Market Outlook & Strategy

Fourth Quarter of 2023

Leigh Bivings, Ph.D., CFP®

Artemis Financial Advisors LLC

115 Newbury Street, Suite 302
Boston, MA 02116
617-542-2420

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Executive Summary

- **Q4 2023.** Markets staged an impressive rally in Q4 with the U.S. leading the way. Investor sentiment moved away from the "higher [interest rates] for longer" view to a "lower and sooner" view after the Federal Reserve surprised the market with a dovish pivot. In the U.S., the market responded by increasing +12.1%. Growth and smaller company stocks outperformed, but all sectors did well.

- Internationally, foreign markets lagged the U.S. market but not by much. International developed markets increased by +10.5% and emerging markets by +8.0%.

- U.S. fixed income returns were also broadly positive. Treasury yields made a big move downward in response to the Fed pivot. The Q4 return for the market's broadest benchmark – the U.S. Barclay's Aggregate Fixed Income index – was +6.8% for the quarter.

- **Full year 2023**. The robust rally in Q4 helped the U.S. market log a very decent year overall, with the market increasing by +26.1%. An additional key driver for the very positive market returns was the euphoria around artificial intelligence (AI) that took Wall Street by storm in the spring. Developed international markets reported a +17.9% return for the year, and emerging markets clocked in at +11.7%.

- As for fixed income, cash appeared to be king until Q4 when most segments of the fixed income complex strongly outperformed cash, leading them to exceed cash returns for the year.

- **2024 Outlook.** The consensus outlook for 2024 is fairly positive with inflation falling to the Fed's target 2.0% by year end, employment at 4.0% and GDP growth at +2.0%. Yet some forecasters believe the Fed has overtightened, creating the seeds for a recession in 2024, and others argue that the U.S. economy is going to remain resilient, preventing the Fed from pivoting to lower rates. In short, the trajectory of the stock market in 2024 will again be dependent on how inflation behaves and how the Fed responds.

- **Artemis Strategy.** We are not making any high-conviction moves in the portfolios currently, remaining with a balanced exposure to both large value and growth stocks and a modest tilt toward quality. We continue to encourage investors to move away from cash.

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Markets in Review – Q4

Markets staged an impressive rally in Q4 with the U.S. leading the way. Investor sentiment moved away from the "higher [interest rates] for longer" view to a "lower and sooner" view after the Federal Reserve surprised the market with a dovish pivot stating that it now believes that it would be reducing interest rates in 2024. In the U.S., the overall market responded by increasing +12.1%. Growth and smaller company stocks outperformed, but all sectors did well. And to everyone's surprise, REITS were the best-performing asset class as the sector is very sensitive to interest rates. The only sector that struggled was commodities (-4.6%) due to rising global economic growth worries. See Figure 1.

Figure 1. Asset Class Returns in USD for 2023 (%)

