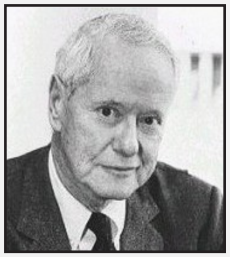
Economic & Market Commentary

Winter 2024



The Law of Unintended Consequences

American sociologist Robert Merton (1910-2003) popularized the theory that actions of individuals or governments often produce outcomes outside those anticipated. For our purposes, the concept states that actions of economic actors (such as the Federal Reserve) may have unexpected or distorted outcomes on financial markets.

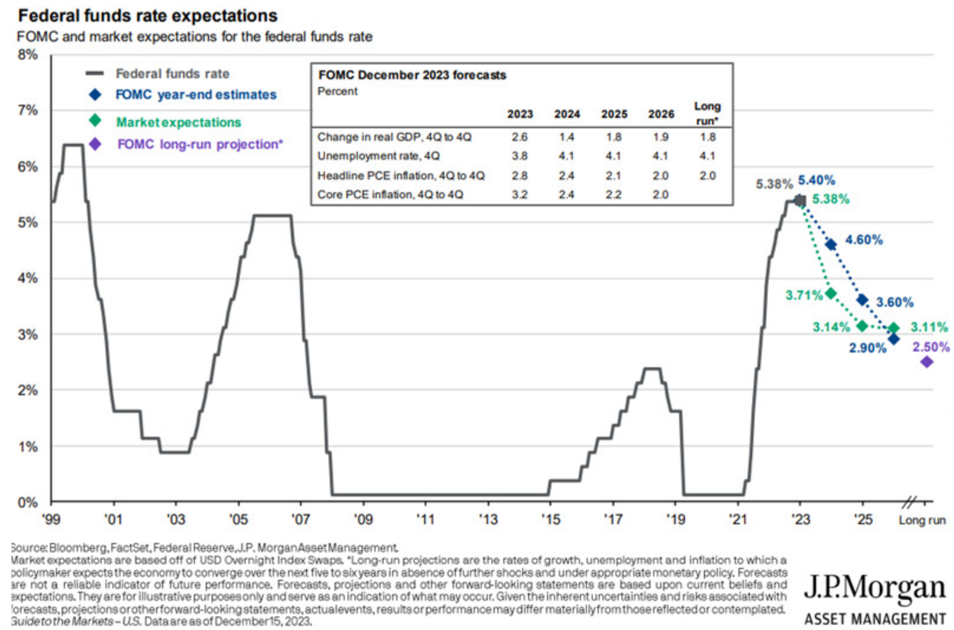
Distortions in the Financial Markets Will End

The Federal Reserve pushed inflation-adjusted (real) interest rates into negative territory during the Covid pandemic. The primary goal – to prevent an economic collapse – was met. Record deficit spending accompanied this, and inflation rose to unacceptable levels. These actions and outcomes altered the valuation balance between equities and fixed income. It was a repeat of the late 1970s – bond yields were well below inflation rates, earning the sobriquet 'certificates of confiscation'. Stocks became the only game in town – particularly growth themes with low sensitivity to broad economic trends.

This era is concluding. The Fed, in its belated steps to reduce inflation, raised short term interest rates well above inflation levels, with longer term markets following along. Price pressures are now moderating and are doing so without a broad economic contraction. While the Fed remains data-dependent, we believe its work is done for this cycle. Its next rate action – well into 2024 – will be a reduction in its target rate.

Where We Go From Here

Let's look at our base case. First and foremost, economic activity will continue on a positive course and a 'soft landing' will be achieved. Strong labor markets and spending will offset weakness in housing and auto markets. Commercial real estate will remain challenged as the adjustment to post-pandemic work patterns evolves. And, importantly, core inflation is moving in the right direction. As noted above, we believe short-term rate hikes are finished for this cycle. In all, near-term economic and inflation outcomes will be better than most expected just months ago. That said, the imbalance between federal spending and tax receipts means longer-term interest rates will not fall back to the levels present for most of the last decade. The supply of new debt risks overwhelming demand unless yields offer a reasonable premium to expected inflation rates.



FOMC December 2023 forecasts
Percent

	2023	2024	2025	2026	Long run*
Change in real GDP, 4Q to 4Q	2.6	1.4	1.8	1.9	1.8
Unemployment rate, 4Q	3.8	4.1	4.1	4.1	4.1
Headline PCE inflation, 4Q to 4Q	2.8	2.4	2.1	2.0	2.0
Core PCE inflation, 4Q to 4Q	3.2	2.4	2.2	2.0	

Reversion to the Mean is Upon Us

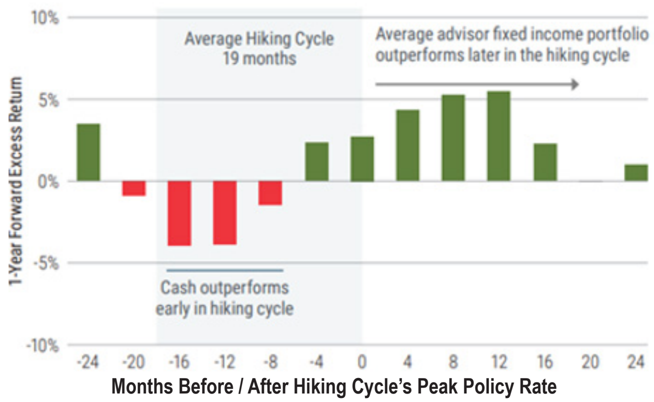
This outlook implies that the traditional relationships between stocks and bonds and, inside stock markets, between value, growth, and international themes, will be restored. The path won't be smooth, but the process will inure to the benefit of conservative, diversified portfolio structures.

