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One North Brentwood Boulevard, Suite 850
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(855) 382-1600
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Investment Insights Monthly

From The Desk of Jack Kraft, CFA, Investment Strategist December 2023

Full Speed Ahead: 2024

The Santa Claus rally might have come early this year as hopes for positive fourth-quarter performance played out in November. Both the S&P 500 and Nasdaq Composite snapped their three-month losing streaks by posting the best monthly stock returns since July 2022. The S&P 500 jumped 8.9%, while the Nasdaq surged 10.7%. Elsewhere, the Dow and Russell 2000 indexes both advanced 8.8%. The stellar stock performance was fueled by a drawdown in interest rates amid optimism surrounding a soft landing and slowing inflation. In fact, the Bloomberg Barclays US Aggregate Bond Index rose 5% in November, posting its best month since 1985.

Economic data seemed to be a big driver behind the positive November returns. Many investment strategists over the past year coined the phrase “goldilocks scenario” for the economy. This term referred to the idea that the U.S. Federal Reserve (Fed) could engineer a soft landing by gradually bringing up unemployment while slowing growth just enough to bring down inflation. Many thought this was out of reach based on the Fed’s track record, but last month’s data suggested otherwise. The labor market looked to weaken in October with a soft payroll growth number, while continuing claims saw its highest level since November 2021. Additionally, inflation data was positive, with the Consumer Price Index (CPI) printing its lowest annualized number since September 2021.

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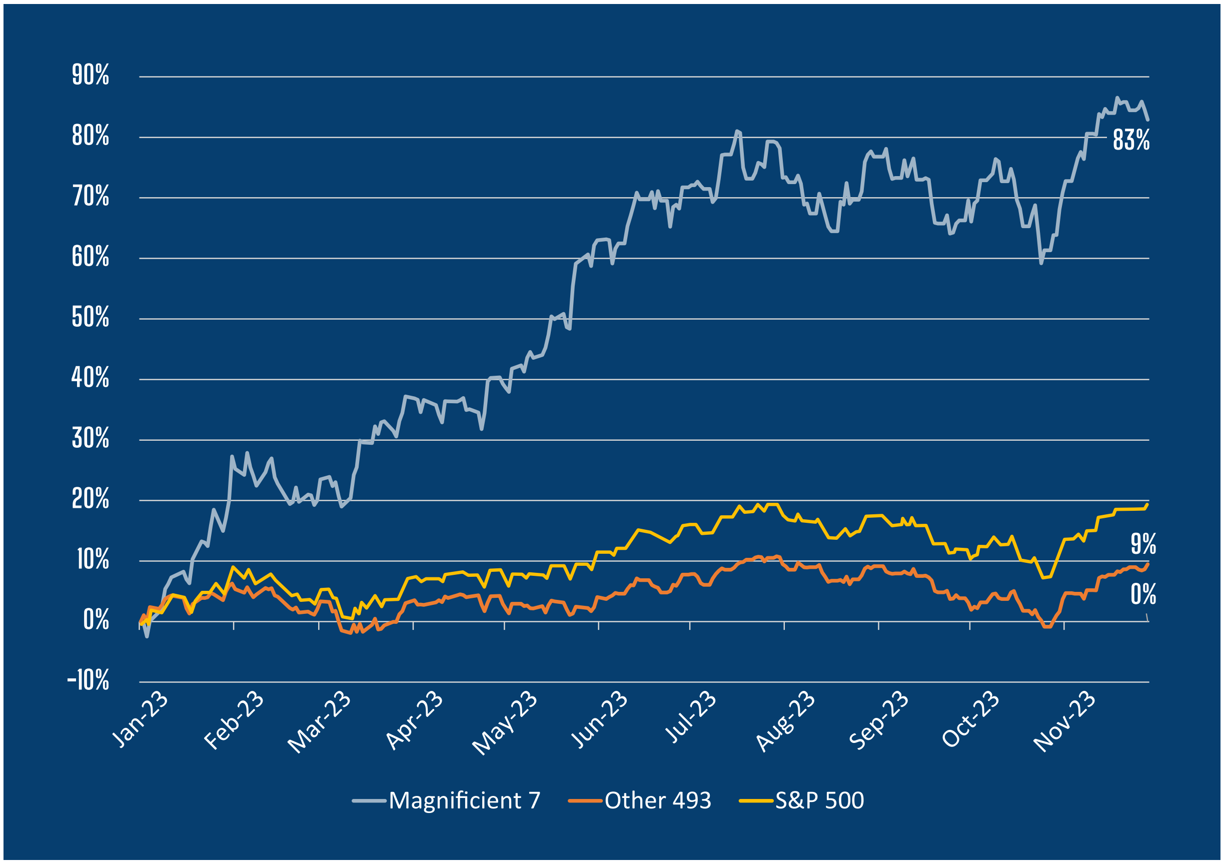
The investor-friendly economic data also rippled through to Fed expectations. Fed Chairman Jerome Powell stuck to his usual script, saying that rate cuts are not on the Fed's mind, and 2% inflation is still far down the road. However, the market's expectations of Fed action shifted meaningfully, with the FedWatch Tool at CME Group pricing in nearly a 0.0% chance of a December rate hike. Additionally, expectations for a rate cut in 2024 were priced in sooner than previously expected, providing a tailwind for stocks. In Fed speak, Fed Governor Waller spoke encouragingly, saying that policy is well-positioned to slow the economy and get inflation back toward the Fed's 2% target. He went on to add that if inflation can get back to 2%, he doesn't see the need for a "really high" policy rate.

