INVESTMENT PARTNERS ASSET MANAGEMENT

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OUTLOOK 2024

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Healthy Portfolios Need Markets with Fresh Breadth

Last year's Outlook report was presciently entitled **"Proceed with Caution… But Do Proceed".** In it, we stated that we would approach 2023 with enthusiasm and optimism about the market's long-term prospects. Specifically, we believed that lower asset prices from the downturn in 2022 could translate into higher levels of future return over the years. We also indicated that we would look for quality companies (and funds) at reasonable prices, and we would attempt to take advantage of higher interest rates to generate portfolio income. After some stops and starts along the way, 2023 proved to exceed our return expectations for both equities and fixed-income investments. In fact, by the time we wrote our mid-year update in early July, we were already concerned that the US Large-Cap equity market perhaps had climbed too far too fast. Much of the rally, to that point, was concentrated in just a handful of Mega-Cap Growth companies – a phenomenon traditionally referred to as *bad market breadth* due to the lack of broader participation from other stocks. After a 3-month equity-market drawdown from August through October, the equity markets turned and mounted a fierce 2-month rally to close out 2023 at near record levels.

This year, we think an appropriate title for our report is **"Healthy Portfolios Need Markets with Fresh Breadth"**. We chose this theme because we think that for indices to maintain their positive trajectory in 2024 it will require participation of more asset classes and sectors rather than a continued concentrated focus on US Large-Cap Growth. While the headline 2023 performance of the S&P 500 (+24%) and Nasdaq (+37%) posted eye-popping numbers, Mid-Cap and Small-Cap indices substantially lagged their Large-Cap counterparts. Furthermore, the sectors of Energy, Financials, Healthcare and Consumer-Staples were all but completely left out of the rally clocking in with flat or even negative returns. In 2024, we expect capital allocators to spread their bets more evenly as valuations mature in some parts of the market and possibly catch up in others. We also expect returns to be more modest for equities in 2024 generally, and therefore we believe it will be important to include income strategies (dividends and interest) in portfolios in an effort to obtain a total return in the coming year.

ECONOMIC PICTURE:

Despite higher inflation and interest rates over the past 2 years, the economy continued to remain resilient in 2023. Personal income, disposable income, personal saving, and corporate profits were all revised upward during the year. Nevertheless, consumer and producer price statistics during the latter half of 2023 eventually began to reflect lower levels of inflation – possibly due to a dampening of global demand from the higher-interest-rate environment. In fact, the International Monetary Fund currently projects slightly *lower* GDP output from developed countries in 2024.

		Projections		Difference from July 2023 WEO *Update*[1]		Difference from April 2023 WEO[1]	
	2022	2023	2024	2023	2024	2023	2024
World Output	**3.5**	**3.0**	**2.9**	**0.0**	**–0.1**	**0.2**	**–0.1**
Advanced Economies	**2.6**	**1.5**	**1.4**	**0.0**	**0.0**	**0.2**	**0.0**
United States	2.1	2.1	1.5	0.3	0.5	0.5	0.4
Euro Area	3.3	0.7	1.2	–0.2	–0.3	–0.1	–0.2
Germany	1.8	–0.5	0.9	–0.2	–0.4	–0.4	–0.2
France	2.5	1.0	1.3	0.2	0.0	0.3	0.0
Italy[2]	3.7	0.7	0.7	–0.4	–0.2	0.0	–0.1
Spain	5.8	2.5	1.7	0.0	–0.3	1.0	–0.3
Japan	1.0	2.0	1.0	0.6	0.0	0.7	0.0
United Kingdom[2]	4.1	0.5	0.6	0.1	–0.4	0.8	–0.4
Canada	3.4	1.3	1.6	–0.4	0.2	–0.2	0.1
Other Advanced Economies[3]	2.6	1.8	2.2	–0.2	–0.1	0.0	0.0
Emerging Market and Developing Economies	**4.1**	**4.0**	**4.0**	**0.0**	**–0.1**	**0.1**	**–0.2**
Emerging and Developing Asia	4.5	5.2	4.8	–0.1	–0.2	–0.1	–0.3
China	3.0	5.0	4.2	–0.2	–0.3	–0.2	–0.3
India[4]	7.2	6.3	6.3	0.2	0.0	0.4	0.0
Emerging and Developing Europe	0.8	2.4	2.2	0.6	0.0	1.2	–0.3
Russia	–2.1	2.2	1.1	0.7	–0.2	1.5	–0.2
Latin America and the Caribbean	4.1	2.3	2.3	0.4	0.1	0.7	0.1
Brazil	2.9	3.1	1.5	1.0	0.3	2.2	0.0
Mexico	3.9	3.2	2.1	0.6	0.6	1.4	0.5
Middle East and Central Asia	5.6	2.0	3.4	–0.5	0.2	–0.9	–0.1
Saudi Arabia	8.7	0.8	4.0	–1.1	1.2	–2.3	0.9
Sub-Saharan Africa	4.0	3.3	4.0	–0.2	–0.1	–0.3	–0.2
Nigeria	3.3	2.9	3.1	–0.3	0.1	–0.3	0.1
South Africa	1.9	0.9	1.8	0.6	0.1	0.8	0.0

