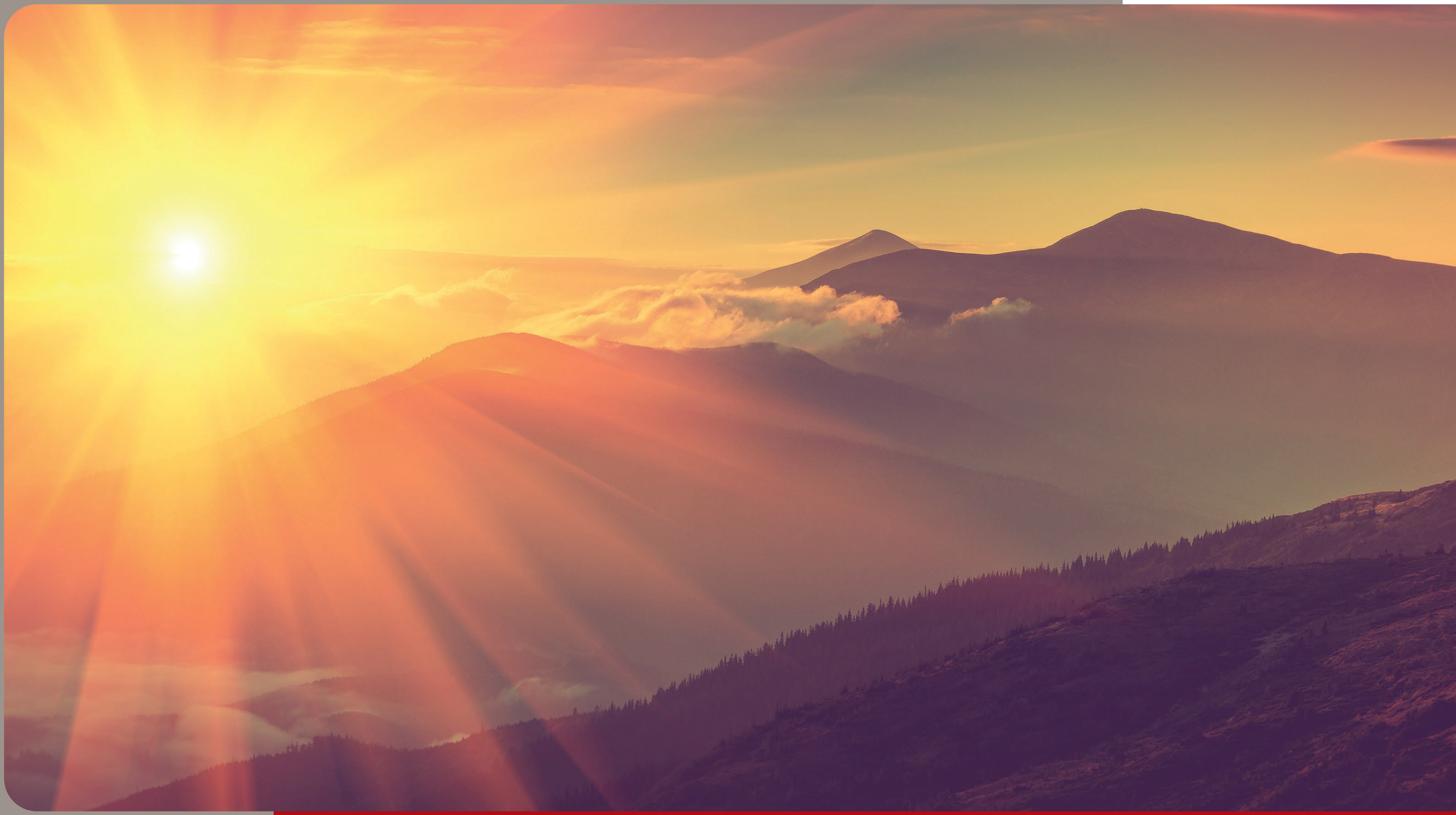

2023 CAPITAL MARKETS RECAP
2024 OUTLOOK

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Written by: The Investment Committee

January 22, 2024

Executive Summary

The major themes from 2022 maintained their relevance in 2023, including the inflation outlook which has driven Federal Reserve interest rate policy, the health of the consumer, and the state of corporate earnings. After 3yrs of upward price pressure, the trend looks to have broken and disinflation strongly in place. Keep in mind, there are three types of inflation: 1) standard inflation when prices drift higher, 2) disinflation when the rate of inflation slows (this is what we've experienced of late), and 3) deflation when prices decline. The consumer would much rather see deflation, and while they are still rather unhappy about the elevated costs of living, they are still employed, and healthy enough to spend. Jobs and wage data appear to be holding, indicating a healthy consumer. After observing this data, the Fed has slowed its hand raising interest rates, and even mortgage rates have started to drop. Don't forget that Gross Domestic Product (GDP) reached 4.9% in the third quarter. And corporate America has in some ways thrived, supported by fiscal spending and new developments in artificial intelligence (AI). It was a year that included some serious volatility, both in stocks and bonds, making this environment particularly uncomfortable even for those with more conservative allocations. Some of this volatility, specifically within fixed income, has shifted the outlook for diversified portfolios for the better.

In the following pages, we will share with you our thoughts and actions for 2023, followed by our outlook for 2024. In review of last year, we will cover:

1) highlights of major market and economic events

2) takeaways and reflections on the year

We then discuss our outlook for 2024, focusing on:

3) major themes and reasons for optimism as well as

4) causes for concern

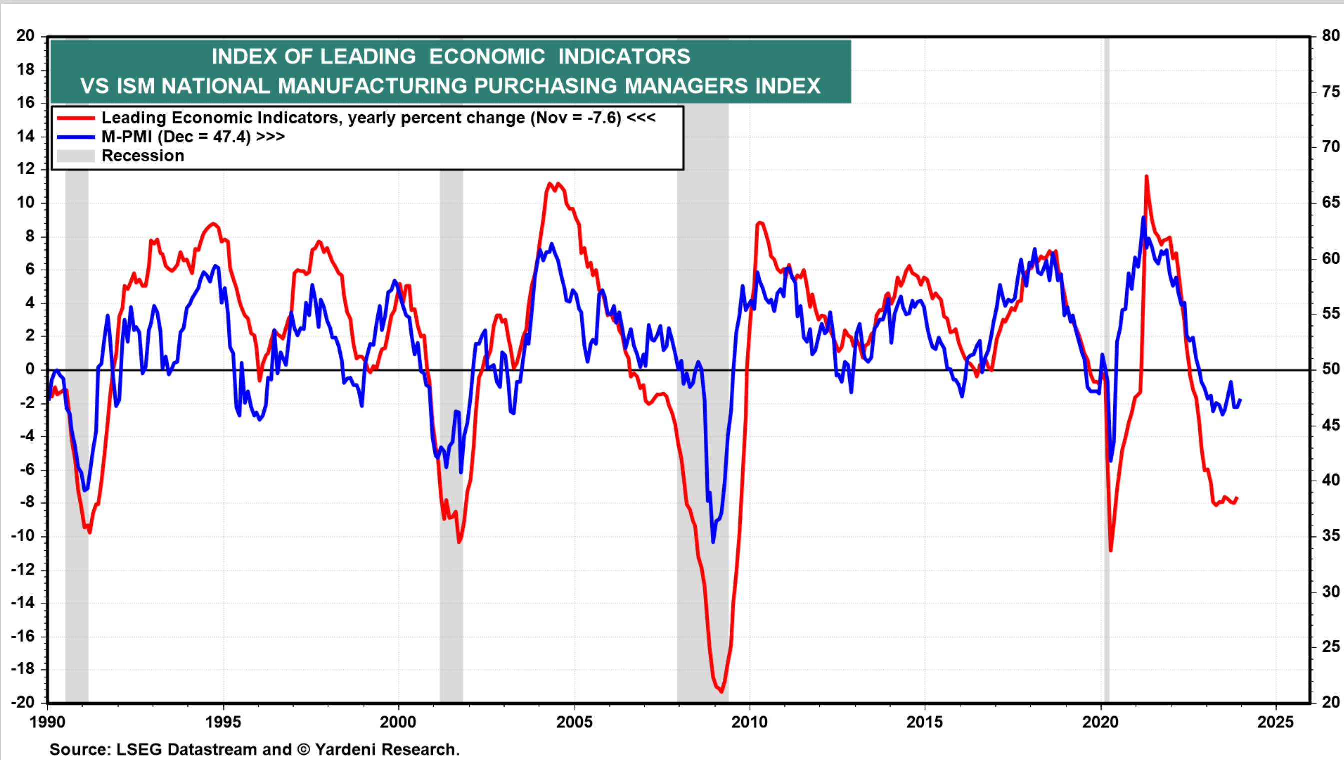
Intro

There was no shortage of interesting economic and market events in 2023. Closing out the year, the inflation pressures that rattled financial markets for 3 years look to finally be subsiding. Ironically, if you awoke from a 12-month hibernation today, you might be led to believe 2023 was quite benign, with the market up double-digits and the 10-year treasury yield ending where it began, just under 4%. All this despite, a few regional bank collapses, a US Debt downgrade, union strikes, record bond volatility, and geopolitical tensions in the Middle East, Eastern Europe, and Asia…phewww… Despite the year ending surprisingly upbeat, US citizens and small businesses alike still feel incredibly sour. We often hear from consumers, “I don’t care what disinflation is, my grocery bill is still 50% higher!” 49% of small businesses that are hiring reported there are 0 qualified applicants in the labor pool currently. These two anecdotes best embody what 2023 meant to the average American or small business owner. Contributing to this rather large chasm between what is felt on the ground by US citizens, and the realities of the broader economy. As investors or asset allocators, we must look at things in the aggregate, without disregarding some of the real stress felt by many. Asking ourselves in each instance, will this evolve or set in motion a broader issue, or is this circumstantial and non-systematic? In the following paragraphs, we hope to debunk some of the pessimism of ‘23 and offer a balanced outlook for the year ahead.

