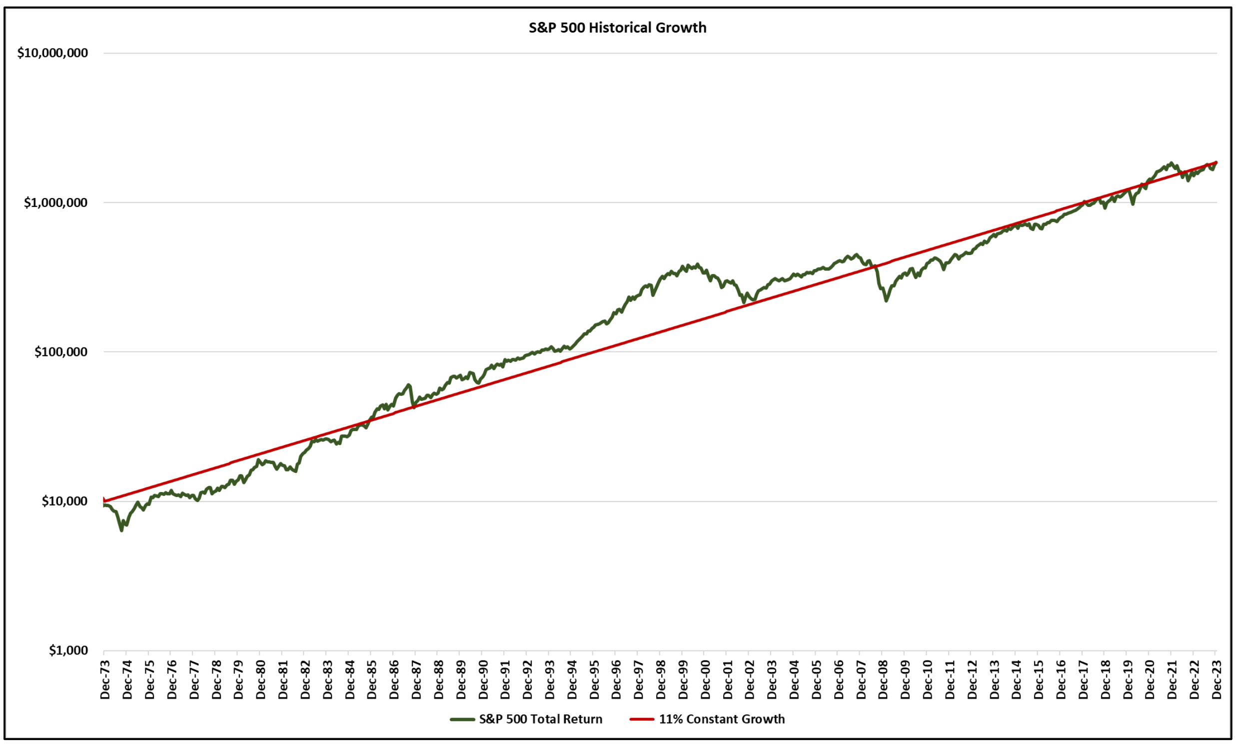
Monthly Investment Update

February 2024

A good friend and colleague astutely pointed out that our 2024 Outlook: “Finally Normal” [2024 Outlook - Finally Normal IRP.pdf] was fairly optimistic and may have not presented risks facing the market and economy in a fair and balanced manner (the second part being my inference of his statement). So, we will focus this month on some of the most prevalent risks out there. But first, the obligatory “stocks for the long run” argument:

The S&P 500 has returned 11% per year over the last 50 years, but never in a straight line. And, just the last five years, we’ve experienced three distinct declines of 20% or greater.[1] Just because markets go up in the long run due to innovation and economic growth does not mean we should ignore risks. Clients have entrusted us to steward their wealth, so we cannot only be blindly optimistic permabulls; we must be careful risk managers as well. Balancing these two roles should provide the best risk adjusted returns to help our clients achieve their long-term objectives in the smoothest manner that we can. This leads to better sleep and fewer emotionally-driven decisions.



“He likens the market to an excitable dog on a very long leash in New York City, darting randomly in every direction. The dog’s owner is walking from Columbus Circle, through Central Park, to the Metropolitan Museum. At any one moment, there is no predicting which way the pooch will lurch. But, in the long run, you know he’s heading northeast at an average speed of three miles per hour. What is astonishing is that almost all the market players, big and small, seem to have their eye on the dog, and not the owner.”

-Bill Bernstein, The Four Pillars of Investing: Lessons for Building a Winning Portfolio

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[1] Bloomberg as of January 31, 2024

One more thing before we go into the risks of 2024: a fun study of history. We experienced a new all-time high for the S&P 500 in January for the first time in more than two years. Going more than a year between all-time highs is actually a quite rare occurance, having only occurred 15 times in the last 75 years. And, in all but one of those occasions, the market continued to advance over the subsequent twelve months.[2] In isolation, this is not a reason to be bullish for 2024, but it cetainly helps the case.

