OVERVIEW

January 2024

CAPITAL ADVISORS

Key Points

- The behavior of the economy and asset markets in 2023 revealed a stark difference between an economic cycle that includes a global pandemic, and virtually every other economic cycle in history.
- This difference helps to explain the surprising resilience of the U.S. economy over the past year-and-a-half in the face of the most aggressive tightening of central bank interest rate policy in over 40 years.
- We believe this distinction also explains the recent, unusual coexistence of economic growth with rapidly falling inflation, an economic pairing that might be likened to dogs and cats living together in harmony.
- Looking ahead, the Federal Reserve (Fed) is widely expected to *reduce* interest rates in 2024 after explicitly signaling a pivot toward easier monetary policy at its December policy meeting.[1]
- As with other elements of the current economic cycle, we suspect the monetary easing phase of this cycle might look a little different than historical experience would otherwise suggest.
- For example, the policy transition from raising to lowering interest rates typically occurs during a recession, when corporate profits and stock prices are depressed, neither of which is the case today.
- We can also imagine uncharacteristic behavior in the fixed income markets due to the funding requirements of our nation's massive budget deficit and growing government debt.
- We are not suggesting the Fed's pending pivot to easier monetary policy is a *bad* thing for the asset markets – it's way better than the alternative – but we are encouraging a more cautious approach than might otherwise be considered for this phase of the policy cycle.
- Not to mention the geopolitical moment we are living through, which necessitates the disclaimer, "as long as…" into any constructive forecast for the asset markets.
- In the stock market, we believe there is plenty of opportunity among the companies we are invested in, and strongly discourage bailing out of stocks due to geopolitical what-ifs.
- That said, investors should expect stocks to go down, maybe by a lot, if any number of visible risks deteriorates substantially in the year ahead.
- This reality justifies a balanced asset allocation for most investors with at least a portion of the portfolio committed to high quality fixed income.

[1] Source: Wall Street Journal; "The Powell Pivot Begins," Dec. 13, 2023

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Recession Mirage

According to numerous prognosticators a recession has been eminent for nearly two years now, yet the downturn remains elusive. One of the lessons of 2023 may be that economic cycles that include a global pandemic are different.

Wrongfooted forecasters can be forgiven based upon the historical record of interest rate cycles because the "standard" preconditions for a recession have been in place for some time. Specifically, the Fed has been executing the most aggressive campaign of interest rate increases in 40 years, and the bond market "yield curve" has been inverted since the summer of 2022 (every recession since the 1970s was preceded by a yield curve inversion and there has never been a curve inversion for more than six months that did not lead to recession).[2] Based upon the evidence, we *should* be in a recession by now.

What's Different?

The defining distinction of the current economic cycle has been the disruption of global supply chains. Prices for many goods soared when supply failed to meet demand due to the combination of government mandates to shut down swaths of the global economy *and* fiscal support programs to protect consumer incomes. Once people returned to work and the extraordinary fiscal programs expired, inflation started coming down quickly.

Arguably, the Fed had little to do with the improvement in inflation so far. Rather, we believe it is the resumption of the *supply* side of the economy, and the surge of economic activity that produced it, that has done the heavy lifting. This dynamic also explains the unusual coexistence of punchy economic growth with falling inflation.

The "Normal" Way to Fight Inflation

In a standard business cycle, the Fed raises interest rates when it believes *demand* is growing too fast and threatens to drive up inflation. More often than not, the Fed pushes short-term interest rates too high – thus inverting the yield curve – demand gets squashed, and a recession ensues. Thus, the "normal" way to tame inflation is for the central bank to attack the *demand* side of the supply/demand equation, and a common consequence is an economic recession. In contrast, the current cycle has been driven by *supply*.

[2] Source: Alpine Macro; An "inverted yield curve" refers to a condition in the bond market in which the yield on short-term government bonds is higher than the yield on longer-term bonds

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Looking Forward

Just as the standard if-then sequence did not apply to the tightening phase of the current economic cycle, we suspect the easing phase of the cycle might unfold differently as well. The natural expectation is for stocks to do really well when the Fed transitions from raising to lowering interest rates, but we suspect the current policy pivot might be incrementally less rewarding for stocks.

