2023
REVIEW AND OUTLOOK

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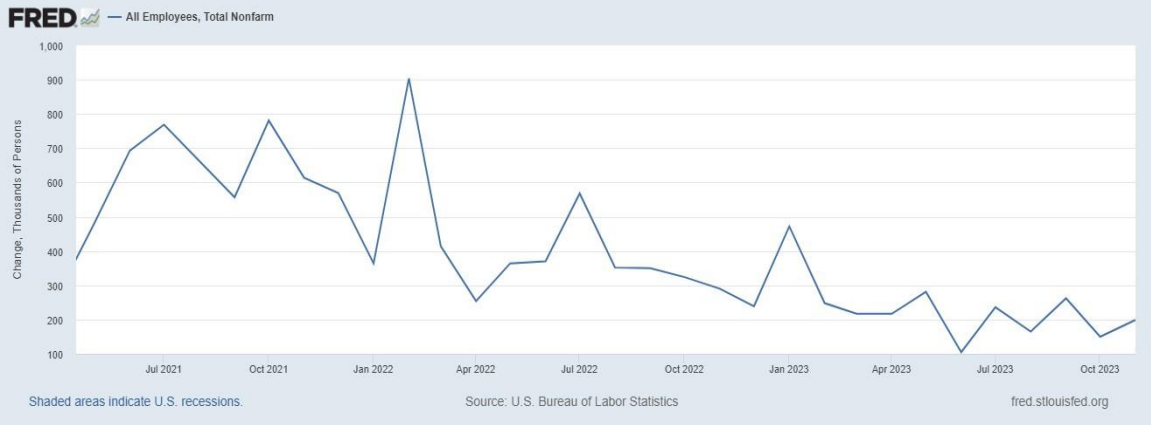
OVERVIEW

The Outlook is Always Uncertain: Dr. Charles Lieberman, Chief Investment Officer and David Lieberman, M.B.A., Portfolio Manager

The soft-landing thesis is now driving investor expectations, but such an outcome is still far from assured. As they say, forecasting is difficult, especially when you try to forecast the future. More data is needed to determine how much the Fed's policy rate hikes have slowed down growth and inflation. Until this becomes clear, the Fed will remain on pause, likely for several months. But with solid growth continuing and no signs of the long-expected recession, the environment should be very positive for stocks and somewhat benign for bonds.

The case for a soft landing

Recent job gains, adjusting the actual reported data by moving striking workers to the months they were employed, creates a sequence from September through November of 262,000, 186,000, and 171,000, suggesting a deceleration in hiring, as seen in the chart below.



Concerns about the soft-landing thesis

Adjusted or unadjusted, hiring has clearly slowed. But much of that slowing was inevitable. It was simply impossible to sustain monthly gains of 500,000 or 400,000 without soon running out of people to hire. Such rapid job growth reflected the rebound from the pandemic shutdown, the Fed's highly accommodative monetary policy, and enormous fiscal stimulus supplied by Washington. That rebound is now largely behind

us. The normalization of the labor market is also evident in average weekly hours worked, which reverted from multi-decade highs following the pandemic to levels comparable to the average of the past decade. We remain comfortable with these same conclusions after the just released December jobs report.

A key part of the slowdown in growth over the past year is due to manufacturing. Demand for manufactured goods soared during the pandemic, causing shortages for many types of goods. As the economy reopened and recovered, demand shifted to services, weakening demand for goods and causing recessionary conditions in manufacturing in 2023. Conditions stabilized by the end of the year and should improve throughout 2024.

Broadly, the labor market is gradually transitioning from an exceptionally strong and nearly historic level of growth to a solid rate of expansion. Will it slow as much as needed to bring inflation to the Fed's 2% objective? It is concerning that hiring is still fairly robust relative to the influx of new job seekers at this stage of the expansion. Labor force participation rose by 0.6 percentage points over the past 12 months, from 62.2% to 62.8%, adding 3.733 million people to the workforce, or an average of 311,000 per month. Among 55–64-year-olds, the labor force participation rate recently hit a cyclical high. Despite that upswell in job seekers, the unemployment rate barely increased from 3.6% to 3.7%. So, the overwhelming majority of new job seekers found jobs, a truly impressive feat. Yet, that too is not sustainable. The peak in labor force participation prior to the pandemic was 63.3%, and baby boomers are still retiring at a rapid rate, roughly 10,000 per day. That's why demographers ballpark underlying growth in the labor force between 50,000 to 100,00 per month. It seems likely that the demand for labor remains strong enough to absorb the influx of job seekers if it remains elevated. But if the supply of labor moderates, as seems more likely in the near-term, labor markets should resume getting tighter, adding to wage pressures. We reaffirm these conclusions even after the large decline in labor force reported for December. Indeed, we think some additional moderation in labor force still lies ahead.

