2024 Outlook: Finally “Normal”

January 2024

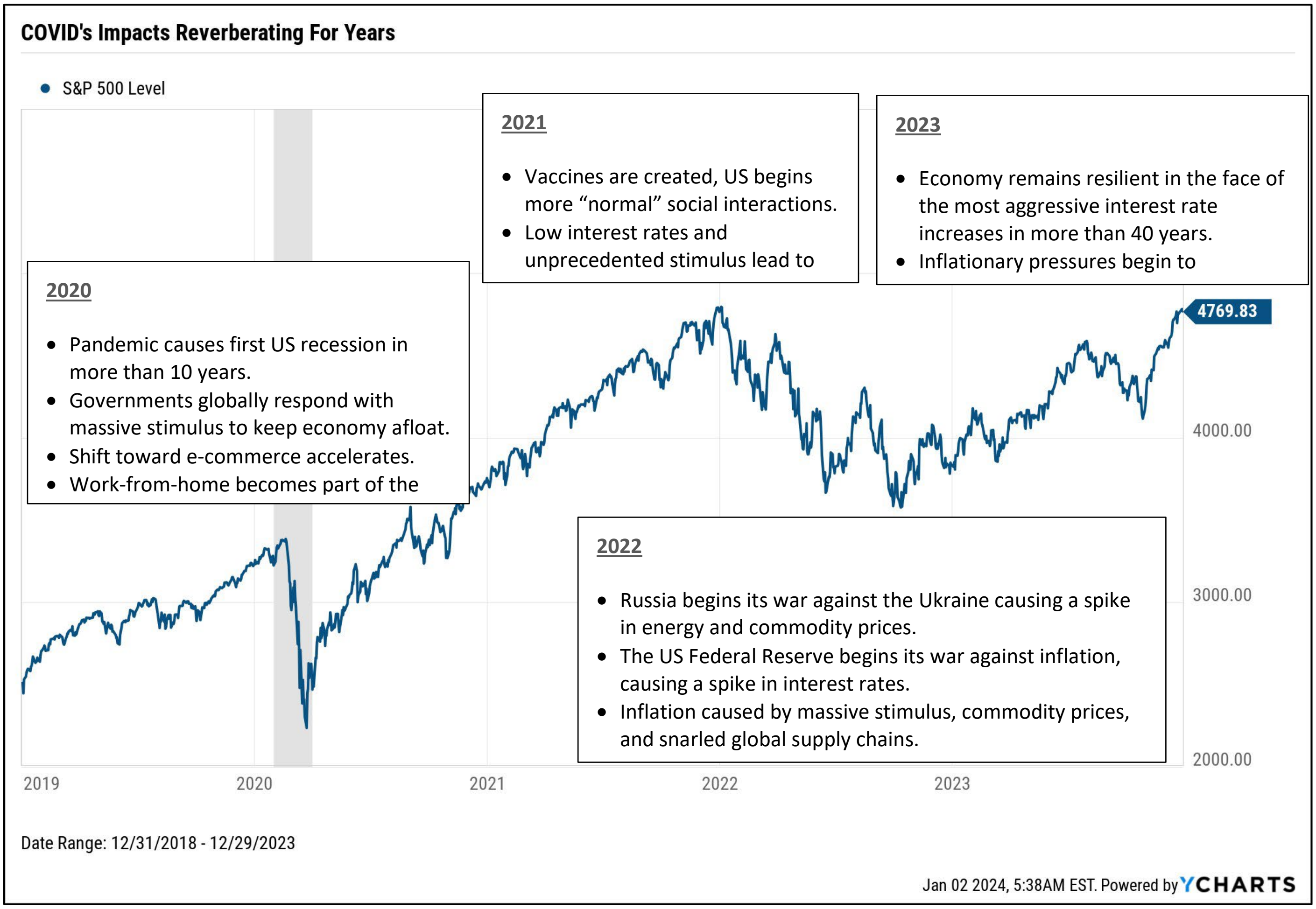
Executive Summary:

- 2024 begins in the most “normal” environment since before the pandemic with respect to interest rates, inflation, and stock valuations.
- We believe that 2024 may be a volatile year for three primary reasons:
    - The year-end 2023 rally was driven by enthusiastic expectations for lower interest rates in 2024. Inflation may prove more resilient, leading to rates remaining higher and investor expectations needing to be adjusted in the short term.
    - The Presidential Election has the potential to be very contentious, and election years tend to be more volatile (not necessarily negative, just volatile).
    - There are two wars in the Middle East and Eastern Europe, with the potential for a third in Taiwan.
- Stocks can end 2024 higher as investors begin to appreciate the potentially massive productivity gains from artificial intelligence across the economy in the coming decade.

