Investment Commentary

2023 Recap

What a difference a year can make. US equities rose in 2023, with the major indices erasing their 2022 declines. The Dow achieved an all-time high, while the S&P closed the year a touch short of its record close from January of 2022. The positive year for the market appeared to be in jeopardy as stocks pulled back throughout Q3 before bottoming in late October and rallying into year-end.

Overall index performance was driven by huge rallies in the so-called "Magnificent Seven" mega cap names. As a result, the 26.2% total return of the official S&P 500 greatly outpaced the 13.9% return of its equal-weight counterpart.

The market entered 2023 with a fair degree of trepidation. Many high-profile analysts were baking a recession into their forecasts, citing the high-rate backdrop, concerns about the consumer, risks to corporate earnings, and (omnipresent) geopolitical uncertainty. Instead, the dominant narratives evolved into mounting expectations for a dovish Fed pivot and the resilience of both the U.S. consumer and corporate earnings. Fears of a hard landing for the economy succumbed to a broad soft- or no-landing consensus.

The Federal Reserve's interest rate policy was top-of-mind in 2023. In December of 2022, the FOMC opted for a 50 bp hike after four straight 75bp increases, and Chair Powell consistently espoused a hawkish message that the Fed had more work to do to bring inflation under control. Through last July, four additional 25 bp hikes brought us to a 5.25-5.50% Fed funds target rate, while officials maintained a "higher for longer" mantra and the market debated just how high rates would go. Despite admitting that the Fed was "navigating by the stars under cloudy skies", Powell continued to express hopes for an economic slowdown without a hard landing, and by October Chicago Fed President Goolsbee felt confident enough to declare that the economy might still be on a "golden path". That proved to be a harbinger of the dovish elements that emerged out of the December 2023 Fed meeting (including dot-plot forecasts for 75bp of rate cuts in 2024), which sparked the equity rally and Treasury yield backup that closed out the year.

The Fed's tone and decision-making over the past year was driven by continued progress on moving inflation back toward its 2% target. Year-over-year headline CPI peaked in June 2022 at 8.9%, dropped to 6.4% by

December 2022 and to 3.1% by November 2023. By November 2023, the Fed's preferred inflation measure of core PCE was up only 3.2%, its lowest reading since April 2021. While services prices, particularly sticky shelter prices, remain a challenge in the "last mile" of the race against inflation, there seems to be increasing confidence that the Fed has inflation under control, with the December University of Michigan consumer sentiment report noting that respondents' year-ahead inflation expectations had dropped to their lowest level (3.1%) since March of 2021.

Several other themes and events impacted the market in 2023. Artificial Intelligence and AI-adjacent stocks had a big year, thanks to enthusiasm for the potential of ChatGPT and other Large Language Models (LLMs). Many large tech firms entered the fray, and companies of all sorts are hustling to adopt AI tools ahead of their competition. The rush of attention on the technology has also sparked calls for increased regulation and oversight, and widespread adoption has done much to underscore its current limitations, such as the tendency for LLMs to "hallucinate" or completely make up false information.

In what now seems a distant memory, March saw the market confront a mini-banking crisis that saw Silicon Valley Bank, Signature Bank, and First Republic Bank ultimately collapse. The proximate cause can be summarized as the mismanagement of duration in the banks' investment portfolios amid the Fed's rate tightening campaign coupled with outsized industry and regional concentration, which exacerbated the resultant deposit flight. That's a mouthful, and don't fret if you still don't completely understand it, as worries about a broader contagion effect ultimately proved unfounded.

Dysfunction in Washington continued apace, notably with the long and winding road that led to a bipartisan deal to raise the debt ceiling just days before a potential default. Government-funding talks also kept the prospect of a government shutdown alive during the second half of the year. A deal on a continuing resolution was reached at the end of September, which delayed the potential crisis to November but led to the ouster of House Speaker McCarthy and a tumultuous leadership contest within the Republican Party. A subsequent "can kicking" in November means the issue will return to prominence in mid-January.

Finally, while geopolitical events continued to populate the front pages, the market characteristically took little notice. The war in Ukraine ground on with few signs of a diplomatic off-ramp. US-China tensions remained elevated amid more import/export restrictions. There were concerns that the October 7th attack on Israel could evolve into a wider regional conflict in the Middle East, but despite the Israeli ground invasion of the Gaza strip, the struggle has remained largely contained. At year-end, the focus was on Houthi attacks on Red Sea shipping, though this may be returning to normal thanks to an international maritime protection initiative.