The primary distinction this time is initial conditions. Historically, the Fed pivots to easier monetary policy when the economy is in recession, corporate profits are depressed, and stocks are well below their previous highs. Today's conditions are the opposite on all fronts.

In the bond market, we have entered unchartered territory regarding the magnitude of the U.S. budget deficit and federal debt relative to the size of the global economy that must finance it. We don't agree with the doomsday scenarios employed by infomercials to sell gold. However, we do worry that longer-term interest rates might become less responsive to Fed policy because the natural buyers of our nation's ever-growing debt may demand higher compensation to attract their capital. The implication would be higher interest rates at the longer end of the maturity spectrum *relative* to short-term rates, which can still be controlled through monetary policy.

A Year of Visible Risks

We cannot consider the year ahead without acknowledging the numerous geopolitical risks that might influence the path of asset markets, perhaps dramatically. The graphic below from the economic research service, *Alpine Macro*, summarizes numerous geopolitical risks on the minds of most investors, including us.

Risks We are Watching in 2024

	Overlooked by Markets	In Markets' Focus
Likely	• **Renewables Rebellion** • **European Gloominess** • The Great Trump Panic • **The 2024 Election Wave**	• **U.S.-China Tech War** • Peace/Russia "Wins" In Ukraine
Unlikely	• **Persian Gulf Aflame** • Wars & More Wars • **Fed Turns Political**	• **East Asia Tensions**

Overlooked Risks Conventional Wisdom Discounted Risks Headline Risks
Bolded Text = Risks With Global Impact

Source: Alpine Macro

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Positioning for the Year Ahead

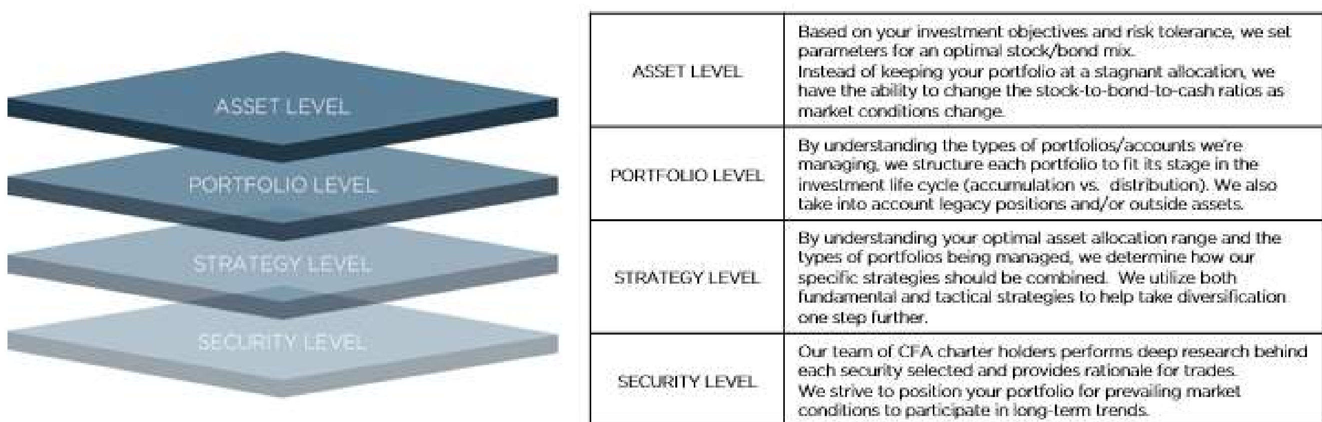
We do *not* believe long-term investments in the stock market should be abandoned for fear of geopolitical what-ifs. Financial markets are always looking forward, which means the risks that are visible to everyone are already reflected in current market prices to some degree. This dynamic describes the proverbial "wall of worry," whereby the stock market climbs whenever a risk that is discounted in stock prices today turns out better than feared with the passage of time.

We feel the year ahead should be no different. Yes, any number of things could go wrong that would cause stocks to fall. If this happens it will be easy to say "I told you so" because the likely catalysts for a problem are staring us in the face. But our worst fears might not be realized, and for each macro risk that evolves in a more favorable direction, market prices have room to adjust higher in response.