Positive Potential Drivers	Risks
Resiliency: Strong labor market powers the economy forward despite weakening household financials	**Inflation:** Inflation resurges, particularly in housing, causing interest rates to stay higher for longer
Productivity: Artificial intelligence & automation drive efficiency gains and profitability growth	**US Election:** Election years tend to be more volatile in general, and 2024 has the potential to be one of the most unpredictable in modern history
Price: Attractive valuation across many parts of the market presents a compelling starting point for 2024	**Geopolitical Conflict:** Increased conflict in Europe, the Middle East, and potentially Taiwan; creating challenges for supply chains, driving up costs, and increasing tensions between trading partners

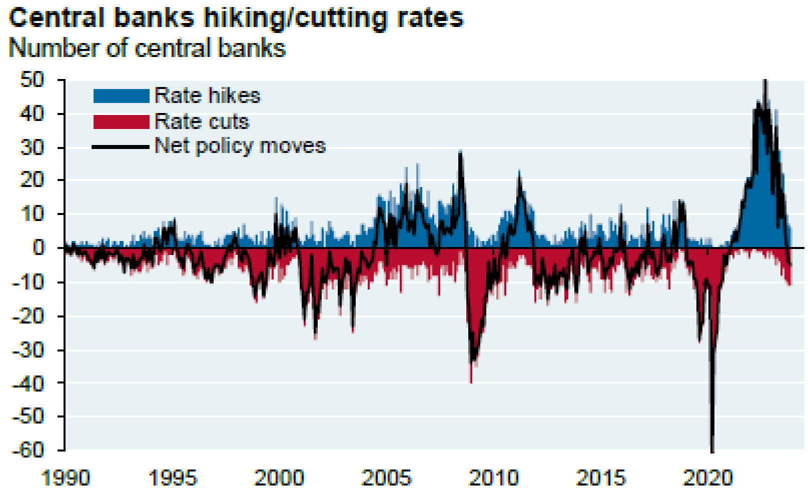
One Chart You Need: The Pandemic's Lasting Economic Impact

There may not be a great example of a "normal" environment in the economy and investment markets, but the last four years have certainly been anything but normal. 2020, an election year, opened with optimism, with markets at all-time highs and the unemployment rate near all-time lows until the pandemic hit. Even though COVID is largely in the rearview mirror, the impact of the pandemic and all of the efforts to mitigate its impact on society and the economy are still with us today.

