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Client Investment Letter

February 2024

Global equity markets posted strong gains for the fourth quarter, as declining long-term interest rates and easing inflationary pressures lifted prices of both stocks and bonds. The solid quarterly returns capped off a positive year characterized by enthusiasm for artificial intelligence, equity market concentration at the top-end, and the general resilience of the U.S. equity market (and economy) over its peers, even in the face of a mini-banking crisis, heightened geopolitical tensions, and high interest rates.

As we turn the page into a new year, valuations are elevated but optimism abounds for a continuation of last year's advances. However, several risks could challenge that enthusiasm. There are high-profile elections this year, both in major developed and emerging markets; wars rage on several continents and are contributing to new global supply chain bottlenecks; and the outlook for future corporate earnings is foggy. How should investors approach such a market environment?

First, while U.S. elections typically add to short-term market volatility, the victory of one political party over the other has not had a meaningful impact on long-term market returns. In fact, since 1974 the best-performing periods for U.S. equities have come during divided government,[1] which as of today remains a probable outcome of the 2024 election. Furthermore, geopolitics has never been a reliable predictor of financial market returns, and the U.S. market is relatively insulated from the current flash points (particularly with regards to shipping disruptions). Finally on earnings, last year the top 10 stocks in the S&P 500 Index generated 30% earnings growth while the remainder saw their earnings contract by -8%.[2] That sets a very high bar for those top 10 firms to meet in 2024, but it offers more upside potential for the other 490 constituents of the index.

We do not know if markets will offer up a repeat of last year, or if the best performers in 2023 will be the worst performers in 2024. What history *has* taught us is that the left-tail events that may trigger a sell-off, or the right-tail advancements that may unleash animal spirits, most likely are not on investors' radars at the moment. We lean into that uncertainty by choosing asset allocations with the appropriate risk/return profile, as well as remaining broadly diversified and not over-exposed to any one company, industry, sector, or country.

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[1] Hartford Funds.
[2] JPMorgan Asset Management.

Q4 Financial Markets Performance

EQUITIES

U.S. stocks advanced most during the final two months of the year, as expectations grew that interest rate cuts were nearing (see Exhibit 1). Declining inflation and slightly softer economic growth will likely allow the Federal Reserve to begin cutting rates sometime in 2024. Top-performing sectors were those most sensitive to interest rates, including information technology, real estate, and financials. Falling oil prices put downward pressure on energy stocks. Small- and mid-cap stocks outpaced large caps for the quarter, but still finished the year behind. Growth generally outpaced value, except in small caps, where interest rate sensitive companies in the financial services and real estate sectors make up a significant part of the index.

Non-U.S. developed market stocks moved higher as well, benefiting from softer inflation figures and expectations that the rate cycle had reached a top. In the Eurozone, rate-sensitive sectors (i.e., technology and real estate) advanced strongly. U.K. stocks also performed well, but a strengthening of the pound vs. the U.S. dollar held back larger companies. Meanwhile in Japan, a relative strengthening in the yen was a headwind for local exporters, but stocks still advanced.

Quarterly performance of emerging market stocks was positive despite weakness in its largest constituent, China. Declining inflationary pressures in Brazil and India, as well as robust tech-related exports in Taiwan and South Korea were major performance drivers. Poland and Mexico also performed well, as political risk eased in the former, while the latter continued to benefit from supply chain near-shoring. Meanwhile, China's ongoing real estate crisis and uncertainty over its regulatory regime continued to worry investors in local equities.

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Financial Markets Performance cont.

Exhibit 1 – Equity Market Returns

Benchmark Index	4th Quarter 09/30/2023 – 12/31/2023	2023 12/31/2022 – 12/31/2023	Year-to-Date 12/31/2023 – 01/31/2024
S&P 500 (*Large Cap*)	11.69%	26.29%	1.68%
S&P 500 Growth	10.09%	30.03%	2.89%
S&P 500 Value	13.63%	22.23%	0.30%
Russell 2000 (*Small Cap*)	14.03%	16.93%	-3.89%
Russell 3000 (*Total U.S.*)	**12.07%**	**25.96%**	**1.11%**
MSCI EAFE (*Developed Markets*)	10.42%	18.85%	0.58%
MSCI EM (*Emerging Markets*)	7.86%	10.27%	-4.63%
MSCI ACWI ex-U.S. (*Total Int'l*)	**9.75%**	**16.21%**	**-0.98%**

Source: FactSet. Performance data presented above is total return (price appreciation plus dividend and/or interest income). Non-U.S. equity benchmark returns are presented net of foreign taxes.