In the bond market there are attractive, mid-single digit yields available in high-quality securities with moderate duration. Unlike most of the past 15 years, investors can use fixed income to reduce the risk profile of their portfolio without eviscerating the expected return of the portfolio below real-world investment objectives like retirement income. Although the optimum mix of stocks vs. bonds is different for everyone, we believe *most* investors should employ a balanced approach to investing in the current market climate, with at least a portion of the portfolio allocated to high quality fixed income.

Current Design of Our Investment Strategies[3]

The remainder of this report addresses the current positioning of each of our investment strategies under current macro conditions. The specific design of *your* portfolio is customized to match your return objectives and risk tolerance. **For a refresher on how your portfolio is designed, and why, please reach out to your Wealth Advisor any time.**



ASSET LEVEL	Based on your investment objectives and risk tolerance, we set parameters for an optimal stock/bond mix. Instead of keeping your portfolio at a stagnant allocation, we have the ability to change the stock-to-bond-to-cash ratios as market conditions change.
PORTFOLIO LEVEL	By understanding the types of portfolios/accounts we're managing, we structure each portfolio to fit its stage in the investment life cycle (accumulation vs. distribution). We also take into account legacy positions and/or outside assets.
STRATEGY LEVEL	By understanding your optimal asset allocation range and the types of portfolios being managed, we determine how our specific strategies should be combined. We utilize both fundamental and tactical strategies to help take diversification one step further.
SECURITY LEVEL	Our team of CFA charter holders performs deep research behind each security selected and provides rationale for trades. We strive to position your portfolio for prevailing market conditions to participate in long-term trends.

[3] The portfolio strategy discussions in this section are supplemental to a compliant GIPS Report. A complete list of Capital Advisors' portfolio models and compliant presentations are available by contacting Capital Advisors.

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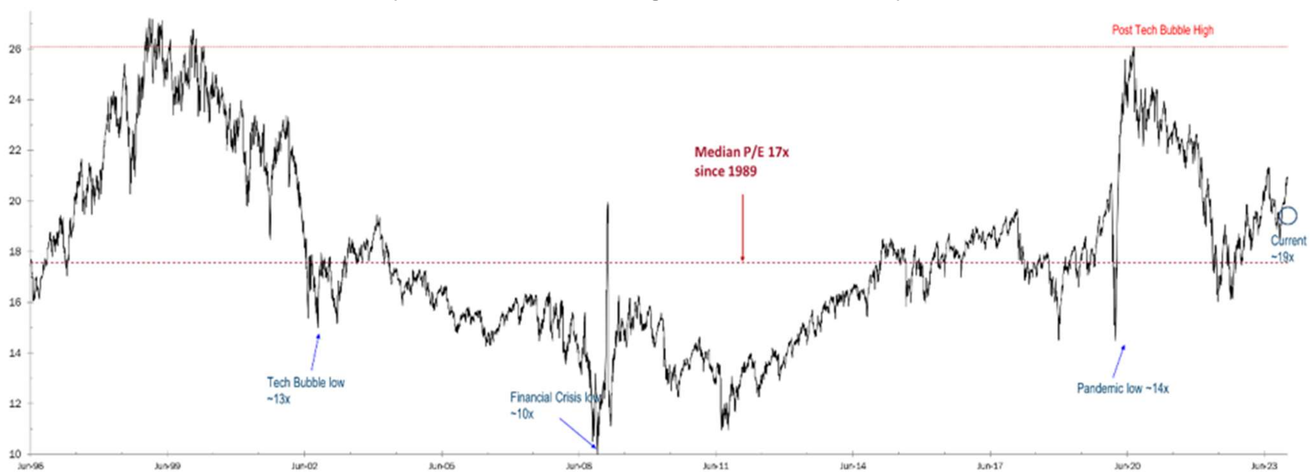
Managed Equity Strategies

The stock market discussion continues to start and end with innovation (value creation) levels. Since we began recent quarterly discussions there, we will begin this discussion with shorter-window items: valuations, interest rates, and the economy…. then move to the enabling innovations we expect to power stocks for the next several years.

Stock valuations appear full at first blush. The S&P 500's 20x price/earnings ratio (P/E) is appreciably higher than the 17x "norm" since the mid-1990s (see the chart below).

