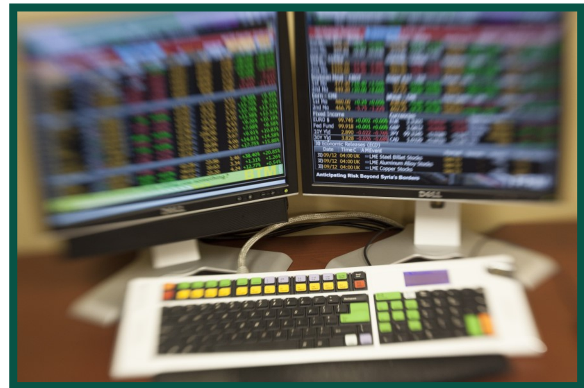
Wallington
ASSET MANAGEMENT

QUARTERLY NEWSLETTER

2023: FOURTH QUARTER **140TH EDITION**



"The world is full of foolish gamblers, and they will not do as well as the patient investor."

~ Charlie Munger, Berkshire Hathaway Vice Chairman and Legendary Investor (1924-2023)

TABLE OF CONTENTS

CAPITAL MARKETS SCOREBOARD 2

EQUITIES 3

FIXED INCOME 5

ECONOMICS 7

WALLINGTON PERSPECTIVE 9

Forecasting in the Face of Heightened Uncertainty

8900 Keystone Crossing, Suite 1015, Indianapolis, IN 46240 **www.wallingtonasset.com**

CAPITAL MARKETS SCOREBOARD

Equities

Indices	4Q23 Total Return (%)	2023 Total Return (%)	Index Characteristics		
Domestic			NTM P/E	P/B	Div. Yld. (%)
S&P 500	11.7	26.3	19.6	4.5	1.4
DJIA	13.1	16.2	17.6	4.6	1.9
NASDAQ	13.8	44.6	26.8	5.9	0.7
Russell 1000 Growth	14.2	42.7	26.5	12.1	0.7
Russell 1000 Value	9.5	11.5	14.9	2.4	2.2
Russell 2000	14.0	16.9	22.0	2.1	1.3
International*					
MSCI EAFE	10.5	18.9	13.3	1.9	2.8
MSCI Emerging Markets	7.9	10.3	11.9	1.7	2.3
MSCI United Kingdom	6.9	14.1	11.0	1.8	3.6
MSCI France	10.4	22.3	13.4	2.1	2.7
MSCI Germany	13.0	24.0	11.1	1.5	2.9
MSCI Japan	8.2	20.8	14.0	1.5	2.0
Global*					
MSCI All Country World	11.1	22.8	16.6	2.9	1.9

Fixed Income

Indices**	4Q23 Total Return (%)	2023 Total Return (%)
Domestic		
U.S. Corp - Gov (1-3 Years)	2.6	4.6
U.S. Corp - Gov (3-5 Years)	4.3	5.2
U.S. Corp - Gov (10+ Years)	12.5	6.3
U.S. Treasuries Master	5.7	3.9
U.S. Corporates Master	7.9	8.4
U.S. Municipals Master	7.6	6.5
U.S. High Yield Master	7.1	13.4
International*		
Developed Markets Sov Bond	8.1	3.6

Commodities

Resource	4Q23 Total Return (%)	2023 Total Return (%)
Precious Metals		
Gold	11.6	13.3
Silver	3.1	-0.6
Industrial Metals		
Copper	4.1	2.0
Aluminum	1.2	-1.1
Energy		
Brent Crude Oil	-19.6	-6.9
WTI Crude Oil	-21.1	-10.6
Natural Gas	-14.2	-43.8

Key Rates

Rates	12/31/2023	9/30/2023	6/30/2023	12/31/2022
U.S. Target Fed Funds Rate	5.50	5.50	5.25	4.50
2-Year U.S. Treasury	4.23	5.03	4.87	4.41
10-Year U.S. Treasury	3.88	4.59	3.81	3.88
30-Year U.S. Treasury	4.03	4.73	3.85	3.97
10-Year German Bund	2.00	2.82	2.41	2.53
10-Year Japanese Bond	0.61	0.76	0.39	0.42
30-Year Fixed Mortgage	6.82	7.20	6.71	6.36

Currencies

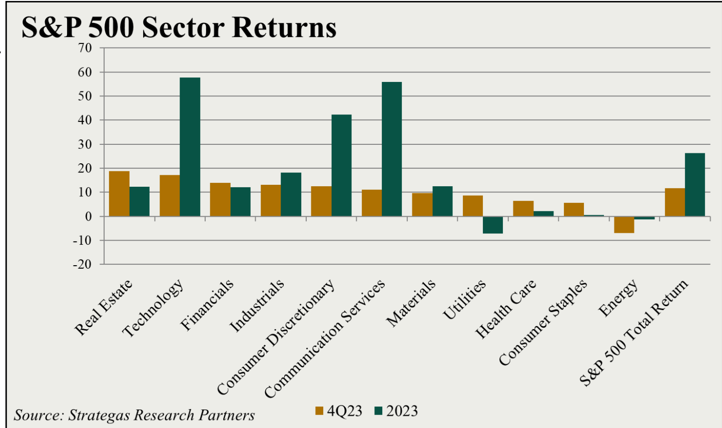
Indices/ Exchange Rates	12/31/2023	9/30/2023	6/30/2023	12/31/2022
ICE U.S. Dollar Index	101.33	106.22	102.91	103.52
USD per EUR	1.10	1.06	1.09	1.07
USD per GBP	1.27	1.22	1.27	1.20
JPY per USD	140.98	149.23	144.54	131.95
CAD per USD	1.32	1.35	1.32	1.35

*Returns denominated in U.S. dollars

**ICE Bank of America Merrill Lynch (BofA-ML) indices

EQUITIES

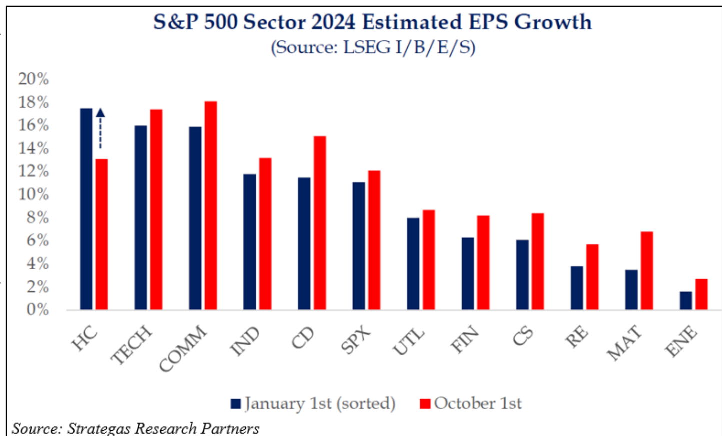
- The Standard & Poor's 500 index (S&P 500) closed the year on a nine-week gain streak, its longest since 2004, as the Federal Reserve (Fed) signaled an end to rate hikes and forecasted rate cuts in the coming year. After a 9.9% decline from August to late October, the index rallied to post a total return (price change plus dividends) of 11.2% in the fourth quarter, bringing its yearly gain to 26.3%. Real Estate and Technology Sector stocks led the way in the quarter, up 18.8% and 17.2% respectively, while the Energy Sector was the only negative performer at -6.9%. Sector performance disparity was wide for the year. The Information Technology and Consumer Discretion Sectors both gained over 50%, but the Energy and Utilities Sectors posted single-digit declines. After the "Magnificent 7" S&P 500 names (Apple, Microsoft, Amazon, Alphabet, Meta, NVIDIA, and Tesla) drove nearly all the index performance through the first three quarters of the year, the late year "everything rally" was a welcome sign of breadth for investors.