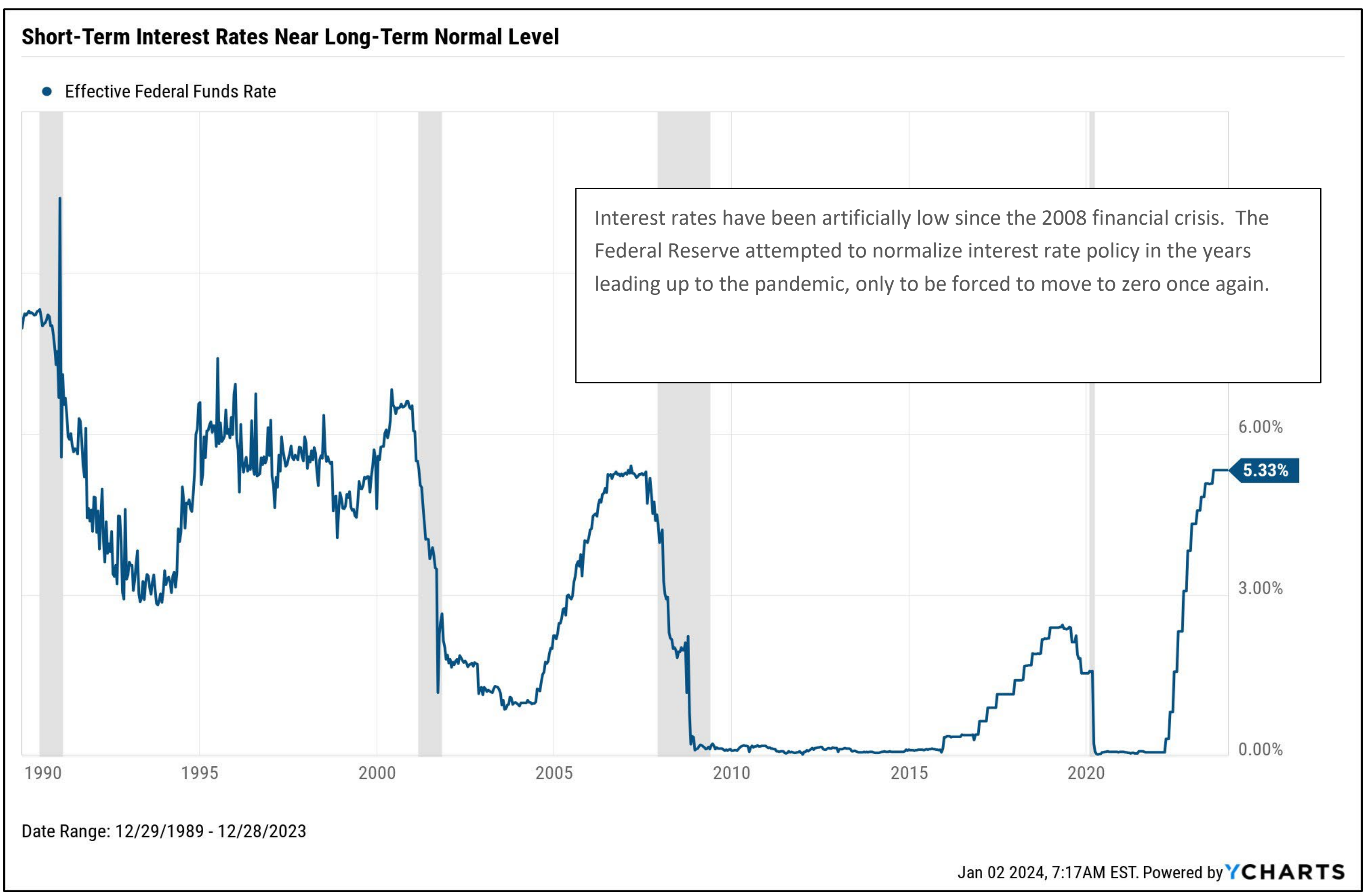


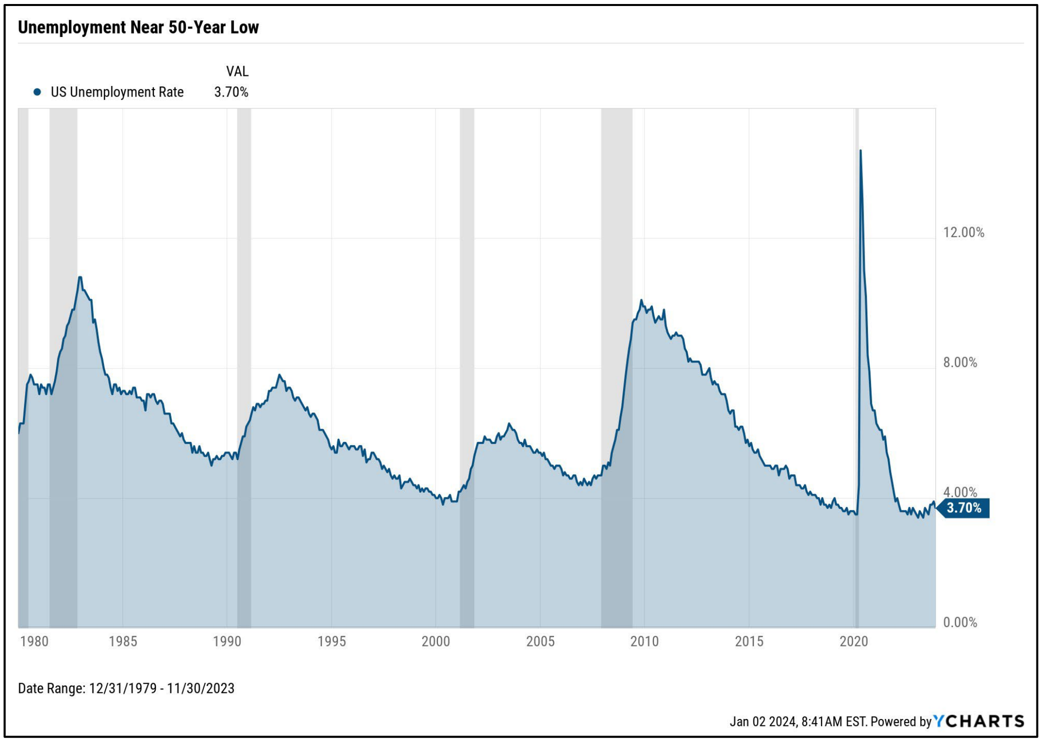
Resiliency:

Following the most aggressive global interest rate-reducing cycle in modern history during the pandemic, we lived through the most aggressive global interest rate-hiking cycle just a few years later. After a very tumultuous period, this year begins in the most "normal" environment perhaps in over a decade. Interest rates on US government debt are more than 4%, and many parts of the stock market appear attractively priced. Inflation and supply chains have largely normalized, albeit at a higher price level than three years ago. The labor market has remained resilient through the most aggressive interest rate hiking campaign in more than 40 years. The path to "normal" was not easy, nor did it occur in a straight line, and arguably it began not in 2020 but in 2008.



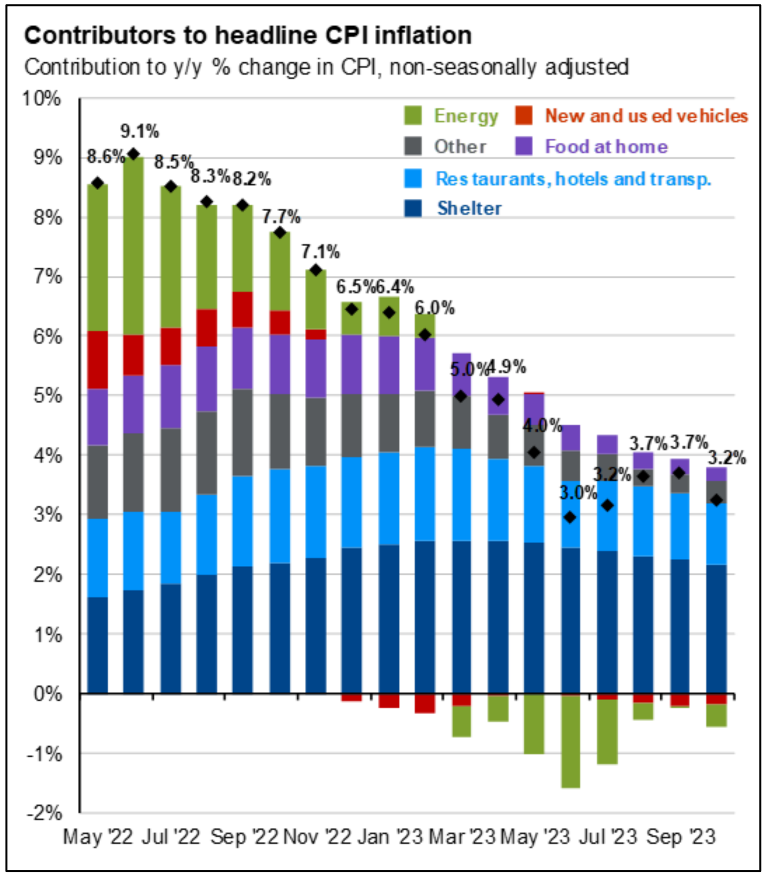
Source: Individual Central Banks, Haver Analytics, JPMAM, November 2023



