



## Investment Newsletter

Fourth Quarter 2023

During the last nine weeks of the year, the S&P 500 staged its best rally since 2004, culminating in a +11.55% gain for the quarter and a stunning +25.67% total return for the year. International markets were also strong, with the MSCI All-Country World ex-U.S. Index posting total returns of +9.75% for the quarter and +15.62% for the year. The key driver of the rally was October's Consumer Price Index (CPI) report which showed lower than expected inflation. This report triggered a positive inflection point in the fight against inflation, resulting in expectations that the Federal Reserve would now be enabled to cut interest rates multiple times in 2024.

Coming into the year, investors had low expectations because interest rates were still rising and equity and bond markets had both suffered poor performance in 2022. However, a sturdy labor market with low unemployment and rising wages kept consumer spending intact and helped avoid a recession. In addition, technological innovation with the advent of generative Artificial Intelligence (A.I.) ignited the so-called 'Magnificent 7' stocks to an equal-weighted average total return of +111.6% in 2023 versus -46.0% in 2022.

The S&P 500's performance in 2023 was astonishing considering it had to endure a banking crisis, a second new war, weaker post-lockdown growth in China, zero corporate earnings growth (versus original expectations of +4.5%), and pervasive expectations for a U.S. recession that never materialized – in fact, U.S. real GDP growth is now projected to be a respectable +2.4% in 2023 versus original expectations of +0.4%. The FDIC's bail-out of Silicon Valley Bank's depositors earlier in the year, coupled with the Federal Reserve's implementation of multiple liquidity programs for troubled regional banks, not only halted a banking crisis that had gone global, but were instrumental in preventing a recession in the U.S.

Fixed income markets also experienced strong performance in the quarter thanks to October's weak CPI report, which immediately collapsed long-dated Treasury yields. The Bloomberg U.S. Intermediate Government/Credit Index returned +4.56% for the quarter and +5.24% for the year. The Bloomberg Barclays Municipal Bond 1-5 Year Blend Index returned +3.90% for the quarter and +3.76% for the year.

This was an extremely volatile year that featured aggressive monetary tightening with four interest rate increases, a subsequent declaration by the government of a successful fight against inflation, and an end to interest rate hikes. The yield on the 10-year U.S. Treasury Note traded in a wide range of 3.30% to 5.00% - a huge move by fixed income standards - and ended the year at 3.88%, approximately where it began the year.

Despite the rise in interest rates, it was an investment environment in which risk was rewarded, with high yield and investment-grade corporate bonds outperforming Treasuries and municipal bonds. In general, corporate balance sheets were in solid condition, and companies had yet to face refunding issues at higher interest rates.

The year ahead may be just as volatile: the inflation battle has yet to fully play out, the massive federal budget deficit will have to be funded with an increased issuance of Treasuries, a fractured Congress will again have to agree on a budget to keep the government running, and there is a U.S. Presidential Election in the fall.

Our fixed income investment strategy remains anchored in the investment of high-quality, reasonably priced intermediate-maturity bonds. Our objective is to lock in higher coupon bonds to ensure a predictable and reliable income stream for client portfolios.

The S&P 500's remarkable performance in 2023 has pushed investor expectations higher. It has also pushed the index's valuation higher, with its forward price-to-earnings ratio now at a robust 19.4x versus 16.7x at the beginning of 2023. This represents a +10% premium to its 10-year average and an +18% premium to its 30-year average. To justify this valuation, let alone produce further performance gains, investors will be seeking answers to the following key questions going forward:

- Has inflation really been defeated, or will a second wave take hold? The Consumer Price Index (CPI) has trended down to +3.1% in November 2023 since peaking at +9.1% in June 2022. However, once inflation takes hold, a second wave of inflation has historically built up over the next several years 87% of the time. This is what happened in the 1970s when the Federal Reserve cut interest rates too soon.
- Will the Federal Reserve cut interest rates as much as expected? Investors are expecting interest rates to be cut 0.25% beginning in March, with a total of four cuts of 0.25% each by September – but the Federal Reserve has indicated only three potential cuts for all of 2024 and the pathway is uncertain.
- Will corporate earnings growth accelerate as expected? S&P 500 EPS growth is projected to be +11.4% in 2024 versus +0.0% in 2023, but consensus estimates have been falling since July 2023. Also, this level of EPS growth will be challenged by U.S. real GDP growth that is projected to be cut in half to +1.2% in 2024.
- Will U.S. consumer spending finally succumb to a slowdown? Despite a low unemployment rate of 3.7%, pandemic-era savings are largely depleted, and credit card delinquencies continue rising. Moreover, multiple public companies have recently indicated a more cautious consumer spending environment.
- Will stock market breadth improve? So far, the answer is 'yes.' For the first three quarters of 2023, the 'Magnificent 7' posted an equal-weighted average total return of +82.9% versus +1.1% for the rest of the S&P 500. For the last quarter of 2023, the 'Magnificent 7' posted an equal-weighted average total return of +12.0% versus +11.7% for the rest of the S&P 500.
- How will election results affect the global economy? Sixty-four countries – including Taiwan – plus the European Union will hold national elections in 2024 – a combined 49% of the world's population.
- Will the development and commercialization of generative A.I. keep pace with the high expectations embedded in technology stocks?
- Will the wars in Ukraine, Gaza, Syria, Yemen, and others metastasize into larger conflicts?
- Will the U.S. government be forced to earnestly address its \$2 trillion annual federal budget deficit – the largest peacetime non-recession deficit in its history at 7.7% of GDP – and its \$34 trillion of total debt?

Entering the new year, the economic and investment outlook has improved, but many uncertainties remain. While no one can predict the future – the key investment lesson learned last year – what we can predict is companies that outperform the stock market over the long term will possess the following characteristics: impressive new product innovation tied to large and compelling secular trends; industry-leading sales, earnings and free cash flow growth; superior and sustainable business models that produce enviable competitive moats, profit margins and investment returns; and visionary and resilient management teams that know how to execute in any business climate. These are the types of companies we are invested in today, and the types of companies we will continue to steadfastly seek out tomorrow as we endeavor to successfully navigate a complex and challenging investment environment.

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