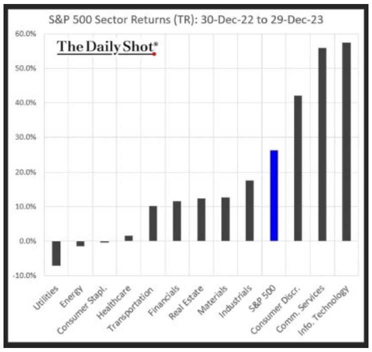

# EQUITY MARKET UPDATE

As of 12/31/23 | Volume 12, Issue 12 | FFTAM.com

Stocks finished the year on a nine-week winning streak, their longest stretch of gains since 2004. Several indexes are within reach of new all-time highs. Inflation cooled and economic data held firm further confirming investors' belief that the Fed is done raising interest rates. Fed Fund futures imply six interest rate cuts in 2024 with the first cut occurring in March. The market appears to have fully priced in the "Goldilocks" scenario of disinflationary growth next year.

The S&P 500 jumped 4.53%. Buying was broad based as all economic sectors increased in value, except for energy which fell 0.08%. Interest rate sensitive sectors like real estate (+8.70%), industrials (+6.96%), and financials (+5.36%) fared the best. The Dow Jones Industrial Average gained 4.93%, while the NASDAQ increased 5.62%. Mid-cap and small-cap stocks were the best performers with boosts of 8.72% and 12.79%, respectively.




The year-to-date story remained the same. Returns were wildly positive, but investors must dig deep into the data because headline numbers are a bit deceiving. The S&P 500 was up 26.26%; however, only three (technology +57.84%; communications +55.80%; and consumer discretionary +42.30%) of the eleven economic sectors outperformed the market. Next, despite the broad-based rallies in November and December, seven companies (Apple +49.00%; Microsoft +58.19%; Amazon +80.88%; NVIDIA +239.02%; Alphabet +58.32%; Meta Platforms +194.13%; and Tesla +101.72%) accounted for 63% of all the money made in 2023! At the moment, the S&P 500 is 0.6% from its all-time high. The Dow Jones Industrial Average (+16.18%) significantly trailed the S&P 500 due to its lower allocation to technology and its overweight of healthcare and financials. However, the index topped 37,000 for the first time and set seven record closes in the final days of 2023. The tech heavy NASDAQ (+44.70%) performed the best on investor enthusiasm about the future potential of artificial intelligence, along with the big tech companies' ability to fund their growth initiatives without accessing the capital markets (therefore making them less sensitive to the rise in interest rates). Meanwhile, mid-cap (+16.39%) and small-cap (+15.94%) stocks trailed the broader market with their overweight exposure to regional banks and unprofitable biotech companies.

The US economy is on firm footing, but in select areas growth is clearly slowing. Segments that are interest rate sensitive like housing and autos have witnessed the steepest declines, while services have held in well. Labor remains the bright spot. December payrolls showed another 216,000 jobs were created. Unemployment fell to 3.7%. Wages were up 4.1% from one

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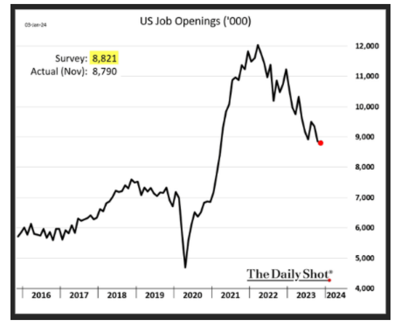


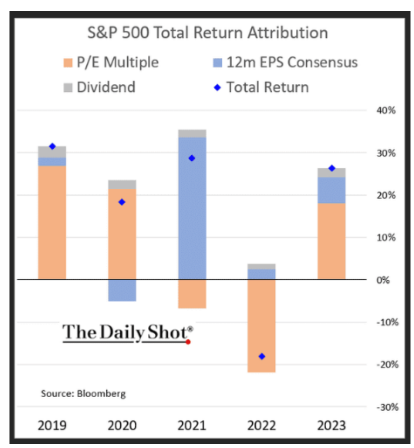

year ago, an amount that far exceeds both the Fed's expectations and the pay raises seen pre-COVID, but down significantly from levels seen earlier in the year. The labor market remains tight, but competition to recruit and retain employees have waned. The JOLTS report showed there are 8.79 million jobs open but unfilled, a large fall from the 11.23 million jobs to start the year.