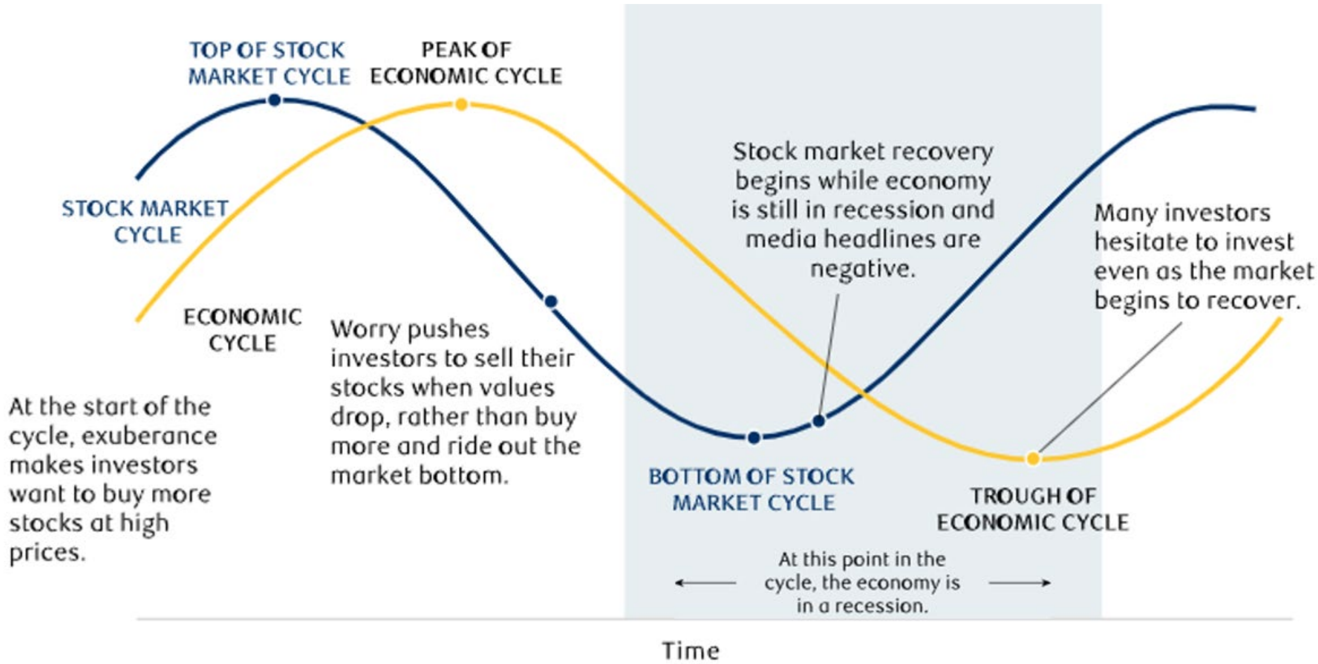


The unemployment rate has remained below 4% for the last two years, and job openings have been plentiful as employers (apparently) remain optimistic about their future. Similarly, household spending, the primary driver of economic growth, has remained positive, albeit at a diminishing rate in the face of higher prices. Credit card debt has been rising and household savings have been declining. Household sentiment remains low, with inflation often cited as the primary reason for the negativity. But, relatively few people worry about their next paycheck or their ability to find a new job, which should allow spending to continue. Additionally, many of us refinanced our mortgages at low interest rates during the pandemic, and we've seen wealth gains in our home equity and investment accounts. We do not believe this is a crisis for US households, but rather a speedbump.

However, in the face of rising costs, lower sentiment, and declining financial health, it would not be surprising to see a collective slowdown of spending amongst American households sometime in the first half of 2024. Given that household spending drives the majority of economic growth, a mild recession remains possible. During their most recent meeting in December, the Federal Reserve Open Markets Committee implied that they expect to reduce interest rates by 0.75% in 2024. This was a significant departure from their previously aggressive stance against fighting inflation. They apparently see that inflation has been subsiding and economic growth is tempering, and the Fed likely doesn't want to be responsible for sending the economy into a recession during an election year.

