

2023 Year-End Letter

As I sit down to write my year-end market letter, it is just a few days until Christmas. As I have done in the past, I will discuss my outlook for the financial markets, as well as how I think investors should consider positioning themselves as we head into 2024.

Where are we today?

The 10-year treasury is yielding around 3.90% at the time of this writing.

The Cap Weighted S&P ETF is trading around 4740 and is up approximately 25% for YTD 2023. The equal weight S&P 500 index is up approximately 12.70%. In the former, the stocks weighting in the index are based on its market capitalization, so stocks such as Apple, Microsoft, Nvidia, and Google make up larger portions of the index. In the equal-weighted approach, each of the 500 companies in the S&P is equally weighted, or to put it more simply, they are all the same size. Most investors have some sense of just how narrow the market has been. The difference in the performance of these two S&P indexes is one way to quantify this narrowness.

International equities are up approximately 16%, while emerging markets (i.e., China, India) are up approximately 7% year-to-date.

On the commodity front, Gold is up around 13%, trading around \$2,070 per ounce, which is near its highest point for the year. WTI Crude oil is hovering near \$73 per barrel, down 7-8% for the year, with a range of approximately \$94-\$67 per barrel for 2023.

Before we talk about 2024, let's see how last year's fall and year-end letters graded out.

U.S. Equities

Excerpts from last year's letters:

One more thing as we transition into 2023, which carries over from my 2022 outlook. I think it will be years before the S&P 500 sees a new high. It is my view the Federal Reserve will stay higher for longer when it comes to rates. Whether the terminal rate ends up being 4.75 or 5.25% is again, in my opinion, not as important as: 1) How long we stay there, and 2) Outside of a major shock, we are not going back to QE – i.e., the Fed will continue to let their balance sheet shrink even after they begin to cut rates, probably in late 2023 or early 2024.

I believe the range for the S&P 500 will be 3550-4350. We are trading 3840 at the time of this writing. Within the U.S. market, I prefer Small Caps to Large, and in a change from previous writings, I think growth is becoming more interesting.

For the last two years, we have pounded the table: "Focus on dividends." And while we still think dividends are important, the opportunities in small cap and growth stocks are

too appealing to resist. There are several individual names, as well as funds and ETFs, that we find attractive in this space.

The year-to-date range for the S&P 500 has been approximately 3780-4740. The market is 8% higher than where I thought it would be trading; I will give myself a B on the range estimate, as I did think there was more upside than downside risk. I give myself a B+ on liking growth over value; I'm unable to give myself an A, because in no way did I think we would see growth so narrowly focused. As for Small Cap over Large Cap – a wise trader once said, “Being wrong and being early feel the same 95% of the time”; we will see. But given that small cap stocks are only up approximately 15%, I have to give myself a D- at the time of this writing. My overall equity grade is a C+.

I still think it could be another year before the market sees a new high, closing over 4900 on the S&P. More on “Higher for Longer” when we get to fixed income.

Fixed Income

Excerpts from last year's letters:

My expected range for the 10 year is 3.40%-4.20%, it is 3.75% at the time of this musing and if I am going to be wrong, I think it will be to the upside. If the ten-year were to trade 4.7%ish, and spreads were to widen, investors could have the opportunity to buy high quality Corporate Bonds in the 6.2-6.5% range, and A-rated Municipals in the 4.75-5.00% range. If I am correct about long-term inflation being in the area of three percent, these investments will provide attractive real returns, meaning net returns over inflation.

The range for the 10-year has been approximately 3.35-5.07%. Late last summer, I adjusted my upside range on the 10-year to 5.30%, and this is still my view (more on this later in my outlook). Investment grade corporate bonds and A-rated municipals did trade in the ranges mentioned last year. I would give myself an A- for my outlook on rates.

Overall, for 2023, I give myself a B-. And if we include my transcripts from 2021 and 2022, I still think I am in the B+ to A- range. 😊

2024 Outlook

Now, let's look at 2024, and I want to start my outlook with Fixed Income. I suspect we will see the Fed begin to lower the Fed Funds rate, but I do not think they will cut rates by 125-150 basis points, which is where the market is trending now. I do think it is possible we could see a Fed Fund rate in the area of 4.00% over the next 18 months.

As for the 10-year treasury, consider the two charts below. The first chart shows the rates on the 10-year treasury for the last years; the second chart captures what may have been the greatest bull market ever in bonds, which began in 1981, and in my view, ended in 2021 (the low was actually in 2020). One of the first rules in charting is “old highs become new support.” When you look at the one-year chart below, note the old highs in yield on the 10-year in January, March, July,

August, and September. These range from 3.80-4.25% and, in my opinion, should set the range for where the 10-year could trade to the downside. Remember, we are trading around 3.90% as I am writing this musing.

