**January 2024 Market Commentary**

***It's A Wonderful Life***

***"You're thinking of this place all wrong.***
***As if I had the money back in the safe.***
***The money's not here…***
***Now wait, now listen to me…Don't you see what's happening?***
***Potter isn't selling! Potter's buying! And why?***
***Because we're panicky and he's not. That's why."***
- ***George Bailey – It's A Wonderful Life***

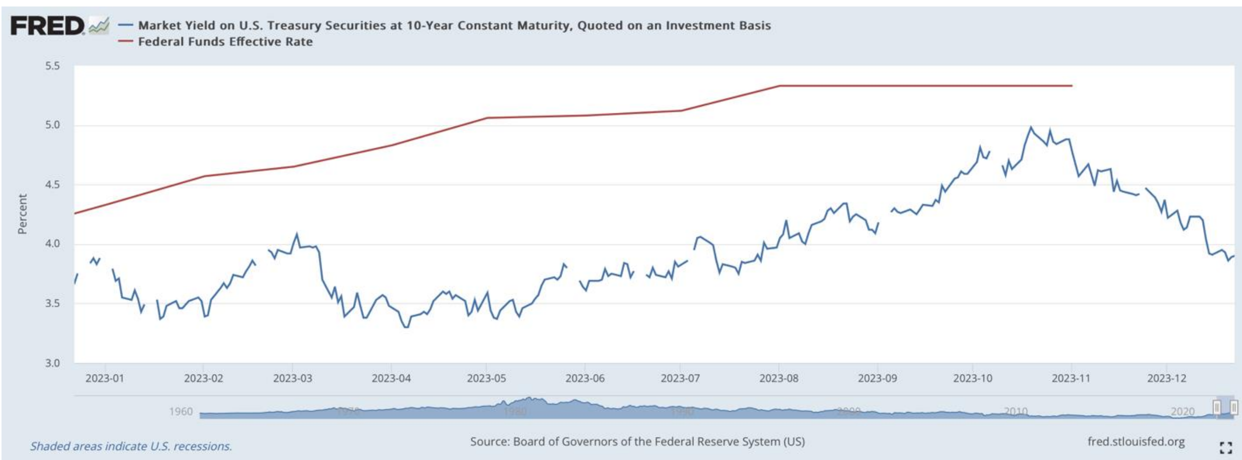
One of the things I try and accomplish with this newsletter is to help people fully understand what happens to their money when they invest, so that they can have a positive relationship with their money. Investing is about understanding the numbers, where capital flows and why, but it is also about understanding our own emotions…namely fear and greed.

Having survived the Great Depression, in 1945 Frank Capra fully understood the emotional connection people have with money; their greed, their desire to keep up with the Joneses, their envy of other's successes, and their fear of losing what little they have. His classic is a great reminder of what is really important in life, friends and family, but also what a healthy relationship with money looks like, and a real understanding of how to make our money work for us.

Since much of what happened in 2023 will continue to influence returns in 2024, let's take a quick look back at last year's important events, and the returns that subsequently transpired.

**<u>The Fed hiking interest rates to a 22-year high.</u>**

The biggest market moving story in 2023 was pretty much the same as 2022, and will probably be the same in 2024…namely, what did Chairman Powell and the Fed do. In the first half of 2023, the Fed raised borrowing costs four times (on top of the seven interest rate hikes in 2022) in its battle against inflation, putting rates at their highest level in over two decades. The central bank paused its rates-to-the-moon campaign in the summer after annual inflation dropped closer to its 2% target, but the sky-high rates caused chaos in the bond market, leading to a few regional bank failures, prompting layoffs in the tech industry, and pummeling both commercial and residential real estate. The Fed's pause is now being interpreted as a pivot to the eventual cutting of rates in 2024. The 10-year Treasury yield went from 3.8% to 5% and then back to 3.8%. A huge part of 2024's performance story will be written by J. Powell and what he actually does or doesn't do with interest rates.

