# 2024 YEAR AHEAD
# 2023 YEAR BEHIND

**"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid instead of trying to be very intelligent."**

~ Charlie Munger

Wealth management for private clients is generally considered to be the holistic process of accumulation, utilization, and transfer of financial resources. Individuals and families have goals, objectives, and needs that must be identified, properly defined, and then perpetually organized. Challenges arise over time that require solutions. The accumulation process is a combination of positive and negative action. Proper stewardship means taking actions that drive an accumulation result, but also avoiding mistakes that erode accumulation. A large part of the investing public has stubbornly believed that part of their positive accumulation actions must be "avoiding the market when they believe it will go down," failing to realize that this is actually a negative action that erodes their accumulation goal.

2023 was one long and brute lesson for those who have failed to learn the most important lesson in the history of wealth management: Behavioral mistakes destroy investor outcomes, and at the top of the list of behavioral mistakes is trying to time entry and exit points. The rationalization to try is usually prima facie acceptable.

THE/BAHNSEN GROUP

"It's obvious we are headed into a recession."

"The Fed is going to break something."

"I have seen this tape before and it just feels like something bad is coming."

"Many hedge fund managers are on TV saying the market is about to drop."

"They are lying about the economy; it's worse than people think."

The only investor who went backwards in 2023 was the investor who acted on these impulses via the sin of market timing, or who listened to famous hedge fund managers on television (who were either wrong or lying, a mystery we will never be able to solve). In fairness, there were other bad influences in 2023 besides famous hedge fund managers. Charlatans and those wedded to a worldview of perma-pessimism are easy to find, though some are more persuasive than others.

But they are not wealth managers. They do not understand the objective of asset accumulation, of defining financial objectives and implementing a plan that pursues those objectives, devoid of the hubris that attempts to do what almost no one does well, and basically no one does sustainably well.

2023 was a year for wealth management, when coming off of the market-challenged year of 2022 investors faced a reasonable reason to believe that "the worst was still to come," and yet had to maintain a coherent, sensible, and proper asset allocation if they were to recover from some of the challenges of 2022, or better still, avoid the opportunity forfeiture that a year like 2023 ended up creating. 2023 hardly produced a straight line-up in risk assets, and there certainly were moments where it looked like both bonds and stocks were vulnerable. But that is sort of the point I am making – the composition of positive risk asset performance this year left no time for timing; it forgave no mistakes in exit and entry; it only offered its total year-end results for those who obeyed the cardinal rules of investing.

And as 2023 reminded us, one of those cardinal rules is to ignore those who do not have your best interests in mind.

We enter 2024 with the same uncertain world that we had in 2023 (and 2022, 2021, 1997, 1983, 1951, 1776 ... you get the point). We also enter it with the same fundamental principles that serve as the bedrock of wealth management at The Bahnsen Group. A portfolio strategy intended to avoid all downside volatility is one that will miss upside, as well. Likewise, a portfolio strategy that is ambivalent about market circumstances will end up regretting it. The solution is not in futile timing but rather coherent allocation.

It belongs at the core of wealth management. To that end, we work.

# 2023 IN REVIEW:

The year began where 2022 left off – with hand-wringing over the state of the economy and the Federal Reserve's intentions for interest rates. Whereas 2022 was mostly spent wondering about the macroeconomic condition thought to be driving Fed policy (inflationary price pressures), 2023 saw less ambiguity around inflation and more ambiguity on the policy side. That policy ambiguity caused most forecasters to err on the side of negativity, believing that eventually monetary policy that tight would spike unemployment, impair corporate profits, and hurt the demand side of the economy. Early 2023 readings in industrial production and manufacturing foreshadowed more concern about economic health.

Those macroeconomic concerns didn't stop equity markets from rallying in the first quarter, with the Nasdaq alone up +17% in Q1. The theme of 2022's battered and bruised recovering would last throughout the first half of the year, with Technology and Consumer Discretionary leading the way.

March presented a massive head-fake for Fed watchers when the anticipated moment of the Fed "breaking something" appeared to arrive. Silicon Valley Bank and Signature Bank of New York were shut down by the FDIC in mid-March, decapitated by a run on the bank that commenced when mark-to-market losses in the bank's bond portfolio revealed a severely impaired balance sheet. Concerns immediately pivoted to the entire regional bank sector where net interest margin was collapsing behind a low-interest loan book with mostly fixed rates and market pressures for higher deposit rates. A few significant bank failures naturally drove a flight to perceived safety with hundreds of billions of dollars leaving small, regional, and community banks, causing fears of an avalanche of bank failures. The FDIC, Treasury Department, and Federal Reserve would signal an unlimited backstop of bank depositor protection by removing the $250,000 cap in the case of Silicon Valley and Signature Bank. The implicit backstop was enough to stop the violent run on smaller bank deposits. In the weeks that followed only one regional bank would fail (First Republic, quickly absorbed by JP Morgan).

The lack of contagion in regional bank weakness did not mean the end of systemic risk fears. The European banking giant, Credit Suisse, would fall into the hands of its largest adversary, UBS, as the central bank of Switzerland would act decisively (and controversially) to end the perpetual skepticism about Credit Suisse's longevity. One could be forgiven for believing that three major regional banks in the U.S. and a 150-year old international financial behemoth failing would be catastrophic for markets, but alas, no such market catastrophe surfaced.

The summer was mostly filled with increasing speculation about what the Fed would do next, though concerns about a "higher for longer" monetary policy were up against a surprisingly resilient environment for corporate profits. Profit declines from peak 2022 levels were far less than anticipated, and economic conditions continued to stay reasonably stable. Unemployment did not inch higher, inflation continued to move lower, and the likelihood of a soft landing increased greatly. The problem going into the fall was that with profits and the economy off the table as a market catalyst, it left the Fed's intentions with interest rates as the primary driver for market activity, and those indications suggested higher than expected for longer than expected.

The worst drawdown of the year that took place was only -10% or so, taking place in Q3, bottoming in the early parts of Q4. This August/September/October sell-off correlated stocks and bonds together perfectly, as rising bond yields and declining stock prices marched in tandem. Additional geopolitical risk surfaced in early October behind an incomprehensible attack on Israel at the hands of the Palestinian terrorist group, Hamas. The response in oil markets proved tame and the human tragedy and geopolitical tension of the moment did not serve as an additional shock to risk assets (did you know that even the Israeli stock market is up +30% since late October?). In fact, the market would soon begin a massive rally that would last the rest of the year.

Strategas Research, Year in Charts, Jan. 3, 2024, p. 2

It would be an incomplete summary of 2023 to not mention the Artificial Intelligence evolution. It most clearly found investment traction in the semiconductor space where it actually makes money, but the overall sector attracted significant capital and produced another market opportunity for confusion between AI-branding and AI-revenue. Not all gains in "big tech" in 2023 were AI-related but a significant component was.

