ADVUS
FINANCIAL PARTNERS

MARKET COMMENTARY

Q4 | 2023

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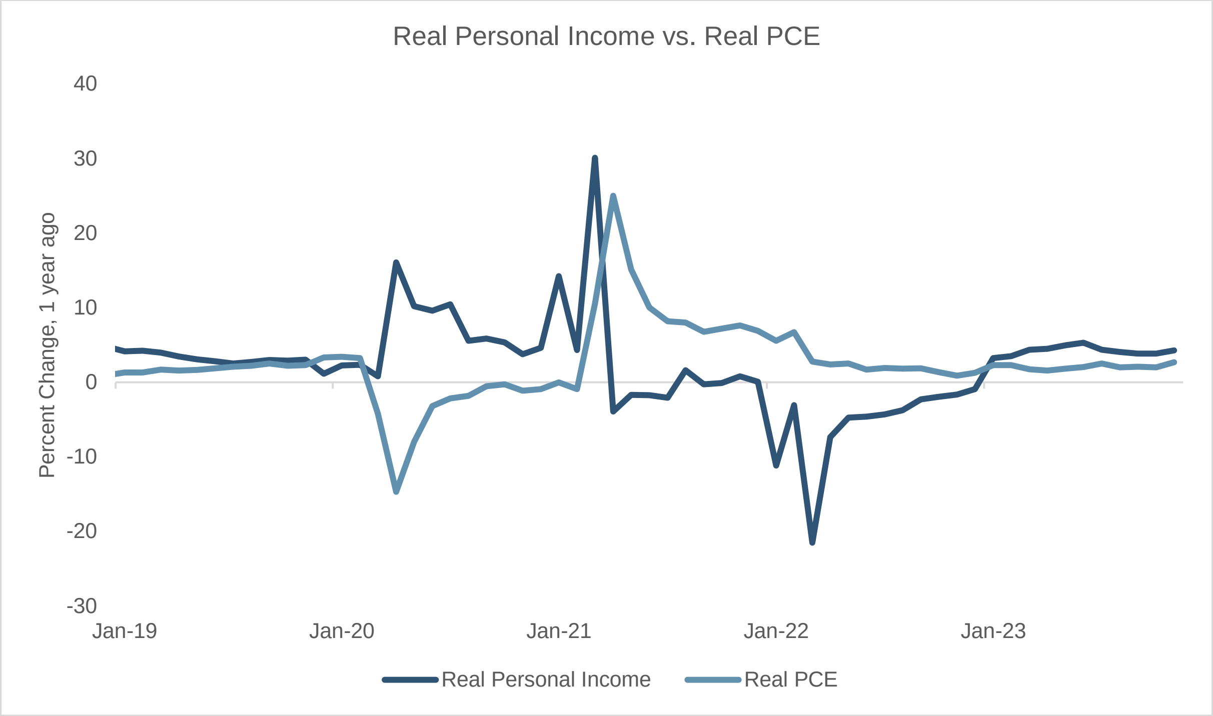
IN REVIEW

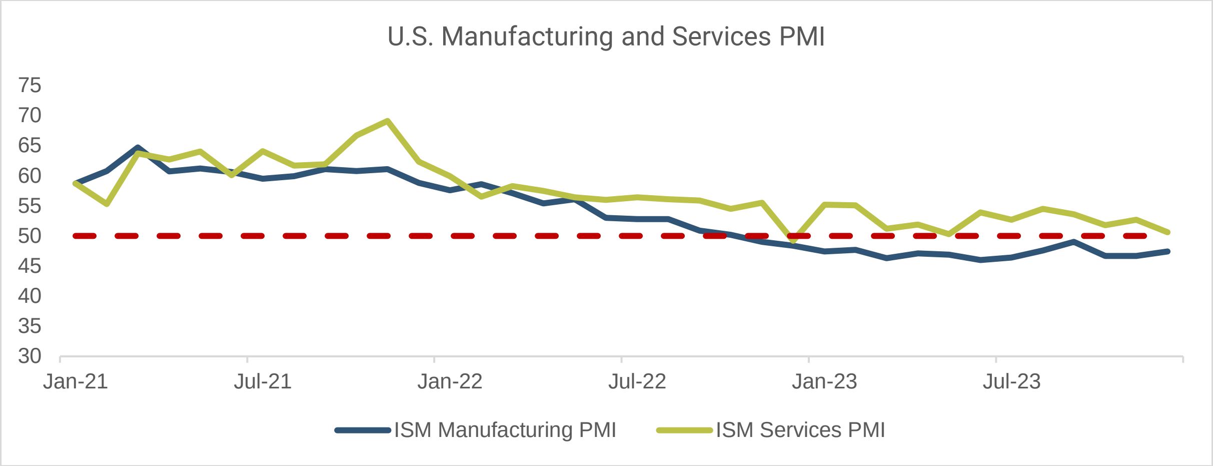
The final quarter of 2023 brought a welcome relief rally for investors, capping off a strong calendar year return for risk assets. After the slight reality check in the 3rd quarter, growing excitement that central banks may cut interest rates sooner in 2024 than previously expected resulted in a risk-on rally. The S&P 500 returned 11.7% in the 4th quarter and over 26% for the calendar year. Global aggregate bonds returned 8.1% over the 4th quarter and 5.7% for the calendar year. Disinflation continued to progress across the globe, leading central banks to step down their hawkish rhetoric. At the same time, economic growth has continued to grow at an above consensus rate and labor markets remain in a healthy position. Recent market performance clearly reflects an increased probability of a soft landing, but risks remain with respect to labor market rebalancing and continued disinflation. Current market valuations leave risk assets more vulnerable should rate cuts be delayed or growth falter, so remaining diversified is crucial at this point.

