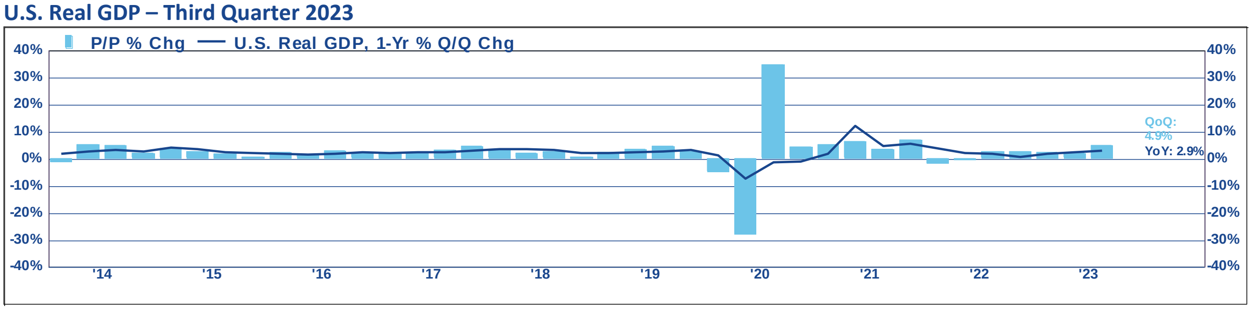
Fourth Quarter 2023 – Investment Commentary

WEST SHORE BANK

This time last year in the midst of an aggressive rate hike campaign by the Federal Reserve (Fed), expert consensus for 2023 was that the economy was going to cool down significantly and the Fed would pivot and cut rates twice by the end of year. Stock markets rallied on this narrative in the first half of the year while the bond market treaded water trying to figure out if Fed policy was restrictive enough.

As the year unfolded, defying banking turmoil and high interest rates, the economy held its ground and then accelerated in the third quarter to an annualized pace of 4.9% fueled by a resiliently tight labor market and firm consumer spending. In August, this resiliency quickly shifted investor expectation to rates being "higher for longer" and that the Fed had more work to do to slow the economy and bring inflation under control. This change in policy outlook put significant pressure on stock and bond markets for a few months.

U.S. Real GDP – Third Quarter 2023



During this market downturn, good economic news was bad news for the markets as it prolonged the theory of "rates higher for longer" by the Fed. Since March 2022, the Fed has aggressively raised rates. Eleven times in fact as the market was anxiously waiting, hoping, and praying for inflation to meaningfully cool, the labor market to soften, and for the economy to weaken more broadly outside of interest-rate-sensitive industries like manufacturing and housing.

As the fourth quarter started, the good news kept coming and October posted the third consecutive monthly stock market decline. Bond yields moved sharply higher during the month with the 10-year treasury reaching a 5.0% intra-day high. The market's wishes were finally answered in November as the majority of economic releases began painting a weakening economic picture and, just like that, bad news was now good news for the markets. The weaker data drove stock prices sharply higher and bond yields moved quickly lower during November. The S&P 500 rose 9.1% and the yield on the 10-year treasury sank from 4.90% to 4.36%.

Table 1 – Stock Index Total Returns – Period Ending December 29, 2023

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	5.58	13.79	44.64	44.64	6.04	18.75	14.80
S&P 500	4.54	11.69	26.29	26.29	10.00	15.69	12.03
MSCI Developed	5.31	10.42	18.24	18.24	4.02	8.16	4.28
Russell 2000	12.22	14.03	16.93	16.93	2.22	9.97	7.16
S&P 400	8.72	11.67	16.44	16.44	8.09	12.62	9.27
Dow Jones Industrial	4.93	13.09	16.18	16.18	9.38	12.47	11.08
MSCI Emerging	3.91	7.86	9.83	9.83	-5.08	3.68	2.66

Upward market momentum carried over into December as the Fed signaled they were done raising rates. The Fed concluded their December FOMC meeting with their normal policy statement and quarterly economic projections. These releases were followed by Chair Powell's press conference. In short, it was the pivot trifecta as the policy statement, projections, and press conference all pointed to a dovish pivot in monetary policy. Meaning, rate hikes are most likely done, and rate cuts are next. Stocks and bonds rallied to end the year posting solid gains for the quarter and the year.

Bullish themes of declining inflation rates, the prospect that the Fed is at the tail end of raising rates, an economic soft landing, and the euphoria surrounding the promise of artificial intelligence drove stocks higher for most of last year except for the three-month period of August to October.