The so-called "magnificent seven" (Alphabet, Amazon, Facebook, Apple, Microsoft, Nvidia, and Tesla) made up 65% of the S&P 500's return last year, and spent much of the year representing over 100% of it. The general narrative is that in tough economic times these companies will be bulletproof, yet in good economic times these companies will also lead the way. This is a widely adopted narrative by investors, retail and institutional alike. Louis Gave refers to this as the "heads I win, tails I also win" form of investing, and it is an expectation that has run into inconvenient realities throughout history. The names vary in valuation but in no cases can be considered "cheap" or even "fair value" and are at risk of stretched valuation combined with significant over-ownership. That said, with 2022 as the exception, there has been a strong resilience for most of these names that understandably creates a sense of security for owners.

Tullett Prebon, Jan. 02, 2023

There is no chart more important in explaining 2023 market action than that of the 10-year treasury yield. With uncanny correlation, as the 10-year rose in the second half of the year risk asset prices declined, and when the yield reversed risk assets rallied.

The year ended with a consensus view of a "soft landing" in the economy, a Fed pivot underway, and a general optimism that markets were on firmer ground. GDP growth picked up substantially in the third quarter, and full-year real GDP growth is expected to come in at +2.4% for 2023, far above early 2023 projections, yet still below historical growth of over +3.1%. Even with Q3's consumer and inventory fueled growth, business investment slowed materially. Better-than-expected economic conditions proved to be the defining narrative of 2023.

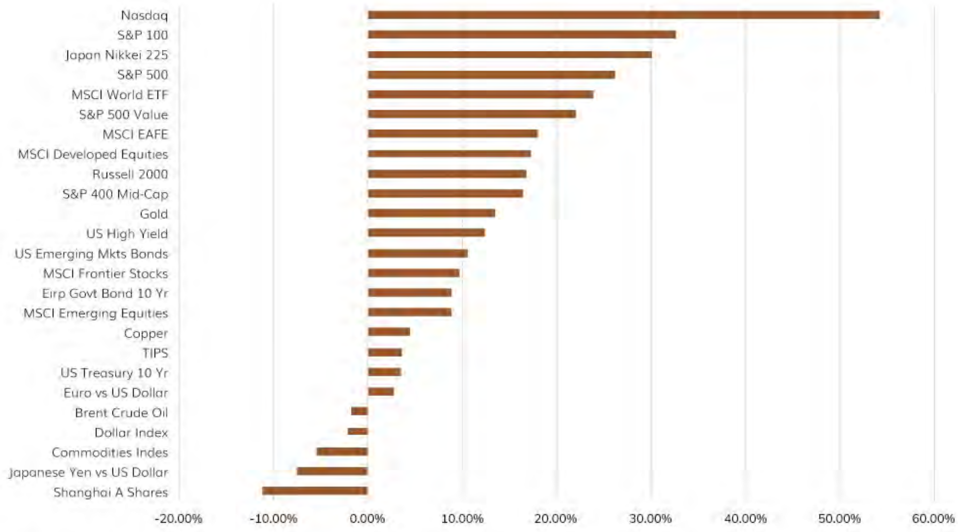
# 2023 MARKET SUMMARY:

At first glance it was very difficult to find an asset class that was not in positive territory for full year 2023. Unlike 2022 where the only positive-performing asset classes on our chart were commodities, the U.S. dollar, and crude oil, 2023 saw basically every stock and bond index, U.S. and global, achieve a positive return. Many of these asset classes achieved that positive result in the final two months of the year, but a calendar year return is what it is.

The results in U.S. equity growth indices are well-known, as is the recovery in the Nasdaq. As you will see below, a robust 2023 in these indices did not bring market levels back to their late 2021 highs, but they certainly covered a lot of ground.

It was always going to be tough for bond markets to not end in positive territory this year, just due to the protective return provided by the current yields now offered entering the year. Even if rates went higher the impact to prices would not be offset by some coupon, unlike the prior year where meaningful price drops were offset by yields below 2%. However, not only did high coupons offer bond indexes positive returns, but a late

## 2023 Asset Performance




Morningstar, Dec. 31, 2023

year price rally added to total return with robust price appreciation, as well.

Oil confounded many investors in 2023, unable to meaningfully drop behind the persistent imbalance between supply and demand, but not advancing as some would have expected as markets shrugged off geopolitical risks as well as a disappointing refill level at the strategic petroleum reserve. Saudi Arabia and its OPEC+ cohorts have regained the mantra of marginal producer and helped to create a floor in the markets in the $70 range, but moments that $90 or higher oil appeared to be back in the cards were short-lived.

Energy may have netted a flat return on the year as an index, but its top-heavy index composition distorts the fact that the midstream energy space was up over 15% on the year, with MLP's up over 25% for the third year in a row. The paradoxical reality that bad energy policy drives investor returns higher and good energy policy hurts returns has been on full display for some time (more on this throughout 2024 and our ongoing political commentary).

Utilities were the only sector to have a real negative return, down -7% on the year. Other defensive sectors were near flat on the year (Consumer Staples down -0.89% and Health Care up 2%). Real Estate entered the fourth quarter as another rate-sensitive sector down on the year but an +18% rally in two months caused the sector to end with a nice double-digit total return on the year.

The major takeaway for markets was essentially one of broad risk-on, a recovery for lower quality/higher valuation areas in the market, a strong result for both domestic and international assets, and a bond market that performed well by year-end in both credit and "boring bond" categories. Only traders and timers could have lost money in 2023.

### 2023 Sector Performance

| | |
|---|---|
| Technology | 55.97% |
| Communication Services | 52.84% |
| Consumer Discretionary | 39.63% |
| Industrials | 18.03% |
| Materials | 12.44% |
| Real Estate | 12.27% |
| Financials | 12.03% |
| Health Care | 1.99% |
| Energy | 0.72% |
| Consumer Staples | 0.89% |
| Utilities | 7.14% |

Morningstar, Dec. 31, 2023

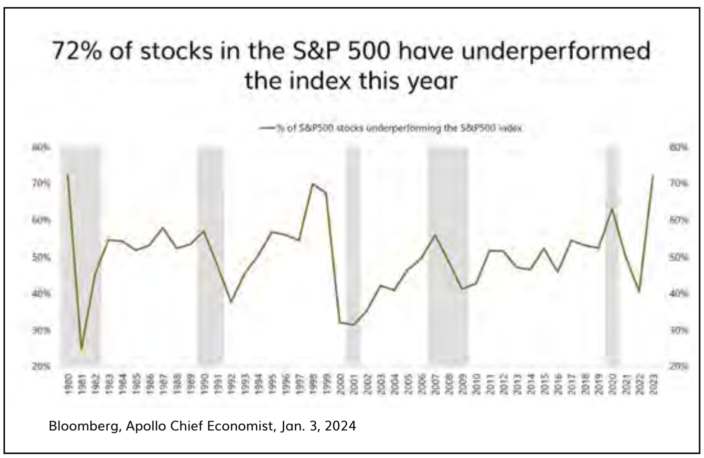
### Real Estate Index vs Year Yield


Bloomberg, Dec. 31, 2023

# 2023 BOTTOM LINE:

## 1 TOP-HEAVY!

It has been said over and over but bears repeating – the market action of 2023 was very top-heavy, with only a real broadening out in the final weeks of the year keeping it from being a perversely top-heavy/tech-specific market. For much of the year a slight majority of companies in the S&P 500 were actually down on the year even with the index up double digits. Most companies in the index did end up in positive territory but with a record level of them performing below that of the total index.



