2023 Year End Letter

Sentiment going into 2023 was overwhelmingly negative after a turbulent 2022. Investors poured record amounts of cash into money market funds and short-term treasury bonds. The majority of economists predicted the U.S. would go into a recession due to the Fed's aggressive tightening campaign to combat inflation levels we have not seen in 40 years. As mentioned in last year's letter, we believed that if our economy did in fact go into recession, it would likely be shallow and short, given the strength of consumers and corporations. We positioned portfolios accordingly, and our clients benefited from our conviction to stay fully invested. The economy proved to be much more resilient than predicted, which led to a strong year for the markets.

As we enter 2024, we expect an increase in market volatility. Therefore, we have shifted portfolios to a more defensive position by raising the allocation to cash across client portfolios. We achieved this by reducing stock exposure while maintaining our existing allocation to bonds. As with past periods of volatility, opportunities will invariably present themselves. We continue to research sectors of the market that have been mispriced, creating an opportunity to strategically reinvest cash. While we are tactically taking a more defensive position in the short term, we do remain optimistic in the long term.

Corporations and Consumers Remain Resilient:

Corporate balance sheets began the year in a favorable position and further strengthened with strong cash flows and earnings. Corporations (like consumers) had plenty of opportunity over the last several years to refinance debt at historically low interest rates. This insulated most companies (especially larger ones) from the negative impact of higher interest rates during the Fed's tightening cycle. U.S. companies are now holding over $3.6 trillion in cash on their balance sheets, which should support continued capital spending, dividend increases, mergers and acquisitions, and stock buybacks in 2024.

Much of this past year's economic resiliency can be attributed to the consumer, which makes up roughly 2/3 of U.S. GDP. The labor market remains strong with the unemployment rate at 3.7% and wage growth above 4%. Wages are now outpacing the rate of inflation after losing ground for 2 years. While there were headlines relating to layoffs throughout the year, they were relatively small and mostly concentrated in large cap technology and media companies.

During the refinance boom of 2020 and 2021, roughly 50% of homeowners refinanced their existing mortgage or reset their interest rate with new home purchases. This sheltered them from the spike in mortgage rates over the last couple of years and preserved their discretionary spending power. Despite a slowdown in residential real estate activity due to the sharp rise in mortgage rates, home prices have generally remained elevated due to the severe lack of inventory. If mortgage rates were to move down even modestly, we should see residential real estate activity pick back up this year.

The Artificial Intelligence Phenomenon:

One of the largest and most compelling stories of the year was a theme that we have been following for some time; the proliferation of artificial intelligence (AI). The potential for AI to boost productivity and economic growth helped propel the entire technology sector to new heights in 2023.

OpenAI's ChatGPT and other generative artificial intelligence programs gained traction throughout the year and the adoption has already been widespread among workers in the U.S. A recent survey by the Conference Board showed that 56% of workers in the US are using AI to help complete work tasks even though only 26% of companies have an established AI policy. In the coming years, wider adoption of AI by corporations will likely support capital spending and lead to productivity and profit gains. The McKinsey Global Institute recently published a research piece that projects generative AI has the potential to generate value equivalent to $2.6 trillion to $4.4 trillion in global corporate profits annually.

The Inflation Picture Continues to Improve:

The Fed has made meaningful progress this year in its fight against inflation, which peaked at just over 9% in June of 2022. In the past, the Fed's efforts have resulted in major disruptions to the economy and the labor market, but the dynamics of this cycle have played out differently thus far. The most recent reading in January reflected the inflation rate had come down to 3.4%. As mentioned in last year's letter, the surge in inflation coming out of the pandemic was not only driven by pent up demand and consumers flush with cash, but also by major disruptions to the global supply chain. As the disruptions have eased, inflation has rolled over without an increase in the unemployment rate.

Over the next few months, there will be endless debates in the media about when and how much the Fed (and other global central banks) will cut interest rates in 2024. To us, it's more important the Fed has shown flexibility and restraint in their response to inflation. The Fed is trying to manage a business cycle and not just simply hammer inflation down to precisely their 2% target without consideration for the broader economic impact. The Fed's prior actions are still working their way through the system and we are encouraged that rates are at a level that provides the Fed flexibility if there is a need to support the economy.

Volatility in 2024:

Strong growth in real household income was driven by wage gains and cooling inflation, fueling consumer spending. A strong consumer, an increase in corporate productivity and a recovery in manufacturing all supported corporate profits this past year. From here, a smaller drag from monetary and fiscal tightening could be supportive of the market as lower interest rates will directly benefit the economy and valuations for stocks and real estate. We anticipate lower rates will force some of the record amount of investor cash on the sidelines (over $8.8 trillion in money market funds) back into the markets. This should be supportive for equity and bond prices throughout the year.

As we mentioned, we do expect volatility to pick back up this year as investors continue to be laser focused on interest rates and the Fed, the economy, and our upcoming elections. Despite the potential for volatility, fundamentals remain strong as consumers and corporations are entering the year in a good position to weather any near-term uncertainty.

We wish you and your family peace, health, and happiness in 2024.

The Sloan Portfolio Management Team

214-720-7500 | 100 Crescent Court, Suite 1130. Dallas, TX 75201 | www.sloanim.com