FIXED INCOME

Global fixed income markets rebounded strongly in the fourth quarter as yields dropped across the board (see Exhibit 2). The perceived shift in monetary policy toward rate reduction was the main driver of performance.

In the U.S., broad market indices recouped losses incurred during the third quarter to end the year higher. Declining yields were the major driver of total returns in the U.S. Treasury market, where gains were commensurate with duration (i.e., longer maturities delivered higher returns).

Global investment-grade bond performance was also strong. The corporate bond market shrugged off slowing growth prospects and focused on the increasing probabilities of an economic "soft landing." Still, higher-grade bonds performed slightly better than riskier debt. U.S. and U.K. securities performed in line, while European bonds slightly lagged.

Junk bonds also posted robust returns but ended the quarter shy of their investment-grade peers. Lower sensitivity to interest rate movements and muted risk appetite were the main causes for the discrepancy.

Developed market sovereign debt posted strong returns with little dispersion among countries (Japanese debt was the outlier, finishing the quarter nearly flat). Emerging market debt also gained ground. U.S. dollar-denominated sovereign debt advanced more than corporates and local currency debt due largely to its strong inverse correlation to U.S. rates.

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Exhibit 2 – Bond Market Returns

Benchmark Index	4th Quarter 09/30/2023 – 12/31/2023	2023 12/31/2022 – 12/31/2023	Year-to-Date 12/31/2023 – 01/31/2024
Bloomberg U.S. Gov't/Credit	6.63%	5.72%	-0.23%
ICE BofAML 1-3 Year U.S. Broad	2.62%	4.66%	0.46%
Bloomberg U.S. Aggregate Bond	**6.82%**	**5.53%**	**-0.27%**
ICE BofAML U.S. High Yield BB-B	7.11%	12.56%	0.09%
JPM non-U.S. GBI (hedged)	6.82%	7.29%	-2.68%
JPM EMBI Global (in USD)	9.26%	10.45%	-1.18%

Source: FactSet. Performance data presented above is total return (price appreciation plus dividend and/or interest income).

Global Economic Update

UNITED STATES

The U.S. economy remains firmly in late-cycle expansion, supported by a resilient consumer. Real GDP growth in the fourth quarter came in at an annualized 3.3%, bringing total growth for the year to 2.5%, outpacing 2022. Most of the growth can be attributed to increases in consumer spending (particularly on services and recreational goods), non-residential business investment, continued government outlays, as well as an increase in net exports (see Appendix A). While most analysts do not expect growth to remain as robust in 2024, prospects of a recession have also diminished thanks in part to a tight labor market and a financially healthy consumer base.

The main question hanging over the economy is the trajectory of interest rates. While the Fed has made it clear that it is done raising rates, rate *cuts* may not arrive as soon as borrowers and financial markets are expecting. Despite significant disinflation, returning to the Fed's 2% target may be impossible in the current environment, bar a more pronounced economic slowdown. GDP growth has remained stronger than the central bank expected, the labor force is stretched thin, and wage growth remains elevated. Further complicating the math for the Fed is another rise in energy prices, as well as potential goods inflation as shipping costs soar due to violence in the Red Sea and drought in the Panama Canal.

CHINA

Despite posting double the real GDP growth of the U.S. in 2023, prospects for the Chinese economy continue to sour.[3] A structural deceleration continues as the economy grapples with a debt-laden

[3] Chinese GDP growth was 5.2% in 2023.

downturn in the property market, a rapidly aging population, an exodus of foreign capital, and a lack of stimulus focused on the consumer.

While the government has stepped in to force developers to complete pre-paid properties, future development is being quashed due to oversupply and strict government mandates for "high-quality growth." More worryingly, net interest margins for Chinese banks are at record lows and commercial banks must absorb increasing losses from bad property and local government loans.[4] With weak bank balance sheets and the risk of further capital flight given the high interest rates on offer in U.S., the People's Bank of China finds itself unable cut rates aggressively enough to stimulate the economy.