Source: International Monetary Fund – World Economic Outlook October 10, 2023

Inflation

Inflation figures have begun to decrease faster than expected from the elevated 2022 levels to an approximate 3% annualized rate more recently. In November, for example, the Consumer Price Index for All Urban Consumers increased 0.1 percent, seasonally adjusted, and rose 3.1 percent over the last 12 months according to the Bureau of Labor Statistics (bls.gov/cpi). That is 0.8 percentage points lower than the 50-year average of 3.9%, but still above the Federal Reserve's target of 2%.

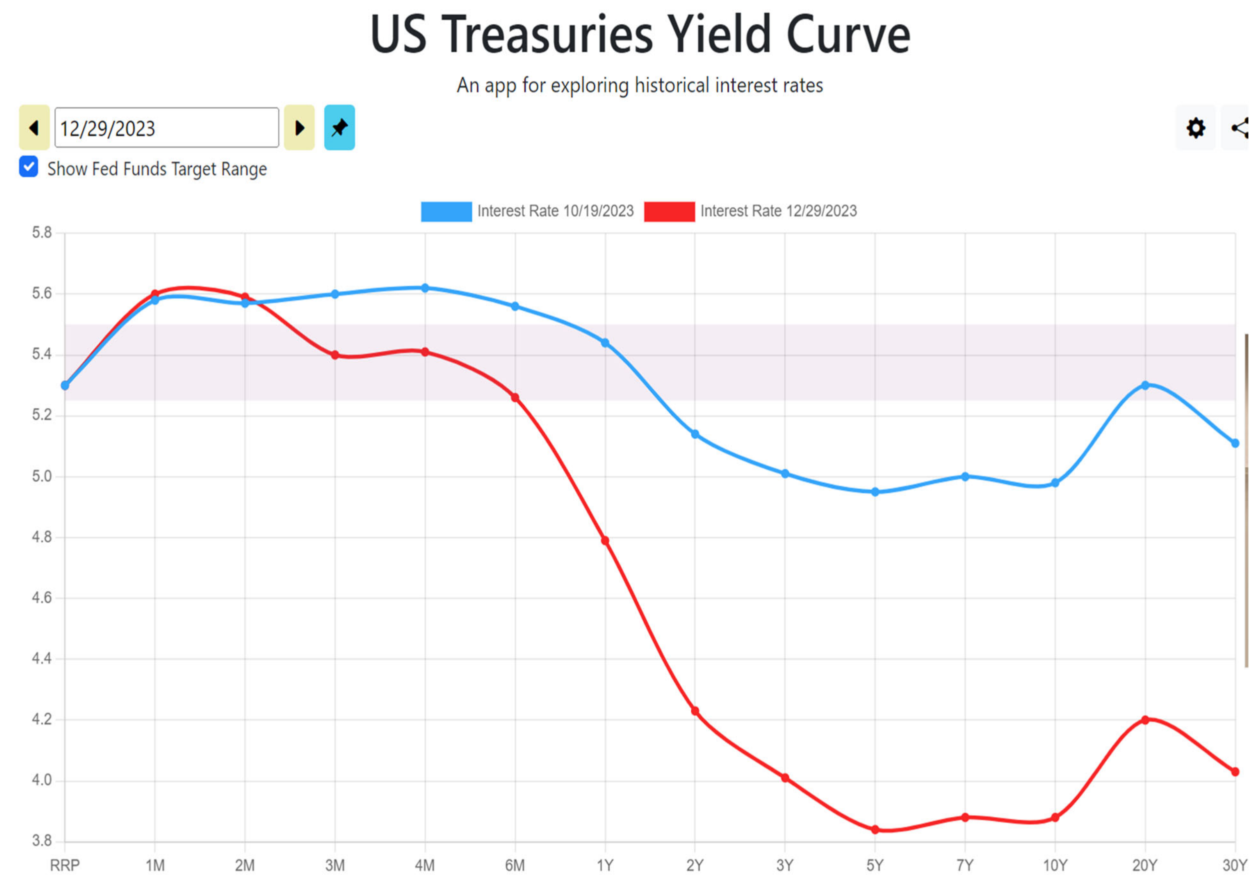
Unemployment

The most-recently-released data, also from the Bureau of Labor Statistics, on December 8th showed that the jobless rate in the US rose slightly from mid-year 2023 to 3.7% in November (from 3.6% in June). While this implies a continuation of a tight labor market, especially when compared to the 75-year average unemployment rate of 5.72%, it may also imply that increases in labor costs may have peaked.

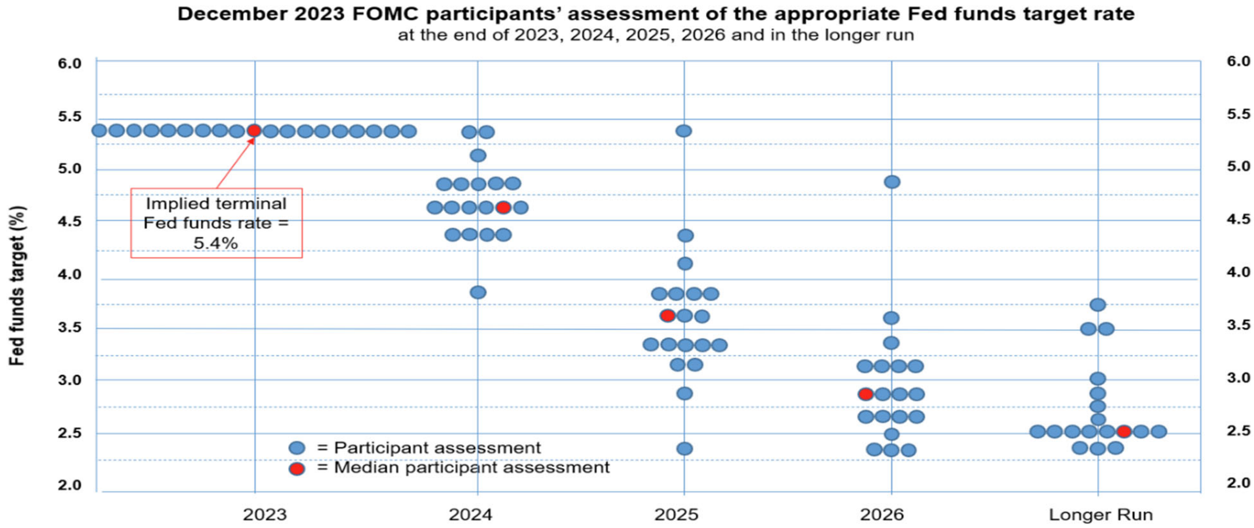
RATE / FIXED INCOME BACKDROP FOR 2024

Rates on the 10-year US Treasury note had a roller-coaster ride in 2023. After opening the year at 3.88%, they peaked at over 5% in October only to close the year at 3.86%. Persistent inflation worries caused a 30% surge in the rate in the 10-year Treasury beginning in the late summer.

