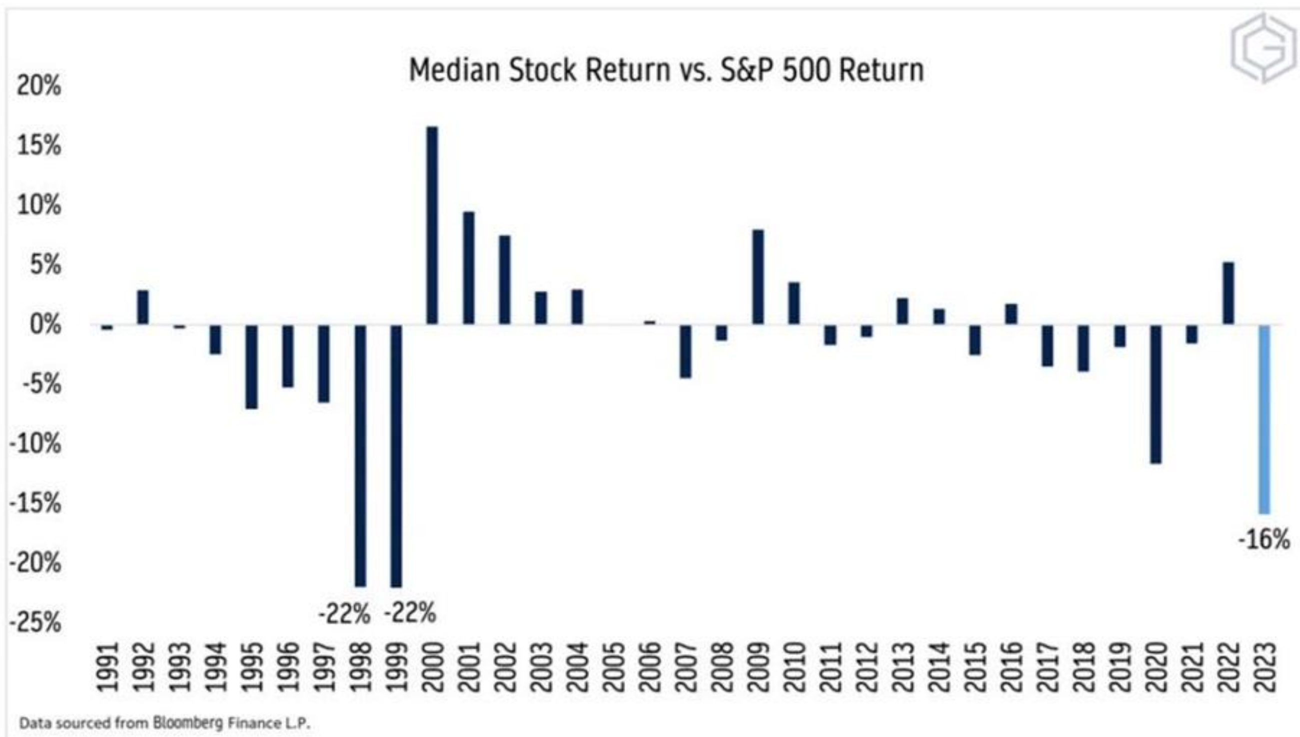
MANAGED ASSET PORTFOLIOS

MAP VIEWS

MAP QUARTERLY COMMENTARY | JANUARY 2024

Investors embraced risk throughout 2023, as they speculated that the Federal Reserve (the Fed) would pivot from their tightening stance that has been in place since March 2022, to one of easing. From a stock market perspective, the year can be summarized in two words: Magnificent Seven (aka Mag Seven). The performance of these seven stocks (Amazon, Alphabet, Apple, Meta, Microsoft, Nvidia, and Tesla) dwarfed that of most other stocks. Investors were avid purchasers of these stocks as they jumped on the Artificial Intelligence (AI) bandwagon. For the first half of the year, these seven stocks drove virtually all of the returns for the broad S&P 500 Index. While market breadth broadened slightly during the second half of the trading year, the Mag Seven stole the show - their performance accounted for over 70% of total index returns. The top ten stocks accounted for nearly 75% of returns, well above the average of 39% during the previous 8 years. To put the impact of the Mag 7 into further context, as seen in the chart below, we are currently experiencing the largest disparity between the S&P 500 Index and the median stock return since the peak of the dot-com bubble. The tech-heavy NASDAQ rose over 40% during the year, having one of its best years ever. While past performance is no guarantee of future results, some might draw comparisons to the dot-com bubble and the years that followed when considering where this index trades in the years ahead. The MSCI ACWI (ACWI), the benchmark for the equity portion of our composites containing global equities, underperformed both the S&P 500 and NASDAQ; however, the ACWI's returns were also largely driven by the Mag 7, as those stocks represent over 17% of the Index.



