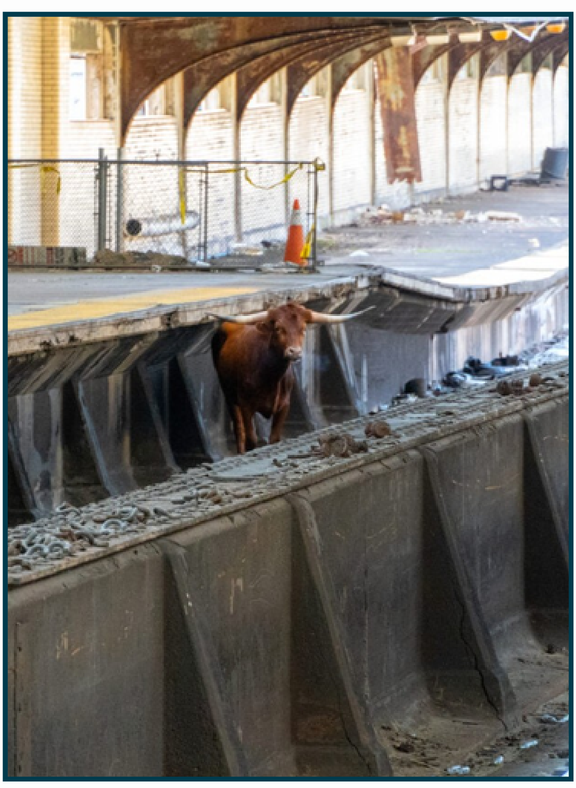
QUARTERLY MARKET UPDATE

PLAN WITH PURPOSE.
INVEST WITH CONFIDENCE.

JANUARY 2024

Bulls can show up in unexpected places. This December, a bull was discovered on train tracks just ~10 miles from Wall Street. We're fairly certain a literal bull was a surprise to most commuters. Likewise, a bull market rally late in 2023 took many investors by surprise.



Investment Principles

- We believe clients should understand and be compensated for the financial risks they take.
- We believe portfolio diversification is an active process that requires more than just traditional stocks and bonds.
- We believe a tax-sensitive approach is key to enhancing real returns.
- We believe each client's portfolio should be customized to best help them achieve their financial goals.

Fourth Quarter 2023 Market Performance, Key Drivers & Outlook

2023 ended with a bang with an 'everything rally' in Q4. For the full-year 2023, US stocks increased 26.1%, International Developed stocks increased 18.3%, and Emerging Market stocks increased 9.0%. US fixed income, as measured by the US Aggregate Bond Index, increased 5.5%. See **Figure 1.** The past year was humbling for many forecasters, albeit in a good way, as the US avoided a much called for recession and shrugged off higher interest rates, a regional banking crisis, and wars in Europe and the Middle East.

Figure 1. Market Performance, Total Returns

	Q4'23	2023
Equities		
US Total Market[1]	12.1%	26.1%
International Developed[2]	10.8%	18.3%
Emerging Markets[3]	6.6%	9.0%
Fixed Income		
Aggregate[4]	6.8%	5.5%

1. S&P Total Market Index, 2. FTSE Developed ex US Index, 3. FTSE Emerging Index, 4. Bloomberg US Aggregate

So what happened? In Q4'23, the S&P 500 staged a late-year rally and finished less than 1% away from its all-time high. With inflation declining, the Fed has been communicating that it expects to 'pivot' to easing. Expectations for rate cuts benefitted both US stocks, as well as fixed income securities, as yields declined. At the same time, optimism regarding a 'soft landing' increased. Recall that a 'soft landing' refers to the Fed's ability to rein in inflation without simultaneously driving the economy into a recession. Supporting this view, the labor market has continued to be strong, and importantly, consumers remained resilient. Consumer spending makes up ~2/3rds of GDP, and as a result, has an over-sized impact on the economy.