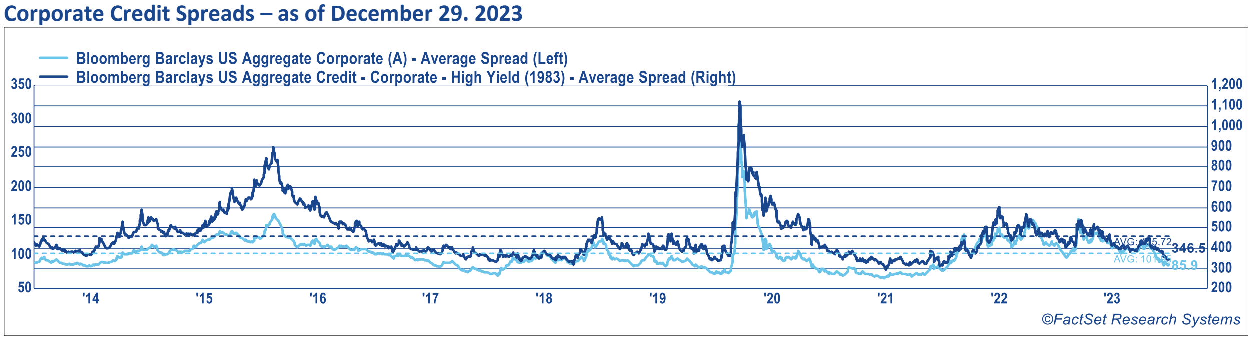
For much of last year the rally was concentrated in a handful of technology stocks and only three of the S&P 500's eleven sectors posted positive returns. By year end, there was much more broad participation as the depth and breadth of the rally expanded the last two months of 2023 with seven of eleven sectors posting double-digit total returns. The tech-heavy Nasdaq Index was the standout as depressed valuations from 2022 along with irrational exuberance of strong growth associated with AI drove this index sharply higher for the year besting all other stock indices.

Bond Index Total Returns – Period Ending December 29, 2023

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg High Yield	3.73	7.16	13.44	13.44	1.98	5.37	4.60
Barclays Michigan Muni	2.23	7.68	6.44	6.44	-0.55	2.26	3.24
Bloomberg Municipal	2.32	7.89	6.40	6.40	-0.40	2.25	3.03
Bloomberg U.S. Aggregate	3.83	6.82	5.53	5.53	-3.31	1.10	1.81
Bloomberg Inter Gov't/Credit	2.32	4.56	5.24	5.24	-1.63	1.59	1.72

Turning to the bond market, bond yields were little changed for the year, but the intra-year ride was quite volatile. In August, bond markets began to come under intense pressure due to the unexpected downgrade of U.S. Government debt by the Fitch credit rating agency. The reasons for their downgrade include a steady deterioration in standards of governance, the steady rise in government deficits, and the expected increase in interest debt burden. These are likely to be on-going risks going forward.

Corporate Credit Spreads – as of December 29. 2023



As aforementioned, stronger-than-expected economic growth put a lot of upward pressure on bond yields in September and October as the "rates higher for longer" mantra took hold. However, weakening economic data in November along with the Fed pivot in December sent multi-decade-high bond yields sharply lower and bond prices higher. Bond prices and yields are inversely related. In the end, the 10-year was unchanged starting and ending the year at 3.88%. Basically, attributes of bond market returns last year were interest income and corporate credit spread compression.

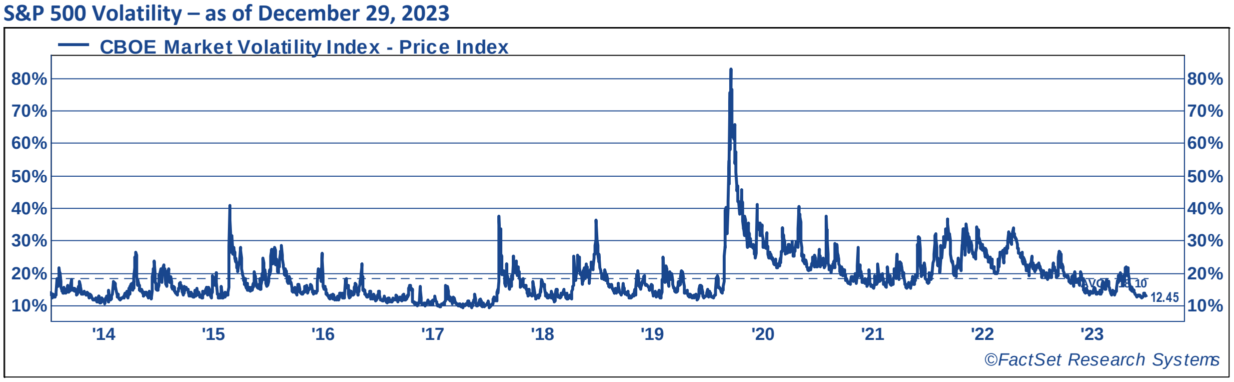
If there was ever a quarter or year to illustrate why it is so important to stay fully invested, it was this past quarter and year. This past quarter provided another illustration of not only just how quickly markets can move but why it is so important to not let short-term downward market pressure influence an investor's behavior and emotion. After three months of consecutive market declines in October, the stock market posted strong returns in November and December and finished the quarter up +12-14% capping off a very solid year.

