Market Commentary

Fourth Quarter 2023

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The fourth quarter of 2023 witnessed significant volatility in financial markets along with a dramatic mid-quarter change in investor perception. Equities, as measured by the benchmark S&P 500 Index, rose by 11.7% during the quarter, bringing the full year total return for the index to an impressive 26.3%. The quarter could be divided into two distinct periods based on investor behavior. From the beginning of the quarter through late October, interest rates drifted higher, and the S&P 500 benchmark declined by 4%. As investors began to believe the Federal Reserve was done raising rates during this cycle, interest rates across the maturity spectrum began to decline and equities reversed higher. This move for both asset classes accelerated following the mid-December FOMC meeting which was seen as extremely "dovish" on interest rate forecasts. From the low point in late October, the S&P 500 rose 16% through the end of the quarter. As we discuss in further detail below, the euphoric rally of the final two months of 2023 has likely pulled forward a good deal of 2024's expected price appreciation.

Fixed income yields declined meaningfully during the latest quarter in moves last seen during the March banking crisis. Shorter-term yields declined the most as investors reduced their near-term inflationary expectations. The 1-year Treasury bill declined to 4.78% from 5.47% on September 30 but was virtually unchanged from the 4.72% rate a year ago. The 2-year Treasury note began the quarter yielding 5.05% and declined to 4.22% at year end. Moves in longer-term maturities were healthy as well. The benchmark 10-year US Treasury note ended the year yielding 3.87%, well below the 4.58% on September 30, and roundtripping the move from 3.88% at the end of 2022. For reasons we will elaborate on, we suspect investors may have gotten ahead of themselves with the fixed income rally and rates may rebound higher in early 2024.

Economic and Market Outlook

Corporate earnings are what ultimately drive stock prices. At the start of 2023, analysts predicted S&P 500 earnings would reach $230 for the year. As we await fourth quarter earnings results, we note the final number for 2023 should approximate $223. This is essentially unchanged from the 2022 results of $222. This means that stocks are currently valued more than 25% higher than they were a year ago due to the market appreciation in 2023. While we agree the Fed is almost certainly done raising interest rates, we disagree on the speed and timing of interest rate cuts. The Fed would need to see meaningful economic uncertainty to cut rates to the extent the market anticipates. This sets up the potential for disappointment in two separate ways. The first potential disappointment for investors could come from the economy continuing to plod along, avoiding significant changes in inflation or unemployment which allows the Fed to keep rates higher than investors expect. An alternative potential surprise could occur if the economy declines more rapidly than the Fed anticipates, forcing them to cut rates aggressively. While this would bring rates down in line with investor beliefs, it would likely come along with weaker than expected earnings which could weigh on equities. Earnings estimates for the S&P 500 in 2024 approximate $250 which a further jump to $275 in 2025. We believe these estimates could prove to be overly optimistic with margin pressures coming from many sources. The index enters 2024 selling at nineteen times forward earnings estimates which is above its long-term historical average.

Market internals are another source of concern. Despite rising more than 26% last year, eight of the eleven economic sectors within the S&P 500 Index declined during 2023. Only technology, communications services, and consumer discretionary showed positive returns. Another example of the bifurcated market is evidenced by the "Magnificent Seven" stocks (Apple Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla), which rose a whopping 106% during 2023. The average stock in the S&P 500 rose a far more pedestrian 11.7% during the year. This huge divergence in the market not only distorts returns but causes investors to chase performance. If you did not have a sizable portion of your portfolio in the Magnificent Seven stocks during 2023, your returns were likely meaningfully below the "market return" of 26.3%. Historically when this happens, investors load up on recent winners, only to find out later they had missed the bulk of the rally. Even though earnings growth in these seven companies averages more than 20%, when the stocks double within a year, valuations get stretched. We are not saying to completely avoid those stocks, but to be mindful of what you own and buy. The top ten stocks by market capitalization total 32% of the S&P 500 – higher than the 27.5% at the dot-com peak in early 2000. This means that an investor who simply buys the index has a third of his portfolio in just ten stocks. Additionally, all ten of these companies are tech-related meaning there is significant industry concentration risk in the index as well.

