

Quarterly

2023 Fourth Quarter Investment Market Report

Since the end of the third quarter, we've seen the mood of the markets transform from somber to jubilant. Chances are that both will prove to be overreactions, but the last two years have been rather gut-wrenching for many investors as the markets have ridden a roller coaster of volatility—so such mood swings come as no surprise. There is still much uncertainty ahead, but the markets did have reasons to celebrate in the fourth quarter. Thanks to reports of slowing inflation, the Federal Reserve was able to signal that it does not foresee the need to hike interest rates any further, likely ending one of the more severe rate hiking campaigns on record, which had been necessitated by skyrocketing inflation post-pandemic. The timing of this pivot in policy was earlier than expected, so both stock and bond markets took great relief in the news.

We have written much this year about the concentration of the top 7 stocks in the S&P 500 and how they have come to represent about 30% of the entire 503-stock index, which is weighted by market capitalization. Through the first three quarters of 2023, nearly all the return in the U.S. stock market could be attributed to those few stocks, meaning the rest of the U.S. stock market was essentially flat for the year – such a lack of “breadth” generally indicates that market rallies may not be very durable. In a welcome sign of market health, this changed in the fourth quarter as the rest of the U.S. stock market kept pace, and even slightly surpassed the performance of those top stocks. For the quarter, an equal-weighted S&P 500 actually outperformed the market-cap weighted benchmark S&P 500 index, and Small Cap stocks fared even better.

INDEX	Q4 2023	YTD 2023
S&P 500	11.7%	26.3%
Equal-Weighted S&P 500 Index	11.9%	13.9%
Dow Jones Industrial Average	13.1%	16.2%
Nasdaq Composite	13.8%	44.6%
Russell 2000 (Small Caps)	14.0%	16.9%

Source: Schwab Center for Financial Research

Equities in both Developed Markets and Emerging Markets also rallied on the expectation that the global battle against inflation was turning the corner. With the market perception that inflation is falling more slowly in the rest of the world, the bullish reaction at year-end was slightly more muted abroad than in the U.S., but all equities markets rallied strongly in the quarter. A slight weakening of the dollar, which we see as a longer-term trend, also provided some tailwind to international markets for much of the year. Developed Markets performed better than the broader U.S. market, and Emerging Markets fared quite well considering the continued stumbling of the Chinese economy has weighed down what would have been a very strong performance for most Emerging Market countries.

INDEX	Q4 2023	YTD 2023
MSCI EAFE (Developed Markets)	10.4%	18.2%
MSCI Emerging Markets	7.9%	9.8%

Source: Morningstar Direct; See disclosures for important benchmark information

With the market perception that inflation is falling more slowly in the rest of the world, the bullish reaction at year-end was slightly more muted abroad, but all equities markets rallied strongly in the quarter.

continues next page

THE BIG STORY: THE FED AND INFLATION

“Euphoric” is not an exaggeration in describing the mood of the markets as 2023 drew to a close. After nearly four years of volatility due to the pandemic and the post-pandemic economic effects, the Fed’s pivot away from ever increasing monetary tightening has spawned hope that investors’ lives might be returning to “normal,” at least what they came to know as “normal” in the decade preceding the pandemic. Contributing to this euphoria is a consensus, however historically unlikely, that the Fed has engineered a “soft landing” for the economy – meaning that the Fed was able to slow the economy enough through interest rate hikes to quell inflation, but not so much as to push the economy into recession.

Last year, the consensus heading into 2023 was that the U.S. economy was almost certainly headed for a recession in 2023. The Fed had undertaken the fastest and most severe interest rate hiking campaign in history to try to reign-in out-of-control inflation. The rate hikes had slammed the brakes on the housing market, the office real estate market was collapsing as much of the workforce decided not to return to their offices post-pandemic, and the wealth effect on the economy was surely to be negative as investor portfolios had suffered significant losses in both equities and fixed income. As we progressed through the Winter and Spring, inflation remained stubbornly high, worker shortages put pressure on wages and motivated organized labor to strike in search of substantial wage increases, raising the specter of inflation becoming embedded in the economy. The Fed continued to hike rates, yet the consumer kept spending, employment remained high, economic growth actually reaccelerated in the third quarter, and the “Great Recession of 2023” never materialized, yet the Fed did make significant strides in bringing down inflation. So much for consensus expectations!

With the end-of-year euphoria that the Fed had pivoted away from monetary tightening mode without having pushed the economy into recession, the bond markets reversed course from what had been another year of declines to post a very strong fourth quarter, resulting in strong gains for the year.

