2024 INVESTMENT OUTLOOK

The year just ended surprised most economic and stock market prognosticators. As 2022 wound to a close, many forecasters predicted that the cumulative effect of the Federal Reserve's then 425 basis points of interest rate increases would slow economic growth in 2023 as both businesses and consumers pulled back, negatively impact the job and housing markets, and possibly even tip the U.S. into a recession. Inflation remained well above the Fed's 2% target, war in Ukraine raged on, and investor sentiment was weak as the S&P declined over 18% in 2022.

As 2023 unfolded, new headwinds arose. Ten-year U.S. treasury rates, which began the year at 3.88% and fell to 3.29% by early April, commenced a steady ascent to 4.99% by mid-October. This occurred in conjunction with the Fed raising rates by an additional 100 basis points in the first seven months of the year. October saw the resumption of student loan payments, after a three plus year hiatus. Hamas' attack on Israel also occurred that same month and the Israeli response effectively opened up a second war in the Eastern Hemisphere, that fortunately has not yet escalated to include other powers in the region. These and other factors caused the S&P 500, which had returned over 20% year to date through July, to pare that gain to approximately 9% by late October as the market officially entered correction territory.

In the year's final two and a half months, the fickle nature of the market was on full display again as inflation metrics moderated and rhetoric from a number of Federal Reserve officials became more balanced leading market participants to price in aggressive rate cuts in 2024. This better than expected inflation news came, in part, due to economic reports that fell short of expectations. Investors chose to focus on the falling inflation numbers and seemed to discount the disappointing macroeconomic data. The ten-year treasury yield declined by over 100 basis points to end the year at 3.86%. Mortgage rates fell by a similar amount. Stocks advanced, with the S&P 500 rising over 10% in the final ten weeks of the year, though it was a narrow rally with many of the more speculative areas of the market leading the move higher. The Dow Jones Industrial Average achieved a new record, surpassing its previous peak in early January 2022. The other major stock market indices are still below their all-time highs of approximately two years ago but performed remarkably well in 2023 as shown below.

Equity Markets – 12/31/23

	Index Price Level	2023 Total Return
Dow 30 Industrials	37,690	+16.2%
S&P 500	4,770	+26.3%
NASDAQ Composite	15,011	+44.7%
MSCI All Country World Index ex-USA	317	+16.2%

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Outlook

Consumer spending accounts for approximately two-thirds of economic activity in this country, so the prospect for ongoing GDP growth in 2024 is highly dependent on the outlook for the U.S. consumer. On this front there is reason for near term optimism. The labor market remains remarkably resilient with an average of 232,000 new jobs created each month through November in 2023. While this is below the 2022 rate when nearly 400,000 monthly jobs were created, it is well above the ten year average of only 162,000 monthly jobs. Similarly, the current unemployment rate of 3.7% is only modestly higher than the seventy year low of 3.4%, achieved most recently in April 2023, and barely above the 3.6% rate in place when the current Fed interest rate hiking cycle began in March 2022. To put those figures into perspective, over the past seven decades, unemployment has averaged 5.8% and peaked at 10% or higher during three separate recessionary periods. Finally, according to the U.S. Bureau of Labor Statistics, there are currently 1.4 available jobs per unemployed worker today. While this is down from a recent high of 2.0, it is above the long term average and higher than the 1.0 ratio that the Federal Reserve believes is consistent with their 2.0% inflation target. In summary, while there are signs of weakening, the job market remains relatively tight, giving workers the ability to bargain for higher wages.

In the latest jobs report, average hourly earnings advanced almost 4.0%, though the three month moving average (an indicator of the more recent trend) was only 3.4%. In either event, both figures have been above recent inflation readings, giving the average American ongoing spending power. The November inflation report showed that the core personal consumption expenditures price index, the Fed's preferred inflation gauge, rose at a 3.2% rate over the past twelve months. Importantly, over the past six months, the rate was only 1.9% providing optimism to those who believe the current interest rate raising campaign may be over for this cycle. Falling inflation has been a boon to the over seventy-one million Americans receiving social security benefits as 2023's cost of living adjustment (COLA) of 8.7% far exceeded inflation last year. Looking ahead, this will be less of a tailwind this year as the 2024 COLA is only 3.2%.

