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INVESTMENT STRATEGY STATEMENT | JANUARY 1, 2024

The Soft Landing Arrives

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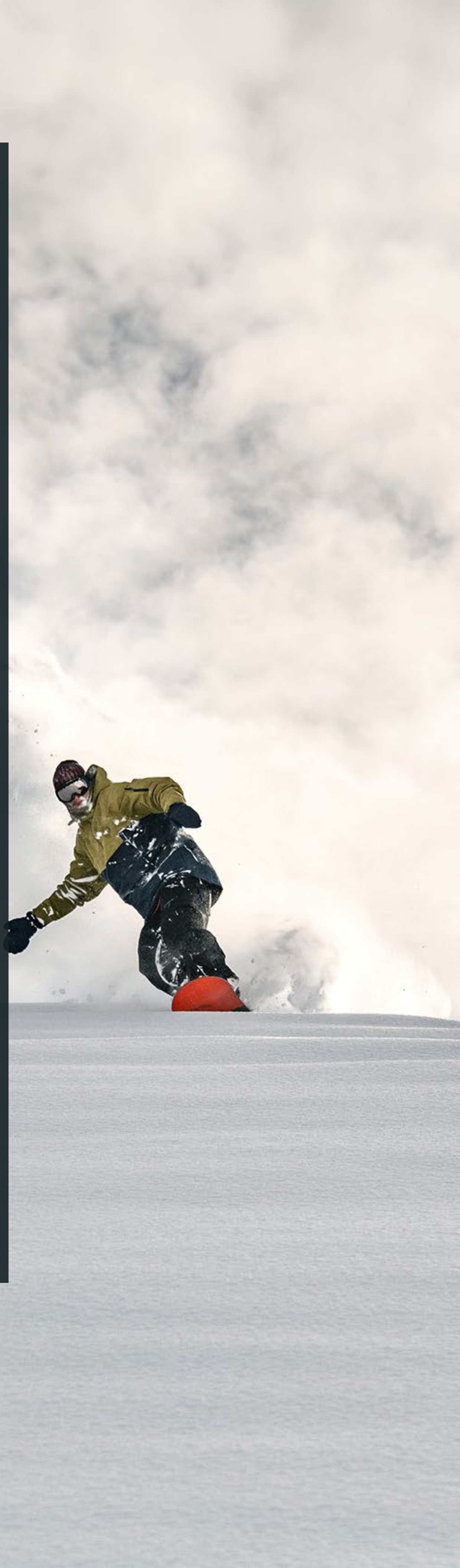


Equity Markets

The Soft Landing is Here

Following the surge in stock prices during November, stock prices took a breather in early December as investors digested the strong gains and looked for additional evidence that the economy is on the path toward taming inflation without a deep economic slowdown, achieving the so-called soft landing. The inflation reports and the December FOMC meeting sent the rally in stocks and fixed income securities back into motion.