General Economic Conditions

Real GDP increased at an annualized rate of 4.9% in the 3rd quarter of 2023. The increase in real GDP reflected increases in consumer spending, private inventory investment, exports, government spending, residential fixed investment, and nonresidential fixed investment. Imports also increased, but not enough to offset the positive impact of the increase in exports. Compared to the 2nd quarter, the acceleration in real GDP in the 3rd quarter primarily reflected an upturn in exports and accelerations in both consumer spending and private inventory investment. The latest estimate for Q4 GDP growth is 2.5% according to the Atlanta Fed’s GDPNow estimate. Supported by a tight labor market and rising real wages, consumer spending defied all expectations of weakness in 2023. The wealth effect from higher equity and home prices as well as excess pandemic savings also contributed to higher spending. In the year ahead, we expect consumer spending to slow as pandemic savings continue to be drawn down and labor markets loosen modestly. However, consumers still look to be in a healthy position as real disposable personal income should rise as inflation falls and interest costs will remain low on long-term fixed debt. Business spending also held up better than expected in 2023 as tighter lending standards did not weigh on activity as much as expected. Additionally, business spending was supported by the race to integrate artificial intelligence. Sustained caution among lenders will likely keep a ceiling on any growth in business spending in 2024. Corporate profits are likely to slow as businesses will find it harder to defend margins with wage growth remaining elevated and pricing power waning. Slowing corporate profits will make the hurdle rate higher for any capital expenditures, posing another headwind for business spending. Residential investment appears to have stabilized at low levels as tight housing supply and steadily high mortgage rates work against each other to establish a floor in the housing market. Net exports are likely to be a mild drag on overall activity as global growth remains sluggish and dollar strength bodes well for imports. Overall, the U.S. economy should slow in 2024. Growth is likely to remain non-recessionary but should be in line with historical trend rates or slightly below. Risks to the outlook include volatility in an election year, still elevated policy rates, and geopolitical turmoil with no foreseeable resolution.