That fever broke when the Fed indicated that it intends to cut rates by 75 basis points in 2024. From November 1st through the end of 2023, the rate on the 10-year bond melted by 23%. The chart below shows how dramatically the shape of the yield curve changed from mid-October to the end of December.



https://www.ustreasuryyieldcurve.com/



Source: Federal Reserve, *Summary of Economic Projections (SEP), December 13*, 2023

Since the November Fed meeting, the market has since extrapolated from their rhetoric that cuts could come as soon as Q1 2024 and that the Fed may continue to cut over the next few years. The bond market has currently *priced-in* approximately 1.25 – 1.50 points of cuts for 2024 (despite the fact that the Fed stated that it is only contemplating loosening by 75 basis points.) This has sharply re-inverted the yield curve, which is sometimes a harbinger of an economic downturn.

Our view is that any cuts will take place later in the year and be shallower than the market presently projects. We suspect that reports of inflation's demise are perhaps greatly exaggerated (to coin a phrase from Mark Twain), and prices might resume their march higher if the Fed's loosening bias unleashes speculation in markets for financial assets (stocks and bonds) and real assets (real estate, commodities). We believe that the sharper and quicker cuts currently priced in would only be the result of an impending recession which, while definitely possible, is not yet our base case at this time. Therefore, we expect the 10-year bond to trade between 3.5% to 4.5% in 2024.

EQUITY VIEW FOR 2024

With respect to equities, we believe that the recent move on the 10-year note possibly pulled-forward a number of years' worth of return into 2023. As such, the market now seems to be looking through to *2025* earnings to support current prices. Corporate profits and cashflows (particularly for growth stocks which dominate the S&P 500) tend to be valued relative to the so-called risk-free rate of return from US 10-year Treasuries. The S&P 500 index ended 2023 at approximately 4750. Now trading at 19x expected 2024 earnings, the index is trading at a premium to its historical valuation. (The long-term average multiple is approximately 16x earnings).

We think that in 2024 the S&P 500 could trade in a range between 16x to 18x its estimated $270 of 2025 earnings, or 4320 to 4860. While *not* our base case at this time, we see the possibility of a clear-sky scenario where the S&P reaches 5130, which would be 19x 2025 earnings. That would depend on revenue guidance meeting or exceeding expectations throughout the year. In the event the economy cools rapidly, however, we think corporate earnings could contract with the S&P 500 index trading at a lower PE multiple e.g. the mid 3000s to low 4000s level. This regression to lower valuation levels could also occur if forward corporate revenue and profit guidance for bellwether companies comes in light and thus fails to support the already lofty expectations in certain sectors of the market. We note, for example, that this occurred as recently as a few weeks ago for both a large retail apparel company and a large international shipping company - sending both stocks 10% lower after their earnings announcements.

S&P 500 EARNINGS FORECASTS: YRI VS ANALYSTS' CONSENSUS (12/26/2023)

Year / Quarter	Yardeni Research - Level	actual (a) / estimate (e)	YOY%	Analysts' Consensus - Level	actual (a) / estimate (e)	YOY%
2024	250.0	e	11.1	244.0	e	11.1
Q1	60.0	e	13.0	56.3	e	6.1
Q2	61.0	e	12.4	60.0	e	10.5
Q3	63.0	e	7.5	63.6	e	8.5
Q4	66.0	e	11.9	64.3	e	17.6
2025	270.0	e	8.0	274.6	e	12.5

Clear Sky S&P YE 2024 = 19 x 2025 est of 270 = 5130 (+8.00%)

Base Case S&P YE 2024 = 18 x 2025 est of 270 = 4860 (+2.30%)

Current S&P YE 2023 = 19 x 2024 est 250 = 4750

Mean Reversion S&P YE 2024 = 16.00 x 2025 est of 270 = 4320 (-8.85%)

Median S&P YE 2024 = 14.96 x 2025 est of 270 = 4040 (-14.95%)

Hard Landing S&P YE 2024 14 x 2025 est of 270 = 3780 (-20.42%)

Mean:	16.04	
Median:	14.96	
Min:	5.31	(Dec 1917)
Max:	123.73	(May 2009)

Price to earnings ratio, based on trailing twelve month "as reported" earnings.

Current PE is estimated from latest reported earnings and current market price.