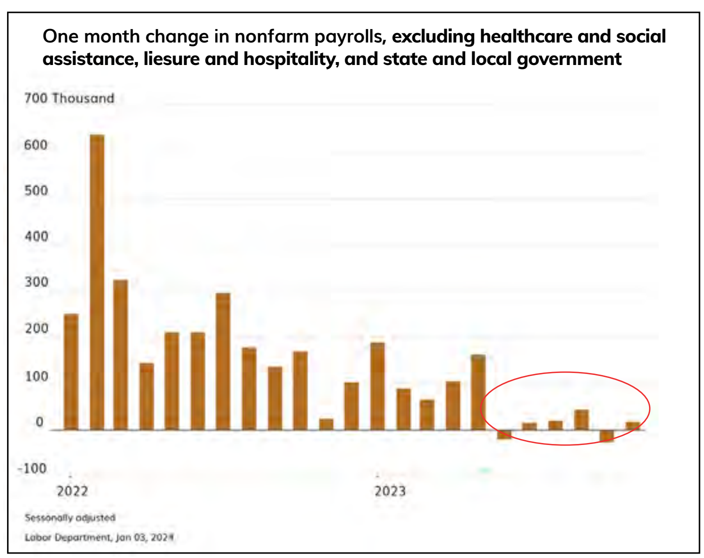

The number of new hires did decrease in 2023 from the levels of 2022, a painfully obvious development based on post-COVID re-hirings of 2022 out of the draconian lockdowns of 2020-2021. But job losses did not materialize in 2023 in any meaningful way, and even the Silicon Valley job losses of 2022 leveled out. A fed funds rate that went from over two years at 0% to meaningfully above 5% was expected to push the unemployment rate above 4%, easily, with most economists debating where around the 5% range we would go. Staying around 3.7% is one of the big surprises of 2023.

It's not all perfect in the labor market. The labor participation rate has improved since COVID, but remains woefully lower than its pre-financial crisis level, with certain demographics most mysteriously below trend. Where job hiring has been most robust is pretty concentrated (health care, leisure and hospitality, and government) and certain aspects of financial, technology, and manufacturing sector hiring have been quite slow (but not negative).

Wage gains averaged 4% in 2023 and the aggregate production of new jobs still remains more robust than even pre-pandemic levels. Job firings are very low as employers have little confidence in being able to replace workers. That can morph into a negative over time if it becomes a problem for productivity, but for 2023 the jobs market was the leading economic surprise.

## 2 A RESILIENT LABOR MARKET

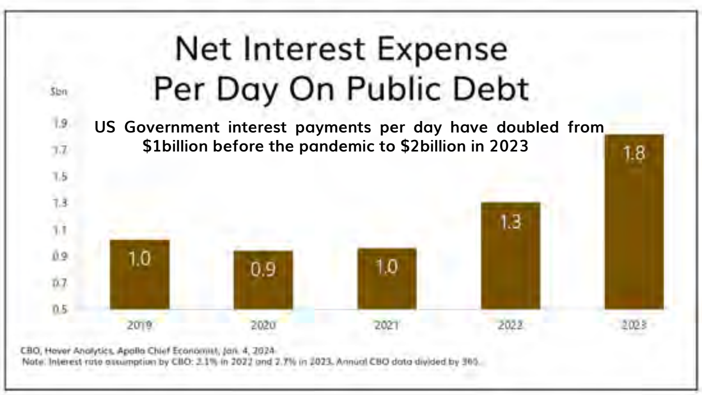
It says a lot about the state of the jobs market that one of the most negative things economic skeptics are saying about the jobs market right now is that "less people are quitting their jobs." I was unaware that excessive job-hopping was considered a positive thing, but if that is the case then that is, indeed, one of the worst things one can say about labor conditions.



# 3 SHORT GOVERNMENT, LONG HUMANITY

One of my favorite euphemisms to capture the paradox of my views on markets and current conditions was stolen from John Mauldin – the idea of being "short government, long humanity." In other words, one could fill up pages documenting all of the things that policymakers have done (and are doing) to damage economic prosperity or impose headwinds to future economic growth, yet that has to be harmonized with the indomitable human spirit God created us with. That human spirit – human capacity for productivity and innovation – has been a true thorn in the side of market bears for millennia.

In 2023 we got to see private sector efficiency at its finest and government headwinds at their worst. The 2023 budget deficit came in at a stunning $1.7 trillion, $300 billion more than the 2022 level where revenues were still COVID-constrained and expenses were still COVID-enhanced. Had student loan cancellation gone through the budget deficit would have come in at $2 trillion in 2023. The effective budget deficit was 7.5% of GDP in 2023, higher than any point it has ever been outside of a war, recession, or national emergency.




And yet it is the private sector that appears to be the reason a recession has, thus far, been averted and economic and market conditions have stayed strong. Operating margins behind greater corporate efficiency have defied critics. Perhaps most notably, corporate treasurers have proven to be far more adept at balance sheet management than they have been given credit for (no pun intended), as the impact of high rates was barely felt in the leveraged loan market or the high yield bond market for the simple reason that most corporate borrowers didn't need to borrow money, having adequately done so back when rates were much lower. Homeowners largely had locked lower rates during the 2020-21 period, and had done so on houses they had vastly more equity in than any time before. Much has been said about the depletion of excess savings over the last year (accurately so), but some credit must be given that there had been excess savings to deplete to begin with.

I do not want to add to the pop culture cuteness that attempts to portray "Taylornomics" as a real economic term, but perhaps 2023 really can be summarized this way:

Government gave us a $1.7 trillion deficit in 2023. Humanity gave us a $1 billion Taylor Swift tour.

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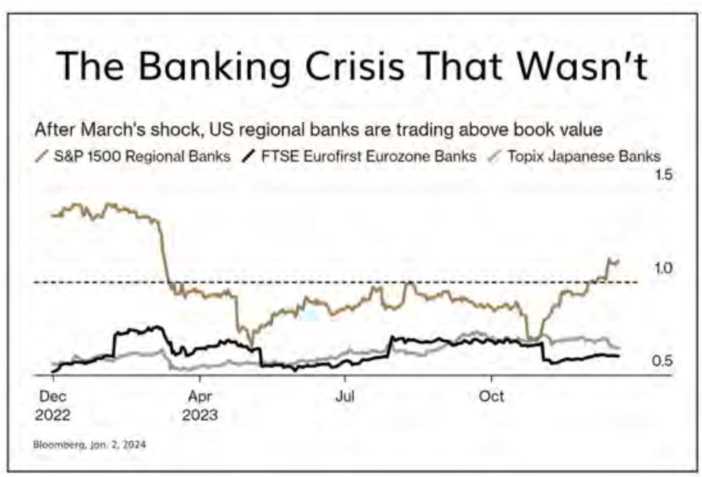
# 4 DISASTERS AVERTED, FOR NOW

(regional banks and commercial real estate)

2023 should be known as much for a couple things that didn't happen as it should be for so many of the things that did. As mentioned previously, the failures of Silicon Valley Bank and First Republic Bank were headline-worthy events, no doubt, and had the potential to spread into a massive contagion event. They didn't. In fact, after an eight-month purgatory below their book value in stock price soared back above their tangible book value by year-end – not back to Q1 highs, but substantially off of mid-2023 lows.