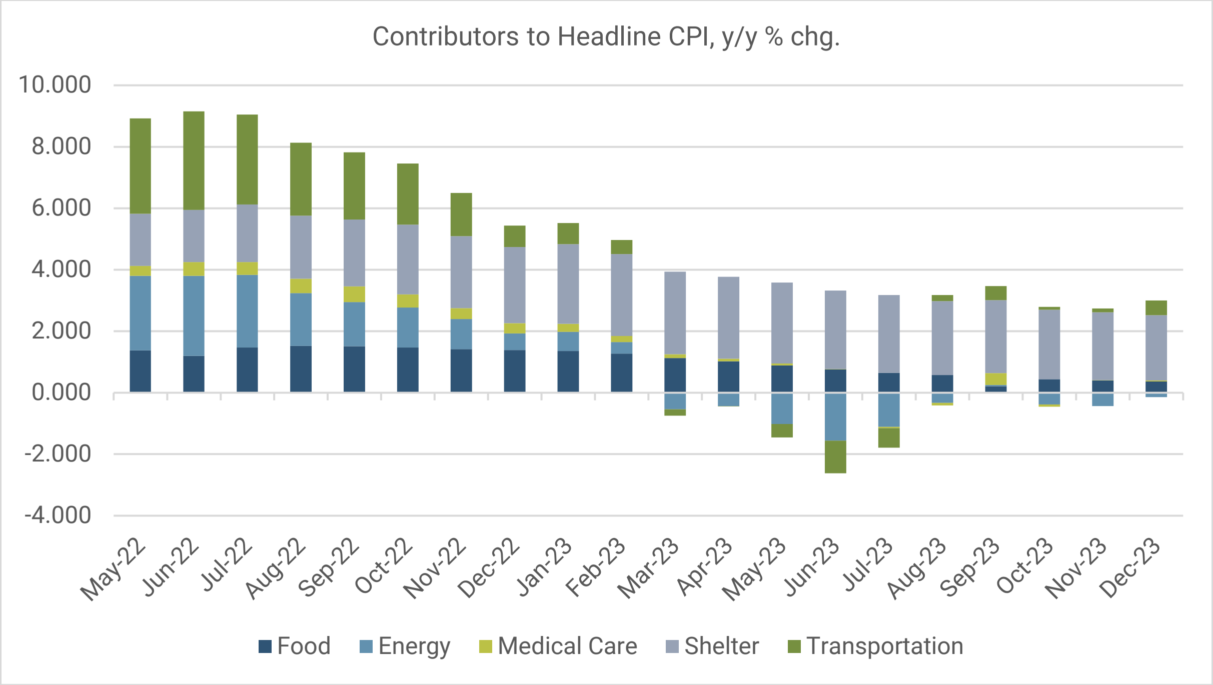


Data from the manufacturing sector remained in contractionary territory throughout the 4th quarter. The Institute for Supply Management's Purchasing Managers Index (PMI) registered 47.4 in December, which is the 14th consecutive contractionary reading (a reading below 50 is considered contractionary). Only 1 industry among the 17 in the survey reported growth in the month of December. Companies are still managing outputs appropriately as order softness continues. Demand eased further, indicated by a contraction in New Orders at a faster rate and the slight increase in the Backlog of Orders. Inputs continued to accommodate future demand growth as Supplier Deliveries increased and Prices decreased further into contractionary territory. Further progress within inputs is important for the current disinflation trend to remain in place. New Orders less inventories, a leading indicator of economic activity, improved on the margin but still points to weaker growth ahead. A recovery in the manufacturing sector would be a welcome sign for the more pro-cyclical equities that were left behind the "Magnificent 7" in last year's market rally.

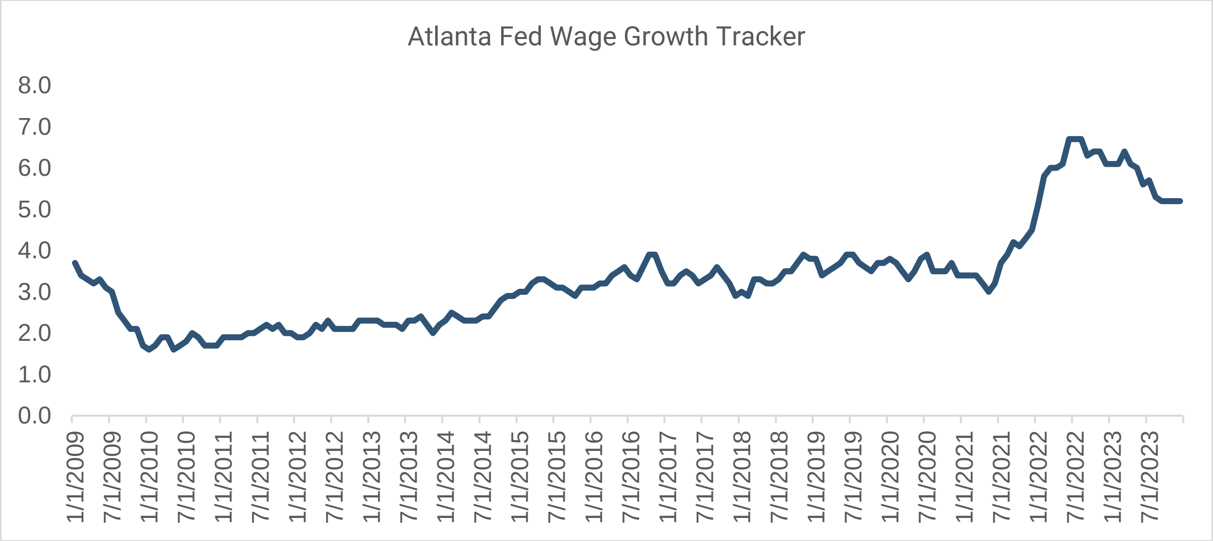


In December, the Consumer Price Index increased 0.3%, marking a 3.4% increase over the previous 12 months. The index for shelter continued to rise in December, contributing to over half of the monthly all items increase. Core CPI rose 0.3% in December, the same increase as in November.

Measures of both headline and core inflation cooled throughout the 4th quarter. The last mile of disinflation needed to begin easing monetary policy will occur in 2024. Although the imbalance between supply and demand in the goods sector has largely resolved itself, the full impact on core goods disinflation is still unfolding and will likely continue throughout the year. Additionally, shelter inflation has considerably further to fall. The rollover in market rents will gradually flow through to shelter inflation data and a reacceleration in rents is not likely given improving multifamily supply and a cooldown in broad price pressures. Finally, the cooling of wage growth likely has further to run as job openings are still elevated relative to levels implied by economic fundamentals. The remaining problem for inflation is the core services ex-housing measure often cited by the Fed when referring to persistent inflation. However, most of that inflation is driven by transportation services, which includes items like auto insurance and auto repair costs. New and used car prices should continue to decline as new car inventories have steadily risen and used car auction prices have fallen. Normalizing production levels help to ensure that this trend can remain in place throughout 2024. In that case, transportation services inflation should fall as auto prices rollover. Having said that, there are still upside risks to the inflation outlook and premature easing could reignite inflation. House prices have stabilized and have even started rising again in some economies due to very low single-family housing supply and strong household balance sheets. A meaningful upturn in house prices would increase the possibility that shelter inflation could be stickier than anticipated. Geopolitical turmoil in Ukraine and the Middle East could result in a spike in energy prices if the conflicts escalate. Such an event may just lead to a temporary spike in headline inflation, but a prolonged period of high energy prices can feed into higher core inflation as well.



