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4Q 2023 Commentary

January 10, 2024

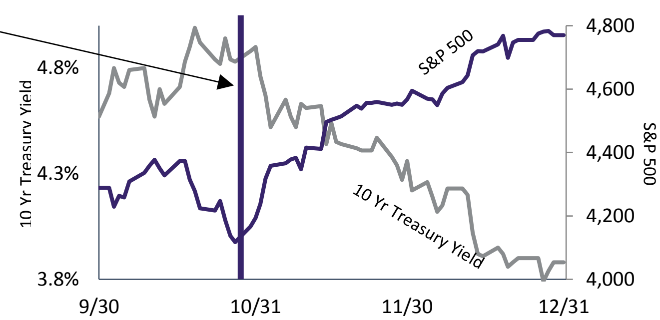
<u>THE BIG THING:</u> Inflation Pressures Eased and Growth Was Surprisingly Strong, Bonds Yields Fell and Stocks Rallied

- Inflation measures showed broad improvement despite very strong economic growth.
- The Federal Reserve "pivoted" to speaking of lowering interest rates in 2024.
- Bonds rallied sharply from late October through December causing interest rates to fall.
- Lower rates eased financial conditions.
- Companies reported relatively strong earnings and outlooks.
- Oil prices fell ~20%, taking pressure off consumers and future inflation.
- Stocks rallied on earnings, easing inflation pressures (costs and labor), expectations of an easier Fed, and lower interest rates.

YIELDS FELL, STOCKS RALLIED

Strong GDP growth report (+4.9%) with low inflation & Fed comments days later caused yields to fall and stocks to rally.

10 Year Treasury Yields & S&P 500



There was a broad rally in the 4th quarter, powering all indices to double digit returns in 2023.

EQUITIES

<u>Quarterly Returns</u>: It Wasn't Just Big Tech Stocks

- <u>Best</u>: Small Value +15.3%, Mid Growth +14.6%, and Large Growth +14.2%[1]
- <u>Worst</u>: Large Value +9.5%, Large Core +11.2%, Mid Value +12.1%
- Almost all indices rose double digits.
- The S&P 500 returned +11.2%, NASDAQ +13.6%.
- International: Developed Markets +10.4% and Emerging Markets +7.5%.

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[1] Large cap growth = Russell 1000 Growth Index; Large cap core = S&P 500; Large cap value = Russell 1000 Value Index; Mid cap growth = Russell Mid Cap Growth Index; Mid Cap Core = Russell Mid Cap Index; Mid cap value = Russell Mid Cap Value Index; Small cap growth = Russell 2000 Growth Index; Small cap core = Russell 2000 Index; Small cap growth = Russell 2000 Value Index; Developed international = MSCI EAFE Index; Emerging markets = MSCI Emerging Market Index. These terms will be used throughout the commentary.

- Gold returned +11% and hit an all-time high; the dollar fell vs Euro, Yen and Pound.
- Bitcoin returned +58%.
- Hedge fund returns were almost all up in the quarter.

<u>2023 Returns</u>: All US Indices Rose Double Digits; Magnificent Seven Produced Magnificent Returns[2]

- <u>Best</u>: Large Growth +42.7%, Large Core +26.3%, Mid Growth +25.9%
- <u>Worst</u>: Large Value +11.5%, Mid Value +12.7%, Small Value +14.7%
- 2023 Average Return of Magnificent Seven Stock was +112%.
- Average return of a stock in the S&P 500 was +14.8%.
- The NASDAQ rose +43%, the S&P 500 returned +26.3%.
    - For the S&P 500, *only three sectors outperformed*: Technology, Communication Services, and Consumer Discretionary.
- International: Developed Markets +18.2%; Emerging Markets +7.0%
    - Mainland China (-3.7%), Hong Kong (-13.85%)[3]
- Gold returned +13%, Bitcoin up +157%.
- Hedge funds were mostly positive.