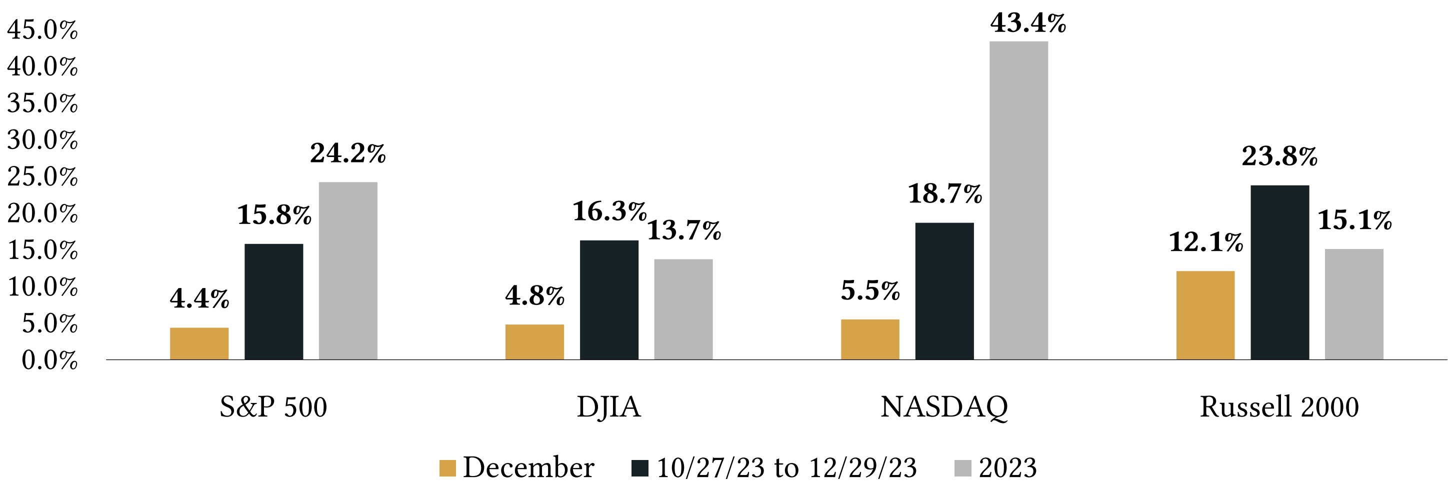
The CPI rose 0.1% month-to-month in November as gasoline prices fell -6.0%. The core CPI rose 0.28% in November, a little faster than the 0.23% gain in October with the year-on-year rise unchanged at 4.0%. Shelter costs rose a surprising 0.4% following a rise of 0.3% in October and accounted for 58% of the monthly rise in the core CPI and 65% of the year-on-year rise. In other words, if a real time shelter inflation measure — which has slowed significantly over the past 12-18 months but only filters into inflation data with a lag — was used in the calculation of the CPI, core inflation over the past twelve months would be just over 1%, below the Federal Reserve's 2% target.

	November	**October**
CPI (month-to-month)	+0.1%	—
Core CPI	+0.28%	+0.23%

Adding on were both the headline and core readings for the producer price index being unchanged in November. Prices further back in the production pipeline point to a further easing in final goods inflation as prices for intermediate processed goods are down -4.1% year-on-year while prices for intermediate unprocessed goods are lower by -13.1%.

More fuel for the rally in stocks and fixed income securities was provided by the Federal Reserve after the FOMC Committee voted

Major Stock Market Indices - Price Change Only



Source: Bloomberg

unanimously to hold rates steady and penciled in three rate cuts this year.

The key insight is that the FOMC Committee moved their forecast for rate cuts in 2024 toward the forecasts that were in the market rather than trying to guide the market toward fewer rate cuts.

The markets responded very positively to the policy pivot by the Federal Reserve with yields falling across the Treasury yield curve and stocks recording strong gains.

More signs of a soft landing were found in the November report on consumer spending and prices. Real consumer spending rose 0.3% in November with modest downward revisions to prior months, in line with real GDP advancing at a pace between 1% to 2% for 4Q 2023. The best news in the report was the inflation data with consumer prices falling -0.1%, pulling the year-on-year change lower to 2.6%.

Core PCE prices rose only 0.06% in November, the smallest increase in the 33 months since the surge in inflation began, with the year-on-year rise falling to 3.2% from 3.4% in October and 5.6% in February 2022. On a six month annualized basis, core PCE prices rose at a 1.9% rate, headline prices at a 2.0% rate, and core PCE ex-rents at only a 1.1% rate.

With the inflation data indicating further progress on easing inflationary pressures and the Federal Reserve pivoting on policy and basically asserting that it believes the soft landing has arrived, common stocks posted strong gains in December with the major stock market indices higher by 4.4% to 12.1%. It is notable that the best performer last month was the Russell 2000 index of small company stocks, which gained 12.1% as the rally in stocks broadened out beyond the handful of big technology winners of the artificial intelligence boom last year.

The major market measures ended 2023 with a bang, gaining 15.8% to 23.8% from the recent low for the S&P 500 on October 27. For all of 2023, the NASDAQ Composite rose 43.4% and is within -6.5% of its record close, the S&P 500 rose 24.2% and is -0.6% below its all-time high, the DJIA rose 13.7% and is 2.4% above its prior record close and notched 7 record closes in December, and the Russell 2000 rose 15.1% but is -17.0% below its all-time high.

