

DECEMBER 31, 2023

Market Summary

U.S. Equity Markets (%)	4Q'23	1 Year	3 Years	5 Years	10 Years	Top/Bottom Sectors (%)	4Q'23	1 Year	Price Comparison (in USD)	Dec. 31, 2022	Dec. 31, 2023
S&P 500	11.7	26.3	10.0	15.7	12.0	Real Estate	18.9	12.2	Oil (WTI spot)	\$80.51	\$71.65
Russell 1000 Growth	14.2	42.7	8.9	19.5	14.9	Info. Technology	17.2	57.8	Natural Gas	\$4.08	\$2.33
Russell 1000 Value	9.5	11.5	8.9	10.9	8.4	Financials	14.1	12.5	Gold	\$1,830	\$2,072
Russell 2000	14.0	16.9	2.2	10.0	7.2	Health Care	6.4	2.0	Fed Funds Rate (Upper Target)	4.50%	5.50%
Russell 2000 Growth	12.8	18.7	-3.5	9.2	7.2	Cons. Staples	5.6	0.6	10-Yr Treasury	3.84%	3.88%
Russell 2000 Value	15.3	14.7	7.9	10.0	6.8	Energy	-6.9	-1.4	VIX	21.67	14.08
Non-US Equity Markets (in USD) (%)	4Q'23	1 Year	3 Years	5 Years	10 Years	Non-US Regions (in USD) (%)	4Q'23	1 Year	Non-US Regions (in USD) (%)	4Q'23	1 Year
MSCI AC World Ex-U.S.	9.8	15.6	1.6	7.1	3.8	Developed Americas	11.3	15.9	Emerging Americas	18.0	33.3
MSCI EAFE (Developed)	10.4	18.2	4.0	8.2	4.3	Developed Asia	9.3	15.4	Emerging Asia	6.9	7.5
MSCI Emerging Markets	7.9	9.8	-5.1	3.7	2.7	Developed Europe	11.2	20.5	Emerging EMEA	8.5	8.6

Source: MSCI, S&P Global, LSEG; Refinitiv, St. Louis Federal Reserve Bank; Periods greater than one-year have been annualized

Economic & Market Highlights

- Beginning in late October, global equity markets reversed a three-month decline in dramatic fashion with the MSCI ACWI Index rising almost 15% over the last two months of the year.
- The rally in equity markets was fueled by a striking drop in interest rates as the yield on the 10-year US Treasury fell from 5.0% to 3.9% from late October through year-end.
- Small cap stocks outpaced large caps in the risk-on market rally although the Magnificent-7 (Apple, Microsoft, Amazon, NVIDIA, Alphabet, Tesla, Meta, aka Mag-7) were not exactly left behind as the group rose over 13% for the quarter.
- The effects of the policy led boom-bust inflationary cycle of the past four years is finally waning as the disinflationary process is in effect on a global basis. Accordingly, Central Bank policy rates have peaked and a pivot toward policy easing in 2024 seems likely.
- Whether inflation in the U.S. can reach the Federal Reserve's 2% target without at least a mild recession is yet to be seen. But Europe, Japan and China are all clearly in a recessionary cycle which is helping to slow the pace of inflation in the U.S.
- The U.S. labor market remains tight but has been coming into better balance over the last few months mostly through reduced demand.

Earnings & Valuation Highlights

- The corporate earnings recession that began in the second half of 2022 abated as S&P 500 earnings rose better than 7% YoY for Q3'23.
- Valuations on an equal-weighted basis look reasonable as earnings are poised to continue their upward march, that began last quarter. U.S. markets look more richly valued on a market-cap-weighted basis although much of the earnings growth over the next year will come from the largest companies.