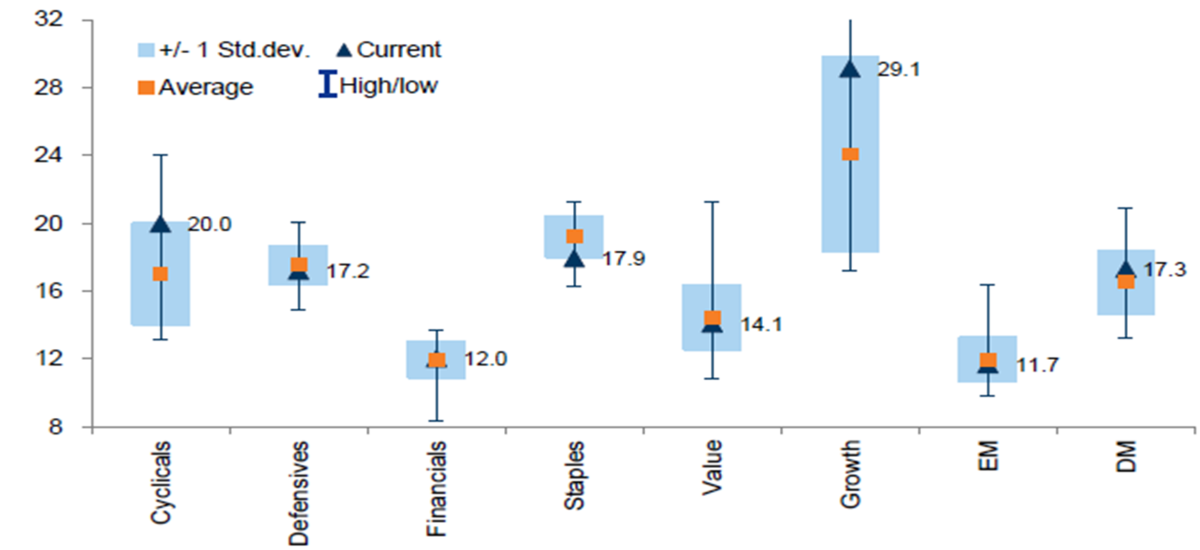
Source: Robert Shiller and his book Irrational Exuberance for historic S&P 500 PE Ratio.

