BlueTrust

Economic Review & Outlook

First Quarter: 2024

A Glass Half Full or Half Empty?

After 2022 was extremely difficult for investors, 2023 brought struggles of its own. The year began amid sharply rising interest rates, geopolitical crises, and slowing global economic growth. In December 2022, a Bloomberg survey of economists had 70% of them predicting a 2023 recession, up from just 30% in June 2022. Given these expectations and the many noteworthy economic events of 2023, the lack of a recession was surprising. The past year's key events included the U.S. Federal Reserve (Fed) raising interest rates four more times, bringing the federal funds rate over 5%, and the total number of rate hikes to 11 since March 2022. We also witnessed the spring 2023 banking crisis, when we saw three of the largest bank failures ever, which brought worries of not just a recession but a potential repeat of the Global Financial Crisis (GFC). Then, at the end of May, the U.S. government narrowly avoided a debt default that could have stressed the global economy. Finally, while the war in Ukraine raged on, in October, a new conflict arose in the Middle East between Israel and Hamas.

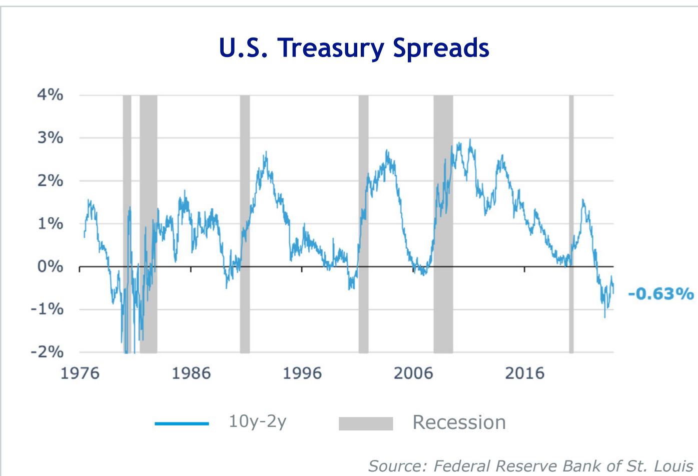
Through it all, the equity market rallied, even if it was choppy at times, and the gains were heavily concentrated in a narrow band of mega-cap, tech-related names with exposure to the potential of artificial intelligence (AI). By December 2023, that same Bloomberg survey mentioned earlier had 49% of economists expecting a soft landing—where the economy slows enough to cool inflation but avoids a recession.

As we turn the page on 2023, we're asking the question: Is the glass half full or half empty?

Economic Overview

Recession Indicators Continue To Flash

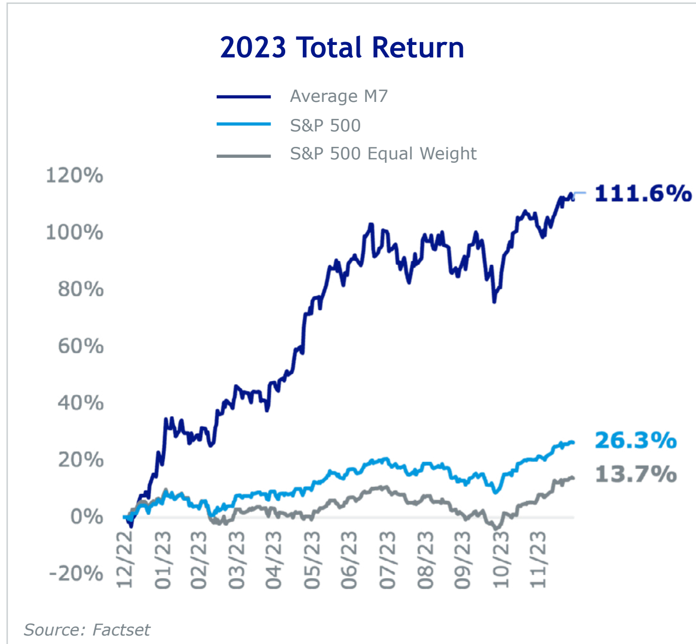
Your opinion of the likelihood of a recession most likely influences your optimism heading into 2024. Since the brief, pandemic-driven downturn in 2020, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), the independent nonprofit that officially declares U.S. recessions, has not confirmed another recession. One working definition of a recession is consecutive quarters of gross domestic product (GDP) declines, which occurred in the first two quarters of 2022. Still, the NBER deferred, given the continuing strength in the job market, industrial production, and corporate earnings. Those trends have mostly continued, but several recession predictors, some of them almost historically foolproof, still point to a forthcoming downturn. For example, the closely watched yield curve between the 10-year and two-year U.S. Treasury notes has inverted—meaning the longer-term bonds have a lower yield than the shorter-term bonds—which has happened before every U.S. recession since the 1960s. That curve has been inverted since July 2022, marking the second-longest inversion since the 1976 birth of the two-year Treasury (1978-1980).



