Pavlic Investment Advisors

Client Review & Outlook

4th Quarter, 2023

Dear Client,

Stock and bond markets staged an impressive reversal in the fourth quarter thanks to a dovish pivot by the Federal Reserve, solid economic activity, and continued declining inflation readings. All these factors conspired to push our portfolios sharply higher to close out the year. The strong fourth quarter performance somewhat obscures the fact that stock and bonds started the quarter under significant pressure. On October 7th, Hamas soldiers infiltrated Israel, killing and kidnapping more than 1,200 Israelis in the worst attack on Israel in decades. The market fallout was immediate as oil prices spiked on fears that a broader regional war would ensue between Israel, Hamas, and potentially Iran. Higher oil prices fueled a further increase in US treasury yields as investors priced in a possible oil-driven rise in inflation. These factors, combined with lackluster earnings reports from companies, resulted in the S&P 500 falling to the lowest levels since mid-May, while the 10-year Treasury yield rose to almost 5.00% for the first time since the mid-2000s. However, markets reversed course in mid-October when Fed Governor Chris Waller made comments that implied that rate hikes were over and rate cuts would be coming in 2024. The market reaction was immediately positive as stocks and bonds rallied hard into the end of October to finish with only a ~2% monthly decline.

60/40 Portfolio: US Stocks (S&P 500) and Bonds (Bloomberg US Aggregate)

Year	Return	Year	Return	Year	Return
1977	-3.0%	1993	9.9%	2009	18.2%
1978	4.5%	1994	-0.4%	2010	11.7%
1979	11.9%	1995	29.9%	2011	4.4%
1980	20.1%	1996	15.2%	2012	11.3%
1981	-0.3%	1997	23.9%	2013	18.6%
1982	25.3%	1998	20.6%	2014	10.6%
1983	16.7%	1999	12.3%	2015	1.1%
1984	9.7%	2000	-0.8%	2016	8.2%
1985	27.6%	2001	-3.8%	2017	14.5%
1986	17.2%	2002	-9.2%	2018	-2.6%
1987	4.6%	2003	18.8%	2019	22.4%
1988	13.1%	2004	8.3%	2020	14.0%
1989	24.8%	2005	3.9%	2021	13.8%
1990	1.7%	2006	11.2%	2022	-16.1%
1991	24.7%	2007	6.1%	2023	18.0%
1992	7.5%	2008	-20.1%		

CREATIVE PLANNING @CharlieBilello

Positive momentum continued in November. The markets posted their best monthly return of 2023, with the S&P 500 rising more than 9% in the month. There were several factors that fueled this rally. First, numerous Fed officials echoed Waller's commentary and investors priced in rate cuts as early as March, substantially earlier than previously expected. Additionally, the Israel/Hamas conflict did not spread and remained contained between Israel and Hamas and oil prices declined as a result, easing inflation concerns. Finally, inflation readings continued to decline. The year-over-year increase in the Consumer Price Index dropped to 3.1% which further fueled investor expectations that rate cuts would come in the first half of 2024.

The Santa Claus rally continued and accelerated in December courtesy of the Fed again. At the December 13th FOMC meeting, Fed officials clearly signaled that rate hikes were over and forecasted three rate cuts in 2024, one more than they had previously forecasted. Additionally, Fed Chair Powell did little to push back against the market's expectations for even more rate cuts. The Fed clearly pivoted to a more dovish policy stance and that fueled a continuation of the rally that started in late October. In summary, 2023 was a year of surprises for the markets an expected recession never materialized, inflation fell faster than forecasted, corporate earnings proved resilient and the Fed surprised markets by pivoting to a more dovish future policy. The result was substantial gains for the major stock indices, including our core-stock strategy held by both us personally, and of course our clients.

2023 Stock Market Review

We focus our stock market review on the most common questions that you asked us during the previous quarter. This quarter, client questions have focused on the Fed rate *cut* expectations, investor sentiment as a near perfect indicator, and the best opportunities found outside of the "Magnificent Seven".

Fed expectations vs. Market expectations of Fed Rate Cuts. Provided there isn't a return to rising inflation in 2024, the Fed signaled it will be cutting rates this year citing their belief that a Federal Funds Rate of 5.25%-5.5% is well above the "neutral" rate. The risk of keeping rates too high for too long is that higher rates slow an economy down by making it more expensive for businesses and individuals to use debt for purchases. As an example, a home buyer utilizing mortgage debt or a business looking to finance capital equipment will have to absorb much higher interest costs than just a few years ago due to Fed policy today. As a result, the buyers who plan on using debt are priced out of the market and they either cut back, or don't make the purchase entirely. This results in slower economic activity, and as a result, inflation comes down—the Fed's desired outcome.