S&P 500 returns after making a record high for the first time in at least a year

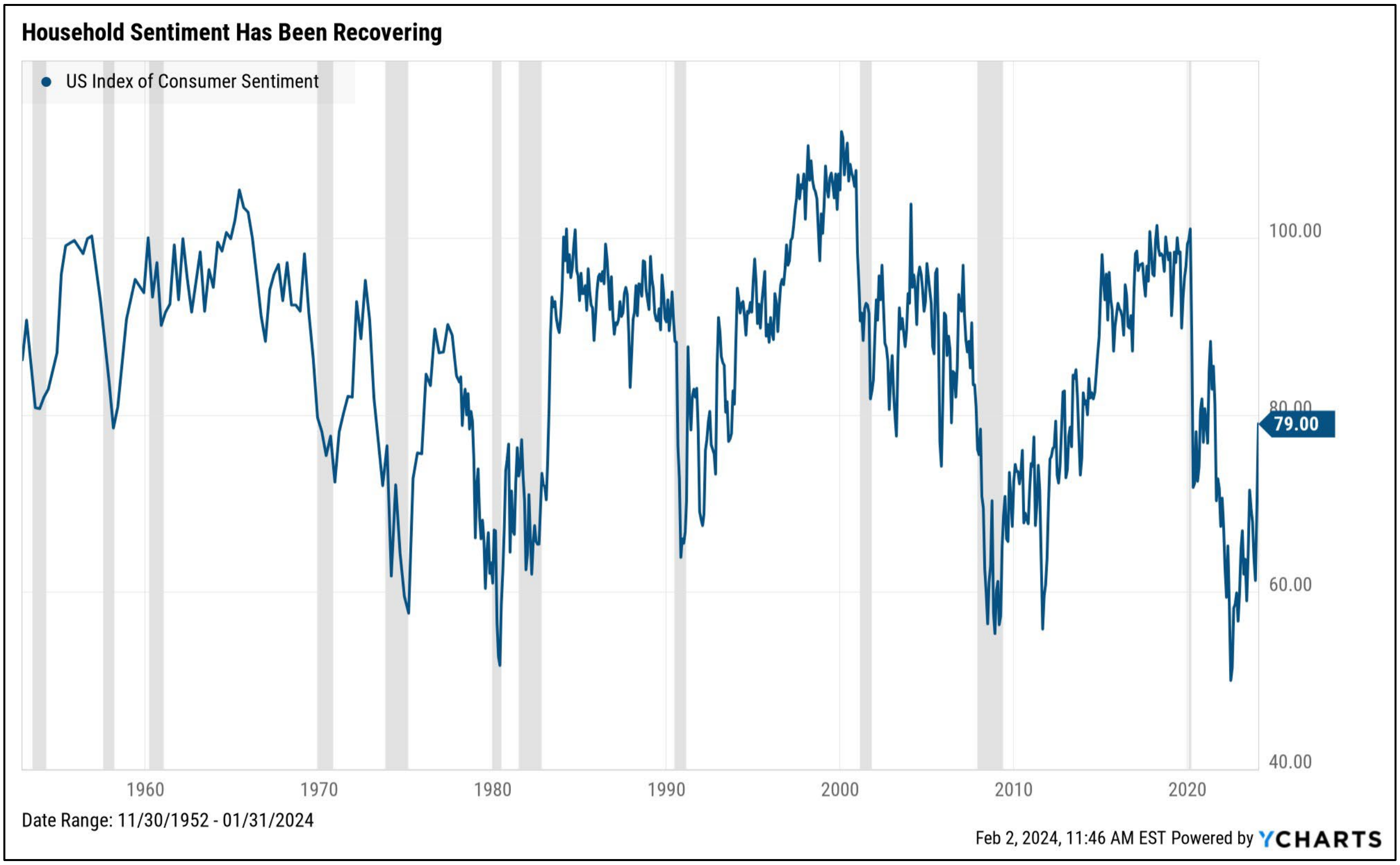
Date	1 months later	3 months later	6 months later	12 months later	Years since previous record high
09/22/54	0%	10%	15%	42%	29
09/24/58	2%	9%	11%	14%	2.1
01/27/61	4%	7%	9%	11%	1.5
09/03/63	0%	2%	7%	13%	1.7
05/04/67	-6%	1%	-2%	5%	1.2
03/06/72	0%	0%	3%	5%	3.3
07/17/80	4%	10%	11%	8%	7.5
11/03/82	-3%	0%	14%	15%	1.9
01/21/85	3%	3%	11%	18%	1.3
07/26/89	4%	2%	-2%	6%	1.9
02/14/95	3%	9%	16%	37%	1.0
05/30/07	-2%	-6%	-7%	-9%	7.2
03/28/13	2%	3%	8%	18%	5.5
07/11/16	2%	1%	7%	14%	1.1
01/19/24	?	?	?	?	2.0
Average	1%	4%	7%	14%	
% Positive	**71%**	**93%**	**79%**	**93%**	