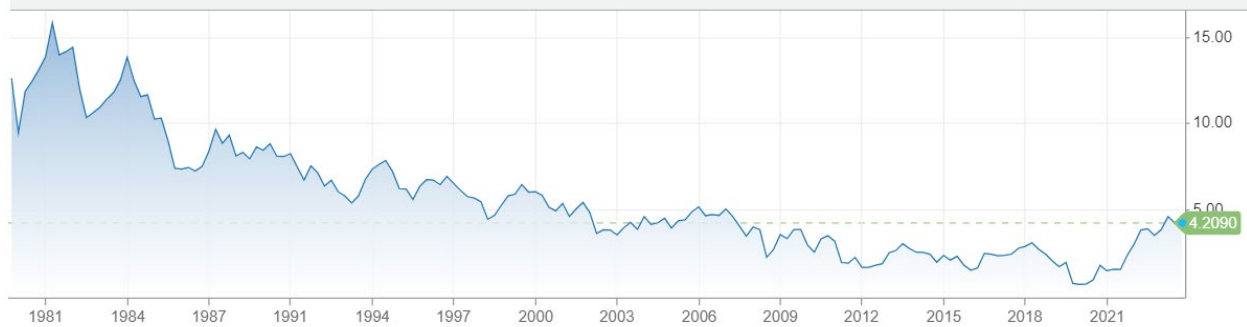
How about the upside? 5.30% remains my best estimate as to where the 10-year could trade. Why this number? Let's take a closer look at the second chart, specifically where the 10-year was trading in 2006, before the financial crisis. Given the scale, it is a bit hard to see, but the levels were in the area of 5.30%. Markets have memories, and I believe markets remember what "normal" was before "The ref got in the game" (the Fed pursuing QE (quantitative easing) which introduced us to Modern Monetary Theory. This new theory, which states that governments can control long-term rates, and that issuing more debt means lower rates, not higher as we were all taught in Econ 101, seemed more than a theory from 2008-2020.

But I think The Fed realizes just how close they came to a real monetary disaster. If it were not for the actions of our enemies – Russia and China – the U.S. could have faced a spike in long-term rates, which would have made the bond route of 2022 seem tame. Russia's invasion of Ukraine and Xi's hard turn back toward a controlled economy have driven billions into U.S. assets. Without these two influences, I think U.S. Treasury rates would have been 150 bps higher. I have often wondered if Putin and Xi understand what a gift their policies have been to the U.S., from the perspective of it making our dollar stronger than it might have been without their missteps.

Unless we have a severe global recession, I do not think we are going back to QE. This means the largest buyer of U.S. debt over the past fifteen years – the Fed – is now a seller. Japan, OPEC and China, some of our previous largest buyers, have all significantly reduced their appetites for Uncle Sam's IOUs, albeit for very different reasons. And all of this comes as the U.S. begins to increase the supply of bonds.

I also continue to be of the view that we have several other factors, such as labor supply, the need for senior care, and supply chains being shortened, which put upside pressure on long-term structural inflation. Again, outside of a severe recession, I think inflation could settle in the 3-3.50% range.





As mentioned above, the S&P 500 is trading around 4740. My projected range for the next year is 4950-3950. In early 2022, I thought it might take three or more years for the S&P 500 to reach new highs over 4850. As I am writing this letter, the market is less than 2% away from reaching those levels, twelve months before I reasoned was possible. We will soon find out! 😊

The projected range above does allow for a slightly higher high, but from my seat, the market is currently fully priced. This opinion is based on my outlook for interest rates expressed in the previous section. If the current market outlook turns out to be correct (the Fed cuts rates by 125-150 bps and the 10-year treasury declines to 3%), I will be wrong. We shall see, and this is why we have markets!

One more comment

A person could read my projected ranges for equities and bonds, and come away with the view that I am extremely bearish for 2024, as stocks are within 3-4% of my upside, while my downside range is some 15-17% lower. And my expected range for the 10-year is 3.80%-5.30%, whereas it is 3.90% currently. I do not see much upside for U.S. Large Cap equities, and anticipate negative returns for U.S. fixed income. However, I still believe investors with balanced portfolios have a good chance of averaging 4.5-5.5% over the next 5 years. At the end of 2021, I thought clients had virtually no chance of enjoying those types of returns.

Enough on my outlook/opinion. Let's get to the important part of this letter: how should investors consider investing their money.

I think clients should be underweight equities. If the S&P were to trade over 4950, I would suggest investors increase their underweight position. If the S&P would trade 4350-4200, consider being equal weight. And should the S&P trade 4050-3900, I would suggest being overweight.