That is not to say there is no government support, but it comes with different knock-on effects versus previous cycles. Fiscal policy continues to support investment and production (particularly in green technology, electric vehicles, and semiconductors). As manufacturing capacity continues to grow, it is pushing down goods prices, both in China and connected economies. So, this time rather than being a contributor to global growth, China is exporting disinflation.

ELSEWHERE AROUND THE WORLD

The European economy continues to disappoint as high energy prices, tight monetary policy, and weak industrial activity have held back growth, particularly in Germany. While there are some signs that these headwinds are easing, momentum for 2024 is still expected to be weak. European trade is more exposed to the current shipping disruptions in the Red Sea, which could lead to rising energy and goods prices this year. Should that occur, hopes of monetary policy easing by the European Central Bank will evaporate as it would be forced to contain broader inflation, causing further harm to growth prospects.

In Japan, inflation continues to build, particularly on the back of the highest wage growth in nearly three decades. All eyes are focused on when the Bank of Japan will finally abandon its negative interest rate policy, but policymakers have stressed they want to see evidence of a sustained inflationary cycle before making any major changes. It is worth noting that rising interest rates will have significant effects on fiscal policy, as Japan's government debt currently amounts to 222% of GDP.[5]

Meanwhile, several major emerging markets continue to benefit from aggressive demand for specialized products (e.g., Taiwan, South Korea), monetary policy easing in the face of declining inflation (e.g., Brazil), and aggressive foreign investment as multinational corporations diversify their supply chains (e.g., India, Mexico).

[4] Goldman Sachs Global Investment Research.

[5] FactSet (as of December 2023).

Investment Strategy

EQUITIES

While the top 10 constituents of the S&P 500 Index absolutely dominated returns in 2023 (and so far into 2024), their valuations – and therefore the expectations for their future earnings – are quite high (see Appendix B). That is not to say that these stocks will not continue to be major contributors to future growth and returns, but disappointing earnings news at these levels could trigger significant price volatility (as we have already seen year-to-date for one of the Magnificent Seven stocks). Therefore, within equity portfolios, we continue to balance low-cost beta exposure to the market with tactical allocations to quality and more attractively valued areas of the market. Selective active management stands reasonably positioned (relative to previous periods) to capitalize on likely wider dispersions in underlying security prices in the years ahead.

While we still believe it is crucial for long-term investors to maintain diversification across markets and currencies, we are continuing to reduce our exposure to international equities, in favor of their U.S. peers. Furthermore, within emerging markets, we continue to rebalance our exposure away from China (which was already underweight in most client portfolios) in favor of other markets with brighter opportunities, such as India.

FIXED INCOME

Despite being at peak rates in the U.S., investors should not interpret that to mean there are no longer opportunities in fixed income. On the contrary, with the expectation that rates may fall in the future (either as inflation continues to cool or if the economy falls into recession), a bond portfolio that is invested in longer-dated securities (i.e., not only immediate obligations such as cash/money market) stands to gain should rates fall. That is why we, and the active bond managers we employ, have been slowly stepping up the duration of bond allocations, to buy that risk-off "insurance" for portfolios.

Of course, we still must manage the chances of an alternate scenario, specifically that the U.S. economy does not decelerate, and inflation remains a stubborn concern for the Fed (potentially leading to further rate increases and/or an upward shift in the yield curve). That could trigger another sell-off in bonds, though it would likely not be as bad as the carnage witnessed in 2022, since current yields are high enough to better compensate investors for negative price returns.

In Conclusion

The start of a new year may seem rudderless for investors as they process the narratives of the previous year, analyze economic and earnings data releases, and look ahead into the unknown. However, that is no different than any other day for a participant in global financial markets. What is more important is for investors to ensure their portfolios are allocated appropriately across the major asset classes in a way consistent with their risk/return profile. To that end, a new year is just as good a time as any for clients to review their Investment Policy Statements to determine if they are still in line with their financial situations.

If there have been any changes in your risk tolerance, liquidity needs, and/or investment goals, please contact us so we may discuss your investment strategy in more detail and decide if any changes are warranted. Additionally, if you have any questions or concerns about financial markets, please never hesitate to call us at +1 (301) 881-3727 or email us at client.services@sol-capital.com.