While we agree with both the market and the Fed that it is now time to bring interest rates back down from their historically high levels, we are concerned about the gap between how many cuts the Fed thinks they will provide and how many cuts investors think will occur. Fed officials are forecasting <u>*three*</u> 0.25% rate cuts in 2024, but investors are currently expecting <u>*six*</u> rate cuts with the first one occurring in March or May. Historically, the difference between these two sets of expectations is not very wide, but it is now. If investors are incorrect and the Fed delivers less than six rate cuts, we would expect the "disappointment" to cause downward pressure on stock prices.

Investor sentiment remains undefeated as a contra-indicator. As we look forward to a new year in the markets and consider the past few years, we can't help but feel as though we are in a proverbial canoe with the investing public leaning to one side of the canoe and then the other, causing it to nearly tip each time. Think back to December 2021. The S&P 500 had just hit an all-time high. The impact of the pandemic was still being felt, but technology companies were surging and leading the market higher as a new "hybrid" (work from home and in the office) world was here to say. Fueled by stimulus and forced savings from government lockdowns, economic growth was strong, inflation was rising and markets admitted that the Fed needed to hike rates in 2022. Put simply, market sentiment was resoundingly bullish and while investors admitted there were some issues, those were minimized and the outlook for 2022 was very, very positive. Of course, that optimism was misguided. The Fed was much more aggressive on rate hikes, inflation exploded, growth slowed and the S&P 500 dropped 19.4%. Consensus was universally bullish and consensus was absolutely wrong.

Now fast forward to the end of December 2022. Investors were despondent. The S&P 500 was ending the worst year in over a decade, the Fed was massively hiking interest rates, inflation wasn't breaking, recession fears were surging, and investors were convinced we were facing either 1) Stagflation or 2) An imminent recession. CNBC polls showed that recession expectations amongst investors were over 80% at the time! Of course, that pessimism was unfounded as growth remained resilient. Inflation was broken and the Fed dovishly pivoted. Proven yet again, consensus was universally bearish at absolutely the wrong time.

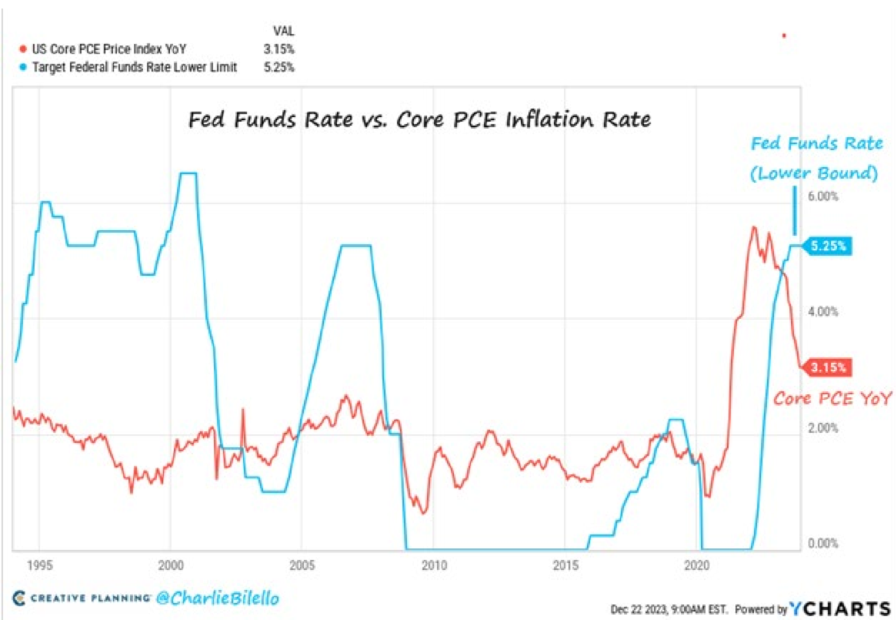
Now, as we sit here in January 2024, the consensus is universally bullish again. The consensus view is the economic soft landing is all but assured. The Fed will cut six times next year but not because of slowing growth, instead because inflation is to continue its freefall. Despite numerous geopolitical issues, none of them will get materially worse, U.S. politics won't be a problem (it's an election year!) and despite a potentially slowing economy and profit margin compression, companies in the S&P 500 will grow earnings by ~10% this year. Exceeding the 5,000 mark on the S&P 500 isn't a matter of "if," but "when." That all may come true and that might be exactly how 2024 works out. But, we've been in this industry long enough to know that when everyone seems to be leaning on one side of the "canoe", it pays to move more towards the middle.

Best opportunities we believe to be found outside of the "Magnificent Seven" in 2024. As we have written about in our last two quarterly letters, the broader stock market indices continued to be driven by an incredibly few stocks—popularly referred to as the "Magnificent Seven" (Facebook, Apple, Amazon, Google, Microsoft, Nvidia, and Tesla). While we didn't own all of them, Microsoft (MSFT—up 58% in 2023) and Apple (AAPL—up 49%) were two of the three largest positions in our portfolios which we in turn trimmed near their respective all-time highs in 3Q23. Although not as heavily covered due to their size, holdings in Applied Materials (AMAT—up 68%) and Copart (CPRT—up 61%) also benefitted from many of the underlying trends benefitting the Magnificent Seven. Detractors from performance were in the energy and materials space, with Devon Energy (DVN) down 22% for the year and Albemarle (ALB) down 33% for the year. That said, our positive returning positions were more pronounced (bigger gains against smaller losses) during the year.