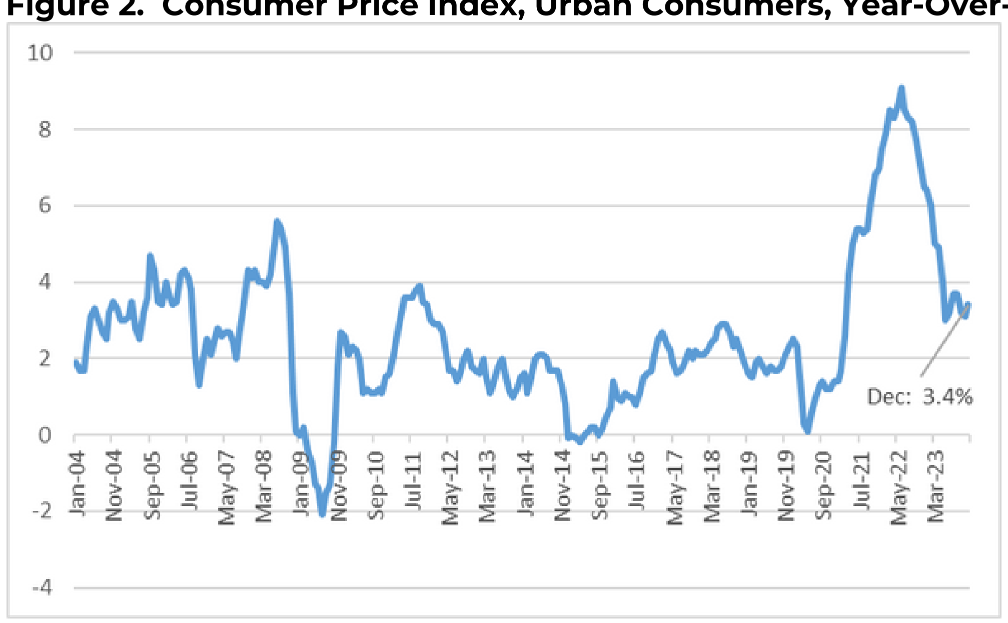
As we look forward, we continue to be 'cautiously optimistic' and are positioning portfolios accordingly. To the extent that investors have become overly confident regarding the 'soft landing' scenario, and interest rates remain in restrictive territory, risks to the downside persist. We continue to stress diversification and lean into options-based strategies that benefit from increased volatility, defensive sectors of the economy (e.g., utilities), and longer-duration fixed income securities that benefit from lower interest rates.

U.S. Economic Trends

The economy, as measured by real GDP is expected to grow ~2.4% for the full-year 2023, and slow-down to ~1.3% in 2024, according to a consensus of professional forecasters. In our view, the most significant risk to 2024 estimates is elevated interest rates. While short-term rates should move lower throughout the year, they will likely remain in restrictive territory, and may take a more meaningful bite out of the economy. Recall that higher interest rates discourage investment by corporations and consumption by consumers. Just ask anyone who has recently considered purchasing a home. While mortgage rates have declined meaningfully, they remain ~7%, translating to much higher monthly payments relative to several years ago. Furthermore, while the Fed is calling for ~3 rate cuts in 2024, the market is calling for ~6 rate cuts, and may have gotten ahead of itself, setting up for potential disappointment. Additionally, we think that if we get more rate cuts than expected, it will be a result of a meaningfully weaker economy.

However, and most encouragingly, inflation has declined dramatically. Inflation peaked at 9.1% in June and, most recently, was up 3.4% in December. See **Figure 2.** While December inflation surprised to the upside, this still represents significant progress from the prior peak, and alternative measures of inflation are trending even lower. Importantly, should inflation continue to decline, it opens up the opportunity for more accommodative monetary policy, which should provide a boost to economic growth and lift asset prices. The likelihood of a 'soft-ish' landing has significantly increased as the Fed continues to navigate difficult terrain.