The yield curve remained inverted all year. Net interest margin remained impaired for regional banks all year. Yet the damage proved less than feared, defaults to the loan book of regionals remained benign (maybe, just maybe, underwriting proved to be better than pre-GFC underwriting this time around), some optimizing consolidation took place, and a banking collapse did not become the consequence of Fed tightening in 2023.

The other "shoe to drop" in 2023 was said to be commercial real estate. Indeed, cap rates have risen since late 2021 across most commercial product (office, multi-family, industrial, and retail), but from preposterously low levels. Demand for prime office space proved much stronger than many predicted and even leasing activity outpaced very low expectations. It would be tough to describe the environment across commercial real estate was sanguine – significant challenges, debt funding gaps, and valuation issues persist. Yet the narrative of a systemic story coming out of commercial real estate into the broad economy did not materialize in 2023, even with peak Fed tightening now behind us.

# 5 THE RANGE-BOUND MARKET CONTINUES

It may not seem possible based on the significant rally cap-weighted index investors enjoyed in 2023, but someone long the S&P 500 for the last two years is actually underwater despite a +24% return last year (that added a stunning $8 trillion to its total market capitalization). The Nasdaq's +44% return last year did not even generate a new high, with a roughly 10% distance still separating current Nasdaq price levels from its late 2021 price.

The house view at The Bahnsen Group is that the bull market of 2009-2021 is not the same market we are in now. Post-GFC multiple expansion, earnings acceleration, and Fed-driven financial repression are all behind us. Any number of positive or negative things can happen in the years ahead, but we see the market as in a period of range-bound choppiness, hindered by high valuations, the Japanification of U.S. economic growth (and policy tools), and various distortions brought about by excessive monetary intervention that limit market normalcy.

# 2023 REPORT CARD:

## 1 INFLATION IS HEADED WAY LOWER

**A+**

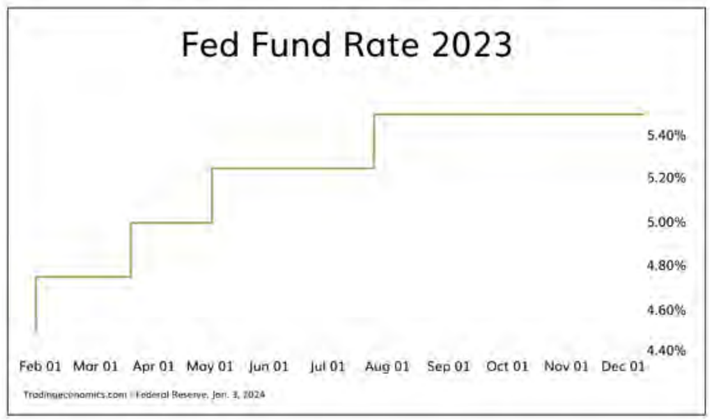
Headline inflation peaked in 2022 at 9.1%, and ended 2023 at 3.1%. This was not a difficult prediction to make given two operating premises: (1) The bulk of 2022 inflation was a result of the COVID shutdowns of 2020-21's impact on supply; (2) The impact to supply from COVID shutdowns was largely over. If either of those premises were wrong the disinflationary conclusion for 2023 would have been wrong, as well. Fortunately, the premises and conclusion forecast were validated.

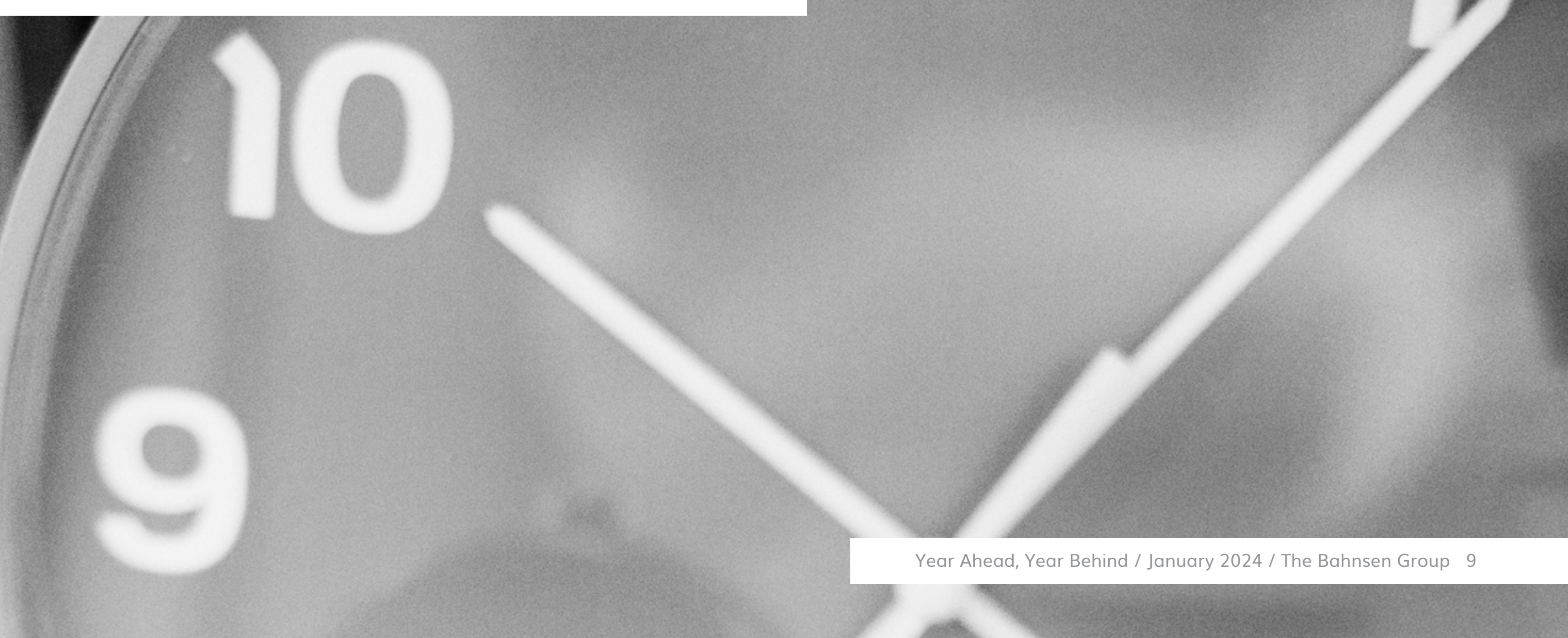
Core Goods inflation is somewhere around 0%, teetering with deflation, as China's weak growth and a return to global supply normalcy has expedited this economic inevitability. Shelter inflation has been the sham of 2023, as the lag effect of measuring rents with leases signed a year prior has taken time to work its way through the data. That lag is not normal in the history of the data because having huge run-ups in rent levels are not normal (like 2020-2022 represented), thereby exacerbating the impact in the data in 2023. Downward pressure in measured shelter inflation in 2024 will push the headline CPI measurement to the 2%-2.5% range, rendering a forecast on this metric for 2024 unnecessary.