Consumer inflation receded as prices increased 3.1% from one year ago. Core inflation that removes food and energy prices held steady at 4.0%. PCE data, the Fed's preferred measure of inflation, showed total prices climbing 2.6%, while prices ex-food and energy rose 3.2%. Investors cheered the data because inflation has slowed significantly from the high-water marks seen last year, and it appears to be approaching the Fed's 2% target in coming months.

With inflation cooling faster than wage gains, consumers have found themselves better off in the last two months. Personal income grew 0.4% last month. This helped total spending rise 0.2%, while retail sales increased 0.3%. Even the savings rate ticked up to 4.1%, although it remains well below pre-COVID levels. Can the welcomed relief of the last two months last? It is important to remember consumers have increasingly funded their expenditures with the use of debt. Credit card balances are at record amounts, and debt delinquency is increasing in both credit cards and auto loans, especially among people with lower credit scores. This makes employment the glue that is keeping the economy from slipping into a possible recession; therefore, monthly job releases and weekly unemployment claims are vital pieces of information to watch.

Business investment has cooled substantially as higher interest rates dissuade business owners from further spending, especially for goods. The ISM Manufacturing PMI Index (47.4) was in contractionary territory for a 14th straight month, while new orders (47.1) have declined 16 months in a row. Services remain the engine powering the economy. The ISM Service PMI Index was 50.6, an expansionary reading. Service based employment fell while prices paid for services stayed hot at 57.4.

Collectively, the data shows the Fed is winning the battle with inflation. They held interest rates at 5.50% during their December meeting and began to lay the groundwork for lower rates in 2024. During the press conference, Chairman Powell acknowledged the risk of causing unnecessary harm to the economy by leaving rates too high while inflation falls. He cautioned it is still too early to declare victory and that interest rates may need to stay at these levels if the inflation improvements of the past few months reverse. Meanwhile, the Fed's dot plots show the central bank is prepared to lower interest rates three times next year. This marks the first time in several years that both the Fed and the market are on the same page regarding the future direction of interest rates; however, the two sides remain far apart on the number of cuts needed.




The ferocious rally since November 1st has ballooned valuations. Stocks are trading at 20.3x forward earnings estimates. This is up from 16.6x to start the year and above both the 5-year (18.8x) and 10-year (17.6x) averages despite the higher interest rate environment. The equity risk premium that compensates investors for the excess risks associated with stocks compared to bonds remains historically thin.

We are on the cusp of another earnings season. Currently, analysts are forecasting fourth quarter profit growth of 2.4%. If this comes to fruition, it will mark the second straight quarter of year-over-year earnings growth. For full year 2023, profits are projected to have grown only 0.6%; therefore, the bulk of last year's stock market rally came from the PE ratio of stocks expanding. Analysts have a much more positive view for 2024 with earnings forecasted to grow 11.5%.

With the market trading at higher valuations than the past decade, it is fair to say plenty of good news has been priced into stocks. Investors are fully convinced that inflation and interest rates will be coming down while overall demand for goods and services will remain strong (i.e., soft landing or "Goldilocks" scenario). This is not impossible, but it sets a very high hurdle for both the Fed and the market.

It is also important to keep in mind that the market's projected valuation is heavily skewed by the premiums being assigned to the big tech companies at the top of the index. If you equal weight the names inside the S&P 500, the forward PE ratio drops from 20.3x to 16.8x, a much more reasonable valuation. Economically sensitive sectors like energy and financials trade at even further discounts.

At a time in which the risk-to-reward outlook appears challenging, we are focusing on quality companies with lower valuations, strong balance sheets, and growing dividend streams to enhance returns. Throughout the summer and early-fall, we were building our allocation to interest rate sensitive areas like banks and REITs which proved to be accretive to performance the past two months. Currently, we find defensive areas like utilities and healthcare to be more attractive. Finally, we believe investors with fixed income allocations should continue to lock-in attractive interest rates by purchasing high quality bonds that provide appealing total return profiles through elevated current income with future price appreciation potential, especially if the economy should experience a recession in 2024.