Sources: Yardeni Research, Inc., multipl.com, IPAM

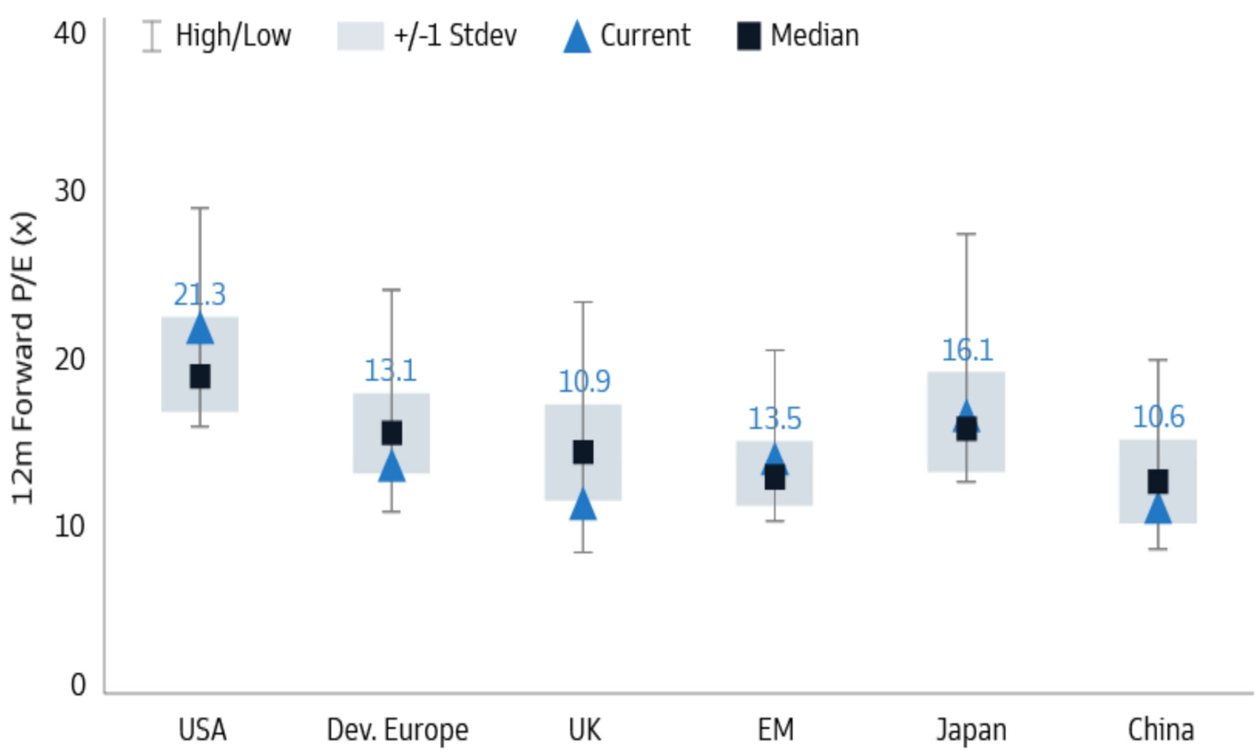
Valuation

As evidenced in the charts below, as of December 2023, US Equities, particularly certain sectors, are trading at a premium to their 10-year historic valuation levels while some sectors and foreign markets are