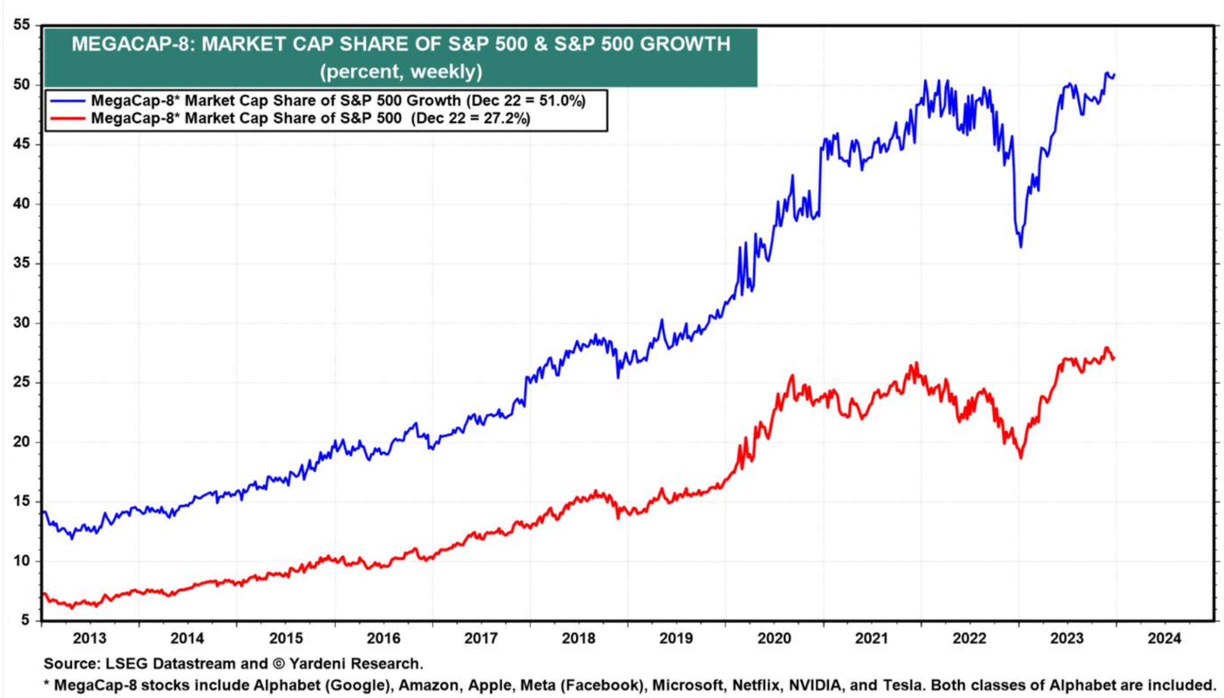



**<u>The year AI emerged.</u>**

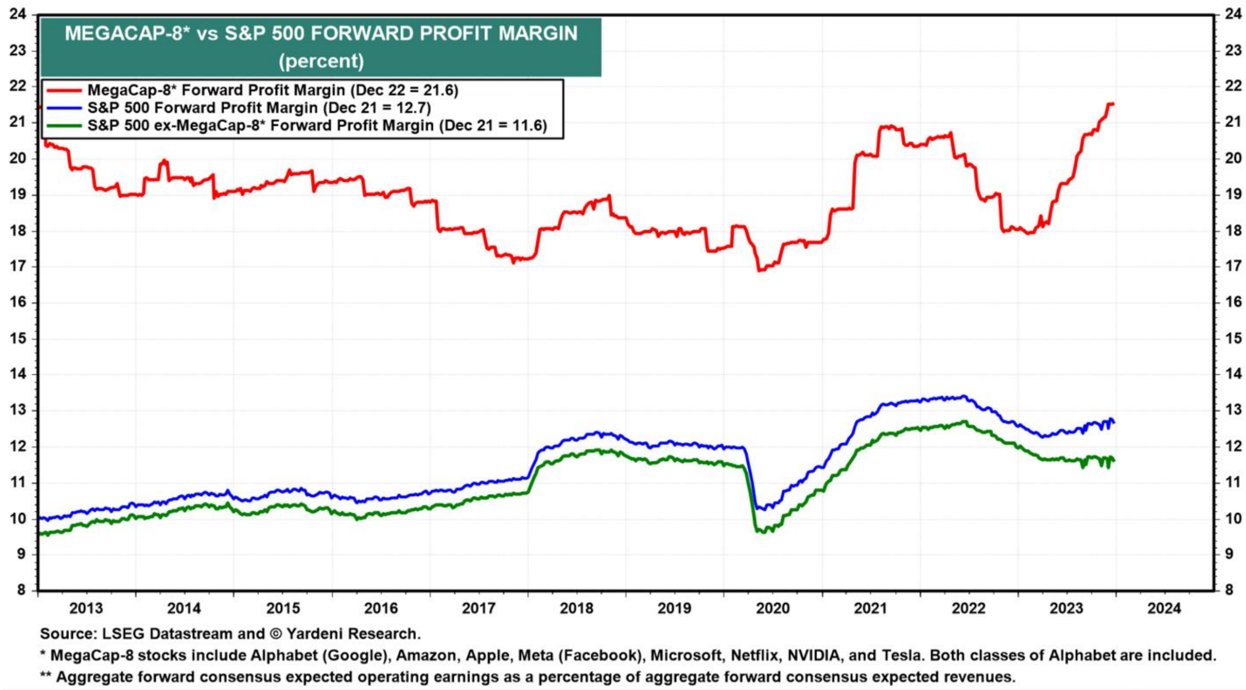
The second biggest story of 2023 wasn't Taylor Swift and Travis Kelce, it was the real emergence of Artificial Intelligence. Even the people running a hot dog stand probably spent 2023 thinking about how to use AI to make their business more efficient. After the blockbuster unveiling of ChatGPT late last year, the disruptive tech instantly became a corporate obsession. Nearly every business is looking at or using AI as a means of increasing efficiencies.