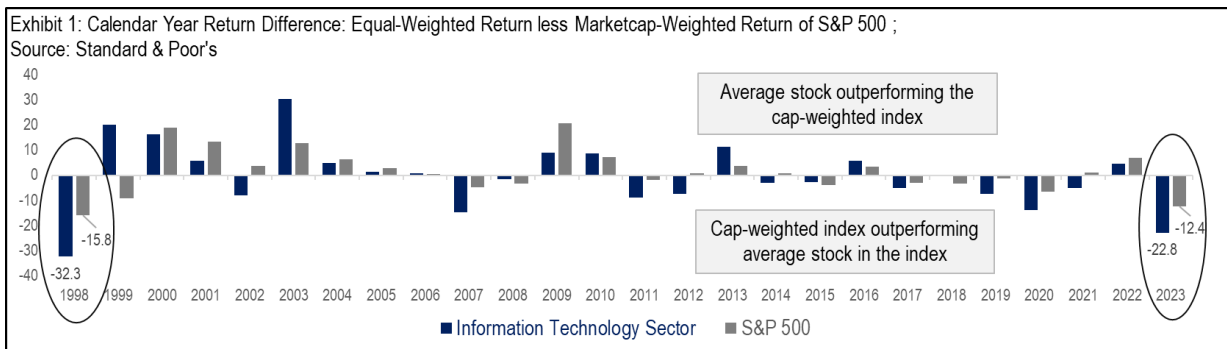
Will the Magnificent-7 Come Down to Earth in 2024?

Calendar year 2023 marked the largest outperformance of the market-cap-weighted S&P 500 Index relative to the average stock in the index since the height of the Dotcom Bubble in 1998. For the year, the S&P 500 Index outpaced the average stock in the index by 12.4%. Communi-

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cation Services stocks saw the largest divergence in return between the average stock and the benchmark sector return at 35.7%, followed by Information Technology at 22.8% and Consumer Discretionary at 18.8% (see Exhibit 1). These three sectors accounted for 46% of the benchmark weight and 87% of the benchmark return. Information Technology had the biggest impact as its return contribution was over twice the 27.5% average



weight of the sector. U.S. Equity market index concentration has reached historic highs. Statistics of note are that the top ten holdings in the S&P 500 and Russell 1000 Growth account for more than 30% and 50% of the index weight, respectively, both all-time highs. The weight of the top ten U.S. companies in the MSCI All-Country World Index is larger than the weight of the next five largest countries combined (Japan, United Kingdom, France, Canada and China). Index concentration alone is not necessarily a catalyst for change, but the last period that saw U.S. equity market indices reach unprecedented levels of concentration was December 1999, at the tail end of the Dotcom Bubble, and following that period the average stock in the S&P 500 Index outpaced the cap-weighted index by more than 80%, on a cumulative basis, over the next seven years from Jan. 1, 2000 through Dec. 31, 2006.

The impact of the Mag-7 on the total return of the index was also a significant driver of the return differential between the average stock and the cap-weighted indices. The Mag-7 began the year representing 20.1% of the S&P 500 Index and finished the year at an astonishing 40% higher weighting of 28.2%. For the year, the weighted return of the group was 87% with an average return of 112% and the group accounted for over 60% of the index return (of note in 1998, during the Dotcom Bubble, 24 stocks were required to reach the same level of benchmark return contribution as the Mag-7 delivered in 2023). Of course supporting those staggering returns was a 16% growth in revenues and better

	Average F12M P/E	Cap-Wtd F12M P/E	Cap-Weighting Impact	Average F12M EPS Growth	Cap-Wtd F12M EPS Growth	Cap-Weighting Impact	Earnings Weight Sector	Cap-Weight of Sector	Cap Weight / Earnings Weight
Communication Services	19.6	20.1	0.4	19.4	27.7	8.3	9.9	8.8	89%
Consumer Discretionary	20.1	34.1	13.9	17.2	27.5	10.3	8.5	11.3	132%
Consumer Staples	19.2	22.4	3.2	5.8	6.1	0.3	6.5	6.3	97%
Energy	11.7	11.7	(0.1)	7.1	(0.5)	(7.7)	7.2	4.1	57%
Financials	15.7	17.8	2.1	6.1	8.3	2.2	17.8	13.3	75%
Health Care	22.9	23.1	0.2	7.2	15.3	8.1	14.2	12.8	90%
Industrials	22.9	23.8	0.9	10.2	14.4	4.2	8.9	9.0	101%
Information Technology	27.5	29.4	1.9	11.5	19.2	7.7	21.7	29.6	137%
Materials	18.8	21.9	3.0	1.1	6.3	5.1	2.5	2.5	100%
Utilities	15.6	16.4	0.7	12.2	11.1	(1.1)	2.9	2.4	83%
Total	17.2	20.6	3.4	9.6	11.3	1.7	100.0	100.0	
Magnificent-7*	35.5	33.0	(2.5)	25.3	20.9	(4.3)	18.8	28.2	150%