If the 2023 stock rally had to be summed up into a theme, many will look back and call it the year of the "Magnificent Seven." If you didn't have direct or indirect exposure to Apple, Microsoft, Amazon, Meta, Nvidia, Google or Tesla, it is likely you felt FOMO (fear of missing out) at some point in 2023. Through the end of November, more than half of the S&P 500's return for the year has been driven by those seven stocks. Back up a little further to October, and those seven stocks were responsible for the entire S&P 500 advance for the year.

Mega-Caps Leave Peers Behind



As of November 30, 2023
Source: YCharts
Note: Magnificent 7 refers to Apple, Microsoft, Amazon, Meta, Nvidia, Google and Tesla

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Since late October, the rally in stocks has started to broaden out to the other 493 stocks, an encouraging sign of healthy market breadth. According to Bespoke Investments, 80 S&P 500 stocks (or roughly 15% of the index) notched new 52-week highs in the first week of December. Additionally, this was a team effort, with all 11 S&P 500 sectors participating, from Energy to Technology. This broader participation has continued into December, with the S&P 500 notching a gain for the first time this year when each member of the Magnificent Seven finished the day down. This type of day in the market is uncommon—it has only occurred once in 2023 and six times in the past four years.

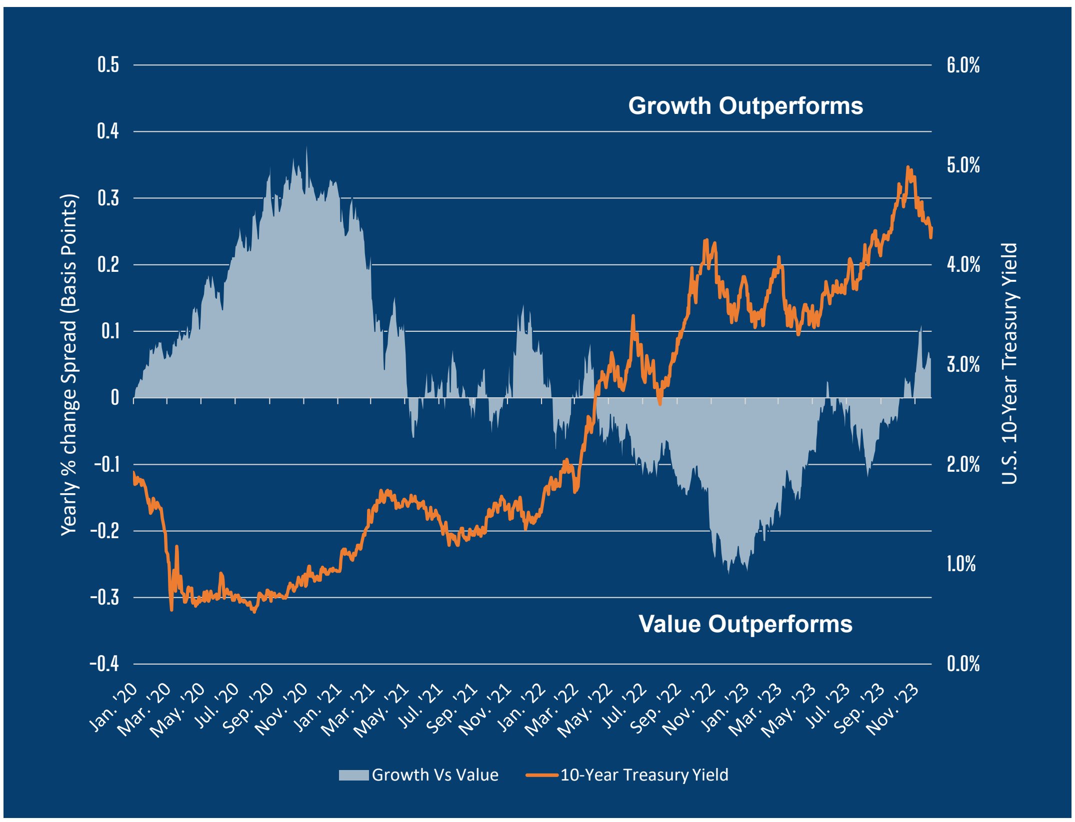
Date	S&P 500	AAPL	MSFT	META	NVDA	GOOG	AMZN	TSLA
	Daily Change	Daily Change	Daily Change	Daily Change	Daily Change	Daily Change	Daily Change	Daily Change
7/21/2020	0.17%	-1.38%	-1.35%	-1.50%	-1.73%	-0.51%	-1.83%	-4.54%
3/10/2021	0.60%	-0.91%	-0.58%	-0.32%	-0.42%	-0.20%	-0.17%	-0.82%
3/12/2021	0.10%	-0.76%	-0.58%	-2.00%	-1.06%	-2.41%	-0.77%	-0.84%
8/10/2021	0.10%	-0.34%	-0.66%	-0.13%	-1.77%	-0.08%	-0.63%	-0.53%
7/25/2022	0.13%	-0.74%	-0.59%	-1.55%	-1.70%	-0.36%	-1.05%	-1.40%
12/11/2023	0.39%	-1.29%	-0.78%	-2.24%	-1.85%	-1.26%	-1.04%	-1.68%