Wage inflation has moderated from the overly hot pace of the early recovery from the pandemic, as measured by the somewhat inaccurate year-over-year average hourly earnings figure, reported as 4.0% in November. That was taken as good news by those hoping for inflation to get to the Fed's 2% target fairly soon. But the more accurate year-over-year employment cost index, total compensation for all civilians, slowed only to 6.8% as of Q3. That remains excessively high and better reflects the low unemployment rate. So, the labor market remains quite tight and any further tightening, as would occur if entry into the labor slows, would be problematic.

Posted job openings serve as another indicator of future employment demand. In the earlier part of 2022, we witnessed job openings soar to 50% more than any number previously recorded, demonstrating the staggering and embedded pressure on hiring. The high level of interest rates contributed to a decline in job openings by 1.5 million, representing a sharp drop by historic standards but not relative to the historically high

levels of job openings available. They are still slowly declining as we enter 2024, but remain above pre-Covid levels.

We see housing as continuing to surprise in 2024 by adding to growth. In 2023, the housing market found a bottom despite ongoing increases in interest rates in the first half of the year. This was in marked contrast to the sizable decline in new housing construction in 2022 as mortgage rates soared. Yet, that negative response ceased in 2023. Why? Conditions in housing reflect two opposing forces, as a severe shortage maintains a high level of demand, while high mortgage rates curtail total demand. In early 2022, the surge in mortgage rates dominated lack of supply. By mid-2022, new single-family homes sales bottomed and resumed growing as new home builders worked with buyers on financing and pricing to improve affordability. It is clear that affordability continues to constrain the upward trajectory of pricing, even as the housing shortage provides a floor under demand, existing and new. Home ownership costs have soared to over 41% of income from the pre-Covid level of under 30% (source: Redfin.) So, as mortgage rates recede, improving affordability, we expect housing to be a contributor to economic growth and labor demand. Housing prices, however, are unlikely to move sharply higher, but housing prices won't ease until supply ramps up.

Economic and Investment Implications

Growth should remain solid and above the economy's long-term sustainable average of 1.5% to 1.75%. The unemployment rate should resume its very gradual decline, depending very much on how many job seekers enter the labor force. If that influx continues a bit longer, so will strong growth and the decline in unemployment may take slightly longer to appear.

Monetary policy is likely to remain on hold while the Fed waits to see how the data plays out. It will take time, months at a minimum, but quite likely at least a few quarters. By then, the upcoming election will be imminent. The Fed will not want to change policy in an election year, especially if the data suggests that rate hikes are appropriate, unless the case is compelling. So, there's a possibility that monetary policy remains unchanged for all of 2024.

The economic environment pictured is positive for stocks and decent for bonds. The economic growth we envision will propel corporate profits further in 2024. Valuations have diverged, with certain large-cap growth stocks commanding premium valuations, while other sectors, notably healthcare and financials, are priced at significant discounts. Small-cap stocks currently trade at some of the lowest valuations observed in the past decade in sharp contrast to the elevated valuations of large-cap counterparts, especially the "Magnificent Seven" tech stocks. In contrast, the bond market is a bit over its skis in expecting multiple Fed policy rate declines. Correcting this misjudgment should not offset bond coupons, so fixed-income investors should earn a modest positive return. But as often happens when the bond market is wrong, it simply pushes out further into the future its expectations, so it is likely to remain well out over its skis. That will also limit any downdraft in bond prices.

A Look Around the World

UPDATE

World Market & Economic Update: David Ruff, CFA®, Portfolio Manager

The year 2023 will go down as a strong year for global equities, with the MSCI All Country World Investable Market Index Net Index advancing 21.58%. The final quarter contributed 11.14% to the index annual return.

As usual with equity markets, 2023 returns occurred with volatility as risks and perceptions of risk vacillated during the year. Looking forward to 2024, many risks still exist, but also opportunities. We'll lay out what we believe to be some key risks, and where attractive investment opportunities reside in the global equity marketplace.