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	2023					
Asset Class	**Q1**	**Q2**	**Q3**	**Q4**	**Total Year**	**Index**
Equities						
All Markets - Global*	6.9	5.9	-3.4	11.1	21.6	MSCI ACWI IMI (net)
U.S. Large Companies	7.5	10.3	-2.1	11.7	26.3	S&P 500
U.S. Small Companies	2.7	7.2	-4.8	14.0	16.9	Russell 2000
U.S. Growth	14.4	14.7	-1.7	14.2	42.7	Russell 1000 Growth
U.S. Value	1.0	5.4	-2.3	9.5	11.5	Russell 1000 Value
Thematics/Best Ideas**	6.9	5.9	-3.4	11.1	21.6	MSCI ACWI IMI (net)
Int'l Developed Markets	8.0	3.0	-4.1	10.5	17.9	MSCI EAFE & Canada (net)
Emerging Markets	3.9	1.6	-2.1	8.0	11.7	MSCI Emerging Markets
Fixed Income						
All Segments - U.S.*	3.0	-0.4	-2.9	6.8	5.5	Bloomberg U.S. Aggregate
U.S. Treasuries*	3.5	-1.3	-4.2	6.4	3.4	ICE U.S. TreasurY, 7-10 Years
U.S. Short Term Treasuries	1.5	-0.2	0.8	2.7	4.6	Bloomberg US Government/Credit 1-3 Year
U.S. Municipal Bonds*	2.8	0.0	-4.0	7.9	6.4	Bloomberg Municipal Bonds
U.S. Corporate *	3.5	0.4	-2.6	8.5	8.5	Bloomberg US Corporate
U.S. High Yield	3.6	2.6	0.8	7.2	13.4	Bloomberg US Corporate High Yield
EM Bonds	2.2	1.5	-2.1	8.1	9.1	Bloomberg EM USD Aggregate
Real Assets						
U.S. Tips	3.3	-1.0	-2.2	4.7	3.9	Barclays Capital U.S. TIPS
Commodities	-5.4	-1.5	6.0	-4.6	(7.9)	Bloomberg Commodity
U.S. Real Estate Income	2.2	2.8	-3.7	9.6	11.8	Fidelity Series Real Estate Income Composite
Global Real Estate - REITS	1.2	2.4	-6.0	15.5	10.1	S&P Global REIT TR

*Used to create Artemis portfolio benchmarks
** ROBO and SHSSX were sold in Q4 and replaced with AIQ.
Current lineup is equal-weighted CIBR, AIQ, and PGINX

Internationally, foreign markets lagged the U.S. market but not by much. International developed markets increased by +10.5% and emerging markets by +8.0%. The latter was weighed down by continued lackluster performance in China and the outbreak of war between Israel and Hamas.

Turning to U.S. fixed income, Treasury yields made a big move downward in response to the Fed pivot. U.S. Treasury 10-year yields peaked in early November at just over 5% and then dropped to 3.8% in seven weeks. Other fixed income segments responded similarly, igniting a nice end-year rally. The Q4 return for the market's broadest benchmark – the U.S. Barclay's Aggregate Fixed Income index – returned 6.8%, and investment grade returned 8.5%. The Q4 rally pushed all fixed income returns into solidly positive territory for the year.