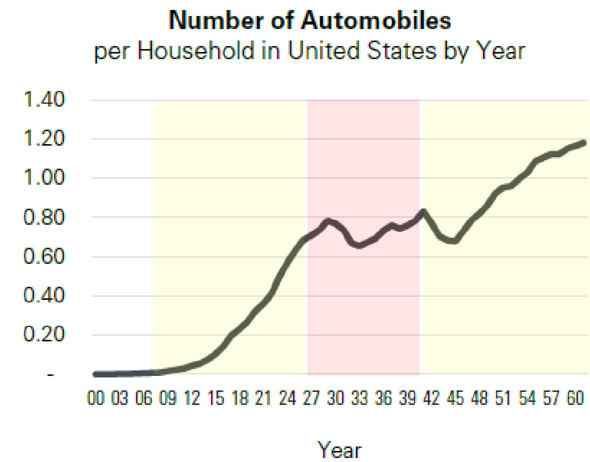


Like in December 2018, when the Fed last pivoted away from monetary policy tightening and the stock market rallied, stocks have similarly rallied sharply to end 2023. Investor sentiment quickly became very positive, and the interest rate futures market is now pricing in nearly 1.5% of Federal Reserve rate reductions in 2024, double the 0.75% that the Fed is currently communicating it plans to accomplish. We believe that entering 2024, investors should be cautious of this enthusiasm around interest rate reductions, particularly if these reductions cause a resurgence in inflationary pressures (e.g., lower mortgage rates drive a spike in home-building activity). This would be positive from an economic standpoint (the economy can withstand higher interest rates better than most thought), but it may be short-term punitive for a stock market that expects the cost of money to be significantly cheaper by the end of 2024. The stock market and the economy are related but they are not the same thing. We are currently at a point where the economy is trying to find a bottom while the Fed is trying to finish its fight against inflation. Things are looking better than they have in the last 1-2 years, but we may not be out of the woods just yet. Investors should remain dynamic and keep dry powder on hand to capitalize on opportunities during the inevitable volatility in 2024.



Productivity:
2023 was the year that artificial intelligence made its way into the general public's sphere of awareness when ChatGPT burst onto the scene. For now, the impact of this technology has been relatively modest when measured across society and the economy, but this is likely just the beginning. Tools like ChatGPT are helping office workers and students produce content faster, but we believe that this technology will be deployed to guide quicker and more efficient decisions across sectors such as logistics, medicine, and finance, to name a few. We believe that we are at the dawn of a new technological revolution that will improve the quality of life in innumerable ways.

To be clear, we believe that this backdrop will drive economic growth and prosperity across many parts of the market. But, to find the best investment opportunities, we must look to history. Technological revolutions tend to be clusters of new technologies that build on each other and permeate nearly all aspects of our lives over time. These periods can last decades. In her work, "Technological Revolutions and Financial Capital" (2002), Carlota Perez studies the interaction between technology, innovation, and economic development. She broadly categorizes the phases of a revolution as two halves: the Installation Phase and the Deployment Phase.



In the Installation Phase, early adopters help to drive the utilization of best practices for the new technology, and as more groups recognize its benefits, investments are made in growth and infrastructure to allow for widespread adoption. For example, Perez identifies the Age of Oil, Automobiles, and Mass Production (1908-1974) as the most recent to our present revolution, the Age of Information and Telecommunications (1971-present). In the Age of Oil revolution, the internal combustion engine and cheap energy through gasoline allowed for the creation of the automobile. In the Deployment Phase, the automobile was standardized and mass-produced cheaply through Henry Ford's advent of the moving assembly line. Later, General Motors created GMAC to provide financing, further catalyzing the explosive growth in the automobile industry. The uptake drove growth across not only automobile manufacturers but also companies producing steel, rubber, glass, and others. The moving assembly line also made its way into other forms of manufacturing, which made the production of household appliances more efficient, and enhanced transportation infrastructure allowed these items to be moved much more quickly and cheaply. As was a hallmark of previous technological revolutions, standards of living increased dramatically.

US Families owning various appliances (% all families) [1]

	Electric Light	Mechanical Refrigerator	Washing Machine	Vacuum Cleaner
1900	3	0	n.a.	0
1920	35	1	8	9
1940	79	44	n.a.	n.a.
1960	96	90	73	73
1970	99	99	70	92

The technological revolution that Perez identifies that preceeded the Age of Oil, Automobiles & Mass Production was the Age of Steel, Electricity, and Heavy Engineering. An early catalyst in this age was the standardization of the lightbulb around Thomas Edison's design. This set off a wave of growth in the Deployment Phase to provide electrical infrastructure across the United States. Utility companies were the beloved growth stocks of this age, but as electricity infrastructure became ubiquitous, their revenue and profit growth slowed, and these companies moved to the mature phase and became "value" stocks (as opposed to "growth"). In the Age of Oil, manufacturing and energy companies became the new growth darlings as their revenues exploded. But, after the widespread adoption of automobiles and manufacturing, their growth slowed like the growth of utility companies in the previous age, and their stocks struggled to keep up with lofty investor expectations.

[1] Charts on this page from "Value is Dead, Long Live Value" by O'Shaughnessy Asset Management (2019)

Some of the best investments during a new technological revolution may not be the exciting growth names at the core of the latest technology but rather the sleepy, boring companies that can "buy and apply" the new technology to drive new growth. For example, the railroad industry, the darlings of Perez's second technological revolution, The Age of Steam and Railways (early 1800s), had been very out of favor with investors throughout the Age of Oil in the 1920s and 1930s as they represented a legacy and inefficient means of transit and logistics relative to automobiles. However, the railroad industry began to transform from steam to diesel in the 1930s, dramatically changing their cost structure and making them competitive with trucking for mass transport of goods. These companies were able to apply the new technology once it had matured, and their cheap, boring stocks drastically outperformed the market in the decades to come.[2]