Turning to oil markets, the commodity gave back all the previous quarter's gains during the final three months of 2023. Beginning the month of October at $90.77, the price for benchmark West Texas Intermediate (WTI) declined for most of the quarter, dropping below $70 in mid-December before rebounding slightly to end the year at $71.65. This compares to a year-ago price of $80.26. OPEC believes "exaggerated concerns" about falling demand is the main culprit in falling oil prices. It is evident that most developed economies are facing the pressures of central banks working to soften overall demand through higher rates. How much this should affect oil prices is subject to debate, but we caution that there are many potential geopolitical triggers to meaningfully higher oil prices. If oil prices were to remain near the $70 level it could help spur consumer spending demand as less money goes to pay for energy consumption.

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The meaningful decline in interest rates during the last quarter will go a long way to improving bank balance sheets. We wrote in our last commentary that "*Banks are still holding hundreds of billions of dollars of bonds with market losses. While most of these are marked as 'held to maturity,' they represent over 20% of total bank equity capital.*" This situation will provide more ability for banks to lend and free up some credit. Declining bond yields and rising stock prices have combined to loosen financial conditions. In fact, since the March bank mini-crisis, financial conditions have been loosening. This serves as a tailwind to consumers, increasing their ability and desire to spend.

As we enter 2024, the list of potential headwinds to financial markets includes the wars in Ukraine and Israel/Gaza, disruptions to shipping routes through the Red Sea, persistently high budget deficits, and the 2024 Presidential election. While each of these may be resolved with little detrimental effect to markets, they require our attention as any of them has the potential to result in a major shock to financial markets.

Portfolio Positioning

The past two years have been challenging for investors to navigate as the Federal Reserve moved with unusual speed to battle rising inflationary pressures. While the bulk of the work is done, the financial landscape is meaningfully changed. The zero-interest rate environment that had persisted since the 2007-2008 financial crisis is likely gone forever. In its place is what many refer to as the "new normal." However, those of us in the business for decades, believe this is actually the "old normal", or how markets functioned before 2007. Interest rates should move up and down with economic activity. The business cycle will continue to assert itself and investors will again need to watch their asset allocation more closely. Since 2007, we lived in the "TINA" world as investors believed "There Is No Alternative" to stocks. The Fed depressed interest rates, so fixed income and money markets yielded almost zero for several years. This compelled investments in equities regardless of valuations or prospective earnings. A normalization of financial markets provides both risks and opportunities for investors. The risks come mainly from the unwinding of certain "sure bets" that have worked for the past decade or longer. These include large-cap outperforming small-cap, US outperforming International, and growth outperforming value. While these may not completely reverse, the movement of interest rates off the zero bound introduces risk into certain trades that previously had little. When interest rates are near zero and the 10-year US Treasury yields 2% or so, investors needed little prodding to buy equities. With money market funds currently yielding over 5% and the ability to earn 5% or more on intermediate term corporate credit, the relative allure for stocks has dimmed. We have not changed our belief that equities are the best method of long-term wealth accumulation along with serving as a potent inflation buffer. However, current market conditions compel us to point out the ability to earn decent returns with much lower levels of risk in cash and fixed income securities.

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Conclusion

If we combine our forecast of positive but uneven economic growth, a softening labor market, and higher than previously expected interest rates through 2024, we posit that the strong rally in the last two months of 2023 "borrowed" some of the price appreciation in equities and fixed income we had expected in 2024. This leaves us believing equities are a bit above fair value, and they will need earnings growth to reaccelerate to move stocks meaningfully higher from current levels. Fixed income yields may also have dropped a bit below where they should be based on economic forecasts and expected levels of Treasury issuance during 2024. While we are cautious, we are not saying to sell aggressively. Investors should maintain a risk-aware focus, concentrating on high quality investments with modest valuations, strong balance sheets, and robust cash flow, rather than chasing the latest fad. Although this defensive position may cause us to slightly lag a sharply rising market, it will protect followers if markets give back some of their recent gains. Income producing assets will hold investors in good stead during choppy or declining markets. When valuations recede towards more historical levels, we will be prepared to become more aggressive in our portfolio holdings.

In closing, we wish each of you a Happy and Healthy New Year. We hope your families and loved ones remain safe. Please inform us of any significant changes in your financial situation or if you have any specific questions or concerns about your investments.

December 31, 2023

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