The labor market remains in a healthy position, contributing to optimism around future growth prospects. Nonfarm payrolls rose by 216,000 in December and the unemployment rate held at 3.7%. The 3-month moving average for nonfarm payrolls now sits at 165,000, the lowest level since early 2021 but still positive. The Quits rate continues to fall, and businesses are pulling back on hiring efforts in the face of slowing consumer demand. Despite a swift decline in job openings during the 4th quarter, unemployment remained steady. This is likely a reflection of the structurally slower labor force growth we're experiencing today. While that keeps a cap on unemployment, a structural lack of labor supply also poses an upside risk to wage growth. The 3-month moving average of median wage growth has stagnated around 5.2% in recent months, a figure too high if inflation is to sustain near 2%. The labor force rebalancing to date has occurred painlessly, with job openings declining and unemployment remaining steady. Incremental rebalancing from this point is likely and it is also likely to continue through lower openings. Whether it is enough to bring wage inflation in line while unemployment stays at low levels is what remains to be seen. A full rebalancing back to pre-pandemic levels likely isn't necessary as that was a period characterized by persistent inflation undershoots, but further rebalancing is certainly needed.



Monetary Policy

The Federal Reserve didn't raise rates at either of their meetings in the 4th quarter, maintaining the target range for the federal funds rate at 5.25%-5.50%. December's FOMC meeting led to a sharp rally in risk assets as Fed Chair Jerome Powell struck a surprisingly dovish tone. In his press conference he acknowledged that rate hikes are likely finished and noted that they intended to cut rates well before inflation reaches the 2% mark. The December meeting minutes also contained some dovish comments. Participants reaffirmed that it would be appropriate for policy to remain at a restrictive stance until inflation was clearly moving down sustainably toward the 2% objective. That note doesn't just call for cuts to begin but it implies that once the threshold of sustainable disinflation is met, the policy rate should no longer be restrictive. Additionally, the minutes alluded to the ending of quantitative tightening for the first time. The committee will likely begin to discuss when and at what pace slowing the runoff of the balance sheet is appropriate this year. The committee's summary of economic projections showed they expect to cut rates by 75 basis points in 2024. Meanwhile, markets have priced in nearly 150 basis points of cuts next year. At this point, that is likely too much easing to price in while inflation remains above target and growth continues to come in above expectations. The Fed has only cut rates by 150 basis points or more in years of recession, so if that much easing were to occur it would likely be due to much lower-than-expected growth.

Investment Performance

The last three months of the year saw strong returns across most major asset classes, accelerated by excitement that central banks will cut interest rates sooner than expected in 2024. Developed market equities returned 11.5% while global aggregate bonds returned 8.1%. The S&P 500 was the best performing major equity index over the 4th quarter due to its growth tilt. Returns for the full year were dominated by the "magnificent 7" tech and AI stocks, which contributed around 80% of the index returns. European equities also delivered strong returns of 6.7% and emerging market equities delivered 7.9% despite ongoing woes in the Chinese stock market. Emerging markets debt was the strongest performer within fixed income as the dollar fell and spreads tightened. Commodities were the outlier delivering -4.6% as markets fully embraced the disinflation narrative.

- **International equities significantly cheaper than U.S. equities** – As of the end of 2023, the forward P/E on the S&P 500 was 19.5, compared to the 30-year average of 16.6. At the same time, international equities are sitting at a 34% discount to U.S. equities with respect to P/E multiples. While the spread between the two is significant, U.S. equities will likely continue to trade at a premium. U.S. economic growth prospects are stronger than the rest of the world and the universe is composed of higher quality companies.
- **Riskier Credit continues to outperform** – Both European and U.S. high yield bonds have outperformed the broader fixed income market year-to-date as default rates have remained low. As global economic momentum persists, investors have been drawn to the large yields and lower interest rate sensitivity these issues offer. Credit spreads are tight by historical standards and even more so when you consider the prospect of slower economic growth on the horizon.
- **Growth outperformed Value in 2023** – Globally, growth equities returned 37% in 2023 compared to 12% for value equities. In the 4th quarter alone, growth returned 13.4% as investors reacted to the dovish outlook from central banks. Value still looks cheap relative to growth, but as economic activity slows and financial conditions loosen, we would expect growth to continue to do well going forward.