Source: JPMorgan

Shifting our view to the year ahead, I hope to provide some insight into portfolio positioning, both size (large, mid and small) and style (value versus growth). I think the answer of where to go lies more within a client's risk tolerance and time horizon. In my opinion, a well-rounded portfolio will include a mix of these asset classes because of the vast difference in performance they offer over a business cycle. For example, in 2022, value was the place to be, while in 2023, the Russell 1000 Growth has outperformed its value counterpart by more than 30%. This is why we recommend having a healthy mix of the two that is supportive of your risk tolerance and goals to have an optimal allocation that provides both downside protection through value stocks and bonds and upside capture via growth stocks.

The value-versus-growth argument for 2024 is ongoing, and depending on the different scenarios that play out, can remain in favor next year. Supportive of the growth narrative is that we are near the later stage of the business cycle and inflation has shown signs of moderating. Due to this moderating inflation, the growth-versus-value trade has become more correlated with economic growth rather than inflation data like it was in 2022. Additionally, the setup for modest economic growth next year, along with markets pricing in rates cuts in the first half of 2024, is supportive of the growth environment given a "goldilocks scenario" for a soft landing. Meanwhile, if economic growth is more robust than expected and rates remain higher than expected for longer, this could be supportive for value stocks. The other scenario that I see as favorable for value stocks is that if a recession materializes, it could cause economic growth to slow and a rotation from growth to value amid hopes for a rebound in cyclical stocks.

S&P 500 Growth vs. Value with 10-Year Treasury Yield



As of November 30, 2023
Source: Morningstar Direct

Market-cap size is also an important factor in portfolio positioning, as 2023 was a year to remember for mega caps and the famed Magnificent Seven stocks. These stocks account for about 30% of the weight in the S&P 500 and will continue to have a substantial impact on index returns (positive and negative) due to that weighting. Many investment strategists continue to be favorable on the group, given their faster-than-peer sales growth and profitability. The group of seven stocks are

