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2023 Fourth Quarter and Year End Commentary

2023 finished up as a strong albeit volatile year for stocks and bonds. The fourth quarter began with a steep decline and then rebounded as corporate earnings supported stock valuations while inflation showed signs of cooling. As a result, rate increases ended. The rally in stocks extended further when the Federal Reserve's chair said we could actually see interest rates come down in 2024. Other Fed board members remained understandably cautious in their tone citing confusing economic data. Consider the manufacturing sector, which accounts for less than 10% of our economy, it's been mired in contraction for the 12th consecutive month[1] indicating consumers may be normalizing spending on goods. Meanwhile, money is still being spent on services and that's important because the service sector represents about 80% of the economy.[2] It's counterintuitive to think bad news could be good news. More people losing their jobs, for example, is perceived as an encouraging sign the economy is slowing and therefore a drop in interest rates could come sooner rather than later. Unfortunately, it's not as linear as it sounds because Fed decisions are data dependent, leaving it impossible for anyone to know when and what is really in store moving forward. Portfolio diversification may be the only practical path to meet a wide spectrum of possible outcomes for both the economy and capital markets. Famous atomic physicist Niels Bohr was fond of the statement: "prediction is very difficult, especially if it's about the future." We couldn't agree more and it's why we value the certainty of knowing our portfolios performed very well in 2023.

Investors could be ahead of themselves expecting more or sooner rate cuts in 2024 than the Fed will deliver. However, if the direction of interest rates and inflation remain downwardly intact, consumer spending and company earnings should hold up. Working in tandem, they can keep a high unemployment type of recession at bay and create a constructive environment for stocks.

Most stocks enter the new year expensive by historic measures.[3] High valuations along with possible interest rate swings leave markets vulnerable to the similar volatility we experienced in 2023. Earnings expectations may be challenged in 2024 particularly for the "Magnificent 7" mega cap technology companies (Microsoft, Apple, Google, etc.) making the news two years in a row, but for opposite reasons: plummeting in 2022 and soaring in 2023. It's unlikely these names continue to advance at such a torrid pace. High

[1] YCharts. (2023). *US ISM manufacturing PMI (I:USPMI)*. US ISM Manufacturing PMI. https://ycharts.com/indicators/us_pmi
[2] YCharts. (2023). US ISM services PMI (I:ISMNMI). US ISM Services PMI. https://ycharts.com/indicators/us_ism_non_manufacturing_index
[3] J.P. Morgan Asset Management. (2023). S&P 500 valuation measures. Guide to the Markets, 5. https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/#

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hopes and expected cost benefits of artificial intelligence (AI) are justified long term, and we believe AI will usher in a sea-change like other booms in the past such as the computer, internet, and cell phone. However, it's just too soon to know who the real winners will be. The introduction of AI may be uneven and slower than investors expect, leaving the consumer to drive economic growth for now.

Throughout the back half of the year, returns in the S&P 500 continued to broaden out beyond the mega cap tech names. In fact, small cap stocks were our best performer for the quarter. We made two small but notable changes in our holdings. First, we exchanged our ETF in artificial intelligence and robotics from FBOT to AIQ primarily because of its smaller footprint in China, but also its low cost and better performance. Also, AIQ is made up of primarily larger corporations that, by the very nature of their size, are less vulnerable to the impact of higher borrowing costs, should interest rates remain higher for longer. Second, and for similar reasons, we increased our exposure to giant U.S. companies by adding Vanguard's ETF MGK, while reducing our global exposure via CGGO.

Roughly 40% of our bond allocation is still in the hands of active management at PIMCO. We continue to use their income fund, PIMIX, which outperformed its benchmark in 2022 when bonds collapsed,[4] and continued its strong performance into 2023 with a total return of +9.2%.[5] The remaining 60% of our bond allocation is distributed across various U.S. Treasury and investment grade corporate bond ETFs with target maturities spread between 2024 (IBTE), 2025 (IBTF), and 2026 (IBTG). When combined, a current yield to maturity of approximately 5% is still attractive.

There are many headwinds facing economic growth and the stock market. Two ongoing wars, election year anxiety, seemingly unmanageable U.S. budget deficits, and economic woes in China along with its uncertain plans with Taiwan, are just a few of our macro concerns. It's difficult to measure how and to what extent the outcome of any of these ongoing events will have on company earnings. An escalated war in the Middle East could affect the price of oil, shipping, and supply chains (particularly in Europe). However, it is inflation that remains our greatest concern.

We know the impact that inflation has on us as consumers at the gas pump or the grocery store, but as portfolio managers we've been searching for historical data about the relationship between inflation and stocks. One of the most interesting pieces we came

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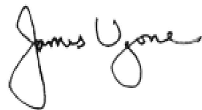
[4] Y Charts. (2022). Mutual funds. https://ycharts.com/mutual_funds/M:PIMXX
[5] YCharts. (2023). Mutual funds. https://ycharts.com/mutual_funds/M:PIMXX

across was produced by Alliance Bernstein. Looking back 75 years (post WWII) they've researched how stocks have fared during various periods of inflation; we found their data encouraging. Their research showed the S&P 500 delivered annualized returns of 10.1% when inflation ranged between 2.1% - 4.0%. There was a drop-off in performance when inflation was higher than 4.1%.[6] They also observed the current spread between bond yields and the expected return in stocks or the "equity risk premium" (ERP). They found that today's ERP is distinctly similar to a period between 1983 and 2008, when market returns were an annualized 10.2%.[7] Unfortunately, there is some rather discouraging data showing the higher the level of inflation, the longer it can take to recede.[8] Until we have a clearer picture of the economy, inflation, and interest rates, we enter 2024 cautiously optimistic with a neutral weighting to stocks. Our base case is for descending inflation, interest rates cuts and a mild recession, if any.

Understanding the impact of inflation is just one of the many reasons why our comprehensive planning process is so important. Please call us if you have any questions whether it's to review your plan, life insurance policies, social security decisions, Medicare considerations, work benefits, estate documents, or if you just need help accessing your accounts.

Thank you.



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[6] Christopher Hogbin, N. Y. (2024, January 10). *Equity outlook: Three questions for investors in 2024*. AllianceBernstein. https://www.alliancebernstein.com/us/en-us/investments/insights/investment-insights/equity-outlook-three-questions-for-investors-in-2024.html

[7] Christopher Hogbin, N. Y. (2024, January 10). *Equity outlook: Three questions for investors in 2024*. AllianceBernstein. https://www.alliancebernstein.com/us/en-us/investments/insights/investment-insights/equity-outlook-three-questions-for-investors-in-2024.html

[8] Arnott, R. D., Shakernia, O., & Swedroe, L. (2022, December 28). History lessons: How "transitory" is inflation? 4th quarter 2023 Economic Outlook: Inflation & Geopolitics. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4305206