S&P 500 Price-to-Earnings Ratio (P/E)
July 1996 to December 2023
(Uses Consensus Earnings Per Share Forecasts)



Source: Bloomberg

Last quarter, we highlighted the outsized impact that a handful of meg-cap companies had on this market-cap-weighted valuation measure, and that the P/E was appreciably below the "norm" when each of the Index's 500 companies received equal treatment in the calculation. While the disparity between market-cap-weighted and equal-weighted S&P 500 indices remains wide, even the equal-weighted S&P 500's P/E is above the "norm" as we exit 2023.[4]

While P/E levels appear high at first blush, they are nearly in line with historic norms given interest rate levels. The following table shows historic average P/E levels at each category of 10-year U.S. Treasury yield levels.

Since 1962 **S&P 500 PE when nominal rates are:** Source: Bloomberg				
10-Year Treasury Range	**0% - 2%**	**2% - 4%**	**4% - 6%**	**>6%**
Average PE	20.4	17.7	20.1	14.7

[4] Source: Bloomberg, the (market-cap weighted) S&P 500 Index's P/E was 22.1x, and the equal-weighted P/E was 18.3x on December 26, 2023. This compares to a "norm", defined as the median S&P 500 P/E since 1996 of 17.0x.

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The data shows that with the 10-year yield currently at 3.9%, a P/E near 20x is not out of the norm, especially with a consensus outlook for multiple Fed rate cuts in the next year.[5] This aspect should link 2024's stock market performance more closely to earnings growth prospects than to P/E multiple expansion prospects. The consensus S&P 500 EPS growth expectation is 10% for 2024 and 11% for 2025, which is approximately in line with historic asset class returns for stocks.[6]

From an economic perspective, balance sheets and cash flows remain strong as the economy continues to struggle with potential recession questions. For example, economic profit margins are currently 11% versus the 6% they have averaged just before entering recessions.[7] Unemployment is also well below the typical pre-recession levels. Credit default rates are a key consideration, but they presently remain below concerning levels and were more of a focus item when interest rates were recently higher.

Equity performance varied very widely this year, closely mirroring a reverse image of 2022. The S&P 500 Index closed on January 3, 2022, at 4797; on December 31, 2023, the index closed at 4770. While dividend-focused styles underperformed the S&P 500 in 2023, nearly all of the strategies we track met or outperformed the Index when we include 2022 for a two-year look.[8] Dividend focused strategies look even better when compared to the Russell 1000 Growth Index, which underperformed the S&P 500 over the past two years.[9] We continue to believe that "enabling innovations" will power attractive value creation over the next several years. This outlook may favor the growth style for absolute returns over the long term, but it also supports the total return aspect of dividend-oriented styles.

The following commentary highlights sectors that underperformed this year. We believe Staples became overvalued late in 2022 and trimmed our positions in favor of secular-growth Tech (primarily **Microsoft: MSFT ~$371**). After a year of significant Staples underperformance, we believe selective opportunities are emerging.

Financials sharply underperformed this year due to the stress that higher interest rates placed upon some economic segments, including highly leveraged real estate and regional banks. We believe companies with the strongest balance sheets and expertise levels should benefit from this situation, as they can acquire the best assets at distressed prices. After reducing *Managed Equity Dividend's* **Blackstone (BX ~$129)** position late in 2021, we added to it on significant weakness in 2023. We also added **Morgan Stanley (MS ~$94)** to the *Dividend* buy list and increased *Managed Equity Growth's* **JP Morgan (JPM ~$171)** position.

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[5] Data source: Bloomberg

[6] Source: Bloomberg. As of December 26, 2023, the consensus 2023 S&P 500 EPS estimate is $221; the 2024 estimate is $243; the 2025 estimate is $270.

[7] Source Bloomberg. Economic profit margins are defined as Corporate Profits divided by nominal GDP; both series are published by the Bureau of Economic Analysis (BEA).

[8] Source: Bloomberg. The comparison includes five of the largest AUM dividend-oriented ETFs between December 31, 2021, and December 26, 2023.

[9] Source: Bloomberg. The time of this writing on December 27, 2023.