▲ **Russell 2000**	15.1%	▲ **S&P 500**	24.2%
▲ **NASDAQ**	43.4%	▲ **DJIA**	13.7%

YTD Index Performance as of 12/31/23

Federal Reserve Pivots on Policy

The Federal Reserve kept rates unchanged at the December 12-13 FOMC meeting, leaving the target range of 5.25%-5.50% in place. This was the fourth time in the last five FOMC meetings that the Committee decided not to raise rates. We would call that the beginning of a trend. The policy statement said the "growth of economic activity has slowed from its strong pace in the third quarter" and that "inflation has eased over the past year but remains elevated."

Chair Powell stated in the press conference that he believed the policy rate was near or at its peak and repeated the statement that "the Committee is proceeding carefully."

In a nod to the rate hiking cycle likely being over, the statement included the word "any" to the assessment: "In determining the extent of *any* additional policy firming that may be appropriate." Effectively watering down any consideration of additional policy tightening, Mr. Powell went on to volunteer that the Committee was preparing to focus on when to lower rates.

In the Summary of Economic Projections, the median forecast for the federal funds rate by the end of 2024 fell to 4.6% from the current level of 5.4%, an 80 basis point decline implying three rate cuts next year. The Committee's "dot plot" penciled in four rate cuts in 2025 and another three in 2026, which would bring the federal funds rate to a range of 2% to 2.25%. The SEP also slightly lowered the growth forecast for next year to 1.4% from 1.5% at the September FOMC meeting and the inflation forecast to 2.4% from 2.5%.

The Committee's forecasts are not only consistent with a soft landing on the horizon for the economy, but that the soft landing has already arrived.

Chair Powell said the Committee could lower rates in 2024 because inflation is well on its way to the 2% target and a recession is not necessary to begin lowering nominal interest rates.

Holding rates steady as inflation falls would cause real, or inflation-adjusted, rates to rise, which the Committee does not want. The Committee would need to lower nominal rates simply to prevent policy from becoming unnecessarily restrictive in real terms as inflation eases further. Mr. Powell asserted that the Committee would not wait until inflation was back to 2% to start lowering rates. Mr. Powell said, "It would be too late. You would want to be reducing the amount of restriction on the economy well before you get to 2%."

The financial markets responded very positively to the policy pivot by the Federal Reserve with yields falling across the Treasury yield curve with two-year yields plunging -35 basis points and ten-year yields falling -20 basis points, breaking 4% and finishing the day at 3.99%. Recall that the ten-year Treasury yield briefly topped 5% on October 23. The major stock market measures all gained more than 1% with the DJIA hitting a new all-time high and the Russell 2000 jumping 3.5% on the day.

One thing that is very likely in 2024 is that rather than fighting an inflation war, the Federal Reserve will be managing the business cycle as the central bank's full employment mandate comes more into focus. To the extent the economy needs lower nominal rates to sustain its ability to continue growing with a healthy jobs market, the Federal Reserve will deliver rate cuts.

- While the markets are pricing in about an 87% probability of the first rate cut happening in March, we think the timing of the first rate cut is definitely dependent upon the economic data.
- Further progress on lowering inflation and wage pressures and a slowing in the economy's growth rate will likely be necessary for the Federal Reserve to make that first rate cut.

Things could definitely play out in a manner that the data supports a March cut, but it is not a slam dunk. The key is that the next policy move by the Federal Reserve will be a cut and that a series of them will likely occur this year.

No matter how many times the Federal Reserve cuts rates this year, the key for the stock market is that the central bank cuts rates because it can, rather than because it had to. Rate cuts resulting from a significant weakening in the economy will not be nearly as constructive for stock prices as rate cuts resulting from declining rates of inflation, which are necessary to avoid a hands-off tightening of policy by real rates moving higher.

What Does a Soft Landing Mean for the Markets?

A year ago, we viewed the backdrop as we entered 2023 as much more positive than the 2022 backdrop of the Federal Reserve transitioning from a very easy monetary policy to an incrementally tougher inflation fighting, restrictive monetary policy stance, which required a reset in the financial markets. Specifically, we were not looking for the economy to fall into recession; the inflation spiral appeared to be broken, and the Federal Reserve was largely finished hiking rates.

Currently as 2024 unfolds, we view the backdrop for common stocks, as well as for Treasury and corporate fixed income securities, as being supportive of higher asset values as the positives we relied upon a year ago continue to develop.

> First, *the economy did not fall into a recession during 2023* and we are not expecting a recession this year.

