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January 9, 2024

"Bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria." – John Templeton

"The challenge with waiting for reversion to the mean (meaning a return to historical relationships) to occur is that it is not unusual for reversion to the mean to take longer to occur than many investors have patience to wait." – Charles Rotblut

Fellow Investors:

What a difference a year makes. Following 2022's historic double whammy of both stocks and bonds declining by double digits resulting in a negative return of 16% for a 60% equites/40% fixed income portfolio, we saw a refreshing turnaround in 2023. The 60/40 portfolio rebounded to an 18% return with both stocks and bonds contributing. For the above we use the S&P 500 Total Return Index for the equity returns and the Bloomberg US Aggregate Total Return for fixed income. For most of the year, the performance of the S&P 500 was driven by the seven stocks now generally dubbed the "Magnificent Seven" (MSFT, AAPL, AMZN, NVDA, GOOGL/GOOG, META and TSLA), however we did see an encouraging broadening of the market's return in the latter two months of the year.

The S&P 500 ended the year with a total return of 26.3% compared to a negative 18.1% return in 2022. Small caps as measured by the Russell 2000 returned 16.9% in 2023 versus a decline of 20.4% in 2022. Developed Markets also returned a healthy 18.9% in 2023 using the MSCI EAFE as a measure. Of course, we must point out the concentration in the S&P 500 to appreciate what this turnaround might mean for the average investor. The "Magnificent Seven" currently comprise 27.5% of the S&P 500 index and the top five account for 24%. Still a highly concentrated index for which to compare a more diversified portfolio. In 2023, the top ten stocks in the S&P 500 accounted for 62% of the full year return. As mentioned above, this lopsided contribution to returns held for most of the year, but we saw a healthy broadening toward the end. According to analysis done by First Trust, the Mag Seven accounted for over 100% of the S&P return through October, but for the year they only accounted for 60.2%. In December alone the Mag Seven only accounted for 17.2% of the index return while the other 493 stocks contributed 82.8%. Quite a change in balance from the first ten months of the year when the other 493 stocks provided a combined negative return. If this broader market participation of positive returns along with solid performance from smaller capitalization equities continues, it will be a welcome environment for individual investors.

While the equity indexes did a major turnaround year over year, we were also fixated on the Fed, interest rates and inflation. Inflation came down from a 12-month (period ending November 2022) CPI increase of 7.1% in 2022 to 3.1% for the 12 months ending November 2023. Keep in mind this is a reduction in the rate of price increase and not a reduction in prices, and this is still persistently above the Fed's goal of 2.0%. Aggressive interest rate increases in 2022 and into 2023 certainly helped in bringing down the inflation rate, but credit is also due to the reduction in the money supply. The latter exploded in the early part of the current administration but has contracted 3% over the last twelve months. See chart below courtesy of YCharts.

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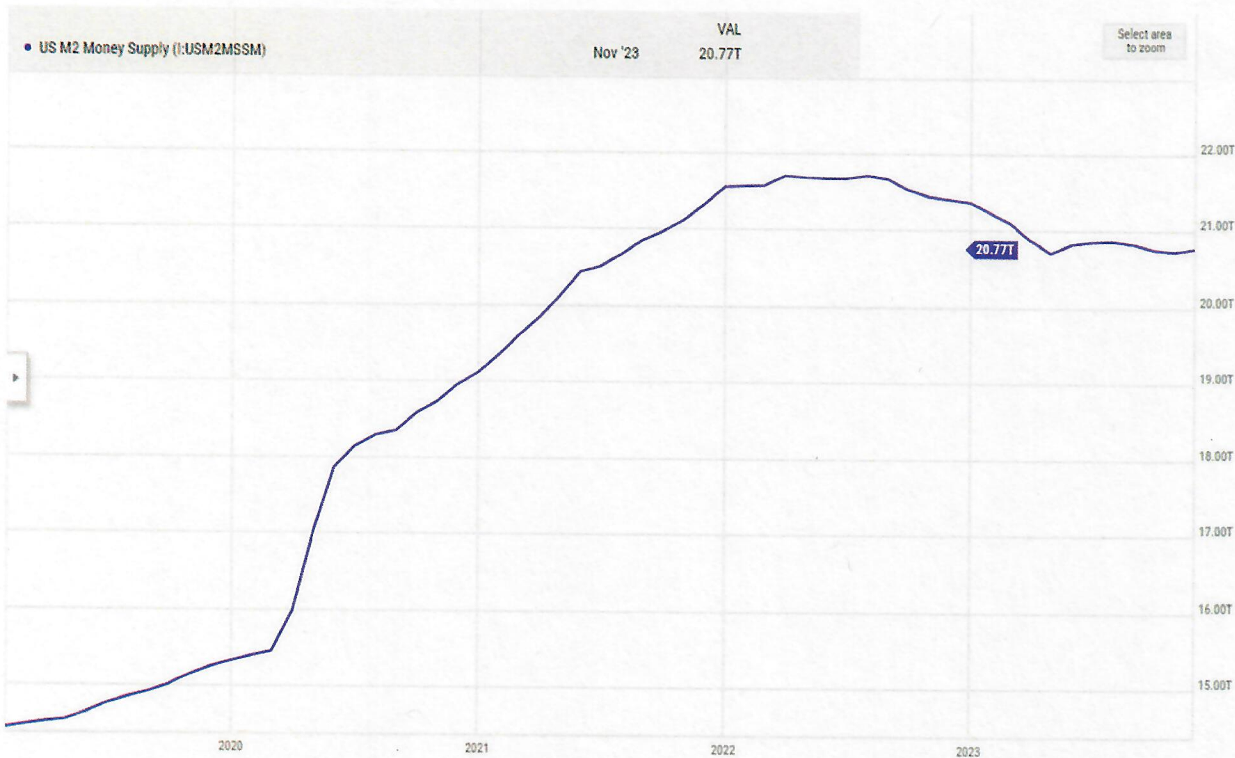