See important disclosures on last page

Concentration Fixation

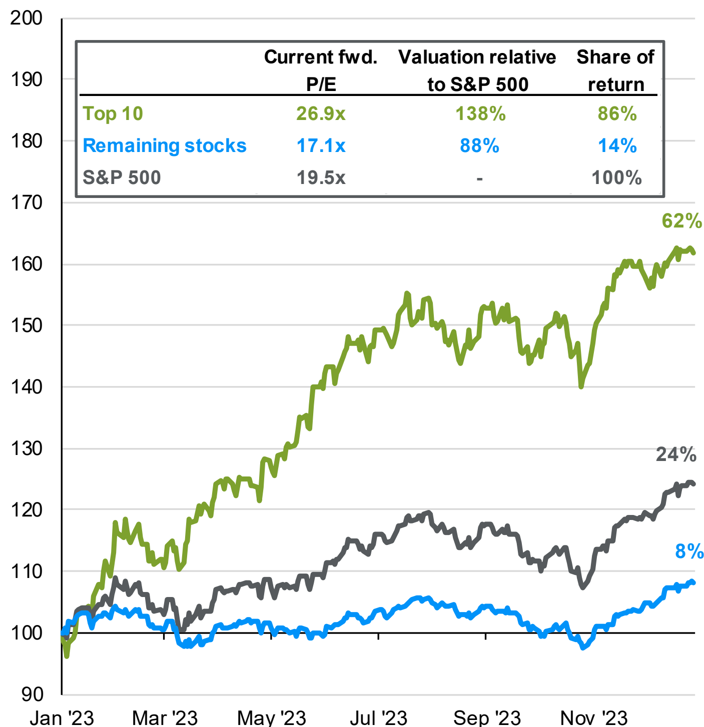
While the entire market performed well in 2023, there's little denying that performance was driven by the biggest companies in terms of market capitalization. In fact, the top 10 stocks in the S&P 500 accounted for over 90% of the index's returns, an unprecedented degree of market concentration. Leading that charge was the tech-centric "Magnificent Seven" of Apple, Microsoft, Amazon, Nvidia, Google, Meta, and Tesla. This situation did not materialize overnight – these stocks have been steadily increasing their share of the market over the past several years, and especially since the beginning of the Covid-19 pandemic, after which the group outperformed both in 2021 and 2023. The group's prolonged outperformance has resulted in a sizable valuation discrepancy between these names and the rest of the companies in the S&P 500, a situation which recalls the Nifty 50 and the dot-com stocks just prior to their crashing.

This doesn't mean that we foresee a crash from the market's erstwhile leaders. (To borrow some phraseology from the financial pundits, the "Mag 7" need not become the "Lag 7".) It does, however, increase the likelihood of relative outperformance by other segments of the market, such as small and mid-caps, dividend stocks, and international stocks. On balance, this would be a good thing for our clients' well-diversified portfolios. In fact, we already saw a healthy broadening of the rally in the last two months of 2023, which isn't surprising, as the prospect of lower rates on the horizon is a rising tide that would lift all boats. What's more, as seen in the bottom right chart below, the fairly balanced relationship between market capitalization and earnings contribution provides some comfort that that market hasn't gone dangerously far into the realm of "irrational exuberance" for its top names. With market participants rooting for broader participation in 2024, the odds are good that becomes something of a self-fulfilling prophecy.

S&P 500: Index Concentration

Performance of the top 10 stocks in the S&P 500

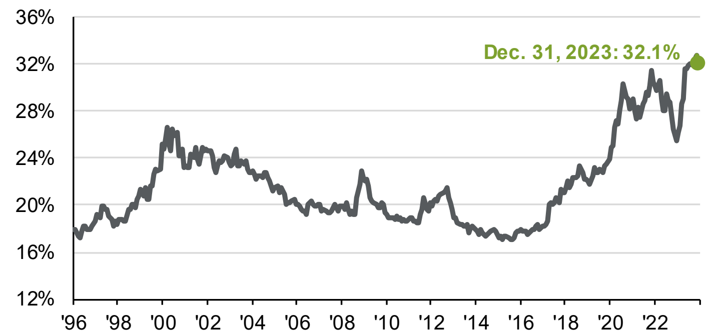
Indexed to 100 on 1/1/2023, price return, top 10 held constant



	Current fwd. P/E	Valuation relative to S&P 500	Share of return
Top 10	26.9x	138%	86%
Remaining stocks	17.1x	88%	14%
S&P 500	19.5x	-	100%

