



Winter 2024

Que Sera, Sera

How quickly times can change! Investors were decidedly pessimistic entering 2023, as it appeared that the Federal Reserve (Fed) in its quest to subdue inflation would have to maintain high interest rates for an extended period. The consensus view of economists was that the higher rates would restrain economic growth, most likely resulting in a recession. The stock market declined in anticipation of the expected tough times, with the S&P 500 falling 18.11% in 2022. Of course, we now know that the dire scenario did not materialize. Instead, inflation rates declined to more manageable levels, and the economy continued to grow at a steady pace. As the end of 2023 approached, investor sentiment turned decidedly optimistic, and the market rallied. The S&P 500 rose 11.69% in the fourth quarter and finished the year up a very respectable 26.29%, near an all-time high.

No doubt about it, the past few years have presented the financial markets with a multitude of formidable challenges. Since 2020 and the outbreak of the pandemic, the markets have had to face a war in Ukraine, international trade disputes, an inflationary spiral, a record increase in interest rates, a banking crisis, and most recently, a war in the Middle East. Given the magnitude of these problems, it is not surprising that the financial markets would experience heightened volatility. But what has been surprising to many is the resiliency of the US economy, which continues to grow despite these headwinds.

During the initial Covid shut down in 2020, the US economy contracted sharply, but it quickly recovered and has grown steadily ever since. Gross Domestic Product (GDP) grew by 5.9% in 2021, and by 2.06% in 2022. Estimates for 2023 put GDP up by another 2.6%. For 2024, economists are forecasting slower growth to start the year but expecting a pickup in the second half. Overall, estimates put GDP for the year up 2.3%.

With the recent good news on inflation, it is possible that the US economy is finally shaking off the aftereffects of the pandemic and returning to more normal times. While inflation at 3.1% is

still running above the Fed's target of 2%, recent reports have given investors hope that we have seen the peak in short-term rates for this cycle. The market is anticipating that the FED will enact two or three cuts in the Fed Funds rate this year. Accordingly, the bond market has rallied to reflect the outlook for rate cuts, with the yield on the ten-year US Treasury bond falling about 100 bps, to 4.10%.

Corporate profits are more variable than GDP but have also grown over the past four years. Despite the disruption of the pandemic, earnings per share for the S&P 500 have increased by about 30.7% since 2019 and are expected to grow by an additional 23.4% in 2024. Should profits meet expectations for 2024, they will have increased by an impressive 45.5% since the end of 2019, when the pandemic was just beginning to emerge.

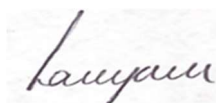
All this positive news on inflation, GDP, and corporate profits has helped the stock market to rally, despite the pressure of the worrisome events around the globe. This can only give great relief to investors who survived the pandemic with their assets intact. However, promising the outlook for 2024 might be, we should point out that the current valuation of the equity markets (as of 12/30/2023) already reflects much of this good news. The P/E of the S&P 500 based upon consensus earnings for 2024 of \$227 per share is about 21x, above the long-term average of 18x. Part of the higher valuation is due to the dominance of a few very large tech stocks, the so-called Magnificent Seven, which are trading at very high multiples. These seven stocks comprise 28% of the market value of the entire index. The equally weighted S&P 500 (contains the same companies as the S&P 500 but each is 0.2% of the total) is trading at a more reasonable P/E of 18x. An even broader index, the Russell 2000 (an index of 2000 smaller US companies) is trading at 15.2x projected earnings over the next 12 months, below the ten-year average of 16.7x. Given the current valuation of US equities, we would not expect returns going forward to approach what the markets accomplished in 2023.

Now that the economy and the markets have recovered to pre-Covid levels, can we look forward to more normal times? It appears that the virus that causes Covid will continue to circulate and mutate but will be a manageable health concern. Nonetheless, given the number of surprises over the past four years, we would caution investors not to become too complacent. Who knows what the future will be? Hopefully, investors have learned from the past that surprises are inevitable, but that the economy and the financial markets will survive them, and that patience will be rewarded.

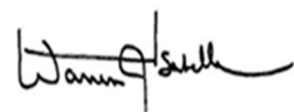
Sincerely,



Donald Collins



Ravi Jain



Warren J. Isabelle