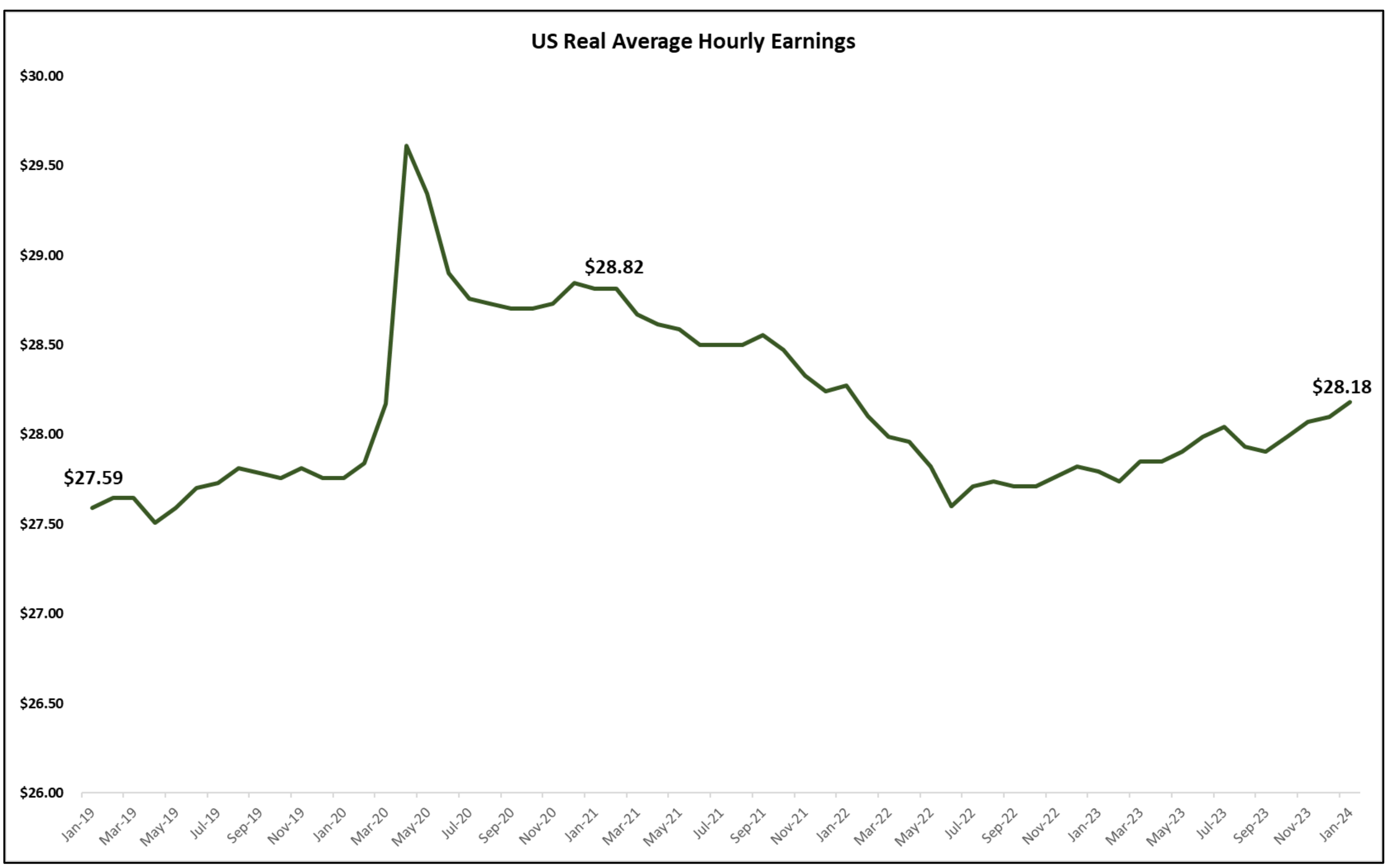
Now for a deeper dive into the risks:

Will household spending slow and cause a recession?

Inflation has been a leading cause of below-average household sentiment over the last two years. In fact, household sentiment reached **its lowest measure in recorded history** in June of 2022 when year-over-year inflation was at its peak. Note that this was occuring during a time when unemployment was low, and the measure was below that of all past recessions, wars, etc. One could speculate why people felt worse in 2022 than during the 2008 financial crisis, September 11th, the Vietnam War, etc., but I might guess it has something to do with 24 hour news and social media intruding into our everyday lives (but I digress). Nevertheless, inflation was a large contributing force to negative sentiment, but as inflation has begun to subside, sentiment has been rising. It is noteworthy that inflation-adjusted earnings have barely budged in five years and are actually lower over the last three years. Five years ago, US average hourly earnings began at $27.59. If we project that forward and stripping out the impact of inflation over the subsequent five years, hourly wages only advanced by $0.59, or roughly 0.4% per year. Obviously, this is not a crisis, but five years of little-to-no gain in prosperity for the average American could certainly be fatiguing. Encouragingly, we have begun to see wages rise faster than expenses once again beginning in 2023, a trend that we hope will continue. Additionally, household debt payments as a percentage of income is relatively low, and the majority of household debt today is long-term fixed rate mortgages. All of these things bode well for household sentiment to continue to rise.

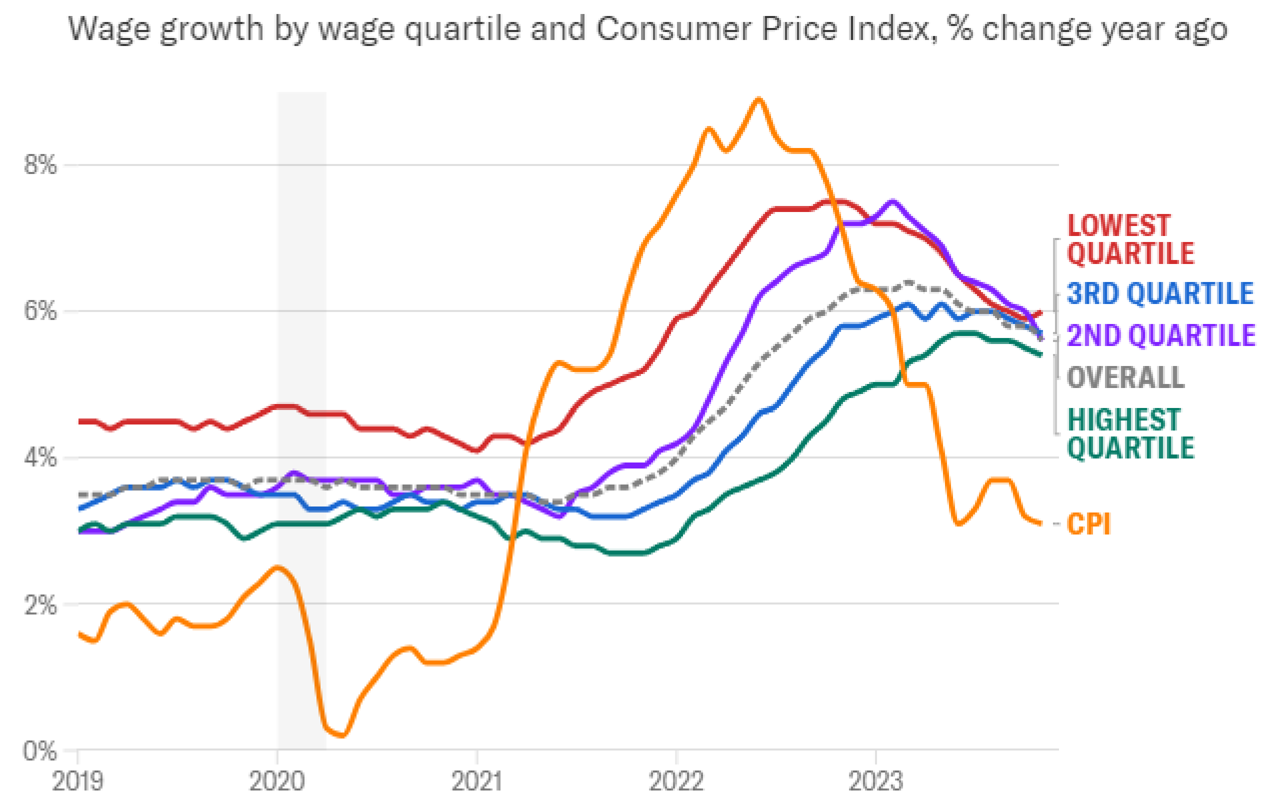
[2] Bank of America





[3]