LOOKING FORWARD

At the beginning of last year, the outlook for the economy and markets was cautious at best. Global inflation had increased over 10% with supply chains in disarray and historically tight labor markets. Calls for recession were widespread as central banks were expected to continue with their historic tightening campaign. Now as we head into 2024, caution and pessimism have waned as policymakers thus far have successfully slowed growth without causing a recession. A soft landing is now the central expectation for markets. The U.S. economy has proven more resilient to high interest rates than expected as consumers were able to term out their debt at lower rates over the previous decade. While consumption will likely slow, rising real incomes and strong household balance sheets should continue to support healthy levels of spending. Inflation is now running at half of its peak pace, so central banks are turning their attention away from inflation risks and toward mitigating growth risks. The normalization of supply-side disruptions should continue to exert downward pressure on prices throughout 2024. Additionally, the easing in rental rates should continue to feed through to shelter inflation. Rebalancing progress in the labor market has been ideal to date. There is room for job openings to continue falling and for wage growth to slow, though persistent wage pressures remain a key risk. In that environment, we'd expect the economy to continue to expand at a non-recessionary, possibly trend-like rate. While the macro backdrop has improved, current valuations clearly reflect that fact. U.S. equity valuations are in the 10th decile, meaning valuations have been cheaper at least 90% of the time historically. Even more concerning is that the recent market rally was entirely driven by multiple expansion, rather than fundamental earnings growth. This leaves equity markets more vulnerable to any policy tightening surprises, though that is not our base case. We remain neutral in our asset allocation as the economic backdrop has improved, but asset markets have swiftly priced that in. We expect equities to grow in line with underlying earnings growth which should be solid after bottoming last year. We prefer U.S. equities relative to the rest of the world as the world's largest economy is better positioned in both the near-term and structurally over the long-term. The companies within the U.S. market also exhibit higher quality balance sheets and earnings streams. Current valuations in the U.S. prevent us from maintaining a significant overweight, but a valuation premium relative to the rest of the world should remain in place. Meanwhile, the opposite dynamic is playing out in international developed markets as valuations look attractive but economic growth prospects look weaker. Fixed income is also poised for positive returns this year as a slowdown in economic growth and inflation and a dovish shift from the Federal Reserve should continue to keep a cap on yields. Investment-grade and high yield credit markets reflect very tight spreads and so using the fixed income sleeve of portfolios as a ballast to equities remains our preference, rather than sacrificing quality to reach for yield. Alternative assets that provide income and return profiles that are uncorrelated to equity markets continue to be a staple in our asset allocation.

Scenario Updates

Base Scenario ***60% Probability***

U.S. GDP growth slows in 2024 as consumer spending and business investment continue to normalize. Growth remains non-recessionary as jobs and real wage growth continues. Inflation continues to decelerate towards target, driven by shelter disinflation. Labor market rebalancing continues, allowing wage growth normalization to progress. The Fed is able to achieve a soft landing and begins with "insurance cuts" in the 2nd half of 2024 in response to cooler inflation and labor market conditions. Equities will remain rangebound as markets are priced for a benign macro view and earnings growth is likely to be modestly positive. Yields should be near their peak as the Fed has completed their hiking cycle.

Upside Scenario ***20% Probability***

Factors that could influence the Upside Scenario:

- The conflict in Ukraine has a swifter resolution than currently expected. Sanctions currently imposed on Russia don't escalate and possibly lessen. Food and energy prices fall further providing more inflation relief.
- GDP growth rates remain in line with expectations, keeping fears of both more tightening and recession at bay.
- Labor markets rebalance fully without creating excessive unemployment, allowing wage inflation to return to normalized levels.
- The last leg of disinflation proves to be easier than expected, allowing the Fed to ease sooner than expected.
- Corporate earnings beat expectations, driven by resilient nominal growth, sustained record-high margins, and better-than-expected consumption spending.

Downside Scenario *20% Probability*

Factors that could influence the Downside Scenario:

- The conflict in Ukraine drags along as a diplomatic solution remains unattainable and the threat of NATO involvement increases meaningfully. Harsh sanctions are imposed on Russia, potentially eliciting an escalatory response from Moscow.
- Iranian proxy forces become involved in the Israel-Hamas conflict prompting a response from the U.S. likely to include sanctions on Iranian oil. Lower oil supply raises prices and raises concerns about inflation’s stickiness.
- Concerns about U.S. fiscal sustainability reassert themselves, causing a spike in longer-dated treasury yields.
- Inflation stabilizes above target. Central banks are forced to resume tightening, but the delay sends terminal rates up significantly.
- The Fed’s decisions thus far prove too restrictive for the economy, sending the U.S. economy into recession. Equities re-test or break through their previous lows as the earnings outlook dims.
- Oil prices continue to climb on the back of voluntary OPEC cuts. Consumer spending is hurt and higher oil prices eventually feed into higher core inflation.
- The slowdown in the housing market has a more pronounced impact on consumer spending and overall economic activity than currently forecast.
- Corporate earnings are well below expectations creating an environment of both falling earnings and compressing valuations leading to sharp equity market selloffs.

ECONOMIC STATISTICS	Current	One Year Ago
Real GDP Growth (Annl. % Change From Prior Qtr.)	2.93%	1.71%
Unemployment Rate	3.70%	3.50%
Labor Force Participation Rate	62.50%	62.30%
Core CPI (Year-Over-Year)	3.90%	5.70%
Real Personal Income Growth (Year-over-Year)	1.90%	-1.30%
10 Year Treasury Rate	4.02%	3.62%

US EQUITY MARKET

Major US Market	Q4 2023	YTD	1 Year	3 Year	5 Year	2023	2022	2021
Russell 3000 Index	12.1%	26.0%	26.0%	8.5%	15.2%	26.0%	-19.2%	25.7%
FTSE RAFI US 3000 Index	11.4%	16.3%	16.3%	12.1%	14.3%	16.3%	-7.9%	31.5%
Russell 3000 Equal Weighted	15.0%	14.8%	14.8%	1.9%	10.4%	14.8%	-22.9%	19.5%
S&P 500 Index	11.7%	26.3%	26.3%	10.0%	15.7%	26.3%	-18.1%	28.7%
Russell Mid Cap Index	12.8%	17.2%	17.2%	5.9%	12.7%	17.2%	-17.3%	22.6%
Russell 2000 Index	14.0%	16.9%	16.9%	2.2%	10.0%	16.9%	-20.4%	14.8%
NASDAQ 100	14.6%	55.1%	55.1%	10.2%	22.7%	55.1%	-32.4%	27.5%