Figure 2. Consumer Price Index, Urban Consumers, Year-Over-Year (%)

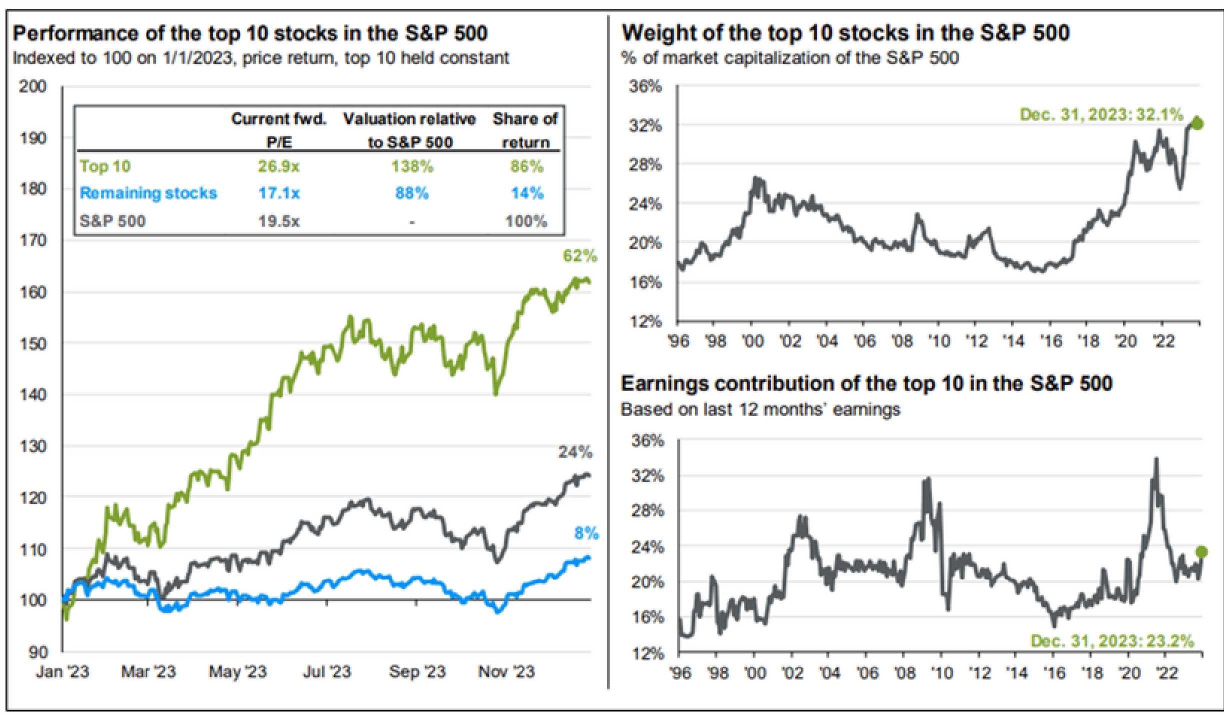


Source: Bureau of Labor Statistics, Bloomberg

U.S. Stock Market

The big keep on getting bigger. 2023 saw the continued dominance of the largest names in the S&P 500. The 10 largest stocks generated 86% of the return, while the remaining 490 stocks generated 14% of the return. These top 10 stocks included mega-cap tech-related companies like NVIDIA, Meta Platforms, Amazon, and Tesla. The largest stocks also continue to make-up an unusually large percentage of the S&P 500, and are more expensive than the rest of the market, relative to the earnings they generate. See **Figure 3.** Momentum accelerated throughout the year in tech-related names, particularly for those perceived to benefit from trends in AI. The dispersion of stock returns continues to be elevated and a full 72% of stocks in the S&P 500 underperformed the index.

Figure 3. S&P 500 Concentration



Source: J.P Morgan Asset Management, FactSet

We are also somewhat concerned about earnings expectations. Consensus estimates among analysts calls for ~11% growth in earnings per share this year. Should economic growth slow, and businesses find it harder to raise prices on goods and services, this may prove to be overly ambitious. See **Figure 4.** We think this sets too high of a bar, and that expectations will need to be revised lower throughout the year, representing a potential drag for U.S. stocks.

