



Portfolio Commentary

Navigator® Global Risk Management

Portfolio Manager



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4th Quarter Rally Proved End of Fed Rate Hike-Driven Weakness

Market Review

It's always darkest before the dawn, and it again proved true during the 4th quarter of 2023. For two years, investor psychology has been driven by a near sole focus on the Fed's tightening cycle, and markets have struggled. Since the market peak on December 31st, 2021 through October 26th, 2023, even the tech-heavy NASDAQ 100 was down 12.6% and the S&P Small Cap ETF endured a full on 20.7% bear market decline.

However, interest rates peaked on October 19th in anticipation of the Fed ending its tightening regime, and as Powell's early November comments verified a pause was in place, stalled equity and credit markets immediately responded. A rally followed, driven by a reversal in interest rates over two months; the 10-year Treasury yield peaked at 5.0% on October 19th, but by December 27th, it had fallen to 3.88%.

The S&P 500 produced a 15.7% gain from the October bottom through the end of the year, and the magnitude of the interest rate moves enabled the 20+ Year Treasury ETF to even outpace that with a 17.8% gain. We were particularly pleased to see expanded market breadth and participation – the missing key ingredient since the end of 2021. This enabled small-caps to gain 22.6% from the October low.

Over 90% of stocks exceeded their 50-day moving averages for the first time since June 2020. Prior losers such as Banks and Real Estate outperformed during a bull market, as small-caps and value stocks led the way during the quarter.

Growth and Technology stocks were the winners during all of 2023, as the NASDAQ 100 was up 55.0%, driven by the magnificent seven Tech mega-cap stocks. For most of 2022 and 2023, Technology stock strength masked underlying broad market weakness, as higher interest rates drove financing costs higher, hitting many cyclical sectors hard. However, the November and December rally welcomed an end to monetary headwinds.

Fourth Quarter Portfolio Highlights

- The November-December rally was accompanied by improving credit conditions across most markets. As a result, our models continued to make new highs towards the end of the year.
- Any weakness that we have seen has been driven by interest rates. We believe confidence in corporate America's creditworthiness remains strong.
- Markets enjoyed strong gains in 2023 but for most of the year, gains were concentrated in the magnificent seven mega-cap Technology stocks. However, that changed in November, when breadth improved and prior laggards like small-caps, Financials, and Real Estate led market gains.
- The decline in interest rates drove both stocks and bonds higher. As a result, our defensive vehicle of choice will be Treasuries when we see credit markets begin to come under stress.

Past performance is not indicative of future results.

This is not a recommendation to buy or sell a particular security. Please see attached disclosures.



Positioning and Outlook

Our base expectation for 2024 foresees a modest growth slowdown, particularly in the first half of the year, with better economic performance in the second half of the year. Inflation continues to trend downward, and yet real interest rates, which the Fed is particularly focused on, remain elevated. This should comfort the Fed and encourage them to at least normalize the yield curve.

Furthermore, corporate profits, particularly for cyclically sensitive manufacturing industries, were crushed in 2022 and early 2023. They have only begun to recover. While the consumer has spent much of their excess savings from the COVID era, consumer balance sheets are solid, and real income driven by a strong wage market should provide an economic tailwind.

Declining interest rates should stabilize mortgage rates and provide a boost to a beaten down manufacturing sector. The JP Morgan Global Manufacturing PMI has been below 50 and in contraction mode for 15 months, yet we have not seen the effects of this slowdown in the form of a recession. Instead, we have seen stocks that are part of the manufacturing economy (now under 40% of the US economy) lag behind the dynamic and innovation-driven services sectors. We believe a global rebound in construction and manufacturing would benefit value-oriented U.S. stocks along with major exporters like China and Germany.

The quantitative models that drive the Global Risk Management portfolio allocations examine trends in credit markets to determine whether risk-taking is being rewarded or punished. After the 4th quarter rally, high yield credit spreads have declined to only 3.2%, which is more historically on the lower side. We know from past experience that spreads can decline further, and from 2004 to 2007 and in 2021 spreads held below 3% for extended periods. Now that the monetary headwinds have finally been eased, broad investor behavior has anticipated a recession, driving long-term interest rates down and inverting the yield curve.

With the markets pricing in six rates expected rate cuts into 2024, it would only require decent and average economic performance to upset such an optimistic rate scenario. Thus, we believe that a correction caused by simply average or solid economic numbers and/or modest inflation fears is a more likely scenario. Given that we have seen zero job market weakness, any above average economic performance will make it implausible for six rate cuts to materialize.

After such a large year-end rally, are markets poised for a major decline? Since value stocks, small-caps, Healthcare, and defensive stocks have not yet participated, we would disagree. On October 27th, the forward P/E of the S&P 600 Small Cap Index had fallen to 12.4, which is not far from major COVID and March 2009 lows. After having neared such major valuation lows, we believe some areas of the market still present reasonable valuations and opportunity. We also believe that upside pressure on interest rates, via inflation fears or what will be substantially larger Treasury issuance in 2024, present the most significant risks to the markets in 2024.

Slower economic growth, possibly during the first or second quarter, could put margins and thus equities under pressure. However, we would likely view that as a buying opportunity. Finally, we can already see that 2024 will bring election-related controversies and volatility and will likely dominate the second half of the year. One rarely mentioned area to watch will be the treatment of the Trump tax cuts, which expire in 2025, and a policy change there could have a market impact. As always, our quantitatively-driven systems do not engage in forecasting or prediction, but rather follow the broad trend evidence and manage risk and opportunity accordingly.

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 80% of U.S. equities.

The S&P SmallCap 600 Index is a stock market index established by S&P Global Ratings. It covers roughly the small-cap range of American stocks, using a capitalization-weighted index.

A Treasury Bill (T-Bill) is a short-term U.S. government debt obligation backed by the Treasury Department with a maturity of one year or less. Treasury bills are usually sold in denominations of \$1,000.

The Nasdaq-100 is a stock market index made up of 101 equity securities issued by 100 of the largest non-financial companies listed on the Nasdaq stock exchange.

A small-cap ETF is a type of exchange-traded fund that invests in small companies whose value is less than \$2 billion

The Global Purchasing Managers' Index (PMI) is a key metric in assessing a country's economic health.

The 10-year Treasury yield is the yield that the government pays investors that purchase the specific security. Purchase of the 10-year note is essentially a loan made to the U.S. government.

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