The Conference Board's Leading Economic Index (LEI), which attempts to frame the path of future economic activity, tends to fall ahead of a recession. In all but one of the last eight U.S. recessions, the LEI dropped from a cyclical peak between nine months (early 1970s) and 22 months (2007-2009 GFC) before an NBER recession. In December 2023, the LEI declined for the 21st consecutive month.

The Magnificent Seven Continue To Drive Stocks Higher, Sway Investor Sentiment

Given all that we've faced over the last two years, especially the swift rise of interest rates and elevated recession fears, investors have been bracing for an equity market downturn. However, it didn't happen in 2023—a pleasant surprise to many despite concerns around the banking crisis, rising U.S. Treasury yields, and higher-for-longer interest rates. Instead, real gross GDP increased at an annual rate of 4.9% in the third quarter, unemployment remains low, and equities have outperformed expectations. However, the market's gains have been heavily concentrated in that narrow band of stocks, now known as the Magnificent Seven (M7): Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, NVIDIA, and Tesla. They accounted for approximately 60% of the S&P 500 Index's 2023 gains, and for much of the year, the broad index would have been down without them. Regardless of where the gains came from, the exceptional year for the S&P 500 has many investors feeling grateful heading into 2024.



Geopolitical Uncertainty Increases

While the ongoing conflict between Russia and Ukraine continued, the biggest news of the fourth quarter was Hamas's surprise attack on Israel in October that launched what could be a lengthy, bloody clash. We send our prayers to those impacted around the globe and pray for quick resolutions in both areas. The new conflict has led to some social unrest in the United States and elsewhere, but the impact on investing hasn't been as significant as many expected. What some have called the "Everything Rally" kicked off in late October when bond yields started to fall (bond yields and prices are inversely correlated), and we saw most major asset classes rally to close out 2023. The notable exception was oil, which hit a six-month low in December despite concerns that the conflict could spread, which could drive oil prices higher.

In the U.S., 2024 brings the anticipation of a presidential election. Polling shows a close race between former President Donald Trump and President Joe Biden, the presumptive favorites in the key political parties, with Trump leading surveys in several key battleground states, owing in part to the perception that he would handle the economy better than the sitting president.

Asset Class Performance

Equities rallied in the fourth quarter, with the S&P 500 advancing 11.7%, finishing 2023 with a 12-month advance of 26.3%. The index has posted outsized gains in four of the past five years, with the exception of 2022's double-digit decline. The S&P bottomed in October 2022 and rallied through July 2023. The index fell from August 1-October 27, 2023 but then rallied for the remainder of the fourth quarter. The M7 drove equity-market gains across the year, though the rally broadened significantly late in the year. The small-cap Russell 2000 Index, which lost ground across the first 11 months of the year, finished with a double-digit yearly gain after a December surge.

Indeed, the "Everything Rally" took center stage in the back half of the fourth quarter as bond yields declined. The rally encompassed not just equities but a broad swath of asset classes, including cryptocurrencies and gold. This rally supported investor confidence, but sentiment shifted throughout 2023 based largely on the prevailing view of inflation, interest rates, and the Fed's path forward. The Fed's higher-for-longer narrative held some sway in the summer and fall, weighing on equity markets. However, cooling inflation and other encouraging economic data helped drive speculation that interest rates had likely peaked. The rally took hold as investors priced in potential rate cuts for 2024, particularly in the fourth quarter. Within equities, previously narrow gains expanded to include lagging style factors and sectors. In U.S. markets, small- and medium-cap stocks outpaced large caps in the fourth quarter (according to Russell Indexes), and areas of the market, such as real estate and regional banks, rallied after trailing for most of 2023.

U.S. stocks significantly outperformed developed market (DM) equities during the fourth quarter and all of 2023, while emerging markets (EM) broadly advanced but trailed DM. Concerns about growth in Europe held back DM equities relative to U.S. markets, which benefited from the dominance of the tech giants, stronger than expected economic growth, and cooling inflation. Japanese stocks were among the developed world's strongest performers, aided by historically loose monetary policy, which helped drive shares of automakers and electronics companies higher. Weakness in China—where many investors expected a post-pandemic reopening to increase gains in 2023—weighed on broad EM indexes amid continuing concerns about the property market and slowing pace of economic growth.