2023 Summary recap

Entering 2023, Wall Street had gloomy outlooks following a -25.4% market contraction reflecting the average non-recessionary bear market. Strategists entered the year remarkably bearish with inflation reaching a 40-year high amid a hot economy, leaving many asking, “how could October ‘22 be the low with the Fed so far from its goals?” Historically, near double-digit inflation had never been defeated without a significant uptick in the unemployment rate and recession. We hadn’t even touched the average drawdowns experienced for a run-of-the-mill recessionary bear market. So, how exactly did the most dangerous words in investing, “this time is different,” come to fruition last year?

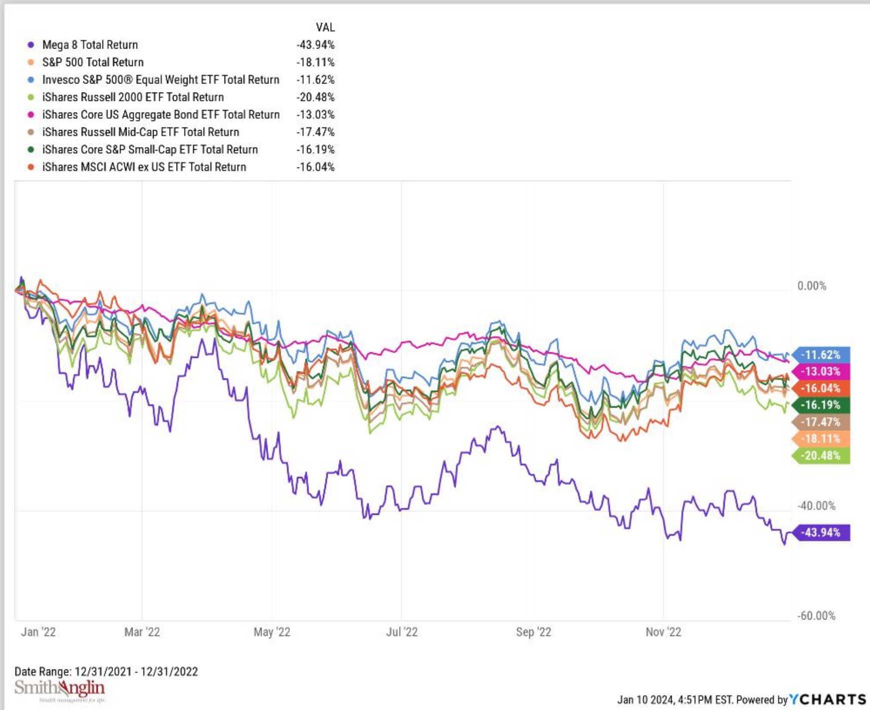
In case you missed it, we told a bit of this story *here*. At the time, widespread uncertainty surrounded the ability of disinflation to continue—when the rate of inflation declines. Was disinflation going to continue despite the persistently strong economic data? When were the impacts of “long and variable lags” from the Fed going to take effect? Many expected the US economy would succumb to recession by at least the first half of ‘23. To be fair to the prognosticators, the setup going into ‘23 had every reliable leading economic indicator, from Yield Curve inversion to the Conference Board’s LEI index, all flashing red. The risk was too great to disregard all these indicators and state, “this time is different!” Especially when one could get paid to wait, hiding out in money markets or US T-Bill’s earning north of 5%.

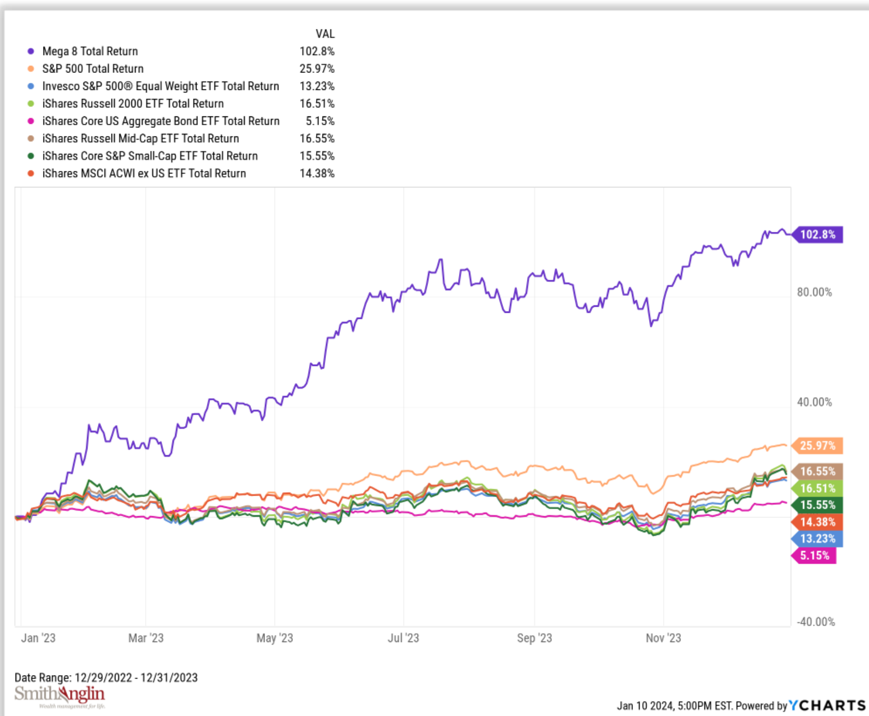


We were mildly a part of this crowd, recognizing the value healthy cash yields would offer in a diversified portfolio. However, we also recognized the risk to the downside couldn't be substantial if any drawdown would be met with buying pressure from money market redemptions. Furthermore, we remained somewhat skeptical of the ability of leading indicators to predict recession, particularly following a pandemic that distorted consumer behavior. Make note, leading economic indicators are predominately the most cyclical or discretionary parts of the economy – durable & manufactured goods. The pandemic caused people to overspend on these items, resulting in a bust shortly after. For that reason, looking beyond traditional indicators of economic health would be far more important, specifically within Services. This spending more than offset the flat line in goods demand, which, in a services-based economy, was far more important in maintaining the overall health of the US.

Market/economic events

2022's laggards became 2023's leaders, with cash and balance sheet quality being of the utmost importance. This led to narrow market performance, albeit fundamentally supported by various factors: cost-cutting, AI/enterprise/data center infrastructure spending, resulting in better-than-expected earnings. This was especially true for the Mega Cap 8. ***(GOOGL, AMZN, MSFT, AMZN, NVDA, META, TSLA, NFLX).***

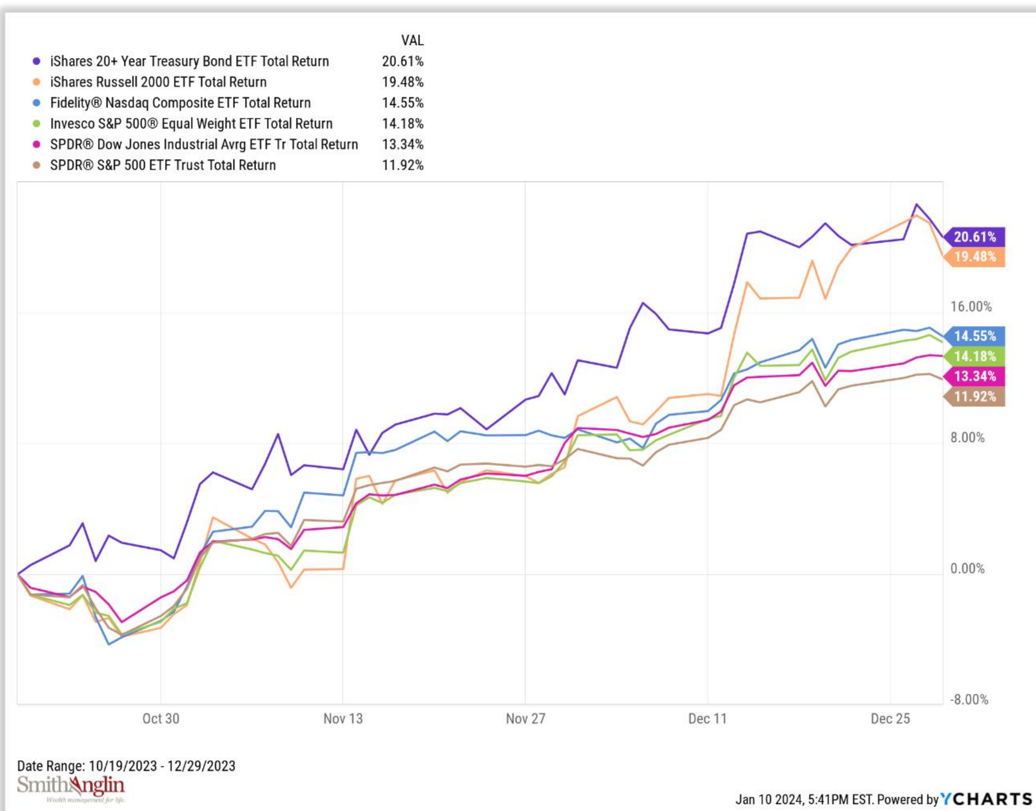




The rest of the market sold off intermittently, beginning with March's regional bank debacle. With a narrow tech-driven rally to follow, markets peaked again on July 31st, reversing course on a US debt downgrade and a resurgence of the "higher-for-longer" narrative. As a result, intermediate/long-term bond rates skyrocketed, with market values drawing down the most on record from their peaks in '21 (bond yields rise as their prices decline).