Those fortunate enough to already own a home remain in excellent financial shape. House prices continue to rise as the supply of new and existing homes for sale remains well below long term averages and current demand levels. Nearly 40% of homes are owned debt-free while the remaining borrowers took advantage of the low interest rate environment as it is reported that the average rate on all outstanding mortgages is only 3.6%. This compares to a current rate of over 6.50% for a thirty year mortgage. Meanwhile, over 90% of mortgages are under 6% while 62% are below 5%. The effective rates are even lower as the U.S. tax code offers a generous tax deduction on mortgage interest payments. This math favors borrowers who can now earn in excess of 5.0% on risk-free money market fund holdings.

While interest rates have declined since late October, they remain well above levels experienced in recent years. This hurts new homebuyers who face higher prices, higher interest rates, and more limited access to credit as bank lending standards have been tightening. There are early signs that rising interest rates are also beginning to be felt by consumers. Credit card delinquencies are above prepandemic norms while subprime auto loan delinquencies are near record high levels. These may be early signs of stress that herald a turning point for the American consumer. This is occurring at the same time that the excess savings built up over the past few years is being spent down. Most observers estimate that those savings will be completely depleted in the first half of this year. This could add pressure to the average American's ability to service their debt as personal interest payments (excluding mortgages) have more than doubled from 1.10% of income to nearly 2.5% over

the past three years. The only times this figure has been higher in the past sixty years were in the mid-1980s, after the technology bubble burst in 2002, and during the Great Financial Crisis in 2009.

Higher interest rates affect the economy with a lag and the full impact of the 525 basis points of Fed tightening has yet to be fully felt. How consumers, corporations and governments deal with the ongoing effects of the higher interest rate environment will influence the 2024 economic and capital market outlook. As maturing debts need to be refinanced in the coming quarters, financial stress will increase on borrowers, many of whom are already struggling to access credit as bank lending standards have been tightening as noted. One area that is almost sure to experience greater challenges this year is the commercial real estate market. Credit rating agency Fitch predicts that defaults on commercial mortgage backed securities will double in 2024 to 4.5%, up from the 2.25% rate posted in November. Greater default rates are predicted for 2025 which, if true, will lead lenders to further curtail access to credit and even higher costs for creditworthy borrowers.

Corporate America, too, will need to refinance significant amounts of debt in the coming years. Bank of America estimates that $1.3 trillion of high yield bonds will mature between now and 2026. The average coupon on that debt is about 6% but today it would cost roughly 9% to refinance it. Many companies will not be able to afford such a dramatic increase. Small businesses, which account for over half of all employment in the U.S., are already struggling with higher costs as they rely primarily on profit from sales, credit cards and private loans, not the debt markets for access to capital. All of these funding avenues are likely to be more challenged in 2024.

Bloomberg Economics forecasts that the global economy will grow 2.7% in 2024, down from an estimated 3.1% last year. The only years with slower growth in the past two and a half decades were the recessionary years of 2001 (technology bubble collapse), 2009 (the Great Financial Crisis), and 2020 (COVID). Similarly, the International Monetary Fund predicts U.S. growth will slow to 1.5% in 2024, down from 2.1% in 2023. Slower economic growth will make it more difficult for the federal government to raise the money needed to fund ongoing deficits. The nonpartisan Congressional Budget Office (CBO) predicts the U.S. economy will expand at an average annual rate of only 2.0% over the coming decade. At the same time, the CBO predicts U.S. budget deficits in excess of 5% of GDP every year from 2023-2033 with an average deficit of 6.1% of GDP during that span. Deficits of this magnitude typically occur during war time and have never happened before during a period of low unemployment and positive economic growth. Time will tell if interest rates can remain low in the coming years as these ongoing deficits have to be financed at the same time that the Federal Reserve and other central banks are reducing their U.S. treasury bond holdings.