Bonds rallied broadly in early 2023 as high-quality paper benefited from concerns about the banking crisis and varied interest rate expectations. However, broad bond market returns were weak in the second and third quarters amid concerns about sticky inflation and government borrowing. In October, the 10-year U.S. Treasury note climbed above 5% for the first time since 2007, but yields quickly declined. Fixed-income markets rallied amid investor optimism, partly fueled by cooling inflation, expectations for easing monetary policy, and the Treasury issuing more short-term than long-term securities to fund the U.S.'s rising fiscal deficit. The Bloomberg U.S. Aggregate Bond Index bounced back from 2022, its worst year since its 1976 inception, with a fourth-quarter rally (6.8%) that left the index up 5.5% for the calendar year.

After serving as the best-performing asset class of 2022, commodities traded lower in both the fourth quarter and trailing twelve months, with the Bloomberg Commodity Index closing the year with a -7.9% return, down more than 20% from its June 2022 multi-year high. Broad economic concerns—including weak manufacturing activity in key markets, slowing Chinese growth, and recessionary fears—weighed on the asset class amid uncertainty about future demand. West Texas Intermediate crude oil prices fell modestly in the first half of 2023, then rallied despite reaching above $95-per-barrel near the end of the third quarter, only to decline sharply in the final three months of the year. The big exception within commodities was gold. Prices notched their first annual increase since 2020, bolstered by concerns surrounding an economic slowdown, geopolitical uncertainty, and rising optimism that inflation and interest rates are likely to decline in 2024.

Q1	Q2	Q3	Q4	YTD
Int'l Developed Stocks 8.6%	U.S. Stocks 8.7%	Commodities 4.7%	U.S. Stocks 11.7%	U.S. Stocks 26.3%
Gold 8.1%	Int'l Developed Stocks 3.2%	Emerging Market Stocks -2.8%	Gold 11.4%	Int'l Developed Stocks 18.9%
U.S. Stocks 7.5%	Emerging Market Stocks 1.0%	Diversified Bonds -3.2%	Int'l Developed Stocks 10.5%	Gold 12.8%
Emerging Market Stocks 4.0%	Diversified Bonds -0.8%	U.S. Stocks -3.3%	Emerging Market Stocks 7.9%	Emerging Market Stocks 10.3%
Diversified Bonds 3.0%	Gold -2.5%	Gold -3.9%	Diversified Bonds 6.8%	Diversified Bonds 5.5%
Commodities -5.4%	Commodities -2.6%	Int'l Developed Stocks -4.1%	Commodities -4.6%	Commodities -7.9%

Source: Bloomberg Commodity Index. Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Bloomberg Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges, and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

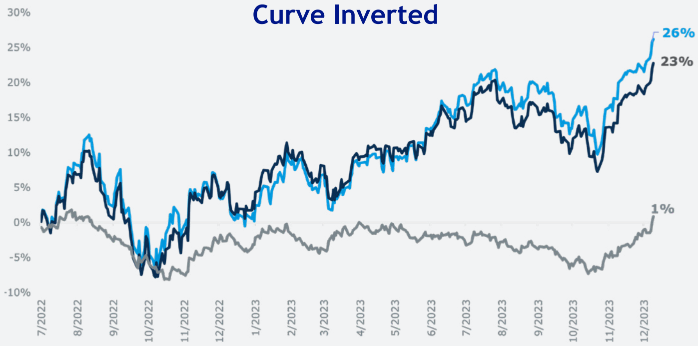
Our Perspective

The Odds of a Recession Are Down, For Now

Despite investor optimism and the broadening rally across equities and other asset classes, the possibility of a recession remains. By late 2023, market prognosticators had generally lowered the odds of a recession, and Goldman Sachs pegged the probability at 15%. Still, the signals mentioned earlier often continue to flash—or flirt with flashing—and have a fairly strong history of being right.

