Happy New Year! As it turned out, 2023 was a year of recovery in both stocks and bonds, though that seemed anything but a forgone conclusion back in October. Both equities and fixed income rallied in November and December as the Federal Reserve signaled its intent to not only halt the rate increases, but to cut rates in 2024. In December alone, the US aggregate bond market increased 3.8 percent which was almost 70% of its full year return of 5.5 percent. The DOW Jones, S&P 500, and NASDAQ increased 4.9, 4.5 and 5.6 percent respectively for the month (Reuters). Currently markets have six 2024 rate cuts priced in; while we think that may prove to be too many, we also believe the first rate cut is likely to come as soon as March.

Lisa Shalett, our Chief investment Officer, writes in this month's On the Markets, that "Investors will likely remember 2023 as a great year… But for economists, strategist, and financial advisors, 2023 will be studied for years to come" as a year that completely defied history and expectations. "Many well-worn paradigms broke in 2023. Consider that it was the first time in decades that rapidly rising interest rates neither destroyed aggregate demand nor dented corporate profits. Thanks to roughly 15 years of balance sheet repair and negative real rates, the US economy was essentially rendered rate-insensitive."

2023 certainly defied our team's expectations. Our January 2023 outlook proved to be far too gloomy as did Morgan Stanley's and Wall Street's in general, though we did correctly predict that bonds would rebound from their worst year in 50 years after the negative returns of 2022. Our team eventually turned more bullish, but it took until October when we began to expect a Fed signal on rate cuts was imminent based on improved inflation readings.

What are our predictions for 2024?

1) We think other investments outperform the Magnificent Seven. Last year's big winners tend to be this year's laggards. We continue to favor the "Wee 493" as they have been dubbed – which is just our way of saying, everything but the Magnificent 7 stocks that produced most of the gains in 2023. The strategist most closely aligned with our thinking on our first prediction is probably Richard Bernstein. He wrote an excellent year-ahead outlook back in December that highlights many of the data points we are also focused on and reaches many of the same conclusions. Chief among them: risk seems excessively concentrated in Mega-cap US Stocks where good earnings may nevertheless disappoint markets. On the other hand, like Bernstein we especially like US small cap stocks, US cyclical stocks, international and emerging market stocks. Bernstein also notes that industrials could also perform well if this period of deglobalization continues. Lisa Shalett also agrees, writing in her weekly commentary on January 8th that investors should "favor value over growth, and SMID and large cap over megacap."

2) **Contrarianism and diversification pay dividends in 2024.** We think that diversified portfolios could do reasonably well again in 2024, despite a series of challenges. Morgan Stanley's Global Investment Committee thinks that "US Equity and fixed income returns are both likely to be in the mid single digits" for the year. On a more global equal-weighted basis, stocks look inexpensive by historical standards (WSJ). Corporate profits for most companies seem to have troughed late last year and be on the upswing. After not offering any yield for a decade, bonds are poised to offer not only 4-5 percent nominal returns, but 2.5 percent real returns after adjusting for inflation (Fred). As Bernstein notes in the piece linked above, while the average investor is

about 2.5 times more aggressively positioned today than they were after the bear market of 2007-2009 (by itself that would be an extremely bearish reading to a contrarian) all the risk looks to be concentrated in one country and one sector – US Mega Cap technology stocks. That leaves a lot of space to find good returns on overlooked high-quality investments.

3**) We think 2 percent inflation is likely no longer a cap on the inflation rate, but a floor** – meaning the Fed is going to still shoot for 2 percent, but the actual rate will generally be above 2 percent rather than below. We think the Fed is going to be motivated to take their foot off the brakes in an election year and that doing so is inherently inflationary, all else held equal. That said, the Treasury's ability to further engage in deficit spending will likely be constrained in 2024 -- at least until after November. So, we aren't predicting runaway inflation – just inflation that is higher than the average of the 2000-2020 period. Morgan Stanley's Strategist Michael D. Zesas wrote an excellent 2024 early election guide in which he notes that "we expect fiscal expansion could only be supported in the event of an exogenous shock to the economy—like a recession, which is not in Morgan Stanley & Co. economists' most recent base case forecast." That sounds right to us. Don't be surprised if full year inflation in 2024 comes in again between 2.5 and 3 percent as it did in 2023. Extending this thinking, we are skeptical the Fed actually provides the full 6 rates cuts currently anticipated by markets in 2024 – absent a bona fide recession. That may create some volatility later in the year. It also means investors should expect higher-for-longer rates and incorporate that into financial planning decisions.

4) Investors will spend most of the year worried that election results will dramatically impact markets, but in our opinion they shouldn't. We are not saying that elections don't matter in the long run. Our prediction is simply that no party emerges with the kind of mandate (or even control) that would be necessary to dramatically alter the direction of things so far as markets are concerned. While small changes at the margin are almost assured, the endless predictions of economic doom by both sides will ultimately prove incorrect. After the election in 2016, Republicans held the House, the Senate, and the Presidency and markets immediately rallied on the expectation of tax cuts/stimulus (Congress). After 2020, Democrats held all three and markets immediately rallied on the expectation of increased deficit spending/stimulus (Congress). We think 2024 will end up a as a sort of split decision and any immediate market fallout will be more muted. That said, the markets will become focused on politics to a more-than-normal degree after the election and early in 2025 as the majority of the Tax Cuts and Jobs Act of 2017 is set to sunset on December 31st, 2025.

We look forward to working with you in 2024. As always, if you have any questions or concerns, please don't hesitate to reach out to any member of the team. We hope you and your family had the happiest of Holiday Seasons and enjoyed some well-deserved time off and time together.

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