[3] Bloomberg, Bureau of Labor Statistics



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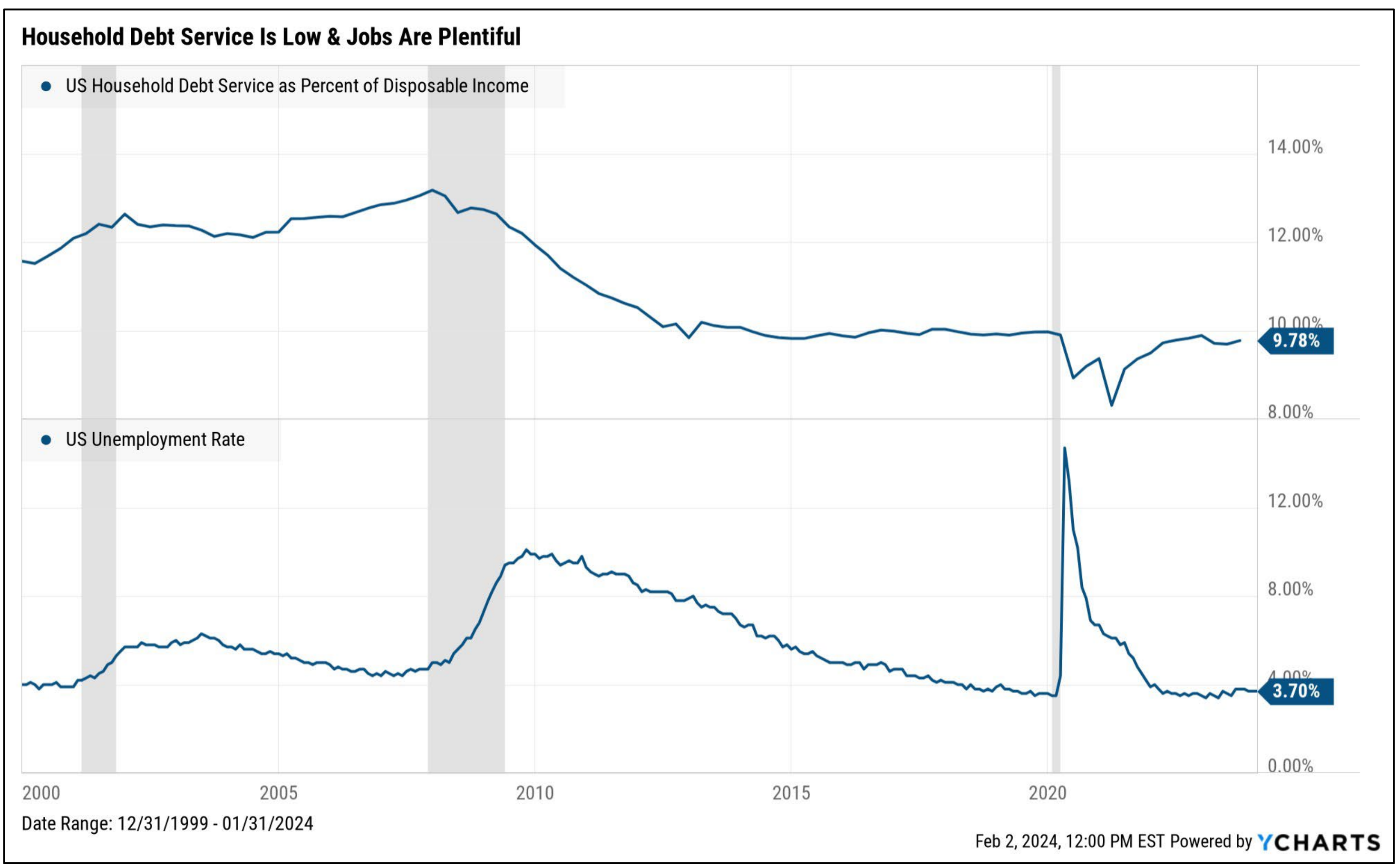
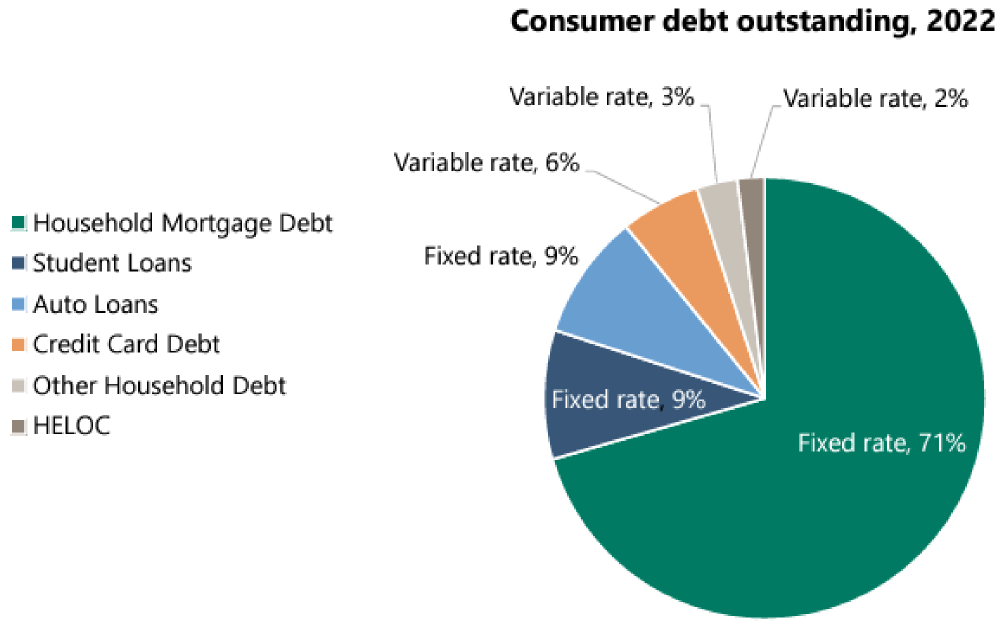