The 10-year treasury yield peaked in October and came down about 1.0% from there to the end of the year. Recent Fed messaging has added some confusion to the markets as the expectations are that rates have peaked, and the question now becomes when they will cut rates and how much. This was a shift in messaging from "rates will stay higher for longer" to fight the last vestige of inflation. The bond market is pricing in a 1.50% decline in rates for 2024, but the concern here is that the inflation job is not done. Much like trying to lose weight, the first eight pounds are much easier than the last two, and as far as inflation goes, we are now battling the last two pounds. Short-term rates have remained high, reflecting that inflation is still a concern in the near term. The declining longer-term rates indicate the market's view that the battle will eventually be won. We shall see. It should be noted that the longer-term rates are very much in line with long-term historical levels, and we should not be expecting a return to the near zero rates of the recent past. Inflation is one of the biggest scourges to a growing economy, so we must hope the Fed succeeds in bringing it down. There is concern that the Fed may ease too soon in order to accommodate the election. The Fed is intended to be independent and free of politics. Let us hope they maintain that.

The first week of the new year did bring a mild sell off in equities, particularly in the big winners of 2023 as well as an uptick in rates. With the large, concentrated gains of 2023, it is expected that we would see some significant rebalancing and it is expected that investors and fund managers would do this in the new year to push off the capital gains taxes by another 15 months. A potential positive for the full year is an estimated $6 trillion being held in money market funds. Eventually that money must go somewhere as short-term rates come down.

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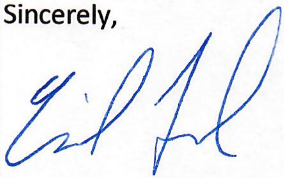
This brings us to the great recession watch. We may be in for the most anticipated recession that never happens. It has been talked about as interest rates increased and the yield curve inverted in addition to other signs so many economists hang their prediction hats on. We are still waiting. We are in the camp that we may very well have experienced and be experiencing rolling sector recessions rather than an economy wide recession and we may not see a broader recession. Employment appears strong, although it is unnervingly concentrated in government jobs. Government does not grow an economy, but rather creates a drag. Also notable is that initial job reports are just that, initial, and are subject to later revisions, sometimes significant. Over the course of 2023, initial jobs reports were eventually revised down by 439,000. The US economy is also seeing a decline in full time jobs partially offset by an increase in part time employment. These are not healthy trends in an economy that is driven by consumer spending. Whether this pushes us into a recession will be seen.

Inflation and interest rates are coming down. Those predicting a soft landing rather than an economy wide recession have increased recently as the economic data seems to support it, contradicting their previous predictions. This would be an accomplishment for the Fed, although we are more inclined to give credit to the resilience of the US economy. Many view the artificial intelligence (AI) revolution as a factor in improving productivity and economic optimism. Again, we shall see, but to be sure it has added enthusiasm. The interesting point to us as far as AI is concerned is that while it will clearly be a positive for the big tech names driving the markets in the past, it has the potential to affect almost every industry and company out there which may be a contributing factor to the broadening of the market.

While not wanting to predict a new bull market, referring to the quotes at the beginning of this letter, there is still plenty of skepticism out there and we need to maintain our patience through ups and downs as the market sorts itself out. And of course, it's an election year. What fun! We wish everyone a safe and prosperous new year.

Sincerely,



Erik Ford

The S&P 500 Index, or the Standard & Poor's 500 Index, is a market-capitalization-weighted index of the 500 largest publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

The MSCI EAFE Index serves as a performance benchmark for the major international equity markets and includes companies in 21 countries in Europe, Australasia, and the Far East (East Asia).

The Bloomberg Aggregate Bond Index is a broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance.

The Russell 2000 Index is a small-cap U.S. stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

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M2 is the U.S. Federal Reserve's estimate of the total money supply including all of the cash people have on hand plus all of the money deposited in checking accounts, savings accounts, and other short-term saving vehicles such as certificates of deposit (CDs). M2 chart from YCharts.

Index return data from JP Morgan Asset Management and YCharts. Indices mentioned are not managed and cannot be invested in directly.

Treasury yield data from YCharts.

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