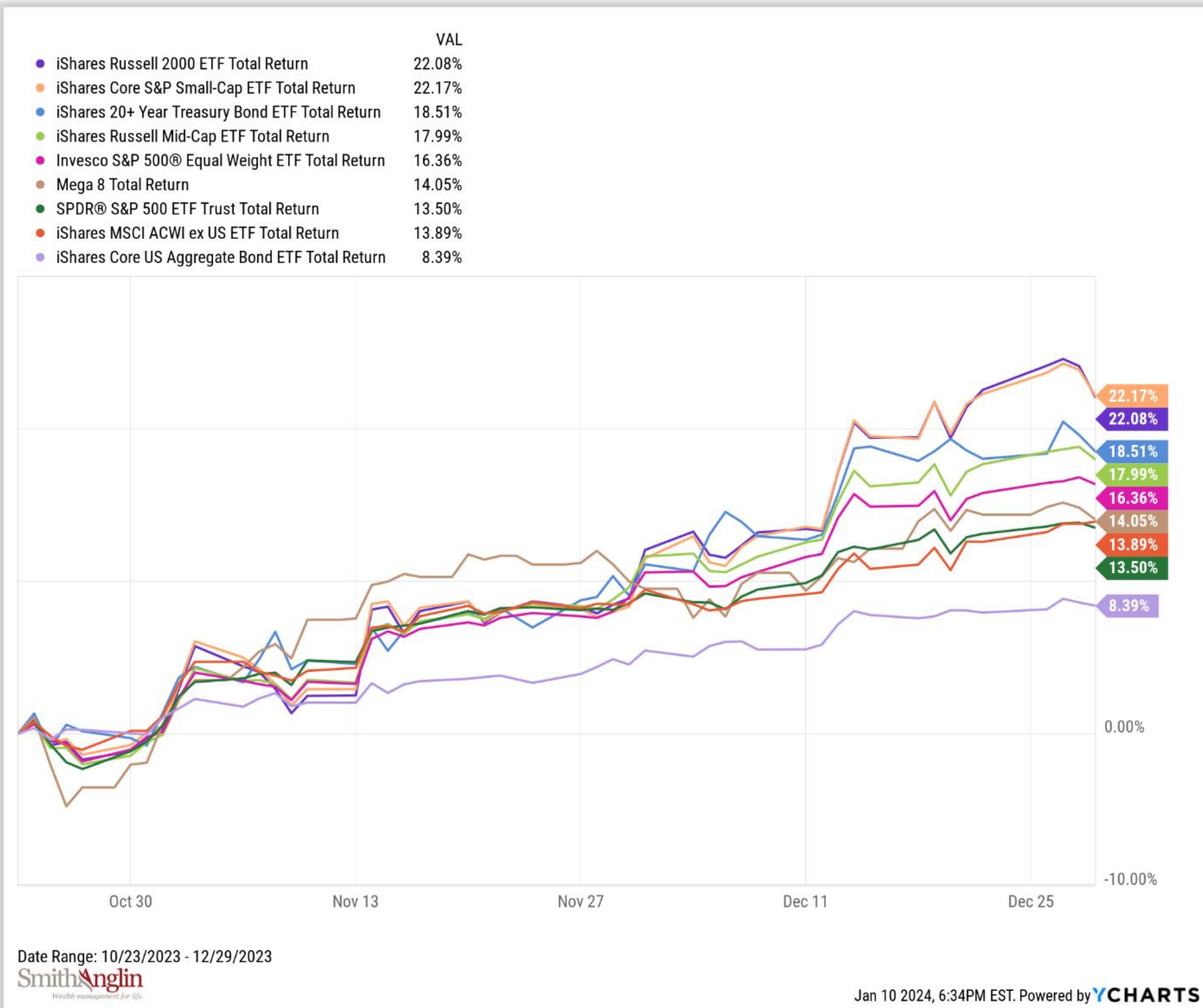
Fast forward to October 19th with the 10yr US treasury approaching 5% and equities down nearly 10% from July 31st, bond yields began to reverse course (yields fall when prices increase). We believe major liability-driven institutions

(Pensions, Endowments) realized the relative value high-quality bonds had reached, specifically in the context of near-peak policy rates. For context, long-term rates were either going to increase another 0.5%, stabilize, or decline by over 0.5%. In other words, over the next year, investors in US 10yr bonds were going to lose 0.9%, make 5%, or cash in a more than 12% return. The result? Long-term US Treasury bonds ended up outperforming most equity benchmarks to close out the year, experiencing 15%-21% in price appreciation depending on the specific tenure.



Thankfully, we decided to increase our exposure to long-term US Treasuries at this moment; despite being a highly contentious decision within the Investment Committee. Much of this came from the supply/demand dynamics exacerbated by government deficits, and quantitative tightening, among other things. In any case, we were happy to pass along the benefits of equity-like performance with a fraction of the risk and felt it to be a healthy entry point, even if it wasn't at peak yields.

Equity market performance bottomed shortly thereafter on October 23rd. From there, stock performance broadened as the result of 1) October's CPI print of 0% MoM and 2) November's JOLTS report which reflected substantial cooling within the job market. The final boost solidifying the rally into yearend was the December Fed meeting and the release of the dot plot in the Summary of Economic Projections indicating the possibility of up to 3-4 rate cuts in '24.

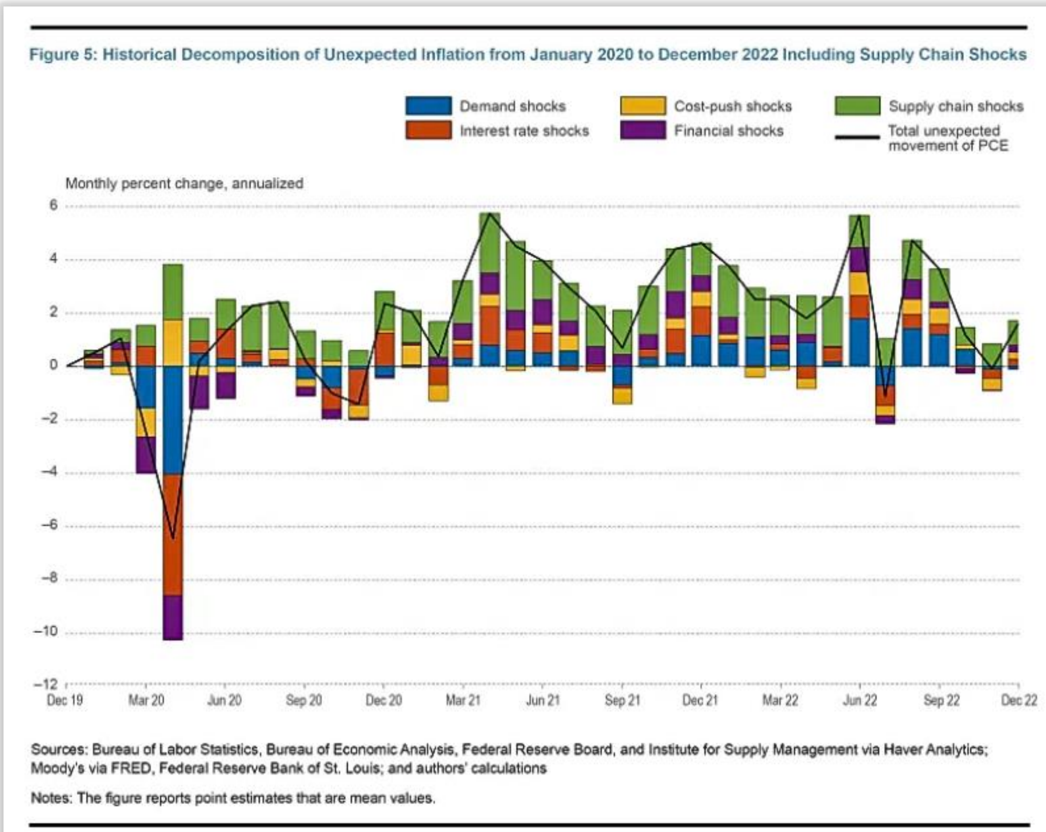


The Fed's dovish pivot in December sustained the rally in bonds, which led to a complete re-valuation of the stock market higher. Everything categorically rate-sensitive pulled drastically ahead of the prior leaders (MSFT, AMZN, NVDA, META, etc). Including but not limited to small-cap, mid-cap, and large-cap value stocks as well as sectors like real estate, financials, biotech, and utilities. A remarkable and rare thrust upward. For context, the Russell 2000 (the small-cap index) went from a 52-week low to a 52-week high in 33 trading days. The last time this occurred was September of '82, the end of Paul Volker's rate-hiking campaign. FYI, this sort of widespread performance is virtually exclusive to bear market bottoms or in response to a rapid decline in real interest rates, inflating the value of future cash flows across nearly all stocks.