Source: Strategas Research Partners

- International stocks performed well in 2023 despite wars in Ukraine and the Middle East, but still trailed U.S. large caps. Developed market stocks as measured by the MSCI EAFE Index returned 10.5% for the quarter and 18.9% for the year, while the MSCI Emerging Markets Index posted returns of 7.9% for the quarter and 10.3% for the year when denominated in U.S. dollars (USD). After falling into negative territory in 2023, U.S. small-cap stocks as measured by the Russell 2000 Index rallied more than 20% from their late October lows to post fourth-quarter and annual gains of 14.0% and 16.9% respectively. The Russell 2000 posted its quickest turnaround in history from a 52-week low to a 52-week high at just 48 days.

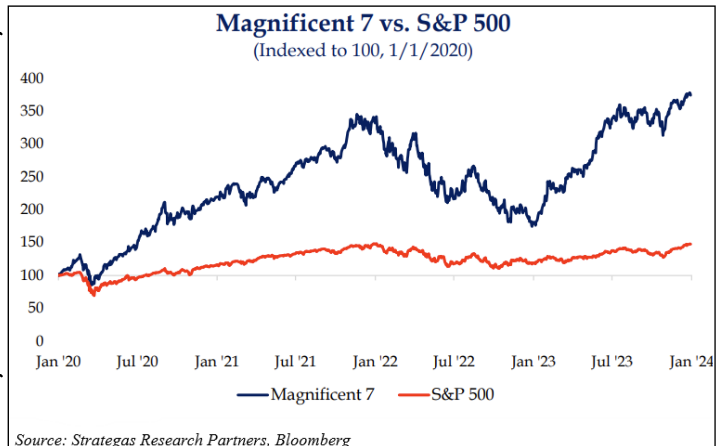
- For calendar year 2023, analysts are expecting earnings growth of just 0.6% once all companies report results for the fourth quarter. While estimates for 2024 earnings fell for nearly every sector over the last quarter, analysts are still forecasting a return to double-digit growth next year. Investor reaction to earnings reports has indicated tepid growth expectations, as they rewarded just a few of the strongest earnings drivers and were quick to penalize weakness. Those companies posting negative earnings surprises experienced an average price decline of 4.4% over the subsequent trading day, almost twice the five-year average of 2.3% according to FactSet. The strong performance of the S&P 500 in the face of tempered earnings caused its price-to-earnings (P/E) ratio to expand, as it opened 2023 at 16.8x forward (next twelve months) earnings and closed December at 19.6x. Investors' willingness to pay more for earnings was due in part to expectations for a more accommodative Fed. The 19.6x forward P/E is rich by historical standards but may be justified given the potential for Artificial Intelligence (AI) as a driver of growth and productivity.



Source: Strategas Research Partners

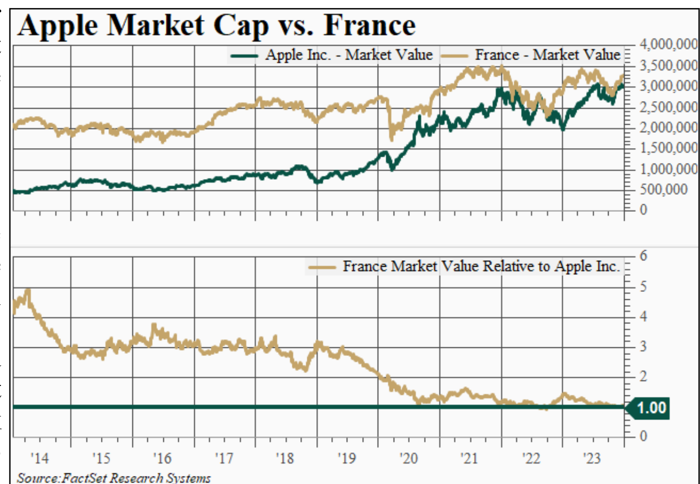
EQUITIES

- By many measures, concentration risk in the S&P 500 is at an all-time high. The ten largest companies by market cap comprised a huge portion of the index, 32.1%, at the close of the year. The concentration grew in 2023, with the previously mentioned "Magnificent 7" contributing over 60% of the index's 2023 total return (up 111.7% on an equal-weight basis) while the remaining companies contributed less than 40% (up 12.9% on an equal-weight basis). Index valuation metrics have also been held up by the largest ten companies, which are valued at 26.9x forward earnings versus a more reasonable 17.1x for the others. Of note, representation within these largest names is narrow, comprised primarily of tech-heavy names such as the "Magnificent 7." Also of note, their valuations appear justifiable, at least in part, given their earnings growth and consistency in earnings relative to the remaining companies in the index.



Source: Strategas Research Partners, Bloomberg

- Concentration risk for these mega-cap names, particularly the "Magnificent 7," extends beyond the S&P 500. U.S. companies now represent 61% of the $60 trillion global market capitalization as measured by the MSCI All Country World Index (ACWI), a notable increase from less than 50% a decade ago. The ten largest S&P 500 stocks now account for almost 19% of the ACWI, compared to just 8% in 2013. For scaled comparison, Apple alone is nearly as large as, or larger than, the entire stock markets of countries such as France, Canada, and the United Kingdom.



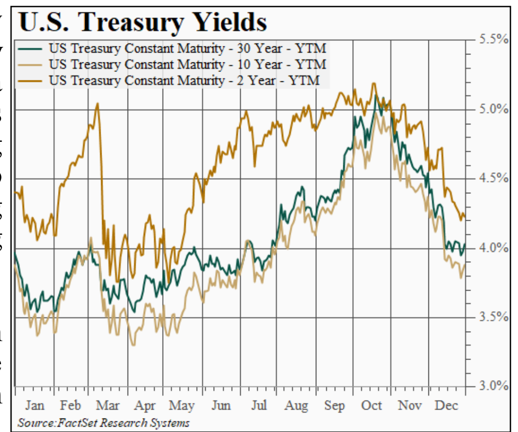
Source: FactSet Research Systems

- In the fourth quarter of 2021, our team wrote about corporate activity reaching an all-time high as 600 companies went public via Special Purpose Acquisition Companies (SPACs). Significantly reduced regulatory burdens and low interest rates influenced the SPAC hot streak. Companies looking to list publicly took advantage of the cheaper and quicker route to market compared to traditional initial public offerings (IPOs). In 2022, the SEC proposed new rules to protect investors, but rising rates had cooled the deal environment considerably. Fast forward to today and that cooling has turned to winter, with $46 billion in shareholder value erased. Higher interest rates put pressure on shaky finances, causing 21 SPAC bankruptcies last year. According to Bloomberg, 44% of SPACs that filed annual reports in 2023 warned investors of potential insolvency, 140 of which will need more financing in 2024 just to continue operations. Of importance, this additional financing will not come cheap with the higher interest rate environment relative to the operating environment prior to their going public.

