January 12, 2024

PATIENCE REWARDED

Dear Investor:

Reviewing just the titles of my recent letters gives a bird's eye view of where we have been in 2023.

- One of the Worst Years Ever – January 13 2023 – referring to 2022
- Hang on Tight – April 12 2023
- Higher For Longer – July 13 2023
- Higher For Longer Act 2 – October 13, 2023
- Patience Rewarded – January 11 2024

Looking back, 2022 remains one of the worst years ever for investors. The pandemic bailouts, high inflation, and subsequent rate increases, brought both stock and bond markets down with a big thud. The bond market was the bigger issue, as losing double digits in high quality bonds very rarely happens. Stocks being down 18% on average was surely no fun either, but it's happened many times before. Both markets being down to that degree made for significant losses for most investors. As we went into 2023, short rates were between 4.25% and 4.50%. Inflation was still in the range of 6%, so the word was that the Fed was going to keep hiking. When I wrote **Hang on Tight** in April, rates were still going up and inflation was around 5%. By **Higher For Longer** in July, rates were at 5.0% to 5.25%, and the Fed had taken their first pause in the hiking cycle. 12-month core inflation was still 4.8%, and the economy was doing even better than expected. Both the stock and bond markets were in the black on the improving inflation picture. The strong economy made investors realize that rates were going to stay high for longer than hoped. By the time we rolled into October, the Fed revealed that that no cuts were planned for 2023, and another hike was still possible. Thus, **Act 2** on high rates. This let the air out of the market and pushed it all the way back to where it was in April and May. The continued steady decline in inflation has the market believing that we have finally seen the top of the rate cycle, and better days with lower rates are ahead in 2024. That theme has powered the market higher, and we ended the year on an up note. Those who held on have been rewarded by recovering the lion's share of what was lost since the high on January 3, 2022, two years ago.

What is the outlook as we head into 2024? The current projections from the Federal Reserve are for growth to slow to 1.4% and the US unemployment rate to rise to 4.1% in 2024. Right now, the economy is estimated to be growing in the 2% to 2.4% range. Unemployment is still very low at 3.7% and 6.3 million people. The growth in payrolls averaged 225,000 per month in 2023. In 2022 it was 3.5% and 5.7 million people, and the monthly average of jobs created was 399,000 per month. You can see we are slowing, but there's still strength in the economy. Auto sales were up 12.4% from 2022. New vehicle inventory has been rising steadily throughout the year as a direct result of the chip shortage

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largely coming to an end. As inventory has gone back up, so have incentives offered by the manufacturers. Naturally, this is helping sales and if rates come down in 2024, more people should be able to upgrade their cars. We've talked enough about housing in the past. It's all about the mortgage rates.

Rate increases are most likely over. I would not put more than a 10% chance on additional rate hikes in this cycle. There would have to be a big change in the inflation outlook for that to happen. Markets are expecting cuts this year. The Fed has projected an average of three cuts this year. The market usually gets ahead of itself, and many players are looking for up to six cuts. Right now, no one is expecting any change at the upcoming January meeting. Many are hoping for an initial cut in March. Unless things were to slow quite a bit, I don't think that is likely. I still believe that Chair Powell is firm on the 2% inflation goal. He wants to be as certain as he can be that we are on a sustainable path to get there, before he eases. Of note, many measures of inflation that cover just the last three, or even six months, are in the range of 2%, or very close to it right now. Thus, if that holds, we could be closer to some cuts beginning. Remember that the whole idea behind a soft landing is to bring the inflation rate back down without driving the economy into a recession, or at least a recession of any real consequence. It does look like the odds of a soft landing have gone up, but it's definitely not a done deal at this time.

Earnings for Q4 are just starting to come out. Unless there are major upside surprises, the SP500 earnings for 2023 will only be slightly ahead of 2022. By that I mean perhaps only 1% or somewhat more. Most of you likely know that a lot of this year's earnings were driven by the superstar companies that have been dubbed "the Magnificent Seven". These companies have a big stake in artificial intelligence (AI) and other related cutting-edge technology. Many of the rest of the sectors did OK, but without the huge moves in the "Mag 7", overall earnings growth would have been negative for sure. Despite concerns about a possible recession, analysts are currently expecting earnings to grow 11.8% this year according to Factset.

On the subject of recession, there are some very smart people out there that I listen to that believe the odds of a recession are as high as 75%. Their analysis is very good, and they make a lot of strong points. I don't know the future and you know my thinking on forecasts. If they are right, the Fed would likely start lowering rates at a much faster pace than is expected right now. Hopefully it would be a soft recession, with a very shallow dip in growth. I would not want to see us pushed back into zero interest rates and QE, a fancy name for printing money we don't have. On a related and important note, the quantitative tightening program (QT) that has been running in the background has brought the Fed balance sheet down from around $9T dollars to $7.7T currently. They have removed well over a trillion dollars of stimulus created during the pandemic. This is good news, and I hope they can continue with this program. Sound money is essential to our long-term survival as a nation. We cannot keep watering down the value of our currency by creating money out of thin air.

On another related subject, I recently watched two very well-done web presentations on the problems we are facing with the interest on our national debt, and they were sobering. Something on the order of 50% or more of our US Treasuries come due over the next three years. These are at very

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low rates and as they are rolled into new securities at much higher rates, the interest will be approximately double. As you look at projections of what this could turn into over the next ten years, it becomes very serious. The interest on the debt will be trying to push everything else out of the budget, and our total debt will become an ever-higher percentage of our GDP. I hear many voices out there talking about this problem. It's not something we can keep ignoring. I think this will lead to higher taxes for all, slower growth, more govt borrowing, and more money printing, which will lead to higher inflation. Not a good picture, or the future any of us want for our families. Our leaders need to get some determination to turn this around.

To end on a more positive note, if we can achieve the soft landing, and lower but positive interest rates, it's possible that the economy could do well for the next several years, and we could have a good bull market run. Most investment firms are expecting a decent market in 2024, with returns likely in the high single digits. Some of the optimism for the near future is already in the prices as we draw to a close in 2023. I haven't really seen anybody expecting a big home run hit in 2024 at this time. Most are also expecting the market to broaden out, meaning that most of the gains will not just be limited to the "Mag 7". There should be more participation from other good companies. A solid year would be very welcome after the roller coaster ride we have been on since the pandemic started in 2020. We do appreciate the patience of our clients who have stayed on track with us these last few years. It has not been easy. Please feel free to contact us anytime to discuss your portfolio.

Best Regards,

David E. Keim

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