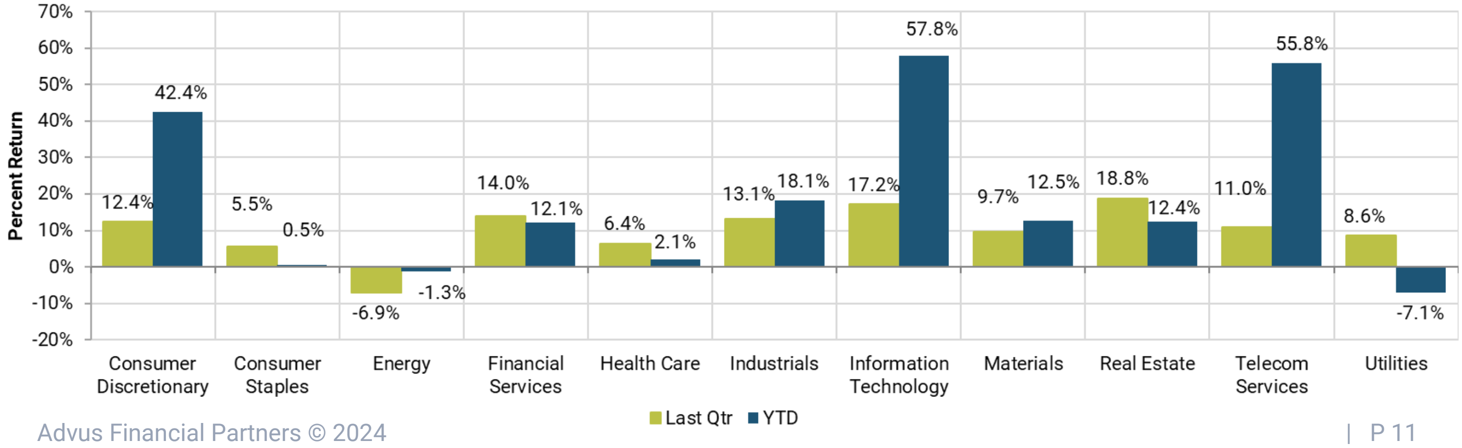
Russell 3000 Style & Cap Summary

	Fourth Quarter Results							
	Mo.	Qtr.	Value		Core		Growth	
Large	Oct	Q4	1.64%	8.01%	22.37%	11.70%	39.34%	14.11%
	Nov		26.36%		31.75%		36.48%	
	Dec		-2.72%		-1.60%		-0.86%	
Mid	Oct	Q4	4.96%	12.11%	17.10%	12.82%	35.59%	14.55%
	Nov		27.06%		30.54%		35.47%	
	Dec		-4.95%		-4.99%		-5.10%	
Small	Oct	Q4	4.63%	15.26%	19.96%	14.03%	34.63%	12.75%
	Nov		22.39%		25.52%		28.48%	
	Dec		-5.97%		-6.82%		-7.71%	

	Year To Date Results		
	Value	Core	Growth
Large	10.64%	29.85%	46.62%
Mid	12.71%	17.23%	25.87%
Small	14.65%	16.93%	18.66%

S&P 500 Sector Performance

Data Source: Federal Reserve, Advus



US EQUITY MARKET (cont.)

Top Weights[a]	Weight	Return	Contribution
Apple Inc	7.22%	12.60%	0.88%
Microsoft Corp	7.04%	19.34%	1.26%
Amazon.com Inc	3.39%	19.52%	0.63%
NVIDIA Corp	3.05%	13.86%	0.42%
Alphabet Inc Class A	2.12%	6.75%	0.15%
Meta Platforms Inc Class A	1.93%	17.90%	0.33%
Alphabet Inc Class C	1.82%	6.89%	0.13%
Tesla Inc	1.75%	-0.70%	-0.01%
Berkshire Hathaway Inc Class B	1.71%	1.82%	0.03%
UnitedHealth Group Inc	1.32%	4.78%	0.06%

Top Contributors[a]	Weight	Return	Contribution
Microsoft Corp	7.04%	19.34%	1.26%
Apple Inc	7.22%	12.60%	0.88%
Amazon.com Inc	3.39%	19.52%	0.63%
NVIDIA Corp	3.05%	13.86%	0.42%
Broadcom Inc	1.06%	35.01%	0.35%
Meta Platforms Inc Class A	1.93%	17.90%	0.33%
JPMorgan Chase & Co	1.17%	18.16%	0.21%
Advanced Micro Devices Inc	0.51%	43.37%	0.20%
Intel Corp	0.45%	41.82%	0.17%
Salesforce Inc	0.59%	29.77%	0.16%