## 2 THE FED FUNDS RATE WILL BE LOWER AT THE END OF THE YEAR

**F**

This is pretty empirical stuff – The Fed Funds rate started the year at 4.25% and ended the year at 5.43% (within the Fed's target range of 5.25-5.50%). That means it went higher, not lower. I was wrong.



## 3 S&P EARNINGS WILL TELL YOU THE TRUTH OF THE RECESSION

A+

I believe this call was not only accurate, but contains the underlying story of markets and the economy in 2023. Here is what I wrote a year ago:

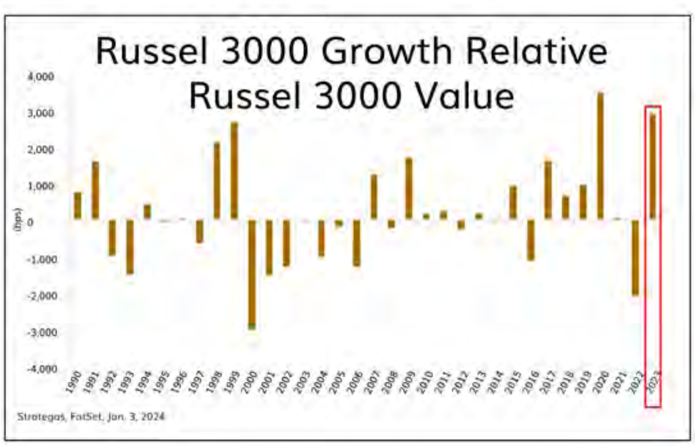
"I do not accept this new talk that we can have a recession without unemployment ticking higher, any more than I accepted the idea that we can have a recovery where jobs do not return. At the core of the definition of economic expansion and contraction is the activity around jobs, wages, and profits. If we are going to have a recession in 2023 then expectations for profits are currently too high, period."

Corporate profits ended up actually outperforming expectations in 2023. The idea that we would have a recession where corporate profits stayed benign was like saying that it would rain but no one would get wet (I made that analogy up myself). This proved prescient in the benign profit, recession-less year of 2023.

## 4 VALUE OVER GROWTH, AGAIN

F

Like the Fed Funds rate call, this can be graded quite empirically. In 2022 value trounced growth by twenty percentage points. In 2023, growth defeated value for all of the reasons discussed elsewhere in this paper. Value, did, however, end up with a robust double-digit return for the year. It just did not achieve the return that growth did in the 2023 calendar year.




If I wanted to push my luck I would make the growth/value call another theme in 2024, breaking my tie over the last two years. But alas, I have a feeling readers know how I would vote there.

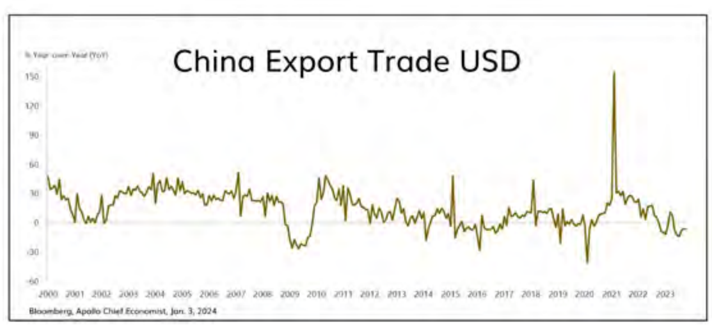
## 5 DO NOT UNDER ESTIMATE THE CHINA RE-OPENING

C-

(Graded on a curve)

This forecast deserves an F. A year ago I wrote of "pent-up demand" after COVID re-openings, of "China's pent-up demand maybe transcending other countries," of a "profound effect on domestic consumption and global trade," of "global oil demand increasing substantially out of a China re-opening" … I could go on and on. This call was wrong, even if we identified it as wrong and began analyzing it as such just a few months into the new year. I am only going with a C- versus an F because (a) I am the teacher here and can do what I want, and (b) In total fairness, every single market commentator, analyst, pundit, economist, and forecaster you will find was also caught dumbfounded by China's underwhelming re-opening. That doesn't change the call that was made, but as my 7th grade son recently found out in English Literature, grading on a curve changes the grade when the whole class bombs the same test.

Ongoing challenges in the frothy Chinese construction and property sector can be blamed for plenty of what ails them. Governmental and even cultural differences can explain some of the different appetites and behaviors out of COVID re-opening (versus the rest of the world). But more than anything else, China's export-driven economy saw significant slowdown in trade. As global trade goes, so goes China's domestic economy.




But yes, this one did warrant further discussion in our 2024 themes. If someone is talking about the global economy without talking about China, they are doing it wrong.

# 6 EMERGING MARKETS TURN IN THE SUN IF DOLLAR WEAKENS

**B**

The hedge given was intentional – it would take a reversal of dollar strength to see earnings growth and attractive fundamentals over-conquer currency impact when it came to emerging markets as an asset class. Alas, emerging markets ended up performing directly in reverse correlation to the U.S. dollar this year, and in periods where the dollar declined emerging markets did, indeed, rally. A significant rally in the dollar from July through October reversed a lot of EM gains, yet like all other risk assets, a rally to close the year gave the emerging markets space a nice return on the year, as the dollar ended up down relative to global currency counterparts just modestly.


# 7 HOUSING: IT'S GOING LOWER, BUT IT'S NO 2008

**B-**

There are a lot of ways this theme could be scored. If anyone feels housing had a great year in 2023 I would like to meet them (I assure you I have met people over the years who would tell me that their house was up +25% in value last year). By all practical measures, housing most certainly avoided any kind of 2008 moment. Prices did not collapse. Forced selling was nowhere to be found. Foreclosures and defaults are minimal. Those whose purpose in owning a home is to tell people what it is worth are sitting pretty. But, of course, there is another side to this coin. All at once, the three elements most relevant to housing were quite problematic. First, affordability remains at record lows between stubborn price levels and significantly higher mortgage rates. Second, volume of activity has come to a standstill. And third, new supply is not nearly coming online quickly enough to meet demand and clear the demand in the market.

The story remains the same for 2024: A sudden increase in price levels seems unlikely based on current affordability, just as a sudden drop in prices seems unlikely based on mortgage rates having topped out and supply being so limited. The question is whether a clearing level will be found that satisfies buyers and sellers when rates normalize.

# 8 CHINA, RUSSIA, AND GEOPOLITICS WILL WEAKEN GLOBAL STABILITY BY THE END OF 2023

**A**

Who wants to disagree with this? The context of the theme was that Sino-Russia relations would take on an increasingly anti-western direction in 2023. They did. Additional geopolitical instabilities were unforeseeable but nevertheless did surface (Israel/Hamas/Iran, Venezuela, North Korea). Putin's strategy of waiting out western resolve around Ukraine appears to have worked. I can think of no country in the Middle East where U.S. relations are stronger now than they were a year ago (the Saudi dynamic may not have worsened a great deal, but it hasn't improved).




# 9 CONSENSUS SKEPTICISM ON PRIVATE MARKETS IS WRONG

A

This was an easy A grade as private debt not only had a fantastic year, free of defaults, free of impairments, free of price volatility, and free of drama, but even saw the already robust yield level escalate as the floating rate nature of much private debt ratcheted higher, pushing total returns into the double digits across the assets class. Not only did the asset class avoid quality impairment and did yield levels float higher, but the opportunity set expanded significantly as the capital markets world turned more and more to private markets solutions outside of the traditional banking system and bond market.