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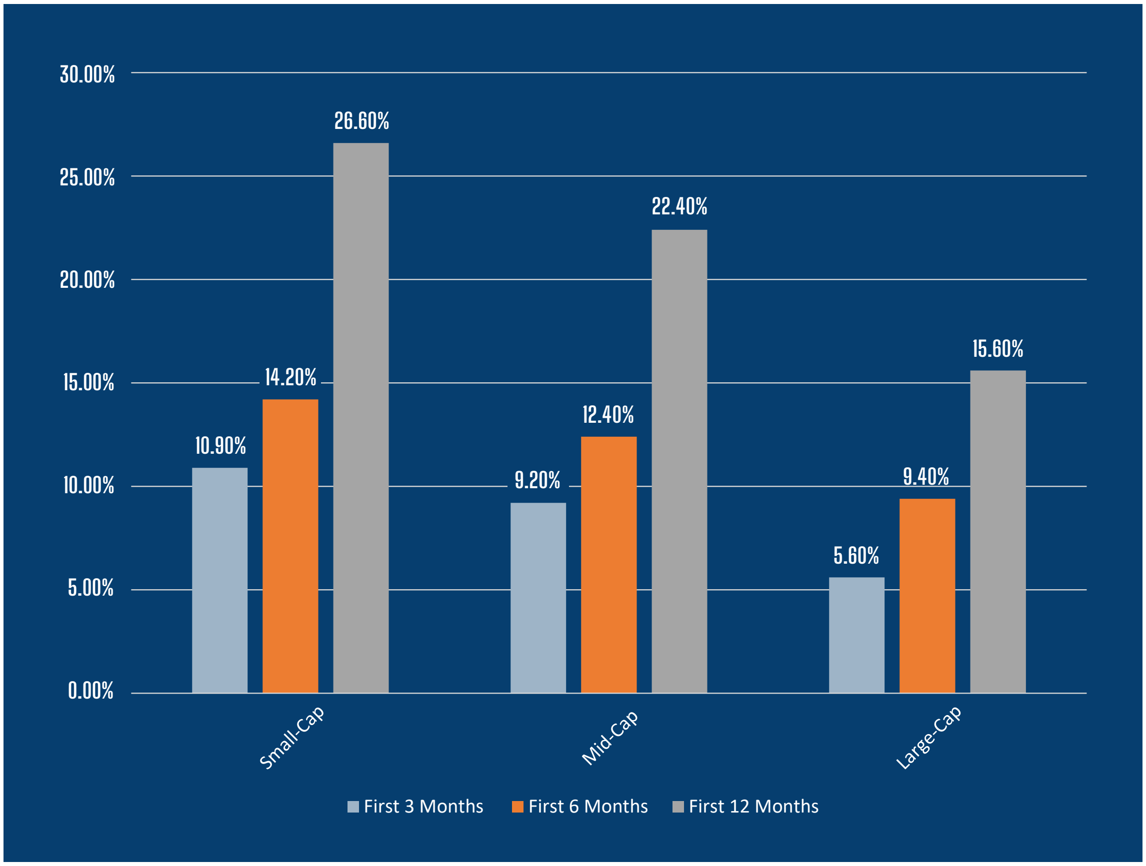
forecasted to have a compounded annual revenue growth rate of 11% through 2025, compared to just 3% for the remaining 493 stocks. Additionally, these seven stocks have higher margins (by 10%+) and substantially better reinvestment ratios of 61% versus 18%. These three metrics show above-average growth, profitability and efficiency compared to their peers and help explain why they trade at a premium to the rest of the market.

One headwind for these stocks and the broader large-cap group is the current valuation setup. This year's rally has been entirely fueled by higher valuations rather than higher earnings—a trend that is unsustainable given that S&P 500 trading is at a 20% premium to its historic average. One area for optimism is in small- and mid-cap stocks that have more attractive valuation profiles and growth expectations. Looking at the price-to-earnings ratio of the Russell 2000 (small-cap index), it is materially below its long-term median, while the Russell Top 200 (large-cap index) is trading well above its median historical value. In addition to the attractive valuations, William Blair points out that since 1954, on average, small- and mid-cap stocks tend to outperform large-cap stocks following the first rate cut.

Performance by Size after First Rate Cut



Past performance is not indicative of future returns.
As of October 31, 2023
Source: William Blair

