January 2024

Market Trivia:

U.S. companies make up what percentage of global stock market capitalization?

Q4 Market Recap

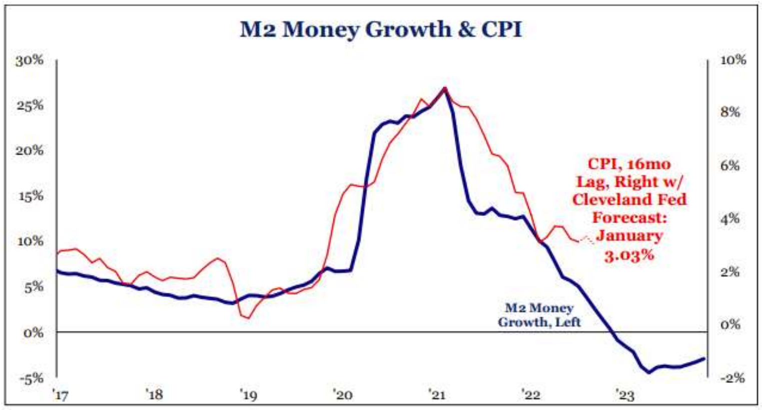
Many analysts and market forecasters missed the mark last year as higher interest rates did not send the U.S. or global economy into a recession. Stocks rallied to end the year, with many global indices regaining all-time highs last seen in early 2022. The S&P 500 was up over 26% in 2023, led by the seven of the largest technology companies in the U.S. Growth trounced value and small caps underperformed large caps by a wide margin. Foreign stocks were up 18% benefitting from a weaker dollar and better than expected corporate earnings. Emerging markets were up almost 10% despite Chinese stocks delivering a negative 10% return for the year. Sparked by the Federal Reserve's perceived policy pivot in the fourth quarter, bonds rallied to end the year in positive territory. High yield bonds and bank loans delivered low double-digit returns last year. November/December marked the best two month gain for global bonds in the past 30 years. Despite strong near-term performance, the three-year annualized return for investment grade bonds remains negative.

Asset Class	Benchmark	December	Q4 2023	2023	Since 1/2022 Market Peak
U.S. Large Cap Stocks	S&P 500 TR USD	4.5	11.7	26.3	1.4
U.S. Small & Micro Cap	Russell 2000 TR USD	12.2	14.0	16.9	-4.1
Intl Dev Stocks	MSCI EAFE NR USD	5.3	10.4	18.2	0.7
Emerging Mkt Stocks	MSCI EM NR USD	3.9	7.9	9.8	-6.4
Global Stocks	MSCI ACWI NR USD	4.8	11.0	22.2	-0.3
U.S. Municipal Bonds	Bloomberg Municipal TR USD	2.3	7.9	6.4	-1.3
U.S. Taxable Bonds	BBgBarc US Agg Bond TR USD	3.8	6.8	5.5	-3.8
U.S. High Yield Bonds	BBgBarc US Corporate High Yield TR USD	3.7	7.2	13.4	0.4
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	5.2	10.7	6.0	-8.7
U.S. REITs	MSCI US REIT NR USD	9.6	15.6	12.3	-8.2
Broad Commodity Futures	Bloomberg Commodity TR USD	-2.7	-4.6	-7.9	3.3
Energy Partnerships	Alerian MLP TR USD	-2.2	5.0	26.6	27.0
Gold	DJ Cmmdty Gold TR USD	1.1	11.4	12.8	6.7

Data from Morningstar as of 12/31/2023. Last market peak for S&P 500 was 1/3/2022.

Federal Reserve Policy Pivot?

At the December FOMC policy meeting, Fed officials announced they were prepared to cut rates about three times in 2024 followed by further reductions in 2025. Policymakers reiterated they will be data dependent as they expect disinflationary growth for the economy in the coming years. Investors interpreted these remarks as a mission accomplished statement in the fight against inflation, which caused stock and bond prices to soar. Market participants now expect the Fed to cut rates 6 times starting in 2024. Rarely does the Fed cut rates by more than 1% outside of a recession. In fact, this has happened only one time in the last 50 years. Put another way, interest rate cuts typically happen when the Fed is trying to rapidly ease financial conditions, often during recessionary periods, rather than during an economic expansion.