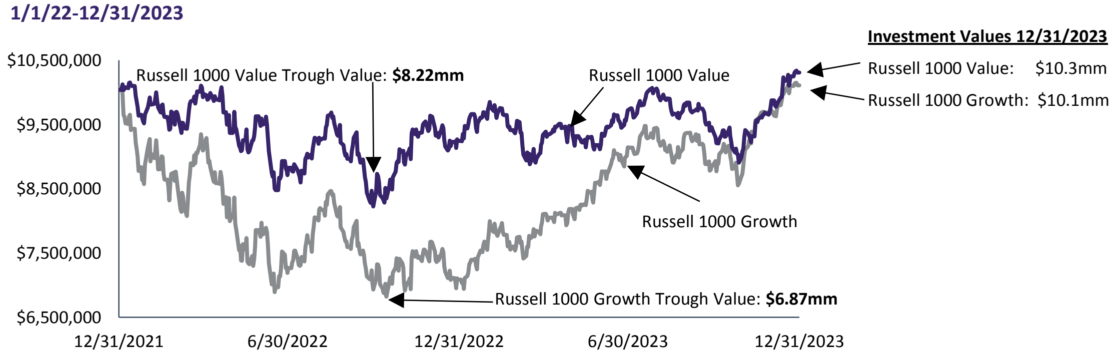
Despite out-performance in 2023, Large Cap Growth and Value indices have similar 2 year returns.

’22 & ’23: Large Cap Value & Growth Had Similar Results But Took Different Paths

Returns for Large Cap Value and Growth stocks over the last two years have been about the same, but the paths and sources of returns have differed.

- Large Cap Growth 2022 Return **-29.1%**; 2023 Return **+42.7%**, **Combined +1.2%**
- Large Cap Value 2022 Return **-7.5%**; 2023 Return **+11.5%**, **Combined +3.1%**

Growth of $10,000,000 Invested in Russell 1000 Value & Growth Indices
1/1/22-12/31/2023



FIXED INCOME

Quarterly Returns: Bond prices reacted positively to lower inflation readings and comments from the Federal Reserve that rates could be lowered in 2024.

- Municipal and corporate bonds ended the quarter returning low single digits.
    - Corporate bond yields fell more than Treasuries, adding to their performance (relative to Treasuries).

[2] Magnificent Seven stocks are Apple, Amazon, Alphabet, Meta, Microsoft, NVIDIA, and Tesla
[3] Mainland China = SSE Composite; Hong Kong = Hang Seng Index

- Bonds sold off in October, with the 10 Year Treasury yield rising to 5%; in November and December bonds rallied significantly; by quarter end short term bond yields fell slightly more than long term bond yields (***Table 2*** below).
    - We aggressively deployed cash into longer bonds where applicable.
- Long term bond *prices* went up more than short term bond *prices* because they are more sensitive to changes in interest rates.
- The US Treasury issued fewer bonds in 4Q than 3Q (when it issued $1 trillion!) and lowered the issuance of longer-term bonds.[4]
- Fed officials spoke of cutting rates in 2024, sparking a rally across the yield curve.
- The Fed continued to shrink its balance sheet[5]:
    - -$126 billion in 4Q
    - -$886 billion since the April 2022 peak

Treasury yields rose and then fell in 2023, ending the year roughly where they started despite historically high volatility.

2023 Returns: Most Treasury yields ended the year essentially unchanged; Treasury holders earned their coupons while corporate bond holders fared better.

- Municipal and corporate bonds generated positive returns in 2023.
- Corporate bonds performed better than both Treasuries and municipal bonds as they benefited from:
    - Higher starting yields and higher coupons.
    - A better economic outlook, causing the spread between corporate and Treasury yields to decrease.

US Treasury Yields

Maturity*	12/31/22	9/30/23	12/31/23	4Q23 Yield Change	2023 Yield Change
3 Month	4.41%	5.46%	5.35%	**(0.11%)**	**+0.94%**
2 Year	4.42%	5.04%	4.25%	**(0.79%)**	**(0.17%)**
5 Year	4.00%	4.61%	3.85%	**(0.76%)**	**(0.15%)**
10 Year	3.88%	4.57%	3.88%	**(0.69%)**	**0.00%**
30 Year	3.97%	4.70%	4.03%	**(0.67%)**	**+0.06%**

**Source: FactSet*

Inflation measures continue to move in the right direction.

Inflation: Deceleration Continued

- Inflation reports continued to come down in the quarter fueling the bond rally.
- The latest (November) year-over-year readings:
    - CPI: 3.1% vs. 6.4% in December 2022.
    - Core PCE: 3.2% vs. 4.9% in December 2022.
        - The Fed focuses on this measure as being indicative of inflation rather than CPI.[6]
        - The most recent (November) six month annualized rate of change was 1.9%, below the Fed's 2% target.