Fourth quarter 2021 SPAC information, as well as all previous Newsletters, are available within the Publications page at wallingtonasset.com.

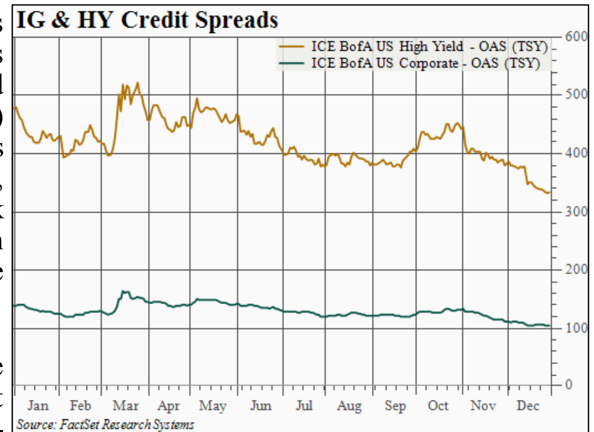
FIXED INCOME

- Lower interest rates caused global bond markets to rally sharply in the last two months of the year. The 10-year U.S. Treasury (UST) yield peaked at 4.99% on October 19, then experienced a steep decline to close the year at 3.88%. Yields decreased across the yield curve spectrum, with the 30-year UST yield moving from 5.11% to 4.03% and the 2-year UST yield from 5.21% to 4.23% over the same period. For the quarter, the Bloomberg U.S. Aggregate Index provided a total return of 6.8%, bringing its 2023 return to 3.3%.

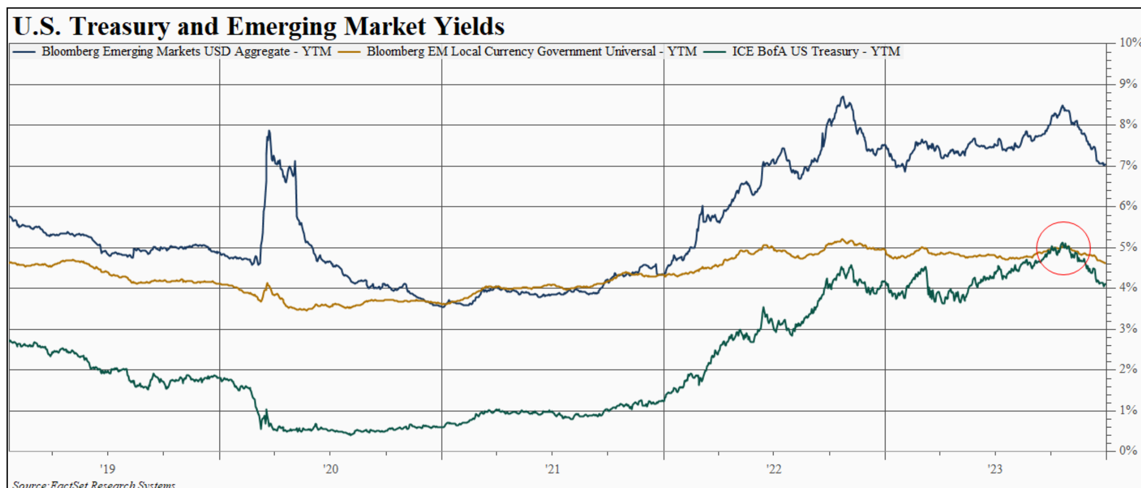


- The steep drop in yields helped fixed income performance turn positive for the year following generally negative performance in 2021 and 2022. Government and corporate U.S. bonds with more than ten years until maturity returned 6.3% for 2023 according to BofA-ML indices, as longer duration instruments benefitted most from the two-month move downward in yields to close the year. Similar bonds with 3-5 years and 1-3 years until maturity returned 5.2% and 4.6%, respectively. While positive, the returns were lower than the return generated with longer-term bonds due to less sensitivity to interest rate movements.

- On a credit risk basis, investment grade corporate bonds outperformed USTs, returning 7.9% for the quarter versus 5.7% for USTs broadly. Despite credit spreads (the yield differential between corporate and government bonds) declining for the quarter, high-yield bonds underperformed their investment grade counterparts, returning 7.1%. This was largely due to these higher-risk companies being unable to fund operations with as much longer-term debt, making their bonds less sensitive to the broad decrease in interest rates.

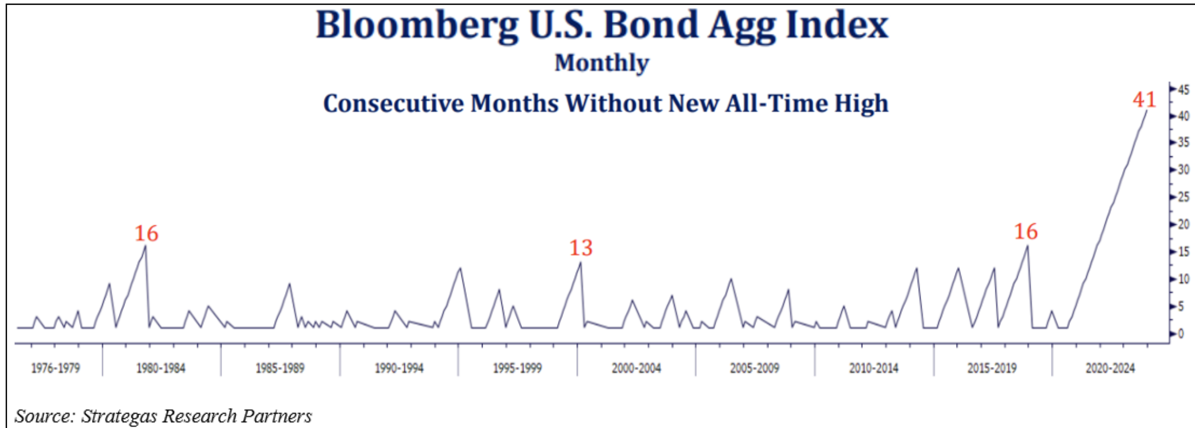


- In addition to high-yield U.S. bonds, fixed income investors have historically looked to emerging market (EM) debt to increase their yield. Segments of this sub-asset class have lost their allure, however, as EM government bonds priced in their local currencies went from yielding over 3% more than USTs in 2021, to less than USTs in October. Although USTs are ostensibly risk free while some EM countries have defaulted on their debt in the past, complex foreign exchange dynamics and currency conversion costs enabled the yield premium offered for holding EM debt to briefly vanish. This was largely due to lower-yielding Asian Pacific countries with currencies that depreciated significantly versus the dollar while the yield premium decreased. Broad EM bond markets denominated in USD continued to offer yields roughly 3% higher than USTs as of the end of 2023.