Weight of the top 10 stocks in the S&P 500

% of market capitalization of the S&P 500



Earnings contribution of the top 10 in the S&P 500

Based on last 12 months' earnings

(Left) The top 10 companies used for this analysis are held constant and represent the S&P 500's 10 largest index constituents at the start of 2023. The top 10 stocks are: AAPL, MSFT, AMZN, NVDA, GOOGL, BRK.B, GOOG, META, XOM, UNH, and TSLA. The remaining stocks represent the rest of the 494 companies in the S&P 500. (Right) The top 10 companies used for these two analyses are updated monthly and are based on the 10 largest index constituents at the beginning of each month. As of 12/31/2023, the top 10 companies in the index were AAPL (7.0%), MSFT (6.9%), AMZN (3.5%), NVDA (3.0%), GOOGL (2.1%), META (2.0%), GOOG (1.8%), TSLA (1.8%), BRK.B (1.6%), AVGO (1.2%) and JPM (1.2%). Guide to the Markets – U.S. Data are as of December 31, 2023.

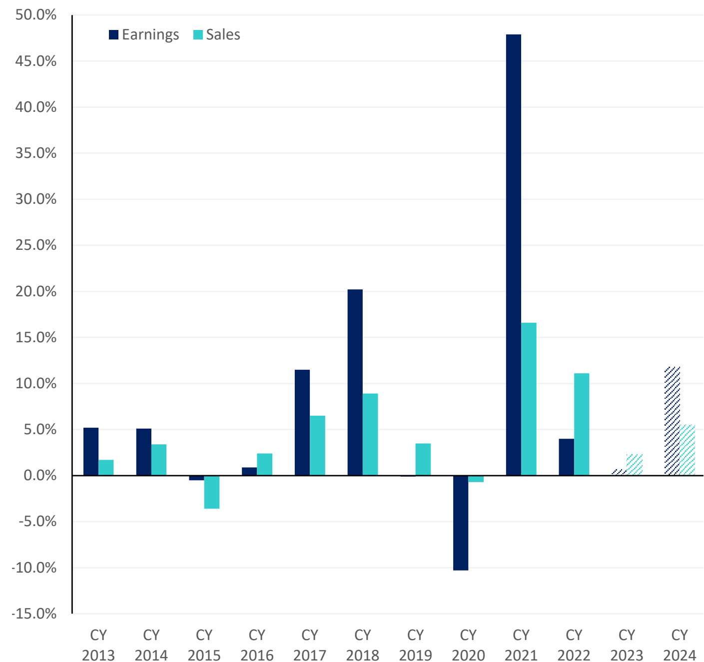
Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

Earnings: The Bar is Set High

Recall that last quarter, we questioned whether there was trouble ahead for the consumer as Covid-era excess savings dried up and inflation and sustained higher rates impacted affordability and drove an uptick in delinquency rates. This is important from a market perspective because the health of the consumer directly impacts the health of corporate earnings. While we continue to monitor those concerns, we'll also be keeping a closer eye on the degree to which disinflation poses a threat to profit margins and earnings. This issue here is that companies raised their prices so much during the economy's bout with inflation that they more than covered higher costs for energy, transportation, labor, and other inputs. This boosted profits but could come at a cost, as it dampens their pricing power and operating leverage going forward. Whether or not companies can defend margins in the face of an incrementally more price-sensitive consumer will be a key determinant of earnings growth in the year ahead.