* Apple, Microsoft, Amazon, NVIDIA, Alphabet, Tesla, Meta

than 33% increase in earnings, figures that dwarfed the average company. The relevant question for investors is whether the Mag-7 will continue to

dominate index returns. Looking purely at prior periods of extreme concentration would indicate that investors would be well-served to reduce exposure to the concentrated, cap-weighted indices (as noted above). The group currently constitutes a significantly larger capitalization-weight in the index, 28.2%, than their earnings weight, 18.8%, even when forward earnings growth estimates are used (see Exhibit 2). Through this lens, the group could be viewed as relatively expensive compared to the rest of the S&P 500 Index. However, this fails to fully account for the higher growth metrics of the group.

While the outsized earnings growth of 2023 for this this group for is not likely to fully repeat over the next year, the group is still expected to grow revenues and earnings at 12.2% and 19.2%, respectively. This compares to the average stock in the index expectation of 4.8% revenue and 9.6% earnings growth. More impressive is that on a dollar basis the group is expected to account for a staggering 32% of the earnings

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growth of the S&P 500 over the next year. The old adage in financial markets is that “it’s a market of stocks, not a stock market.” This is true of the Mag-7 as well with some stocks looking more reasonably priced, such as META trading at a price/earnings multiple in-line with its expected earnings growth rate, NVIDIA trading at a discount to its near-term earnings growth rate, and others looking more expensive such as Apple trading at more than four times its expected growth rate. Whether the valuations of any of the Mag-7 is defensible will largely depend on their ability to grow their earnings at or above current expectations over the coming years. Should the companies successfully deliver on their earnings expectation the companies have a fair likelihood of continuing to deliver attractive stock returns, but at their current valuation of an almost two-times premium to the average stock, investors have far less margin of safety and any misstep in revenue or earnings growth is likely to be met with a swift and painful re-setting of the stock price. This also means that passive, cap-weighted strategies, could struggle versus strategies with more room to diverge from the concentrated mega-cap exposures in the large cap indices.

Conclusion

Inflation has been receding and the U.S. economy continues a path toward normalization while generally outpacing expectations. One of the main reasons why the U.S. avoided a recession in 2023 was consumers continued to spend despite rising prices, of course a strong labor market aided this spending in no small degree. But signs of some slowing and re-balancing of the labor market are showing and the resilient consumer spending of the past few years is not likely to be repeated in 2024. There is still a reasonable chance the U.S. avoids a recession while Europe, Japan and China are not so lucky. Global Central Banks are now clearly shifting toward a rate cutting stance and this is becoming fully reflected in equity and bond market prices. As in any environment, there remain a multitude of risks to the global economy and financial markets. The most obvious risks appear to be interest rates remaining “too high for too long” and mounting geopolitical risks in Europe, Middle East and Asia. The rise in risks are taking place at a time when governments are constrained in their ability to respond to any calamities with fiscal stimulus as debt dynamics are far less attractive than at any point since the Global Financial Crisis. The shift from growth to contraction can happen quite swiftly. Since WWII real GDP in the quarter prior to the U.S. economy entering recession has averaged 3.5% with a median of 2.6%. The two negative quarters of real GDP to start 2022 followed a 7.0% real GDP print in 4Q’21. Despite the many and varied risks, it is still our base case that if any recession arises it will be very mild and the Fed will respond with a more aggressive rate cut policy than is currently expected. U.S. consumer balance sheets are still reasonably healthy, although in a weakening trend. Corporate balance sheets are in good standing as well. These tail winds along with an environment of high-single digit to low double-digit corporate earnings growth present a fairly attractive set up for financial markets into 2024.

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