4 Source: Bureau of Labor Statistics

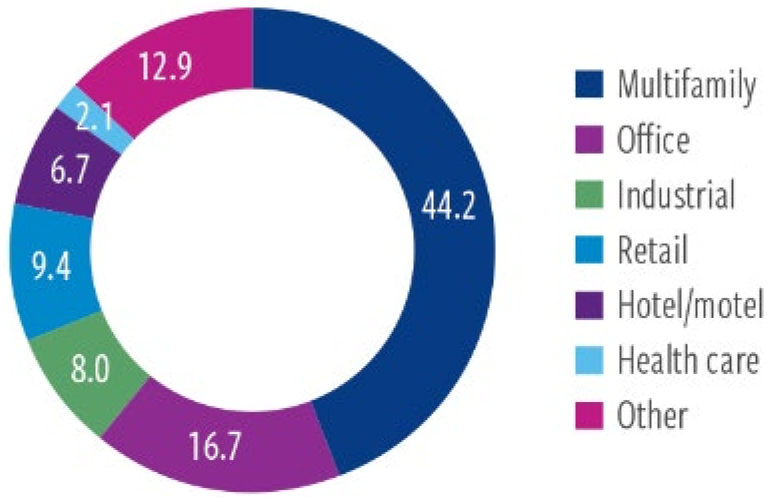
89% of US consumer debt is fixed rate (mortgage, student, and auto loans)



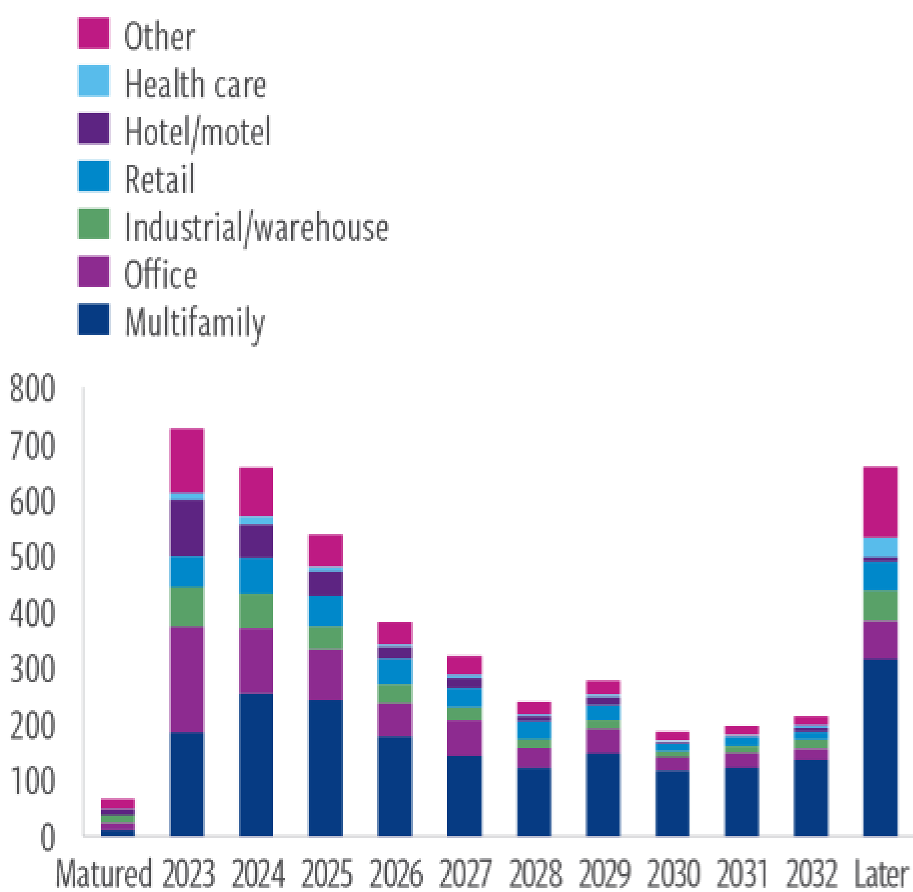
Source: FRBNY Consumer Credit Panel, Haver Analytics, Apollo Chief Economist

What's going on in commerical real estate? Are vacant office buildings and the banks financing them about to implode? What happens when they need to be refinanced?

The commerical real estate mortgage market is roughly $4.5 trillion in outstanding loans with roughly 40% held by banks. Regional and community banks hold approximately 30% of all commerical real estate debt outstanding, and this exposure represents 20% of their assets, on average. There are 4,600 banks outside of the top 100 across the US that hold up to 20% of all CRE mortgages, which should significantly held to reduce systemic risk. Office real estate is absolutely a problem, but the risks should be relatively isolated given that these loans represent just 17% of all CRE mortgages outstanding.[5] We believe there will be pockets of stress by geography and lender, but we do not see signs of commerical real estate causing broad economic stress in 2024.



