Timothy D. Hussar, CFA | Director of Investments

Tim is Director of Investments of WhartonHill Investment Advisors. He is also a Partner of the firm and member of the Investment Committee.

QUARTERLY INVESTMENT PERSPECTIVES: **Q1 2024**

2023 Review

The Santa Claus rally came for the market at the end of the year, with stocks of all stripes and sizes rising to close out the fourth quarter and 2023. Over the final three months, the S&P 500 returned 11.6%, bringing its year-to-date total return up to 26.2%. While the majority of the year saw market returns concentrated in the "Magnificent Seven" stocks – comprised of Apple, Amazon, Facebook, Google, Microsoft, Nvidia, and Tesla – the final month of the year saw mid and small cap stocks participate in the rally as well. Boosting confidence were continued positive data points from the economy, as well as falling inflation data. The deceleration of inflation helps gives the Federal Reserve room to not only stop hiking interest rates, but also potentially lower them in the next year. While the economy has performed better than expected, there was growing concern that the longer interest rates stayed above 5%, the greater the negative effects would be and the harder it would be for the economy to recover from.

At their December meeting, Federal Reserve officials noted that rate hikes have run their course, and that while rate cuts are on the table for 2024, that decision would depend on how both inflation and economic data progress. As inflation has come down, so have bond yields, which has boosted price returns across the bond market. After spending much of the year in negative territory, the Barclays US Aggregate index rose 6.8% in the fourth quarter and pushed its full year return into positive territory at 5.7%. Global bonds, which have performed worse than U.S. bonds over the last few years thanks to negative yields, rose 11.2% over the fourth quarter and returned 5.6% for 2023. At the end of the year, the One-Year U.S. Treasury yield stood at 4.8% and the Ten-Year U.S. Treasury yield was at 3.9%.

While the final year return numbers for most major indexes make it seem like everything was smooth sailing for investors through 2023, the underlying data shows that it was anything but. The Wall Street Journal ran an article in March pondering "Why the Recession is Always Six Months Away," describing the feeling of economic pessimism that accompanied elevated interest rates. Intermediate bond returns were negative for most of the year as yields rose. Outside of the magnificent seven, the average stock experienced flat to slightly positive returns for most of the year, until December. Large cap stocks experienced a 10% drawdown in the third quarter while mid cap stocks experienced a 15% drawdown over the same time frame. While looking at point to point returns in investing makes it seem "easy" the journey along the way is often but. What will investors face in 2024? Is the recession six months away? Our Annual Outlook will seek to answer these questions and provide some of our thinking as we embark in a new year.

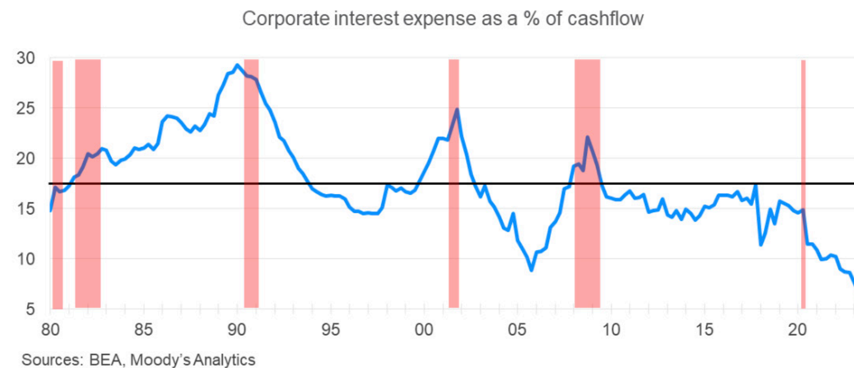
Investment Market	Q4 - 2023	2023
U.S. Large Cap Stocks	11.6%	26.2%
U.S. Mid Cap Stocks	12.7%	17.1%
U.S. Small Cap Stocks	14.0%	16.8%
International Developed Stocks	10.7%	18.4%
Emerging Market Stocks	8.0%	9.0%
Barclays US Aggregate Bond	6.8%	5.7%
Barclays Global Aggregate Bond	11.2%	5.6%

