Wealth Management
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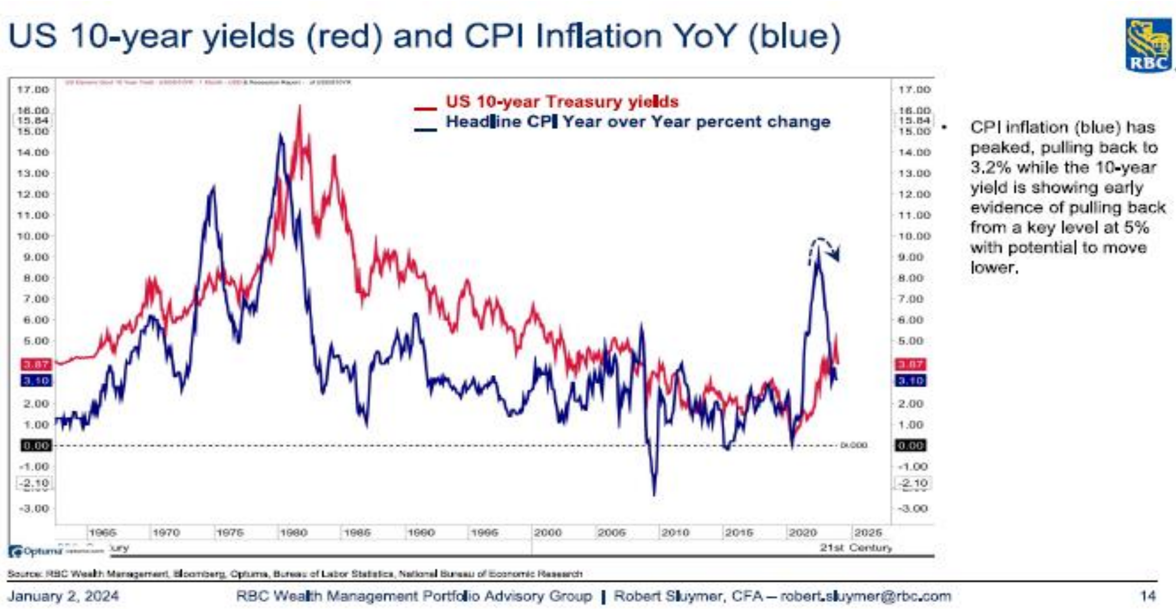
Year End 2023

In the first 10 months of 2023 the artificial intelligence fueled magnificent seven sailed far ahead of the rest of the stock market. Those few huge technology stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla) did a horizon job. They were so far ahead the other stocks were left out of sight. They now make up about a third of the U.S. index, the S&P 500.

The rest of the stock market only caught a bit of breeze in the final two months, when bond yields plunged. The 10-year U.S. Treasury yield went from over 5% in late October down to 3.8% at year-end. CPI inflation, which had peaked at 9%, ended the year at 3.2%. Inflation falling like a rock may allow the Federal Reserve to pivot from pounding inflation to coasting into a soft landing. The chart below shows a history of inflation (the blue line) and the ten year U.S. Bond yield (the red line) since 1965.



After the trauma of 2022, I spent much of 2023 looking for a recession, which was very much the consensus opinion, but it remained seemingly just out of sight. The inverted yield curve – two-year bond yields moved above 10-year bond yields in 2022 – had been a reliable indicator of an economic contraction. This time the inverted yield curve's signal has been either early or wrong and, in investing, there is little difference between being early or wrong. The threat of a recession implied extra caution was called for and that view was hard to reconcile to adding to risky technology bets.

Central banks' aggressive rate hikes, which began in March 2022 and ended with the Fed's last hike in August 2023, brought short rates from 0%-0.25 to today's range of 5.25%-5.5%. In 2023 the economy has been resilient, with GDP growth expected to be about 2.6%. A year ago, it was thought that only an economic hard landing – a recession and a sharp rise in unemployment -would bring inflation under control. Today, a soft landing and no recession appear possible. The long lead time between rate increases and their effect on the economy make predictions of this kind fraught. For much of 2023 investors appeared unconvinced. Barron's reports (December 26) that "Reflecting U.S. investors' 2023 mind-set, there were net outflows of $131.9 billion from U.S. equity funds this year, and inflows of $895.1 billion into U.S. money-market funds in the same period, according to LSEG Data & Analytics."

We may have been on the wrong tack for much of 2023, at least for the first 10 months. The rise in interest rates was particularly hard on areas of the stock market I have long favoured. Dividend stalwarts like telecoms, utilities, banks, pharmaceuticals, and small company stocks were among the worst performers in 2023. Compared to the indices, we were under exposed to artificial intelligence plays. It is worth remembering that the 7 big winners in 2023 were about the biggest losers in 2022. Only one of the magnificent seven ended 2023 above where it traded in early 2022.

In sailboat racing, nobody wins all the time. There are just too many variables. Wind, current, equipment, stamina, teamwork, much can go wrong. It is the same in investing. Current events are unpredictable and the number of variables is countless. I try to learn from mistakes and to be philosophical about the inevitability of errors. The last time we had a frenzy for technology stocks, the internet boom of 1999-2000, even while NASDAQ crashed until 2002, value stocks and, GARP (growth at a reasonable price) stocks that I seek, outperformed. However, the stock market today does not seem wildly overpriced the way it was in 1999. As Tom Lee of Fundstrat (December 26, 2023) points out the S&P 500 without the FAANG (Facebook, Amazon, Apple, Nvidia, Google) trades at about 15.3 times forecast 2025 earnings, which is not unreasonable with 10-year bond yields rates below 4%. The FAANG trade at 25 times earnings but are growing rapidly so perhaps that is also not unreasonable.

The stock market has a wall of worry to climb: the inverted yield curve and the potential recession, under used commercial real estate as workers stay home, under used retail real estate as shoppers shop online, wars in Europe and the Middle East, baked in assumptions about declines in the bank rate, and a recent surge in investors' optimism, to name a few. But stock markets need a wall of worry to climb because of course if there was nothing to worry about everyone would have bought in already and there would be nobody left to buy.

As this is 2024, I can't resist pointing out that this is a presidential election year. Just as there is a seasonal tendency for the stock market to bottom in the fall so there is something of a four-year rhythm to the stock market, tied to the presidential cycle, as RBC's Robert Sluymer, CFA, likes to point out (January 2). Sluymer observes that on average presidential election years since 1928 have been choppy in the first half of the year during primary season but strong in the second half.

Last years' losers can be this years' winners. In 2024 we will keep Charlie Munger's advice in mind and try to avoid doing stupid things. Thank you for reading and for your support. All the best for the New Year.

Sincerely,

George Stedman, CFA

Senior Portfolio Manager
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