SPINNAKER TRUST

From the Helm

JANUARY 2024

01

2023 YEAR-END MARKET REVIEW AND OUTLOOK

Despite a bevy of negative economic data, the highest Federal Funds Rate since the early 1980s, a regional banking crisis, a reduction in bank lending, a deeply inverted yield curve, and war in the Middle East, equity markets had an extraordinarily strong 2023. The S&P 500 and Nasdaq 100 rose 26.6% and 54.8% for the year, respectively. The S&P 500 culminated the year with nine straight weeks of gains, delivering the fourth best year for the index in history. The equally weighted S&P 500 index returned 11.7%. The Nasdaq 100 recently hit all-time highs and delivered one of the best years in its history, second only to 1999. There was wide sector dispersion during the year, with the Technology (largely Apple and Microsoft) and Communication Services (40% Facebook/Meta and Google/Alphabet) returning 56.5% and 54.5%, respectively. On the tail end, the Utilities and Energy sectors trailed. Increases in interest rates explain the -10.4% decline in utilities while softer energy prices (relative to expectations given the Russia Ukraine war) explain a -4.8% decline in the energy sector.

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Down the market-cap scale, returns were strong but not quite as euphoric, with small and mid-cap stocks returning 15.8% and 16.3%, respectively. International equity markets rose by 15.5% during the year, with developed and emerging markets up 18.2% and 8.9% in U.S. dollar terms. For much of the year, it seemed that the Bloomberg Aggregate Bond Index would break a record for the number of consecutive years "in the red" but, thankfully, yields broke lower after peaking at just over 5% at the end of October. The bond index finished 2023 up by 5.5%. Broad commodities finished the year -6.2% lower, while gold prices rose by 12.7%.

One year ago, our team called for an economic slowdown that would meet the definition of a recession and negatively impact markets in 2023. To speak plainly, we were wrong. Traditional economic analysis and recession forecasting relies on business cycle analysis, which involves many things, the most prominent being the rate of change of various leading economic indicators including Manufacturing Purchasing Manager Surveys, M2 (total money supply), and the yield curve, amongst others. These signals, with a lag of 12-24 months, have historically been highly effective at predicting recessions. There has been just one false signal since WWII. The Fed kicked off its interest rate raising program in the spring of 2022, so the 24-month threshold is nearly upon us. At this point, we just do not see the signs of an imminent recession.

Our economic models were directionally predictive in 2023. We expected earnings expectations to decline by -15-20% over the course of the year. They declined by -8%, and earnings breadth (the percentage of S&P 500 companies with earnings growth) hit a cycle low. We expected leading economic indicators to worsen to levels seen during previous recessions, and that they did. We expected the unemployment rate to rise modestly. It did, moving from 3.6% to 3.9%. But unemployment then moved back down again. We believed the Fed when they told us that a recession was required to tame inflation in mid-2022, and, today, we believe that the Fed is just as surprised that their rate hiking program has not caused more damage.

Why was it "different this time?"