Fixed Income is Back in Favor

Fixed income now provides positive inflation-adjusted returns across the maturity spectrum. And, at its December meeting the Fed's Open Market Committee again held its target rate steady (albeit without ruling out future hikes). Following, history shows that as the Fed approaches peak tightening expected forward returns on longer-term debt far outstrip those available from short-term cash. It's time to put cash reserves to work.

We recognize the risks to this forecast from continued Federal debt growth. Extension risk from cash to bonds is a concern. As such, average maturities in the three- to five-year range are appropriate – favorable yields are locked in with controllable price risk. An emphasis on high quality offers additional protection. Our portfolios reflect this.

Difference in returns between average advisor fixed income portfolio* and cash



As of 31 March 2023. SOURCE: Bloomberg, Morningstar, PIMCO.

**To maximize ata availability back to 1978 we use a simplified average advisor portfolio that is 40% Intermediate Core Plus / 40% Multisector Bond / 20% Short-term Bond. All Morningstar category indices respectively, rebalanced monthly.*

Past performance is not a guarantee or a reliable indicator of future results. All returns and yield data are based on monthly data. Cash: Citi 3-month T-bill Index.

Used with permission from Pacific Investment Management Company LLC.

Equity Market Participation Will Broaden

An era of negative real interest rates, uncomfortably high inflation, and the emergence of AI as a theme created a performance- and growth-chasing environment like that of the late 1990s internet bubble. High quality defensive and value themes were left on the sidelines; the ten largest companies in the S&P 500 (nearly all technology issues) represented almost one-third of the market value of the entire index by late 2023. This dominance of large capitalization growth themes will end. Return opportunities are compelling in the under-represented stock sectors, and we expect to see capital move in their direction.

Weight of the top 10 stocks in the S&P 500

% of market capitalization of the S&P 500

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
The top 10 S&P 500 companies are based on the 10 largest index constituents at the beginning of each month. As of 11/30/2023, the top 10 companies in the index were MSFT (7.3%), AAPL (7.3%), AMZN (3.5%), NVDA (3.0%), GOOGL (2.1%), META (1.9%), GOOG (1.8%), TSLA (1.7%), BRKB (1.7%), UNH (1.3%), and LLY (1.2%). The remaining stocks represent the rest of the 494 companies in the S&P 500.

J.P.Morgan ASSET MANAGEMENT

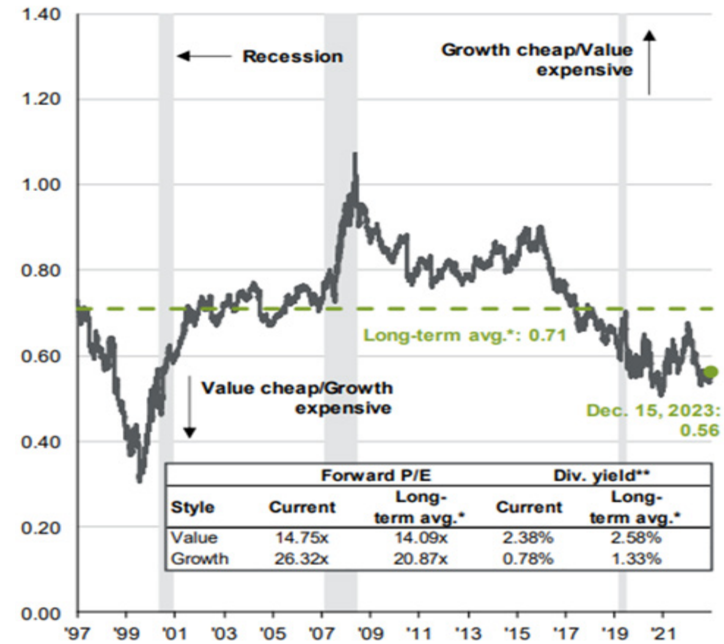
Guide to the Markets-U.S. Data are as of December 15, 2023.

In the U.S., the valuation gap between growth and value themes has been wider than its long-term average for a half decade. With the headwind of high short-term rates ending, and with prospects for reasonably positive economic activity rising, smaller company, cyclically sensitive, and dividend-oriented U.S. stocks should do well.

This same valuation advantage is present in international markets. The gap between U.S. and international price-to-earnings ratios is the widest in this century. Even considering the impact of high-multiple growth themes in the U.S. index, superior opportunities for value-oriented investors are present across the globe. And, if forecasts of falling short-term rates are correct, the value of the dollar in international markets should decline. Historically, such periods are associated with superior relative performance by international stocks. Again, our portfolio allocations reflect these views.

Value vs. Growth relative valuations

Rel. fwd. P/E ratio of Value vs. Growth, 1997 - present



	Forward P/E		Div. yield**	
Style	Current	Long-term avg.*	Current	Long-term avg.*
Value	14.75x	14.09x	2.38%	2.58%
Growth	26.32x	20.87x	0.78%	1.33%

Source: FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management.
(Left) Growth is represented by the Russell 1000 Growth Index and Value is represented by the Russell 1000 Value Index. *Long-term averages are calculated monthly since December 1997. **Divident yield is calculated as the next 12-month consensus divided by most recent price.

A Caveat and Conclusion

Our clear thesis is that a value orientation is appropriate for both equity and fixed income construction. That said, one of the truisms of investing is 'valuation is not a timing device'. We do not know when this reversion to the mean – as noted earlier in this Outlook – will begin in earnest. The components are in place, however, and we believe we will see solid progress in this direction in 2024. Portfolios under our management are well positioned to participate. To learn more, contact your Advisor and Investment Manager for an update. Your success matters to us.

Economic & Market Commentary is written by the Investment Services Department at Security National Wealth Management.