Quarterly Economic and Market Comments
December 31, 2023

A lot of money has been lost by those who ignored Sir John Templeton's sage investment observation that "The four most expensive words in the English language are "this time it's different". At the same time, a lot of money has been lost by those who ignored Warren Buffett's observation that "Anything can happen anytime in the markets". A year ago, central bankers around the world were rushing to raise interest rates with no end in sight. Stock prices had been hammered, in particular the big U.S. technology companies, the so-called "FAANG" stocks, that had led global stock prices higher over the previous decade. Bond prices had also received a drubbing such that 2022 was the third worst year in history for a portfolio 60% invested in U.S. stocks and 40% in bonds. It had all the earmarks of a classic business and market cycle. The Wall Street Journal reported in the opening issue of 2023 that more than two-thirds of economists at 23 large financial institutions, bearing in mind Templeton's advice, were betting that the U.S. would have a recession in 2023 and, for the first time in this century, the average Wall Street strategist expected the S&P 500 to end 2023 slightly lower than where it began. It was said to be "the most advertised recession in history".

It is unclear at this point to what extent the world will ultimately unfold differently from what the consensus was expecting a year ago, but certainly 2023 did not go according to plan. Between March 16, 2022 and the end of 2023, the Federal Reserve increased its benchmark Fed Funds rate from 0.1% to 5.3%, yet the S&P 500 was higher at year-end than when the interest rate hikes began in 2022. Most importantly, the relative winners in 2022, so-called "value" stocks, which were candidates to lead a new cycle, were losers in 2023, and "growth" stocks, the big losers in 2022, were big winners in 2023. By the end of the year, growth stocks had more or less made up all the ground they lost in 2022 as large-growth stocks outpaced large-value stocks by the second biggest margin in 25 years. However, the real story was not growth stocks in general, but rather the performance of the so-called Magnificent 7, the slightly updated version of FAANG. On the one hand, because of their strong competitive position, solid balance sheets, and free cash flows, and the fact they are American, they are perceived to have defensive characteristics in an uncertain world. At the same time, with the launch of the ChatGPT app last November, they are thought to be well placed to cash in on the growth of artificial intelligence. An index of 49 companies with exposure to A.I. was up 75% in 2023. As alluring as the outlook might be for the Magnificent 7, however, the valuations are equally daunting. The market capitalization of these seven stocks represents roughly 18.5% of the entire global stock market capitalization and the 5 biggest of them represent the biggest concentration in the S&P 500 since 1964. Their market capitalization relative to the U.S. economy is greater than was the entire U.S. market in 1990. The median price-to-book ratio for these companies is 12.5, the median price-to-sales ratio is 7.8, and the median price-to-earnings ratio is 35.8. Yet, Microsoft, for example, whose P/E ratio is around the median, is only expected to have earnings grow by 3.5% in the year ended this June. Still, at least the Magnificent 7 are growing and make money. Such is the infatuation with technology in general and artificial intelligence in particular that the Philadelphia Semiconductor Index rose 65% in 2023 even as global semiconductor sales fell by more than 10%. The big American semiconductor company, Micron, lost a record $7 billion over the last four quarters, yet its stock rose 70%.

At the end of October, the U.S. economy was holding up better than expected, but apart from the Magnificent 7 and various other niche/country situations, markets were doing poorly, as expected. After the regional banking crisis, the percentage of stocks outperforming the S&P 500 over the previous

three months hit a record low and, by year end, less than 30% of S&P 500 stocks had outperformed the indices, the lowest percentage since 1998. By early November, the median year-to-date return of eight broad asset classes was on pace to be negative for only the 10th time in the past 50 years. The Magnificent 7 were up by 50% even as the remaining 493 stocks were down on the year. Zero coupon U.S. Treasuries in October were down 66% from their highs in 2020. Many speculative favourites of the last cycle continued to fall in 2023. WeWork, which traded around $500 a share in 2021 and had a huge market capitalization, but which never made money and managed to lose $17 billion since 2016, finally went bankrupt in November. Recently, the Wall Street Journal reported that 464 stocks on the Nasdaq were trading below $1 per share, up from less than 100 earlier in the year. Then, interest rates started to fall, reflecting progress on inflation and the markets' belief that an end to monetary tightening was in sight. Sure enough, the Federal Reserve Board went from reiterating that it would keep interest rates "higher for longer" on December 1st to talking about cutting rates three times (at least) in 2024 on December 13th. This "dovish pivot" supercharged the markets. The eight major asset classes that were underwater in mid-November ended the year up 12%. The last two months of the year saw the best ever 2-month rise for global investment-grade bonds and the rally in the short-term Treasury Bond ETF after the Fed pivot was a 12-sigma event (i.e. statistically very, very improbable). Amazingly, 10-year U.S. Treasuries ended the year yielding 3.88%, exactly where they started, but the rally was enough to lift long-term U.S. Treasuries to a slight positive return and avoid an unprecedented third consecutive down year. Nor was this just a U.S. phenomenon. In the U.K., within the space of six months, a projected five interest rate hikes turned into five cuts.

