Surprise!

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Last year started ominously – with widespread predictions for a U.S. recession by economists as well as warnings from robust historically-based quantitative models. Wall Street strategists, on average, predicted a decline in stocks for the calendar year for **the first time in decades**. The failure of Silicon Valley Bank and other regional banks in the first quarter turned up the heat. Still high inflation, the ongoing war in Ukraine and political polarization domestically did not help the mood in the room.

For much of the year, performance somewhat met initial expectations - Most stock and bond markets were close to flat or even down for the year as recently as late October before…**Surprise!**…nearly every asset class rallied strongly the last two months of 2023 and markets stole victory from the jaws of defeat, turning a weak year into one that was better than average.

Year-end figures mask many important developments throughout the year. As we reflect on 2023, it's useful to review returns across a variety of asset classes during three distinct periods - up until the July peak, then during the Autumn correction, and finally with a keen eye on the "everything rally" to end the year.

Asset Class	Index	Year-to-Date Through July 31	From 7/31 to 10/27	Year-to-Date Through Oct 27	From 10/27 to 12/31	Full Year 2023
U.S. Large Cap	S&P 500 - Size Weighted	20.7%	-9.9%	8.7%	16.3%	26.3%
U.S. Large Cap	S&P 500 - Equal Weighted	10.7%	-13.3%	-4.1%	18.5%	13.7%
U.S. Small Cap	Russell 2000	14.7%	-18.0%	-5.9%	24.2%	16.8%
Non - U.S Developed	MSCI EAFE	15.5%	-11.6%	2.2%	15.9%	18.4%
Emerging Markets	MSCI Emerging Markets	11.6%	-12.9%	-2.9%	12.2%	9.0%
Core Bonds	Bloomberg Aggregate	2.2%	-4.4%	-2.3%	8.1%	5.7%
Liquid Alternatives	Morningstar Multialternative	4.0%	-0.4%	3.5%	2.4%	6.0%

We don't expect readers to comb through all these numbers. But we have, and we found what we think are several important points to consider:

a. **Large Cap U.S. stocks dominated** the full year results - with their 26% gain leaving everything else in the dust. (More on that later.)

b. But Large Cap U.S. stocks did NOT dominate the year-end rally. We listed two versions of the S&P 500 in the table so that you could see that the "equal weight" S&P 500 index, which gives each stock an equal (roughly 0.002%) weight in the index, outpaced the more widely followed size-weighted S&P 500 index. And not only did Small Cap stocks comfortably beat Large Caps during the year-end rally, but non-U.S. Developed Market stocks were not far behind U.S. Large Caps as well.

c. **Directionally, Stocks and Bonds moved in tandem** up and down throughout the year, but especially during both the Autumn correction and the year-end rally – providing little diversification benefits to each other.

d. With stocks and bonds both volatile and moving together, liquid Alternative investments (illustrated in the bottom row) provided a smooth ride and **portfolio-cushioning diversification**. In fact, as late as October 27th, Liquid Alternatives were the **second-best performing** category year-to-date (+3.5%).

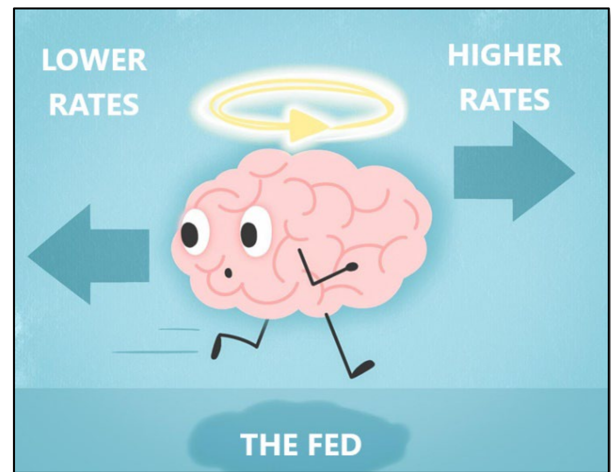
A large part of the 2023 story was how the traditional size-weighted S&P 500 index was driven by eye-popping gains in the very largest, mostly Technology, companies. According to J.P. Morgan, the top ten stocks in the index returned 62% on average while the **remaining 490 stocks returned only 8%.** Over 70% of stocks in the S&P500 *underperformed* the index last year, making it nearly impossible for any broadly diversified strategy to keep up. Going back to 1980, there have been only two similarly extreme episodes - in 1980 and 1998/9. What happened next? Both times, a sharp reversal in market dynamics followed whereby many more stocks outperformed the top-heavy index.