Looking forward, we continue to focus on "where the puck is going" versus where it has been, and we have shifted our portfolios to more value-oriented and small-cap oriented companies with an overweight in sectors that were left behind in 2023 including health care, utilities, and real estate. Technology powered the broader indices in 2023 and technology continues to be by far our largest sector weight, however we are finding many more opportunities outside of the Magnificent Seven and technology in general.

2023 Bond Market Review

"Higher for Longer": Dead or hear to stay? After the US 10-year Treasury yield hit almost 5.0% (the actual intra-day high was 4.98%) on October 16th, yields fell over 1.0% through the end of the year sending the 10-year US Treasury yield down to 3.90%. Falling interest rates meant a welcome increase in bond market values (bond market prices move inversely to interest rates). This was a nice break from the proverbial "swimming upstream" in the bond market as coupon interest earned was being offset by market value declines in a rising rate environment. Our messaging has remained the same: we focus on collecting $100/bond par value at maturity in addition to collecting the interest payments along the way. The benefit of depressed market values is that, as bonds mature, we are able to make new bond purchases with the bond maturity proceeds at ~6.0% annualized yields.



With the 10-year US treasury rate falling ~1.0% in 4Q23, clients have been asking, "Is the "higher-for-longer" interest rate environment dead?" We don't think so. Yes, market rates are lower than they were in October, but they still remain well above the average that we have been able to achieve in the investment grade bond market for much of the last 15 years. About six percent per year annualized returns while minimizing interest rate risk is great, in our view, especially as we expect money market fund rates to decline in 2024 as the Fed begins to lower the federal funds rate.

2024 Market Outlook and Commentary

What a difference a year makes. At this time last year, the S&P 500 had just logged its worst annual performance since the financial crisis, the Fed was in the midst of the most aggressive rate hike campaign in decades, inflation was above 6% and concerns about an imminent recession were pervasive. As we begin 2024, the market outlook couldn't be more different. The Fed is likely done with rate hikes and cuts are set to begin in early 2024. Economic growth has proven more resilient than most could have expected, and fears of a recession are all but gone. Inflation dropped substantially in 2023 and is not far from the Fed's target while corporate earnings growth is expected to resume in the coming year. Undoubtedly, that's a more positive environment for investors compared to the start of 2023, but just like overly pessimistic forecasts for 2023 proved incorrect, as we look ahead to 2024, we remain cautious with the level of overall complacency, i.e., the broader stock market indices such as the S&P 500 and the NASDAQ are trading near all-time highs. Put simply, a lot of good news is already reflected in current prices.

What we are watching, first and foremost, is the deviation of rate cute expectations between the Fed and the market. Secondly, regarding economic growth, it's foolish to assume, just because the economy was resilient in 2023, that it will stay resilient in 2024. The longer rates stay high (and they are still high), the more they create a drag on the economy. Meanwhile, all of the remnants the of pandemic-era stimulus are largely spent and there is some economic data that's starting to point towards reduced consumer spending. We believe it is premature to believe the economy is totally "in the clear" and a slowing of growth is something we will monitor. Meanwhile, inflation has declined sharply, but it still remains solidly above the Fed's 2% target. Many expect inflation to continue to decline while economic growth stays resilient. However, while that's possible, it's important to point out it's rare. Declines in inflation are usually accompanied by economic slowdowns. Finally, corporate earnings have been resilient, but companies are now facing margin compression as inflation declines and economic growth potentially slows. Earnings results and guidance in the fourth quarter were not as strong as earlier in 2023 and if earnings are weaker than expected, that will be another potential headwind on markets in 2024.

Bottom line, while undoubtedly the outlook for markets is more positive this year than it was last year, we won't allow that to breed a sense of complacency because as the past several years have shown, markets and the economy rarely behave according to investor expectations. As such, while we are prepared for the positive outcome currently expected by investors, we are also focused on managing risk. The past several years demonstrated that a well-planned, long-term focused and diversified investment plan can withstand virtually any market surprise and related bout of volatility, including multi-decade highs in inflation, historic Fed rate hikes, and geopolitical unrest. We are finding the greatest opportunities outside of the Magnificent Seven at much cheaper valuations (chart right).

Successful investing is a marathon, not a sprint, and even intense volatility is unlikely to alter our diversified approach set up to meet long-term investment goals. We will stay invested, remain patient, and stick to that plan no matter what the market environment throws our way. Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

"The stock market is like the weather in that if you do not like the current conditions, all you have to do is wait and the sunshine will reemerge." – Low Simpson