Despite worries that AI technology could bring about Armageddon, the consensus view is that a new AI-defined technological boom is upon us and that the largest tech companies will be the first to take advantage of this technology. This has fueled a rally in the biggest tech stocks that has taken these companies to a level of market dominance never seen before.

Ed Yardeni calls these companies the Mega-Cap 8, and they currently make up about 27% of the entire S&P 500. This group of just eight stocks has contributed 52% of the S&P 500's gains in 2023.

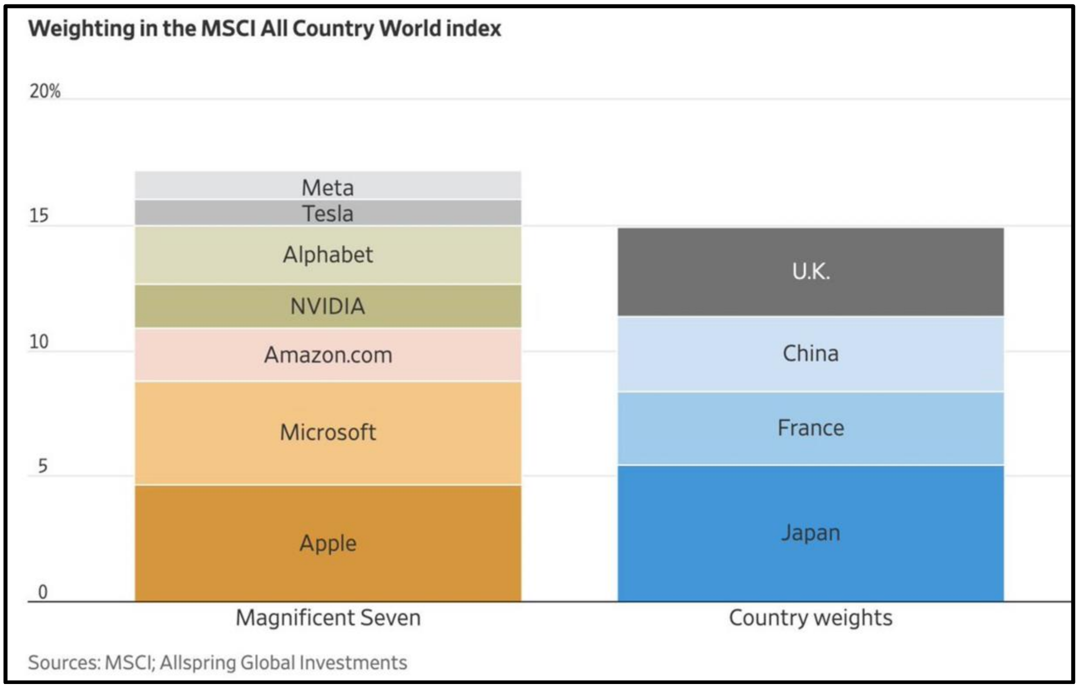



And while this might look and smell like a bubble, there is a reason they have outperformed the broader market…they are growing much faster and they are very profitable. Over the next 3-5 years these stocks are expected to grow their earnings by 40%, while their profit margins are nearly twice what the average is for the other 492 stocks.




We are in the very early stages of AI implementation, and one thing you can be pretty sure of in 2024, the technological advances will continue to surprise us.