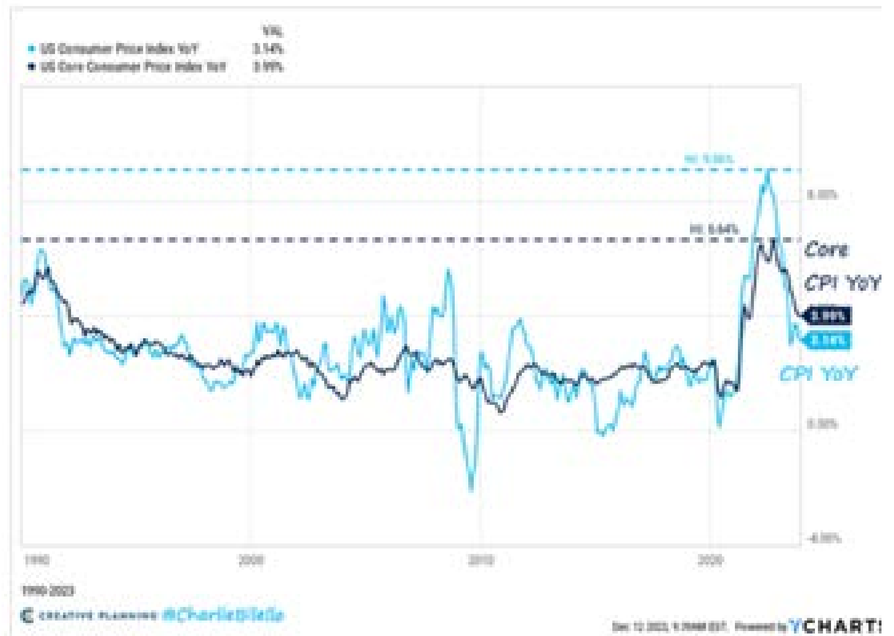
1. The U.S. Labor Market: Labor was famously in short-supply post Covid-19. As a result, workers were firmly in the drivers' seat, switching jobs and demanding much higher wages. Companies, small and large, worked hard to staff up in 2021 and 2022. It is reasonable that these companies would hang onto their workers absent a material decline in profits. While corporate profits and margins did fall in 2023, they did not fall enough to necessitate layoffs. Recessions are slightly different each cycle, but in each, the defining feature is a rise of at least half a percentage point in the national unemployment rate. No layoffs mean no meaningful curb in consumer spending.

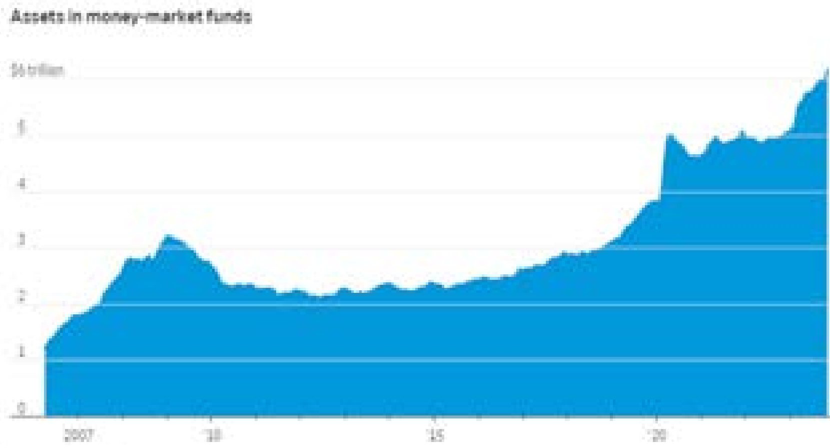
2. The U.S. Consumer Does Not Quit: The U.S. consumer, in aggregate, has been holding up the economy. U.S. consumer spending makes up 70% of the GDP measure in the U.S. and a massive 17% of global GDP. For three years, "real" consumer incomes were negative, which means that inflation exceeded income growth. Over the last few months, "real" consumer incomes have turned positive again while prices at the pump have fallen. U.S. retail sales over the holiday season rose by 3.1% as compared to last year. Further, Baby Boomers and the wealthiest 10-15% of U.S. consumers actually benefitted from higher interest rates by earning ~5% on their savings via the money market!