2023 Reflections

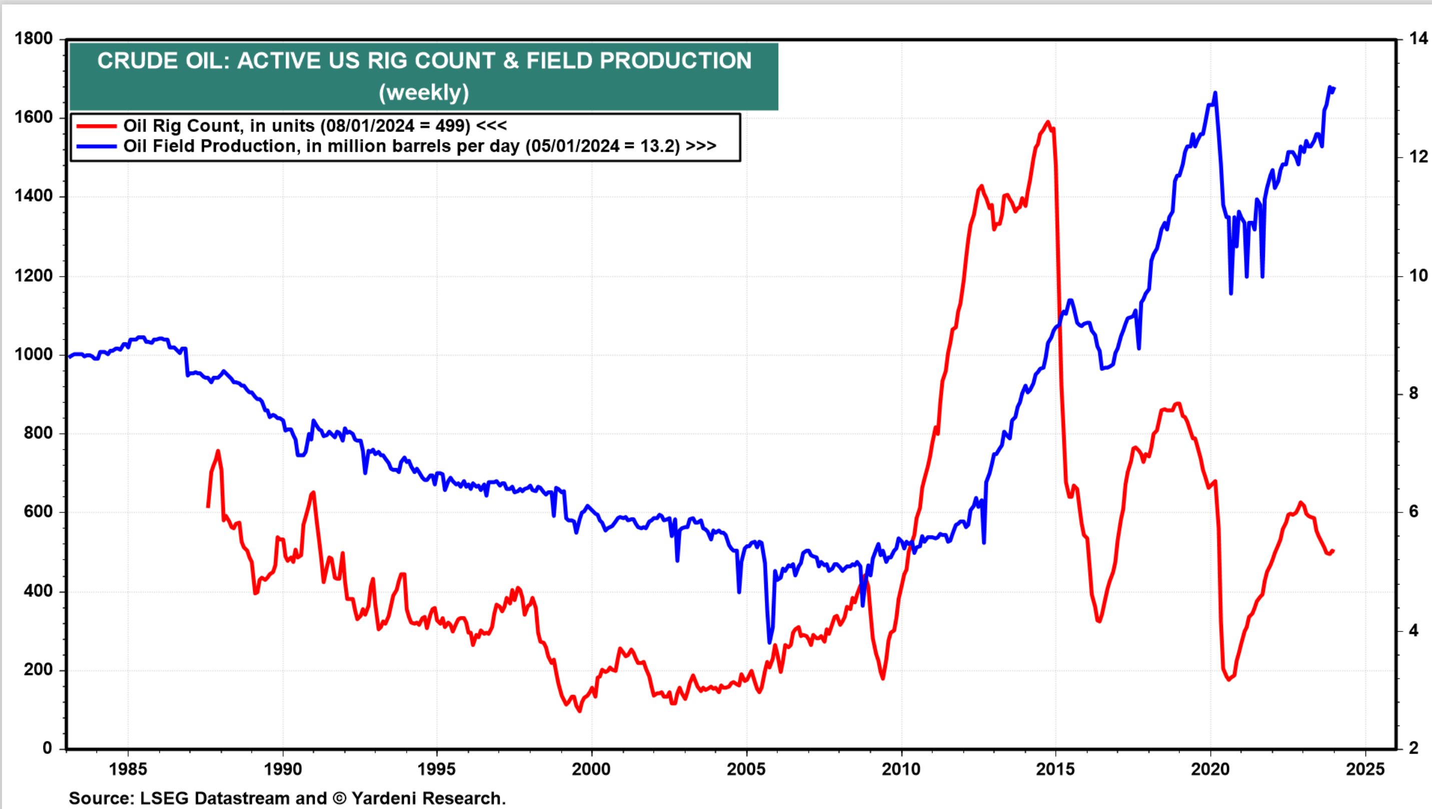
Why has inflation come down so quickly without any substantial increases in the unemployment rate? How much impact did the Fed have?

Just as inflation burned bright from volatile shifts in consumer spending habits, it wasn't implausible to be nearly as quick to flame out. It's tough to say whether it was the chicken or the egg, but we'd venture to say it was a confluence of circumstances. The pandemic led to the overconsumption of durable/non-durable goods, only to be magnified by our private sector's complex global supply chain and inventory management practices. Just look at the decomposition of inflation the Cleveland Fed attributed to Supply/Demand shocks.



It's also important to note very few if any analysts/strategists predicted Russia's invasion of Ukraine and add to that a resilient consumer (spending aided by a host of sources: fiscal checks, larger cost of living adjustments on Social Security, higher wages, and tight labor markets). These factors extended the time horizon for inflation to normalize. Thankfully, businesses have been able to adapt to tight labor markets and higher wages by replacing labor with tech and reducing unnecessary costs. Companies have utilized things like kiosks, full self-check-out and customer service chatbots/AI assistants, and thus far, rates of productivity appear to be picking up. On the goods side, companies were given breathing room to mend their supply chains as consumer spending habits normalized.

Another big driver of disinflation was energy prices, virtually going in the opposite direction as predicted by much of Wall St. This had big second-order impacts on goods disinflation or outright deflation and kept lower-income households spending via lower costs at the pump. With a hostile administration towards fossil fuels, underinvestment in capacity/production, OPEC+ production cuts, and an escalating Russia/Ukraine conflict, energy bulls were calling for triple-digit WTI. First and foremost, the impact Biden had on oil prices was marginal at best. Higher crude had far more to do with Russia's invasion of Ukraine, EU winter consumption, and lack of US refining capacity/underinvestment, not the rig count, political ideology, or limits to drilling on Federal land. Even following cuts by OPEC+, oil has failed to sustain itself above $80 a barrel for more than a few months. The reality is that the US is a net exporter of energy and has been for over a decade now. Conversely, much of the oil that is imported is from Canada or Mexico, disconnected from the Middle East or Russia. Ironically, inventories are elevated, and production is hitting record highs. Forced capital discipline has resulted in recent advances in horizontal drilling techniques, allowing far more production from the same well.



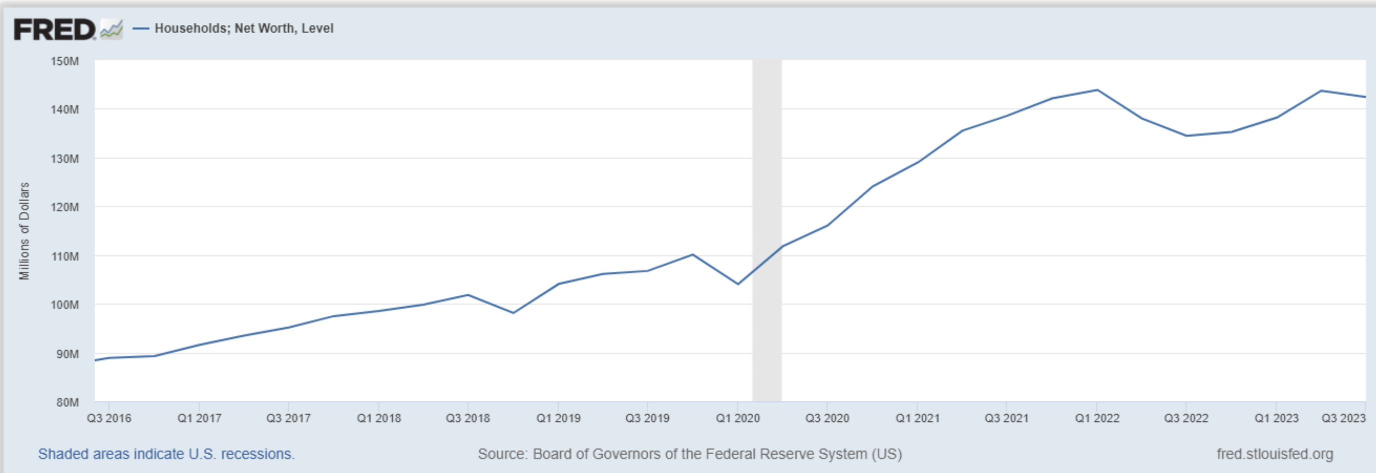
What led to such resilient stock market performance and resilient corporate earnings/margins?

As mentioned previously, it all started with cost-cutting in the technology sector by layoffs and reducing other excesses in operating expenses. Some of the highest compensated employees were both middle management, coders/software engineers, and outside sales. With the adoption of ChatGPT and other large language modelers (LLMs), the average coder was able to have an expert on tap at any moment. This reduced the need for costly subject matter experts, or third-party consultants. Furthermore, with the tremendous brand recognition of these tech giants, reducing their sales workforce and marketing budget came at little cost to revenue growth at all.

Also noteworthy are the adoption and integration of these new AI tools into enterprise technology stacks, which have not only improved the outlook for top-line growth for the tech sector and software companies, but also when you consider the data center infrastructure needed to build, operate, and train these AI models. more on this later. Not to get overly excited, but many argue it was AI that saved the market, will solve our labor shortages, and will be the catalyst for what would otherwise be a US economy heading for secular stagnation. It's certainly exciting, but there are many regulatory considerations for the speed at which adoption can responsibly and ethically occur, specifically in a services-based economy.

How did consumer health and spending stay so elevated throughout the year?

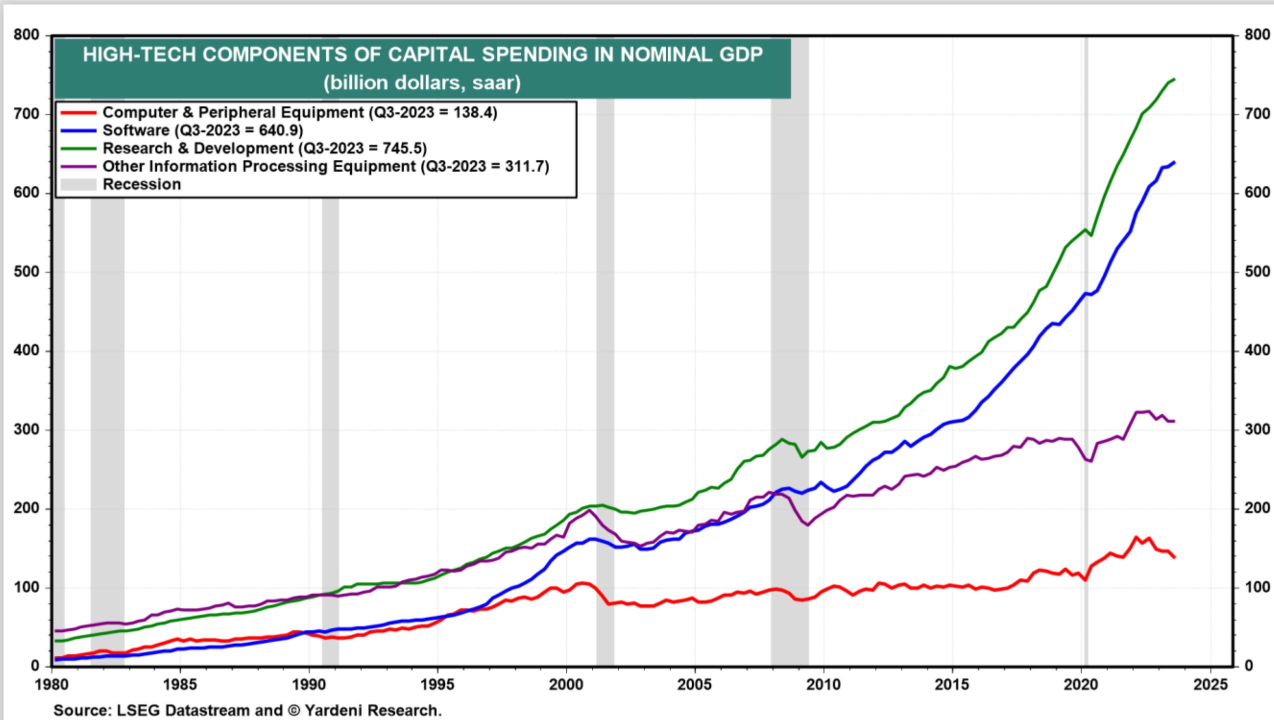
Low fixed-rate 30-year mortgages and high levels of home ownership were both significant contributors to stabilizing consumer spending. Not only this, but the retirees who often fall in this category of homeowners, experienced substantial increases to their net worth and income via COLA adjustments to Social Security of nearly 9% over 2022. Below is a chart showing just how much the American household net worth grew from '19 -'22.



