Investment Tally & Perspective

MAJOR ASSET CLASS RETURNS					
	4th Qtr. 2023	1-Year	3-Year	5-Year	10-Year
Equities					
S&P 500 Composite	11.7%	26.3%	10.0%	15.7%	13.2%
MSCI EAFE Net	10.4%	18.2%	4.0%	8.2%	6.2%
MSCI EM (Emerging Markets) Net	7.9%	9.8%	-5.1%	3.7%	5.7%
Fixed Income					
Bloomberg US Aggregate	6.8%	5.5%	-3.3%	1.1%	1.5%
Bloomberg US Corp Investment Grade	8.5%	8.5%	-3.3%	2.6%	2.9%
Bloomberg Emerging Markets Unhedged	8.1%	9.1%	-3.1%	1.8%	3.0%
Other Assets					
Dow Jones US Select REIT	16.4%	14.0%	7.2%	6.1%	4.5%
S&P GSCI	-10.7%	-4.3%	19.2%	8.7%	5.6%
S&P GSCI Gold Spot	11.0%	13.5%	3.0%	10.1%	8.7%

Source: Envestnet Tamarac

All returns greater than one year are annualized

* The market indices discussed are unmanaged. Investors cannot directly invest in unmanaged indices

Market Activity - Equities and fixed income markets posted above average returns during the fourth quarter. For fixed income, the strong recent performance pulled the benchmarks into positive territory for the year, after two consecutive years of negative returns. When looking at the diagram above, we are struck by just how strongly U.S. equities have performed over the time periods outlined.

Economic Activity – The U.S. economy has continued to demonstrate resilience and strength in the face of some of the harshest central bank policies in decades. The Fed is projecting the economy to grow 2.6% when comparing the last quarter of 2023 to the final quarter of 2022. This can be compared to the Fed's own estimate of long-term trend growth for the U.S. economy at 1.8%. The core personal consumption expenditures (PCE) index, a measure of inflation, is expected to be 3.2% higher in Q4 2023 relative to Q4 2022 per the Fed. For reference, this figure was approximately 4.4% last December. Furthermore, core PCE over the past six months has grown at an annualized pace of 1.9%, versus the Fed's long-term target of 2.0%. How is it possible that growth can be above average while inflation falls? Shouldn't an economy growing above trend create inflationary pressures? The answer, like many things in economics and markets, may be described by supply and demand.

There have been two areas of supply improvement in 2023: supply chains and labor. While difficult to boil supply chain health into a single metric, the New York Fed has attempted to do so with its Global Supply Chain Pressure Index. The tightness experienced during COVID has given way to slack in 2023. Secondly, the Institute of Supply Management releases an index of supplier deliveries, which can be seen on the next page. An index level under 50 indicates delivery times are getting faster.