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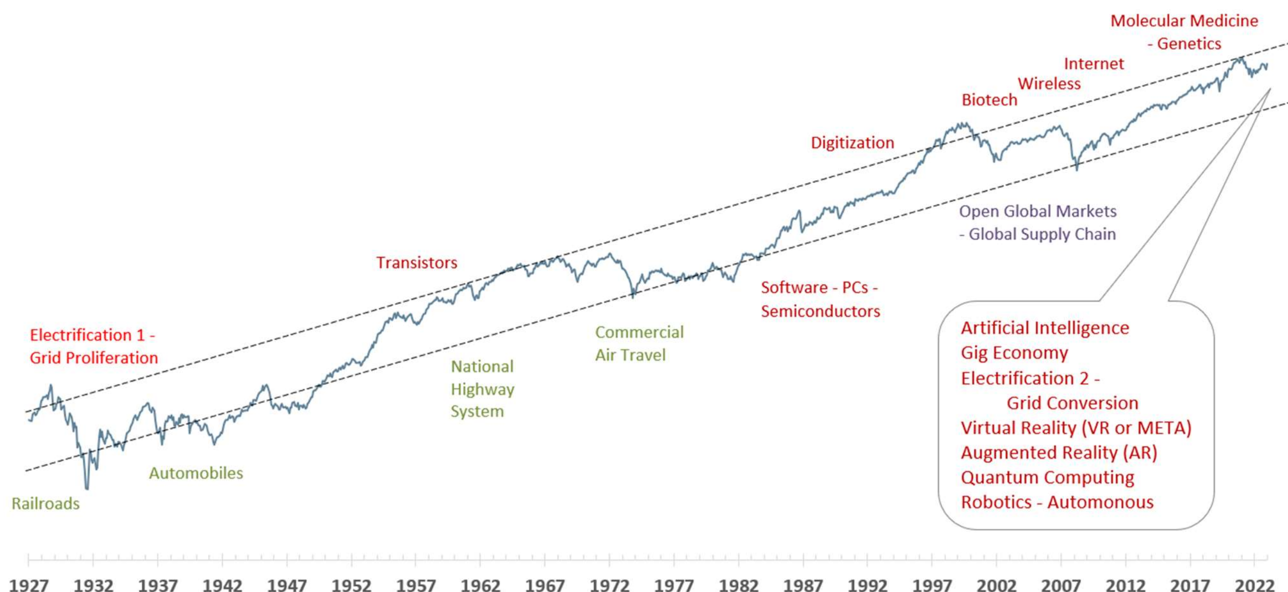
After outperforming in 2022, Health Care sharply underperformed in 2023. Higher interest rates caused innovative, smaller research firms to restrain their new equipment spending due to a lack of attractive financing. Stricter regulations also restrained the group's performance. While the area lacks immediate catalysts, we remain confident in the sector's outlook, as medical technology continues to advance impressively. In recent weeks, several larger pharmaceutical companies have taken advantage of the situation to acquire smaller, innovative biotechnology companies. This early-cycle trend could help stabilize equipment demand. **CRISPR Therapeutics (CRSP ~$67)** was a 2023 standout, as it recently became the first company to get a drug approved based on gene editing technologies. We strengthened that position as soon as we believed approval was likely, and subsequently took some profits after a sharp runup in the stock following the approval.

We continue to seek opportunities to rotate toward secular growth and innovation in the *Managed Equity Growth* strategy. In *Managed Equity Dividend*, we intend to remain focused on high-quality companies and highly diversified factors while favoring those we believe are enabling innovation trends. An economic "soft landing" scenario can favor certain Industrial and Financials groups that pay attractive cash dividends. In both strategies, our investment process focuses on companies that we feel have excellent management teams, powerful business models, and strong balance sheets, preferably with the ability to help shape the evolution of their markets.

U.S. Stock Market
Jan. 1, 1927 to Dec. 31, 2023



Source: Bloomberg; Capital Advisors

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Fixed Income

The bond market completely reversed direction over the past three months, as interest rates declined between 0.7% and 0.8% across the yield curve.[10] Much of this coincided with the Fed's messaging that rate hikes were all but done, and looking forward, the Open Market Committee is more likely to decrease rates starting sometime this year. In fact, Fed Funds Futures markets have priced in over six rate cuts of over 1.5% through year end 2024.[11] We still believe it is time to "lock in higher yields for longer" for our clients' bond strategies. However, we are very cognizant of the nation's financing concerns, as mentioned earlier in the document, and are currently focused on overweighting interest rate risk on the short-to-intermediate part of the yield curve, with limited exposures too far out the maturity spectrum.