trading at a discount. This dynamic solidifies our feeling that the market rally should spread out and diversify broadly if it is to continue in 2024.

12-month forward P/Es relative to the last 10 years



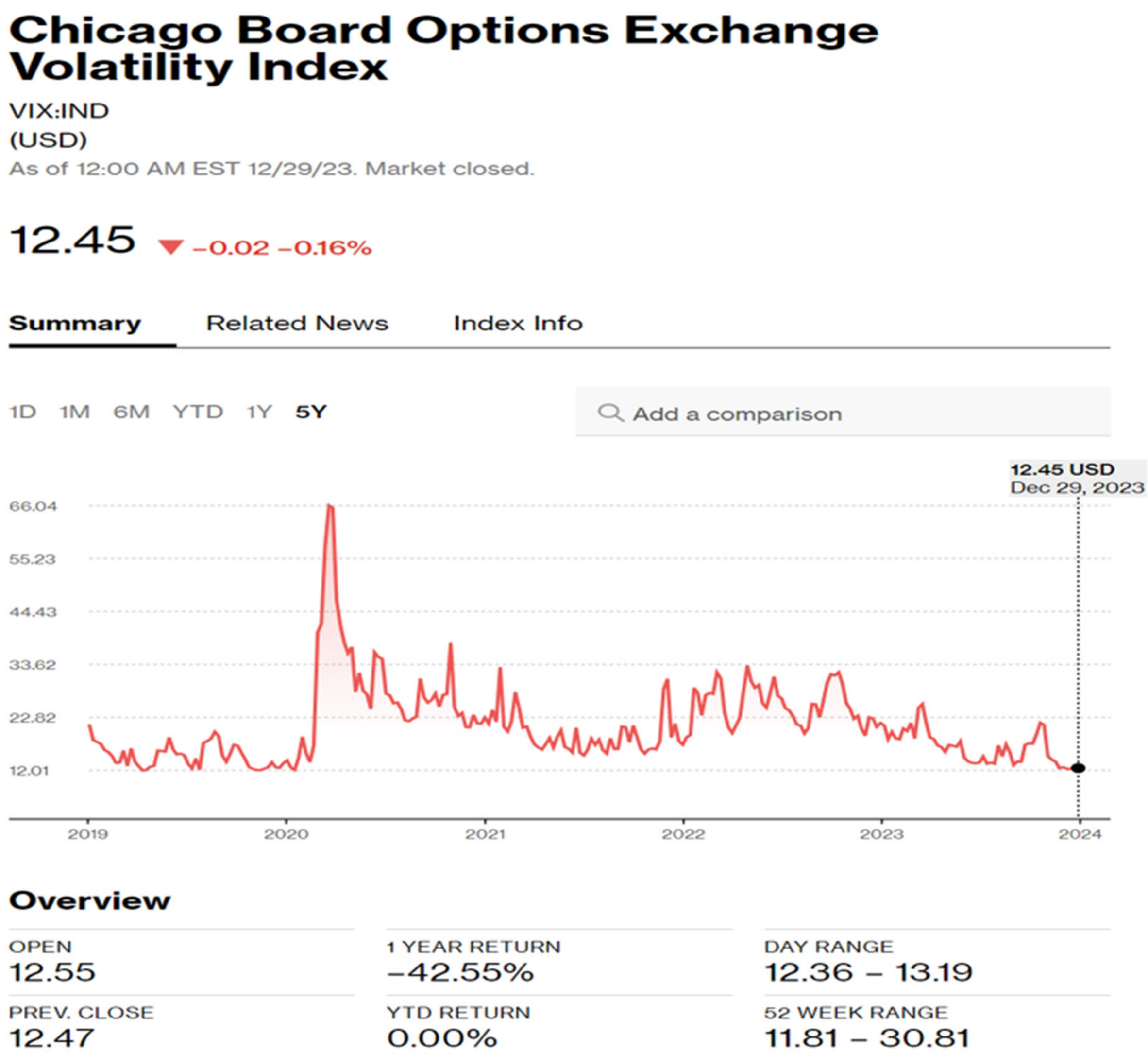
Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research