After consecutive down years, Core Bonds finally posted "normal" returns, but the path to the full year returns was anything but normal. As the table above showed, there were large fluctuations and the -2.3% year-to-date return through late October threatened investors with an unprecedented third consecutive year of declines in Core Bonds. But then, Core Bonds rallied 8.4% over the last two months of the year - their best two months since 1982!

All this volatility in the stock and bond markets must have been driven by volatility in the economy, right? Not really. Through June 30th, the last three quarters of reported annualized GDP growth were pretty consistent: 2.6%, 2.2%, and 2.1%. Not until the first estimate of 3rd quarter GDP growth was released on October 30th and came in at 4.9% did we see a meaningful fluctuation in GDP growth.

What about inflation? Again, not really. The trailing 12-month rate of CPI inflation started the year at 6.4% and declined steadily until bottoming at 3.0% in June. It then climbed back to 3.7% in August and September before sliding back to 3.1% in November.

By our estimation, neither of these economic figures – GDP or Inflation – were the primary drivers of markets last year. While they certainly mattered, the more influential factor was the Fed, and just as much their words as their actions. The Fed stopped raising short-term interest rates in late July but continued to verbally defend their option to keep raising rates, pressuring markets during the Autumn correction. Then, in the fourth quarter, seemingly out of nowhere… surprise… the Fed proclaimed that they were done raising rates and suddenly were even open minded to cutting rates in the foreseeable future. This turnaround, known as **the "Fed Pivot",** helped fuel the rally in the stock and bond markets to end the year.



Looking forward, we think the economy and the capital markets that reflect it are facing a three-forked road – and two of these paths are potentially perilous for investors.

1. Either the economy finally succumbs to an economic slowdown severe enough to be labeled a recession, and the Fed cuts rates fast and furiously, or…

2. Inflation continues to fall, giving the Fed enough leeway to lower interest rates gradually and deliberately. This would likely require some economic weakness, but in this scenario, it does not reach the level of a meaningful contraction or a technical recession. When you hear the phrase "**soft landing**", this is what they're referring to.

3. Alternatively…It turns out that calls for the death of inflation were greatly exaggerated, price increases pick up steam again, and the Fed cannot cut rates.

As you'd expect, as varied as these paths are, so too are their impacts on different types of investments. Here's our take on how various investment categories would be *expected* to behave under each scenario:

	Recession	Soft Landing	Inflation
Stocks	Very poorly	OK to good	Mixed
Bonds	Very good	Good	Poorly
Real Estate	OK	Very good	OK to poorly
Alternative Strategies	OK to good	Good	OK to good

We think that **all three of these scenarios are still possible** for 2024. Looking at the economy, while its resiliency in 2023 surprised many, it's finally showing cracks that justify a loss of confidence. Bank lending, the lifeblood of our credit-intensive economy, is tightening. Readers may not see it in their lives, but there's real pain being experienced within lower income groups - Delinquency rates on credit cards and sub-prime auto loans are spiking sharply. The labor market is clearly (finally) weakening - Job openings are down sharply. Layoffs are up. So far in January, there have been meaningful job reductions announced at some Tech and Finance companies. (Citigroup recently announced layoffs of 20,000 jobs.)