Figure 4. S&P 500 Earnings Per Share Growth

S&P 500 year-over-year pro-forma EPS growth

Annual growth broken into changes in revenue, profit margin and share count

Share of EPS growth	2023	Avg. '01-'22
Margin	-2.5%	3.1%
Revenue	2.9%	4.1%
Share count	-0.3%	0.3%
Total EPS	0.1%	7.5%

Source: J.P Morgan Asset Management, FactSet
**2024 and 2025 EPS growth is based on consensus analysts estimates*

Given these dynamics, we continue to emphasize individual security selection, as well as the need for diversification. We favor tilts away from the largest names in the index, simply from a risk management perspective, as well as tilts towards quality (e.g., companies that generate high earnings relative to their invested capital), and sectors with earnings that are less dependent on the economic cycle (e.g., utilities).

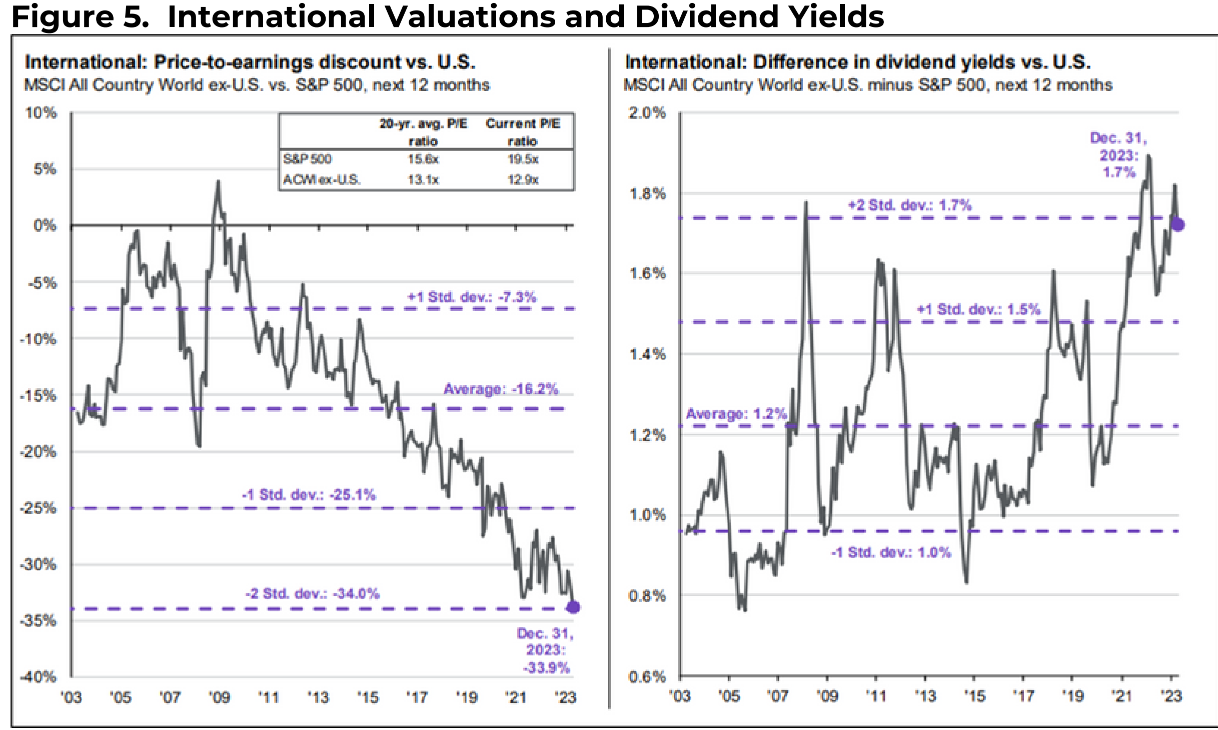
Importantly, we continue to believe that ''time in the market' is more important than 'timing the market', and our tactical tilts continue to be modest. Investing legend, Warren Buffett, benefits from the wisdom gained over a lifetime of investing, and views investing in U.S. stocks as an expression of confidence in American business. Like Mr. Buffett, our confidence regarding the long-term ingenuity of American business is unwavering. At a high-level, we benefit from the millions of people that go into work each day, focused on producing goods and services that meet the needs of consumers, and thereby, grow revenue and profits. We continue to believe that over the long-run, while the path may be bumpy, stocks are the best way to compound returns.