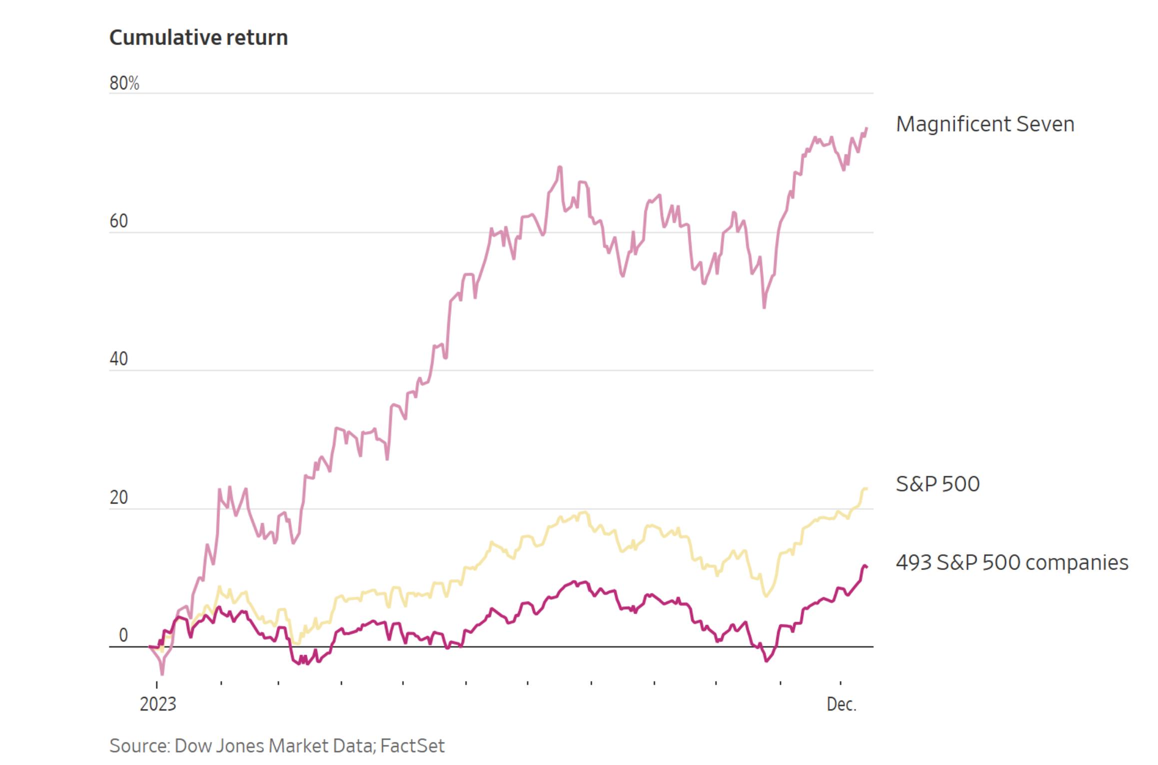
2023 Full Year Review

The robust rally in Q4 helped the U.S. market log in a very decent year, with the overall market increasing by +26%. In addition to the Fed pivot, a key driver for this outcome was the overall resiliency of the U.S. economy. According to one survey, at the beginning of the year 85% of economists were predicting that the U.S. would be in a recession by the end of the year. This view was reinforced when a couple of regional banks failed in March, leading economists to wonder what was going to be the next shoe to drop. The overarching view was that the 500 basis point increase in interest rates over the last 18 months was bound to stop the economy in its tracks in 2023 and was the necessary medicine to cure inflation. Such pessimism proved to be misplaced as U.S. GDP growth in 2023 was robust, with the latest figure (Q3 2023) showing +3.0% real growth YoY.

Why has the U.S. economy been so resilient? Several initial views have been put forward. First, economists now believe that supportive fiscal policy helped to offset the contractionary effects of monetary tightening. Second, consumers were still spending down their Covid savings; and third, the Fed appears to have done a very good job of thwarting a broader banking crisis with the special lending facility it put in place following the failures of Silicon Valley Bank and First Republic. Finally, the U.S. also let up on immigration restrictions that took some pressure off the labor market.

An additional key driver for the very positive market returns was the euphoria around artificial intelligence (AI) that took Wall Street by storm in the spring. As a result, big technology stocks (namely, the so-called 'Magnificent Seven' of Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla and Meta Platforms) that had declined by over -40% in 2022 due to increasing interest rates saw renewed interest by investors and shot up by over 75% in 2023. By the end of the year, the group of seven represented about 30% of the S&P 500. See Figure 2. The remaining 493 stocks returned only +12% for the year.

Figure 2. S&P 500 Performance in 2023



Tech's dominance in the U.S. market led the U.S. to outperform other equity markets again in 2023 at +26%. For the full year 2023, foreign developed markets returned +18.9%, not bad considering that parts of Europe flirted with recession and more stubborn inflation than in the U.S. Emerging markets (+10.3% for the year) struggled more on a relative basis due mostly the continuing problems in China, which is now about 30% of most emerging market indices.

Indeed, the accelerated rise in U.S. tech stocks masked some decent outperformance from international developed equities. BlackRock makes an interesting observation in its end-year summary. In 2023, it notes that the average international stock outpaced the average U.S. stock through late November. The MSCI EAFE Equal Weight Index (where each stock in the index gets an equal weighting, as opposed to a market-capitalization-weight index) outperformed the S&P Equal Weight Index by nearly 5% in 2023, adding to the 15 percentage points of outperformance since the bear market ended in October 2022. Should the mega-cap stocks in the U.S. lag in 2024 – a possibility without additional Fed rates cuts to sustain their momentum – the outperformance by the average large international stock

may become more obvious. And this outperformance came on the back of a rather tough year in Europe when inflation remained above target and the zone's industrial sector suffered from high energy prices and sluggish global demand.