Name	Jun-1926 to Dec-1941	Jan-1942 to Dec-1958
SOUTHERN RAILWAY CO	-78.3%	8876.3%
NORTHERN PACIFIC RAILWAY CO	-91.0%	6878.9%
SOUTHERN PACIFIC CO	-85.7%	4338.9%
NEW YORK CHICAGO & ST LOUIS RR	-78.3%	3957.0%
ATCHISON TOPEKA & SANTA FE RY C	-61.4%	3434.3%
S&P 500	34.11%	1484.0%

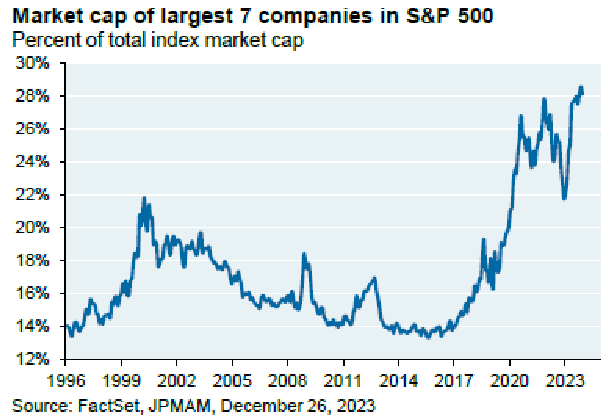
The challenge for investors today seeking value is to identify companies and industries that may drive new revenue and profitability gains from artificial intelligence, robotics, and automation. Some early examples are showing up in our daily lives, like the robot that picks our groceries or the social media algorithms that learn our preferences to determine the next post or advertisement we see. Behind the scenes, companies like Deere increasingly utilize autonomous tractors to harvest fields and drones to fertilize crops. In medicine, AI systems are helping to diagnose diseases and perform drug research faster than ever before.

Virtual assistants are already driving efficiency for service-oriented companies. We believe that we are still in the Installation Phase of AI, and there will be scores of companies that benefit across industries from its mass deployment in the years to come.

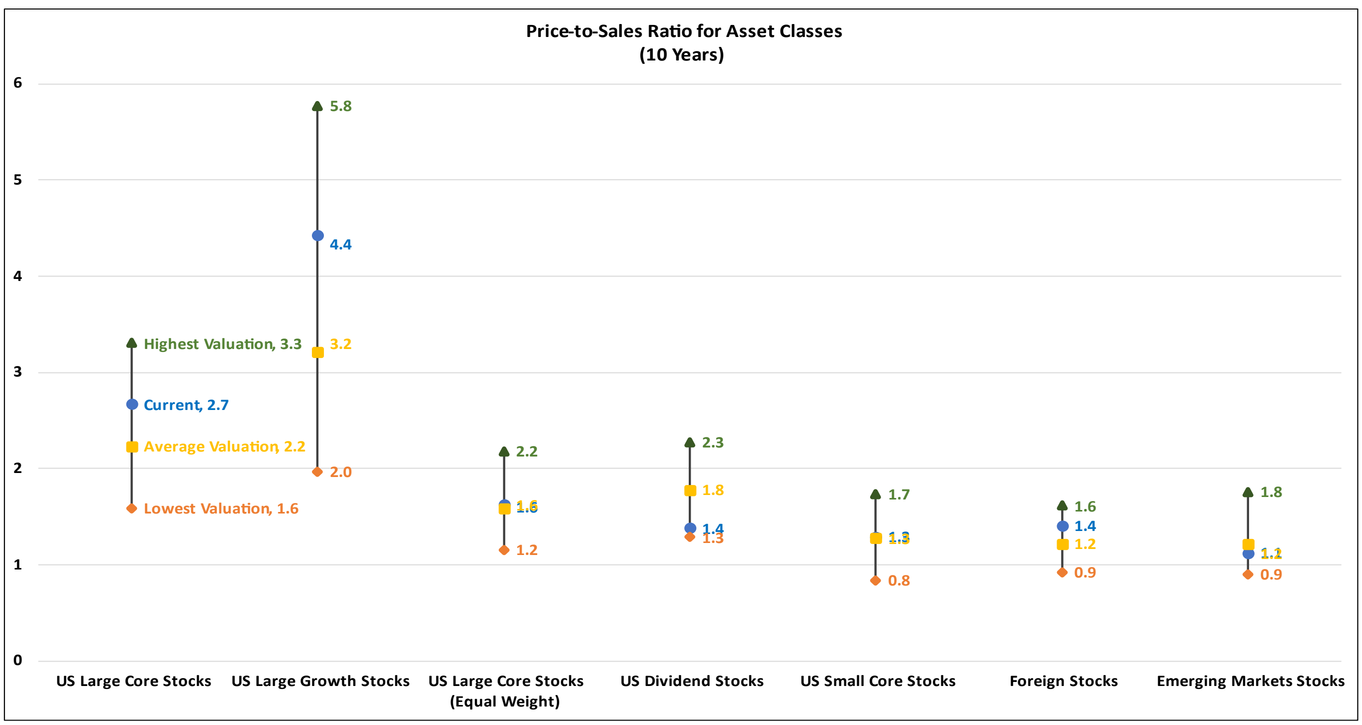
[2] "Value is Dead, Long Live Value" by O'Shaughnessy Asset Management (2019)

Price:

As interest rates have normalized over the last two years, so too have the prices of many parts of the stock market. Large technology companies like Apple and Microsoft are skewing the apparent price of the market. When removing those companies or looking at other asset classes, stock market valuations appear fairly priced or downright cheap. We believe that in the coming years, investors will begin to favor these companies as well, lifting their valuations. Additionally, we expect productivity gains from artificial intelligence to permeate other industries beyond just technology, leading to enhanced revenues and profits across the market in general.