Despite current weakness, the unemployment rate remains under 4.0% (which is unusually low) and it's been there for 25 months – the longest streak since 1969. For the economy to avoid a recession next year, something **unprecedented** will have to happen. Unemployment has never risen from below 4.0% to above 4.0% without a recession. And unemployment has never remained below 4.0% for more than 35 months. So, to avoid a recession this year, either unemployment must remain below 4.0% for a record length of time, or it would need to rise from a low of 3.4% (Jan 2023) to over 4.0% without a recession. Thanks to the impact of Covid on the labor force and the economic impact of trillions in government stimulus, we are more open minded to "this time is different" than at any other time earlier in our careers. But we still find it hard to bet on a never-happened-before outcome in a key indicator like employment.

When looking at inflation, we're struck by the vast range of forecasts from analysts that we find credible. Several predict inflation to keep abating and snuggling up close to the 2% figure that the Fed wants to see. While others think it will rise again to wreak havoc on the market's expectation of a soft landing. As a result, surveys of economists reveal an **unprecedented range of forecasts** for the path of inflation and interest rates this year. With the labor market softening, we see a path for inflation to continue to subside. But we're also concerned that the easy improvements in supply chains, energy prices, and housing may already be in the rear-view mirror. Plus, conflicts in the middle east could inflate energy and shipping costs. An inflation surprise in 2024 remains a significant risk to stocks and bonds.

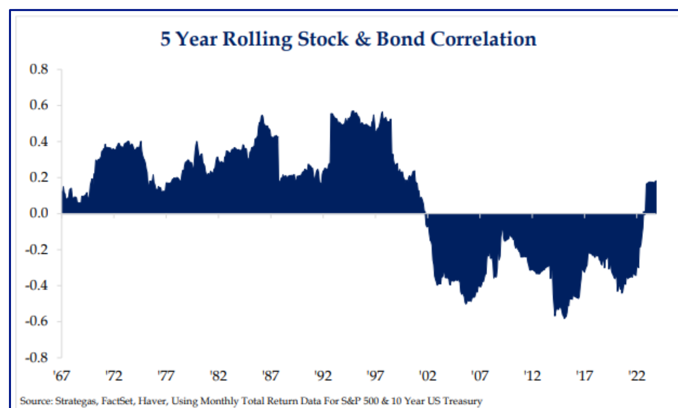
So, we begin another year with perhaps more questions than answers and a wide range of potential outcomes. Let's look at Core Bonds. Last year, the yield on the 10-year U.S. Treasury fluctuated between 3.3% and 5.0%, somehow finishing precisely where it started the year – at 3.88%. Where it ends this year will depend on which of the three paths the economy takes. But we can do some sensitivity analysis to estimate a range of how yield changes might drive Bond returns. The diversified Bloomberg Core Bond index starts the year yielding 4.53%. If rates (and credit spreads) don't change, it should provide a return of about the same – 4.5%. If the 10-year U.S. Treasury yield rises all the way back to 5.0%, we estimate Core Bonds would lose about 2.4% for the year. On the other hand, if a slowing economy were to see rates fall and end the year at 3.0%, Core Bonds should return about 10%. This range of returns in Core Bonds is a welcome change from the poor risk/reward profile during the ultra-low interest rate environment of much of the last decade.

Within the global stock markets, we would not be surprised if 2023 was somewhat of the "peak" of outperformance for many mega-cap U.S. Tech stocks. While they are all great companies, across the board, their valuations are high. The revenues and market value of these companies are now at sizes that are hard to comprehend, and the law of large numbers may make it harder for them to continue to outperform. Consider for a moment that the market capitalization (value) of just seven large U.S. "Tech" stocks (Apple, Microsoft, Google, Amazon, NVIDIA, Meta, and Tesla)

is worth more than the entire market cap of all publicly traded stocks in Japan. And the U.K. And Canada. **Combined.** These seven stocks are now worth four times (4x) the value of all 2000 companies in the Russell Small Cap Index. Ten years ago, the value of those seven stocks and the small cap index were about equal - 1 to 1. And many of these companies (Apple, Meta, Google) also face significant regulatory and anti-trust scrutiny here in the U.S. and in Europe. From simply a performance cyclicality perspective, last year the tech-heavy Nasdaq index had its best year since 1999, and we know what happened from 2000-2003.

