Mission Accomplished?

Quick Look

- Year 2023 turned out to be a banner year, defying consensus forecasts as it delivered both above-average economic growth and investment returns.
- The Fed's pivot at their November meeting ignited an everything rally and a peak in rates.
- Bonds gained 4.5% in November, their best monthly return in more than 40 years. With stocks gaining 9% as well, balanced portfolios saw their best monthly return since 1991.
- The last two monthly inflation readings were cooler than expected, dropping annualized inflation to 3.1%, its lowest level since March 2021.
- The current consensus for 2024 calls for an economic soft landing, accompanied by six rate cuts from the Fed.
- The unprecedented fiscal stimulus post-COVID, along with the profusion of debt refinancing by both consumers and corporations in 2020-2021 when rates were still low, has limited the Fed's pass-through effect, as compared to previous tightening cycles.
- This past year was a great reminder that consensus forecasts rarely age well, and often understate the wide range of outcomes that drive short-term market sentiment and make market timing such a costly mistake.

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Opus Capital is an evidenced-based investment advisory firm driven by our overriding mission to help people. We believe the marriage of comprehensive financial planning + statistically proven investment principles creates the clearest roadmap to long-term success.

We are independent and transparent in all aspects of investment management decision making and financial planning. We selectively partner with like-minded individuals and families, endowments, foundations, and 401(k) plans in over 30 states.

Quarterly Investment Letter, Q4 2023

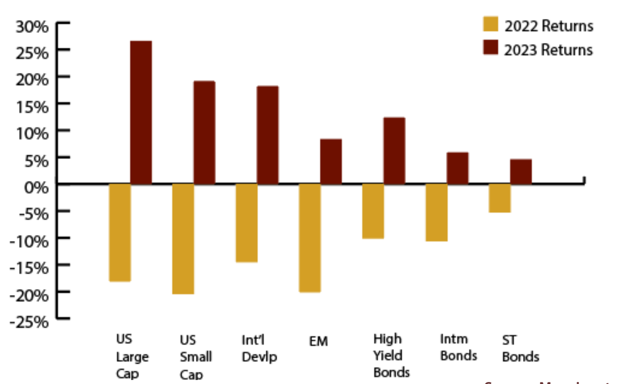
One year ago, investors were licking their wounds from Year 2022, which was the worst calendar year performance of the post-war era for balanced portfolios. Year 2023 was not forecast to be much better. The consensus for 2023 could be summarized as the following:

- The forecast by Wall Street strategists was for stocks to decline (as measured by the S&P 500 Index).
- The economy to enter a modest recession and that annual GDP growth would amount to a paltry 0.3% (the Fed's own forecast was just 0.5%).
- The unemployment rate was forecast by the Fed to jump to 4.6%, resulting in the loss of 1.5 million jobs.
- Inflation would slow to 3.1%, primarily due to the forecasts above.

Forecasts remain as futile as ever. Instead, here is how Year 2023 played out:

- The S&P 500 Index surged 25%+ and is just a fraction away from recovering all its Year 2022 losses.
- Assuming Q4 estimates hold, the economy grew 3% this year, not only defying recession calls, but also growing above long-term trend.
- The unemployment rate held firm below 4%, as 2.8 million jobs were added.
- Inflation slowed to 3.1%, despite the outcomes above.