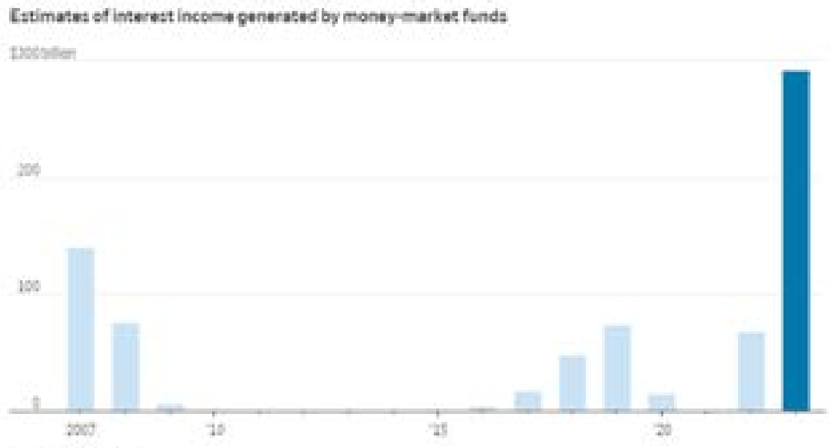
3. Higher Interest Rates Don't Hurt if No One is Paying Them: 40% of homes in our country are owned debt free. Of those with mortgages outstanding in the U.S., 92% are paying a fixed rate of less than 4%. Large, publicly traded companies did a good job of refinancing their debt in 2020 and 2021 when interest rates were at rock bottom. That low-cost debt will start to roll off in 2024 and 2025. Smaller companies have a more challenging debt profile and are largely subject to financing at higher and/or floating interest rates.

4. Inflation Was Indeed Transitory: Inflation measured relative to prices last year has come down to within shooting distance of the Fed's stated goal of 2%. The price of goods is contracting, while the price of necessities (food & shelter) is rising at 1-2% on a rate-of-change basis. Inflation tied to Services, commonly thought of as the price for experiences, remains relatively high.

5. U.S. Government Deficit Spending as Pseudo Stimulus: The Federal Reserve has been quietly reducing its balance sheet back to pre-pandemic levels in an operation called Quantitative Tightening. However, U.S. government deficit spending has more than made up for the tightening impact of QT. This includes programs like the Inflation Reduction Act and the CHIPS Act. In 2022, our spending deficit was 4% of GDP. For 2023, we are on-track to run a budget deficit of more than 7% of GDP, levels that we have not seen except during recession or periods of war. We've run budget deficits since the 1960s, but we've never run a deficit this large outside of crisis periods. Today, what the government pays in interest expenses exceeds the annual defense budget. The U.S. Treasury has been able to issue Treasury bills (very short-term debt) rather than longer-term bonds to finance these deficits, therefore avoiding "locking-in" higher debt costs.







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TURNING TO THE OUTLOOK FOR 2024

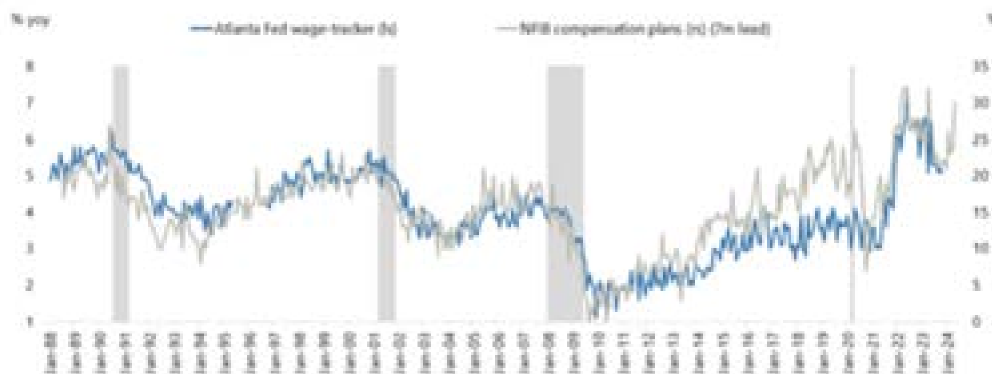
Much was made of the massive move in the largest Technology stocks in 2023, often referred to as the Magnificent 7. This group of stocks – Nvidia, Amazon, Alphabet (Google), Meta (formerly Facebook), Apple, Microsoft, and Tesla – rose by 75% last year, while the remaining S&P 500 constituents rose by about 12%. The Magnificent 7 accounts for more than 27% of the index. Typically, narrow rallies make for an unhealthy market, as capital crowds into the winners. When a broad group of stocks performs well, investors consider that circumstance to be healthy. To have a strong 2024 in the markets, we believe that the average stock will have to perform better. The last few months suggest that this may happen. Small and mid-cap stocks trailed the S&P 500 considerably until the end of October. They rose by about 12% during the fourth quarter, outperforming the broad index and the Magnificent 7.