Just to give you an idea of how massive these companies have become, their market-cap weighting in the MSCI ALL Country World Index is now larger than the combined weight of all the equities in Japan, France, China, and the U.K.

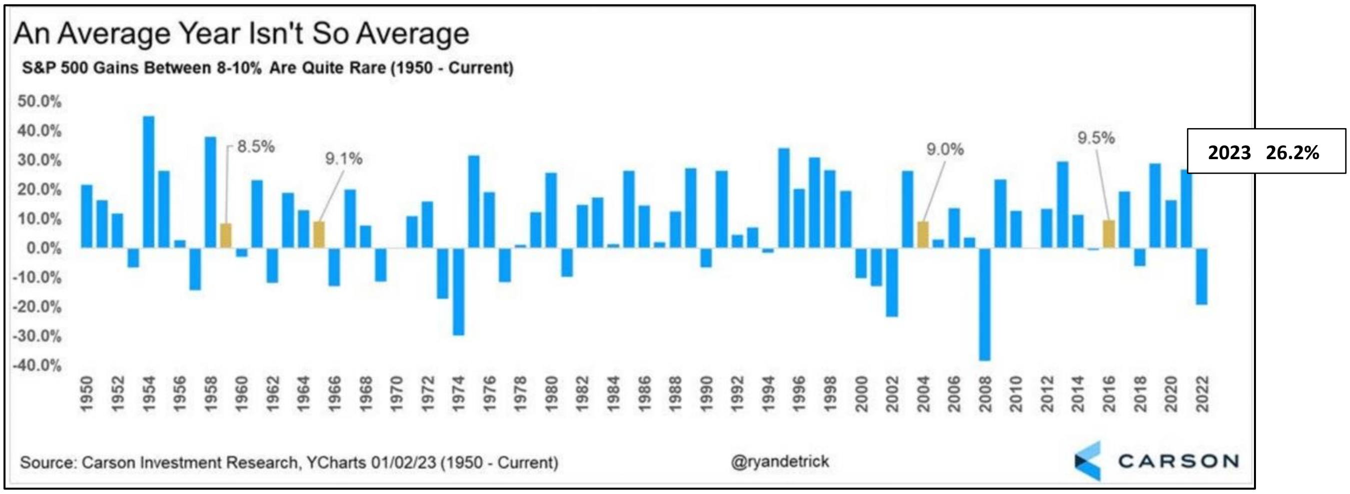



***Warning: Past performance is no guarantee of future returns.***

While the headlines will scream about how great 2023 was, I think it's important to remember that much of 2023's rally was simply reversing the damage done in 2022. For that reason, I'm showing both years returns so we can better appreciate what has transpired.
***<u>Don't confuse brains with a bull market.</u>***

| Asset | 2022 Return | 2023 Return | Two Year Annualized |
|---|---|---|---|
| S&P 500 | **-18.17%** | **26.19%** | **1.62%** |
| S&P 500 Equal-Weight | **-11.62%** | **13.70%** | **0.24%** |
| NASDAQ 100 | **-32.58%** | **54.85%** | **2.18%** |
| Tech Sector | **-27.73%** | **56.02%** | **6.19%** |
| Russell 1000 Growth | **-29.31%** | **42.60%** | **0.40%** |
| Russell 1000 Value | **-7.74%** | **11.36%** | **1.36%** |
| S&P 600 Small-Cap | **-16.19%** | **16.07%** | **-1.37%** |
| MSCI Total Int'l Ex-US | **-16.45%** | **15.87%** | **-1.61%** |
| US Aggregate Bonds | **-13.02%** | **5.65%** | **-4.14%** |
| US Treasury 7-10 Year | **-15.16%** | **3.64%** | **-6.23%** |
| US High-Yield Bonds | **-10.99%** | **11.53%** | **-0.36%** |

As the last two years vividly showed, returns in markets can be pretty volatile. Even though the average return of the S&P 500 over the past eight decades was 9%, it rarely produces that in any given year. **In the last 73 years the S&P 500 total return has only been between 8-10% four times.**




**Predicting the future is a fool's game…Let's Play!**

A little over a year ago I shared the following table with you so we could play the game of market forecasting. Again, predicting the future return on stocks is pretty straightforward; you just have to take the current dividend yield, add the earnings growth, and predict what you think investors will pay for those dividends and earnings. A year ago, Wall Street analysts were expecting the S&P 500 to generate about $233 in earnings for 2023, and we had a dividend yield of 1.74%. Your task was to guess what you thought earnings would actually be, and what Price-to-Earnings ratio the market would assign to those earnings. How did you do?

