EQUITY MARKET UPDATE

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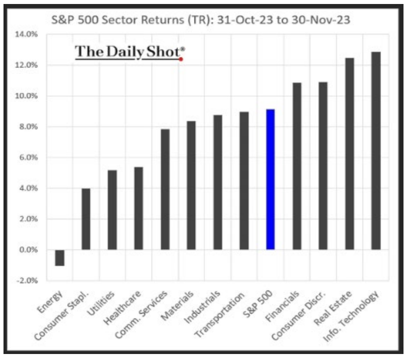
Stocks reversed a three-month skid with their best performance of the year in November. Bonds saw their strongest month for total returns since the mid-1980s! Decelerating inflation and softer economic data led investors to abandon their "higher-for-longer" view of interest rates. Quarterly earnings were also better than expected. The market is now convinced the Fed is done raising interest rates, and Fed Fund futures imply five interest rate cuts in 2024 with the first cut occurring in May. The Goldman Sachs Financial Conditions Index softened by its largest amount in 40 years, which indicates the market has fully priced in the "Goldilocks" scenario of disinflationary growth next year.



The S&P 500 jumped 9.13%. Buying was broad based as all economic sectors increased in value, except for energy which fell 1.00%. Interest rate sensitive sectors like technology (+12.87%), real estate (+12.46%), and financials (+10.92%) fared the best. The Dow Jones Industrial Average gained 9.15%, while the NASDAQ increased 10.84%. Mid-cap and small-cap stocks underperformed their large cap peers with boosts of 8.50% and 8.23%, respectively.

The year-to-date story remains the same. Returns are positive, but investors must dig deep into the data because headline numbers are a bit deceiving. The S&P 500 is up 20.79%; however, only three (technology +52.02%; communications +48.66%; and consumer discretionary +34.12%) of the eleven economic sectors are outperforming the market. Next, seven companies (Apple +47.01%; Microsoft +59.40%; Amazon +73.92%; NVIDIA +220.15%; Alphabet +50.21%; Meta Platforms +171.85%; and Tesla +94.90%) account for over 75% of all the money made in 2023! The Dow Jones Industrial Average (+10.72%) has significantly trailed the S&P 500 due to its lower allocation to technology and its overweight of healthcare and financials. The tech heavy NASDAQ (+37.00%) has 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 (+7.06%) and small-cap (+2.80%) stocks have trailed the broader market with their overweight exposure to regional banks and unprofitable biotech companies.

The US economy is on firm footing, but 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, but it too has cooled. November payrolls showed another 150,000 jobs were created. Unemployment rose slightly to 3.9%. Wages were up

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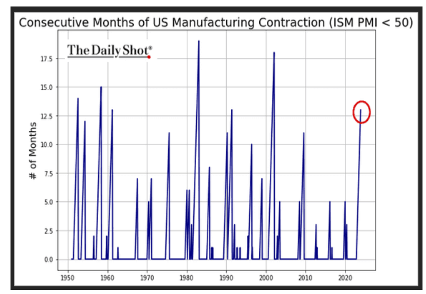
4.1% from one year ago, an amount that far exceeds both the Fed's expectations and the pay raises seen pre-COVID, but down significantly from levels seen earlier in the year. The labor market remains tight, but competition to recruit and retain employees have waned. The JOLTS report showed there are 8.7 million jobs open but unfilled, a decline of over 900,000 jobs from the previous month.

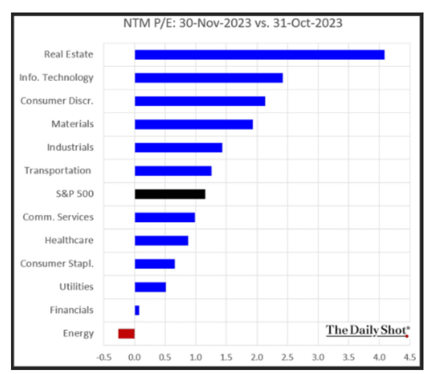
Consumer inflation decelerated as prices increased 3.2% from one year ago. Core inflation that removes food and energy prices slipped to 4.0%. PCE data, the Fed's preferred measure of inflation, showed total prices climbing 3.0%, while prices ex-food and energy rose 3.5%. The data presents a major challenge for the Fed. Inflation has slowed significantly from the high-water marks seen last year; however, levels remain above the Fed's 2% target.