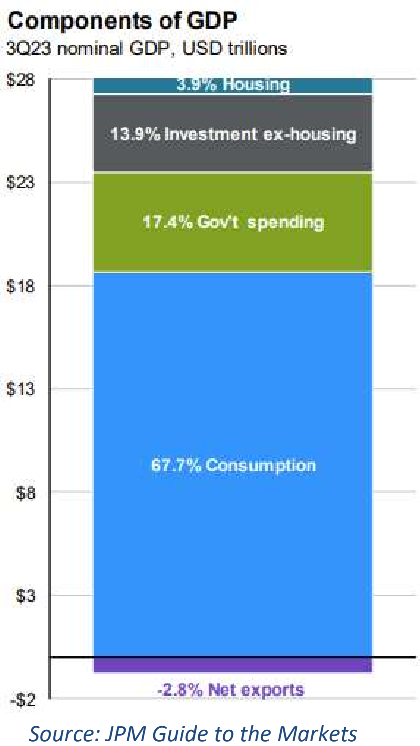


Source: Strategas

So why would the Fed telegraph rate cuts if our current economy is steadily growing at current interest rate levels? Because the Fed is concerned about *real* interest rates being too high and the downward trend for inflation appears likely to continue. Fed balance sheet reductions since mid-2022 have significantly reduced money supply growth over the past 18 months. Over the past six years, inflation (measured by the Consumer Price Index) has loosely followed the money supply with a lag (see chart above). Other data points such as declining manufacturing prices paid, inventory discounts, falling energy costs, normalizing supply chains, and declining rent inflation all point to lower inflation ahead. From this perspective, cutting rates now would be necessary to keep the real fed funds rate and its related impact on the economy unchanged. Fed Chair Powell reiterated this concept during the December FOMC meeting press conference, stating that central bankers want to 'reduce restriction on the economy well before 2%...so you don't overshoot' and have restrictive policy weigh on economic activity.[1]

Resilient Economy and Consumer

Real U.S. GDP growth surprised to the upside with a 4.9% increase in the third quarter. This was a notable reversal from the previous four sequential quarters of decelerating GDP growth. Private goods-producing industries, private services, and state and local government spending were major contributors to Q3 growth (see high level chart to the right).[2] Inflation cooled meaningfully throughout the year with the CPI dropping from 6.4% to 3.1% at the end of the year. Accounting for the lagged effect of rent inflation and credit contraction over the past 12-18 months, many economists expect core inflation will reach the Federal Reserve's 2% target in 2024. The U.S. unemployment rate finished the year at 3.7%, and initial claims for unemployment insurance remain low. While job openings and the quits rate have fallen from recent highs, labor demand remains strong.[3]



Source: JPM Guide to the Markets

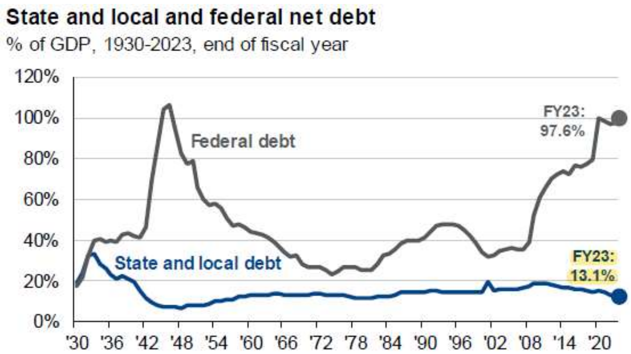
There are areas of concern within the U.S. economy, however. Manufacturing continues to contract with December marking the 14th consecutive month of declines.[4] Higher mortgage rates have chilled the housing market with existing U.S. home sales falling to 2010 levels.[5] Home builders have used low existing home inventory to their advantage with new housing starts jumping 42% year-over-year in November. Investors took notice as homebuilder stocks rallied over 60% last year.[6] Uncertainty prevails regarding the direction of commercial office space in the coming years