Top Detractors[a]	Weight	Return	Contribution
Exxon Mobil Corp	1.13%	-14.19%	-0.19%
Exxon Mobil Corp	0.72%	-10.60%	-0.09%
Chevron Corp	0.46%	-12.01%	-0.06%
Pfizer Inc	0.29%	-10.70%	-0.04%
Bristol-Myers Squibb Co	0.56%	-5.34%	-0.03%
Cisco Systems Inc	0.21%	-10.30%	-0.02%
Schlumberger Ltd	0.17%	-10.06%	-0.02%
Aon PLC Class A	0.11%	-11.63%	-0.01%
Charter Communications Inc Class A	1.75%	-0.70%	-0.01%
Tesla Inc	0.09%	-10.13%	-0.01%

(a) = SPDR S&P 500 ETF

Data Source for all data in tables: Morningstar Direct

INTERNATIONAL EQUITY

International Equity Market Performance	Q4 2023	YTD	1 Year	3 Year	5 Year
MSCI EAFE	10.47%	18.85%	18.85%	4.53%	8.69%
MSCI EAFE Value	8.28%	19.79%	19.79%	8.31%	7.76%
MSCI EAFE Growth	12.75%	17.97%	17.97%	0.59%	9.18%
MSCI EM	7.93%	10.27%	10.27%	-4.71%	4.08%
MSCI ACWI Ex. USA.	9.82%	16.21%	16.21%	2.04%	7.60%

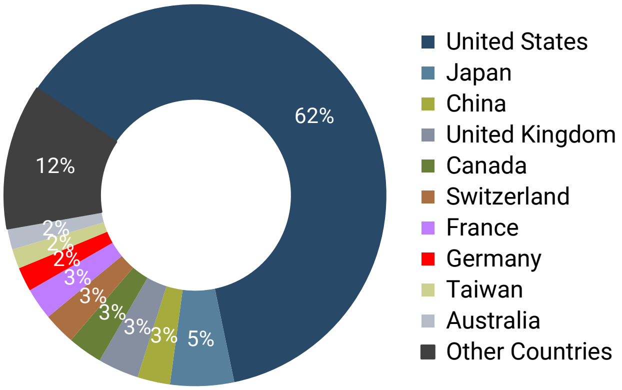
	Last Quarter			Year To Date		
	Local	USD	Impact of US Dollar [(a)]	Local	USD	Impact of US Dollar [(a)]
MSCI ACWI Ex USA	5.45%	9.82%	4.37%	14.66%	16.21%	1.55%
MSCI Europe	5.65%	11.10%	5.45%	15.04%	20.66%	5.62%
MSCI Europe Ex UK	6.67%	12.41%	5.73%	17.32%	22.69%	5.37%
MSCI United Kingdom	2.33%	6.87%	4.55%	7.68%	14.11%	6.44%
MSCI Pacific Ex Japan	6.82%	11.42%	4.60%	5.86%	6.53%	0.68%
MSCI Japan	2.24%	8.22%	5.98%	29.04%	20.77%	-8.27%
MSCI France	5.78%	10.36%	4.59%	18.14%	22.28%	4.14%
MSCI Switzerland	1.32%	10.12%	8.81%	6.31%	16.87%	10.55%
MSCI Germany	8.34%	13.04%	4.70%	19.77%	23.97%	4.20%
MSCI Canada	8.70%	11.45%	2.75%	13.31%	16.44%	3.12%
MSCI China	-4.78%	-4.21%	0.57%	-10.57%	-11.04%	-0.47%
MSCI India	12.21%	11.98%	-0.23%	22.00%	21.29%	-0.71%
MSCI Brazil	14.57%	18.05%	3.48%	22.71%	33.38%	10.66%
MSCI Russia	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

Assumes Gross Reinvestment of Dividends

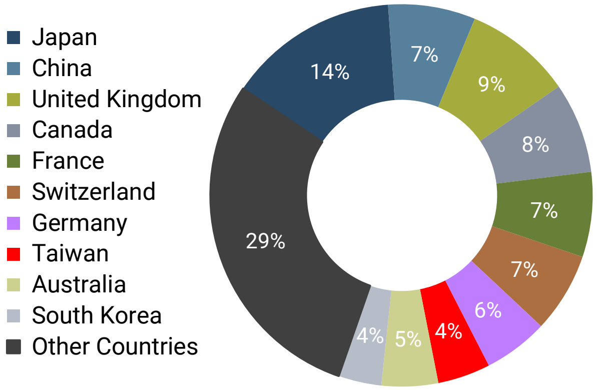
(a) Impact of Dollar: For a US investor, a strengthening dollar has a negative impact on non-US asset returns when converted to US dollars since the conversion requires more of a foreign currency to purchase the more expensive US dollar. A weakening dollar has the opposite effect; the foreign currency can buy more US dollars.