International Stocks

The U.S. stock market continued to outperform the rest-of-the-world in 2023. U.S. stocks were up 26.1%, while International Developed and Emerging Market stocks were up 18.3% and 9.0%, respectively. International markets posted strong results, albeit somewhat weaker than the U.S. Within International Developed, the strongest contributors included Japan, France, the United Kingdom, and Germany, while the largest detractor was Hong Kong. Within Emerging Markets, the strongest contributors included Taiwan, India, and Brazil, while the largest detractor was China.

Europe and China have been lagging economically, but have the opportunity to accelerate. The Eurozone likely entered into a recession last year, and the European Central Bank is expected to cut rates, providing an incremental boost to the region. Additionally, China's economy has ramped-up slower than anticipated post COVID lock-downs, and is expected to receive further stimulus with fiscal and monetary support this year. Meanwhile, many emerging market nations (e.g., India) continue to benefit from stronger demographics, a growing middle class, and the implementation of technology. Several positive trends coincide with international markets that trade at an extreme discount to U.S. markets, as measured by price relative to expected earnings. International markets also carry significantly higher dividend yields. See **Figure 5.** In our view, should the global economy strengthen, international markets will outperform, and vice versa. As a reminder, international markets have a greater concentration of cyclical businesses. However, most importantly, we continue to believe that owning stocks across the globe is a meaningful part of a well-diversified portfolio.

Figure 5. International Valuations and Dividend Yields



Source: J.P Morgan Asset Management, FactSet

Fixed Income

The U.S. Aggregate Bond Index increased 5.5% in 2023 in an unusually volatile year. The 10-year US Treasury yield increased from 3.87% at the end of 2022, to a peak of 4.99% in October, before trending back down to approximately where it started, hitting 3.88% by year-end. A softer inflation print in November was a major catalyst to the Q4 rate decline. As a reminder, there is an inverse relationship between bond prices and yields. As yields decline, bond prices rise, and vice versa. See **Figure 6.**

Figure 6. US Treasury, 10-Year Yield

Source: Bloomberg

Another key driver of fixed income returns is 'credit spreads'. Credit spreads should be thought of as the additional yield received from investing in riskier fixed income securities (i.e., comparing corporate bonds to a US Treasury). Credit spreads 'widen' when risk is perceived to be elevated, and 'narrow' when risk is perceived to be more muted. Investment-grade corporate credit spreads narrowed ~31 bps, or 0.31 percentage points, throughout the year, as investors became more optimistic regarding a 'soft-landing' scenario. Spreads continue to be tighter than average. As credit spreads meaningfully widen, we may tactically add exposure to higher-yielding securities.

At a high-level, fixed income securities offer the most attractive yields in ~15 years, and continue to offer diversification benefits (i.e., rates typically decline in a recessionary environment.) If rates stay about the same, or trend lower, we think high-quality fixed income securities should provide solid returns. Risks include higher government spending, resulting in Treasury issuances that exceed demand, or a resurgence in inflation that prevents the Fed from cutting short-term rates. However, all in, we continue to be excited about the potential for fixed income, particularly in the context of a portfolio, and given the current risk/reward profile.

As always, we continue to invest on your behalf, consistent with the PWM investment philosophy. We consider it a privilege to help our valued clients reach their financial goals.

Thank you for your continued trust and, as always, we remain available to address any questions or concerns.

Sincerely,

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