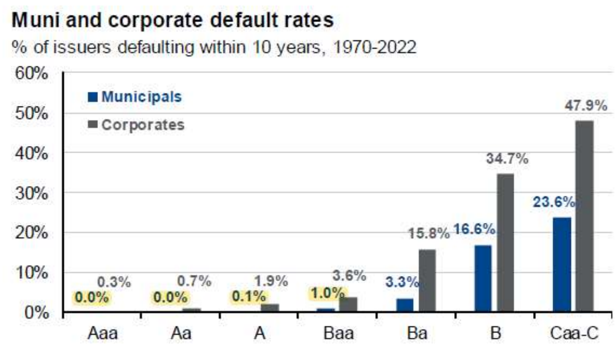
[1] Federal Reserve. Transcript of Chair Powell's Press Conference 12/13/2023.
[2] BEA, GDP by Industry. Release date 12/15/2023. https://www.bea.gov/data/gdp/gdp-industry, accessed 1/3/2024.
[3] BLS, The Employment Situation – 12/2023 & JOLTS Summary – 11/2023. https://bls.gov. Accessed 1/7/2024.
[4] ISM, ISM Report on Business – PMI – December 2023. https://ismworld.org. Accessed 1/7/2024.
[5] National Association of Realtors, Existing-Home Sales – December 2023. https://www.nar.realtor. Accessed 1/6/2024.
[6] Data from Morningstar using SPDR S&P Homebuilders ETF (XHB) as a proxy. +60.1% 2023 mkt total return.

as landlords may need to refinance debt in a difficult environment. While storm clouds may be brewing, consumer strength continues to drive the U.S. economy forward.

Fiscal Uncertainty

U.S. federal government finances continue to weigh on debt markets and economic growth potential. The U.S. Treasury had to finance a larger-than-expected $2+ trillion deficit last year. This caught investors off guard and made for a volatile summer as the Treasury initially used longer dated bonds before shifting to more T-Bill issuance in early Q4. To make matters more complicated, large foreign investors in U.S. Treasuries (notably China) have been steadily reducing holdings over the past few years.[7] Pair this with a continued need for U.S. Treasury issuance and we would not be surprised if interest rates for intermediate-term Treasury bonds remain elevated for the years to come. Persistent deficit spending may lead to higher income tax rates in the future which makes tax-exempt municipal bond interest increasingly attractive to high income investors. In contrast with the federal government, state and local governments have done a



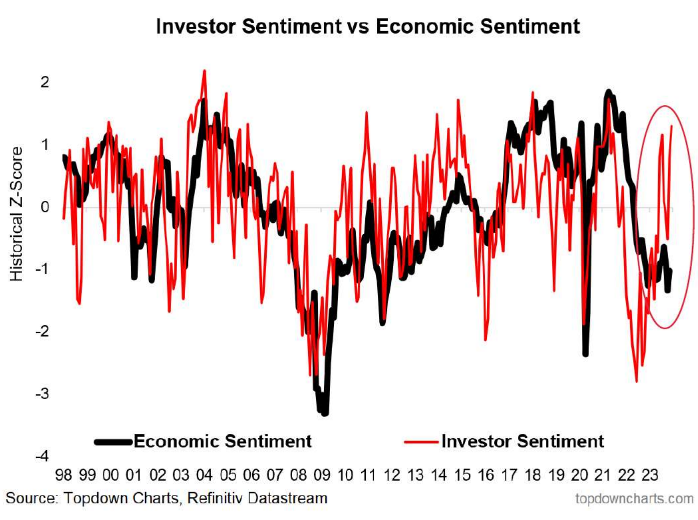


Source: JPM Guide to the Markets Q1 2024

good job of managing their fiscal situation (see left chart). Net debt to GDP has declined since 2008. Considering municipal bonds have substantially lower default rates than taxable bonds (see right chart), we expect municipal bonds to continue to look attractive in the coming years.