Managed Credit Strategies

Within our *Managed Credit Strategies*, we are orienting the portfolios toward better credits, with roughly 70% of our clients' exposure in companies currently rated A- or better, on average.[12] We believe our BBB exposure has better balance sheets than the broad market, but we are willing and able to further reduce this allocation should we see specific situations worsen. We also hold a modest allocation to U.S. Treasuries, as applicable, to provide further credit diversification from any potential slowdown in the economy.

Our overweight to investment grade corporate credit generally outperformed Treasuries in the fourth quarter, while our slightly defensive duration posturing detracted from the substantial rate rally. With interest rates still materially higher than years past, we will look to add interest rate risk, but not go out much past 10-years. On a go-forward basis, portfolios are now yielding around 4.5%, depending on one's yield curve positioning.[13]

Municipal Bonds

Our *Municipal Bond* portfolios continue to be focused on "A" and above credits with strong debt coverage and liquidity profiles. We have also intentionally over-weighted essential service revenue bonds (water & sewer, utilities, etc.), and general obligation bonds with an average portfolio credit quality of "AA." Although our conservative posture caused slight underperformance relative to the benchmark proxy this quarter, our portfolios did participate nicely as interest rates marched lower. Municipals also seem to have caught a bid on the heels of the ever-increasing financing concerns of the United States. A larger federal budget deficit/ debt may translate into higher taxes, possibly making the asset class more attractive. Municipal bond portfolios are now yielding between 2.6% and 2.9% tax free *(between 4.3% and 4.8% at the highest marginal federal tax rate)*[14] depending on one's yield curve positioning.

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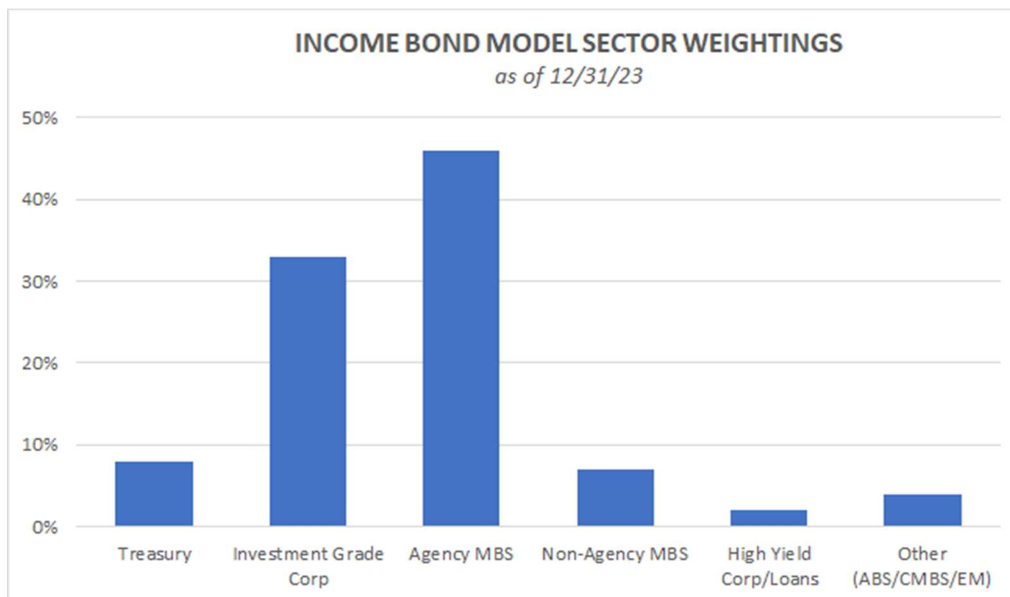
[10] Source: Bloomberg
[11] Source: Bloomberg
[12] Source: ORION
[13] Source: Bloomberg, ORION
[14] Source: ORION, Bloomberg, highest marginal tax rate of 40.8% = 37% federal plus 3.8% net investment income tax