S&P 500 Earnings & Revenue Growth

2013-2024



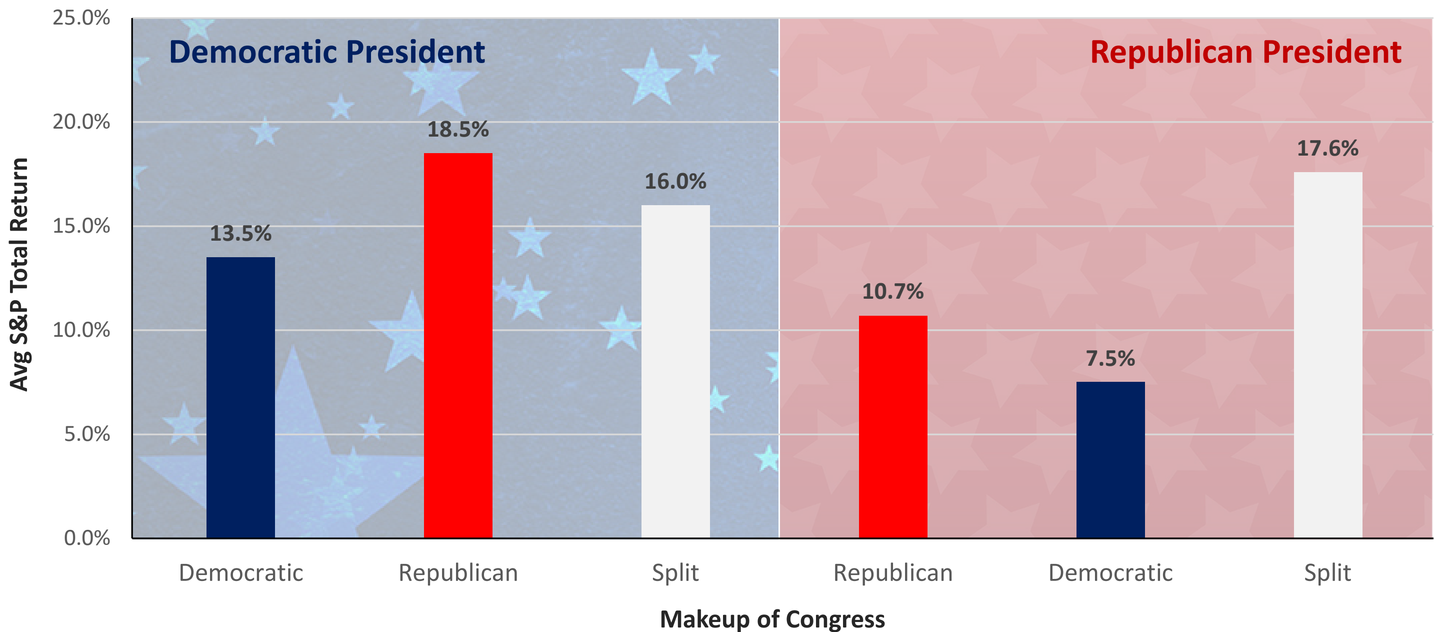
Source: FactSet

	CY 2013	CY 2014	CY 2015	CY 2016	CY 2017	CY 2018	CY 2019	CY 2020	CY 2021	CY 2022	CY 2023	CY 2024
Earnings	5.2%	5.1%	-0.5%	0.9%	11.5%	20.2%	-0.1%	-10.3%	47.9%	4.0%	0.7%	11.8%
Sales	1.7%	3.4%	-3.6%	2.4%	6.5%	8.9%	3.5%	-0.7%	16.6%	11.1%	2.3%	5.5%

Source: FactSet

The market's significant gains last year received little in the way of assistance from earnings. Remarkably, the high-flying technology sector actually saw a decline in earnings, driving outsized price-to-earnings multiple expansion. It follows that if the rally is to continue in 2024, earnings will have to play a larger role in supporting higher prices. They are expected to do so -- according to FactSet, analysts see a year-over-year earnings growth rate for 2024 of 11.8%, above the trailing 10-year average of 8.4%. Meanwhile, consensus for net profit margins is 12.3%, which would be the highest since FactSet began tracking the metric in 2008. A lot of commentary we've read of late has cast doubt on these optimistic projections, and we tend to agree that risks to these numbers are skewed to the downside. If corporate earnings underperform expectations, history tells us that we can expect high-quality, dividend-paying value stocks with stable free cash flows to outperform.

Average S&P 500 Index Total Return Performance: 1950 - 2022



Source: Morningstar, Bloomberg. **Past performance is no guarantee of future results.** This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future. The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Indices do not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Investors cannot invest directly in an index.

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Chart Courtesy of First Trust

Closing Thoughts:

We've yet to mention that 2024 is a critical election year, and that is by design. We know the election is top-of-mind for many of our clients, and we'll have plenty to say about it in the months ahead. We can give you a sneak peak of what our conclusion will be though – stay invested! Market history is clear on this point: who controls the White House and Congress doesn't have a tremendous impact on average returns, and certainly not a big enough one to justify moving to the sidelines.

2023's market performance was a welcomed surprise, and with uncertainty still elevated, investors would be wise to expect – and accept – the unexpected. That mentality is even more prudent in a market where the consensus for a soft landing appears to be largely "priced in". While this optimistic outcome is appropriate as long as unemployment remains below 4%, we must be wary that consensus is often wrong. Fear and greed are ever-present, and volatility can rear its head in an instant. Without a crystal ball, it is impossible to know next month or quarter's reason to be worried. While a soft landing seems promising today, it would be foolish to think that 5.25% of interest rate hikes will have zero economic consequences that are yet to be seen and understood.

Through it all, our approach will remain consistent. We'll continue to do the "blocking-and-tackling" of building well-diversified portfolios for our clients, with an emphasis on quality earnings and cash flows on the equity side, and a balanced approach to duration in fixed income.

We wish you all a healthy and prosperous new year!

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WEALTH MANAGEMENT

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