One year ago, the investing consensus overwhelmingly predicted recession in 2023. We also believed that narrative. Today, the consensus has completely flipped, and the loud and overwhelming consensus is for a Fed-engineered "soft landing" in 2024. A "soft landing" means that both growth and inflation slow, but not enough to cause a recession. It means that the unemployment rate basically stays where it is at 3.6% (historically, quite low), that corporate earnings grow again, and that the Fed cuts interest rates back to more reasonable levels.

We do not believe that there will be any material increase in the U.S. unemployment rate in 2024 for the reasons discussed above, but we do think that consumer spending will slow in the coming year. As inflation falls, so too, should wage growth. The excess cash built up by Covid-era stimulus (checks to households, PPP loans, etc.) has run out for 80% of Americans and U.S. companies, with savings now back to trend levels. Rent and student loan moratoriums are over. Consumer travel statistics are slowing back to trend, and credit card balances are building.

Today, the investing consensus is that inflation will continue to fall on a rate-of-change basis through 2024. If this enables the Federal Reserve to lower interest rates moderately, it will likely be positive for equity markets.

However, there are risks. One potential surprise could be a comeback in inflation in the second half of the year. A strong economy could embolden employees to demand higher wages, pushing services inflation higher. While the rate-of-change of inflation is slowing, aggregate prices are 20-25% higher than they were pre-Covid. Workers may try to recoup real wages lost.

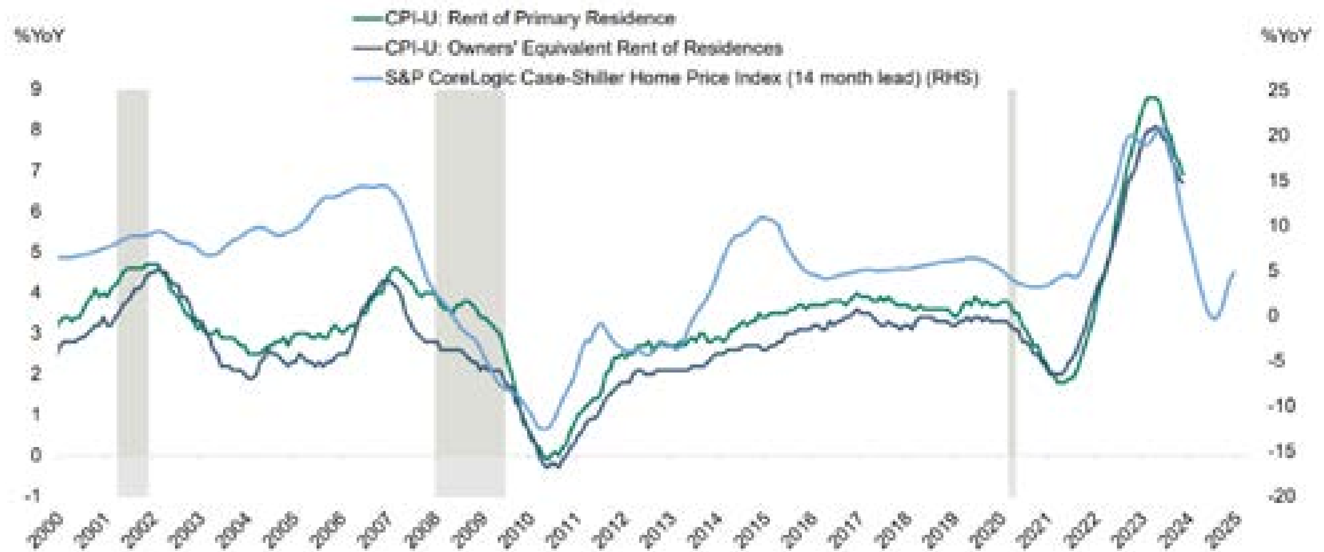


Another key factor will be Shelter inflation, which makes up 1/3 of CPI. Home prices are, once again, rising on a national basis thanks to rising consumer confidence, falling mortgage rates, and pent-up demand. The Shelter reading typically follows with a lag.