**Year-end 2022 S&P 500 Estimated Return Scenarios**

| | | Estimated Forward Earnings S&P 500 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | $ 180 | $ 190 | $ 200 | $ 220 | $ 230 | $ 240 | $ 250 | $ 260 | $ 270 |
| | 13 | -37.05% | -33.65% | -30.25% | -23.45% | -20.05% | -16.65% | -13.25% | -9.85% | -6.45% |
| | 14 | -32.34% | -28.68% | -25.02% | -17.69% | -14.03% | -10.37% | -6.71% | -3.05% | 0.62% |
| | 15 | -27.63% | -23.71% | -19.79% | -11.94% | -8.02% | -4.09% | -0.17% | 3.75% | 7.68% |
| | 16 | -22.93% | -18.74% | -14.56% | -6.19% | -2.00% | 2.18% | 6.37% | 10.56% | 14.74% |
| | 16.4 | -21.04% | -16.75% | -12.46% | -3.88% | 0.41% | 4.70% | 8.99% | 13.28% | 17.57% |
| Estimated | 17 | -18.22% | -13.77% | -9.32% | -0.43% | 4.02% | 8.46% | 12.91% | 17.36% | 21.80% |
| P/E Ratio | 18 | -13.51% | -8.80% | -4.09% | 5.32% | 10.03% | 14.74% | 19.45% | 24.16% | 28.87% |
| | 19 | -8.80% | -3.83% | 1.14% | 11.08% | 16.05% | 21.02% | 25.99% | 30.96% | 35.93% |
| | 20 | -4.09% | 1.14% | 6.37% | 16.83% | 22.06% | 27.30% | 32.53% | 37.76% | 42.99% |
| | 21 | 0.62% | 6.11% | 11.60% | 22.59% | 28.08% | 33.57% | 39.07% | 44.56% | 50.05% |
| | 22 | 5.32% | 11.08% | 16.83% | 28.34% | 34.10% | 39.85% | 45.61% | 51.36% | 57.12% |
| | 23 | 10.03% | 16.05% | 22.06% | 34.10% | 40.11% | 46.13% | 52.15% | 58.16% | 64.18% |

**Current (11/8/22) S&P 500 Price $3,823**
**Current 12-month Forward Earnings Estimate $233**
**Current Dividend Yield 1.74%**
**Current S&P 500 P/E 16.41x**

As we sit here at the end of 2023, we see that 2023 earnings are expected to come in around $221 (5% below the $233 expected a year ago), but the P/E ratio on that $221 in earnings expanded to 21.4x, which equated to a total 2023 return of 26%. A fabulous year. The big question, even though earnings were lower than expected, why did the P/E ratio expand from 16.4x to 21.4x? The main reason is that it became apparent that inflation was retreating without the economy falling into a recession, therefore allowing the Fed to stop increasing interest rates and maybe even begin cutting rates in 2024.

So here we sit today with the S&P 500 at 4,770, yielding 1.34%, and estimated 2024 earnings of $245 (an estimated earnings increase of 11% over 2023). Your mission, if you choose to accept it, is to guess whether you think earnings will be at $245, or some other number, and what you think the market is going to pay for your earnings guess at year-end 2024. In other words, what is your estimated year-end 2024 P/E ratio? Then plug those numbers into the table below and you can see what your total return will be.