[4] https://www.ft.com/content/30ca0fe4-a3e0-4e59-8590-b486443fe400
[5] Source: Federal Reserve and PSG; the Fed owned $4.1 trillion of Treasury Notes and Bonds as of 12/27/2023.
[6] PCE stands for Personal Consumption Expenditures. It is an alternative measure of inflation to the CPI. CPI only measures consumer expenditures, whereas PCE measures consumer plus other related spending. One example, regarding healthcare, CPI measures the out-of-pocket expense for the consumer, where as PCE measures that plus the amount an employer is paying through health insurance services paid for by government through programs such as Medicare. PCE is updated more frequently than CPI, capturing changes in consumer spending more quickly.

ECONOMIC AND MARKET ENVIRONMENTS

A strong and stable job market continues to support economic growth, but near term volatility in stock and bond markets would not be surprising.

"Goldilocks" Scenario of Strong Growth, Large Productivity Gains, Decelerating Inflation and Solid Job Market Boosted Confidence and Expectations

- 3rd quarter GDP growth came in at an eye popping 4.9%, the highest since 2014 (excluding the COVID distortions of 2020 and 2021).
- 3rd Quarter Productivity was 5.2%, the highest non-recessionary increase since 2000.
- The job market looks stable as unemployment claims remain historically low and wage growth slowed from 5.3% in 2022 to ~4% in November.
- Bond market futures imply the Fed will cut rates 1.5% (or six 0.25% cuts) by year end 2024.
- Valuation of Large Cap Growth stocks soared 24% in 2023, as the Price to Earnings multiple expanded from 21.5x to 26.8x.[7]
    - Large Cap Growth (26.8x) is now 88% higher than Large Cap Value (15.2x) and more than double that of Small Cap Core (13.0x)

Growth Stocks and the Bond Market May Be Ahead of Themselves

- The Magnificent Seven generated strong earnings growth in 2023, but revenue growth is slowing for many of them.
    - *Example: Apple's revenues have fallen four straight quarters but the stock was up 51% in 2023.*
- Interest rates are still significantly higher than they were two years ago.
    - Corporations face higher refinancing costs compared to a few years ago.
- Geopolitical risks have not affected energy markets in a significant way, and the risk of a wider war in the Middle East does not seem to be discounted in stock or oil prices.
- Treasury continues to issue a significant amount of debt and the Federal Reserve continues quantitative tightening, increasing the supply markets must digest.
- Inflation has slowed thanks to normalized supply chains, lower oil prices, and increased supply of multi-family housing (apartments), but any flare up is likely to cause a sharp selloff in bonds and higher valued stocks.

CONCLUSIONS

Bonds:

- Bonds continue to be attractive compared with returns we could obtain over much of the 2012-2021 period.
    - They are not as cheap as they were in September and October.
    - We continue to deploy cash, though at a more measured rate than a quarter ago.
- We do not expect bond yields to make new highs in the coming quarter, but modestly higher interest rates seem reasonable.

Small cap stocks look attractive.

Stocks:

- Small and Mid Cap stocks look attractive given current valuations.
- Some Magnificent Seven stocks look stretched from a valuation perspective (Apple, Tesla), while others (Microsoft, Meta, Alphabet) appear more reasonably valued.

[7] Source: FactSet, using analyst estimated earnings for the next 12 months as of 1/3/2022 and 1/2/2023, respectively.

- Value oriented sectors seem to have fewer headwinds in 2024 as bank concerns have eased, energy prices are near recent lows, and utilities and REITs have priced in higher interest rates to some extent.

Distressed private investments deserve consideration.

Private Investments:

- We believe there are attractive opportunities in the alternative space on a risk reward basis.
- We continue to avoid popular leveraged loan products.
- We continue to favor distressed credit.
- In addition to our existing distressed investment funds, our research has identified a high yield, short-term lending fund and a distressed hotel investment fund for our clients.
    - We will reach out to qualified investors, but please call if you'd like to learn more.

PSG'S NEWEST ADDITION

We are excited to announce the addition of Laurie Ghali to the PSG family as Chief Compliance Officer. Laurie joins us with 20+ years of compliance experience including Wells Fargo, Barclays, Credit Suisse, and Smith Barney / Morgan Stanley after graduating from Clark University. Welcome Laurie!

DISCLOSURE