Turning now to U.S. fixed income, what was looking to likely be another poor year turned out to be a rather good one overall due to the rally in Q4. As a result, most fixed income returns outperformed cash, with the Barclay's Aggregate Fixed Income benchmark returning +5.5% and corporate bonds returning +8.5% for the year.

Finally, as everybody knows, it was a terrific year for cash, which earned just over 5%, its best showing in over 20 years. In brief, what are called short-duration assets (i.e., cash and bonds that mature in less than two years) had a banner year.

2024 Outlook – U.S. Market

Given that the consensus outlook for economic growth and market returns has been wildly wrong over the past few years, I can hardly blame you if you want to skip this section![1] Indeed, the median Wall Street forecast from 2020-23 missed its target for end-year S&P levels by an average of 13.8 percentage points annually, more than double the actual average annual performance of the stock market. It's a huge miss.

But for whatever it's worth, the consensus outlook for 2024 is fairly positive. JP Morgan, for example, believes the U.S. will avoid a recession, achieve 2% real GDP growth, 2% inflation (by the end of the year), and not see more than 4.0% unemployment (current level is 3.7%). This is essentially a return to the pre-pandemic trajectory.

This does, however, represent a growth slowdown relative to 2023, in which we saw Q3 YoY real U.S. GDP growth clock in at 3.0%. Most forecasters, including JP Morgan, see the economy going through a "soft spot" due to the lagged effects of high interest rates, consumers running out of their pandemic savings, the resumption of student loan payments, and importantly, much less fiscal support from the federal government.

[1] As one of my favorite market pundits pointed out, regular investors have mis-forecasted the market's trajectory over the last 3 years, too. In 2022, investors believed big technology stocks would be immune to rising interest rates. The year before that investors believed that paying very high prices for unprofitable stocks would make them rich.

While JP Morgan and others are essentially forecasting a "soft landing" (i.e., a non-recessionary growth deceleration with core inflation falling toward 2%), some believe the Fed has now overtightened, creating the seeds for a recession in 2024. But there are also those who argue the opposite – that GDP growth into 2024 will persist and inflation will be sticky. Hence, the Fed will not reduce short-term interest rates at the rate and magnitude the market currently forecasts (six rate cuts in 2024). Here's the important thing to understand: <u>Both these potential outcomes bode poorly for equities</u>. So once again, the trajectory of the U.S. stock market in 2024 is dependent on how inflation behaves over the next months.

And, of course, a lot else can go wrong. There is the usual list of geopolitical concerns, with a potential broadening of the current war in the Middle East a top concern. And it seems that nobody can truly fathom how a Trump win in 2024 might affect markets.

Politics aside, after this year's run-up, better corporate earnings will be needed to drive the U.S. market higher given current valuation levels, and this may be tough because real wages are finally rising and more debt will need to be refinanced at higher rates. Much here depends on productivity (recently surging) but this may not last, and we can't expect the productivity-enhancing potential of AI to fill the gap yet.

In summary, it seems that 2024 is shaping up to be another year of the markets responding to the Fed's every word and adjusting expectations accordingly. This means it's likely to be another volatile one in markets.

Artemis Strategy

It's been tough navigating the markets over the last few years. Standard economic models and relationships haven't held, and we (and I mean everyone) still don't fully understand the various ways the pandemic distorted the global economy. A key learning for us is that active management (even at the macro level) can be a high-risk gamble in such an environment. Indeed, we largely bought into the consensus view over the last few years, which for the reasons already discussed, didn't always pan out. Thankfully, as a small firm we are able to be fairly nimble and adjust our tilts in pretty short order, but it still hurts to be wrong.

With this key learning in mind, we are not making any sizeable bets currently as, in my view, we are still in a poorly understood post-pandemic recovery environment. As such, our portfolios are fairly balanced between U.S. large growth and value, our quality tilt is not extreme, and our thematic sleeve (now only in select client portfolios) is focused on fewer, high-conviction ideas. Finally, we do overweight the U.S. relative to the global equity benchmark, but we are not putting all of our eggs in the U.S. market.