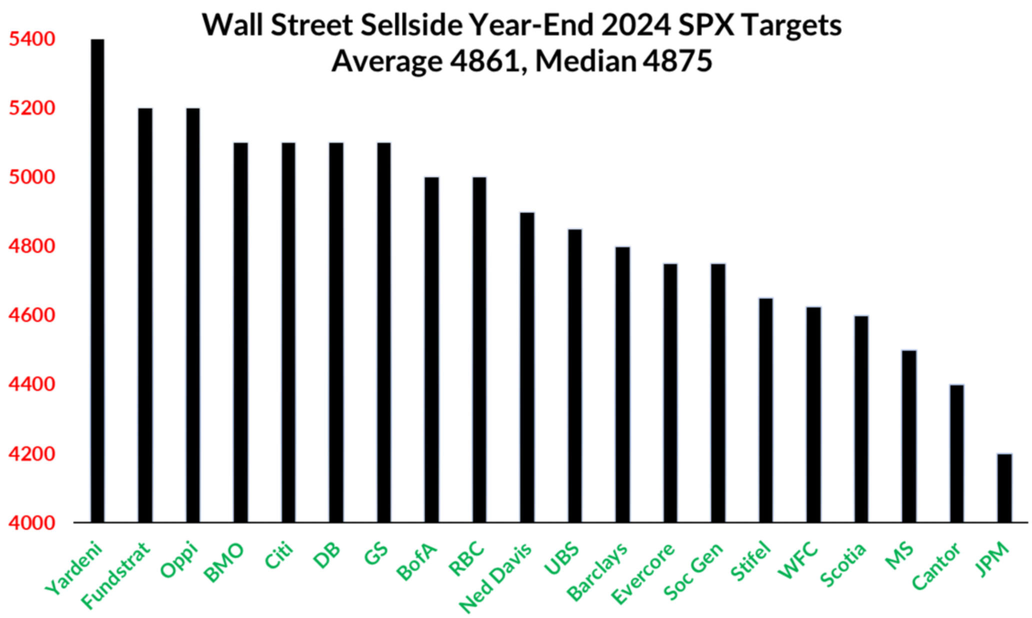
For example: if you think earnings will grow from $221 in 2023 up to $240 (an 8.6% gain) in 2024, and the P/E ratio stays around 21x, then you can expect a total return of about 7%. Another scenario could be something like this; the economy is stronger than expected and earnings grow to $250, but because of that strength inflation stays above 3% and the Fed doesn't cut rates as much as expected…P/E's contract to a more normal 18x and the expected total return is about -4%.
Feel free to create your own scenario and see what kind of return you can expect, just remember that it is totally a guess. It may be an educated guess, but it's still a guess.

## Year-end 2023 S&P 500 Estimated Return Scenarios

| | | Estimated Forward Earnings S&P 500 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | $ 190 | $ 200 | $ 220 | $ 230 | $ 240 | $ 250 | $ 260 | $ 270 | $ 280 |
| | 13 | -46.88% | -44.15% | -38.70% | -35.98% | -33.25% | -30.53% | -27.80% | -25.08% | -22.35% |
| | 14 | -42.89% | -39.96% | -34.09% | -31.15% | -28.22% | -25.28% | -22.35% | -19.41% | -16.48% |
| | 15 | -38.91% | -35.77% | -29.48% | -26.33% | -23.19% | -20.04% | -16.90% | -13.75% | -10.61% |
| | 16 | -34.93% | -31.57% | -24.87% | -21.51% | -18.16% | -14.80% | -11.45% | -8.09% | -4.74% |
| **Estimated** | 17 | -30.95% | -27.38% | -20.25% | -16.69% | -13.13% | -9.56% | -6.00% | -2.43% | 1.13% |
| **P/E Ratio** | 18 | -26.96% | -23.19% | -15.64% | -11.87% | -8.09% | -4.32% | -0.55% | 3.23% | 7.00% |
| | 19 | -22.98% | -19.00% | -11.03% | -7.05% | -3.06% | 0.92% | 4.90% | 8.89% | 12.87% |
| | 20 | -19.00% | -14.80% | -6.42% | -2.22% | 1.97% | 6.16% | 10.35% | 14.55% | 18.74% |
| | 21 | -15.01% | -10.61% | -1.80% | 2.60% | 7.00% | 11.40% | 15.81% | 20.21% | 24.61% |
| | 22 | -11.03% | -6.42% | 2.81% | 7.42% | 12.03% | 16.64% | 21.26% | 25.87% | 30.48% |
| | 23 | -7.05% | -2.22% | 7.42% | 12.24% | 17.06% | 21.89% | 26.71% | 31.53% | 36.35% |

**Current (12/31/23) S&P 500 Price 4,770**
**Current 12-month Forward Earnings Estimate $245**
**Current Dividend Yield 1.34%**
**Current S&P 500 P/E on Forward Earnings of $245 = 19.5x**

If you're curious how your forecast stacks up to Wall Street strategists, probably pretty good. With the S&P 500 ending 2023 at 4,770 the range of strategist return forecasts for 2024 runs from a high of 13% to a low of -12% and a median of 2%. In other words, everyone can forecast, but being correct is purely luck.