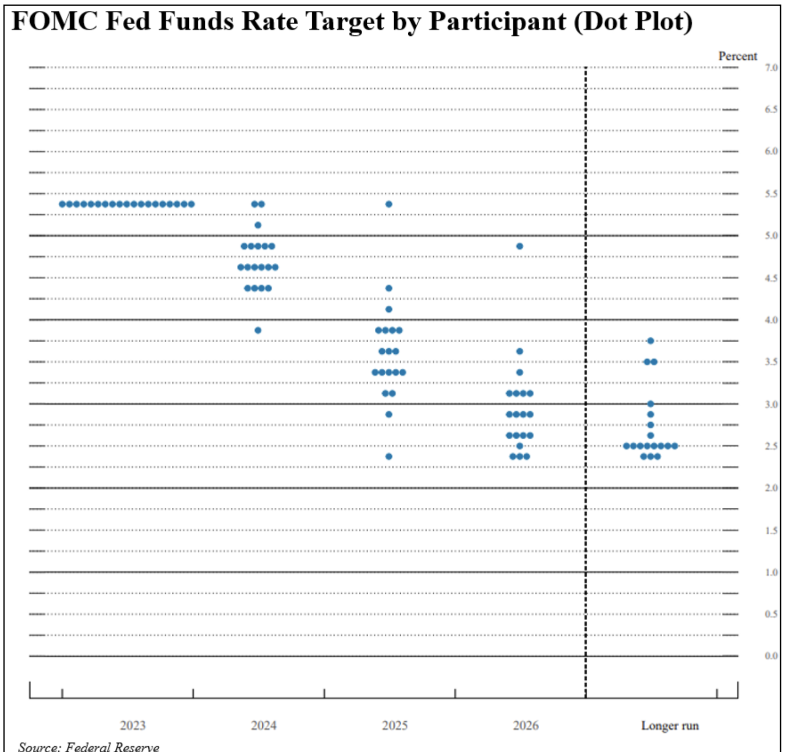


FIXED INCOME

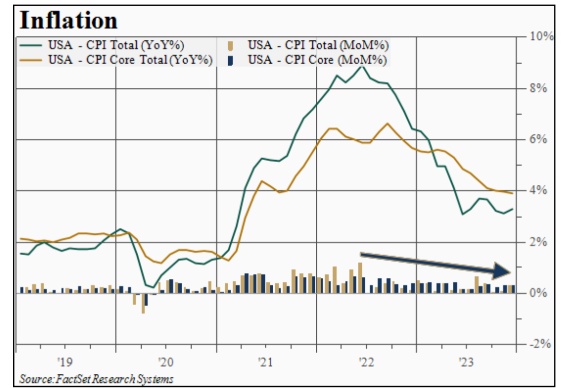
- Prior to the March banking failures and the October reversal in yields, bond markets were on track for what would have been a record three consecutive years of negative performance. The Bloomberg U.S. Aggregate Index peaked on August 4, 2020, and is down 9.9% on a total return basis through the end of 2023. The drawdown on an interim basis has been much worse, however, hitting -18.4% at its nadir on October 24, 2022. The numbers are even more stark when considering the amount of inflation experienced over this time frame. The Consumer Price Index (CPI) increased 14.9% between August 2020 and October 2022 and 19.1% between August 2020 and December 2023, further worsening the inflation-adjusted return on bond instruments. Even Treasury Inflation Protected Securities (TIPS) have provided only a -0.9% total return from the peak in bond markets through the end of 2023, highlighting the difficulty in truly safeguarding a portfolio from inflation.



- On December 13, at his press conference following the final Federal Open Market Committee (FOMC) meeting of the year, Fed Chair Jerome Powell declared, “We believe that we are likely at or near the peak rate for this cycle.” His comments allowed the yield on the 10-year U.S. Treasury note to continue its descent lower which started with the release of the FOMC’s Summary of Economic Projections. Contra to this statement, 12 days prior at a Fireside Chat at Spelman College in Atlanta, Georgia, Powell remarked that “it would be premature to conclude with confidence that we have achieved a sufficiently restrictive stance, or to speculate on when policy might ease.” One would have expected negative economic reports to create such a seismic shift in rhetoric from arguably the most influential person for financial markets. However, between the Fed Chair’s remarks, there were reportedly more jobs created than expected, a lower -than-expected unemployment rate, and an acceleration in the month-over-month core inflation rate. These numbers suggest continued economic strength and potentially persistent inflation, the opposite of what would prompt Powell to make a shift. Other FOMC participants such as New York Fed President John Williams, Chicago Fed President Austan Goolsbee, and Atlanta Fed President Raphael Bostic have tried to walk back Powell’s change in tone and stated that it was premature to be even thinking about cutting rates. Clarity from the Fed would be welcomed but is clearly not expected.

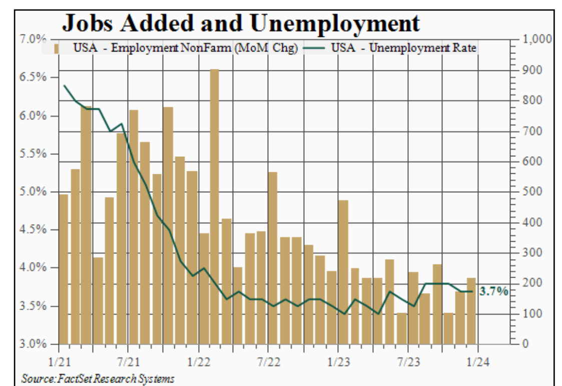


- The U.S. economy received a holiday gift when the U.S. Commerce Department reported that inflation fell in November, its first monthly decline since April 2020. The Fed's favored inflation measure, the Personal Consumption Expenditures Price Index, declined 0.1% for the month. This brought the year-over-year (Y/Y) rate to 2.6% and the annualized rate to 2.0% over the last six months. Another measure of inflation, the CPI, also reflected a receding inflationary environment but at a slower pace. It rose 3.4% over the 12 months ending in December. Much of the difference can be explained by the CPI having about twice the weighting to shelter costs (more than 30% of the index) and less than half the weighting to healthcare services (about 7%). Shelter costs include tenant rent (7.7%) and owners-equivalent rent (25.8%) which is based on what it would cost homeowners to rent their homes. The good news is that rents are coming down, but this will be reflected in CPI numbers with a lag.