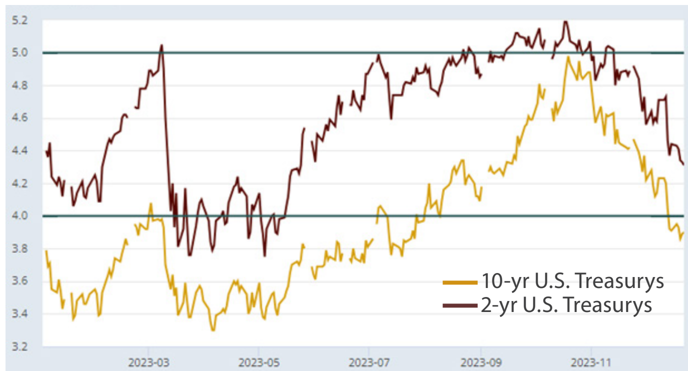
Returns 2022 vs 2023



Source: Morningstar

Year 2023 turned out to be a banner year, delivering both above-average economic growth and investment returns. The latter looked precarious as late as the end of October; stocks were in a 10% drawdown and YTD gains were attributed entirely to the Magnificent-7 stocks, as the other 493 stocks in the S&P 500 Index collectively were negative. Bonds, meanwhile, had posted six consecutive months of losses for the first time in history. The culprit of market weakness for both stocks and bonds at the time was the ascent of Treasury rates, in which both 2-year and 10-year Treasurys had reached 5%, marking their highest level in 16 years.

Market Yields on U.S. Treasury Securities



Source: Federal Reserve

The pivot came at the November 2nd Fed meeting, when the Fed intimated they were potentially finished with rate hikes. Treasury rates immediately fell, igniting an everything rally. Bonds gained 4.5% in November, their best monthly return in more than 40 years. With stocks gaining 9% as well, balanced portfolios saw their best monthly return since 1991. Gains in stocks were no longer exclusive only to the Magnificent-7, as risk assets across the spectrum - unprofitable tech and biotech, banks, REITs, crypto, gold, junk bonds, etc. – all joined the party. U.S. small caps, which had fallen to a 52-week low, rallied 25% to reach a 52-week high by mid-December.

Over the last two months, we also received a slew of surprisingly positive economic data. Q4 GDP growth, previously expected at 1%, finished December tracking near 3%. The last employment report was stronger than expected, as were re-

U.S. EQUITY RETURNS (%)

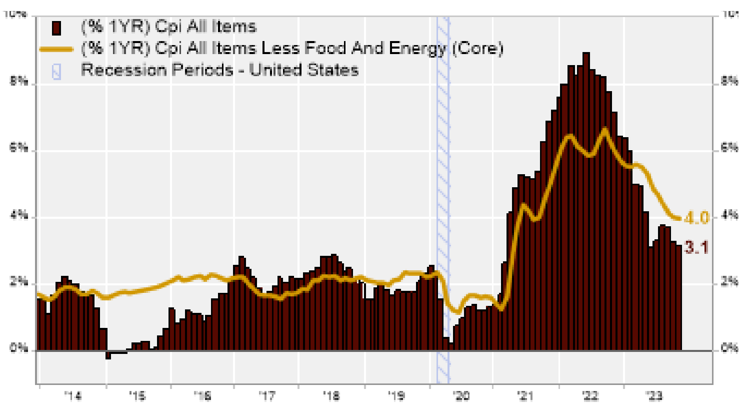
As of 12/31/2023	Q4 2023	1-Year	3-Year	5-Year	10-Year
S&P 500	11.7	26.3	10.0	15.7	12.0
Russell 1000 (Large Cap) Growth	14.2	42.7	8.9	19.5	14.9
Russell 1000 (Large Cap) Value	9.5	11.5	8.9	10.9	8.4
Russell 2000	14.0	16.9	2.2	10.0	7.2
Russell 2000 (Small Cap) Growth	12.8	18.7	-3.5	9.2	7.2
Russell 2000 (Small Cap) Value	15.3	14.7	7.9	10.0	6.8

Source: Morningstar

Continued from page 2 . . .

tail sales. With mortgage rates falling, single family new housing hit a 19-month high in November and are up nearly 10% since last year. Perhaps most importantly, we have had two monthly inflation readings that were cooler than expected, dropping annualized inflation to 3.1%, its lowest level since March 2021. The notion that the economy keeps on trucking while prices are cooling seems incompatible and serendipitous. But also, tremendous! Sign everyone up.