Portfolio Positioning for 2024

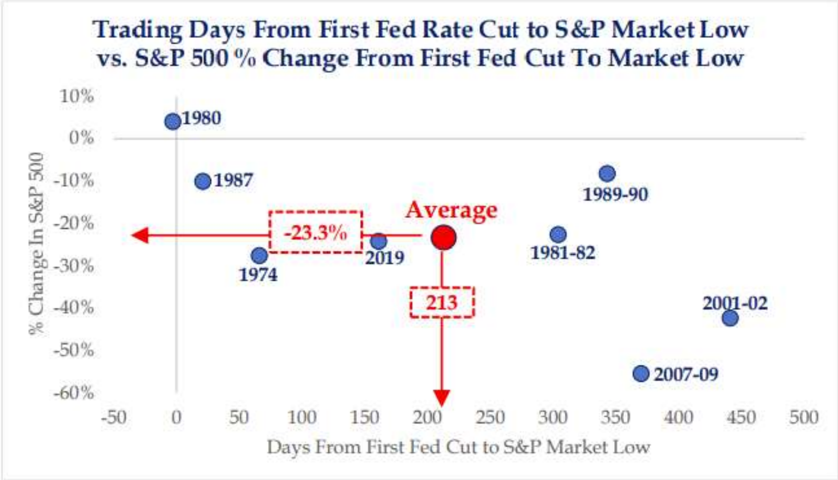
How should investors position their portfolios for 2024 and beyond? Will stocks continue to rally or has the easy money been made?



For starters, pricing recession risk has been incredibly difficult over the past few years. Despite signs of a recession from commonly used indicators like an inverted yield curve, the economy is still expanding. Investor sentiment recently turned quite bullish while economic sentiment is much more muted (see chart to the left). Much like in 2020, last year's stock gains were driven by multiples expansion rather than rising earnings. In fact, 2023 earnings growth for the S&P 500 is expected to be less than 1%, lower than long-term averages. Looking ahead, analysts remain optimistic and expect year-over-year

[7] Board of Governors of the Federal Reserve System (US), Rest of the World; Treasury Securities Held by Foreign Official Institutions; Asset, Level [BOGZ1FL263061130Q], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BOGZ1FL263061130Q, January 6, 2024.

earnings growth of 11%+ in 2024.[8] As mentioned above, the Fed rarely cuts rates in a healthy economy. How do stocks and bonds typically perform after rate cuts? The short answer is that rate cuts have historically been negative in the short term for stocks (see chart below) but strongly positive for bonds.[9] Note that the 1984 rate cut cycle (rate cut but no recession period) is missing from the chart below. The S&P 500 produced strong returns during this period (August 1984 – October 1986).[10]



Source: Strategas

While it is tempting to chase market rallies, many U.S. stocks are priced to perfection with above-average valuations and a soft economic landing baked into interest rate expectations. We believe it is prudent to rebalance to long-term asset allocation targets while maintaining a diversified portfolio that can perform well in a variety of economic scenarios such as disinflationary growth or a mild recession. Fortunately, higher rates have increased the return and diversification potential for bonds. Conservative investors may expect a brighter future for their investment portfolios in the years to come.

Thank you for your continued trust and please reach out to your PCM advisor if you have any questions or would like to discuss your situation.

Sincerely,
The Private Capital Management Team

Market Trivia Answer: Approximately 63% as of 12/31/2023, as measured by the MSCI ACWI Index.

[8] Factset. Earnings Insight, January 5, 2024.
[9] Morningstar data using Bloomberg Aggregate Bond Treasury USD during the following periods: June 1974-April 1975, April 1980-June 1980, July 1981-August 1982, September 1984-August 1986, July 1990-September 1992, January 2001- June 2003, September 2007-December 2008, July 2019-October 2019, March 2020-April 2020.
[10] Morningstar using S&P 500 TR USD index during the following periods: August 1984 – October 1986.