The attraction of new capital in 2023 will test underwriting discipline in 2024, but the anti-fragility of the asset class through this severe of a Fed tightening cycle is a real testimony to the future of this space for risk takers.

# 10 THE ENERGY STORY IS NOT DEAD

A

This may seem like a generous grade considering the broad energy sector was only flat for 2023 and energy commodity prices were all negative. However, the context was clearly about "reduced capital expenditures, lower debt levels, and increasing free cash flow" all benefiting the midstream sector in particular (where 72% of our energy exposure lies). Robust returns across the midstream space validated this call, as did the 25% annual return (for the third year in a row) in the MLP space. Export LNG is nowhere near its peak capacity, heavy hostility towards new pipeline approvals has bid up the economic value of incumbent assets, and financial market activity in the space has been reasonably (not perfectly) encouraging.

**Total: Five A's, two B's, one C, two F's**

# 2024 THEMES:

## 1 FED PARTICULARS WILL BE OVER-RATED

*The media will be focused on the Fed, but earnings, valuations, and geopolitics will trump specific monetary policy decisions.*

The Federal Reserve will cut rates in 2024, but the magnitude of cuts will not matter as much as many prognosticators think. The "will they/won't they" drama in March and thereafter will enhance "day of" volatility (see #8), but it will not be material to full year market performance.

Market history has provided moments where the Fed cut rates and markets still suffered (2001 comes to mind). Of course, there are plenty of moments where the Fed cut rates and markets went higher, too, but causation is difficult there. Market expectations for the direction of monetary policy and the terminal levels matter far more than specific cuts at a specific point of time. In this sense, it is priced into markets that the Fed is going to be cutting, and the tightest part of the cycle is behind us. That development created a historical Q4 2023 rally, but says nothing about 2024.

There are those who worry about a surprise Fed pivot off of their pivot (in other words, reversing back to a more hawkish posture). The odds of that happening are not 0%, but they are close to it. The Fed is well aware that it is an election year, and that $750 billion of corporate debt has to be re-financed in 2024, and that $500 billion of commercial real estate debt is set to be re-financed (rate resets). They administered policy with deep knowledge of these "fiscal walls" the last couple of years, and we would be very skeptical that they would run into any further distress at this point.

The fact that most "floating rate" borrowers of a smaller size in earnings and capital strength seem to have survived the tightening in 2023 as they have is shocking. And yet, the data is what it is, and now over a trillion dollars of floating rate borrowed money will begin costing borrowers less money in the months and quarters ahead. The positives here are both in avoidance of distress events, but also in the enhanced earnings that is likely to result.

Could this optimism be premature? Could 2024 prove to be a year of reckoning from the lag of tightening over the last 18 months? Again, the odds are not 0%, but the likelihood is low given the forward-looking nature of markets.

# 2 BIGGEST CONTEST OF 2024: DEGLOBALIZATION VS. PRODUCTIVITY BOOM

*We are sitting on a rare, unappreciated possibility for an upside surprise, and no one seems to care.*

How many times do market pundits write about what can go wrong? How much time do investors spend thinking about risk and downside? It's understandable that 95% of time is spent in that space – defense can be offense, and loss hurts investors psychologically more than gain benefits them (inescapable human nature). Yet what is something that "can go right?" What is an unappreciated upside risk that warrants further analysis?

Deglobalization is often presented as a positive thing to the extent it theoretically means re-shoring jobs previously moved offshore. A justifiable skepticism exists that this will play out as cleanly as some suggest, but it also carries a threat to economic growth. If the initial benefit of globalization was greater access to markets, more advantaged cost structures, and a wider customer base, then by definition deglobalization means (to some degree) lesser access to markets, higher cost structures, and a narrower customer base.

But facing these possibilities, there are counter-factuals that have to be explained. Rene Aninao of Corbu describes this as the "something is going on" phenomena. Unemployment is well below 4% despite two years of monetary tightening. Inflation has decelerated rapidly. Financial conditions are actually quite constructive (less constructive than they had been but nowhere near as restrictive as feared). And corporate profits are at record highs (and expected to grow further). These conditions suggest a productivity boom playing out in the midst of excessive debt, poor business sentiment, and the expected headwinds of degloblization.

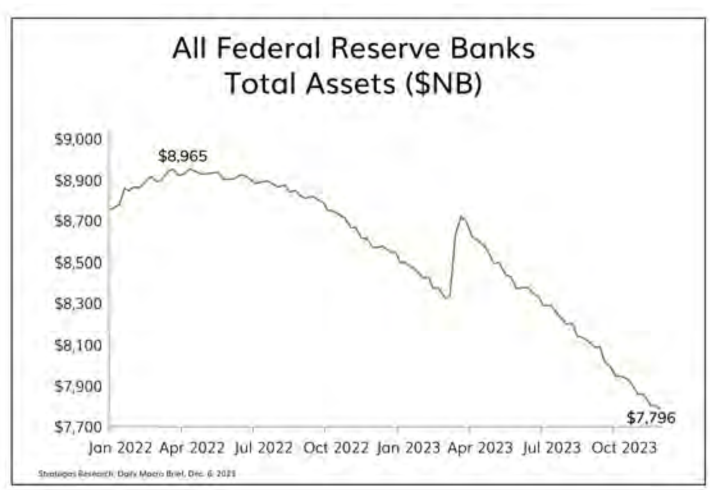
2024 (and thereafter) will either see a productivity boom out of a reinvigorated capex cycle, wise investment into growth sectors, and a renaissance for the industrial and manufacturing part of our economy, or the marginally negative reality of deglobalization will win out. We will not necessarily see the final round of this match in 2024, but the fight will begin and there will be a judge's scorecard, assuming geopolitical reality (more in theme #9 below) doesn't undermine this story via substantive damage to the supply chain.

# 3 QUANTITATIVE TIGHTENING IS THE UNDERRATED STORY, ONE WAY OR THE OTHER

*The Fed will not get to reduce another $1 trillion from their balance sheet, and may end up adding to it by the end of the year.*

The Fed has signaled they are ready to begin cutting rates, showing in their own dot plot three rate cuts in 2024 (even as markets anticipate six cuts equaling 150-175 basis points of a reduced federal funds rate). The obsession with rate policy has distracted conversation from the other monetary policy tool most responsible for tightening financial condition this cycle – quantitative tightening. The Fed has successfully reduced over $1 trillion from their balance sheet since they began, and has said they intend to continue reducing their bond holdings by $80 billion per month (another $1 trillion).