What to own

I still like both Small Cap Stocks and Biotech, and would be overweight both sectors. There could be some interesting things brewing in the energy sector. U.S. production will likely start to fall in the first half of 2024. Initially, this won't be a problem, as OPEC has spare capacity. But ultimately, I believe there will be another great run for the energy sector, and if it comes under pressure, investors should watch for opportunities to increase exposure. Within the space, I prefer companies

in the production business with large proven reserves. Clients should talk to their advisors, and may want to consider a mutual fund or an ETF.

While it is a crowded trade, I think investors should have exposure to large cap U.S. growth stocks (Amazon.com Inc (AMZN), Microsoft Corp (MSFT), Google (GOOG), etc.). Although these stocks are expensive, consider what Goldman Sachs has pointed out: this is the first cycle we have seen where the disrupters are already profitable companies.

Clean Energy was, for the most part, a train wreck in 2023. However, we need to remember governments around the world have put billions of dollars in motion to combat Global Warming, or Climate Change, whichever label you prefer, and those dollars are going to have an impact on the sector. Whether they will have an impact of the trajectory of our climate, no one can say with any certainty, but we know the money is going to be spent, so follow the money!

Currently, the discounts on closed-end funds are not attractive. However, if we see a spike in volatility, investors may want to revisit the space.

As for fixed Income, the move in rates, which accelerated in the third quarter of 2023, played right into my fixed income plan, and as the 10-year traded over 4.50%, we started to increase duration. Unfortunately, the move to over 5% happened much quicker than I had imagined, which meant I did not get to extend durations as much as I had hoped.

Between early November and today, the yield on the 10-year has plummeted from its high of 5.07% to a low of 3.80%. Most fixed income experts believe we have seen the highs, and they may well be right. But as stated above, markets have memories, and I think they will want to, at minimum, revisit the 4.20-4.50% range for the 10-year, even if the consensus is right and we are headed to 3%.

At this time, I suggest investors be patient and not add to long-term bonds. Those who feel they still need to lock in more long-term rates should use a move back to 4.20-4.40% to make those changes. Those who were fortunate enough to have extended duration when the 10-year was over 4.70% may want to consider being a little more patient. A weekly close above 4.50% could open the door to a test of the highs, and perhaps my target of 5.30%.

Currently the spreads (what investors are paid to take credit risk) are way too tight, in my view. This means staying with high credit quality, as well as being on the short end of the curve. I would be underweighting high yield. Readers may recall there are two ways I think about the space. One is the spread over treasuries, which today is around 3.50% over, meaning an investor is getting paid 3.50% more than treasuries to own high yield debt. To put this in context, the historical range for the spread, setting aside 2008 when we saw 20% over, has been approximately 10.50-2.50%. So when things are really scary, investors were paid 10.50% more than treasuries to own high-yield debt.

The second way I have come to think about high yield debt is the total yield earned. To calculate the total yield, I take the high yield spread plus the 10-year treasury rate. When this number gets over 9.50%, I start to get interested, and if it trades over 10.50%, I want to be overweight high

yield debt. At the time of this letter, the 10-year is 3.90%, and the high yield spread is 3.50%, which gives us a current total of 7.40%...no, thank you. Last fall, the total briefly traded 9.50%.

Investors should consider high yield debt as part of their equity allocation, and we suggest using a fund to get the exposure. Talk to your advisor if you have interest. Our work has identified fund groups which have done a good job in this space.

Also, if we get a move back up in rates, keep fixed annuities on your radar. Of course, you must be comfortable with the credit rating of the company, but last year several quality firms offered fixed rates in excess of 5% for periods of 5-7 years. These contracts also offer tax-deferred growth. Clients should talk with their advisors to see if this arrow should be a part of their fixed income quiver.

And then there are alternatives. In my 2021 letter, I encouraged investors to consider adding non-correlated instruments to their portfolio mix, with Managed Futures being one of the vehicles. In 2022, that asset class delivered double-digit returns, as stocks and bonds tumbled. Investors who are worried about risk may want to increase their exposure to this asset class. Historically, funds in this segment have done well during periods of financial stress. They also benefit greatly when short-term interest rates are over 4%. Clients may want to ask their advisor if these instruments are a potential fit in their asset mix.

Closing thoughts

In my closing thoughts, I need to mention A.I. These two letters are a letter on their own, which is beginning to take shape in my mind. In the meantime, I would suggest you invest an hour to read this: <https://www.newyorker.com/magazine/2023/11/20/geoffrey-hinton-profile-ai>. Chilling is but one adjective which comes to mind.

Also, the 2024 election. I have several musings (poems) which are taking shape as I reflect on next fall, and I would be happy to share those, upon request. Folks at the end of the political spectrums may grimace a bit, but I think everyone will, at times, nod and smile.

Thank you for your trust and confidence. We look forward to being of continued service.

