Lebed
Asset Management LLC

Investment Commentary—January 2024

Financial markets ended 2023 on a very positive note with stocks and bonds rising sharply for the quarter and the full year. The surge began in late October and saw the S&P 500 Index of large company U.S. stocks rise nine weeks in a row, something that hadn't happened in nearly twenty years. By some measures, the U.S. bond market recorded its best quarterly return in over thirty years.

In many respects the fourth quarter was a mirror image of the previous three months. For most of the summer and early fall, stock and bond markets were focused on the idea that the U.S. Federal Reserve would keep interest rates "higher for longer" to bring inflation under control. Long-term interest rates surged, causing stocks and bonds to slide. By late October inflation data was markedly improving, and the Fed hinted that the inflation fight was largely complete. The higher for longer theme faded and markets rallied sharply.

Over the course of 2022 and 2023, the Federal Reserve pursued the most aggressive interest rate hikes in four decades. While history strongly suggested these rate hikes would lead to a recession, so far that hasn't happened. Financial pundits are increasingly declaring that the Fed has achieved a "soft landing," deliberately slowing the U.S. economy to fight inflation without triggering a recession. While the jury is still out on a soft landing, the economic data is encouraging. Even with the possibility of a mild recession this year, it seems unlikely to be the kind of serious downturn that would significantly eat into corporate profits. Rising corporate profits and declining interest rates are typically good for stocks, and investors are betting that's what 2024 will deliver.

Earlier in 2023 stock market gains were largely confined to a small group of technology-related stocks dubbed the Magnificent Seven--Alphabet (Google), Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. Gains were more widespread in the fourth quarter, with the Russell 2000 Index of smaller company U.S. stocks, which lagged badly for most of 2023, returning 14.0%, slightly outpacing the Magnificent Seven. Despite the recent surge in smaller company stocks, the overall stock market remains extraordinarily top heavy. According to J.P. Morgan Asset Management, the current level of stock market concentration in a small number of names is a three standard deviation event, i.e. something that only happens 3 times in 1,000. Even if the Magnificent Seven continue to be the largest stocks in the S&P 500, they will almost certainly represent a smaller percentage of the overall market five or ten years from now and therefore underperform. To make matters worse, they may not even be the largest U.S. stocks in ten years. The ingredients are in place for the behemoth technology-related stocks that climbed so rapidly in 2023 to lag badly in the years ahead.

The fourth quarter surge in U.S. stocks left the S&P 500 less than one percent shy of the all-time high recorded on January 3rd, 2022. The rapid climb in share prices in the fourth quarter of 2021 set the stage for an awful 2022 in which the S&P 500 returned -18.1%. Is history about to repeat itself? There are reasons to doubt it. Early in 2022 the storm clouds of inflation were gathering. Bonds offered paltry yields and price declines in the event of rising rates. The mantra of TINA ("There Is no Alternative" to stocks) was in full force. Out of desperation to find acceptable returns outside of bonds, investors drove stocks to unsustainable levels just as the Federal Reserve was about to launch the most aggressive interest rate hike cycle in four decades.

Heading into 2024 the picture is more benign. Inflation appears to be under control and the Fed is likely to reduce short-term interest rates substantially over the course of the year. The economy will slow down but may avoid a recession. Even in the event of a mild recession, corporate profits seem likely to hold up reasonably well. Still, with the S&P 500 near an all-time high, are valuations stretched? Has the stock market come too far, too fast? To answer that question, we updated the enclosed chart of cumulative long-term returns from large company U.S. stocks.

Despite fluctuations from year to year, the long-term total real return trend of U.S. stocks over the last 143 years is remarkably stable. The words "total real return" are important to explain. "Total" refers to the fact that dividends are included. "Real" refers to the fact that returns in the chart have been adjusted for inflation. If a stock increases in price by 5% and pays a 4% dividend in a year with 3% inflation, your total real return would be approximately 5% + 4% - 3% = 6%[1]. The fact that the total real return index (the blue line) never deviates too far from the trend line[2] indicates that over very long periods of time, U.S. stocks have consistently delivered a 6.4% total real return. Considering everything that has happened over that time, from two world wars to the Depression to multiple radical economic transformations, that is a remarkable fact.