As short-term rates moved higher throughout 2022 and 2023, trillions of dollars flowed into treasuries, some of it at the expense of a well-thought-out investment objective and asset allocation. Some investors were tempted by the allure of +5% treasury yields for it has been a very long time since investors could capture such yield levels. Doing so was a costly mistake, however, as those that relinquished staying invested and chose to lock in a +5% treasury yield absorbed a material opportunity cost as a Balanced portfolio total return in 2023 averaged between 13%-15%.

Shifting to 2024, we expect the economy to experience below-trend growth, a positive yet volatile year for the stock market, and for bonds to post returns similar to 2023. In 2024, the question will be answered whether the Fed's aggressive rate hike campaign will result in an economic soft landing or a move into recession. We are in the soft-landing camp.

Economic data has been weakening of late and we expect this trend to continue as rate hikes continue to work their way through the economy. According to FactSet, consensus estimates look for the U.S. economy to grow 1.2% in 2024 which is in line with the Fed's most recent projection of 1.4% growth. The labor market should continue to soften and become more balanced between worker supply and demand but currently worker demand still outweighs supply and is one reason we feel the economy will not fall into a recession in 2024.

S&P 500 Volatility – as of December 29, 2023

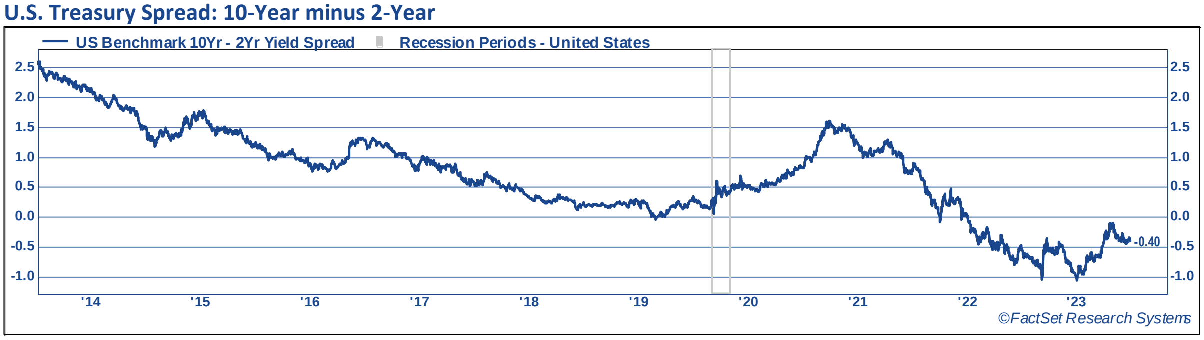


During the most recent market weakness, we went from neutral to overweight stocks due not only to the prospect the Fed was done raising rates and more attractive valuations, but also because of the trillions of dollars on the sidelines invested in treasuries. We continue to favor small and mid-cap stocks over large-cap stocks as their valuations still register below historical averages. Unlike 2023 where stock volatility was low for most of the year, we expect volatility to increase this year as uncertainty is likely to rise with growing geo-political risks, the wonderful presidential election year, rising deficit spending and debt levels, and what impact a slower economy may have on earnings growth.

In December, several companies moved their 2024 guidance lower due to weakening demand including Fed Ex, Nike, and General Mills. Earnings growth will be a key factor to support market multiple expansion. According to FactSet's latest Earnings Insight report, consensus earnings growth for 2024 is 11.5%. This growth rate will be very closely watched during the upcoming fourth-quarter 2023 earnings season which is set to kick off in earnest the week of January 15th.

The yield curve has been inverted (short rates higher than long rates) since July 2022 and we expect the yield curve to flatten and then steepen as this year unfolds. The short end of the yield curve is controlled by Fed rate expectations, and they are forecasted to cut rates three times in 2024 followed by four rate cuts in 2025. We expect the rate cuts to begin in the second half of 2024 and this would put the short end of the yield curve in the range of 3.25% to 3.75% at the end of 2025.

U.S. Treasury Spread: 10-Year minus 2-Year



The recent rally in the long-end of the yield curve is overdone and we expect the 10-year treasury to move higher from current levels and settle into a range of 4.25% and 4.75%. The jury is not out yet on inflation, the Fed is still unwinding their balance sheet, and deficit spending is expected to remain robust. This all points to a lot of treasury supply hitting the market. Moreover, let's not forget that Washington is anything but functional which means spending budget deadlines will likely be in the headlines as well.

Happy New Year and wishing you and your family all the best in 2024!

Prepared by Perry Adams – SVP & Director – West Shore Bank Wealth Management – January 2, 2024
Sources: FactSet, Federal Reserve