Volatility

In 1993, the Chicago Board Options Exchange created an index which attempts to measure market sentiment. The now widely-used Volatility Index is based on a complicated equation which takes into account the volume of bets investors make in the options market that the S&P 500 index will go up or down in the near term. A VIX reading above 30 is generally considered to be a market panic, 20 and above is associated with a volatile market, and levels below 15 are typically related to calm markets.

In our mid-year update we commented that market volatility had fallen through the floor and was too low relative to market risks. At that time the VIX was trading at 14.83. Subsequently, volatility spiked as interest rates climbed sharply through October, registering a reading of over 20 by the middle of that month. It wasn't until the Fed signaled a pause in its tightening bias that the VIX began to descend – now hovering at a 5-year low of about 12. While it is not a perfect gauge, many times high future expected equity returns are marked by low valuations and high volatility. (When market participants are fearful, opportunities usually abound.) Currently, however, we have the opposite environment for both valuation and volatility - and that leads us to believe that 2024 could be somewhat anemic for equity returns absent better breadth of participation of other industries, market-caps and geographies.



OPPORTUNITIES

So how are we going to invest in 2024, and what are the themes? We view the following as some of the potential opportunities for the coming year:

- Innovation, automation, and AI are creating demand growth in new markets. This is a long-term trend that we expect to unfold over the balance of the decade and beyond.

- Large cap companies generally have solid balance sheets and have thus far proven resilient in the face of inflationary pressures.

- Small-cap and Mid-cap equities may be due for a "catch-up" relative to large cap peers.

- Large disparity between growth and value could spark a rotation into lagging sectors. Healthcare, Financial Services, Utilities, Energy, and Consumer Staples are defensive sectors, for example, which could attract money-flow.

- Higher dividend yields in various asset classes may offer attractive potential long-term returns.

- Tactical tilt towards sectors with strong cashflows remains in focus.

- Bonds continue to be an attractive risk hedge and income provider if inflation continues to retrace back toward central bank targets.

- Alternatives and Satellite strategies may offer appealing diversification benefits, inflation protection, and income production.

- International valuations appear compelling relative to domestic markets.

Income, As Usual

The Federal Reserve seems to have reached its *terminal Fed-Funds rate* – i.e. the level at which it has decided to *pause* or *pivot* from its tightening bias. Despite the higher rate environment, corporate defaults still remain relatively low for the time being, and employment is still very robust. Thus, as we expected, excellent opportunities emerged across the spectrum in fixed income this past year. If rates do ultimately continue to fall over the next few years, there will likely be many candidates within the asset classes of bonds, dividend-paying stocks, and multi-strategy funds which attempt to generate income. Since we generally believe in compounding income as a key component in the mission of obtaining a total return, we are encouraged by the opportunities evolving in the current environment.