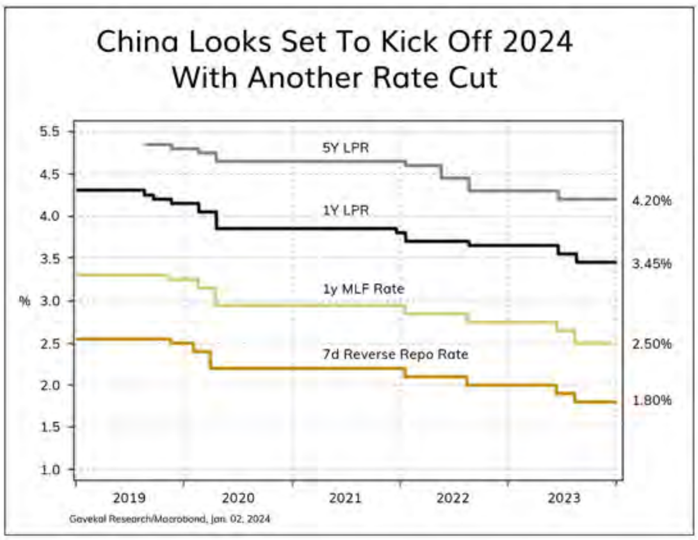
While financial conditions allowed this level of tightening without credit market reaction, a 2024 theme will prove to be a policy pause or reversal of this intention. Bank reserves, financial market liquidity, and complexity in the reverse repo market will all work to reclaim the position many of us (including Jerome Powell in 2013) have had since QE became a part of the national lexicon – getting a patient off of the medicine is a lot harder than getting the patient on it.



# 4 CHINA TO SPLIT THE BABY ON JAPANIFICATION

*A fiscal response to their economic woes could be useful if it was focused on deregulation, but it won't be. Their monetary plans are the bigger question.*

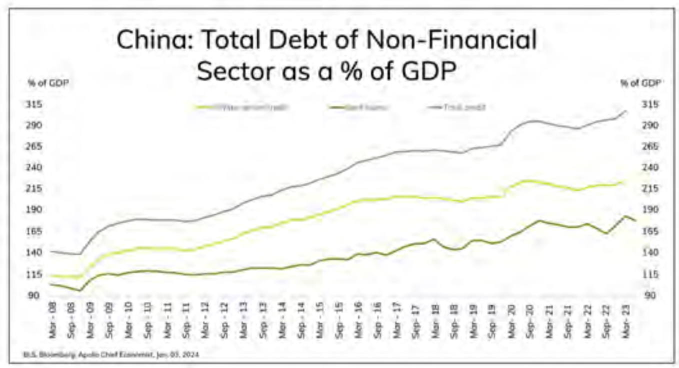
2023 was a year of global monetary tightening, with central banks all over the world (led by the Fed) continuing their 2022 practice of hiking interest rates and squeezing liquidity out of the financial system, right? Well, that is certainly true, as long as the second largest economy in the world is excluded from that description. The People's Bank of China (PBOC) cut policy rates across the board multiple times in 2023, and we enter 2024 with China's precarious economic position the most significant variable in the entire global economy.




China faces deflationary pressures that have become par-for-the-course for large overly-stimulated, overly-indebted economies after years of excess and mal-investment. The "Japanification" story that has played out in this generation in Japan, and the United States, and the European Union, appears ready to work its way through the growth darling of the last 25 years. What is unclear is whether or not China will respond in kind – that is, will they liberally use fiscal and monetary policy tools to a point of counter-productivity as their economic rivals have, in an attempt to export their deflation around the globe.

A very likely scenario is that fiscal policy will be part of the 2024 prescription to counter falling growth. It is even likely that some of this could work, especially where it is limited to removing highly unproductive policies that currently serve as a headwind to growth, innovation, and risk-taking. But a fiscal policy portfolio that limits itself to deregulation in the People's Republic of China is unlikely, and head fakes in the favor of resurgent Chinese growth may not last.

The bigger unknown for 2024 is the extent to which China will utilize monetary policy to counter their economic headwinds. The PBOC has, thus far, used small, incremental rate cuts, wary of signaling a surrender to Japanification. The real estate sector woes in China are deep, and China's own diminished supply capacity (construction, manufacturing, production) assures lower demand and consumption domestically and externally.




China can cut taxes, stop harassing internet companies, and try to put on its best Milton Friedman mask to facilitate modest economic growth. But China's fundamental problems are irresolvable – economic freedom and political tyranny cannot be optimally mixed. That foundation is ill-equipped to deal with the economic issue they face that not even freer western countries have been willing to address cogently – excessively poor resource allocation over time has to be unwound, and distortive fiscal and monetary treatments only exacerbate the problems over time.

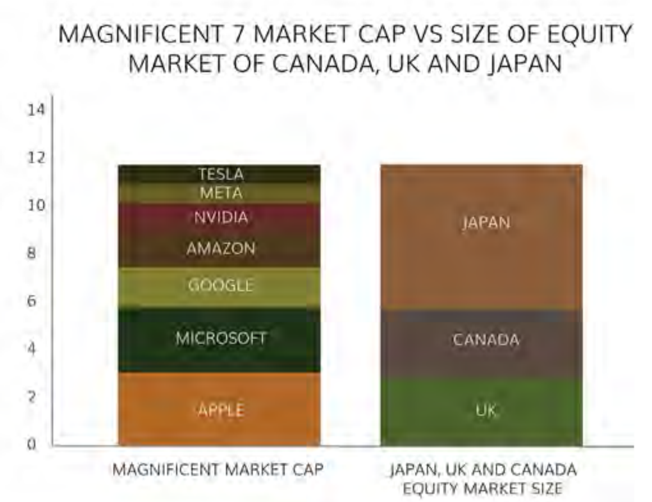
The most likely scenario is that 2024 will see some modest and temporary benefit out of fiscal tools, and that the PBOC monetary direction will dictate how serious China is about exporting their deflation. A surrender to Japanification may rally global markets in 2024, and may doom global growth further in the years ahead.

# 5 BROADER MARKET PARTICIPATION

*The market's reliance on just 5-10 companies is unsustainable, and the sooner this trend is reversed the better (if history is any guide).*

It first has to be pointed out that this trend is already underway, and that the breadth of the market rally in the last two months of 2023 was quite impressive. While the full year 2023 market action was still extremely top-heavy, there is ample reason to believe that this theme for 2024 has already gotten a good head start. Forecasting exactly what markets will do in 2024 may not be possible, but forecasting that another year of just a few mega-cap tech companies providing all of the return is off the table seems reasonable to me.

In 2020 one of the extraordinary realizations was that, at one point, the entire energy, consumer staples, utilities, and materials sectors – all put together – had a lower market cap than just two U.S. big tech companies. Suffice it to say, the reversal of that over the next two years was violent. Likewise, entering 2024, this dynamic seems unsustainable:



Bloomberg, Apollo Chief Economist, Jan. 3, 2024

Seven companies being 30% of a 500-company index is outrageous. Now, if their earnings were 30% of the index, that would be one thing, but even by that metric (with an adjustment for forward growth), the weighting is disproportionate to reality, and subject to adjustment.

The good news for those more sanguine on the "magnificent seven" than we are is that there are two ways for the weightings to adjust. Sure, they can depreciate in price, and maybe they will. But that is not the essence of this theme. Broader market participation from the areas that were less involved in 2023 price action also levels the playing field to some degree.

There are two types of equity investors who should be hoping for a reversal in this top-heaviness: those who own the  top-heavy names, and those who don't. History is crystal clear that these weightings either mean-revert the easy way, or the hard way.