Sources: Morningstar, as of 12/31/2023

MARKET REVIEW AND OUTLOOK

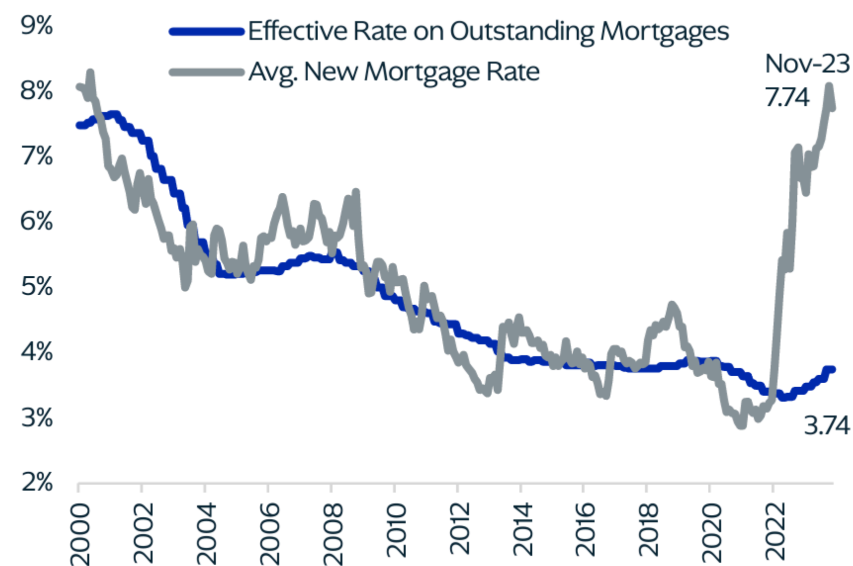
The Recession is Six Months Away. Or is it Sixty Months Away?

"The next economic downturn has become the most anticipated recession in recent U.S. history. It also keeps getting postponed." It is easy to think that this was a Wall Street Journal intro for a story written this week. But it was written in March of 2023 and it chronicles how the start of 2023 showed most economists broadly anticipating a recession by mid-year due to the Fed's aggressive rate hiking campaign. Over 80% of global central banks were raising interest rates at the end of 2022 and many more continued to hike into 2023, with very few cutting rates. The economy remained resilient in the face of rising rates. In January of last year, employers added 517,000 jobs and the unemployment rate dropped to 3.4%, a 53-year low. As the year progressed, the recession was staved off by a variety of factors including: pent up demand for large ticket items such as vehicles, or appliances; a robust jobs market that was spurred on by employers looking to fill record high job openings; and extremely low interest expenses for corporations and consumers. Corporate interest expense as a percentage of company cashflow is at a 40-year low level of around 5%. The minimal interest costs that companies are experiencing are due to a refinancing wave before and after COVID when interest rates were at zero. Though there has been caution on the part of corporate America as they weigh increased investment costs, and this has softened business conditions, balance sheets are very healthy and executives are not having to make job cuts to offset higher interest rate expenses.



MARKET REVIEW AND OUTLOOK

Similarly, consumers could lock in record low mortgage rates prior to the recent upturn in yields. While current mortgage rates for a new home purchase range between 6-7%, the average rate on all outstanding mortgages is just 3.74%. When you consider the fact that a mortgage expense is usually the largest single item in a household budget, the fact that this expense has remained static while wages have increased with elevated inflation and significant amounts of stimulus over the last three years has provided a buffer for the economy.



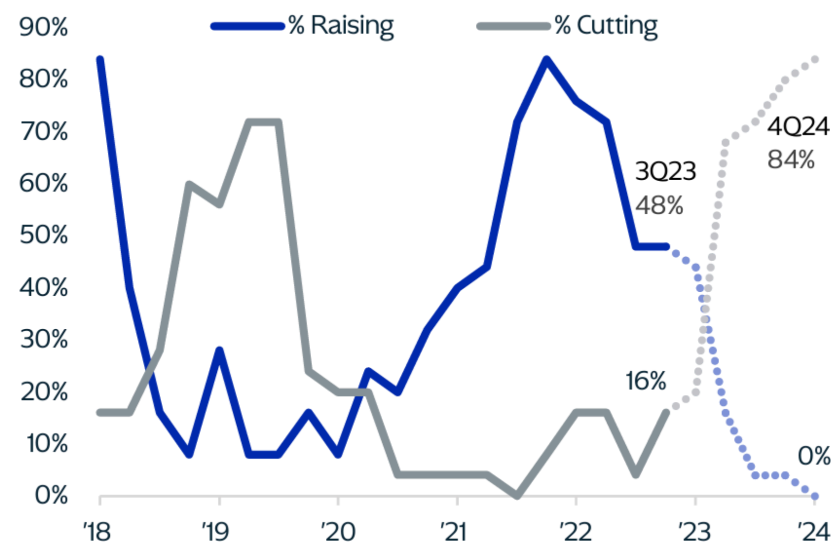
Data as at November 20, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