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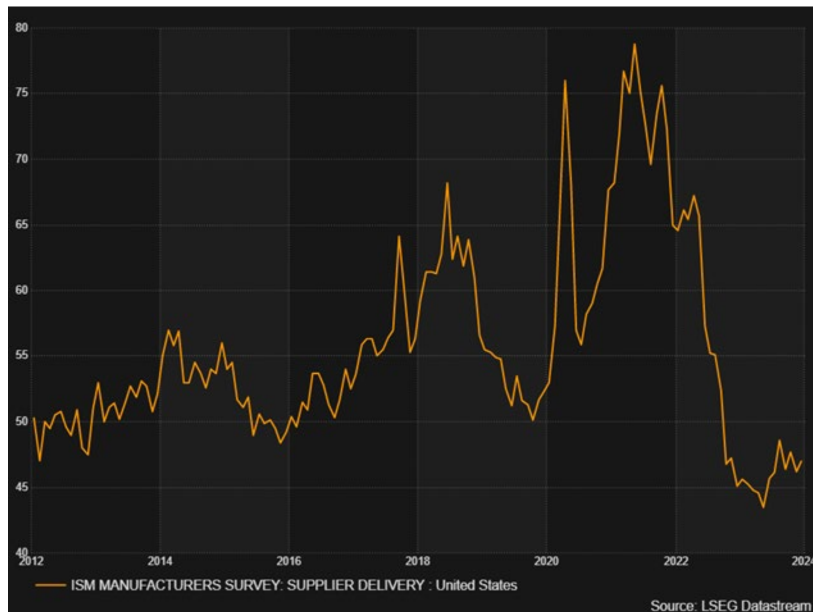
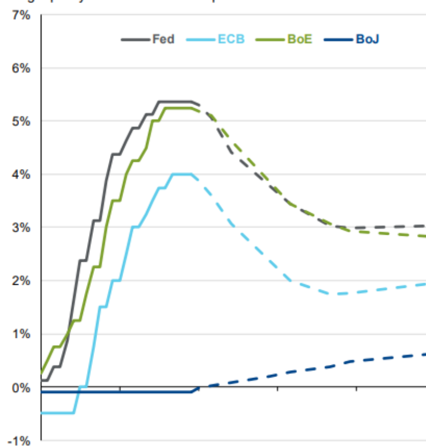
A second area of supply improvement is the labor market. Jobs growth has far exceeded what is required to keep the unemployment rate steady. Yet despite this, the unemployment rate has been steady for over the past year. This dynamic can be explained by the expansion of the labor force, i.e., labor supply. While total labor force participation (labor force divided by civilian population) is still not back to pre-pandemic levels, this high-level overview masks interesting details. The 55+ community participation rate dropped and has stayed low since the pandemic, while the 25 to 54-year-old cohort is approaching levels not seen since before the financial crisis.



The San Francisco Fed attempts to disaggregate core PCE inflation by its demand and supply components. Their data shows both demand and supply contributing to this year's inflation improvements. Trying to boil something as complex as the U.S. economy into simple metrics has a high margin of error. However, one thing is certain—easy gains on the supply side have been made, and how inflation unfolds from here will have large implications on Fed policy, the economy, and the markets.



Source: J.P. Morgan

<u>Monetary Policy</u> – The Fed appears to have finally pivoted from rate hikes to rate cuts. Going into the last meeting, the market had priced a Fed Funds rate of approximately 4.25% by year end 2024. After the meeting, the market dropped this expectation to 3.80%. Implied probabilities suggest the first cut may come during the Fed's March meeting. Going forward, the Fed is likely to be paying close attention to "real" rates, rather than the actual Fed Funds level. As a refresher, real rates are what is left when inflation is subtracted from nominal rates. With the Fed Funds rate at 5.5%, as inflation falls the "real" component increases, which the Fed takes as a tightening of monetary policy. We agree with this premise if prices and incomes are rising due to inflation at a faster rate than the cost of debt, then debt becomes easier to service, and vice versa.

<u>Valuation & Sentiment</u> – While there were a few pullbacks during 2023 for the S&P 500, the general trend was improving earnings growth and expanding valuation multiples. Today, equities look objectively expensive, particularly against higher risk-free rates. However, the latter may be poised to decline if 2024 unfolds as expected. Analysts are looking for 11.5% growth in S&P 500 EPS in 2024, above the past 10-year average of 8.4%. Latest trends have not been inspiring. Q4 2023 earnings are forecasted to expand 2.4% when reported in coming days, however, this has been revised lower by 5.8% since September 30th, according to FactSet. This downward revision is larger than normal. Also raising concern is the number and percentage of companies issuing negative guidance. The S&P 500 will need to see strong earnings to maintain today's valuation level.

LINCOLN CAPITAL – INVESTMENT OUTLOOK & STRATEGY

Economics - From experience, we have learned that forecasts of economic and financial market activity are best made with humility, and received as guesstimates composed with part science and part art. Yet the forecasting process augments the development of informed views that often cut through the fog, thereby allowing investors to better weigh risk/reward probabilities of various assets classes. Accordingly, our humble market forecasts follow.

Gross Domestic Product, the country's total economic output, is organized into four components—personal consumption, business investment, government spending, and net exports. In 2023, all four of these segments expanded nicely. Our view is for these trends to continue in early 2024, and we will continue to pay close attention to inflation and inflation expectations, as these are primary data points for the Fed given their stable price mandate. Connecting the dots, inflation has a direct impact on interest rate levels and credit creation, which directly impacts labor employment and unemployment, as well as Fed actions relative to their full employment mandate.