- Real gross domestic product (GDP) grew at an annualized rate of 4.9% in the third quarter, preceded by GDP growth of 2.1% in the second quarter and 2.2% in the first quarter. Combined, GDP grew at a rate of 3.0% for the first three quarters of 2023, driven by consumer spending, government spending, and nonresidential private investment. GDP growth is expected to slow to 2.5% in the fourth quarter. Consumer spending was up 0.2% in November and 0.1% in October, building on a 0.7% increase in September. Mastercard data showed holiday shopping was solid with sales increasing 3.1% between the 2022 and 2023 holiday shopping seasons. One question confronting economists is why spending remains resilient despite consumers being gloomy. The University of Michigan Index of Consumer Sentiment was 69.7 in December, up from its June 2022 low, but far below its high of 101.0 in February 2020. A primary reason was inflation; prices were 19.1% higher in December than just before the pandemic. Spending has been supported by a strong job market, positive real wage growth, excess pandemic savings, and the wealth effect from rising home and stock prices. Consumers are also adding to credit card debt as savings dwindle.

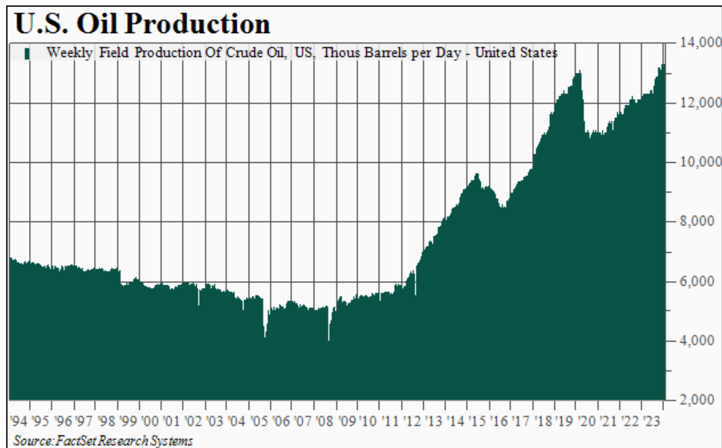
- While cooling, the job market remains a pillar of strength for the economy. Monthly job creation in 2021 was over 600,000, declining to 399,000 in 2022 and 225,000 in 2023. Job growth has become more concentrated; healthcare, government, and leisure and hospitality accounted for more than two-thirds of job gains in 2023. Only 100,000 new jobs are needed each month to keep up with the growth of the working-age population. The Labor Department announced that 216,000 jobs were added in December versus 173,000 in November, and the unemployment rate held steady at 3.7%. This marked the 22nd straight month that the unemployment rate was below 4.0%, the longest stretch since the 1960s. The steady unemployment rate was supported by the labor force participation rate falling to 62.5% in December from 62.8% in November, resulting in a labor force reduction of 683,000. This could put upward pressure on wages. On an annual basis, average hourly earnings were up 4.1% in December, ahead of inflation. There were 8.8 million job openings at the end of November, down from the record 12 million in March 2022 as the quit and hire rates are now back to normal.



ECONOMICS

- Home ownership affordability hit a three-decade low in October. The average monthly mortgage payment for a new homeowner of $3,322 exceeded the average apartment rent of $2,184, causing the buy-to-rent premium to increase to 52%. This was due to higher mortgage rates and higher home prices. While the 30-year fixed rate mortgage has declined from its October peak at 7.79% to 6.61% recently, the S&P Core Logic Case-Shiller National Home Price Index was up 0.6% in October and 4.8% Y/Y. The index has appreciated for five straight months. Home prices are higher primarily due to a lack of inventory. Existing home sales for the 12 months ending in November were down 7.3%, and the National Association of Realtors estimates that home sales in 2023 will end up being the lowest since 2011. People still feel locked in by lower mortgage rates and are thus not selling their homes. This has led to more new home sales as they now account for one-third of all homes sold, up from a historical average of 10-15%.

- The International Energy Agency recently forecasted that oil demand will peak before the end of this decade, and the recent U.N. climate conference also delivered a historic message; the participating countries agreed that global energy systems must transition away from the use of fossil fuels to reach net zero emissions by 2050. However, the major oil companies do not seem to agree. Exxon Mobil recently bought Pioneer Natural Resources for $60 billion, and Chevron paid $53 billion for Hess Corp. Meanwhile, OPEC+ has cut production by another 900,000 barrels per day in an effort to increase oil prices. Their actions to date have not been successful, though, as the U.S., Brazil, Canada, and Guyana all have increased production. The U.S. is currently the largest global oil producer at 13.3 million barrels per day and now exports 4.5 million barrels daily. The U.S. is now adding oil to its Strategic Petroleum Reserve (SPR). It plans to expedite the return of 4 million barrels to the reserve by the end of February amid lower energy prices rather than waiting until summer. Currently, the SPR holds 354 million barrels of oil, slightly less than 50% of its total capacity (714 million barrels), and near 40-year lows. But events in the Middle East could dramatically change the energy situation. There have been attacks on ships in the Red Sea which is a major artery of oil and gas exports. The Strait of Hormuz could also become a flash point with 21 million barrels of oil per day moving through this artery.



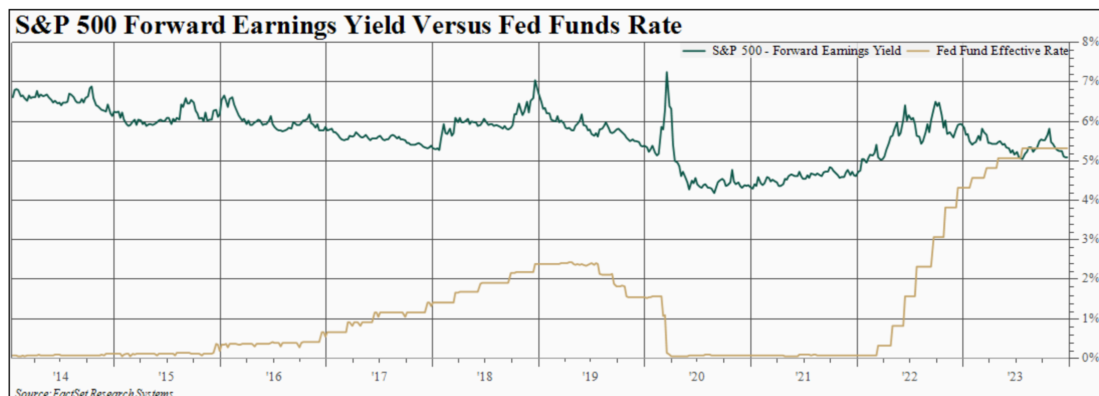
Forecasting in the Face of Heightened Uncertainty

As we noted in last quarter's Wallington Perspective, correctly forecasting the trajectory of the economy and financial markets has historically proven difficult, if not impossible. The last two years have been no exception. At the beginning of 2022, the Fed was still proclaiming that inflation was transitory. The year began with lofty expectations for the S&P 500 as it closed at a record high of 4,797. However, in March, with inflation running at its highest level in 40 years, the Fed began one of the most aggressive series of interest rate hikes since the early 1980s. Subsequently, the S&P 500 fell over 25% by October. Although the National Bureau of Economic Research opted against declaring an official recession, the first two quarters of the year also provided negative real GDP growth which was not evident in many economic forecasts prior to that time.