Welcome as the year-end rally was, it left some important unanswered questions. The dispersion between industry groups was huge. Sectors that include the Magnificent 7 rose more than 40%, Industrials and Financials performed in line with the Dow Jones Industrial Average (+13.7%), while the defensive sectors (Health Care, Consumer Staples, Telecoms, and Utilities) declined on balance as did Energy in the face of falling commodity prices, specifically crude oil's 10% drop. Commodity sectors historically perform poorly after the peak in interest rates so no big surprise there. On the other hand, defensive sectors are typically the best performers, but not in 2023. Why not? Perhaps the answer lies in a recent Bank of America poll (before the Fed's dovish pivot!) that said a "soft landing" for the global economy is the base case for 75% of investors.

A year ago, it was widely assumed that events would play out more or less as they had done in previous monetary tightening cycles, including a recession in the U.S. starting sometime in 2023. In a poll of investors in December 2022, there were 32% more bears than bulls. Today, it is widely assumed that this time is different and, in the same poll referenced above, but taken in December 2023, there are now 32% more bulls than bears. What a difference a year makes! Partly this change in view is because inflation has subsided to the point where the Federal Reserve has basically declared, "Mission Accomplished", and they are thought to be in a position to ease monetary conditions to the extent required to avoid a recession. As John Authers of Bloomberg notes, "You hear the word Goldilocks a lot, a belief that 2024 will see lower interest rates in combination with steady, slow growth. Such conditions don't happen often, which is why they've been tagged with the name of a fairy tale. But it could happen (as Buffet would say)." More important than the progress on inflation or the Fed pivot is probably the power of the year-end market rally. The S&P 500 ended the year with a nine-week winning streak. It has only done better three times since 1950. The Friday after the Fed pivot saw the biggest daily flow into the S&P 500-tracking ETF (SPY) in history. At year end, the percentage of S&P 500 stocks reaching overbought status reached its highest level in decades. The smaller-cap Russell 2000 Index went from a 52-week low to a 52-week high in 48 days, the shortest turnaround time in history. This sort of enthusiasm is excessive in the short run, obviously, but has typically led to further gains down the road. A number of historical precedents also suggest higher stock prices in 2024. A

gain of 10% or more in the last two months of the year has always, since 1950, led to gains the following year. Similarly, since 1950, when U.S. stocks fell by more than 10% (like 2022) and then rose by more than 10% the following year, the year after (i.e. 2024) has always ended higher. Lastly, once again since 1950, the S&P 500 has never ended an election year lower under a first-term President.

Of course, these historical factoids are lacking a compelling rationale. Similarly, few want to be accused of ignoring Sir John and investing based on "this time it's different" so the hunt goes on for reasons why it really is different or why, in fact, what is happening has happened before. There have been 14 interest rate-hiking cycles in the U.S. since 1950. Eleven of them ended in a recession. Three did not and some are pointing to those instances as possible templates for the "soft landing" outcome. However, when you look into them, they all seem quite different and more benign than today's scenario. The year 1966 saw a 25% drop in the U.S. market as interest rates rose and the yield curve inverted briefly. However, the Federal Reserve reversed engines quickly, the leading indicators of economic activity never really went negative, and Gross Domestic Income remained relatively strong throughout. More importantly, the stock market gain off the lows of 36%, identical to the upturn to date in the current cycle, was followed by a bigger bear market starting in 1968 as the Federal Reserve was forced to start raising interest rates again. So, the analogy with 1966 seems weak and, in any case, hardly a positive precedent. The next example of a so-called "soft landing", 1984, is completely irrelevant. The stock market decline was a modest 15%, the yield curve never came close to inverting, and the leading indicators and Gross Domestic Income remained solid throughout. The last "soft landing" cycle, featured recently in the Wall Street Journal in a hopeful article, was in 1995. True, Greenspan raised the Fed Funds rate from 3% to 6%, but stock prices did not really decline, the leading indicators, as in 1966, never really went negative, the yield curve did not invert, Gross Domestic Income remained robust, and, as in 1984, for example, the U.S. recession probability model based on state conditions never remotely got off the mat. So, it seems clear that anyone who wants to believe in a soft landing cannot rely on historical precedent, but rather must come up with a reason to believe that, in fact, this time it is different.