These factors have certainly helped the economy over the last year, but will the effects of interest rates remaining high be a problem for the economy six months from now? Is the recession truly six months away this time around? It would not be surprising to see some weakness in the economy and stock market as consumers continue to feel the pinch of elevated prices and companies still wrestle with the uncertainty over high interest rates. While the jobs market has been very strong over the last two years, the pace of hiring is slowing down, and unemployment could start to tick higher this year. However, it is important to note that there have been rotating areas of weakness in the economy over the last year, which has put the Federal Reserve on notice. From the regional bank issues in early 2023, to difficulties in commercial real estate and new home construction later in the year, there have been a variety of data points showing slowdowns in various sectors. Should the slowdown become more widespread, it seems that the Fed is ready to respond. Just as quickly as central banks hiked rates in 2021 and 2022, they are expected to cut rates just as dramatically in 2024 if economic conditions start to weaken.

MARKET REVIEW AND OUTLOOK

KKR's investment team estimates that over 80% of central banks were hiking rates at the end of 2022 and that at the end of 2024, over 80% of central banks will be cutting rates as a result of a combination of low inflation readings and soft economic growth. Because the market is forward looking, it has already anticipated lower interest rates. This is why we experienced such a strong Santa Claus rally for the stock market in the fourth quarter (Jerome Powell and other bankers signaled that rate hikes were done) and it is why the Ten-Year Treasury yield went from its prior year peak of 5% in October to under 4% at the end of December. If the Fed continues to play nice with the market and signals that they are ready to respond to softer economic data with lower interest rates, it is likely that business confidence will pick up rather than bottom out, as executives believe that the tighter monetary conditions we are in currently will loosen.

In conclusion, if the economy softens, but remains positive due to anticipation that financial conditions will improve in the next year, it is our view that the recession is not six months away but could be much further away than that. If the Fed responds quickly and businesses begin to deploy capital because of better monetary conditions, keep from engaging in a spiral of layoffs, this should facilitate the soft landing that many have anticipated. Different areas of the economy have been in mini-recessions over the last year, which may not have produced the technical definition of a recession - two straight quarters of negative GDP growth. The isolated weaknesses in the economy have kept it from overheating and as a result, it's possible that the next recession may be closer to 60 months rather than 6 months away.



Hiking / cutting rates defined as an increase in rates over the past three months. Data for US, JP, CN, AU, CA, EZ, NZ, NO, SE, GB, JP, CH, IN, ID, KR, PH, TW, TH, VN, BR, CL, ZA, TR, IL, CZ, HU, PL. Data as at November 4, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

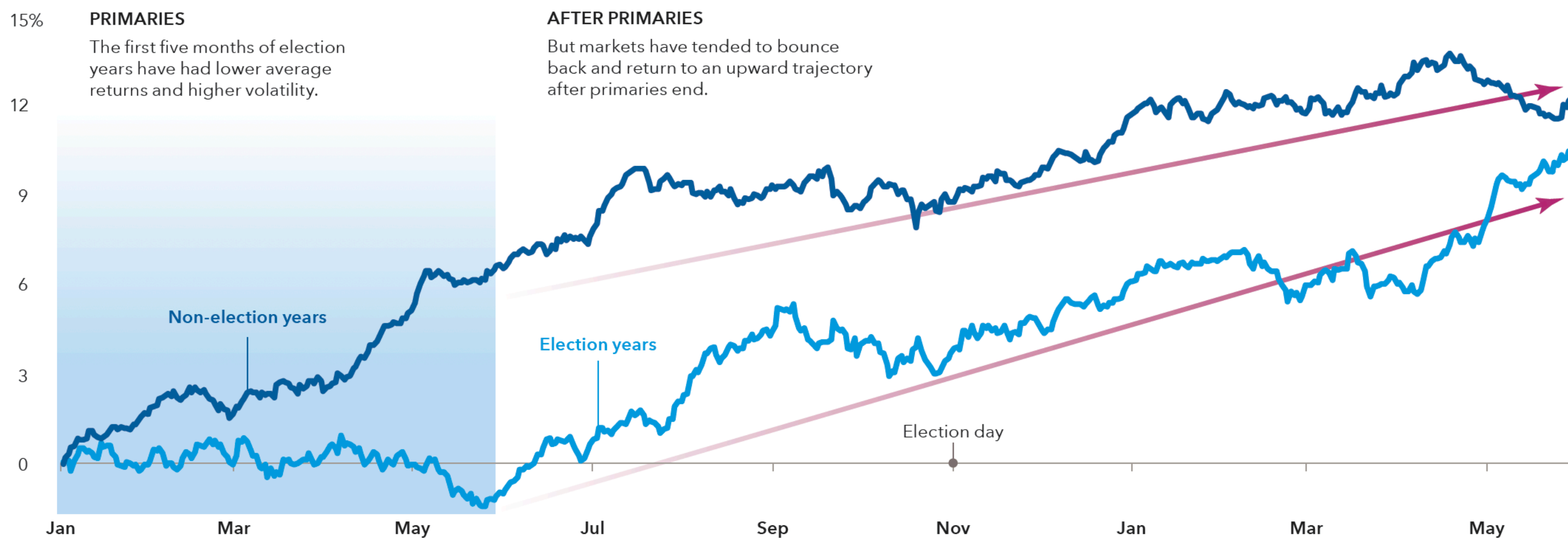
Growth will likely slow in 2024 before reaccelerating in 2025.