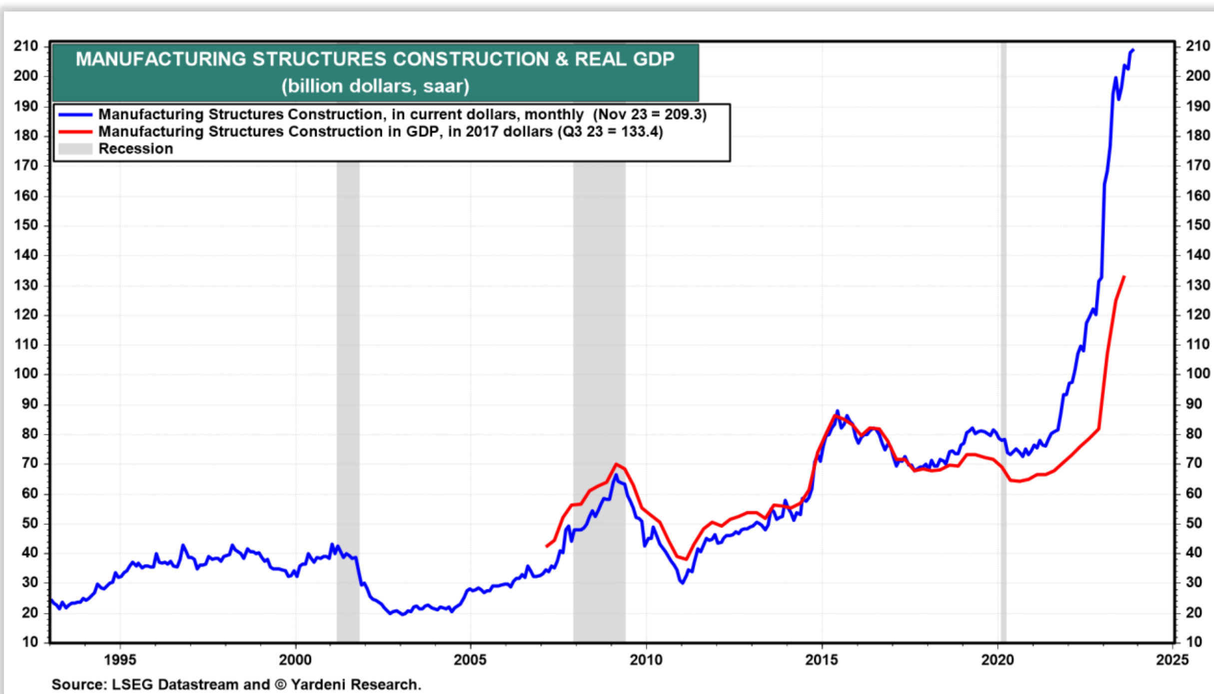
2024 look: Reasons for optimism & Reasons for concern

Making the case for the upside…

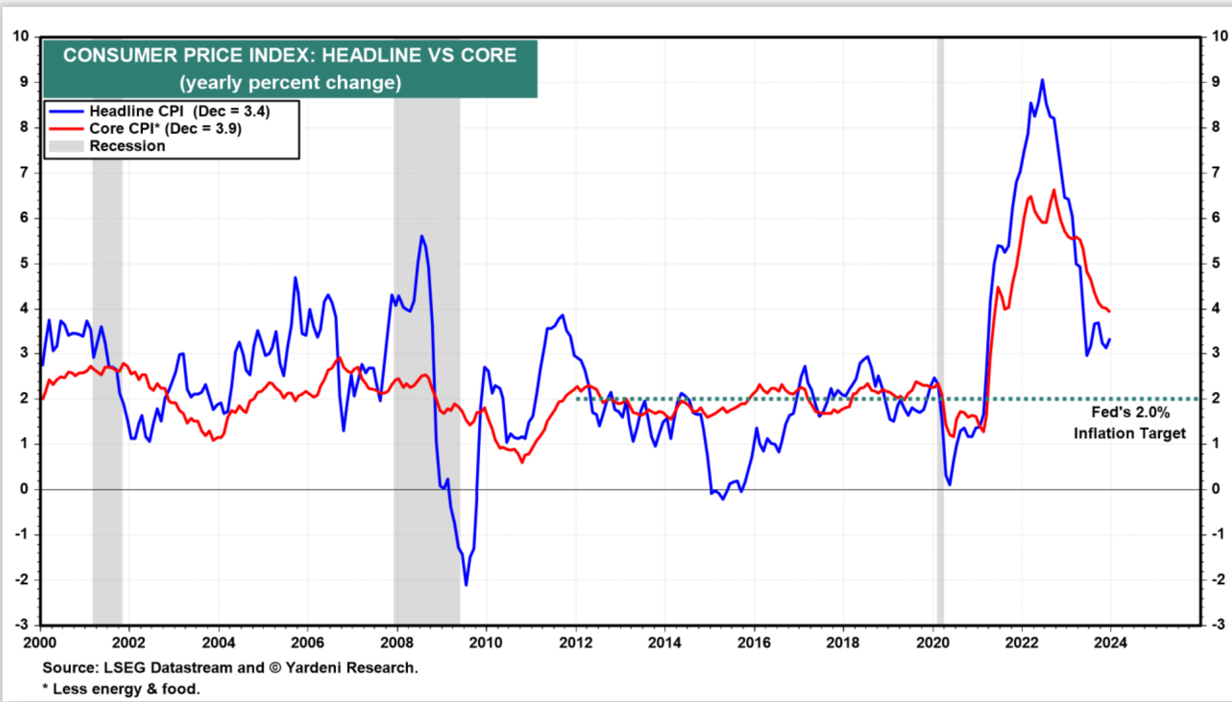
Artificial Intelligence and its supporting infrastructure are likely a tailwind for the earnings of the broader stock market. For the next 12months, it's not so much the use case and the productivity gains that we are excited about, it is more so the infrastructure needed to support it. Clearly this infrastructure story not only impacts tech, but virtually every sector/industry involved in its construction and maintenance. Further into the future, we will have a better understanding of just how useful it will be, who all will benefit, and how to properly regulate it. Currently, think faster pharma research, faster/better data analysis for retailers/goods manufacturers, automating administrative/clerical tasks, better/faster insurance underwriting, the possibilities are broad and margin accretive. There are certainly risks of job displacement; but quite a few should be created through the process, which has historically been the case. Overall, AI should free up time for knowledge workers to use more of their human discretion where it counts and less so where it doesn't. I think everyone agrees emailing, scheduling, and paperwork should be things we all spend much less time doing. Where things get hairy is whether regulation will step in to throttle development upfront and to what degree. We hope development will be regulated upfront, even though it might come at the cost of slightly less earnings growth on the S&P500. Nonetheless, the use cases and addressable market opportunities are a huge tailwind.



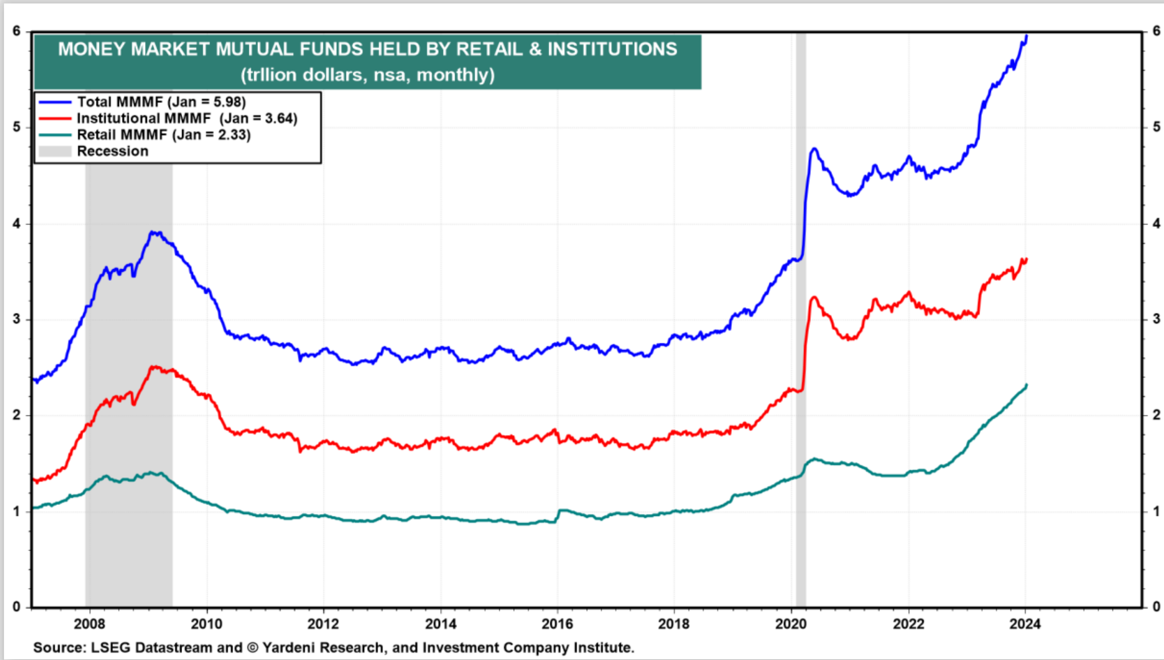
Fiscal Bills working their way into US economy, specifically The Bipartisan Infrastructure Law as well as the Inflation Reduction Act passed in 2022 and 2023, respectively. The US has also expressed a strategic priority to repatriate supply chains, reducing reliance on China in green technologies, and semiconductors. These factors will pave the way for growth over the next decade, and we can already observe the trend in real data, look at the explosion in manufacturing structure spending since 2021!