Debt maturities by property type and lender type ($)



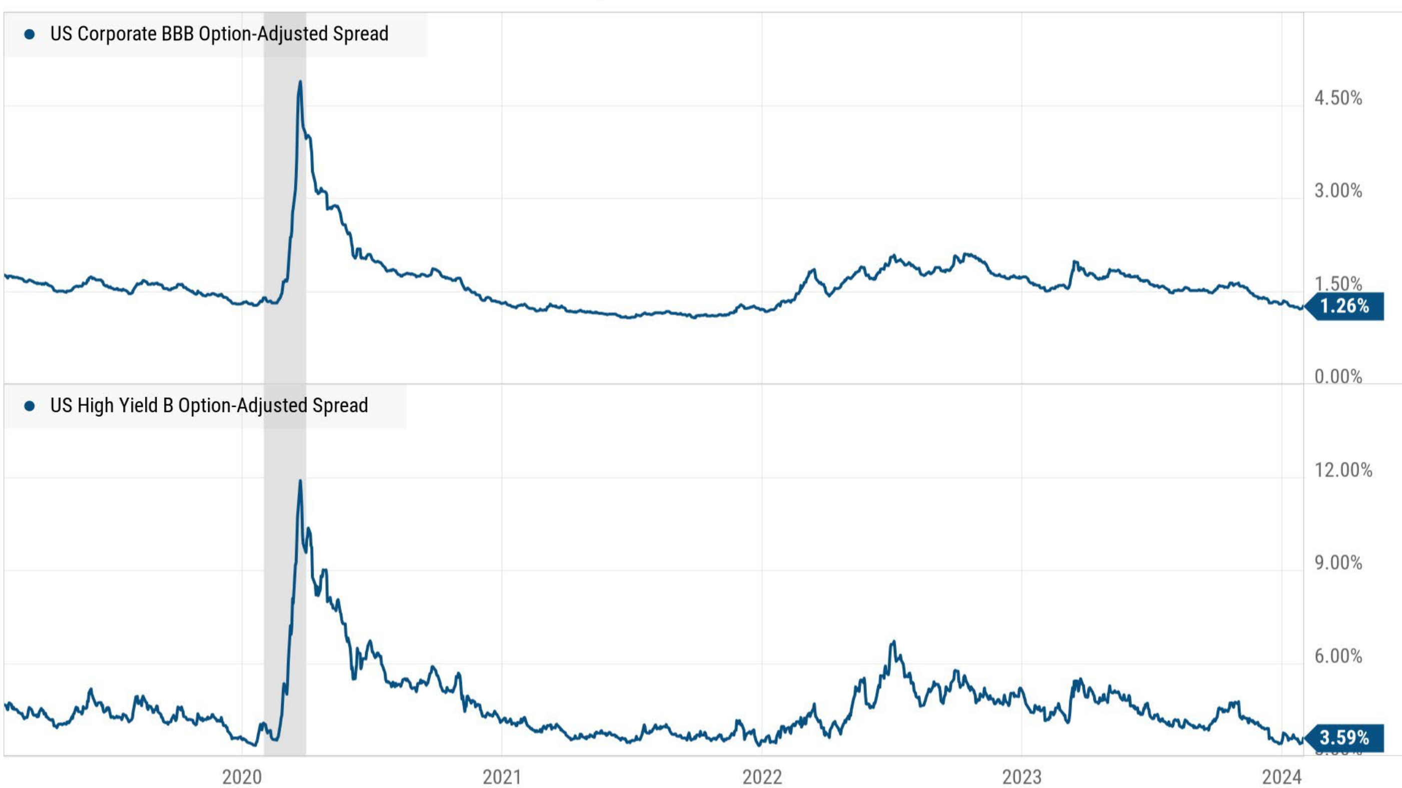
[5] Source: Cohen & Steers as of March 2023.

Loans as a percentage of total bank assets

Bank size	# of banks	% of total assets	CRE as % of total	Office as % of total	% of total bank CRE	% of total CRE mortgages
Top 25	25	64.9	4.3	0.5	30	13
\$10bn – \$160bn	135	20.6	16.2	2.0	36	16
\$1bn – \$10bn	829	9.7	24.3	3.2	25	11
\$100mn – \$1bn	2,965	4.6	18.3	2.6	9	4
<\$100mn	761	0.2	7.2	1.1	0	0
Total	**4,715**	**100**	**9.3**	**1.2**	**100**	**45**
Region & community	**4,690**	**35.1**	**18.6**	**3.0**	**70**	**32**

[6]

The Bond Market Doesn't Seem Worried About A Default Cycle



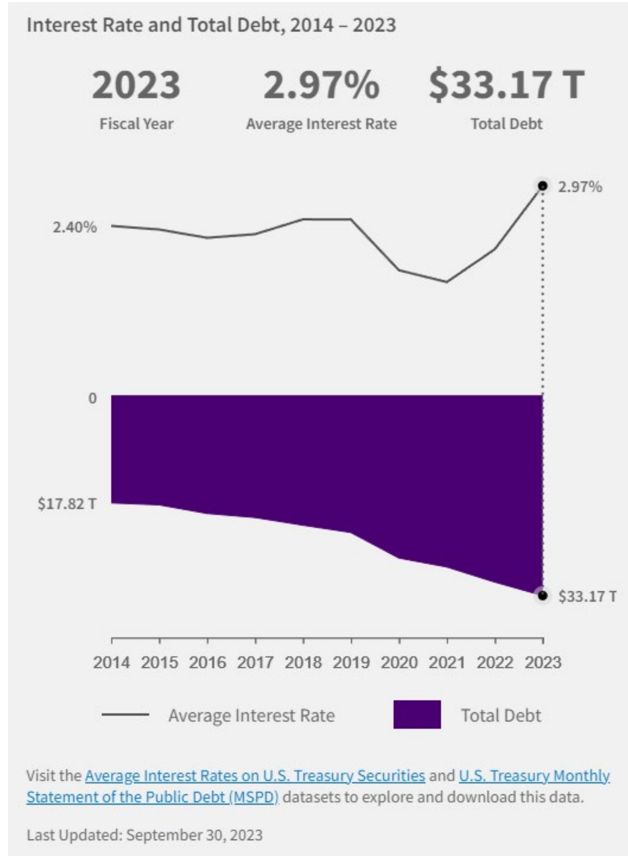
Date Range: 02/01/2019 - 01/31/2024

Feb 2, 2024, 12:25 PM EST Powered by YCHARTS

[6] Source: Cohen & Steers as of March 2023.