MARKET REVIEW AND OUTLOOK

Stocks and Bonds for the Long Run

The track record for stocks to generate positive returns in any given calendar year is strong, but also comes with persistent volatility risk. Calendar year 2023 was no exception, with strong returns for the full year and a 10% correction during the year. It would not be surprising to see positive returns for 2024 with some volatility mixed in as investors potentially take profits after last year's rally in reaction to weaker economic data. This would also match the historical precedent for Presidential election years, which typically see volatility earlier in the year as the primaries are being contested, with stronger gains in the back half of the year as the election winner comes into clearer focus.

On average, stocks are higher 83% of the time in an election year. While the chart above shows a greater degree of volatility occurring in the first five months of an election year, compared to a non-election year, the track record from there forward is positive. In the twelve months following the Presidential primaries, stocks are up 11.3% on average, compared to an average return of 5.8% in the same period of non-election years. Staying on the sidelines to await the winner of an election cycle has not been a prudent investment decision. Also in favor of forward stock returns is the historical track record after the Federal Reserve has stopped hiking rates.



SOURCES: Capital Group, RIMES, Standard & Poor's. Includes all daily price returns from January 1, 1932 through December 31, 2022. Non-election years exclude all years with either a presidential or midterm elections. Past results are not predictive of results in future periods.

In election years, stocks tend to rally after a more turbulent start.

MARKET REVIEW AND OUTLOOK

Going back over the past fifty years, the S&P 500 has generated an average return of 5.7% in the six months following the last rate hike and an average return of 9.3% in the twelve months after the last rate hike.

Looking out beyond this year, long-term return projections remain positive for stocks and underscore their importance for return generation in a diversified portfolio. BNY Mellon and other investment bank research departments release 10 year forward return assumptions for many different areas of the investment world. As of the end of December, their projections for U.S. equities are for a long-term, annualized return of 7.3%.

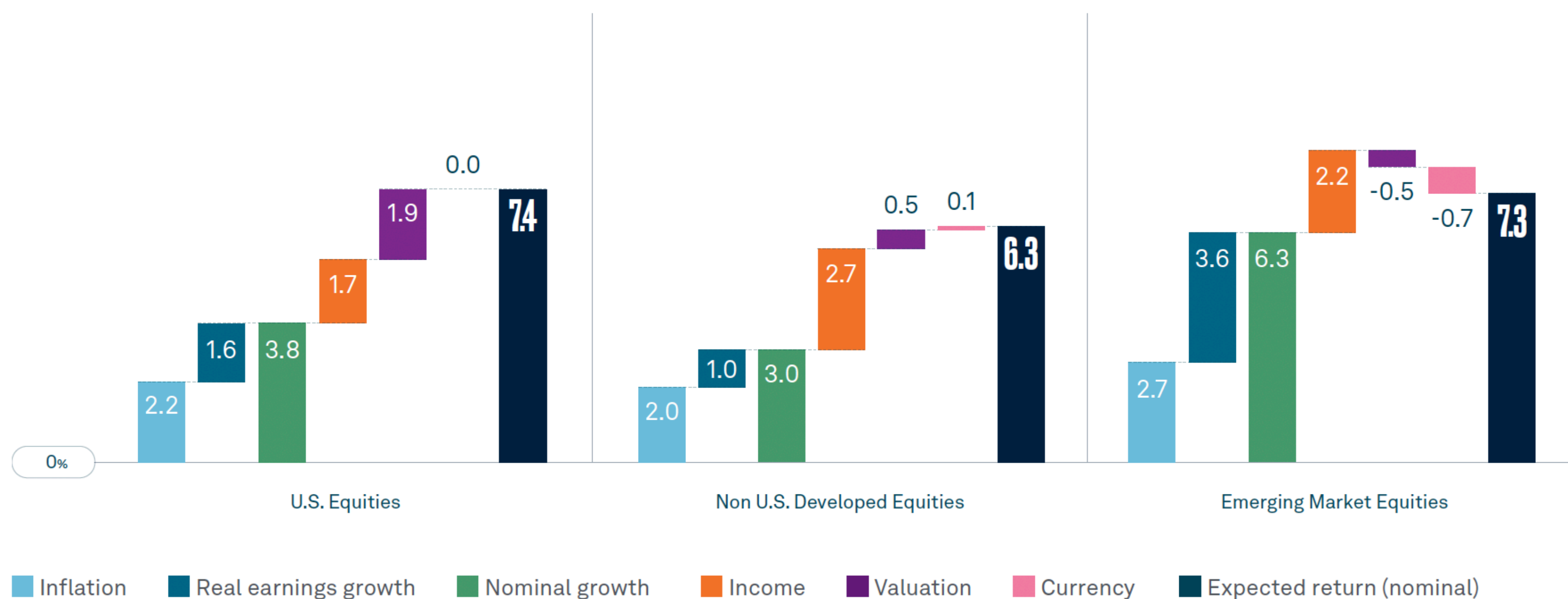
While this is down from the 11.8% annual returns that the S&P 500 has delivered over the trailing 10 years, it is still in excess of 10 Year U.S. Treasury bonds, which are currently yielding 3.9%. For an investor seeking to generate a total portfolio return in the mid to high single digits over the long-term, stocks remain a necessary allocation choice, even if the potential for short-term volatility is ever present.