To be clear, we are not necessarily sounding an alarm on companies like Apple, Microsoft, and Amazon. These are great companies with massive competitive advantages, and they will likely continue to grow and consolidate competitive strength. However, those advantages may be fully reflected in their stock prices today, so we are increasingly looking elsewhere for value. And, as history has shown us over long periods of time, those on top don't tend to stay there forever. General Electric, for example, was the largest US company by market value at the start the century and it has lost 1% per year in the subsequent 23 years.[3]



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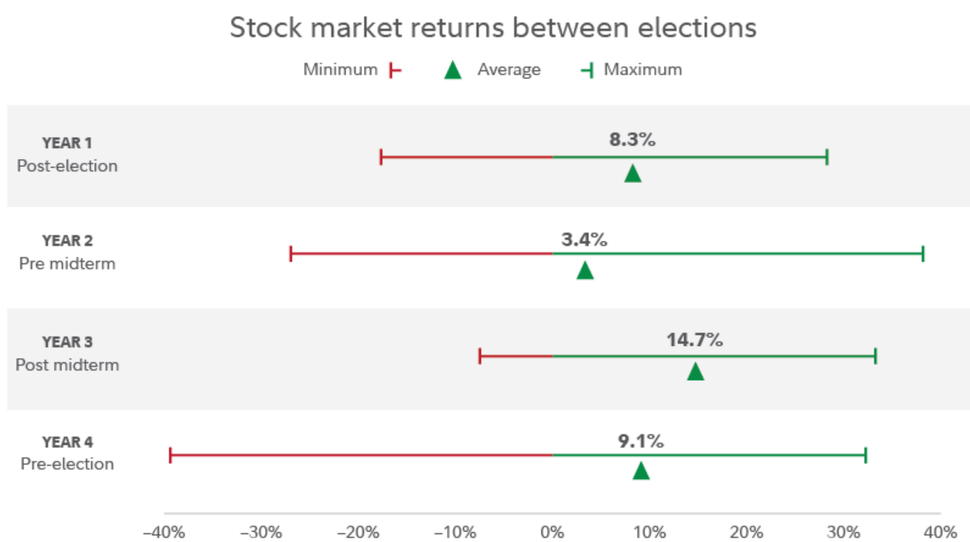
[3] Bloomberg

[4] Source: Bloomberg as of December 30, 2023. US Large Core Stocks represented by S&P 500 Index, US Large Core Stocks (Equal Weight) represented by S&P 500 Equal Weight Index, US Dividend Stocks represented by WisdomTree US High Dividend ETF, US Small Core Stocks represented by Russell 2000 Index, Foreign Stocks represented by MSCI EAFE Index, Emerging Markets Stocks represented by MSCI Emerging Markets Index. The indices/ETFs presented are not intended to be benchmarks for performance. Rather, they are intended to be demonstrative of a particular sector or segment the investment universe discussed. Each ETF was selected as opposed to an index to more accurately reflect what an investor might experience. There are other ETFs or indices that might be representative of the same spaces. However, we believe the ones shown are sufficiently representative to assist us in explaining our investment thesis.

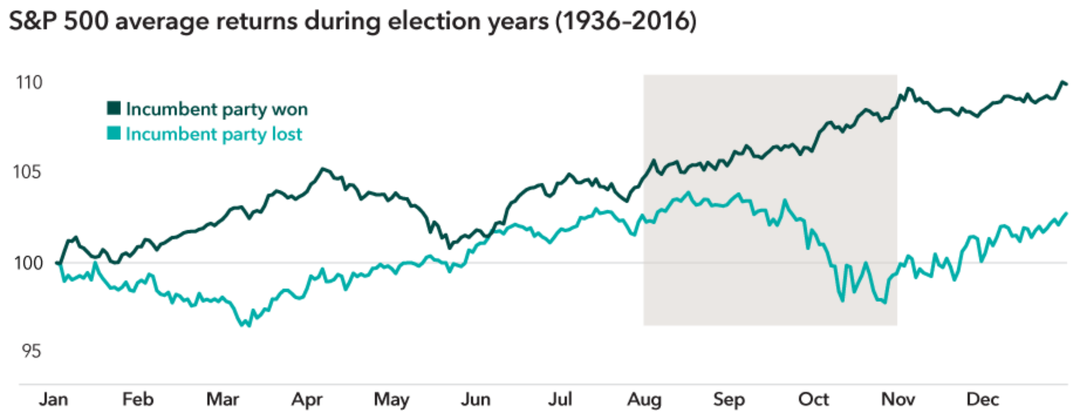
The 2024 Election:
This election has the potential to be one of the most divisive and unpredictable elections in modern history. Donald Trump ended his term in office with a 41% approval rating, and Joe Biden currently has a 39% approval rating. For comparison, Obama, George W. Bush, Clinton, George H.W. Bush, Reagan and Carter ended their presidencies with approval ratings of 55%, 26%, 64%, 45%, 55%, and 32%, respectively.[5] When polled, 56% of US adults indicated they would be "very" or "somewhat" dissatisfied with Joe Biden as the Democratic presidential nominee in 2024, and a similar majority (58%) felt the same about Donald Trump as the Republican nominee.[6] The obvious next question is: does who is President matter for the stock market? The unsatisfying answer: there are too many variables and we need more data to draw actionable conclusions. For example, the S&P 500 index has produced a double-digit annual return during both the Trump and Biden administrations despite their unpopularity. That return probably had less to do with who was President or which party was in control of Congress, and instead was driven by monetary policy at the Federal Reserve and innovation from companies like Nvidia and Microsoft.