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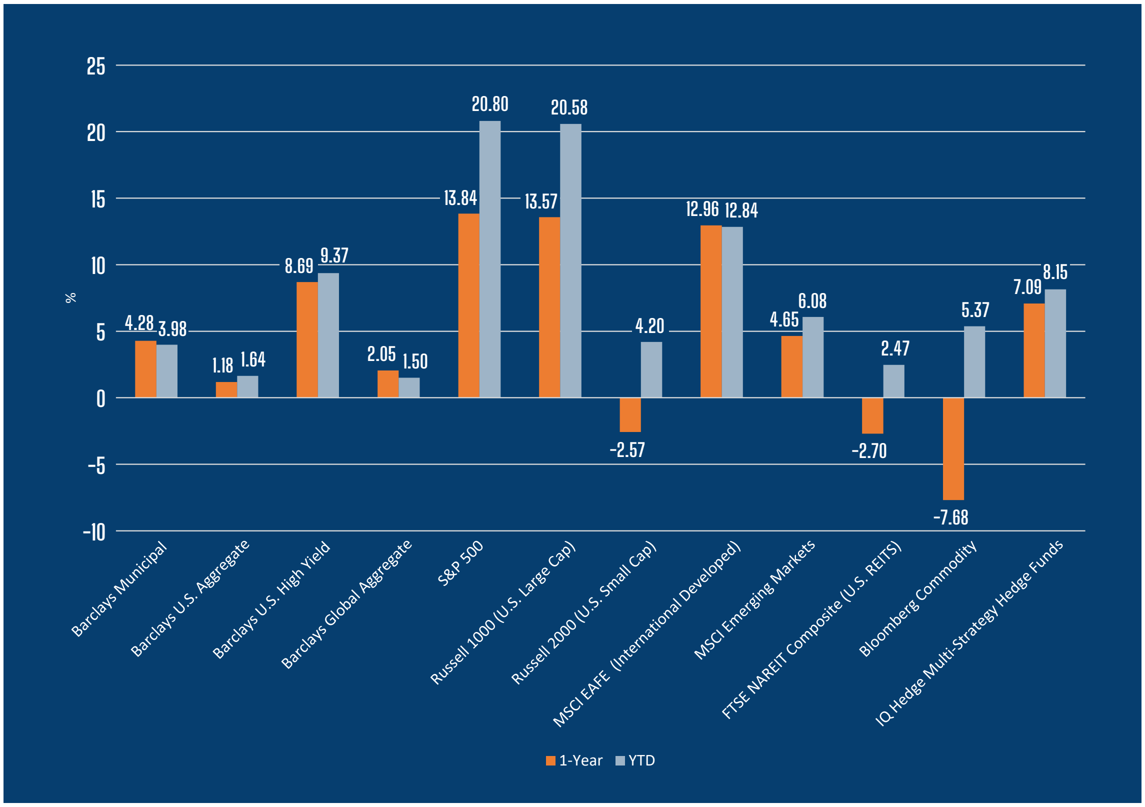
Asset Class Returns

Comparing Recent 1-Year and Year-to-Date Total Returns



Source: Conway Investment Research

Fixed Income

- Treasury and other sovereign debt yields plunged across the globe, leading to strong gains for core fixed income, credit and municipal bonds.
- The Bloomberg Aggregate Index rose an astonishing 4.5% in November.
- Credit spreads tightened across the board last month with the risk-on sentiment.
- The weaker U.S. dollar also provided a nice boost to non-U.S. assets.

Equities

- U.S. equities surged higher in November, led by tech/growth stocks across all market capitalizations.
- Growth led value in large caps but the difference in returns was flat within small caps.
- Small caps rebounded 9.1% last month but continue to significantly underperform large caps year-to-date.
- Non-U.S. equities performed well in November with strong gains from Europe and small caps.
- Similar to the U.S., growth led value within EAFE markets, but small caps outperformed large caps by about 80 basis points.
- Within emerging markets (EM), Latin America and Eastern Europe drove the 8% return. Weakness in China caused EM Asia to underperform.

Alternatives

- Hedge funds had a very strong month in sympathy with other asset classes. They generally lagged bonds and stocks for the month but have posted strong returns year-to-date.
- REITs were up over 8% in November, pulling them into positive territory this year.