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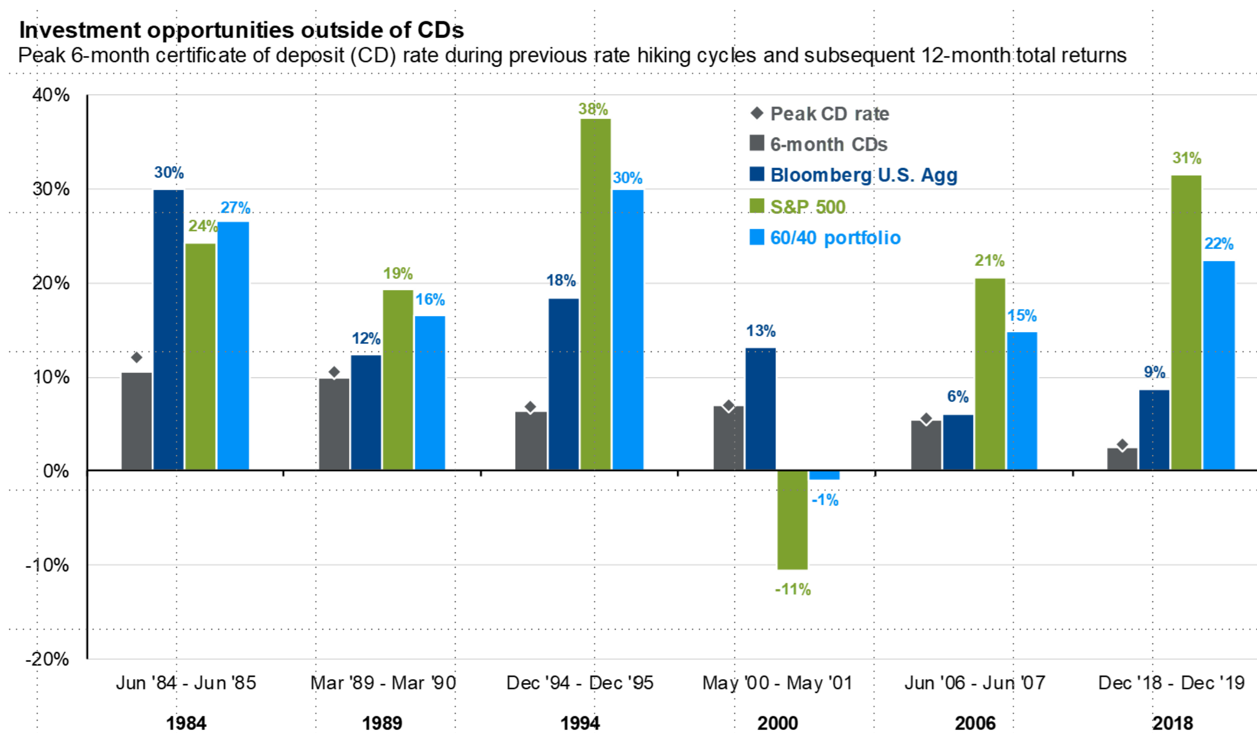
We are, however, gently encouraging folks to reconsider their cash allocations as these are likely to be even more of a drag on performance going forward. As we all know, 2023 was the year for cash, but in the end, investors would have been better off holding fixed income, given how the market turned out. Better still, simply holding one's total allocation in a 60/40 mix (i.e., not carving out a cash holding), would have given investors over 3x the return they got in cash. Figure 3 shows that once CD rates hit a peak, they perform poorly on a relative basis in the next 12 months. But you might argue that this is yet another historical relationship that may not hold in the current environment and you may/may not be right. Yet investing is an odds game and we do think the odds favor bonds over cash in 2024.

Figure 3. Asset Class Returns Following a Peak Rates in CDs



Source: JP Morgan