13.3%

Estimated S&P 500 earnings growth in 2024

S&P 500 Price Index (12/31/21 – 12/29/23)

Source: Yahoo Finance

> *Earnings surprised to the upside* during 2023, and that makes a downturn in the economy less likely in 2024. Looking at operating earnings on the S&P 500, earnings fell on a year-on-year basis over the three quarters of 2Q 2022 to 4Q 2022. The drop in operating earnings at year-on-year rates of -10%, -3.2%, and -11.2% was the result of rising input costs rather than a significant decline in demand and was not at all near the order of magnitude associated with the economy falling into a deep and prolonged downturn.

> *Operating earnings have grown* over the first three quarters of 2023 and look to advance about 8.6% over the four quarters of the year. The analysts at Standard & Poor's are looking for operating earnings on the S&P 500 to grow 13.3% over the four quarters of 2024. This earnings recovery bodes well for the outlook for the economy in 2024 as growing earnings are typically associated with a recession coming to a close or no recession at all. The reason an economy that isn't already in recession tends not to drop into one during an earnings recovery has everything to do with employment.

Companies that are seeing a rebound in earnings are *not under pressure to cut jobs*, so the jobs market stays healthy and households maintain their incomes and are not forced to pull back on spending in any material manner. This is particularly true of more cyclical industries — such as manufacturing — that often drive earnings and economic cycles.

The resiliency of the jobs market in 2022 and 2023 — where a decline in open positions in the economy rather than actual jobs losses supported consumer spending — was a major factor why the economy avoided the widely anticipated recession in 2023, following the aggressive tightening of monetary policy by the Federal Reserve to combat the surge in inflationary pressures. The bottom line is the rebound in operating earnings in 2023 boosts the likelihood that a recession is not on the horizon, particularly with the Federal Reserve indicating rate cuts are on the way in 2024.

The economy has slowed from the strong 4.9% annualized pace in 3Q 2023, but is maintaining forward momentum and is likely growing at a pace between 1% and 2%. Taken with the disinflationary trends in the economy, it appears the much desired soft landing has arrived. Should the economy be more challenged this year than we expect, the Federal Reserve will likely make a course correction to a much more accommodative policy stance rather than a less restrictive posture to kick the economy back into expansion.

After inflation surged to a four decade high in 2022, consumers are finally finding some deals. Prices on consumer technology started falling in 2022 as supply chain disruptions eased and demand fell as many households had already updated their technology earlier during the pandemic. At the same time, healing supply chains have boosted inventories and eased shortages across a broad array of durable goods. Goods prices have stopped pushing inflation higher with durable goods prices in the CPI lower by -1.6% year-on-year and falling at a -5.1% annual rate over the past three months.

- Airline fares have cooled as demand for domestic flights softened and airlines flooded the market with seats.
- Falling gasoline prices are bringing households relief at the pump.
- Deals are gradually returning on auto dealership lots as inventory rebounds from supply chain shortages and pent-up demand has been largely satiated.
- Wage pressures are easing as workers returned from the sidelines to fill open jobs, leading to a relatively painless balancing of the jobs market.
- Consumers are still waiting on relief at the supermarket, however, as fresh grocery prices have cooled, but many packaged food items have not.

Progress on inflation and the slowing economy led to the policy pivot by the Federal Reserve at last month's FOMC meeting. The timing and magnitude of rate cuts this year are unknown, but rate cuts are on the way as the Federal Reserve wants to avoid a passive tightening of monetary policy by leaving rates unchanged as inflationary pressures ease.

Lastly, institutions and individuals have a record of more than $6.0 trillion parked in cash-like money market funds and additional trillions invested in Treasury bills with maturities of one year or less.

As short-term interest rates tick down over the next two years, a healthy portion of that cash should become a tailwind for both common stocks and fixed income securities as investors will increasingly fear missing out.

This does not mean we do not have some concerns as we enter 2024. The Federal Reserve is trying to assess how long it needs to keep interest rates high to ensure that inflation is fully under control without grinding economic growth to an unnecessarily painful halt.

The central bank also does not want to be forced to start hiking rates again after cutting them. Threading that needle will be a delicate maneuver, which is why Chair Powell has avoided declaring victory prematurely, despite clearly taking a dovish tone as last month's FOMC meeting.