At the beginning of 2023, the widely adopted view among economists was that the U.S. would experience a recession at some point in the next 12 months. Such a forecast was not surprising given the persistence of the yield curve inversion which began in early 2022. In the last 50 years, all seven recessions have been preceded by an inverted yield curve using 2-year and 10-year USTs (2-year yield higher than 10-year yield). The Fed rapidly raised interest rates to over 5% through July and even caused a regional banking crisis. The Federal Deposit Insurance Corporation (FDIC) bailed out over $300 billion of deposits across three relatively large institutions in the first half of the year. The yield on the 10-year Treasury bond reached 5% in October, the highest level since 2007, and 30-year fixed mortgage rates reached nearly 8%, the highest level in decades. Yet, no recession occurred during the year.

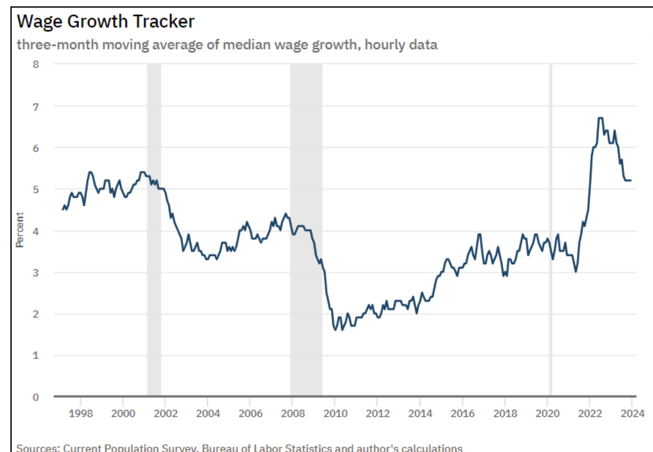
Many forecasts for the stock market at the start of 2023 contained meager returns at best, with some predicting a continuation of the negative environment experienced the prior year. The basis for these forecasts was primarily an expectation of a recession and the impact it would have on corporate profitability. Michael Wilson of Morgan Stanley is thought to be one of the best market strategists in the business. After being one of the few strategists to correctly forecast a bear market in 2022, and gaining even more positive recognition in the process, his pessimism continued into 2023. At one point, Mr. Wilson indicated, "The headwinds significantly outweigh the tailwinds, and we believe risks for a major correction have rarely been higher." As he noted, one of those top headwinds was profit risk. Concerns about profitability were justifiable given recessions have historically led to earnings-per-share (EPS) declines of 29.5%, on average, for the S&P 500 according to D.A. Davidson.

Higher interest rates also negatively impacted stock market forecasts for 2023. The TINA theory (There Is No Alternative) helped support equity returns for years leading into the pandemic, but with rates higher, bonds once again provided a more competitive alternative to equity investments. As noted earlier, the S&P 500 began 2023 with a 16.8x forward P/E ratio which was down significantly from the 21.6x level where it started 2022. The inverse of 16.8 equates to a 6.0% "earnings yield." Although a simple analytical tool, the thought was that the risk was too high to place capital in the equity market with an earnings yield this low relative to the yield on cash instruments and bonds. Little to no anticipated earnings growth, or even negative growth, intensified that thought. Yet, the S&P 500 moved higher into July, confounding many strategists. Of note, though, they were correct for the majority of stocks. As we wrote in our second quarter newsletter, "Just seven large, tech-based growth stocks (Apple, Microsoft, Meta, Alphabet, NVIDIA, Tesla,



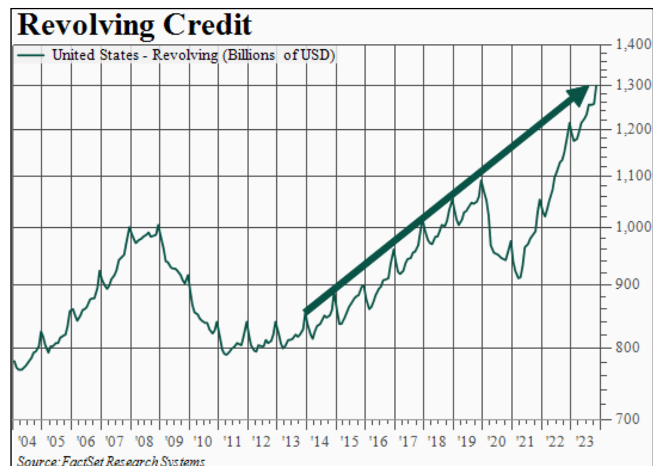
and Amazon) drove virtually all of this (2023) year's S&P 500 return before the market's performance finally began to broaden in June." These companies, known as the "Magnificent Seven" due to their size and performance, grew to a combined weight of more than 30% of the S&P 500; a concentration level that certainly magnifies the risk of the index.

The S&P 500 fell 10% into late October due to September and October being mired in pessimism with inflation remaining stubbornly high, and investors fearing higher-for-longer interest rates. As mentioned earlier, the interest rate on the 10-year Treasury bond reached its highest level since 2007 and 30-year fixed mortgage rates reached their highest levels in decades. Those strategists with negative stock market predictions were no doubt feeling vindicated until unanticipated dovish statements by the Fed and the continued downward trajectory of inflation lowered interest rate expectations. This enabled the S&P 500 to resume its upward path, again initially led by the "Magnificent Seven." Through October, their concentration in the capitalization-weight S&P 500 index accounted for all the gains in the index. To illustrate the magnitude of the concentration, the equal-weight version of the index had a negative return for the year through mid-November, which made it difficult for diversified equity portfolios structured to manage risk to perform well. With expectations of lower rates and the perceived risk of a recession lessening, the S&P 500 broadened out with more companies providing positive returns. Ultimately, over 65% of stocks in the S&P 500 provided positive returns for the year. Far from dissuading investors, and confounding the vast majority of market strategists, the earnings yield on the S&P 500 fell even further to 5.1%, essentially in line with the fed funds rate. When the year closed, the "Magnificent Seven" accounted for nearly two-thirds of the S&P 500 appreciation as the index ended 2023 at 4,770, just 0.6% below its January 2022 high watermark.



So why did the widely anticipated recession not happen and how did the S&P 500 provide returns of over 20%? Or said another way, how did the majority of forecasters get it wrong? The primary reason for no recession in the U.S. was that while the labor market cooled, it remained robust. From 2010 through 2019, the economy averaged adding about 194,000 jobs per month. For 2023, the economy added roughly 225,000 jobs per month (aided by an exceptional 472,000 jobs added in January). While the U.S. economy lost more than 9 million jobs in 2020, the largest calendar-year decline on record, many of the jobs lost were in the leisure and hospitality sector. A majority of job gains in 2023 were in leisure and hospitality, healthcare, and government, as the economy continued to stabilize and normalize after the pandemic.