US Consumer Price Inflation



Source: FactSet

As we enter 2024, let's summarize the current market consensus:

- An economic soft landing is the most likely outcome for 2024.
- Fed rate hikes are not only over, but the Fed will also cut the federal funds rate from 5.5% to 4.0% by year-end.
- S&P 500 earnings will grow 12%, a notable improvement over 2023's mild earnings recession.
- Bond yields will be lower in 12 months' time.
- Inflation continues to slow towards the Fed's long-run 2% target.

Juxtaposed to one year ago, markets are pricing in good outcomes. All the pieces matter, but do they all fit together?

The Soft-Landing scenario hinges on the economy's ability to hang in there while the Fed administers the antidote to lower inflation back down to 2%. In past attempts, the antidote has almost always killed the patient, but there is growing conviction that this time will be different. If it does occur, this will be lauded as one of the great achievements in Fed history. The Fed has engineered ten tightening cycles over the last 50 years; 1994-95 would be the only cycle that landed soft. The current cycle would require the economy to digest 5.25% worth of rate hikes, the largest rise in 40 years. Admittedly, to this point it appears on track, but declaring victory already seems premature given the enormity and elusiveness of the task. In our opinion, maybe let's not hang the "Mission Accomplished" banner in the Federal Reserve building halls just yet.

The December Fed meeting only emboldened investors' confidence in the Soft-Landing plausibility. Fed Chair Powell noted that the strong economic activity from the third quarter had moderated, that the labor market was coming back into balance, and that inflation had moderated. The Fed also reduced their Federal Fund rate projection by a half of a percent to 4.6% by next year, and mentioned that the timing for initiating interest rate cuts was a topic of discussion at the meeting. While Powell himself stated "we still have a ways to go" and "no one is declaring victory" over inflation, the takeaway from market participants was to ready the aircraft carrier, because the Fed was preparing for landing.

With inflation declared conquered and economic activity still in good health, the market is ready to see the Fed wrap up their mission by initiating rate cuts. The market-implied probability of a rate cut at the Fed's March meeting has jumped from near 0% at the end of October to an 80% likelihood. This is a remarkable turn of events, given that odds of additional rate hikes were still priced as a 50% probability just two months ago. Fed Funds futures are now implying six rate cuts to occur next year, which is three more than the Fed is forecasting. As can be seen in the chart below, Fed Funds cuts of six (approximately 1.5% of rate cuts) now matches the same amount of rate cuts that was expected when markets were certain of a recession.

Futures-Implied Fed Funds Rate Change in 2024

Source: The Daily Shot

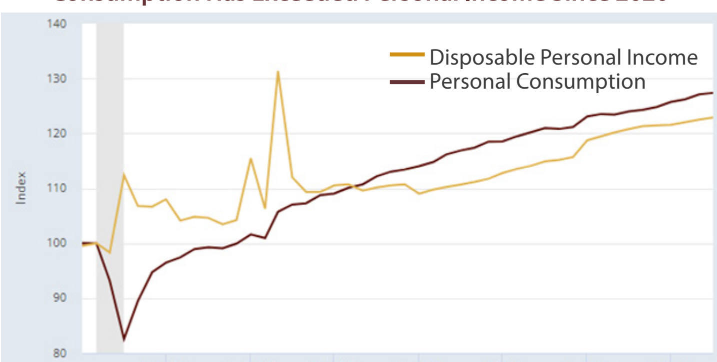
All the above sounds great, but could it be a bit too convenient? The pieces struggle to fit together, and the discussion gets circular.

- It seems highly unlikely the Fed would cut six times without a recession.
- Congruently, it feels you can have either 12% EPS growth or six rate cuts, but not both.
- If six rate cuts are being priced in, some portion must be a hedge against the potential for a hard landing.

- » Bond yields have fallen roughly 1% across the curve in the past two months. Is that really just a reaction to expected rate cuts? Can yields continue to move lower in 2024 without deteriorating growth?
- » Thanks to the rally in stock prices and decline in yields, have financial conditions eased enough on their own without Fed intervention?