There are a few historical patterns that we have been able to observe. For example, mid-term years tend to be the worst in a Presidential term (year 2), with an average annual return of only 3% and a wide range of outcomes. Election year (year 4), where we are currently, tends to produce a healthy return on average (9% annually) but with a high degree of variability. The lesson here is that markets tend to do well in the long run, but election years do tend to be more volatile, so it is appropriate to remain dynamic in 2024 with plenty of "dry powder" to capitalize on opportunities that may present during volatility.[7]



[5] FiveThirtyEight.com
[6] Associated Press-NORC Center for Public Affairs Research
[7] Fidelity

And, despite the best efforts of rigorous and scientific polling, the markets tend to be a pretty good forecasting tool for who will win the election. In 20 of the last 24 Presidential elections since 1936, if the S&P 500 index was up the three months before election day, the incumbent party won. Implying that, collectively, we all vote with our wallets to some degree.[8]



Source: Strategas. Returns are indexed to 100 on January 1 of each election year. Returns are in USD. The shaded region approximately shows the three-month period prior to Election Day.

[8] Capital Group

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Outlook & Positioning Summary

Economy

✓ Economic Growth	5.2% US Gross Domestic Product (Q3 2023)
✓ Employment	Solid, but showing signs of deterioration
• Households	Not overindebted but savings and sentiment low
• Financial Conditions	Inflation Remains Above Target, Interest Rates Elevated, Bank Lending Declining. US Government Spending on Infrastructure.

Markets

✓ Valuation	Many Assets Trading At-or-Below 15-20 Year Averages
✓ Earnings	Growing and beating expectations
• Trend	Narrowly Focused on US Large Tech Stocks
• Investor Sentiment	Turned Positive

Portfolio Management	=	Overall Risk	Maintain risk exposure in-line with your long-term plan
	+	Active Management	Dispersion high, opportunity for security selection
	=	Alternatives	Recently reduced in favor of traditional bonds
Equities	=	Large Cap Equities	Maintain exposure, shift towards dividends
	+	Small Cap Equities	Attractive valuation, opportunity for stock pickers
	+	Foreign Equities	Attractive valuation
	=	Emerging Market Equities	Attractive valuation, elevated geopolitical risk
	=	Commodities	Lower on recession fears, but energy prices rising
	=	Public REITs	Varies significantly by property type, reviewing opportunities
Fixed Income	=	Interest Rate Sensitivity	Recently increased as rates are higher, and Fed looks to be nearing end of tightening cycle
	=	Credit	Credit spreads near long-term averages, focus on higher quality
Key Themes	+	Healthcare	Potentially transformative but unloved by investors
	+	Infrastructure	Trillions required for transportation, energy & communications
	+	Disruptive Technology	Seeking durable revenue growth after sharp rise & fall

Prices & Interest Rates

Representative Index	December 2023	Year-End 2022
Crude Oil (US WTI)	$71.33	$80.26
Gold	$2,072	$1,819
US Dollar	101.38	103.52
2 Year Treasury	4.23%	4.41%
10 Year Treasury	3.88%	3.88%
30 Year Treasury	4.03%	3.97%

Asset Class Returns

Category	Representative Index	1 Month	YTD	2022	1 Year	3 Years	5 Years
US Large Companies	S&P 500	4.5%	26.3%	-18.1%	26.3%	10.0%	15.7%
US Large Companies	S&P 500 Equal Weight Index	6.9%	13.9%	-11.5%	13.9%	9.4%	13.8%
US Dividend Companies	WisdomTree High Dividend Index	5.2%	0.2%	-0.5%	0.2%	10.7%	9.4%
US Growth Companies	Russell 3000 Growth	4.8%	41.2%	-29.0%	41.2%	8.1%	18.9%
US Value Companies	Russell 3000 Value	5.9%	11.7%	-8.0%	11.7%	8.8%	10.9%
US Small Cap Equity	Russell 2000	12.2%	16.9%	-20.4%	16.9%	2.2%	10.0%
Global Equity	MSCI All-Country World	4.8%	22.2%	-18.4%	22.2%	5.8%	11.7%
Foreign Developed Equity	MSCI EAFE	5.3%	18.2%	-14.5%	18.2%	4.0%	8.2%
Emerging Market Equity	MSCI Emerging Markets	3.9%	9.8%	-20.1%	9.8%	-5.1%	3.7%
US Fixed Income	Bloomberg Barclays US Agg. Bond	3.8%	5.5%	-13.0%	5.5%	-3.3%	1.1%
US Fixed Income	Bloomberg Barclays Municipal Bond	2.3%	6.4%	-8.5%	6.4%	-0.4%	2.3%
Global Fixed Income	Bloomberg Barclays Global Agg. Bond	4.2%	5.7%	-16.3%	5.7%	-5.5%	-0.3%

Source: YCharts as of December 31, 2023. Annualized returns for data longer than 1 year