Along with job gains came wage gains. Average hourly earnings increased 4.1% in 2023, a higher growth rate than both headline and core inflation figures. The Atlanta Fed's Wage Growth Tracker, which seeks to measure median wage growth, presented an even better picture for the consumer base with a 5.2% increase for 2023. While both average and median wage growth declined from their peak, they fell slower than inflation, increasing the purchasing power of consumers.



Additionally, although reports have indicated less demand for new credit card loans, consumers have not been shy about rebuilding their credit card balances. The amount of revolving credit (the majority of which is credit card balances) plunged in 2020 and early 2021 as stimulus checks allowed many consumers to pay down their debt, and lifestyle restrictions limited how people were able to or interested in spending their money. Through 2022 and 2023, revolving credit soared past old all-time highs, increasing to over $200 billion more

than before the pandemic. While the long-term trend is for credit to expand with consumers' net worth and the cost of living, this steep increase in debt reached prior trend levels.

The bottom line is that the strong labor market, real wage gains, and a rebuilding of credit card balances helped the economy overcome the most aggressive rate hiking cycle since the early 1980s. Consumer spending increased at more than a 7% annual rate since the beginning of 2020 and importantly comprises almost 70% of GDP. Consumers continued to have the means to support businesses, and businesses continued to hire workers, thereby supporting consumption. GDP grew at a rate of 3.0% for the first three quarters of 2023, driven by consumer spending, government spending, and nonresidential private investment. It is expected to come in at 2.5% when the final number is posted for the fourth quarter – no recession in those numbers. There has not yet been an inflection point where the slowing economic environment has led to widespread layoffs and weakened the consumer.

With no recession in 2023, earnings held up better than many expected and supported the stock market. Once all companies in the S&P 500 have reported for the fourth quarter, analysts anticipate earnings growth for the year will have been slightly positive, at 1% or less, with sales growth of less than 3%. This growth was positive enough to avoid a negative market environment like witnessed in 2022, but not so positive that one would expect the S&P 500 to generate a return of more than 20% as it did for the year. As mentioned, while the breadth of stock market gains improved as the year closed, this superior performance was driven by just a few stocks which had grown to excessive weights in the index. Investors were also willing to pay more for earnings as seen in the higher P/E multiples at the end of the year, as confidence grew that the aggressive monetary policy promulgated by the Fed was now in the rear view mirror.

Looking forward to 2024 and beyond, the Congressional Budget Office (CBO) is forecasting GDP growth to drop to 1.5% in 2024 and increase to 2.2% in 2025. Their 2024 forecast is lower than 2023 growth and is referred to as a "soft landing." A soft landing is the conventional economic forecast for 2024 although some economists are still forecasting a recession. To have a soft landing, real (inflation-adjusted) economic growth must decline but remain positive, and inflation must continue to decline to the Fed's 2% target. This is referred to as a "Goldilocks" scenario. This is a rare occurrence, but it happened in the 1990s. The Fed raised the fed funds rate from 3% at the beginning of 1994 to 6% by March 1995; not quite as aggressive as the Fed's tightening from March 2022 to July 2023. The economy slowed but there was no recession. The Fed then made some moderate cuts in the fourth quarter of 1995, much like the anticipated cuts in 2024.

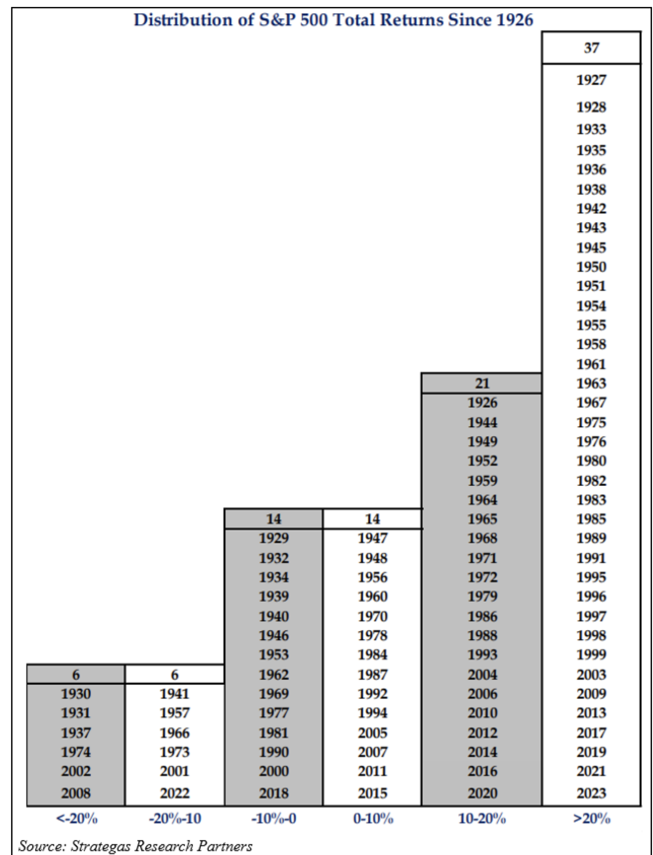
A soft-landing scenario does not have history on its side as there are few examples of the economy avoiding a recession after a tightening cycle. While it can last for months, a soft landing is a transition to either improved economic growth or a recession. There was a temporary soft landing before every recession as happened in 1969, 1979, 1989, 2000, and 2007. The yield curve inversion has persisted, and as noted earlier, this has always been followed by a recession since 1970. In the last 70 years, the Fed has never managed to substantially reduce inflation from above a 4% level without causing a recession. Recessions have started on average 24 months after the Fed starts raising rates, and that happened in March 2022. The lagged impact of monetary tightening is variable, as it takes time for higher interest rates to have their full impact. The latest rate hiking cycle was the most aggressive in 40 years. Also, The Conference Board Leading Economic Index has declined for 20 consecutive months, longer than any stretch in history not involving a recession.

There are also concerns that the consumer may not be able to continue supporting the economy. Although the job market has stayed strong, the strength needs to shift from post-pandemic normalization to more broad-based strength. The ratio of job openings to the unemployed has plummeted and is nearing pre-pandemic levels. Also, full-time employment as a percentage of the working-age population has not recovered to levels before the pandemic. As noted earlier, consumer credit is back to its pre-pandemic trend, but it is also growing at a much faster rate than that trend, and credit card interest rates are at a much higher level. There are also concerns that the prevalence of buy-now-pay-later plans have hidden the cost of purchasing decisions which have already been made. The capacity or desire to add an additional $100 billion to credit balances as was done last year may no longer exist.