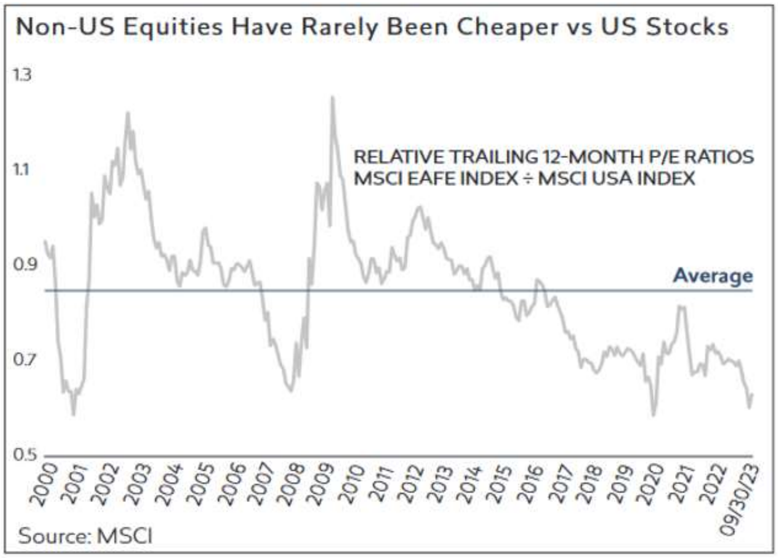
The total real return index fluctuates significantly but rarely exceeds the red line (100% above trend) or falls below the green line (50% under trend). When the total real return approaches the red line, caution is in order. When it approaches the green line, the outlook for U.S. stock returns is extremely positive. At the end of 2021 the total real return index had gotten closer to the red line than it had in many years, and we sounded a cautionary note. While the index continued to be above the trend line at the end of 2023 it was considerably closer to the trend line. To the extent large company U.S. stocks are overvalued, much, perhaps even most, of the overvaluation is in the Magnificent Seven. A well-managed portfolio of U.S. stocks that is very selective with regard to technology-related stocks is likely to deliver very satisfactory long-term returns. In fact, most areas of the global stock and bond markets outside of the Magnificent Seven are either reasonably or attractively valued. The chart below, for example, illustrates that foreign developed market stocks, as measured by price/earnings

---

[1] When combining percentages, adding doesn't quite work. For small percentages, however, it's very close.

[2] Notice the numbers on the axis at the left of the chart. They go up by powers of ten (10, 100, 1000, etc.) By using a "logarithmic" axis, a constant rate of return becomes a straight line.

ratios (the most common measure of how expensive or inexpensive stocks are), are much more attractive than U.S. stocks. The previous low points in 2000 and 2007 were followed by long periods in which non-U.S. stocks outperformed U.S. stocks.