As John Kenneth Galbraith once famously said, ***"The only function of economic forecasting, and subsequently stock market forecasting, is to make astrology look respectable. The economic output is affected by the aggregate activity of billions of people and thousands of seen and unseen forces."***

Here is another example of the futility of forecasting markets. Take a look at the forecast from the Fed's best and brightest economists at the end of 2022. The they forecasted GDP growth in 2023 of **0.50%**, here's what actually happened:

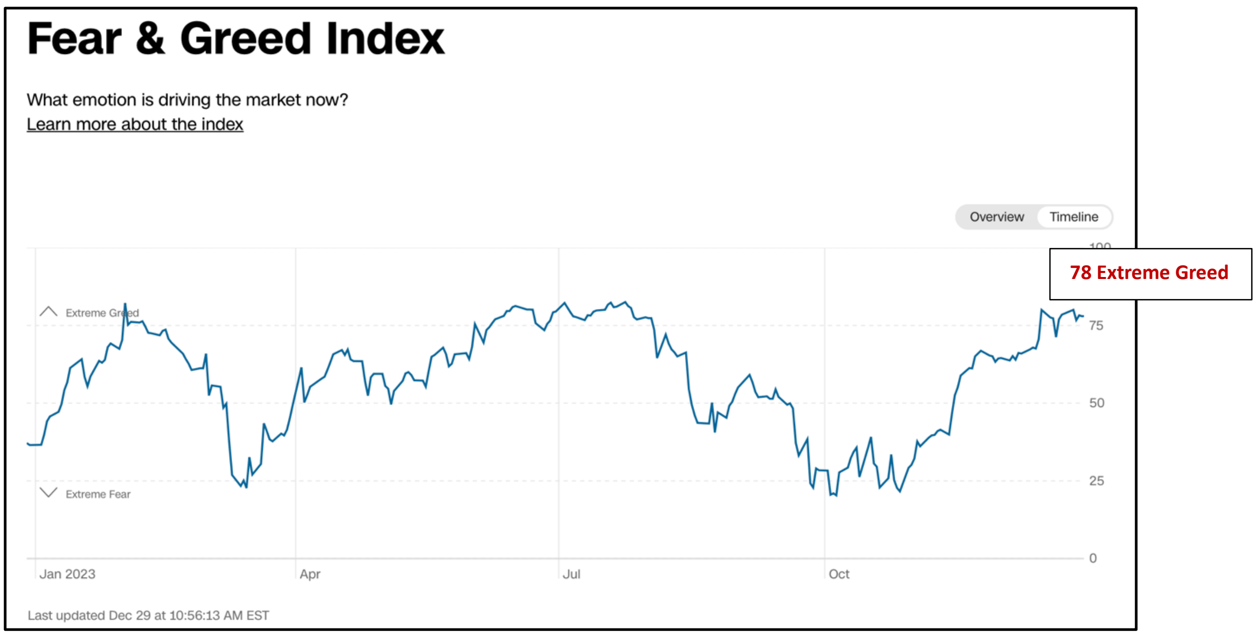
**1st Quarter 2.2%**
**2nd Quarter 2.1%**
**3rd Quarter 4.9%**
**4th Quarter est. 1.3%**
**2023 Full Year est. 2.4%**

Their GDP growth forecast for 2024 is 1.4%. Don't bet the house on that.