Historically, deep recessions were a painful, yet necessary requirement to periodically flush out bad (un-economic) assets and debts. In more current times the economy has experienced "rolling recessions" where certain sectors and industries have downturns while the overall level of activity continues to experience growth. Our view is that if a recession were to develop, then odds favor it being a more modest decline given the lack of imbalances apparent in the economy. We anticipate more of the same going forward based on technology continuing to increase productivity at techno-speed, led by generative AI (Artificial Intelligence) becoming imbedded in all sectors, industries, and GDP components.

Financial Markets – Two years ago, full year (2022) forecasts did not envision a painful year with bonds experiencing double-digit negative returns and stocks finishing the year with a decline approaching 20%. In 2023, stocks ended the year with strong double-digit returns in the last ten weeks fueled by the path of inflation heading toward Fed target levels, and Fed communication that they were prepared to cut interest rates in 2024. Recent history has been filled with low probability or unanticipated events occurring, including the war in Ukraine, the Middle East and, of course, COVID.

With this background, as we continue to "expect the unexpected," we maintain asset allocations at normal or neutral levels with a "defensive bias" (i.e., the allocation of a portion of funds into lower-risk securities). While our accounts fully enjoyed positive returns in the past year, our concern for a softer second half in 2024 may lead us to reduce portfolio risk as we approach and move through the spring and summer months. While the market may continue moving higher, note that stocks have historically declined prior to recessions becoming evident. If stocks become overvalued and/or the outlook changes, then we will act according to our evaluation of risk/reward relationships with related probabilities.

New Year Budget Resolutions

As we enter 2024, many Americans use the beginning of a new year to start "anew" with resolutions, a tradition that is believed to be thousands of years old. To most, it gives the opportunity to cast aside unfulfilled goals from the previous year for new ones. Finance related resolutions always appear on the lists of most common, as noted in a 2023 study conducted by WalletHub showing almost half of Americans have planned a finance related New Year's resolution for this year. Whether the resolution is to save more, spend less, or a combination of both, building and maintaining a budget can help obtain these goals. Continue reading for tips on how to build a simple and maintainable plan.

At a basic level, budgeting is a way to keep track of money you are receiving and spending. At a more comprehensive level, it outlines anticipated income towards expenses, savings, and debt repayment. The first step in building an effective budget is to calculate your net income—what you take home after taxes, health insurance, and retirement plan contributions. The next step is to track spending. While this may seem daunting, we suggest exporting all transactions from your credit/debit cards and checking account for a year. You will then be able to see your total expenses by month as you sift through each transaction to see where you are spending the most. Once the appropriate data is tallied, it is time to make a budget plan.

One popular budgeting method is the 50/30/20 rule. First introduced by Harvard Law Professor (and now Senator) Elizabeth Warren, this straightforward rule states that you divide your after-tax income into three primary categories: 50% for needs, 30% to wants, and 20% to savings. Examples of needs include housing, utilities, insurance, and groceries. Wants include dining out, vacations, streaming service costs, gym, or hobby memberships. Savings can include retirement contributions, 529 plan contributions, emergency funds, and extra loan payments.

Americans are notoriously known more as spenders than savers, and this method ensures an adequate amount is being allocated to savings. Within savings, priority #1 is building an emergency fund to cover at least three to six months expenses. After that, look towards contributing to a retirement plan and paying down any high-interest debt, particularly credit cards. Once the budget is set, it is important to review it regularly, as your income and expenses may change over time.

One of the most popular budgeting apps on the market, Mint, is shutting down soon. Inuit, which owns Mint, has suggested users download and migrate to Credit Karma (which they also own); however, it is unclear what features will carry over. Other programs are available with an annual fee, such as the popular You Need a Budget (YNAB), which starts at $99 per year, or Empower budgeting, which is $8 per month. Google provides a free template in Google Sheets.

As Certified Financial Planners, Lincoln Capital has the tools and expertise to assist you in building a budget and managing cash flow. As always, please contact us if we may be of assistance in any manner.

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