Always present, geopolitical risk may again take center stage in 2024. Of immediate concern, a broadening of the Israel-Hamas War with direct involvement by Iran could add significant pressure to global supply chains. We're already experiencing inflated shipping costs with the Iranian proxy, the Houthis, harassing ships in the Red Sea. The added fuel and journey time costs an estimated 20% more for Asia-to-US and Asia-to-Europe routes. Suez Canal transit accounts for about 12% of international trade. Of greater concern would be Iran's closure or disruption of normal ship traffic through the strategically important Strait of Hormuz. Persian Gulf exports account for 21% of global petroleum liquids consumption with 88% passing through this strait to destinations in Asia, Europe, and North America. Historically, conflicts involving the Persian Gulf can lead to an energy price spike of 80% or more. Crude prices moving to $150 would slow global GDP by one to two percentage points according to some World Bank studies. Easy to be alarmed by this risk, it's important to remember this is not new. Accordingly, we handicap Persian Gulf disruption low probability and believe normal traffic functioning will return to the Red Sea. In other words, the current conflict remains contained.

> An effective Suez Canal closure stresses the global economy, reducing world GDP by half a percentage point or more according to some estimates.

Probably a more significant geopolitical risk for equities lies in the US-China relationship deteriorating further. Although a recent meeting by Presidents Biden and Xi appears to have stabilized the relationship for now, the 2024 US election may elicit greater China-bashing rhetoric. Importantly, no apparent progress was made on trade tariffs and technology export controls. To review, the US export controls seek to restrict the China's ability to acquire, develop, and manufacture advanced semiconductors and related technology in the hopes of limiting China's development of AI and advanced weapons. In retaliation, China restricted access to several materials and technologies including polysilicon for solar panels, EV battery technology as well as graphite, a crucial mineral

for these batteries. Maybe of more concern, Beijing also effectively banned exports of some refined rare earths elements. While supplies of these elements exist in several parts of the world, refining occurs almost exclusively in China, a process which reportedly took 15 years to build. Fortunately, to date, the impact from this Chip War remains muted.

Some believe this US-led silicon blockade limits China to only 10% to 20% of the high-performance chips needed. Doomsayers, of course, warn China, facing a high-performance chip shortage, may be forced to take over Taiwan. They highlight President Xi's recent dialogue with President Biden where the former reportedly asked the US to support a peaceful Taiwan takeover, but again reiterated China use of force, if necessary, to bring about unification. To date, there has been little detailed analysis of the ramifications of a Taiwan takeover by China. Most assume this leads to a direct conflict or war between the US and China, precipitating another global financial crisis. We believe there would be an initial negative financial market response, likely punishing Chinese, US, and all global equities, possibly with technology hardware and related firms taking the biggest hit as the market reacts to the unpredictable consequences of a military confrontation directed at Taiwan. That said, the longer-term implications may not be dire, especially if China promises to provide continued access to the Taiwanese semiconductors on which the world depends, and assuming the US exhibits military restraint. Moreover, we view this scenario as a remote risk at the moment. Of course, a US-China military conflict could follow many tracks, but in a worst-case scenario, it would probably result in China dumping US treasuries, or possibly, US seizure of Chinese-held US treasuries. Either scenario leads to rapidly rising interest rates causing global economic pain. Fortunately, the countries' respective political leaders understand this. Thus, we believe China's extensive holdings of US debt will act as a deterrent to takeover action by the Chinese, at least, for the next several years. Second, we question the idea that these high-performing chip restrictions truly limits China in their defense and AI ambitions. Already a global leader in mature chip technology, including those used in military operations, we doubt chip shortages will impact China arms production. Further, the technology gap in the production of the most advanced semiconductors produced in Taiwan and China appears to be closing rapidly. This makes the urgency to take control of Taiwan by China less crucial in our opinion.

Of course, there are many other global risks. Prominently, in the US, political risks may be elevated in 2024. The Presidential race promises significant intrigue with a major candidate facing several criminal indictments, a never before occurrence in American politics. Efforts to keep candidate Trump off the ballot may have to be decided by the Supreme Court, probably adding to already extreme political polarization. The political division may amplify with another pending government shutdown, and impeachment efforts against President Biden. Maybe most worrisome, another episode of questioned election legitimacy could lead to social unrest. While not dismissing these risks, US democratic and financial institutions to date have withstood volatile election years in the past with little disruption to the economy and markets.

In some ways, Europe may be better positioned in 2024. With less exposure to technology, the region may be shielded from the US-China competition and less vulnerable to the sector's volatility. Obstacles remain, however. China's EV dominance challenges Europe's own EV industry. A potential increase in European tariffs on Chinese EV cars and equipment could spark a Chinese response, an important development given China's status as Europe's most important and fastest growing major trade partner. This latter fact may boost Europe in 2024, however, as the Chinese economy appears to be finding its legs after a shaky 2023. China's economic strengthening should lead to an export recovery in Europe, especially by Germany. Of the three major world regions, Europe's economy currently shows the most anemic growth. However, we look for its central bank, the ECB, to pivot to accommodation, probably earlier than the US. In summary, with investor expectations low, we believe Europe may surprise with its economic resiliency, just as it did in 2022, after the Russian invasion of Ukraine and its impact on energy supplies. We're finding companies in Europe exhibiting durable growth at attractive valuations. Accordingly, we have relatively higher allocation to the region in our global and international portfolios.