While the Federal Reserve is forecasting three rate cuts this year, the futures market for the federal funds rate is betting that rates will fall more on the order of 6 cuts in 2024, with an 87% probability of the first rate cut coming at the March FOMC meeting.

To the extent the market is too optimistic on rate cuts, investors could be disappointed if the central bank does not cut rates as early and as often as the market is expecting.

Additionally, returns in 2024 will present a tradeoff between the strong returns generated last year and the ability of earnings to grow at a sufficient pace such that returns this year will not be reliant upon an unhealthy expansion of price-to-earnings ratios.

While a decline in yields and expectations for further declines this year, along with lower policy rates, provided stocks with a push higher in late 2023, earnings will determine the path for stock prices in 2024. When thinking about earnings in 2024, keep in mind that the economy is 12% larger in 3Q 2023, in nominal terms, than it was in 4Q2021—just prior to the peak in the S&P 500 on Jan 3, 2022.

Lastly, do not be surprised if common stocks are hit with some selling pressure over the next couple of weeks as investors take some capital gains that were postponed from late 2023 to avoid paying capital gains taxes this coming April. Delaying taking gains pushed the tax burden out to April 2025.

A growing economy, a further easing of inflation, and rate cuts should allow stocks to regain their upward trajectory should a near term bout of volatility hit the market.

Treasury Market

Breathtaking Decline in Treasury Yields

The drop in Treasury yields since mid to late October has been nothing short of breathtaking. The combination of inflationary pressures easing at a faster pace than investors — and even the Federal Reserve — expected, the economy's growth rate showing signs of slowing to a below trend pace, and the Federal Reserve pivoting to a policy of rate cuts in 2024 sent yields on Treasury and corporate securities lower, along with mortgage rates.

The current ten-year Treasury yield of 3.87% is 106 basis points lower than the 4.93% yield at the end of October, and 114 basis points lower than the 5.01% yield that briefly was in place in late October. While lower nominal yields are unambiguously positive for the economy as they lower the cost of capital, it is also noteworthy that about 83% of the decline in the nominal ten-year yield since October was an 88 basis point drop in real yields, from 2.52% to 1.64%—still high compared to the post-Financial Crisis period, but becoming less restrictive.

	Current Yield	End of October
10 yr. Treasury	-3.87%	4.93%
2 yr. Treasury	-4.25%	5.04%

Despite the Federal Reserve holding rates steady for the past five months, the yield on two-year Treasury notes at 4.25% at month end is 79 basis points lower that the 5.04% yield at the end of October—right in line with the three rate cuts the Federal Reserve penciled in at last month's FOMC meeting for 2024. The yield on two-year Treasury notes is about as low as it can go until the Federal Reserve actually starts cutting rates.

In the last two editions, we commented that the main message from the inversion of the Treasury yield curve, which has been in place since July 2022, is that the level of shorter term and longer dated yields could not hold as the economy and inflation both cool.

Treasury Market Talks to Federal Reserve

	Ten-Year Treasury Yield	(minus)	Two-Year Treasury Yield	(equals)	Yield Spread
9/30/21	1.49%		0.28%		121bp
3/07/23	3.98%		5.07%		-109bp
9/29/23	4.58%		5.05%		-47bp
10/31/23	4.93%		5.04%		-11bp
11/30/23	4.33%		4.68%		-35bp
12/29/23	3.87%		4.25%		-38bp

Source: Bloomberg

We thought the set up looked good for yields to drop across the entire Treasury yield curve this year toward 4%. Well, following the Federal Reserve's policy pivot last month, the yield on the ten-year Treasury note has already broken 4% ending 2023 at 3.87%.

We look for a further decline in ten-year Treasury yields this year, but expect that the bulk of the decline is behind us.

However, we expect more significant declines in yields on two-year to five-year (3.84%) Treasury yields over the next 12-to-24 months as the Federal Reserve follows through on a series of rate cuts. We look for the normal, positive slope of the Treasury yield curve to return by late 2024 or early in 2025. Solid long-term income streams with the possibility of some additional price appreciation can still be locked in at the longer end of the yield curve, while income (plus the possibility of some price appreciation with lower risk characteristics) can be found in the intermediate (3-to-7 years) portion of the yield curve. In general, positive fixed income returns this year will depend upon further declines in inflation and real yields.

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Disclosures