Finally, energy is a massive wild card. There is no clear resolution of the Russia Ukraine war, and the Israel Hamas conflict still threatens to become a more regional conflict as shipping in the region is now impacted. Any sharp rise in energy prices would translate quickly into prices at the pump and will immediately impact U.S. consumer spending and markets. If the Fed cuts interest rates in the first half, but inflation accelerates in the second half of 2024 for any of the above reasons, the positive feelings toward equity markets could turn quickly.

Investors' funds flow into equities and the sentiment readings that we find most predictive are at euphoric levels. The broad index S&P 500 ETF (ticker: SPY) saw $40bn in in-flows in December, the largest single month in flows since the vehicle was created in 1993. The investment community expects corporate earnings to grow by 13% relative to 2023 levels, while average earnings growth in any given year is 8-9%. Market valuations in the U.S. are quite rich, with the S&P 500 and Nasdaq trading at 19.5 and 25.2xs earnings expectations over the next 12 months, respectively. Small and mid-cap stocks are both trading at 14.5xs, a much more reasonable level.

HOME PRICE INFLATION REBOUNDING



MONTHLY FLOWS TO THE SPDR S&P 500 ETF TRUST

Note: Latest figure reflects flows for Dec. 1-20, 2023.
Source: FactSet

On the bullish side of the ledger, there is a lot of cash sitting in money market funds earning a nice, risk-free 5%. Our analysis suggests that about 2/3 of that amount is money from households and small and mid-sized businesses that moved working capital funds into money markets to earn some income. This money is unlikely to be invested. However, that leaves about 1/3 that could move back into traditional investment allocations in 2024, which would be very bullish.

We acknowledge that there is a path for 2024 to be a year of solid gains for equities, particularly if the market continues to broaden out. If inflation does continue to fall, valuation multiples could expand even from their current full levels. Further, presidential election years are typically strong for markets, especially in the fourth quarter of the year when the political outcome is known. As a result, we believe investors should be fully invested according to their long-term asset allocations. The risks we are most concerned about relate to (i) current euphoria and high expectations, (ii) a return of inflation and a need for interest rates to remain higher for longer, (iii) geopolitical risks and their impact on energy prices, and (iv) the general unsustainability of U.S. fiscal policy.

While we were humbled by markets in 2023, we learned a lot and continue to evolve our investing processes. As always, we believe that high-quality, diversified portfolios through business cycles are and will remain the winning formula. It should be an exceedingly interesting year in markets.

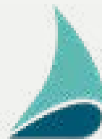
03

THE CORPORATE TRANSPARENCY ACT

In 2021, Congress enacted the Corporate Transparency Act to combat money laundering, terrorist financing and other illicit financial activities. Beginning on January 1, 2024, many companies in the U.S. must report information about their beneficial owners to FinCEN (the Financial Crimes Enforcement Network). Companies that are required to report include limited liability companies, corporations, or other similar entities that are created by filing a formation document with a secretary of state. Existing companies will have until January 1, 2025, to file. Failure to comply could result in serious criminal and civil penalties. Please contact your legal counsel for assistance in determining if you are required to file for an existing entity. Entities created after January 1, 2024, will have 90 days to report applicable beneficial ownership information to FinCEN.

WELCOME MACEY ROBERGE!

Macey recently joined our account administration team from a local law firm, where she was a trust and estates administrator. Macey has over 10 years of fiduciary experience, and we are excited to have her join our team.



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This marks the last printed version of our Spinnaker Market Review & Outlook Newsletter!

After more than 20 years of sending this to clients and friends via mail, we have decided to distribute via email on a go-forward basis.