in focus, monetary policy is just one of many factors that will influence markets. Geopolitical risk, the U.S. presidential election, labor markets, and inflation will likely fill the headlines and all could be sources of volatility.

From an economic perspective, we enter the year on solid footing, so I believe a recession is unlikely in the first half of 2024. There are several factors supporting solid economic and corporate earnings growth, while inflation continues to decline. I think the biggest recession risk will come from weakness among consumers in the latter half of the year as we near the end of the Covid-related subsidies that fueled consumption for the last few years. Evidence of this is a spike in credit card and auto loan delinquencies. Absent a payment pause on student loans, we would almost certainly see a spike in delinquencies there as well. I will continue to closely monitor the economic data and adjust my view if appropriate, but for now I see no recession ahead.

As I stated in my third-quarter commentary, I believe the Fed has the upper hand on inflation and that it will continue to trend lower. That has been playing out and I believe inflation will continue to grind lower in the near term. Many other metrics I read about suggest that inflation is already at or below the Fed's target.

The chart below illustrates the year-over-year inflation rate and year-over-year inflation rate excluding shelter costs, which is a key CPI input. (It makes up about 30% of the CPI.) While year-over-year inflation recently came in at 3.1%, this number drops to 1.4% when excluding shelter. These levels are near the Fed's goals, which suggests that the Fed's policy has been working, and over time inflation should continue to fall, particularly if shelter continues to decline.

Inflation Has Fallen Towards Fed's Goals



Source: U.S. Bureau of Labor Statistics. Data as of 11/30/2023.

Since the Fed started their aggressive tightening cycle, the debate has been about the odds of a “soft landing” or “hard landing” for the economy. In other words, would the Fed be able to thread the monetary policy needle and raise interest rates enough to stamp out inflation, but not so high that it propels the economy into a recession.

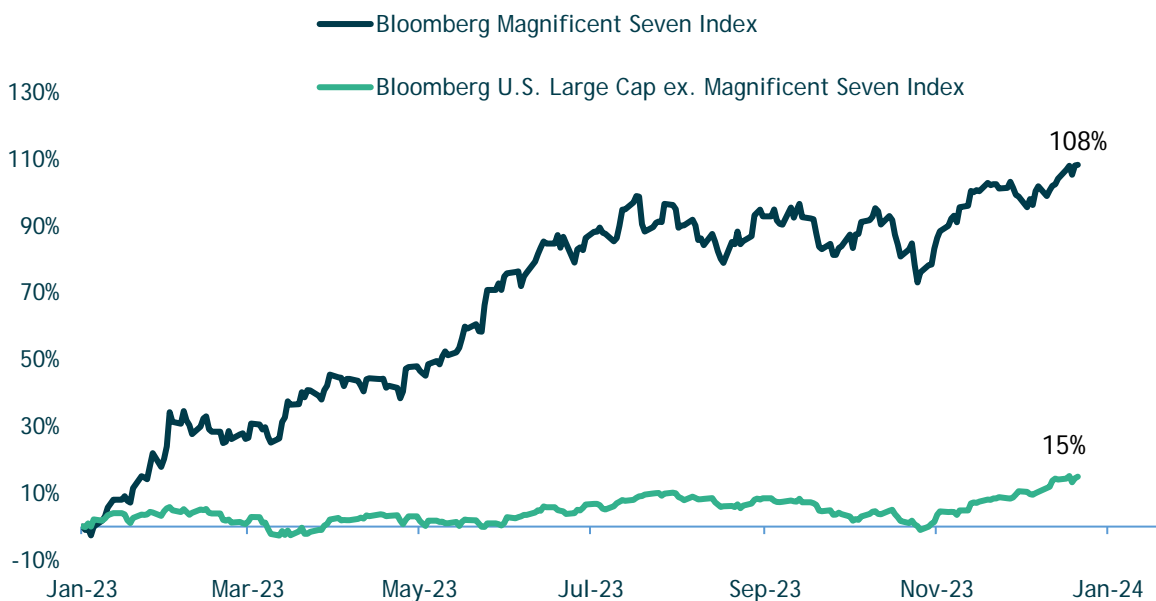
When it comes to determining recessions, the National Bureau of Economic Research (NBER) is the scorekeeper. Their definition of a recession is a “significant decline in economic activity that is spread across the economy and that lasts more than a few months.” The business cycle since the onset of the pandemic has been anything but ordinary. Instead of a simultaneous and broad-based decline in economic activity, I’ve observed specific industries struggling with isolated declines over time, while the board economy has managed to stay afloat.