Powell himself has admitted to the Fed's surprise in the resilience of the economy. Remember, the Fed's own forecast called for 1.5 million jobs losses this year, all the while knowing that job losses of this magnitude have always coincided with a recession. The Fed was all but calling for a hard landing, and yet find themselves still in play to pull off the Soft-Landing mission, thanks in part to the good fortune of misestimating the employment picture by 4.3 million jobs to the positive. Continued monthly additions to payrolls has, in turn, equated to the resilience in consumer spending. The unprecedented fiscal stimulus post-COVID, along with the profusion of debt refinancing by both consumers and corporations in 2020-2021 when rates were still cheap, has limited the Fed's pass-through effect, as compared to previous tightening cycles.

Consumption Has Exceeded Personal Income Since 2020

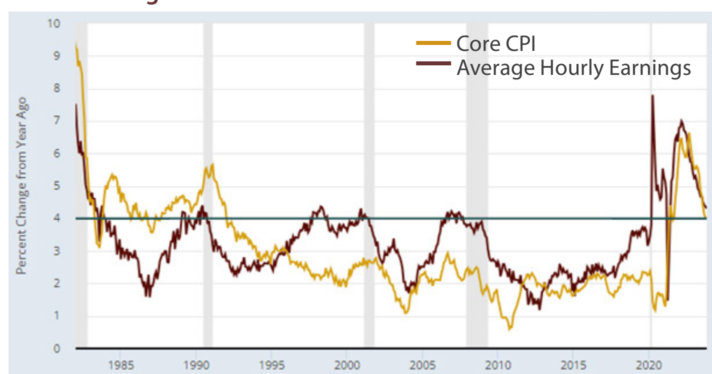


Source: Federal Reserve

Consumer spending has been further boosted by consumers' willingness, or need, to spend down their savings rate, as disposable personal income has trailed personal consumption since the onset of COVID. While disposable personal income has kept up with overall inflation since COVID, it has lagged consumption, and it is probably not a coincidence that consumer sentiment deteriorated once consumption began exceeding income. Savings rates have dwindled down below 4%, which is near historical lows. Perhaps consumers are simply confident in the security of their employment, but it leaves consumers venerable to weather future economic challenges.

On an encouraging note, real wages have turned positive as inflation pressures have receded. This can help rebuild savings and improve purchasing power. Still, the question remains as to how inflation can sustainably slow to 2% if wage growth remains above 4%. It would be convenient if wage increases simply slowed congruently with inflation, but historically, wage pressures typically only subside in conjunction with job losses. Any period of sustained job losses has been the cause, or effect, of a recession.

Wage Growth at 4% Has Preceded Recessions



Source: Federal Reserve

If all of this sounds muddled, or circular, then we have described it correctly. Soft landings are not for just any stuntman. This is Evel Knievel-level stuff. The Fed is halfway over the canyon, but the landing is far from the sure thing being bandied about. This past year was a great reminder that consensus forecasts rarely age well, and often understate the wide range of outcomes that drive short-term market sentiment and make market timing such a costly mistake.

We appreciate your partnership with our firm, and we wish everyone a happy and healthy New Year!

INTERNATIONAL RETURNS (%)

As of 12/31/2023	Q4 2023	1-Year	3-Year	5-Year	10-Year
Int'l Developed ex US	10.4	18.2	4.0	8.2	4.3
Emerging Markets	7.9	9.8	-5.1	3.7	2.7

Source: Morningstar

FIXED INCOME RETURNS (%)

As of 12/31/2023	Q4 2023	1-Year	3-Year	5-Year	10-Year
Aggregate Bond	6.8	5.5	-3.3	1.1	1.8
Muni	6.4	5.6	-0.5	1.9	2.4
Int'l Bonds	7.9	6.7	-4.3	0.0	0.1
High-Yield	6.2	12.1	1.9	4.7	3.7
Short-Term	3.4	5.7	0.1	1.9	1.6
90-Day T-Bill	1.4	5.4	2.5	2.0	1.3

Source: Morningstar

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