INDEX	Q4 2023	YTD 2023
Bloomberg US Aggregate Bond Index	6.8%	5.5%
Bloomberg Global Aggregate Bond Index	7.0%	5.6%
Bloomberg Municipal 5-Yr Index	5.2%	4.3%

Source: Morningstar Direct; See disclosures for important benchmark information

As we begin the New Year, the economy has continued to grow at a moderate pace...

WHAT’S AHEAD IN 2024?

As mentioned above, the consensus market expectation now is that the Fed will indeed achieve a “soft landing” for the economy. At present, most economic indicators do, in fact, indicate that we are headed in that direction. Of course, the signs were at least as strong that we were headed for a recession last year!

As we begin the New Year, the economy has continued to grow at a moderate pace, corporate earnings have held up well, consumers have remained resilient, unemployment remains even lower than what could be considered “full employment,” and recent inflation readings indicate a return to target levels faster than the Fed expected - so there is plenty of fuel for optimism in the markets.

It is worth remembering, however, that market euphoria is often followed by market indigestion! There is a reason why the Fed has only ever been able to achieve one “soft landing” – it was 1994 and it was, encouragingly, followed by prosperity for the rest of the decade. The challenge is that the Fed only has very blunt instruments with which to implement monetary policy, and their impact is not felt for 6 to 18 months after they take action. By moving an interest rate that banks use to lend money to each other overnight, the Fed tries to steer the entire economy. Imagine using a sailboat rudder to steer a cruise ship! While the ship’s instruments may all show we are headed in the right direction, we have yet to feel the full effects of “rudder movements” from months ago or other waves ahead that may impact our course. It is perhaps healthier to think of the “soft landing” as an “average expectation” across the range of possibilities. If the Fed can keep the ship on course using its limited tools, a soft landing is possible.

What are some of the potential “waves” ahead that could throw us off course?

There are plenty of variables that could cause the economy and the markets to drift off course, including resurgent inflation, overstimulation of the U.S. economy due to massive government spending programs or even huge defense spending as we continue to supply arms to our allies around the world who

are either at war or in a state not far from it (not to mention we will need to restore our own depleted inventories). The U.S. is incurring budget deficits of between 6-8% of GDP, a level you typically would only see in wartime, and we are expected to run these deficits for the foreseeable future. The tightening moves that the Fed has already made will likely continue to have slowing effects on the economy, which could still tip the economy into recession. Record deficit spending and the related borrowing could overwhelm the market's appetite for U.S. Treasury debt, which would raise interest rates and slow the economy. So how might these variables come together to form different scenarios for investors?

The "Goldilocks" case is the "soft landing" (not too hot, not too cold!).

Market optimists think the inflation reports will be benign enough to allow the Fed to start cutting interest rates as early as March, the economy may slow further, but is unlikely to dip into recession, and as rates fall, the recent stresses on real estate and regional banks will lessen, allowing the economy to be able to shift into a stronger phase of growth. Even if we see some of the "Magnificent 7" mega-tech stocks pull back due to a calming of A.I.-mania, the rest of the U.S. stock market would likely enjoy moderate returns, especially small cap stocks. Developed markets stocks should also benefit from falling rates in addition to a weaker dollar, and emerging markets could also prosper (as many of the individual countries have) if the Chinese economy stops acting like an anvil around the neck of the region. Falling interest rates would fuel a strong year for fixed income, and hopefully portfolios benefit from some other less correlated asset classes as well since this would be yet another year where stocks and bonds move in the same direction due to inflation-related issues being a major driver of market movements.

The stubborn inflation case (too hot!)

is the one that very few market participants seem to be concerned about, despite the fact that this is the most common source of unpleasant surprises over the last couple of years. Record deficit spending is inflationary. Geopolitical conflict could alter course and make a host of items suddenly more expensive. Labor markets are still tight, and if the economy strengthens, they are likely to get tighter. It might not make any sense for the Fed to start cutting rates and fuel further economic growth in that situation, meaning interest rates stay

higher for longer than the market is currently anticipating, or even have to go up further if inflation warrants it. As inflation is the key driver in this scenario, this would be negative for both equities and fixed income markets and would likely further slow the economy, possibly finally tipping it into a recession.

The recession case (too cold!) is the one that preoccupied year-ago forecasts and is still possible.