Regarding the Fed, its current consensus thinking is that the federal funds rate will fall by 75 basis points in 2024 to an upper target of 4.50%. Meanwhile, Wall Street forecasters are calling for double that with six 25 basis point cuts priced in for a total decline of 150 basis points. Which prediction proves more accurate will depend on a host of factors, including the path of inflation and rate of economic growth. Most market participants believe the Fed can successfully engineer a soft landing whereby inflation will moderate while recession can be avoided. The central bank's track record on this front is mixed at best with only two such prior examples in 1984 and 1994. While this favorable outcome remains a possibility, it is worth remembering that a soft landing has never been achieved at a time when inflation remained above the Fed's target and with a job market as strong as it is today. The significant easing of financial conditions in recent weeks also raises the probability that inflation may not moderate as much as many investors expect.

Current consensus estimates for S&P 500 corporate profit growth this year call for bottom line results to improve by 11.2% versus an estimated 0.7% in 2023 according to FactSet. The 2024 prediction

seems overly optimistic with economic growth set to slow. At the same time, stock market valuations remain above the historical trend line. The current forward price earnings (PE) ratio of 19.4x is modestly above the thirty year average of only 16.6x. Should earnings revisions head lower as the year unfolds, the forward PE ratio would move higher, meaning stocks may be pricier than investors currently believe. Longer term valuation metrics (for example, the Case-Shiller PE) suggest stocks are priced for only mid-single digit returns over the coming decade; an acceptable result, but one that is well below current market expectations.

The political and geopolitical landscape will influence the capital markets in unexpected ways in the year ahead. The political divide in the United States will come into increased focus as we inch closer to the next presidential election in November. At present, both political parties in this country have candidates that a significant portion of their own voter bases disfavor. At the same time, a number of moderate members of the House and Senate have announced that they will not run for reelection. They cite intensifying political conflict and growing intolerance in our nation. The loss of these calmer and more sensible voices will likely make bipartisan compromises more difficult to achieve in 2024.

The two ongoing wars show little sign of being resolved any time soon. The Russia-Ukraine conflict has seemingly reached a stalemate while the situation in Gaza and the Middle East appears to be escalating with an increasing number of rebel attacks on ships moving through the Red Sea, a route critical to global commerce. Companies have already begun to reroute sea traffic to avoid that region, a costly endeavor that will ultimately be passed on to consumers in the form of higher prices. Such incidents also raise the risk of escalating that military engagement to include other global powers which would be a very unwelcome development. By their very nature, geopolitical events are difficult to predict, though investors would be wise to take today's increased risks into account. Even before these two conflicts erupted, increased global competition and protectionism were on the rise, trends that are likely to continue.

Investment Conclusion

The new year will undoubtedly present investors with unexpected challenges and opportunities. Coming into 2023, few could have predicted the twists and turns that ultimately unfolded. The same is likely to be true this year. Calls for a soft landing are almost uniformly assumed by investors. While that possibility may occur, other less favorable outcomes cannot be ruled out.

The appropriate percentage of a client's portfolio invested in stocks, bonds and cash are determined by factors that do not change based on the short term outlook for the market. Investors are well served to remain focused on their goals and to build and maintain portfolios designed to achieve those objectives. A diversified mix of conservatively financed companies overseen by capable leadership teams and which have reasonable outlooks for profitable growth are the bedrock of investment portfolios. Over full market cycles, such securities should provide the growth necessary to counteract inflation, perhaps the greatest risk facing long term investors. Complementing these investments with short to intermediate term high quality bonds will generate income that can be used to meet client needs or which can be reinvested for future growth. These holdings, along with available cash reserves, also provide stability of principal that allows investors to ride out periodic market disruptions that inevitably occur due to changing economic circumstances and swings in investor psychology.

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