If there is a change in leadership in 2024, there are many stock market categories that could perform well. Higher dividend stocks have languished and by some measures are relatively cheap. Non-U.S. stocks are not just significantly cheaper than U.S. stocks but would also benefit from a weakening of the U.S. Dollar. And Small Caps have been out of favor for so long, that many investors may be grossly under allocated to them – a potential source of future demand. The strong performance of these categories relative to Large Caps during the year-end rally could be a signal of a more enduring change in leadership.

For a long time, we allocated to Alternative assets and strategies largely as a substitute for bonds that offered little return and high risk. That commitment was well rewarded in 2022 when both stocks and bonds declined over 14%. But now that Bond yields are "satisfactory" again, we recently re-examined our allocation to Alternative strategies. We concluded that we should stick with Alternatives, not just for their attractive risk/reward profiles, but perhaps more importantly, for their significant **diversification benefits**. As we explained earlier, stocks and bonds danced together in both 2022's bear market and last year's choppy but up market. This chart, which goes back to the '60's, shows that the 5-year correlation of performance between stocks and bonds has recently turned positive (meaning they are moving in tandem) after a couple of decades when they danced to different drummers. But it also shows that for over 30 years prior to the year 2000, stocks and bonds were more likely to move together than to diversify each other. If this relationship holds again, and it's more likely to be the case in an environment with elevated inflation risks, then Alternative strategies will remain an important tool to diversify core stocks and bonds.



Within Alternative assets, we're excited about some of the "easy money" to be had and for the potential for a turnaround in some categories. We think Private Credit, where yields on many funds are over 9%, is unusually attractive. Last year Reinsurance was the top performing investment in the Alternatives tool kit (it far outperformed the S&P 500 index). Insurance premiums have skyrocketed in recent years and if 2024 is merely a "normal" year for hurricanes and other events, Reinsurance returns should remain strong. Several Alternative asset classes that struggled in 2023, namely Venture Capital (VC) and Private Real Estate, could benefit from catalysts this year. VC could rebound nicely if the IPO market opens again (it's been fairly closed for almost two years) and Real Estate would benefit from lower interest rates. Finally, "cash plus" Alternative strategies – those strategies designed to produce returns of 4-6% over cash – should continue to offer good diversification to core stocks and bonds, along with attractive return profiles in the presence of higher cash yields.

As we design portfolios for 2024, our highest conviction is that investors should have low conviction. We think not much was resolved in 2023 – this year begins in some ways better but in other ways worse than last year. Is recession risk really off the table or has the inevitable just been delayed? Has inflation been slayed or has the Fed shown its cards too soon? Following the market's year-end rally, investors are "all-in"

on the soft-landing scenario. Either a recession or just moderately higher inflation and interest rates would be **quite an unpleasant surprise** and would catch many investors offsides.

In the residential real estate market, which slowed to a crawl last year in the face of 8% mortgage rates and limited supply, a common refrain amongst realtors and investors is:

> "*Survive until '25 and it will all be fixed in '26*."

While not overly bullish, we're **much more positive than that**. Conservative investors should be feeling good about higher yields on Bonds. Aggressive investors should welcome the potential broadening of the opportunity set beyond a handful of Large U.S. stocks. And all investors should be enthusiastic about the risk/reward profile and important diversification benefits available within the Alternative investments complex.

Looking at our portfolios, we're emphasizing diversification, trimming exposure to some of last year's big winners while increasing exposures to "smaller large caps" beyond the top ten, and seeking to capitalize on higher interest rates through both U.S. Treasuries and Private Credit. Perhaps surprisingly, in spite of what we think is heightened uncertainty this year, we find ourselves more optimistic about our ability to deliver compelling 3-5-7 year returns now than at any other point in recent memory.

This year *could be* another good year for investors. That would require more of a soft-landing experience than a recession or inflation spike. And thanks to the hangover of the historic fourth quarter rally and the uncertainty associated with the presidential election; any strong gains might be backloaded toward the end of the year again. Either way, investors should **expect volatility**, maintain **realistic expectations**, and be positioned for **a variety of outcomes** so that neither they, nor their portfolios are surprised this year.

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