On fixed income, it is important to highlight that though intermediate term bond yields have fallen slightly over the last three months, and the Federal Reserve is likely to cut interest rates in the next year, yield levels remain attractive. U.S. Treasuries yield between 4-5% depending on the maturity, corporate bonds yield over 5%, while high yield and more speculative areas of the fixed income universe offer yields between 8-10%.

We have spent considerable time and effort over the last few years exploring alternative investments and their role in client portfolios, especially given how volatile public stock and bond markets have been. However, the long-term return potential for fully liquid stocks and bonds remains attractive and we continue to emphasize their importance as a core part of a diversified portfolio.

	Forward S&P Returns	
Date of the Last Rate Hike	**6 Months**	**12 Months**
April, 1974	-18.4%	-2.6%
February, 1980	8.5%	11.1%
May, 1981	-6.5%	-10.9%
February, 1989	20.1%	14.2%
February, 1995	19.0%	32.1%
May, 2000	-6.8%	-15.0%
June, 2006	12.1%	18.3%
December, 2018	17.8%	27.3%
Average	5.7%	9.3%

FIGURE 15 **2024 10-Year Equity Market Nominal Expected Return Building Blocks (probability-weighted economic scenarios)**



Source: BNY Mellon Investor Solutions. Data as of September 30, 2023.

U.S. equities are expected to return 7.4% annually over the next decade.

MARKET REVIEW AND OUTLOOK

Closing Thoughts

Once again, we thank our clients for their trust and confidence as we have navigated with them not just a tumultuous calendar year, but multiple years in a row that have featured no shortage of risks and geo-political events. We do not take our stewardship of your investment strategy lightly and continue to seek out the best possible investment strategies for charting the future course.

We remain positive on the U.S. economy despite the many challenges it has faced in the near-term. The consumer remains resilient, businesses continue to find ways to innovate, and the jobs market has underpinned the strength of our economic machine. While rates have jumped to their highest levels in the last twenty years and it has caused volatility across bond and stock markets, those who took a long-term view and rode out the storm of 2022 were able to see the benefits in 2023.

Market returns may be harder to come by this year as economic growth cools due to the prolonged elevation of interest rates. However, we see reasons to be optimistic, particularly as it relates to innovation and capital spending in the U.S. and the healthy balance sheets of both consumers and corporations help ward off the effects of slower growth. The potential for the Federal Reserve lowering interest rates, which has been widely telegraphed, combined with the building blocks for attractive long-term returns are helping guide us as we continue to seek out new investment opportunities. As always, we look forward to speaking with you about your personal investment plan and strategy.

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All data as of 12/31/23 via Bloomberg, Eaton Vance, St Louis Federal Reserve JP Morgan, the Wall Street Journal, and Bloomberg.

Charts via, in order of appearance, BEA, KKR, KKR, BNY Mellon, Capital Group, WhartonHill, BNY Mellon, KKR.