Throughout 2020, Covid had an unprecedented impact on societies around the world. Many non-essential service-oriented businesses such as air travel and tourism experienced a depression-like scenario as demand evaporated. Conversely, goods-related businesses experienced a boom. Then through 2021 and 2022, consumer habits flipped and demand for services surged as economies around the world re-opened. As inflation took hold and interest rate increases became inevitable, rate-sensitive areas of the economy contracted. The housing market froze, and a higher cost of capital for technology firms caused funding to dry up and there were layoffs across the sector. In 2023, I’ve seen regional banks and commercial real estate experience declines.

All of which is to say that the most anticipated recession ever has yet to materialize. Many economists now expect it to happen in the second half of 2024. With various sectors of the economy experiencing contractions at different times over the last few years, my expectation is for a mild slowdown, not a deep economic downturn across sectors. But of course, I’ll be closely monitoring corporate earnings, labor statistics, and financial conditions to best assess the ultimate type of “landing.” There is growing consensus that a “soft landing” may occur in the U.S. in 2024, and I’m not ruling that out, especially if the Fed cuts rates sooner than later. That said, I recognize that soft landings are quite uncommon, occurring only four times in the last 75 years.

Within the U.S. stock market, performance in 2023 was driven by the handful of mega-cap growth stocks, dubbed the “Magnificent 7” (Apple, Microsoft, Nvidia, Facebook, Alphabet, Netflix, Amazon). These stocks had an average return in excess of 100% for 2023 and now represent a combined weight of more than 28% in the S&P 500 and 47% in the Russell 1000 Growth Index – near historic highs. However, much of the return in these stocks was driven by expanding valuation multiples leaving them expensive relative to the broader market.

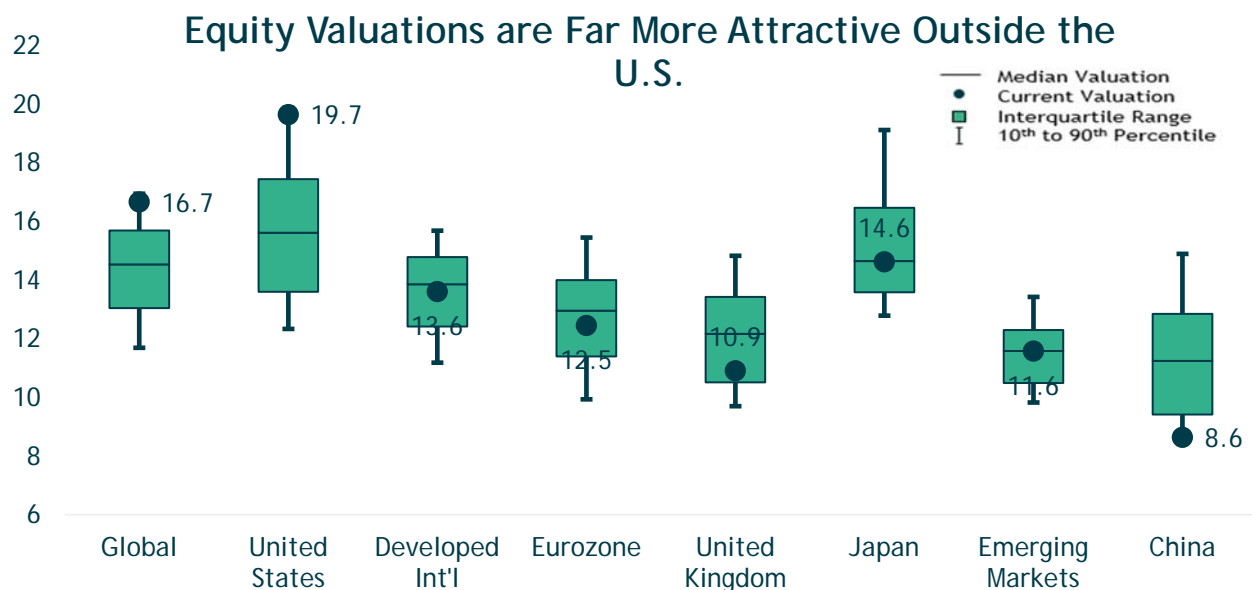
Top Heavy Performance in the U.S.