There are a number of factors that cumulatively help explain why the American economy has been more "resilient" than many expected a year ago. Interest rates have risen sharply, but, relative to the rate of inflation, they are not particularly high. Secondly, many homeowners and businesses locked in interest rates when they were a lot lower and have been relatively unaffected by higher rates. The borrowing cost for the S&P 500 is around 2% compared to almost 4% for 10-year U.S. Treasuries. Nearly half of S&P 500 debt is set to mature after 2030. Over the past three years, 30-year mortgage rates in the U.S. rose from a low of 2.65% to a peak of 8%, yet house prices over the same period rose 32%. In many cases, homeowners cannot sell their homes and keep their cheap mortgages so the supply of existing homes for sale has dwindled. Last, but not least, there is the impact of fiscal policy which has been huge. Incredibly, an index of government fiscal, exchange rate, and monetary policies rose in July to its most stimulative level ever outside of war or recession. The CHIPS Act, the Inflation Reduction Act, and other legislation put trillions into the hands of consumers. This cash pile has been whittled down and should be spent during the first half of this year. There have been major incentives to bring manufacturing back to the U.S. and to invest in "green" initiatives with the result that manufacturing construction spending is 60% higher than a year ago. It is estimated that two-thirds of the growth in the U.S. economy in 2023 was attributable to fiscal stimulus. Looking out over the next decade, the Congressional Budget Office is projecting massive budget deficits, but not much change is expected for 2024, which should act as a modest drag on economic activity. Taken together, these factors seem unlikely to prevent the lagged impact of the monetary tightening of the past two years from generating a recession in the U.S., not to mention Europe and elsewhere. The obvious Great White Hope is productivity which is the key to economic growth in a world where populations are set to

shrink in most industrialized countries. Over the very long run, productivity in the U.S. has been pretty stable at around 2% per annum, but it has swung between 1% and 3%. Currently, it is rising from a low point during the pandemic and many are thinking/hoping that artificial intelligence will spur a productivity boom not unlike the "Roaring 20s" or the late 1990s. "A.I. is about to supercharge the innovation pipeline," wrote Bill Gates at year end. "A.I.'s impact is not artificial" and "You thought 2023 was a big year for A.I.? Buckle up" are two other recent headlines. Sadly, the potential outcomes from A.I. are so disparate and hard to quantify and so many positives are built into current stock prices that it is virtually impossible to rationally project the economic and investment impact of A.I. over the next few years relative to other factors. To steal from Sam Spade in the Maltese Falcon, "Artificial intelligence is the stuff that dreams are made of."

Meanwhile, back on Planet "This time is not different", the evidence pointing to a U.S. recession in 2024 continues to build and is more convincing than it was a year ago. Yet skepticism abounds. "Why reliable recession indicators are faltering," writes the Globe at year end. They take on the yield curve, the leading indicators of economic activity, and the Sahm Rule (which states that when the unemployment rate rises 0.5% above its prior 12-month low, a recession is underway). It turns out that the only argument they produce against these historically foolproof indicators is that the recession hasn't happened…yet. In this cycle, the yield curve has been inverted longer and has been more inverted than at any time since 1941 with the exception of the 1978-81 period when the Fed Funds rate went to 20%. The yield curve-based Federal Reserve model indicates the odds of a recession in 2024 are 94%. The leading indicators have fallen for 20 consecutive months, something we have only seen in 2007-08 and 1973-75, which encompassed two of the biggest three recessions of the post-World War II era. There are so many data points supporting the notion of economic weakness that it is hard to pick and choose. Just a couple of examples: Employment has been an area of supposed strength and yet the employment numbers have been revised downwards every month of 2023 from their original release. Last year was the third worst year for downward revisions in the past 50 years. On a related note, the last ten American economic datapoints released in December all showed downward revisions. When people say the U.S. economy is resilient, they point to Gross Domestic Product (GDP) which is what people are spending. The flip side of the coin is Gross Domestic Income (GDI) which is what people are earning. Currently, GDP exceeds GDI by a record amount (i.e. GDI is saying that the American economy is a lot weaker than GDP is indicating). Lastly, only 6% of U.S. manufacturing industries reported growth in December. Over the past 30 years, this kind of weakness has only been seen during the recessions of 2001 and 2008-09. So, there you have it. As we enter 2024, the stock market and the majority of economists and strategists are saying, "This time it's different." Conversely, the majority of tried-and-true indicators and possibly Sir John himself are saying, "Probably not."