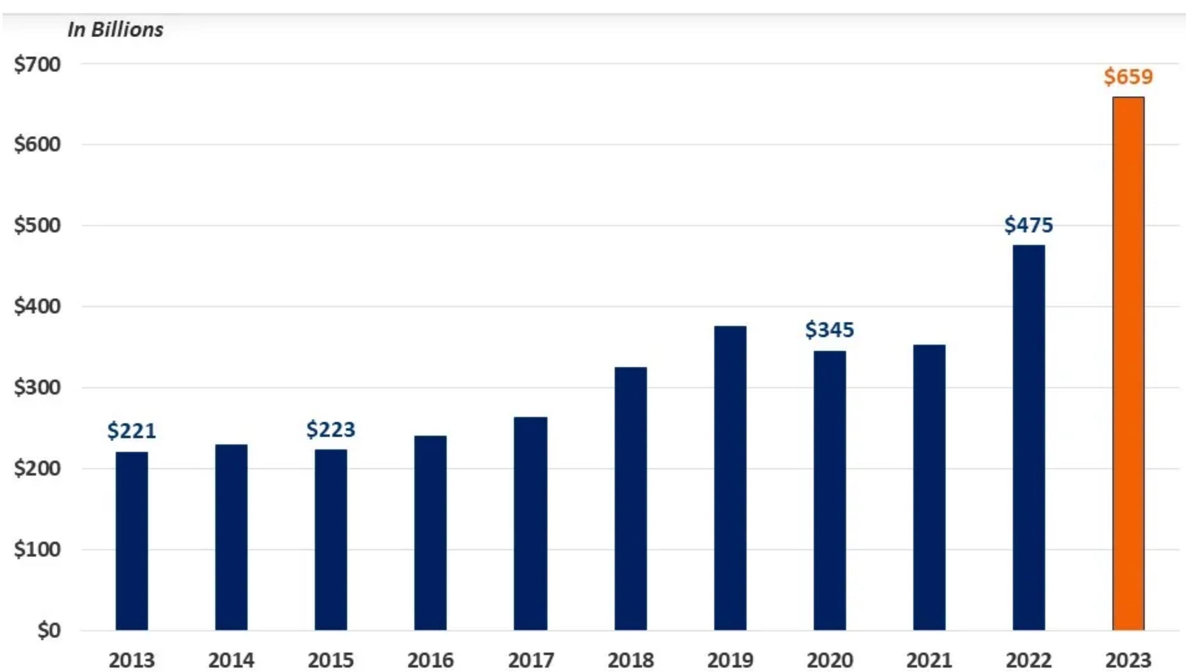
How do government deficits impact the economy today and in the future? Is military spending artificially propping up the economy?

In the 4th quarter of 2023, US real gross domestic product rose 3.3% (annualized rate) with total government spending accounting for 0.6% of the increase coming from government expenditures and investment (just 0.1% from military spending). Total GDP in 2023 for the US was $27.4 trillion, with approximately $1 trillion coming from national defense spending. Defense spending has increased over the last decade, but not at a pace materially greater than real GDP.



The bigger question is, can we pay for it? With total government consumption representing $4.7 trillion of a $27.4 trillion economy in 2023, is there a risk that this contribution to economic activity is unsustainable due to budget deficits and higher interest costs? Yes.