COUNTRY WEIGHTS

MSCI All Country World Index



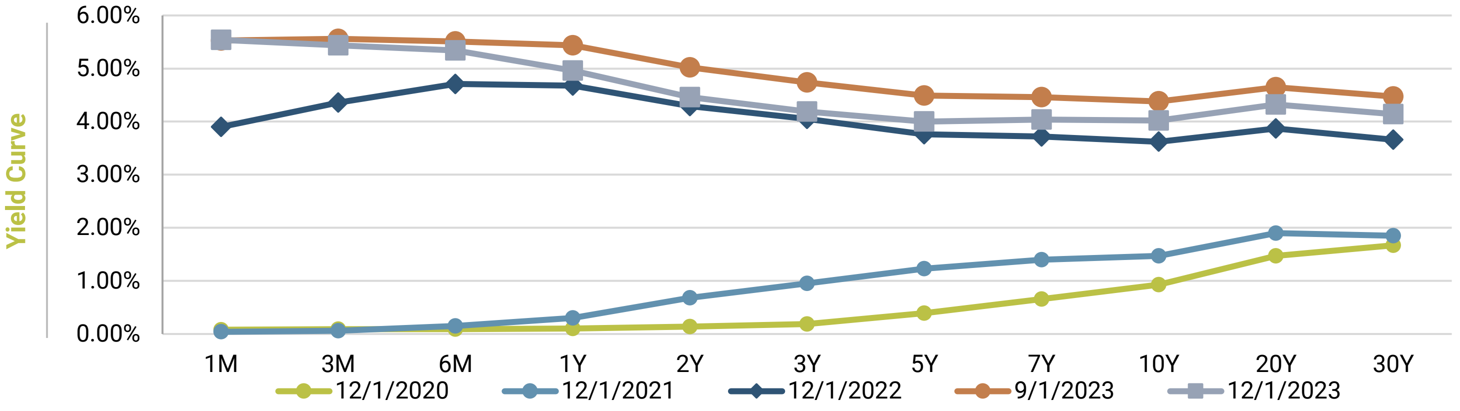
MSCI All Country World Index *(Ex. USA)*

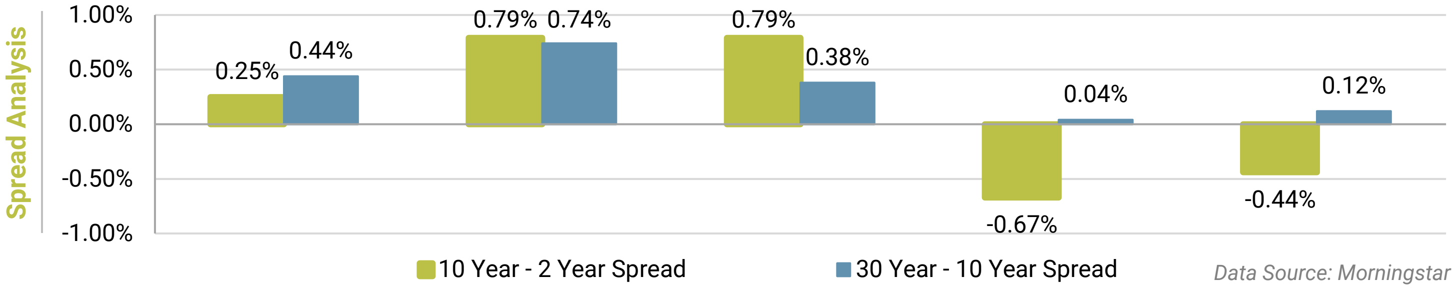


Data Source: Morningstar and iShares ETFs as the representative index proxies. Weights are average for Q4

FIXED INCOME

Major Market Averages	Q4 2023	YTD	1 Year	3 Year
ICE BofAML US 3M Treasury Bill	1.37%	5.01%	5.01%	2.15%
Bloomberg Barclays US Govt/Credit 1-3 Yr	2.69%	4.61%	4.61%	0.09%
Bloomberg Barclays US Govt Interm	3.97%	4.30%	4.30%	-1.83%
Bloomberg Barclays US Govt/Credit Interm	4.56%	5.24%	5.24%	-1.63%
Bloomberg Barclays US Govt/Credit	6.63%	5.72%	5.72%	-3.53%
Bloomberg Barclays US Agg Interm	5.50%	5.18%	5.18%	-2.06%
Bloomberg Barclays US Agg Bond	6.82%	5.53%	5.53%	-3.31%
Bloomberg Barclays Global Agg Bond	8.10%	5.72%	5.72%	-5.51%
Bloomberg Barclays US Treasury	5.66%	4.05%	4.05%	-3.82%
Bloomberg Barclays US Treasury US TIPS	4.71%	3.90%	3.90%	-1.00%
Bloomberg Barclays US Corporate IG	8.50%	8.52%	8.52%	-3.29%
Bloomberg Barclays High Yield Corporate	7.16%	13.45%	13.45%	1.98%
Bloomberg Barclays Municipal	7.89%	6.40%	6.40%	-0.40%
Bloomberg Barclays Municipal 7 Yr 6-8	6.47%	4.99%	4.99%	-0.31%
Credit Quality				
B of A/Merril Lynch US Corporate AAA	8.42%	6.48%	6.48%	-5.55%
B of A/Merril Lynch US Corporate AA	7.33%	6.70%	6.70%	-4.05%
B of A/Merril Lynch US Corporate A	7.65%	7.58%	7.58%	-3.39%
B of A/Merril Lynch US Corporate BBB	8.24%	9.46%	9.46%	-2.77%
B of A/Merril Lynch US Corporate BB	7.34%	11.44%	11.44%	1.37%
B of A/Merril Lynch US Corporate B	6.78%	13.96%	13.96%	2.24%
B of A/Merril Lynch US Corp. CCC & Lower	6.60%	20.36%	20.36%	3.61%





Data Source: Morningstar

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