ETF Bond Models

Our *Aggregate Bond* ETF strategy continues to be 100% invested in "defined maturity," investment-grade corporate bond ETFs. The significant decline in investment grade corporate yields positively impacted the model's outperformance relative to the benchmark in 2023. In addition, we were able to take advantage of the massive interest rate volatility in the quarter. Interest rates rose significantly in October, and we swapped a shorter maturity ETF for a longer one. Following the precipitous decline in November and early December, we sold the same ETF prior to year-end. This also contributed to the solid return of the model. Today, there is a relatively conservatively positioned laddered maturity structure of ETFs ranging between 2025-2029, and the model carries an average net acquisition yield of approximately 4.7%.[15]

The *Income Bond* ETF strategy has focused on maximizing cash flows within the construct of balancing risks, most notably through sector diversification (see chart below). Much like the active bond management we performed in the *Aggregate Bond* strategy, we took advantage of higher rates in October by selling the shortest maturity corporate ETF and increased our exposure to AAA-rated, agency mortgage-backed securities (MBS) via the **iShares Mortgage-Backed Securities ETF (MBB: ~$94)**. This proved timely as rates began to decline shortly thereafter and MBS significantly outperformed the shorter corporate bonds. In December, we reduced our interest rate risk in the corporate space by selling one ETF that could invest in bonds out to 30-years in maturity with one that has a maximum maturity of 10-years. Today, the model carries an average net acquisition yield of approximately 5.0%[16].



Source: ORION, iShares, State Street, Doubleline, Janus Henderson

[15] Source: Bloomberg, iShares, State Street
[16] Source: Bloomberg, iShares, State Street

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Tactical Global Strategy

Global risk markets came to life in the fourth quarter to enable a strong finish to the year for this strategy. Among the sectors included in the strategy, the standout performers during the fourth quarter were **U.S. Small-Cap**, **Real Estate,** and **International**. The most notable change in the portfolio for the upcoming quarterly holding period will be a shift to overweight from under-weight for **High-Yield Credit**. Sectors that will see a modest decrease in weighting include **International Small-Cap**, **U.S. Small-Cap** and **U.S. Equity Dividend**.

Tactical Global Strategy
Asset Allocation for the Upcoming Quarter

Asset Class	New Weighting (1/2/2024)
International Developed Markets	Overweight (17%)
High-Yield Credit	Overweight (17%)
U.S. Large-Cap Growth	Overweight (17%)
Emerging Markets	Neutral Weight (11%)
U.S Mid-Cap	Neutral Weight (11%)
International Small-Cap	Neutral Weight (11%)
U.S. Equity Dividend	Underweight (5%)
Real Estate	Underweight (5%)
U.S. Small-Cap	Underweight (5%)

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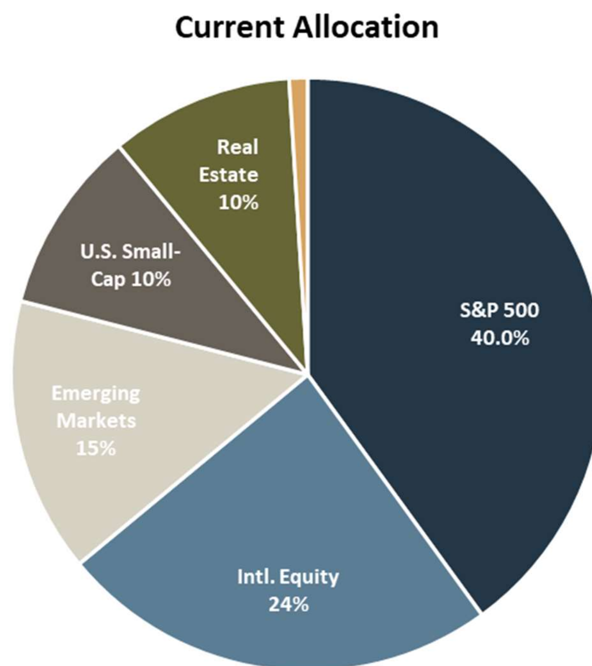
Dynamic Allocation Strategy

This strategy adjusted its asset mix fairly actively in 2023 as global risk markets navigated a range of issues including aggressive monetary policy, a mini banking crisis, and the outbreak of a second hot war, among others. Through it all the Dynamic strategy captured enough of the upside in global equities to deliver a high single-digit return for the year, without suffering a material drawdown during the period. This is consistent with the strategy's positioning on the risk-reward spectrum between stocks and bonds, where the objective is to deliver a higher long-term return than bonds with lower volatility and drawdown risk relative to the stock market. As of quarter-end the portfolio was invested in all five of its risk market sectors.