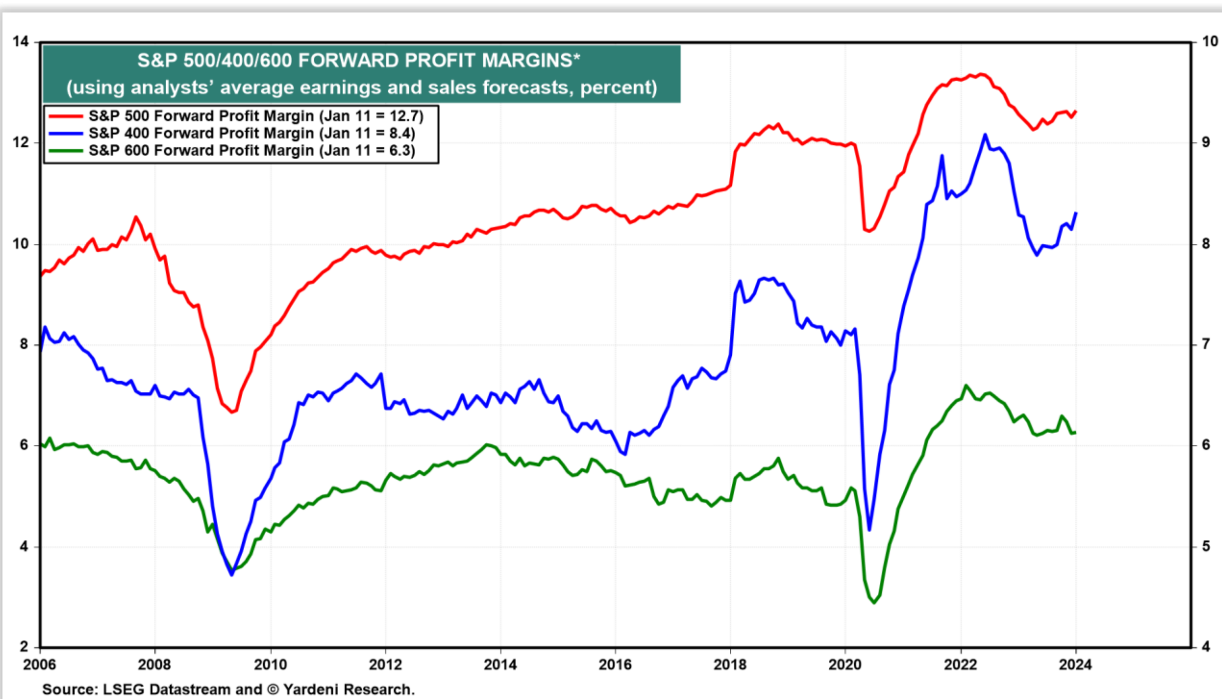
<u>Inflationary goals nearing the Fed's targets,</u> without an economic crash. This is a tailwind for both equities and bonds, as well as the housing market. Although excess savings are dwindling, we remain confident overall consumer spending will stay elevated as long as 1) the jobs market remains robust with stable wage growth and 2) retirees/homeowners maintain their robust balance sheets. Furthermore, the average 60/40 investment portfolio is now generating nearly twice the income versus two years ago. Retirees can now capture the proverbial 4% rule without needing virtually 80%+ in stock exposure. Bonds and income-centric investments are back in a big way and there couldn't be a better time to consider shifting towards a more balanced allocation. Particularly now with disinflationary trends and a dovish interest rate outlook.

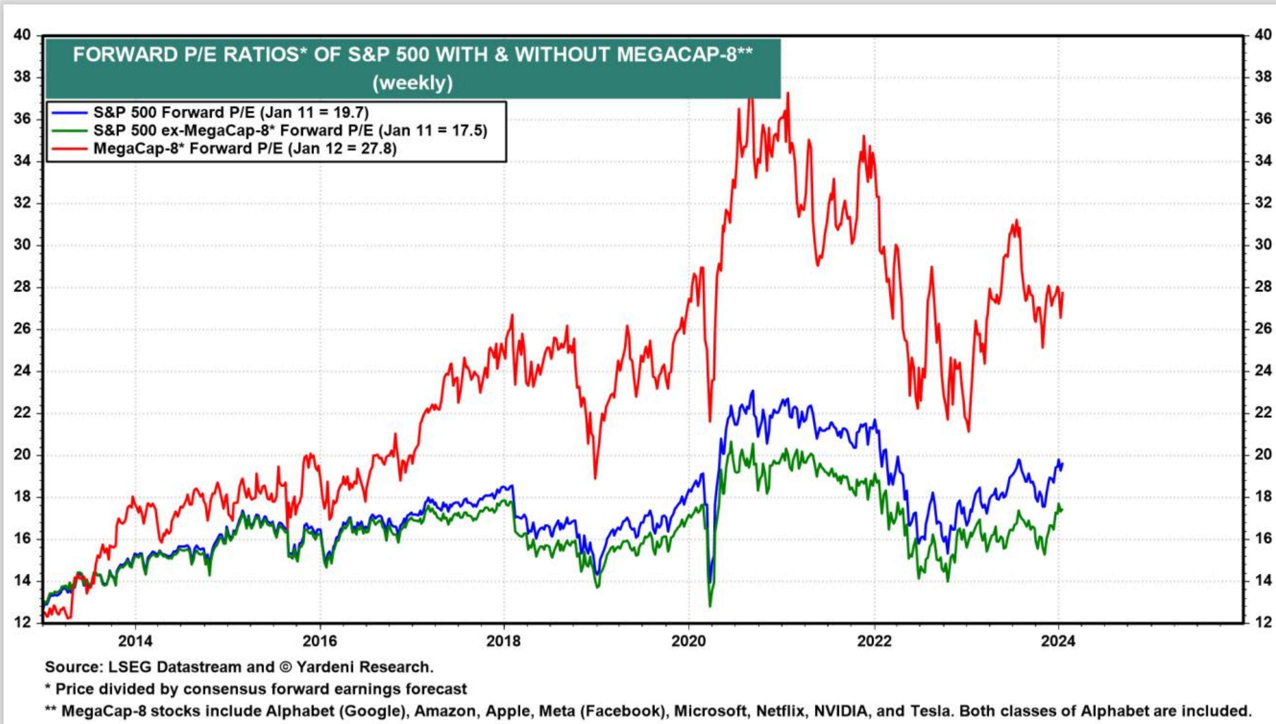


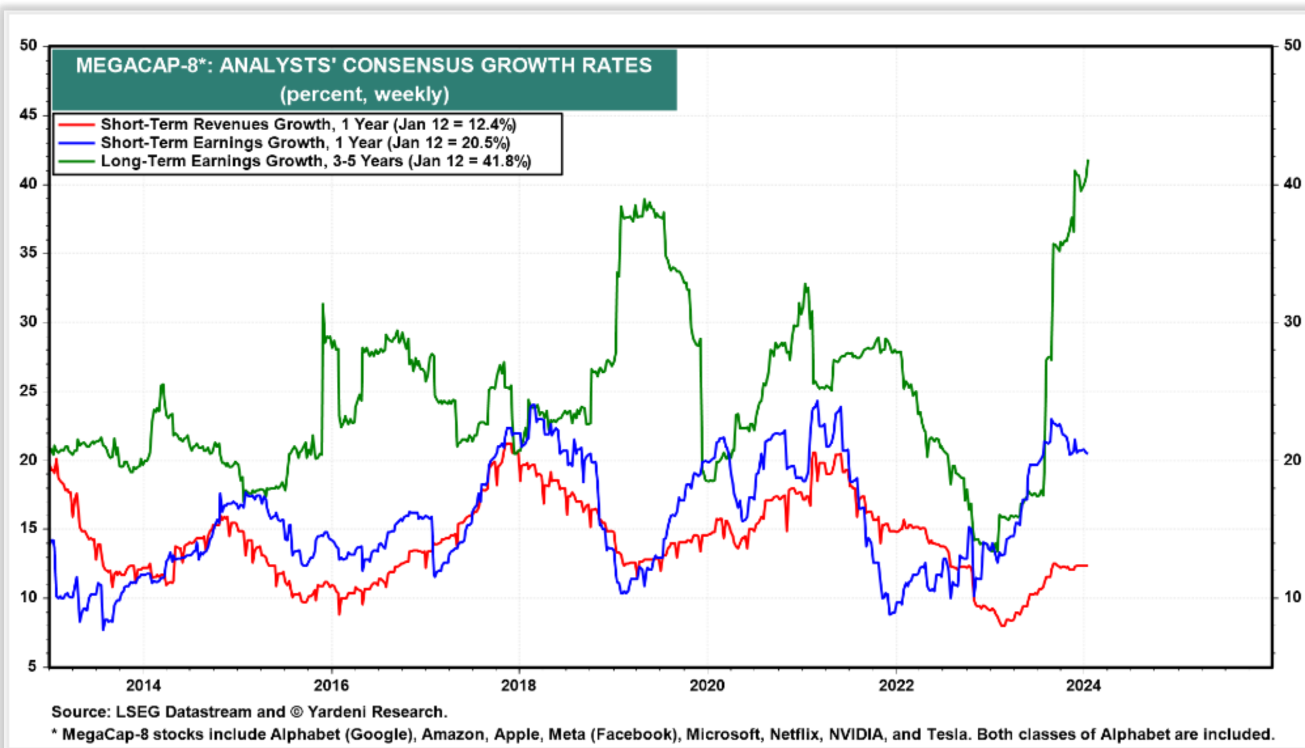
Huge cash balances on the sidelines. Although the equity market has come a long way over the past year, there remains an enormous amount of <u>cash on the sidelines</u> looking for opportunities as sentiment improves, rates on cash fall. This should provide a floor to equities upon selloffs as investors come rushing in to snatch up opportunities.