Wally Sparks

P.S. January 14, 2024

AI: Consider the two poems below:

Amidst the dry and dusty land,
The well was not spring fed,
She sought water, empty jar in hand,
Her heart heavy with silent dread.

A stranger sat by the well's rim,
The well was not spring fed,

He spoke of water, not from within,
But a well that eternally fed.

The woman paused, puzzled and stirred,
The well was not spring fed,
How could this man provide what's unheard?
Her thoughts in wonderment spread.

As words unfolded, something changed,
The well was not spring fed,
Her life's path rearranged,
By truths from this well, love widespread.

So she left her jar, no longer in need,
The well was not spring fed,
Her soul refreshed, no more to concede,
In this meeting, her spirit was led.

Though ancient tales may often be told,
The well was not spring fed,
New life springs forth, as stories unfold,
From this well where love's truth is spread.

And the second poem:

A man left Judea for Galilee,
Stopped for a drink and took a knee,
Word of his words had spread.
He sent twelve off for food to eat,
In the noon day sun he took a seat,
The well was not spring fed.

A woman approached, she was of mixed race.
The townsfolk knew well her disgrace,
Never an empty bed.
The man from Galilee asked for a drink.
“You’re a Jew, what do you think.”
The well was not spring fed.

But broken women were special to him,
One would be healed just touching his hem.
Always she had bled.
This woman came for water her chore.
With husbands numbering more than four,
The well was not spring fed.

But Her Samaritan heart began to thaw,
As her story was told she stood in awe,
By what the Nazarene said.
“On this mountain we worship God’s name,
He lives in Jerusalem, you Jews all claim”.
The well was not spring fed.

“The time is coming when worshipers will see,
God is spirit and **I am He**.
Darkness is now dead.
Can you imagine her dash back to town?
“At Jacob’s well, The Messiah I found!”
Our well is not spring fed.

They came in droves and asked him to stay,
And many were saved the next two days.
Discovering Heaven’s bread.
They listened to her, then heard Him speak.
“We now believe he’s the Savior we seek.”
His well is spring fed.

Do you seek relief from the thirst of sin?
Or trust temporal dew time and again.
Consider the words in red.
Open the Bible, read about Ruth;
Worship The Father in the spirit of truth.
Your well can be spring fed.

One of these was written by an amateur poet over a period of eighteen months as he reflected on this piece of scripture, and the other by CHATGPT. Can you tell which is which? Or better still, which poem in your view was the better of the two?

“The Coming Wave” by Mustafa Suleyman. A good friend recently gave me this book. It was a page turner, and I consumed it in two days. This afternoon, I plan to start my second journey through what is now on my list of the most important books I have ever read from an investment perspective. For those who are curious, send me an email and I’ll share with you the other titles on my list.

This book gave me a good base understand of AI, AGI (*Artificial General Intelligence*), and ACI (*Artificial Capable Intelligence*). I also now have a greater appreciation for the size and speed of this coming wave. I swayed back and forth between excitement and fear. The author, who has incredible credentials, believes the wave is needed and will help us solve some critical problems (he is a progressive, which should not be a surprise based on his background). But he also asks if the wave should, or can, be contained. His call for an Apollo-type approach to the question has merit, in my view. From an economics perspective, he is clearly in the “Un-Constrained Camp”

("A Conflict of Visions," Thomas Sowell), so some of his solutions did not resonate with me, but again his call to arms when it comes to dealing with AI is constructive.

My advice: Read the book! My request: Share your biggest takeaways with me, both as it pertains to your area of work and in general. In addition, from an investment perspective, name three industries you want to own and two you would avoid, based on what you learn. And take some time to think downstream, i.e., what could the second and third order effect be, and who benefits and who loses?

I have my own initial thoughts, which may change with a second reading. Although I am happy to share those, I am very interested in what you think. We are blessed to work with gifted individuals, and you have been the source of some of our best ideas, so 1) Read the book, and 2) Share your thoughts with me.

Back to the poems. The first poem was generated by CHATGPT. My request was, "Help me write a poem about Christ's encounter with the woman at the well and use the line 'The well was not spring fed' in every stanza." The prose was generated in seconds.

The second was written by me, over about eighteen months reflecting on this piece of God's Word. Pause and think on this. I did not ask for science, I asked for art. Maybe you could tell the first poem came from CHATGPT (and maybe you liked it better), but what if we ask again in three years? Or, better still, in three months? Will we be able to tell...?

I look forward to your insights!

Respectfully,

Wally Sparks

DISCLAIMERS:

The S&P 500 is an unmanaged index of 500 widely held stocks that's generally considered representative of the U.S. stock market.

The information has been obtained from sources considered to be reliable, but we do not guarantee that the foregoing material is accurate or complete. Any opinions are those of the author Walter Sparks and not necessarily those of Raymond James. Expressions of opinion are as of this date and are subject to change without notice.