the serious investor

WINTER 2024

THE SERIOUS INVESTOR: WINTER 2024

Welcome to the winter edition of LVW's *The Serious Investor.*

Economic growth moderated but continued to beat expectations in the fourth quarter, while inflation eased and the Federal Reserve indicated that it anticipated cutting interest rates three times in 2024. Those developments supported strong gains in both the stock and bond markets between October and December.

Investors became more optimistic in the fourth quarter about the potential for a soft landing, in which inflation and interest rates could come down while the economy continued growing and the labor market remained firm. The Consumer Price Index (CPI), which had risen 6.5% in 2022, declined from a 3.7% annual rate in September to 3.1% as of November before ticking up to 3.4% at year-end. Meanwhile, economic growth moderated but remained healthy, with the U.S. economy adding nearly 500,000 jobs in the fourth quarter. A recent Bank of America survey found that 66% of fund managers expect a soft landing in 2024.

The financial markets rallied. The S&P 500 gained 11.2% in the fourth quarter, capping a 24% surge for 2023 as a whole and recouping the remainder of its 2022 losses. Mega-cap growth stocks, bolstered by the prospect of lower interest rates and enthusiasm for AI, pulled the market higher. The so-called Magnificent Seven—Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia and Tesla—gained an average of 11% in the fourth quarter and 109% on the year. The average S&P 500 company returned 12% in the fourth quarter and 14% during 2023 as a whole. Other rate-sensitive assets also moved higher; notably, Bitcoin gained 150% in 2023.

After trailing large caps by wide margins in recent years, small caps tracked by the Russell 2000 Index advanced 14% in the fourth quarter, besting the large-cap Russell 1000's 12% return. Like the United States, developed international markets posted strong gains, with the MSCI EAFE Index gaining 10.1%. Emerging markets on the whole posted smaller returns than developed markets, as weakness in Chinese stocks partly offset strength in Eastern Europe, Latin America and elsewhere.

Declining inflation and prospects for rate cuts fueled a rally in the bond markets. The yields on 2- and 10-year Treasurys each fell by more than half a percentage point in the fourth quarter. The Bloomberg U.S. Aggregate Bond Index returned 8% in the last eight weeks of the year, one of its strongest eight-week stretches on record. Nonetheless, the yield curve remains inverted and a return to more normal bond-market conditions is likely to be bumpy.

2023 serves as a valuable reminder that economists and market forecasters are often wrong, and investors should take their prognostications with heaping helpings of salt. Consider that entering 2023, the Blue Chip consensus outlook of economic forecasts called for real GDP to grow 0.3% for the year, CPI to rise 4.0% and the unemployment rate to end the year at 4.4%.

Bloomberg Economics' probability models put the likelihood of recession at 100%. Instead, real GDP likely increased 2.4%, CPI fell to 3.4% and unemployment finished the year at 3.7%.

Likewise, the average forecaster tracked by Bloomberg predicted a down year for the S&P 500, with their predictions ranging from -17% to +10%—however the index had one of its better years on record. Investors who tried to time the market by selling out of stocks a year ago probably rue that decision. In our view, for investors to benefit from the powerful effects of compounding, they need to stay invested in a diversified portfolio.

Our investment discipline considers markets through the lens of valuation, growth, liquidity and positioning (sentiment). Our analysis leads us to the following insights as 2024 begins:

Valuation: The Magnificent Seven distort U.S. index valuations

Overall, global equity markets are valued somewhere between average and expensive, varying by geography and style. In the United States, the S&P 500 is slightly above historically average valuations, influenced by the large technology stocks that make up almost one-third of the index. Goldman Sachs notes that the overall benchmark's price-to-earnings (P/E) ratio is in the 87th percentile of its range since 1975 but is expensive mainly because of the influence of the Magnificent Seven. In fact, the P/E of the average stock is only slightly ahead of its long-term average of 14. International developed markets appear reasonably priced, and emerging markets appear cheap relative to history.

Growth: Corporate earnings could outstrip modest economic growth

Real GDP growth is expected to soften in 2024, with the U.S. forecast to slow from 2.2% growth in 2023 to 1.1% in 2024. Globally, most major developed market central banks are likely finished raising rates, and economists expect solid GDP growth of approximately 2.5%. With respect to earnings, top-down analysts are forecasting 11% growth for S&P 500 companies while bottom-up forecasts are more muted, at about 7%. No one really knows, but we think the latter are more likely and could be enough to support current stock prices.

Only one-third of earnings in the S&P 500 come from the U.S. consumer, while about 40% of S&P 500 revenues come from outside the United States. In 2024, corporate earnings may continue to charge ahead while the U.S. economy slows.

Liquidity: Tight conditions may persist despite rate cuts

Financial conditions are likely to remain somewhat tight even if the Fed cuts interest rates. The Fed continues to reduce its balance sheet by approximately $90 billion per month, and real (after-inflation) interest rates remain restrictive, at about 1.5% as of January 11, 2024. That said, Fed policy is perhaps the most important factor when considering liquidity, and we believe the probabilities suggest that the Fed is done raising rates for this cycle.

Positioning: Lots of cash remains on the sidelines

Last year began with the consensus expecting recession and an equity bear market. These conditions led global investors to position very conservatively through most of 2023. Entering 2024, investors still hold more than $6 trillion in cash and money markets. Professional investors are overweight cash, on the whole, according to the Bank of America Fund Managers Survey, and only 15% are overweight equity—well below the historical average of 60%, according to Barron's. In 2023, $1.3 trillion flowed into cash instruments, dwarfing flows to equity funds (less than $180 billion) and bond funds ($270 billion). These conditions suggest there is plenty of dry powder that could fuel further gains in global stock and bond markets.

We appreciate your continued trust and confidence in LVW Advisors.

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