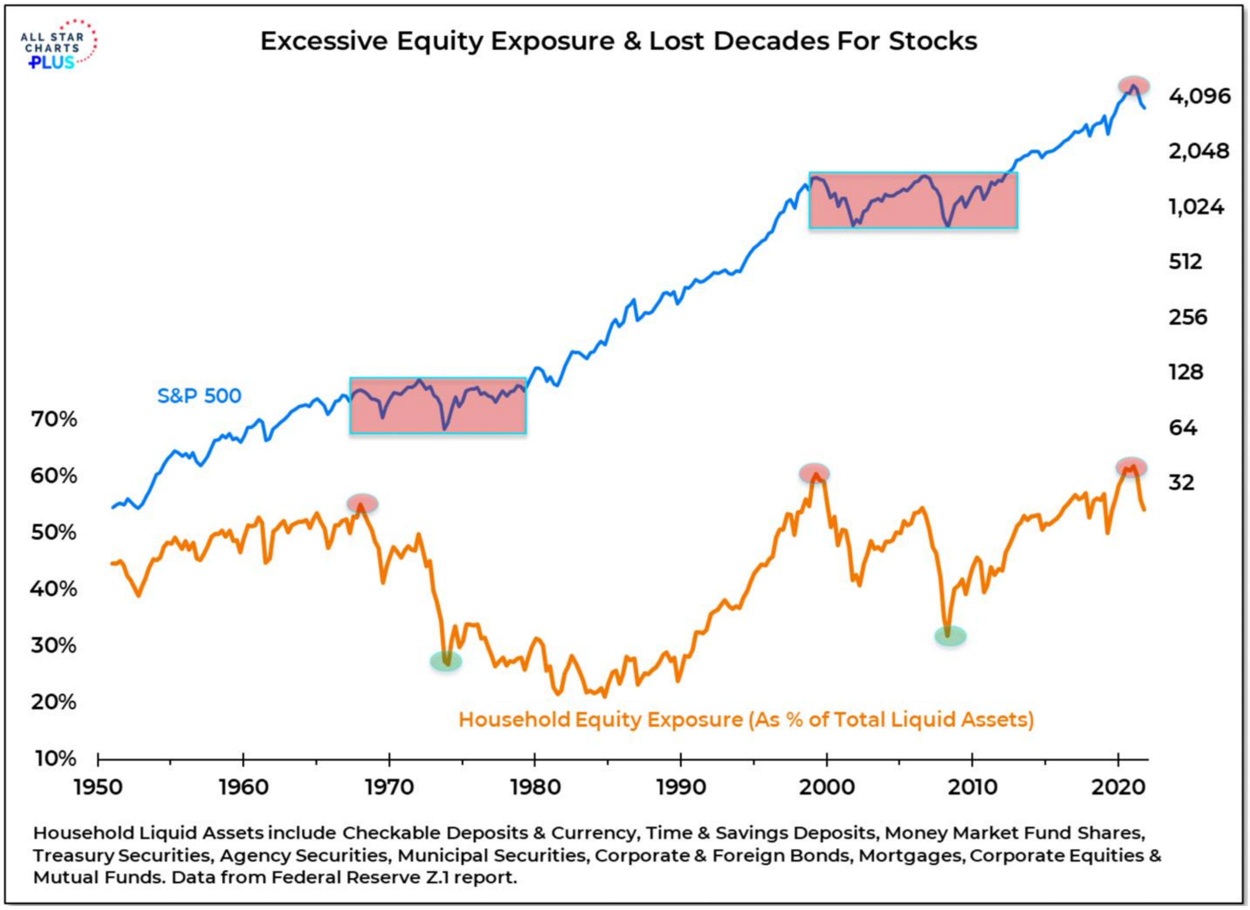
## Fear & Greed

As Mr. Potter taught us in ***"It's A Wonderful Life"***, it can often be very profitable to take advantage of other's emotions, especially when they reach extreme levels of fear or greed. Mr. Potter was certainly not alone in this belief, Nathan Rothschild famously said, ***"The time to buy is when there's blood in the streets."*** And Warren Buffett has said, ***"Be fearful when others are greedy, and greedy when others are fearful."***

Humans often succumb to any number of behavioral biases – performance chasing (FOMO), overconfidence, confirmation bias, herd mentality – that result in them making the wrong financial decisions at the wrong time. The **CNN Fear & Greed Index** below shows that we are currently at extreme levels of greed, which generally means that near-term returns are often below average.




Another longer-term look at periods of excessive greed and fear is depicted in the graphic below. Here we see that when households have increased their equity ownership as a percentage of all of their liquid assets, stocks tend to tread water for several years. From 1945 to 1968 stocks appreciated about 8.2% annually, but when equity exposure peaked in 1968, the market treaded water until 1981, with a 1.16% annualized price return. Then from 1981 to 2000 stocks had an impressive 14.4% annualized return until they peaked in March of 2000. They then treaded water until 2012, with a price return of -0.1%. After 2012 stocks rallied again by 13.7% annualized until their recent peak in June of 2021. Since then, we've had a price return of just 2.6%.




None of this is an exact science, but understanding our own emotions as well as those around us is a powerful tool that we should use when adjusting our asset allocations.

As we enter 2024, we all need to embrace the fact that complex adaptive system, like markets and economies, cannot be predicted. Bad news tends to happen seemingly overnight, and is subsequently broadcasted constantly on the news, while good news happens gradually. We just don't see the slow advancements in metals, ceramics, electronics, batteries, chemicals, medicines, etc. that will one day produce something magical. Good things happening significantly outnumber bad things, and that is the main reason economies grow over time and stocks appreciate more often than not.

It's important to have a plan that helps you block out the constant bombardment of mostly negative news, so you can consistently invest, diversify, adapt, and let the magic of compounding work for you. After all, it really is a wonderful life.

As always, be careful out there, and Happy New Year.

Chris Wiles, CFA