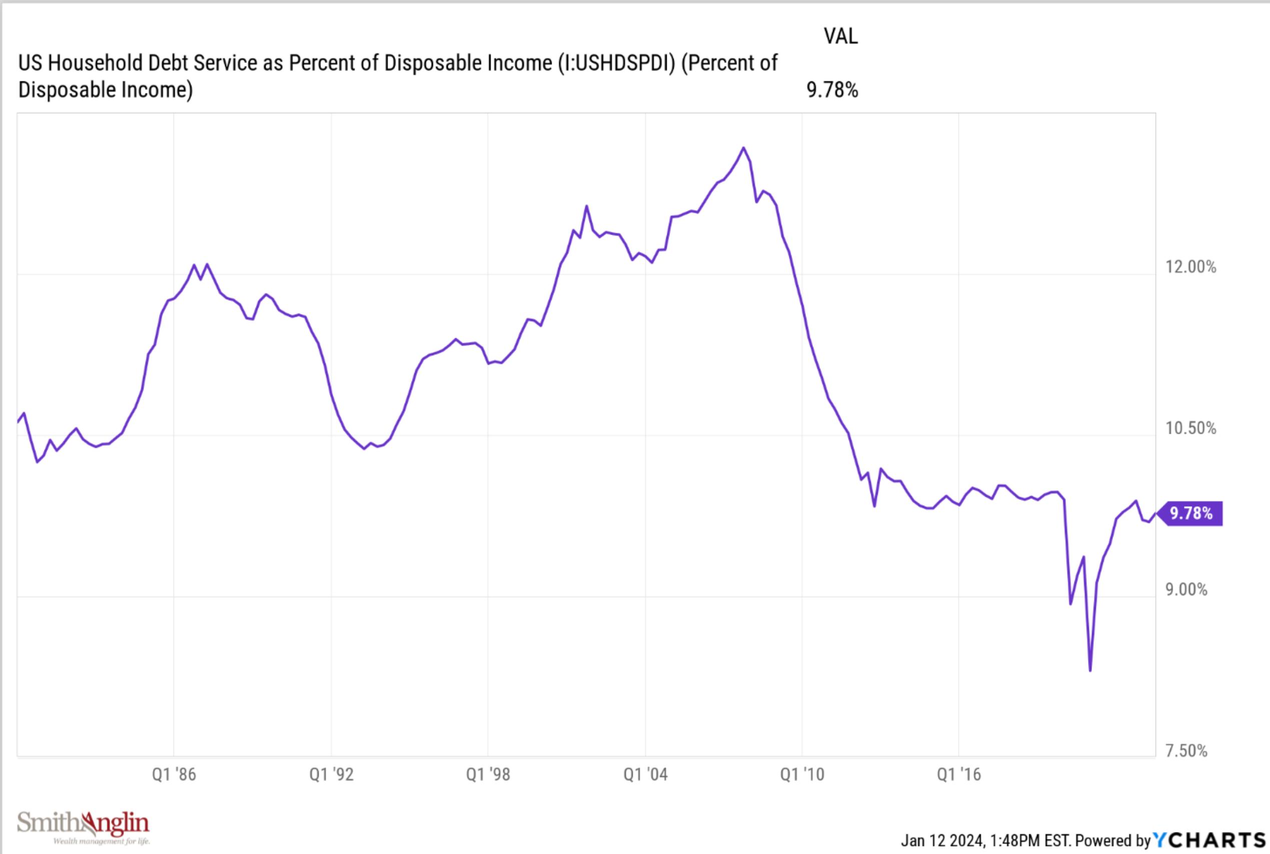
Corporate profits have stabilized much better than anticipated, and fundamentals are not stretched, specifically for the Mega Cap 8. As CEO and Consumer Sentiment improve, we believe revenue growth can continue for sectors and industries adjacent to tech as well, such as industrials, construction/manufacturing, materials, and utilities. These trends are powerful, and there is a mountain of capital being thrown at them given the endless problems and priorities they address. Thankfully, valuations both in and outside the Mega Cap 8 are considered fair to slightly discounted compared to interest rates. As mentioned previously, the tech majors have seen the greatest amount of fundamental improvement, contrary to popular belief.







The overall health of the US corporations/household is in far better condition than it was five years ago. That certainly doesn't mean stress doesn't exist, rather it simply isn't broad enough to knock the US economy off track. Most corporations were able to lock in low costs of debt, carry high levels of cash, and insulate themselves from the higher rates. This created a stimulative effect for some corporations/households with cash rates often exceeding their previously acquired liabilities.



For consumers, analysts were concerned home values were going to fall from higher mortgage rates and result in decreased consumer spending. In reality, the shortages in the housing market—driven by homeowners being mortgage-locked, underbuilding of Single-Family Homes following 2008, and a surge in household formations by Millennials & Gen Z—meant that the housing market never sold off meaningfully. According to Redfin, over 62% of homeowners have a mortgage below 4%, and 82.4% below 5%. Debt service as a % of disposable income for households as well as debt service as a % of earnings for corporations is historically low.

Unfortunately, individuals often misinterpret leverage in the system by looking at absolute measures, without any important context like inflation, assets, or serviceability. Imagine if we did the same thing to our clients, showing how their absolute level of debt went from maybe $50k in student loans to $500-$750k in mortgage, auto and personal loans, without showing the other side of the balance sheet or cash flow statement?

Given this relative balance sheet strength and the likelihood rates decline over the next 12 months, we feel confident both intermediate investment grade and high yield corporate bonds should offer favorable returns, possibly low double-digits the next 18-24months, with little risk of broad credit spread expansion (excluding CRE of course) or default. As you can see below, the "maturity wall" for high yield issuers begins to meaningfully increase in 2025. However, if this supply were to drive down corporate bond pricing temporarily, we would likely be opportunistic buyers.

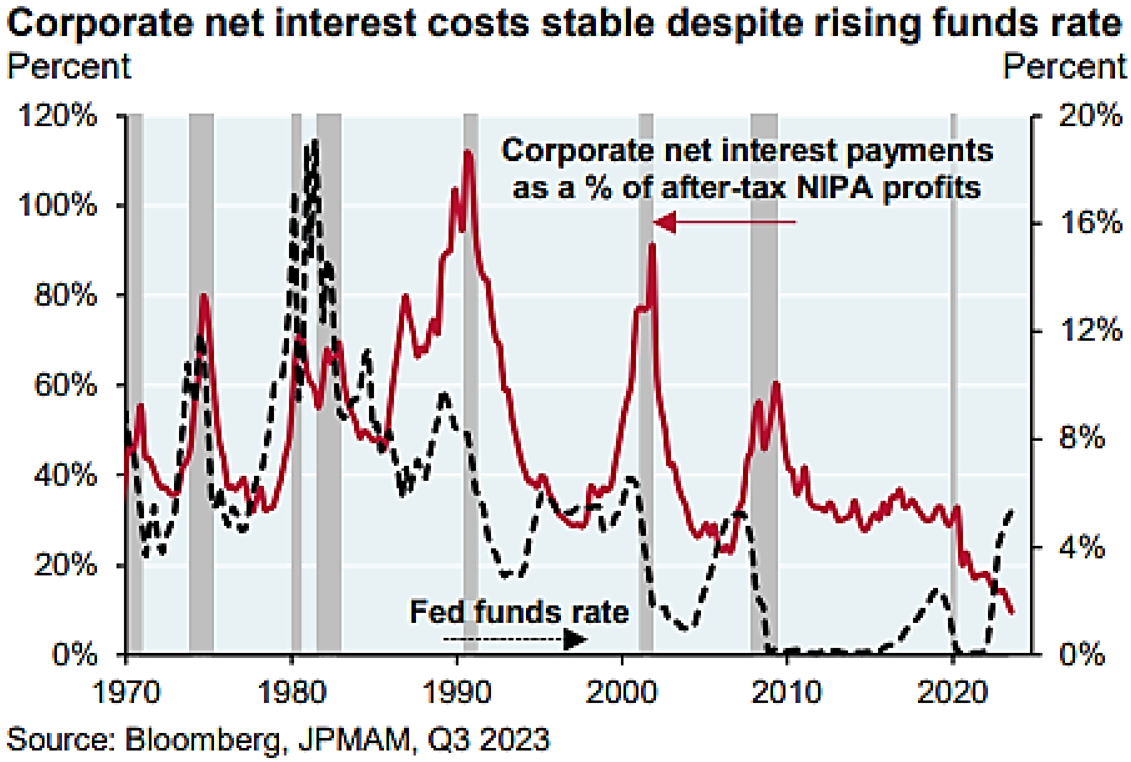
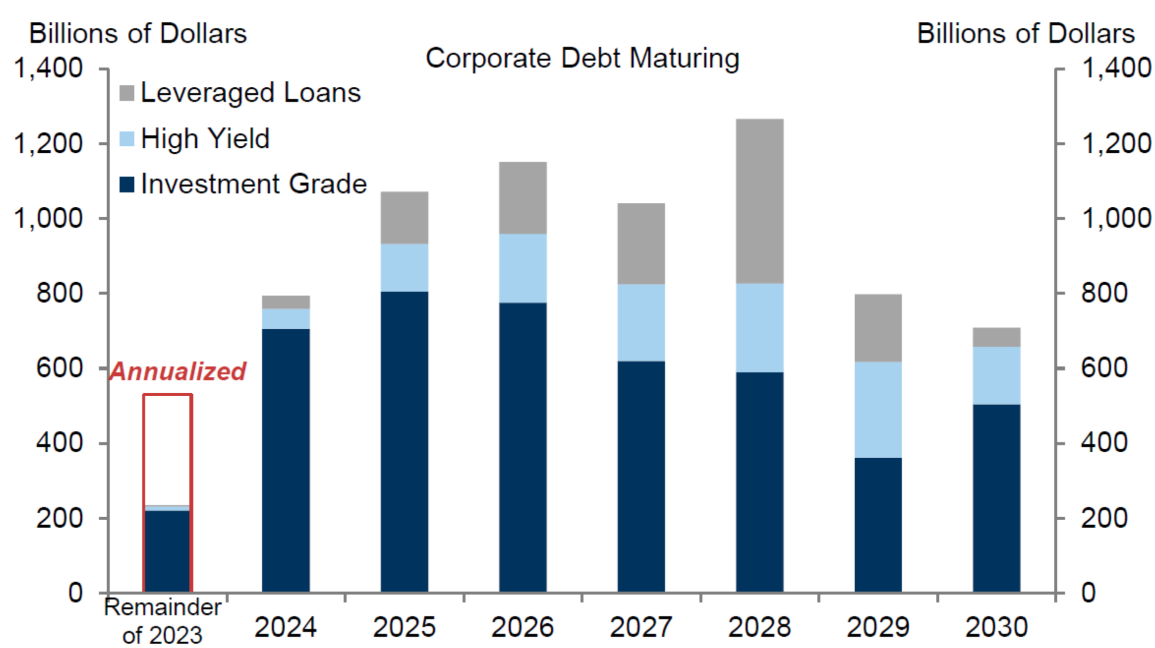