Source: Morningstar Direct. Data as of 12/31/2023.

With the market confident that interest rates have reached their cyclical peak, there is evidence of a shift in market leadership, with equity gains broadening out beyond the “Magnificent 7.” As seen in the chart above, the remaining 493 stocks in the S&P 500 index rallied 15% to end the year. I believe the recent broadening out of equity performance has the potential to persist over the course of 2024, and I wouldn’t be surprised to see those sectors of the market -- whose performance has significantly lagged -- begin to outperform in 2024. For example, small-cap stocks out-performed large-cap stocks late in the year. I anticipate the annual portfolio rebalance, with anticipated portfolio changes, will result in a shift away from the big winners of 2023 and towards more attractively valued areas of the market that tend to perform well in periods of heightened volatility and during an economic slowdown.

Our overall portfolio equity allocation continues to favor another unloved segment of the market – foreign stocks. Heading into 2024, the valuation discount for developed international and emerging-market stocks versus the U.S. is the widest it’s been in decades. From 2006 through 2016, the U.S. and developed markets traded within one multiple point of each other. The average forward P/E for the S&P 500 over the period was 14x compared to 13x for MSCI EAFE. Since 2016, the valuation gap has widened substantially. The S&P 500 now trades at nearly 20x forward earnings while the MSCI EAFE remains close to 13x. The story can be seen in the chart below -- U.S. stocks trade toward the top end of their valuation range while other regions offer up better relative values. Most other markets are trading roughly in-line or slightly below their historic averages. All else equal, lower starting valuations imply better long-term expected returns and provide more of a valuation cushion should multiples contract in a stock market sell-off.



Source: Bloomberg LP. Data from 1/1/2006 to 12/27/2023.

I remain positive on Core Investment Grade bonds (Bloomberg U.S. Aggregate Bond index). Within the credit sector, I believe fundamentals remain relatively healthy despite higher debt costs. Interest coverage, the level of leverage, and cash levels all look better than in historical periods late-cycle. And, as I've shared with you over the last several quarters, bond investors continue to benefit from higher starting yields. Core Investment Grade bonds are currently yielding 4.5%, which is above the current 3.1% inflation level, so bonds are providing a positive real (after-inflation) yield. Finally, I believe core bonds will provide downside mitigation in the event of a recession or decline in the stock market.

Despite my generally optimistic sentiment on the bond market, there is a risk of investors piling too much money into short-term bonds, which are currently yielding more than bonds with longer maturities. I believe that extending bond duration -- by investing in longer-maturity bonds, even if their current yields are less than shorter-maturity bonds -- will pay off for investors looking to lock in returns on "safe" money.

In addition to core bonds, our portfolios continue to have meaningful exposure to several other sectors of the bond world through the PIMCO Income fund (PIPXX, PIMIX). Exposure to fixed-income sectors outside of the traditional bonds provides an attractive risk-return potential.

Closing Thoughts

I think it is quite possible that 2024 will be a year where investors again enjoy some of the classic underpinnings of investing, where stocks and bonds are less correlated and provide diversification benefits to portfolios. This was not the case in 2022 and 2023, when stocks and bonds both declined meaningfully and then posted gains.

While there are likely to be bouts of volatility, these inevitably create opportunities. Currently, I see opportunities within the stock market, particularly if the anticipated broadening of market performance continues into areas of the market that have lagged. Within fixed-income, I believe that rates have peaked, inflation is under control for now, and that interest rates will decline to the Fed's 2% target by the end of 2024. In this environment, I will continue to take advantage of the inverted yield curve, capturing higher yields from shorter-term securities and cash, while

also looking to extend maturities and lock in today's relatively higher yields for clients whose portfolios require a bigger "safety net."

As we enter 2024, I wish you and your loved ones peace, happiness, and good health in the new year.

Thank you for your continued trust and confidence.

Best,

Kelly D. Kane, ChFC, CFP®

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