We certainly believe that AI is in the early stages as the next technological revolution, very similar to where the Internet was in the mid-1990s. For investors, this creates both opportunities, and risks. We own names such as Microsoft, Meta, and Apple in portfolios containing global equities, but mostly at weights below those of the market indices. We believe the shares of these companies do offer long-term value and that their business models are well-positioned to benefit from the evolution of AI over time. From a valuation perspective, however, shares of these, and many of the other Mag Seven, reflect a certain level of this success already. That does not indicate that the shares cannot rise further from here, but rather that the easy money may have already been made. Looking forward, we believe the AI theme in the broader markets will widen as investors embrace companies that successfully integrate AI into their businesses in order to improve efficiencies, drive down costs, and/or increase revenues. We view this as the prudent way of participating in the AI movement without paying exceedingly high valuations, thereby offering a more favorable risk-adjusted return opportunity.

Adding fuel to Wall Street's interest rate debate, headline inflation has moderated during the course of the year, providing investors with a glimmer of hope that the Fed would begin to lower interest rates sooner rather than later in 2024. As we have opined previously, we believe that inflation will likely remain above the Fed's target for the foreseeable future. Accordingly, we suspect investors may have gotten too jubilant around prospects for lower interest rates. We believe intermediate to long-term inflation rates will settle in the 3 to 4 percent range. We are particularly focused on sticky inflation, which, you may recall from previous MAP Views, refers to sustained increases in wages and prices on certain consumer goods that usually do not change frequently or drastically. If inflation settles in toward the lower end of the spectrum, the Fed has a modest amount of room to cut rates.

Objectively, the Fed should not be compelled to cut rates aggressively unless the economy weakens, and unemployment rises, for there are economic risks to cutting too early. Wall Street is currently forecasting approximately seven quarter-point rate cuts following the Fed's recent commentary after the December committee meeting. We agree that the Fed may begin to cut rates at some point in 2024; however, we think it will be at a pace of fewer cuts than current Wall Street projections, barring a significant unexpected market event. Additionally, we contend it may be too early to declare victory on the inflation front and hit the soft landing the Fed has been guiding too, especially in light of their poor history of nailing soft landings in the past. Historically, the Fed has managed a soft landing only twice following nine tightening cycles over the past five decades. Furthermore, we also consider it possible the Fed may find itself in a position of becoming much more data-dependent as it moves towards that goal.

Source: Board of Governors of the Federal Reserve System (US)

As depicted above, bond prices have fallen in 2021 and 2022, as well as during the first three quarters of 2023. However, Wall Street's jubilation around rate cuts drove interest rates lower during the fourth quarter. As such, we portend that Wall Street is playing the mean reversion game. Asset classes do not go straight up or down; therefore, a relief rally may be overdue. It is important to remind investors that interest rates tend to move in multi-decade cycles. As the chart below illustrates, bonds were generally in a bull market for nearly four decades prior to the last three years. Previous to that, bonds were in a roughly quarter-century long bear market.

Source: Board of Governors of the Federal Reserve System (US)

It is worth mentioning that even within that 40-year bull market for bonds (declining interest rates), there were years such as 1994 and 2009, where bond prices declined significantly as interest rates rose. Therefore, it is logical to expect years where rates will decline within the confines of a secular bond bear market. The laws of supply and demand do work. Given the government's propensity to spend, we see a continual supply of bonds on the horizon. With China, Japan, and the Fed (previously large buyers of bonds) sitting on the sidelines, we believe that such an environment is conducive for interest rates to move higher over the next few years. Recall we typically hold bonds to maturity and do not attempt to time short-term movements in the bond market. Accordingly, we keep our weighted average maturities relatively short (under three years), except for a few Treasury Inflation Protected Securities (TIPS). We believe such a strategy helps position portfolios for better risk-adjusted returns.

Although the Fed is meant to remain politically neutral, it is a difficult task when located in Washington, D.C. Appointed by the President and confirmed by Congress, it almost makes the Fed a political creature by default. In 2018, President Donald Trump openly questioned whether he would fire Fed Chairman Powell because he disagreed with their policy of raising interest rates. One need only look at the history books to see evidence of previous Fed Chairs' politically driven agendas. For example, former Fed Chair Arthur Burns felt pressure from his friend former President Nixon during a tumultuous time in our history to engage in expansionary monetary policies in the run-up to the 1972 election. Given these past events, one must wonder if the current Fed could be inclined to cut rates sooner rather than later to give the economy a little extra boost heading into November's election. While the Fed cut rates during the election years of 2008 and 2020, those cuts were driven by very specific economic events. In 2008, the Fed cut rates to zero (from 4.5% at the end of 2007) in an unprecedented attempt to support the U.S. economy from the fallout of the Global Financial Crisis. In 2020, the Fed cut rates to a range of 0-0.25% from a range of 1-1.25%, as well as launched $700 billion in quantitative easing to shelter the economy from COVID-19.

In closing, we would like to wish everyone a peaceful, healthy, and prosperous 2024. We also invite you to join us in the coming weeks for a special edition round table (webinar) as we discuss in depth our outlook for 2024, as well as a white paper discussing the market implications of the 2024 election. We truly appreciate the opportunity to serve you as we strive to deliver the best possible long-term risk-adjusted returns. We encourage you to contact your MAP representative with any questions or concerns. Let's continue navigating the market together and making informed decisions for the new year.

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