# 6 2025 EARNINGS WILL DICTATE 2024 PERFORMANCE

*In the second half of 2024 we may see revisions to 2025 earnings expectations, up or down, that will determine 2024's equity market behavior.*

In 2023 it appears that S&P 500 companies achieved about $221 of earnings, with expectations for $245 in 2024 (+11%) and $275 in 2025 (+12%). A bigger risk to markets in 2024 is 2025 revisions than 2024 under-performance. Markets are discounting mechanisms. 2024 pricing will largely be driven by 2025 expectations, at least in the second half of the year. Right now earnings expectations feel excessively optimistic if 2024's earnings growth is to materialize (12% growth on top of 11% growth in successive years).

# 7 THE ELECTION WILL BE THE TOP NEWS STORY OF 2024 AND THE FIFTH PLACE MARKET STORY

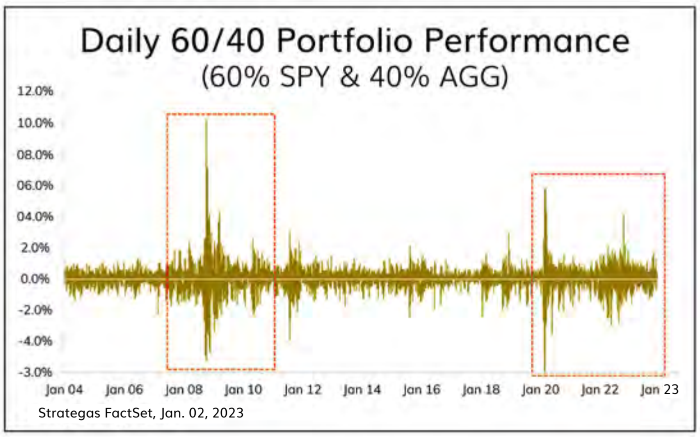
40% of world GDP is electing a new head of state in 2024. It is a serious year around the globe when it comes to power and policy. Here in the United States, the last sixteen Presidential "re-election" years have been positive for stocks. And while many would argue that incentives exist for incumbents to do things that help markets in pursuit of their re-election prospects, one has to wonder what that could entail in the present moment? The Fed has a much more important lever on the economy at the moment than the President does, let alone the Congress. Attempts to curry favor with social programs and debt forgiveness are politically risky in their optics, and neither side of the aisle is likely to go for anything that pushes already explosive budget deficits higher. Debt ceiling debates will probably ~~bore us again~~ receive media attention again, but really the major market ramifications of 2024 politics will not be before the unpredictable election, but after. What if President Trump is convicted? What if he is acquitted? What if an unexpected candidate ends up on the ballot for either party? Any of these things can, and will, add to volatility, but they will all be sorted through as the noise that they are. In the end, our country if a 50-50 country politically right now, and even when the President-elect is known, the state of the House and the Senate and the national mood all impact what may happen for drug policy, for energy policy, for tax policy, etc.

I expect a profoundly upsetting 2024 in American culture. And I expect this to be no market story at all.

# 8 FASTEN YOUR SEATBELT FOR TEN MINUTES OF TURBULENCE, A LOT

*Daily volatility to remain elevated, with ample opportunities for stock and bond volatility to tier up even higher.*

This is hardly a forecast for something new in 2024. Consider the increase of daily volatility (which cuts both up and down) since COVID compared to the decade in between the financial crisis and COVID. Stock and bond markets are more susceptible to enhanced moves up and down, quick-trigger responses to the news cycle, and, of course, Jerome Powell press conferences.




2024 is going to be ripe for a market already prone to unproductive zigging and zagging. In addition to the normal market environment that has facilitated a higher volatility regime, we face the possibility of economic ambiguity, monetary ambiguity, political ambiguity, and geopolitical ambiguity. The way in which a news story plays out over a full year, or even just a quarter or month, may be perfectly benign for a given asset price, but consider the possibilities on the horizon in 2024 for intra-day and intra-month market reaction.

Before the exciting stuff, there is the just vanilla macroeconomic. Imagine a higher-than-expected inflation reading one month and what that may do to traders forecasting the Fed. Or imagine an inflation reading lower than expected and how that may jerk the futures expectations the other way. On the other hand, imagine the Fed loosening more than expected because of actual recessionary conditions re-surfacing (I promise you that is not out of the question). In all of these cases different catalysts with different causes could all create short-term volatility spikes that mean nothing to the actual fundamentals and direction of markets.

But that is just the boring stuff – inflation, interest rates, the Fed, etc. Can we see scenarios whereby global geopolitics spikes volatility? It does not seem to be a reasonable expectation to believe that 2024 will end with the Russian invasion of Ukraine in the same state it is now. It is outside of the skill set of an economist or portfolio manager to assess the strategic and military landscape, but it is also the simplest conclusion to draw that ample opportunities exist for the situation to worsen (or improve) over the next year. The political challenges to maintain funding support for Ukraine combined with renewed intent from the Putin regime to overtake Kyiv leave that matter wholly unpredictable in capital markets. A treaty where Ukraine agrees to some surrender of land to Russia more favorable to Russia than pre-2022 conditions in exchange for an end to the war is possible but hardly likely. A complete Ukrainian victory resulting in a complete Putin exit is also possible, theoretically, but not worthy of strong odds. A 2024 in which there is headline risk around escalation and even land gains by the Putin regime has to be on the table.

Ukraine and Russia are hardly the only international incident, I should add. Israel/Hamas, Iran, China/Taiwan, North Korea – the list goes on and on. It is nothing new, but it sits inside an especially sensitive period for markets in terms of knee-jerk reactions.

And did I mention our own election, with immense cultural and political polarization, a former President under controversial indictments running for re-election, an electorate divided as close to 50/50 as we have ever seen, and immense opportunity for market reaction to an expected slew of news events? Use your imagination if you must.

# CONCLUSION

At the beginning of 2023, a whopping 85% of economists surveyed by the Financial Times predicted a recession in 2023. Consensus opinions are wrong, a lot, and we enter 2024 wary of much of the consensus.

Equally dangerous is formulating an opinion just to be out of consensus, devoid of reflection and analysis. Being wary of a boat with all the people on one side is one thing; finding a boat no one wants to be on is another. We enter 2024 with enough ambiguity – adding the complexity of popularity (or unpopularity) to the mix is obnoxious.

If someone had a crystal ball and knew how many times the Fed would cut rates in 2024, what would happen to the economy this year in terms of the unemployment rate, who win would the election, and what Nvidia's top-line sales would be, that person would still lack any coherent ability to predict investment markets in 2024. And more importantly, that person would still face the multi-year challenges that all investors face.

As we enter 2024 financial market realities exist that pre-date COVID, that force some kind of post-COVID equilibrium in the economy on which far too few investors are focused. Get on either side of COVID, of the Fed tightening, of the Presidential election – one way or the other, we still face an economy experiencing generational sub-par growth, a market often driven by popularity of just a few names, and a policy regime that, despite good intentions, has created significant distortions in capital markets.

There is no way to predict the unpredictable, as many investors learned in 2023. Fortunately, wealth management is not, never has been, and never will be, about prediction. It is about principles. That's right – principles, not prediction. That is the essence of wealth management across the accumulation, withdrawal, and transfer stages of an investor's life.

To these ends, we work.

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