Investment Implications: When concerns about a recession rise, it can be tempting to pull out of equity markets or scale back your portfolio's risk level. However, recent returns—across the "flashing" time periods, especially in late 2023—indicate that allowing tried-and-true recessionary indicators to dictate such investing moves would have been a mistake. If you pulled out of the market, you'd have missed out on 2023 gains, especially

Performance Since the Yield Curve Inverted



Performance Since LEI Peaked

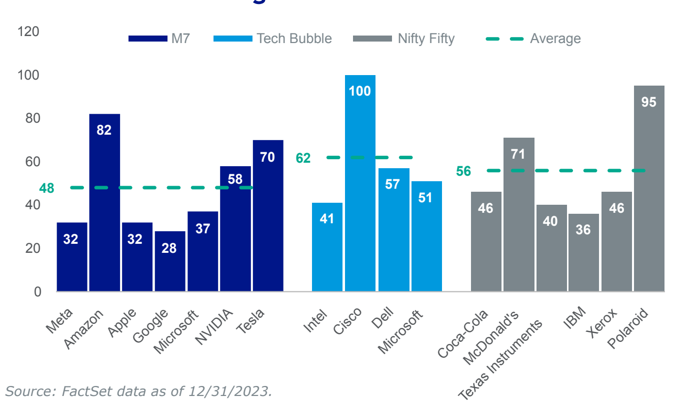
Source: FactSet. Data as of 12/31/2023. LEI - Leading Economic Index, which is a composite of leading economic indicators.

the rallies in November and December. Current data indicates a deep recession is less likely, so we haven't decreased total equity exposure. However, our models indicate a higher probability of lower economic growth, so fixed income still plays an integral part in our portfolios, given their higher current yields and protection against recessions if one occurs.

How Much Higher?

The equity rally of 2023 was good news for most investors, especially those with exposure to the M7. However, when equity prices rise sharply, valuations follow. We are concerned that the valuations of these companies are not sustainable despite their earnings being stronger than expected. In fact, the price-to-earnings (P/E) ratios for the M7 are so high that the word "bubble" comes to mind, and it's worthwhile to look back at two recent examples. In the dot-com boom of the late 1990s, investors piled into technology, media, and telecom stocks, only to see the bubble burst. The Nasdaq Composite Index, which rose fivefold from 1995-2000, declined nearly 80% from March 2000 to October 2022, and the index didn't recover to its previous high until 2015. In the early 1970s, the so-called Nifty Fifty stocks were a set of large-cap, growthy names that were considered "one-decision" stocks, meaning you bought them and held them without worrying too much about selling them for valuation reasons. These were great companies with strong year-over-year annual earnings growth, and they posted average annual returns of nearly 28% in the five years leading up to 1972. However, their

P/E Average of Previous Bubbles

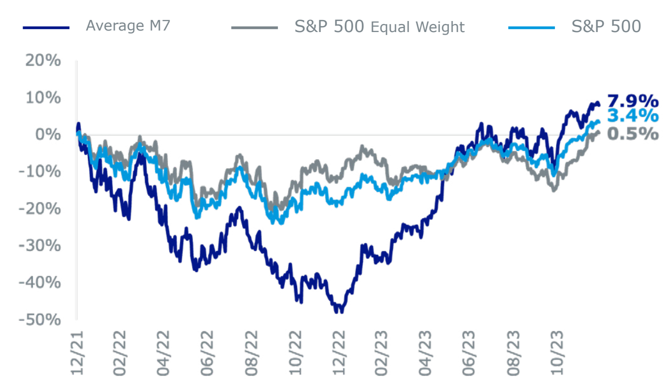


Source: FactSet data as of 12/31/2023.

P/E ratios reached more than twice that of the S&P 500, and when a recession hit in 1973, they fell sharply and lagged the broader market over the next five years.

Investment Implications: We're not predicting that there's a bubble about to burst. However, Inherent Value is one of our core investment principles because when any asset is overpriced, its future growth potential tends to be limited. We have exposure to the M7 through our core equity positions, but we believe it's too risky to overweight them, and there is more potential upside remaining in the other 493 names. It is also important to remember that a portfolio of the M7 can fall just as fast as it rises. The performance of the M7 from 2022-2023 tells a very different story than just the returns in 2023.

2022-2023 Total Return

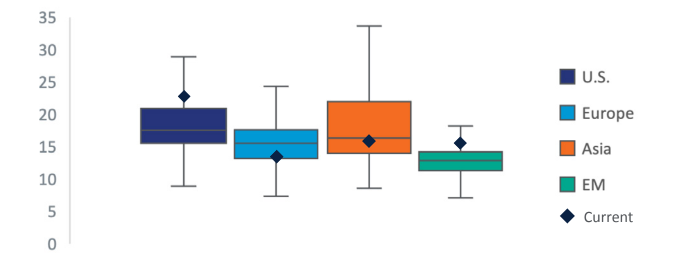


Source: FactSet. Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, NVIDIA, and Tesla and represent "M7," the "S&P 500 Equal Weight" is represented by Invesco's S&P 500 Equal Weight ETF (RSP); data as of 12/31/2023.