International Focus Strategy

International equities advanced nicely in the fourth quarter to enable a solid double-digit return for this strategy in 2023. Of all the major risk markets globally, we believe emerging markets might have the greatest potential for positive mean reversion following several years of relative under-performance versus developed market equities, particularly in the U.S. It seems noteworthy that emerging markets have weathered the massive tightening of U.S. monetary policy over the past two years without a crisis of some kind. This is almost unheard of historically and it suggests a material improvement in the fiscal resilience of many less developed economies, in our view.

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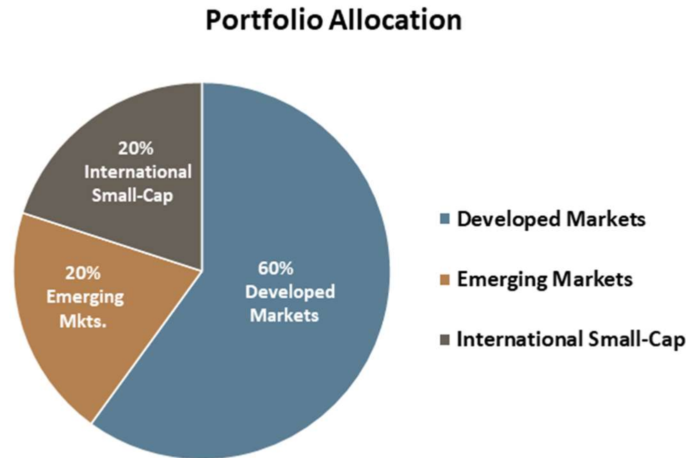
Looking forward, we believe international equities are set up nicely for the year ahead with a likely reversal of U.S. monetary policy, and a possible tailwind from a weaker U.S. dollar exchange rate. Among non-U.S. markets, we would expect emerging markets to benefit most from this combination of variables, if they happen.



The *International Focus* strategy provides a strategic commitment to international equities to expand the universe of companies for investment within a diversified portfolio. To enhance the potential diversification benefits of this expansion, the strategy seeks to capture a return premium relative to common international equity benchmarks through disciplined emphasis on three market factors that have demonstrated a long-term history of attractive risk-reward characteristics: Value, Momentum and Low Market Capitalization, or “small cap."

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The **Russell 1000 Growth Index** seeks to track the investment results of an index composed of large- and mid-capitalization U.S. equities that exhibit growth characteristics.
The **Russell 1000 Value Index** seeks to track the investment results of an index composed of large- and mid-capitalization U.S. equities that exhibit value characteristics.
MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S.
MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.
MSCI EAFE Small-Cap Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of small- and mid-cap stocks in the developed markets, excluding the U.S.
Vanguard High Dividend Yield ETF is an exchange-traded fund that seeks to track the performance of the FTSE High Dividend Yield Index, which consists of common stocks of companies that pay dividends that generally are higher than average.
Morningstar Dividend Yield Focus aims to track high-yielding, qualified dividend-paying, U.S. based securities screened for companies with
financial health. The Index is calculated on a total return basis with dividends reinvested and is not assessed a management fee. It is not possible to invest directly in an index.
Bloomberg Aggregate Bond Index is an unmanaged index made up of U.S. Government, corporate, mortgage-backed and asset-backed securities rated investment grade or higher. The index is designed to measure the performance of the domestic investment-grade bond market.

Estimated portfolio yield represents the 12-month run-rate of interest and/or dividend payments in a strategy divided by the market value of the securities and cash reserves invested in the strategy. Estimated interest/dividend payments and market values are calculated by a portfolio accounting system from *Orion* using a single client portfolio that Capital Advisors believes to be representative of clients' portfolios invested in the same strategy. The actual portfolio yield for any single client portfolio may be lower or higher than the yield quoted. The underlying holdings of any presented portfolio are not federally or FDIC-insured and are not deposits or obligations of, or guaranteed by, any financial institution.

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The information provided is supplemental to a fully compliant GIPS Report. A complete list of Capital Advisor's portfolio models and compliant presentations are available by contacting Capital Advisors at the number listed below. The actual return and value of an account fluctuate, and at any time the account may be worth more or less than the amount invested.

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