In closing, I'll restate the important caveat that past performance is not necessarily indicative of future results. That said, equities, representing ownership in companies, historically outperform other asset classes like bonds, real estate, and cash over the long term. This occurs in spite of wars, rumors of wars, trade conflicts, and other causes of economic turmoil as equities benefit the most from human ingenuity and innovation. Of course, all investors suffer from ignorance of the future, and temporary setbacks should be expected. Risks should be monitored and carefully considered, but investors should not be paralyzed into non-investment because of them. Diversification, both by kind of company and geography, remains key in avoiding concentration risk, mitigating volatility, and preserving capital.

Inflation vs Interest Rates

UPDATE

Our Thoughts on Interest Rates in the Near Term: Kevin Kelly, Portfolio Manager

Interest rates will likely continue to be volatile as investors try to handicap both the path of inflation and constant fear of recession risk (which could also lower inflation). We do not foresee a meaningful increase to short-dated Treasuries (1-3 year) as we think the Fed is likely done hiking rates for a while and the path of potential cuts is simply unknown at this time. For short-dated Treasuries to decline abruptly, a recession would need to occur. We are focusing on 3-7 year bonds currently as we think there is good value there. Long-end rates (10-30 years) while influenced by inflation, will be impacted by government deficits and global interest rates.

In general, we do not feel it is prudent to try to precisely handicap interest rates. Predicting interest rates is not a fixed income 'strategy' although many investors will try to do so. A good bond manager should be aware of when interest rates seem dramatically too low (near 0 bound) or way too high (in excess of short-term elevated inflation levels). We feel strongly that active management, combined with solid credit research and security selection is a repeatable strategy.

We have and will continue to actively manage duration as a portfolio of individual securities naturally fades duration over time (bonds get closer to maturity).

The Past Will Not be Prologue in 2024

UPDATE

We Do Not Expect to See a Repeat of 2023: Dr. JoAnne Feeney, Portfolio Manager

One story of the market in 2023 can be told very simply and with mention of just a handful of companies. We expect 2024 to be very different. In 2023, the majority of the S&P 500's total return of 26.3% was driven by just seven companies, collectively known as the Magnificent 7.[1] That small group was responsible for just over 60% of the market's return, and a fund tracking that index would have had 26% of assets in those stocks during the course of the year. Most of those companies—Amazon, Microsoft, Nvidia, Alphabet—moved higher on the strength of growth prospects related to generative artificial intelligence (AI). Nvidia provides the powerful computer chips that enable the creation of AI applications (such as ChatGPT), while Amazon, Microsoft, and Google (of Alphabet) provide the cloud computing services which allow businesses to make use of AI applications. The world has only just begun to see the potential of generative AI and investors are trying to understand where and how it will be deployed. As they do, they want to own stocks of companies at the center of this technology revolution.

But let us not forget another key driver last year: rising interest rates for most of the year. Indeed, we had a mini banking crisis early in 2023, which exposed the vulnerability of asset values to that rise in interest rates. So, it was remarkable that a handful of high growth stocks appreciated as much as they did – normally, higher interest rates reduce valuations of growth stocks because of the more severe discounting of their future profits. Not so last year for the Magnificent 7. Now, part of the reason for this apparent theoretical contradiction was the fact that these stocks had dropped so sharply in 2022 when interest rates first moved higher. When looked at over both 2022 and 2023, the performance of those seven companies' stocks is less impressive: three of the seven were down over that two-year period (TSLA, AMZN, GOOG), while three were up only modestly (META, AAPL, MSFT). The stand out was Nvidia's stock, which was up 68% over those two years. And for good reason: Nvidia's chips command a very high price and have seen a dramatic increase

[1] Apple, Microsoft, Alphabet, Nvidia, Amazon, Meta, Tesla.

in demand because of those AI applications. Moreover, demand is expected to continue to grow above 30% per year for several years to come. The expected growth in earnings from this surge more than offsets the dampening effect on valuation of higher interest rates.