Conversely, the economy could escape a recession and therefore prove the above recessionary indicators to be false signals. While often costly words, this time indeed may be different. None of these indicators likely have in their history such a low probability event as a pandemic. Further, there are certainly paths where

consumption continues to stay strong. The recent trends of de-globalization/reshoring can be expensive and are inflationary in theory but could also support domestic job growth. Baby boomers retiring could lead to demographic shifts which keep the labor market tight and lead to continued wage gains for the country's consumer base. The wealth effect from over a decade of strong capital markets and the addition of higher - yielding bond markets could help boost consumer spending from these retiring baby boomers and other beneficiaries. People may grow impatient waiting for mortgage rates or housing prices to fall, helping to normalize the housing market and the associated spending that comes with changing homes.

With all of the uncertainty, economic projections are widely dispersed and conflicting and have led to much debate. No doubt the most important forecast involves interest rate cuts by the Fed. According to the Fed's dot plot, three rate cuts have been penciled in for 2024. The Fed's dot plot is a chart which shows where each Fed official thinks the fed funds rate will be at the end of each year and in this case, 2024. Surprisingly, in the face of this information, the market via the fed funds rate futures market is projecting six rate cuts. Much of the difference can be attributed to the loss of the Fed's credibility because of its erroneous forecasts in the past, especially not recognizing non-transitory inflation in 2021 and not starting the rate hiking cycle until March 2022. They were too optimistic in their forecasts early on and a little too pessimistic lately.



As for the financial markets, forecasts for 2024 are also widespread which is understandable given the Fed policy shift and the high amount of uncertainty in the economic environment. The S&P 500 certainly exceeded expectations in 2023 as it did in 2019, 2020, and 2021, all of which were well above the average appreciation since 1950 of approximately 9%. Many strategists use this as a baseline in making market forecasts. Fortunately, the widespread skepticism at the beginning of 2023 does not appear to have turned to excessive optimism as we start the year. After difficult earnings years, earnings for the S&P 500 are expected to rise by about 11% this year. That is a tailwind for the market but expecting earnings growth in a slowing economy is always a risk. Valuation multiples based off those earnings are even more uncertain. Many questions face equity investors, with one of the most important being whether or not the Fed will be able to decrease interest rates in a steady manner without reinvigorating inflationary pressures. Also, will elevated P/E ratios result in a steeper fall for the stock market if we do experience that long-awaited recession? Will the recent exuberance over an Artificial Intelligence (AI) revolution ultimately evolve into a productivity boost to a wider array of companies, allowing for even higher EPS growth than expected and increased valuations? Can AI succeed without hurting the job market and therefore consumers? These questions are only answerable with the benefit of hindsight, and even then, market reactions can be uncertain. Had someone offered forecasters the advance knowledge that Silicon Valley Bank was going to fail, it is unlikely they would have predicted the S&P 500 would continue to advance over 20% for the rest of the year.

Many of the economic uncertainties that exist today are creating a tenuous environment for fixed income (bond) investors. If bringing inflation down further proves more difficult than expected or the economy exhibits strong enough growth, the Fed would likely not engineer as many rate cuts or could even raise rates again. As a result, bond prices would likely decline in the short term while offering higher yields. This is similar to what occurred in 2021 and 2022, although there is little likelihood at this point with such an aggressive Fed. With a stronger economy, the credit worthiness of companies and municipalities would likely remain as is today or even improve, a positive for bond investors favoring corporate and municipal credits. However, if the economy enters a recession, or economic growth proves to be soft, market expectations of six rate cuts by the Fed may prove omniscient. With inflation at more elevated levels, though, it is doubtful the Fed would be as aggressive as in past periods such as 2000-2002, 2007-2008, and in March 2020 when the Fed engineered the equivalent of nine or more rate cuts. Depending on the severity of the economic landscape, the credit quality of many corporate and municipal bonds could also come into question, creating even more uncertainty for those investors. A more direct effect of rate cuts would be a decrease in the interest rates paid on many money market funds. According to St. Louis Fed data, in the low interest rate environment that persisted between 2010 and 2018, money market funds held about $3 trillion, as the funds were offering little better than cash returns. This number has roughly doubled to over $6 trillion since money market funds are now often providing significantly higher returns than the vast majority of savings accounts. The yield curve inversion and the potential for interest rate cuts present money market investors with a difficult decision: enjoy the higher rates currently available now but with the possibility of lower rates in the future, or “lock in” rates today via longer-term bonds. While the rates today are lower on longer-term bonds than money market funds due to the inverted yield curve, a weaker economy than expected could cause the Fed to lower short-term rates to levels below what is currently available on longer-term bonds.

The accompanying chart was sent to Wallington from Justin Yost, CFA, with Avantis Investors in an email entitled “As Much of 2023 That Fits on One Page.” His email read, “Turning the page on another extraordinary year – no doubt full of unexpected news and events. While unlikely that any single chart could convey all that investors experienced this past year, we have assembled a few data points and headlines to help advisors reflect and prepare for 2024.” While some of the events listed are not relevant for investors, especially Taylor Swift being nominated as Time Magazine’s Person of the Year, the chart does reflect how difficult it can be and how much noise there is confronting strategists and investors in forecasting. This is especially true in a world with news events at our fingertips every single day. Further, the uncertainty surrounding all these factors inherently fails to mention what will likely be the most impactful developments of 2024, the unknown unknowns.

Source: Avantis Investors, FactSet

The only surety is that there will be an event not currently being discussed which will impact the capital markets and the economy. As we have witnessed in our 35 years at Wallington, much of what we see and hear is important information, but it is crucial to assess and utilize the information in an appropriate manner. Instead of utilizing it to make bold forecasts, which can prove to be successful at times but can also be very costly as seen with even the best of forecasters, greater success is achieved by utilizing the information in the context of a strategic approach to the financial markets. In doing so, we are able to overcome the confirmation and recency biases that are indigenous to all of us as human beings and which so often undermine even the best of forecasters.

"Over the very long run, it is the economics of investing – enterprise – that has determined total return; the evanescent emotions of investing – speculation – so important over the short run, have ultimately proven to be virtually meaningless. "

~ John Bogle

"The investor is bombarded with staggering amounts of information, staggering amounts of stimuli that are designed to get the investor to buy and sell and trade, to do exactly the wrong thing, to create excessive profits for these intermediaries that aren't acting in the investor's best interests."

~ David Swensen

The information contained herein has been compiled from sources Wallington Asset Management, LLC believes to be reliable but no warranty, expressed or implied, is being made that the information is complete or accurate. Wallington Asset Management, LLC and its affiliates, employees and/or directors may have investments in positions associated with securities required to implement and maintain a particular investment strategy. Information presented is not an offer to buy or sell, or a solicitation of any offer to buy or sell any securities which may be mentioned herein. All securities are subject to price and yield change and subject to availability. Any recommendations or opinions expressed herein may be subject to change without notice. Past performance is not to be construed as a guarantee of future results. Wallington Asset Management, LLC does not render tax advice. All rights reserved. Any unauthorized use or any reproduction, modification or distribution of the materials is strictly prohibited.