We continue to find value in international opportunities. From a valuation perspective, U.S. stocks tend to trade at a premium compared to international equities, and that makes sense, given the American market's growth orientation and scope. However, the valuation gap has expanded rapidly in recent years, especially since the onset of the pandemic.

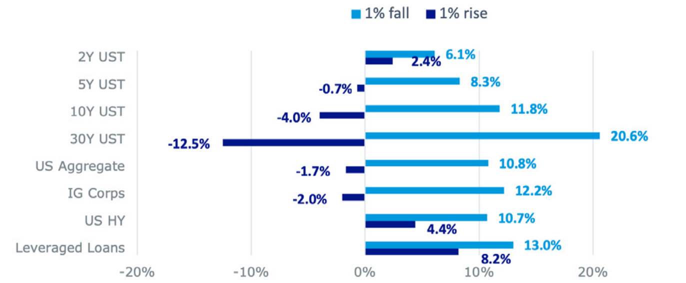
We also see opportunities in fixed income. Given the likelihood that the Fed will start to lower interest rates in 2024, we've been increasing the duration in our bond portfolios. In this cycle, rising interest rates have been the primary driver of bond prices, as opposed to a deterioration in credit quality. Real yields, which

Price-to-Earnings (P/E)
1995-2023



Source: Factset

Total Return Impact of 1% Rise or Fall in Interest Rates



Source: JP Morgan

subtract the expected inflation rate from nominal yields, remain at multi-year highs, which tends to be good news for bond investors. Of course, high real yields make it easier for consumers to save than spend and make it harder for businesses to borrow and invest; remember that the Fed is actually trying to slow down the economy. Many companies refinanced their debt when interest rates were near zero, so they have yet to feel the lagging pressure of rising interest rates, but they likely will, as significant amounts ($3 trillion, according to Goldman Sachs) of corporate debt are set to mature in 2024-2026.

While interest coverage ratios—earnings before interest and taxes divided by interest expenses—have come down from post-pandemic highs, they haven't fallen much, but that could change. As a result, we are extending duration by focusing on higher credit quality in our fixed-income solutions.

Ongoing Conflict

From a purely investment perspective, peace would likely be good news for the markets. The unrest in Ukraine drove oil prices to decade-plus highs in mid-2022, but they quickly retreated. The Hamas-Israel crisis also pushed prices higher, but the impact was brief. We believe the conflict will likely continue to have a limited impact on oil prices unless it escalates to include other countries. Gold prices have also been increasing, and we believe that's likely tied to recent geopolitical events. (To learn more about our perspective on oil, read our recent blog post. For more on gold, check out this post.)

Investment Implications: No one knows how these conflicts will play out. Instead, we create portfolios that can perform well in a range of scenarios, monitor them closely, and make changes if any of these geopolitical issues escalate.

Conclusion

So, is the glass half-full or half-empty? It's a tough call. We tilt more toward full than we did in early to mid-2023, but a recession is not off the table.

We're thankful for the storms we've weathered in 2023 and the market rebound, but there's still a great deal of uncertainty. The conflicts overseas continue as we head into a full-bore election cycle that looks to be close in terms of who ends up in the Oval Office and which party controls both houses of Congress. It will likely take years to know if AI will have a lasting impact on increasing corporate productivity and efficiency, but investor sentiment on the issue (and the high valuations of key AI companies) will likely shift repeatedly over that time.

In turbulent times, it's easy to get caught up in the headlines of the day or fixate on how recent market returns have driven portfolios down (as in 2022) or up (like in 2023). Think back over the last two years and all that's happened in the world. It's amazing to realize that the S&P 500 rolled through all the worry, the ups and the downs, only to end 2023 at almost the same level as it closed 2021—right near all-time highs.

That, more than anything, is a reminder that successful investing is a marathon, not a sprint. Whether the glass is half full or half empty at any moment in time isn't all that important. It's much more vital to recognize and accept that highs, lows, and uncertainty are part of investing. The remedy to the turbulence is managing the risk with a well-diversified portfolio that aligns your short- and intermediate-term cash flow needs with your long-term financial goals.