Despite wages growing at a faster pace than pre-COVID, consumers are struggling with the effects of inflation. Total spending rose 0.2%, down sharply from the 0.7% rise the previous month, and retail sales declined 0.1%. The combination of ebbing real income growth, high interest rates, reduced savings, and the resumption of student loan payments are eroding discretionary income. The consumer is increasingly funding their expenditures with the use of debt. The savings rate fell to 3.8%, well below pre-COVID levels. 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.



Business investment has cooled substantially as higher interest rates dissuade business owners from further spending, especially for goods. The ISM Manufacturing PMI Index (46.7) was in contractionary territory for a thirteenth straight month, while new orders (48.3) have declined for 16 of the past 17 months. Services remain the engine powering the economy. The ISM Service PMI Index was 52.7, an expansionary reading. Service based employment held steady while prices paid for services stayed hot at 58.3.

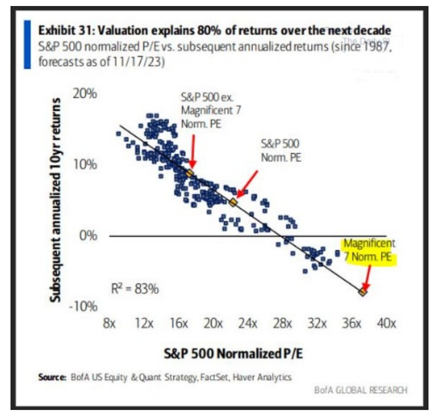
Collectively, the data shows the Fed is winning the battle with inflation. They kept interest rates at 5.50%, but they were cautious to declare an end to their rate hiking campaign. During the press conference, Chairman Powell hinted the central bank may be done raising rates by saying current policy is "well into restrictive territory." However, he hedged his bet by saying "it is premature to conclude with confidence that we have achieved a sufficiently restrictive stance" regarding rates. Powell was confident that rates are high enough to slow the economy and weaken inflation, but the central bank is unsure how long it will take for inflation to return to 2%. He reiterated the need for interest rates to remain at these high levels for an extended period to fully break the inflationary pressures.



Stocks are trading at 18.7x forward earnings estimates. This is up from 16.6x to start the year and above both the 5-year (18.6x) 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.

Third quarter earnings season concluded, and results were better than feared. Profits were up 4.8% from one year ago, ending a streak of negative year-over-year comparisons that began in October 2022. Analysts believe earnings will grow 3.0% in the fourth quarter, a slight downward revision from their previous view of 3.4% growth. They have also decreased their 2024 earnings growth forecast to 11.7% from 12.2%.

With the market trading at similar valuations to the past decade, it is fair to say plenty of good news remains priced into the market. Investors have fully grasped the view 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 is a very tall task for the Fed to achieve. Art Cashin, Managing Director of UBS Financial Services, told CNBC that “historically interest rates take the stairs up and the elevator down” to illustrate the difficulty of breaking inflation without triggering a recession. When looking at the VIX index which measures the level of fear or stress in the market, it is trading at pre-pandemic levels. This indicates investors believe the chance of a recession in the next twelve months is low. Collectively, this places outsized importance on monthly job numbers and weekly unemployment claims since the economy is being powered by consumer spending.



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 18.7x to 15.4x, a much more reasonable valuation. Economically sensitive sectors like energy and financials trade at even further discounts. This tells us that most of the market has already accounted for a meaningful deceleration in economic activity in 2024.

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, but their ferocious rally in November has put that trade on pause. 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.

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