With our best regards,

SOL Capital Management Company

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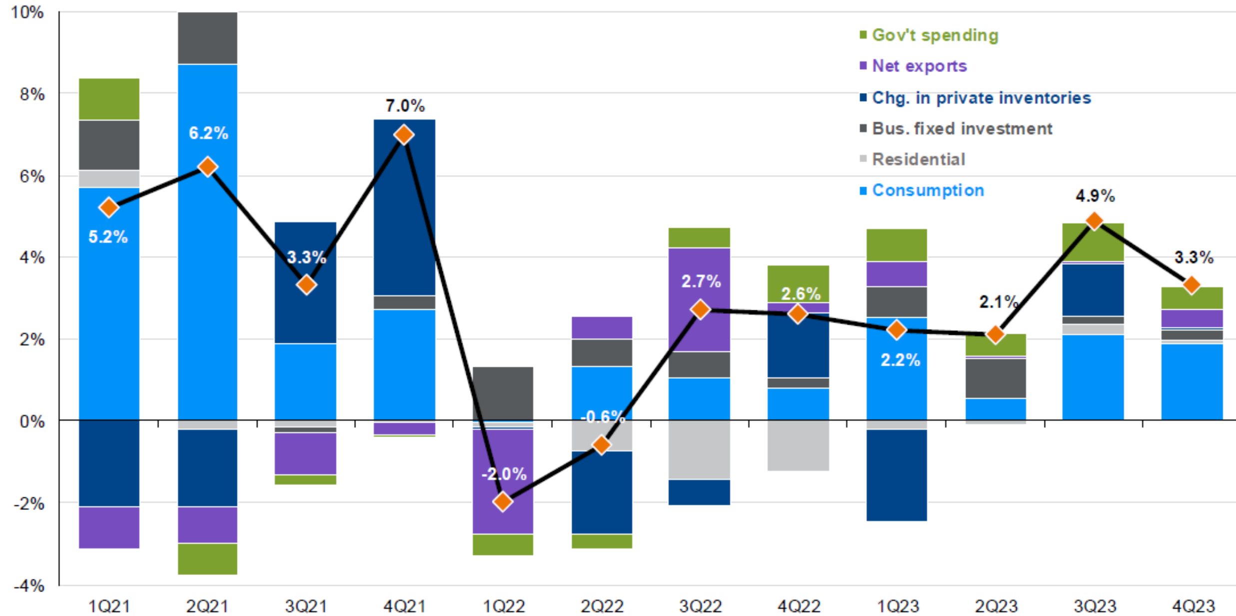
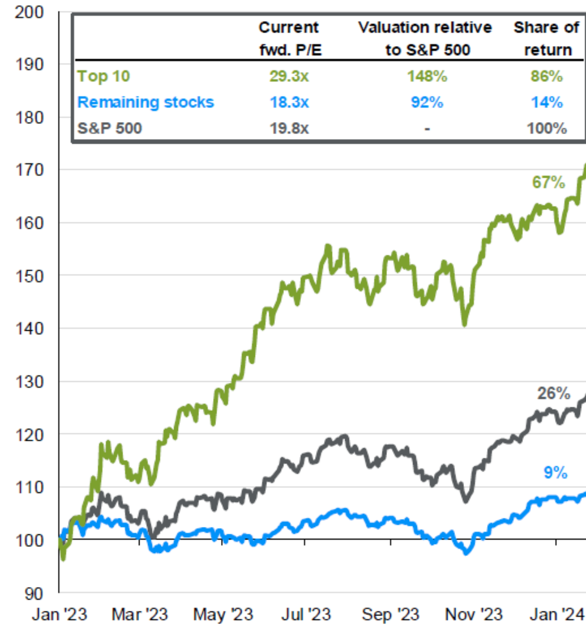
Appendices

APPENDIX A: Contributors to Real GDP Growth



Source: JPMorgan Asset Management, BEA, FactSet. Data as of 31 January 2024.

APPENDIX B: S&P 500 Index Concentration



	Current fwd. P/E	Valuation relative to S&P 500	Share of return
Top 10	29.3x	148%	86%
Remaining stocks	18.3x	92%	14%
S&P 500	19.8x	-	100%

Source: JPMorgan Asset Management. Data as of 31 January 2024.

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Disclosures

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