Diversification of Style, Market-Cap, Geography, and Sector

Our research will continue to be devoted to identifying managements that reflect on their profit picture while maintaining their corporate balance sheets. Companies with stable cashflows and solid balance sheets not only have sustainability in bad economic conditions, but they have flexibility to pay (or increase) dividends, buy back stock, and maintain their credit ratings. We believe that essential industries with long-term staying power are also vital to societal infrastructure – namely communications (including equipment), software (particularly data management and cybersecurity), and biotechnology. We also note that there are defensive sectors which might be attractively priced such as healthcare, energy, consumer staples, and utilities. In 2024, we believe the market will begin to recognize that such opportunities are not limited to just a small number of Mega-Cap names, but exist across Market-Caps and geographic locations.

RISKS

On the other side of the ledger, we view the following as some of the risks for 2024:

- US large cap equities are currently at extended level of valuation, historically.
- Geopolitical concerns – Middle East Conflict, War in Ukraine, China / Taiwan Tension, North Korea
- Inflation may re-emerge if Fed loosens too quickly
- Decreased corporate profits from higher commodity and interest expense
- Higher energy prices and interest expense effecting consumers, households
- Market liquidity and strains
- Financial system shocks, defaults, real estate valuations
- Possible Domestic, Eurozone, or Emerging Market recessions
- China property developer leverage
- Overvaluation of US dollar vis-a-vis other currencies
- Election-year malaise

Political Risks

When our domestic economy is strong, and markets are upwardly biased, we sometimes forget how fragile the situation in the world is. Russia's invasion of the Ukraine and the unrest in Israel remind us of war's grave human toll. Last year we expected that the war in the Ukraine would conclude in the intermediate term as pressure from free world nations remained resolute. Now we're not so sure. War in the Middle East, and China's continued ambition to bring Taiwan under its control are further significant risks that the market also seems to be ignoring for the time being.

Domestically, we have a Presidential election at the end of 2024 in the midst of a deeply divided, polarized environment. While not always the case, over a 90-year period, equity returns have historically tended to be off-trend and only modestly positive during election years. Perhaps this is due to the uncertainty of policy initiatives of a new administration or new Congressional make-up.

Economic Risks

As mentioned above, according to the International Monetary Fund, GDP growth in many developed economies is projected to be flat or even down slightly in 2024. The impact of higher rates trickles through the world economy with a lag. So, even though the Fed has signaled the potential for cuts, the effect of higher rates will still be evident during 2024 as a headwind to growth.

Financial Risks

One of the indicators of a weakening economy is the rate of corporate defaults on financial obligations. According to Fitch Ratings commentary of December 27 2023, high yield defaults are expected to increase from 2.99% in 2023 (up from 1.3% in 2022) to 5-5.5% in 2024. Their projection assumes that the higher interest rate environment will persist and serve as a headwind to the economy in the coming year. Increased defaults could put additional strain on financial markets as borrowing costs tend to increase, particularly for non-investment grade credits, and equity valuations could decrease – especially for companies in need of ongoing financing. This is something that market participants will be evaluating carefully during 2024. https://www.fitchratings.com/research/corporate-finance/default-rates-to-rise-in-us-europe-as-weaker-growth-offsets-rate-cuts-27-12-2023#:~:text=In%20the%20US%2C%20Fitch%20forecasts,in%202024%20relative%20to%202023.

SUMMING IT ALL UP

We are coming off of a year where investments in a number of asset classes exceeded expectations – particularly in US Large-Cap Growth. If the rally in equities is to continue, we believe that the participation needs to be broader based and spread wider geographically. Though the volatility index currently suggests otherwise, we recognize we are operating in an environment with many risks and uncertainties. We will be looking for opportunities to invest in quality companies (and funds) at reasonable prices, and to take advantage of still-high interest rates to generate portfolio income. In the meantime, we are honored and privileged that you have entrusted us to guide you in your pursuit of achieving your long-term financial goals. Speaking of which, it’s always a good time to reassess your risk profile and objectives. If they have changed, or you would like to modify risk in your portfolios, please let us know.

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