If the rate hikes to date continue to slow the economy, the consumer finally stops spending now that Covid savings are exhausted, stressed bank balance sheets limit lending (especially at the community bank level where so many small businesses are served), and the regional banks start seeing more defaults on the myriad loans they made to build office buildings that are now largely empty, a substantial slowing of the economy is certainly possible, namely a recession. In this case stocks would likely fall as earnings and price multiples decline, but with the Fed likely lowering interest rates, bonds would move in the opposite direction, providing solid returns in fixed income.

And then, of course, there are always a range of scenarios that we cannot even contemplate yet because the events that might drive them have yet to happen. However, we think these are the three most likely major scenarios to play out over the next year. Hopefully, "Goldilocks" wins out, but, as we know, market consensus is more often wrong than it is right.

We have discussed in recent newsletters the dangers posed by inflation-driven markets because stocks and bonds tend to be highly correlated, depriving investors of the diversification benefits they had become accustomed to over the previous 40 years since inflation had essentially been "defeated."

Two of the three scenarios above involve inflation-related scenarios where we would expect this correlation to continue, and in all 3 scenarios, investors can benefit from diversifying into a broader range of asset classes to improve risk-adjusted returns, or essentially the amount of return earned per unit of risk. Thus, as we have been throughout 2023, we at Montis will be discussing with clients the benefits of further diversifying their portfolios.

Investors can benefit from diversifying into a broader range of asset classes to improve risk-adjusted returns.

FINANCIAL PLANNING NEWS:

A Roth conversion is the process of moving (pre-tax) money out of a traditional IRA into a Roth account. You pay taxes on the amount of the exchange, in return for never having that money taxed again, either as the Roth account grows or when you take the money out in retirement. But the mathematics around these conversions can be a bit tricky. Is it better to pay taxes now vs. when the money comes out? The traditional (and rather simplistic) rule of thumb has been: if your tax rate in the future will be higher than it is today, then this move will save you money. If not, then it will cost you money. If the rates are the same, then the Roth conversion will be an essentially neutral transaction, from a tax standpoint. So why is this tricky? Because there are a number of other factors to consider. First of all, you are paying taxes today in return for a tax break in the future. If you put the money you would not have paid in taxes into a side account, what rate of return would it generate? This, of course, is unknown, but so too are future tax rates.

A recent study looked at various factors, and found that the number of years between the conversion and the time when the money comes out can play a role in whether the Roth conversion is a winning or losing strategy. Calculating the advantage based on this holding period, alas, is also complicated because we cannot predict the future rate of return or the future tax rate with any degree of confidence.

Another impact the article looks at is the tax cost of liquidating other parts of the portfolio to pay those taxes on the Roth conversion.

There are a few additional complications. One often-overlooked issue is that reducing future tax rates with a Roth conversion will also reduce the IRMAA surcharge that the retiree would have to pay on Medicare premiums. Lower future income might also mean a lower long-term capital gains rate on holdings in a traditional (taxable) retirement account, from 20% for high income earners to 15% for people in lower brackets. Those future bracket thresholds are also unknown.

If you have large tax loss carryforwards or are experiencing a year when their income is low, then that creates an opportunity to convert IRA to Roth assets at lower rates, upping the odds of successful tax arbitrage. All things considered, most Roth conversions can be expected to reduce total taxes within the joint life expectancy of a typical married couple, so long as the conversion is carefully planned. If you are curious to learn more about the potential benefits for you, please ask your advisor for more detail!

Important Disclosure Information

Please remember that past performance is no guarantee of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Montis Financial, LLC ("Montis"), or any non-investment related content, made reference to directly or indirectly in this commentary will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful). Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this commentary serves as the receipt of, or as a substitute for, personalized investment advice from Montis. No amount of prior experience or success should not be construed that a certain level of results or satisfaction if Montis is engaged, or continues to be engaged, to provide investment advisory services. Montis is neither a law firm, nor a certified public accounting firm, and no portion of the commentary content should be construed as legal or accounting advice. A copy of the Montis' current written disclosure Brochure discussing our advisory services and fees continues to remain available upon request or at www.montisfinancial.com. Please Remember: If you are a Montis client, please contact Montis, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing, evaluating, revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. Unless, and until, you notify us, in writing, to the contrary, we shall continue to provide services as we do currently. Please also remember to advise us if you have not been receiving account statements (at least quarterly) from the account custodian.

Historical performance results for investment indices, benchmarks, and/or categories have been provided for general informational and comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. It should not be assumed that your Montis account holdings correspond directly to any comparative indices or categories. Please Also Note: (i) performance results do not reflect the impact of taxes, (ii) comparative benchmarks and indices may be more or less volatile than your Montis accounts, and (iii) a description of each comparative benchmark and index is available upon request.