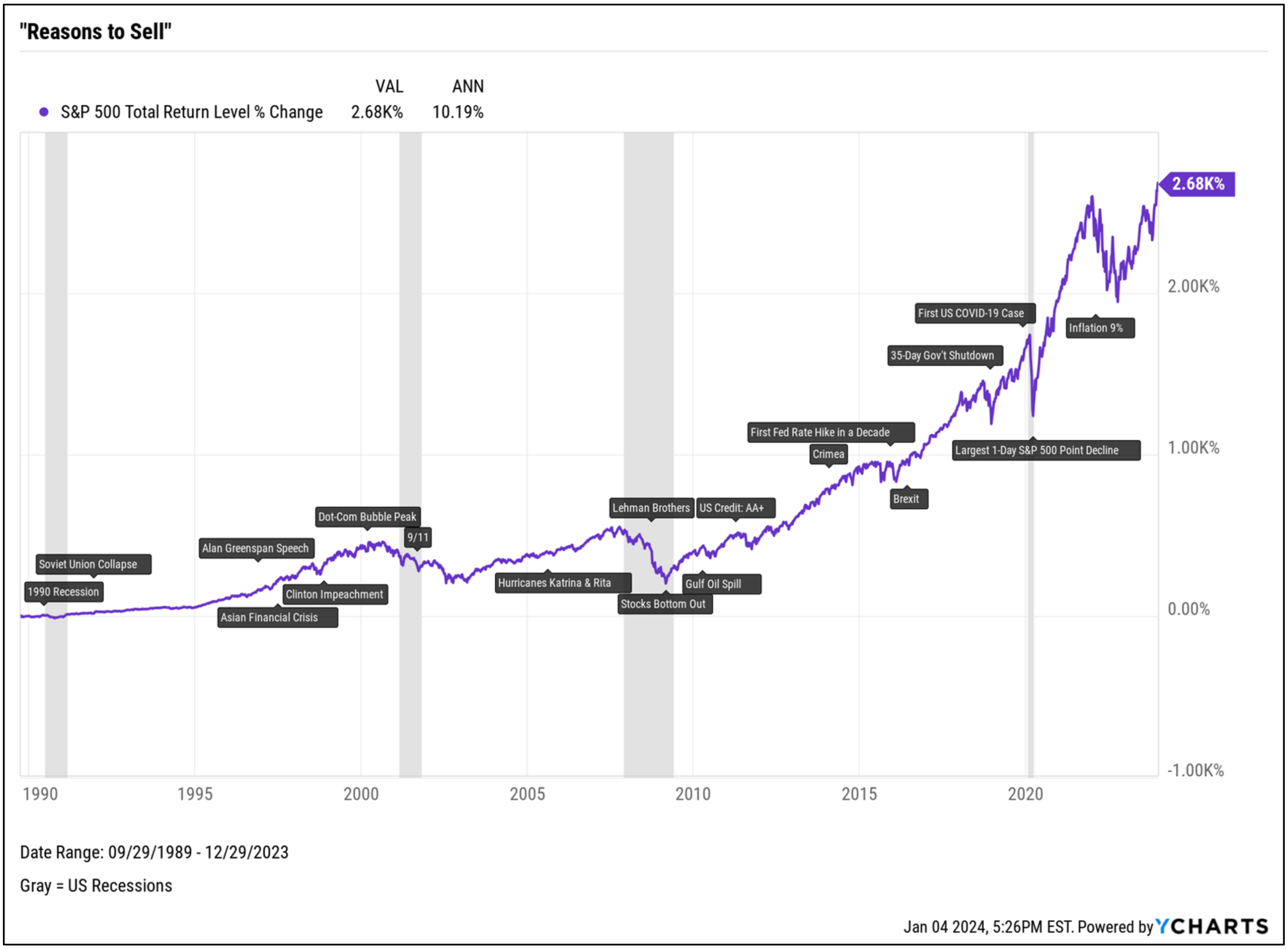
The US is absolutely on an unsustainable fiscal path, but predicting when that path becomes a crisis is very difficult. For now, we don't see signs of a collapse in the US Dollar or inability for the US to borrow to finance its deficits. If left unchecked, that day will come, but no one can know when or why or how. For a deeper dive into the history and dynamics of national debt crisis, I recommend Ray Dalio's "The Changing World Order: Why Nations Succeed and Fail". In the meantime, its increasingly likely that federal interest costs could crowd out other government spending on infrastructure and education, potentially eroding our competitive position in the world. But, we have an absolute powerhouse of an economic engine for innovation and growth in this country, and we remain optimistic that will be in place for decades to come.



Congressional Budget Office as of September 30, 2023

We could go on and on with potential risks, but I think the letter is long enough for this month. There is an old investing adage that, "bull markets climb a wall of worry." So, as long as there is balance and due focus on risks among investors, I feel OK. When everyone stops worrying about risks and see nothing but clear skys ahead, that's probably when we should start to take cover. For now, the US economy is growing, companies are growing, inflation is moderating, interest rates are moderating, households are in decent financial shape, sentiment is improving, and valuations across many asset types look reasonable. Things are OK. Of course, there are risks, both known and unknown. There always are.

Thank you for the opportunity to steward your wealth and for the trust you've placed in us. Navigating the complexities of global economies and markets on your behalf is an honor and a privilege that we take very seriously. We look forward to a prosperous 2024 together.



Outlook & Positioning Summary

Economy

✓ Economic Growth	3.3% US Gross Domestic Product (Q4 2023)
✓ Employment	Solid, but showing signs of slowing
✓ Households	Low fixed rate mortgages, unemployment low, wages growing, inflation moderating, sentiment rising
• Financial Conditions	Inflation Remains Above Target, Interest Rates Elevated, Bank Lending Declining. US Government Spending on Infrastructure.

Markets

✓ Valuation	Many Assets Trading At-or-Below 15-20 Year Averages
• Earnings	Outperforming expectations but relatively modest growth
• Trend	Equity markets are being driven by the anticipated direction of interest rates.
• Investor Sentiment	Investors quickly turned bullish in Q4, but starting to moderate

Asset Class Returns

Category	Representative Index	1 Month	YTD	2023	1 Year	3 Years	5 Years
US Large Companies	S&P 500	1.7%	1.7%	26.3%	20.8%	11.0%	14.3%
US Large Companies	S&P 500 Equal Weight Index	-0.8%	-0.8%	13.9%	5.2%	9.3%	11.5%
US Dividend Companies	WisdomTree High Dividend Index	-1.4%	-1.4%	0.2%	-4.2%	10.3%	7.4%
US Growth Companies	Russell 3000 Growth	2.2%	2.2%	41.2%	33.1%	9.0%	17.3%
US Value Companies	Russell 3000 Value	-0.2%	-0.2%	11.7%	5.7%	8.9%	9.1%
US Small Cap Equity	Russell 2000	-3.9%	-3.9%	16.9%	2.4%	-0.8%	6.8%
Global Equity	MSCI All-Country World	0.6%	0.6%	22.2%	14.7%	6.1%	10.2%
Foreign Developed Equity	MSCI EAFE	0.6%	0.6%	18.2%	10.0%	4.6%	6.9%
Emerging Market Equity	MSCI Emerging Markets	-4.6%	-4.6%	9.8%	-2.9%	-7.5%	1.0%
US Fixed Income	Bloomberg Barclays US Agg. Bond	-0.3%	-0.3%	5.5%	2.1%	-3.2%	0.8%
US Fixed Income	Bloomberg Barclays Municipal Bond	-0.5%	-0.5%	6.4%	2.9%	-0.8%	2.0%
Global Fixed Income	Bloomberg Barclays Global Agg. Bond	-1.4%	-1.4%	5.7%	0.9%	-5.7%	-0.9%

Source: YCharts as of January 31, 2024. Annualized returns for data longer than 1 year

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