Exhibit 3: $230bn ($525bn Annualized) of Corporate Debt Matures in the Remainder of 2023, $790bn in 2024, and $1,070bn in 2025



Source: Bloomberg, Goldman Sachs Global Investment Research

Favorable foreign equity market returns and broadening outside the "Mega Cap 8." This call has been made for many years, mostly based on low valuation, years of underperformance, and a reversal of dollar strength. Reluctantly, we will still make this argument, however we'd like to offer a bit more context. It's a given that every year of drastic underperformance and valuation disparity raises the chance for some catchup, if not for any other reason but market-wide portfolio re-balancing. Nearly all investors, institutional and retail, are currently drastically overweight US large-cap tech and underweight pretty much everything else. After years of underperformance and limited access to capital, small and mid-cap value, now offer fortress like balance sheets, high cash flow and buybacks yields, and growing dividends. Entire sectors and index's in the Eurozone, UK and Japan, are at 50% discount to US large cap, and offer mid-single digit buyback yields and similar growing dividend yields. In other words, not a whole lot needs to go right when buybacks and dividends combine to capture 6-9% by itself. There are also many reasons to believe the near zero earnings growth traditionally experienced from these "old economy" sectors could be in the rear-view mirror. Not only as the developed world modernizes and develops its domestic manufacturing capabilities, but also as it aggressively races to reduce carbon emission goals via the energy transition and infrastructure improvements. It's important to note that these high levels of buy backs are often a signal, or leading indicator, representing a vote of confidence by management in future earnings growth. Put it all together and the odds look pretty good.

Risks to the downside…

Geopolitical risks in the Middle East, Eastern Europe, and escalating tensions between the US and China. We do feel this is a lower probability outcome. Even if given the information ahead of time, it is often hard to predict the longer-term effects on financial markets. In the short run, they often drive inflation or supply chain disruptions that cascade into larger problems. Given the US is both energy independent and decoupling from China, the impact should be lessened to a degree. However, we do not minimize the semiconductor reliance we have on Taiwan.

It is also worth noting that China is not without its reliance on the US. The US makes up over 60% of its exports. In addition, Chinese domestic consumption is weak, and their economy is vulnerable. Chinese aggression to the US would be existential on many levels. However, analysts made the same argument for Russia invading Ukraine. The takeaway? Leaders of autocratic nations are often incredibly unpredictable.

Bond markets have now priced in twice the amount of rate cuts the Fed has released in their Summary of Economic Projections. Interest rates and valuations are tied at the hip. Valuation expansion has been strong despite recent guidance revisions to the downside for revenues and earnings by most sectors and industries. Now, this is not uncommon. Following each earnings season most companies beat the latest quarter and pour water on guidance. This prevents management from setting unachievable goals and is one of the reasons two thirds of companies beat expectations on average. Today, the macro headwinds that prevented a broader equity market rally have now reversed course. Now, more than ever, we simply need the fundamental outlook to improve outside just technology companies; thus far, we have yet to see any green shoots.

Inflation re-accelerates driven by housing shortages and cutting rates too soon. Although disinflationary pressures appear to be well in place, costs of living are still much higher than they were 24 months ago. Most measures of housing prices have gone back to increasing, which means affordability likely won't improve much even if rates drop. This could drive a re-acceleration in measures of inflation, with housing or shelter making up most of the consumer price index (CPI) and personal consumption expenditures (PCE). Specifically, if more new homebuyers are pushed out of the homeownership process and back into the rental market.

In the background runs a stubbornly hot economy and elevated fiscal deficits, increasing the risk the Fed cuts too soon. The last time the US economy experienced similar inflation followed by drastic disinflation was in the mid 70's, with

Arthur Burns at the helm. A lot has changed since then with technology and US energy independence, but a few things are consistent: preceding years of unchecked fiscal expansion and an exogenous supply/demand shock. Under pressure from Richard Nixon, Fed president Arthur Burns brought policy rates back down following the first signs of disinflation and economic stress. This action occurred a few times throughout the 70's, creating what might have otherwise been a 2-3yr recessionary resolution into a decades long problem. The issue finally came to a head in '82 via aggressive policy action from Paul Volker. The result? A 10% unemployment rate, a deep recession and virtually a lost decade in stocks from 1970-1982.

Disinflation/deflation of goods prices and it's negative impact on corporate profit margins, specifically for discretionarys and staples. Corporations were in a good spot despite the tightening monetary policy due to 1) aggressive cost cutting/efficiency improvements and 2) price advances on the goods they sold. Specifically rising faster than their input's were. This dynamic reminded everyone "why" stocks can be such a good inflation hedge over the medium/long term (inflation ultimately gets passed down to the consumer).

Conversely, what happens when companies have exhausted their efficiency/cost-cutting measures and the goods they sell are marked down? Or even worse, the volume of sales also declines. In a period of margin compression, the only way for profits to stabilize is by increasing units sold, and top-line revenue by more than your margins have declined. Companies like Walmart, Costco, Dollar General, and General Mills, are often most exposed to this dynamic and have been releasing concerning guidance. The good news is today's market is far less exposed to this sector compared to the 70's, and as a result, much less inflation/deflationary sensitive to goods prices and the cyclicality of consumer spend. We have chosen to be cautious with our exposure to this area and have worked to underweight it the best we can. Conversely, even if goods disinflation does result in struggling or no earnings growth for the broad market, this sort of persistent disinflation results in the Fed dropping interest rates, which could have an offsetting impact by raising valuation multiples on said earnings. Moral of the story? No single variable is ever "fixed" and is precisely what makes forecasting so difficult.

US deficit spending is one of those issues that will always be worth monitoring and near-term tail risk to financial asset valuations. This year more so than others. Deficits can create a dynamic in the bond market called Bear Steepening, a rare phenomenon in which long-term rates rise meaningfully higher, despite any meaningful move in short-term rates. Touching on this previously, many argued the abrupt run up in long-term rates that ended October 19th were driven by this dynamic. Ultimately, this would take a backseat given softness in the near-term inflation and jobs data (JOLTS). Yet, with no recession on the horizon, the case for a 10yr below 3.75% is hard to fathom. Ultimately, this "Bear Steepening" often results in abnormally high bond/stock volatility, and positive correlation between the two asset classes (not good for balanced portfolio). At the end of the day, we maintain this as more of a "tail risk", meaning its likelihood of occurring is more remote. Furthermore, the jury's still out if in today's technologically driven economy, this dynamic is even plausible. Especially if the seeds are being sown by AI for higher productivity and economic growth, the enemy of inflation. Heck, we aren't even certain if this was the primary driver of the Q3 '23 run up in yields. In any case, we have positioned ourselves appropriately if given a second opportunity to acquire more long-term treasuries at elevated rates.

To be clear, our government will always have periods of deficit spending. The key is to avoid growing them at a faster rate than the economy over extended periods. Although coordination of monetary and fiscal expansion has helped avoid the rampant inflation warned by monetarists like Milton Freidman, one cannot ignore the second order effects that inefficient allocation of resources can create. Look at the past 30yrs in Japan! It will be interesting to see if these dynamics change as we attempt to deficit spend away two decades of global supply chain infrastructure in the name of national security. Ultimately deficits will need to either pay for themselves by increasing tax revenue and cutting spending, or by elevating the rate of economic growth. The latter is often the hope of congress regardless of political affiliation, differing only in mechanism. Ultimately, we hope the ‘26’s TCJA expiration will offer the much-needed impetus for Congress to act, hopefully with solutions that won’t make life even more prohibitively expensive, specifically for both retiree’s, middle class wage earners and owner operators alike.

Closing

Many of the favorable catalysts that drove the strong recovery from October 2022’s low of 3500 and throughout 2023, still are well anchored. However, markets rarely move in a straight-line up and for that reason, we have kept dry powder available for those opportunities. We feel confident the positive tailwinds driving equity earnings and markets are likely too strong to push major benchmarks below previously set lows. For this reason, trimming stock exposure moving forward is likely unwise and for those concerned, we instead encourage leaning on fixed income or other alternative asset classes to mitigate volatility. We appreciate your trust in these difficult market environments and reassure you that we work tirelessly to capture the best risk-adjusted return possible.