Because the surge in 2023 for these seven was largely a recovery from 2022's decline and from the dawning comprehension of AI's potential among investors, we are unlikely to see such concentrated appreciation in the market repeat itself. Two dynamics for 2024 seem likely. First, the Federal Reserve has already made significant progress in its inflation fight so interest rates are unlikely to move higher. Will they move lower as the market expects? That is very much an open question, that we address separately. And second, another transformational technology like generative AI is unlikely to come along again, so soon. Yes, AI will continue to be adopted and we will see more companies discuss its benefits for increasing sales, reducing costs, and raising profits, but those opportunities are now likely to be dispersed more widely across the economy. That itself points to a broadening of the opportunities for valuations to increase and points to less concentration in stock price behavior.

The rise of AI's importance was a surprise for investors last year, and surprises may come from other quarters. Another surprise, for example, was the potential of weight-loss drugs and the impact they may have on people's consumption patterns. This year will likely bring its own surprises, and these, by definition, are difficult to predict. Will the next surprise come from new medical device technology, perhaps? Or might we see a breakthrough in cancer treatments? Or will robotics and smarter software combine to boost productivity in some areas of industrials, and will that benefit from the deployment of the infrastructure subsidies? We may not know where the next breakthroughs will be, so we want to find the companies with the leadership to be well positioned. This leaves us with a frequent refrain: be diversified in quality companies and plan to own them for the long term when quality can win out over temporary disruptions.

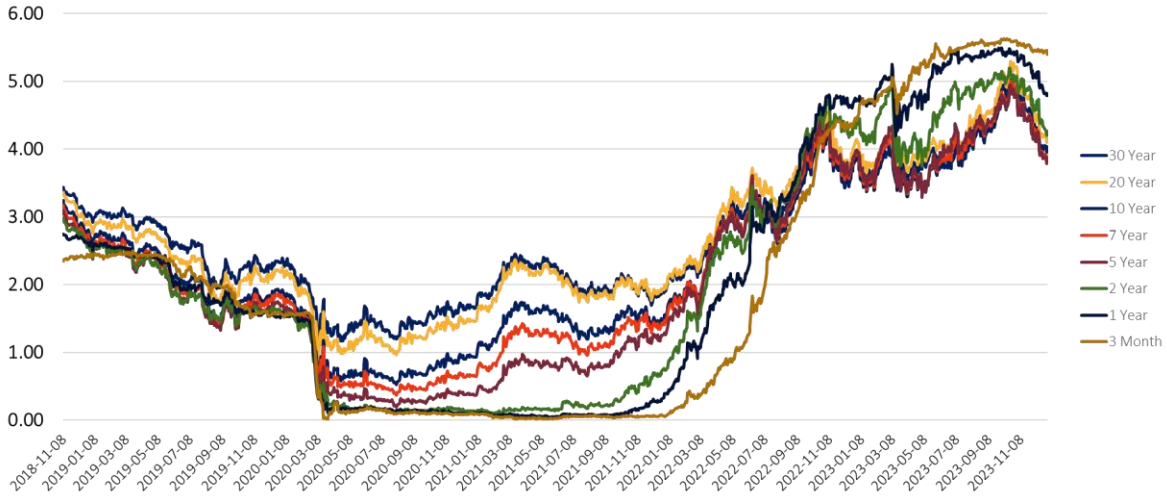
Expectations For Money Market Rates

UPDATE

Savers Are No Longer Punished, But for How Long?: Kevin Strauss, CFA®, Portfolio Manager

Total money market fund assets hit a record $5.9 trillion, according to data from the Investment Company Institute. While high end money market rates are approximately 5.0% today, they are expected to come down meaningfully over the next few years, as the Fed lowers interest rates. In fact, as of late 2023, all duration fixed income assets have started to yield less, suggesting future rate cuts are expected. Based on the Federal

Reserve's Summary of Economic Projections (SEP), the Fed's expectation for the Federal Funds Rate is 4.6% in 2024, 3.6% in 2025, 2.9% in 2026, and 2.5% in 2027.



Source: https://fred.stlouisfed.org/series/DGS30#0 1/2/2024

The drop in yields could move some investors into stocks, while others will take a more conservative approach with a fixed income approach. The goal with the fixed income approach is to lock in higher yields for a longer period of time.

This is exactly the thought process we have utilized in our taxable Private Fixed Income strategy, pushing our duration out to 4 years, with an average yield-to-maturity of 5.25%.

At Advisors Capital Management, we live by the maxim that no two investors are alike. That's why we offer separate accounts with individual portfolios constructed to satisfy the full range of sophisticated needs and objectives. From managing concentrated stock positions to ensuring tax efficiencies, we invest with meticulous attention to detail.

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