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November 30, 2023	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Bloomberg U.S. Treasury Bill 1-3 Month	0.45%	0.91%	4.65%	5.02%	2.06%	1.82%	1.18%
Bloomberg Municipal	6.35%	5.44%	3.98%	4.28%	-0.96%	2.03%	2.77%
Bloomberg US Govt/Credit Intermediate	1.16%	1.48%	3.38%	3.57%	-0.27%	1.43%	1.14%
Bloomberg U.S. Aggregate	4.53%	2.88%	1.64%	1.18%	-4.47%	0.71%	1.37%
Bloomberg U.S. High Yield	4.53%	3.31%	9.37%	8.69%	1.37%	4.15%	4.27%
S&P/LSTA Leveraged Loan	1.22%	1.20%	11.48%	11.94%	5.66%	4.91%	4.29%
Bloomberg Global Aggregate	5.04%	3.79%	1.50%	2.05%	-6.37%	-0.73%	-0.09%
U.S. Equity Indices							
DJ Industrial Average	9.15%	7.78%	10.72%	6.19%	8.85%	9.41%	10.89%
S&P 500	9.13%	6.84%	20.80%	13.84%	9.76%	12.51%	11.82%
NASDAQ Composite (Price)	10.70%	7.62%	35.92%	24.05%	5.26%	14.18%	13.36%
Russell 1000	9.34%	6.70%	20.58%	13.57%	8.72%	12.25%	11.56%
Russell 1000 Growth	10.90%	9.32%	36.63%	26.17%	8.92%	16.36%	14.69%
Russell 1000 Value	7.54%	3.75%	5.61%	1.36%	8.27%	7.52%	8.09%
Russell Mid Cap	10.23%	4.72%	8.82%	2.94%	4.91%	8.72%	8.93%
Russell 2500	9.00%	2.38%	6.06%	-0.25%	3.26%	6.91%	7.53%
Russell 2000	9.05%	1.61%	4.20%	-2.57%	1.13%	4.78%	6.13%
Russell 2000 Growth	9.10%	0.69%	5.97%	-0.83%	-4.26%	4.16%	6.17%
Russell 2000 Value	9.00%	2.50%	1.96%	-4.73%	6.47%	4.72%	5.71%
Non-U.S. Equity Indices							
MSCI World	9.43%	6.28%	18.55%	13.56%	7.56%	10.53%	8.89%
MSCI ACWI	9.28%	6.02%	17.14%	12.58%	6.19%	9.61%	8.16%
MSCI ACWI Ex-U.S.	9.02%	4.54%	10.62%	9.84%	2.17%	5.57%	3.90%
MSCI EAFE	9.30%	4.88%	12.84%	12.96%	4.32%	6.51%	4.39%
MSCI EAFE Growth	10.71%	6.64%	11.57%	10.33%	0.32%	6.91%	5.11%
MSCI EAFE Value	7.95%	3.22%	14.19%	15.68%	8.15%	5.68%	3.42%
MSCI Europe	9.89%	5.81%	14.90%	14.95%	6.36%	7.66%	4.46%
MSCI Japan	8.56%	3.67%	15.70%	16.03%	0.96%	4.94%	4.97%
MSCI AC Asia	7.56%	3.15%	7.32%	7.34%	-3.17%	3.47%	4.15%
MSCI EAFE Small Cap	10.08%	3.62%	5.97%	7.13%	-0.40%	4.13%	4.71%
MSCI ACWI Ex-U.S. Small Cap	9.70%	3.57%	9.25%	9.48%	2.16%	5.84%	4.83%
MSCI Emerging Markets	8.02%	3.83%	6.08%	4.65%	-3.66%	2.73%	2.50%
MSCI EM Asia	7.61%	3.36%	4.72%	3.91%	-5.42%	3.35%	4.02%
MSCI China	2.52%	-1.85%	-8.84%	-4.09%	-16.89%	-3.39%	0.93%
MSCI EM Eastern Europe	8.70%	20.86%	39.08%	46.26%	-31.20%	-19.01%	-10.21%
MSCI EM Latin America	14.07%	8.65%	23.21%	18.38%	11.70%	4.72%	1.44%
MSCI EM Small Cap	9.65%	4.37%	19.14%	18.01%	8.10%	9.11%	5.22%
MSCI Frontier Markets	7.15%	0.95%	8.85%	7.25%	0.73%	2.45%	2.27%
Hedge Fund Indices							
IQ Hedge Multi-Strategy	3.12%	1.77%	8.15%	7.09%	0.58%	2.66%	2.44%
Real Assets Indices							
FTSE NAREIT Composite	11.97%	8.05%	2.47%	-2.70%	3.37%	3.65%	6.90%
Alerian MLP	6.86%	7.31%	29.37%	23.29%	34.51%	10.33%	2.29%
Bloomberg Commodity	-2.25%	-1.99%	-5.37%	-7.68%	13.60%	6.29%	-0.72%
S&P Global Infrastructure	9.72%	6.42%	2.44%	0.19%	5.62%	5.82%	5.44%
Other							
CBOE Market Volitility (VIX)	-28.78%	-26.26%	-40.38%	-37.22%	-14.36%	-6.49%	-0.58%

Source: Morningstar

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