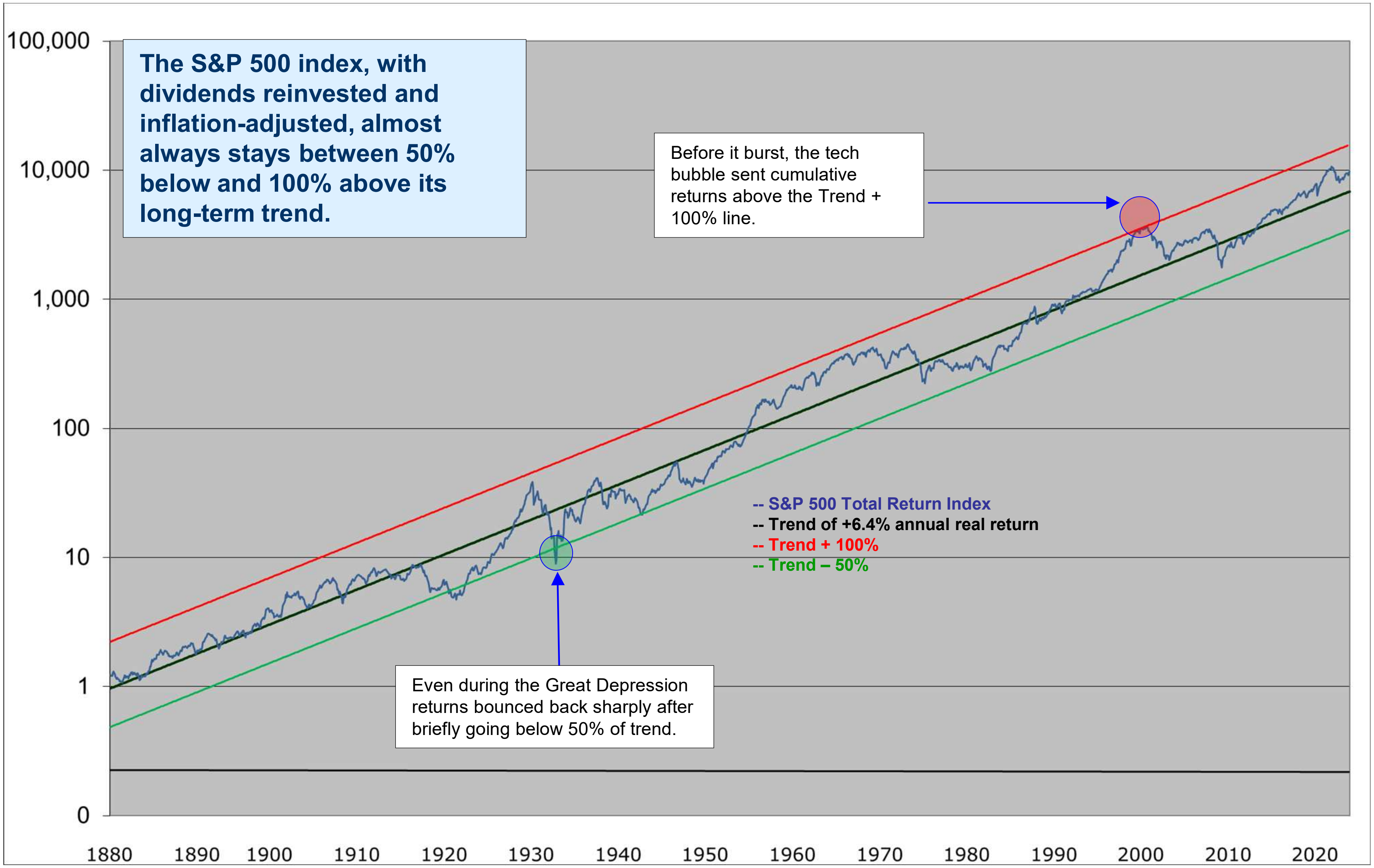
While some of the outperformance of U.S. stocks over the last ten years can be attributed to the preeminence of U.S. technology companies like the Magnificent Seven, it's worth remembering that the world's largest electric vehicle manufacturer is BYD Auto (China), and most semiconductor chips, the core technology of the Information Age, are etched with lithography equipment from ASML (the Netherlands) in Taiwan Semiconductor foundries.

To be sure, 2024 presents some risks to stock investors. If inflation proves to be more persistent than it now appears, or if two years of aggressive rate hikes leads to a serious recession after all (neither of which is in our base case scenario), the stock market would likely experience a meaningful decline. And 2024 will feature a presidential election that may feel enormously consequential. If you start to worry about the possibility that your preferred candidate may lose, you may want to pull out the total real return chart. The chart covers 143 years, including a depression, two world wars, numerous financial crises, and twenty-eight presidents. Over that time, the ability of companies to grow and prosper for the benefit of shareholders has proven remarkably resilient. We suspect that resilience will continue whatever the results of the election might be.

Of course, it's never a bad time to make sure you have enough of your future cash flow needs in bonds to ride out any stock market downturn. With prospective bond returns dramatically better than two years ago, now may be an especially good time. But take advantage as well of the substantial long-term returns available from a diversified stock portfolio.

Boston, MA
January 12, 2024

S&P 500 Total Real Return Index 1880 - 2023



- Raw data is from www.irrationalexuberance.com, the website for Robert Shiller's Irrational Exuberance.
- The total real return index is presented on a logarithmic scale. It is based on the **monthly** average price of the S&P 500 Index (including its backward extension by Alfred Cowles) and assumes dividend reinvestment at that price.
- Because the total real return index includes reinvested dividends and adjusts for inflation, its values do not correspond directly to the widely quoted price index.
- The trendline uses the average of the total real return index from 1876 to 1885 as a starting point and assumes a 6.4% annual real return from that point forward.
- Past performance is not necessarily indicative of future results.

Chart and analysis prepared by Lebed Asset Management, LLC