Strengthening Our Clients' Financial Lives

Forza Investment Advisory, LLC

FROM THE DESK OF BOB CENTRELLA, CFA **January 9, 2024**

Happy New Year and wishing you all a blessed and healthy 2024 and beyond. I received a belated Christmas gift when the Steelers snuck into the AFC playoff picture on Sunday. I'm not overly optimistic on their chances but as they say, "On any Given Sunday!" Congrats if your team also made it to the playoffs and has a chance to go to Las Vegas for the SB.

After 2022's year of carnage there was a lot of angst about how 2023 would unfold. Few were expecting 2023 to turn out so well in the equity markets, but a strong January led to optimism until the banking crisis hit due to rising rates. The market bottomed in March after the Fed intervened and Silicon Valley Bank was sold, leading stocks back up and close to highs in August for a solid gain in the first 7 months. Then bond yields started rising again with the 10-year UST reaching 5% and stocks stumbled in Q3. Also, Hamas attacked Israel bringing back some more angst in October. After stocks fell about 10% at the end of October from the August high, the Fed caught investors by surprise and offered a more dovish outlook for interest rates (supporting lower interest rates) as inflation data got better. That fueled stocks to a 15.7% gain from the bottom to a big year overall. The S&P 500 returned over 26% for the year including dividends. Also, bonds rallied as the 10-Yr yield dropped back below 4%. You may recall that in my Q3 letter I proclaimed that "**It's the 10-year Stupid**". And it sure was, as stocks followed the rally in the 10-year bond.

Below is a table of price returns for various assets in 2023.

ASSET	% RTN	ASSET	% RTN
Bitcoin	156.76%	Dow Jones Industrials	13.70%
Ether	91.27	Comex Gold	13.34
Nasdaq 100	53.81	DJ Select REIT	9.32
Nikkei 225	28.24	MSCI Emerging Mkts	6.07
FTSE MIB Italy	28.03	IShares High Yld Bond	5.11
Taiwan	26.83	FTSE 100 UK	3.78
S&P 500	24.23	Barclays Bond Agg	2.34
Spain Ibex 35	22.76	7-10 Yr UST	0.64
Bovespa Brazil	22.28	20+ Yr UST	-0.68%
DAX Germany	20.31	WSJ US Dollar	-0.75
SP 200 Equal Weight	19.48	Shanghai Comp	-3.70
Cac-40 France	16.52	Nymex Crude	-10.73
Euro Stoxx	15.66	Lean Hogs	-22.49
S&P Midcap 400	14.45	Nymex Nat Gas	-43.82
S&P SmallCap 600	13.89	Argentine Peso	-78.14

The crypto currency Bitcoin had a big bounce-back year climbing 156.8% while Ether rose 91.3% as the big winners. Bitcoin has been rising in anticipation of the SEC allowing Bitcoin ETFs to trade. But stocks were the big winners in 2023. The Nasdaq 100 rose 53.8% led by the now called Magnificent 7 (Apple, Microsoft, Alphabet, Meta, Amazon, Nvidia, Tesla). These 7 stocks alone generated over half of the S&P price gain of 24.2%. Almost 75% of the rest of the stocks in the S&P 500 underperformed the index so it was a very concentrated gain among the mega-cap stocks in the index. Foreign stocks also had a strong year led by the Nikkei 225 up 28.2%, Italian MIB +28%, Taiwan +26.8%, Bovespa +22.2%, German DAX +20.3% and the French CAC-40 up 16.5%. Overall, the Euro Stoxx index rose 15.7%. Among other indexes

and assets, the Dow Jones Industrials rose a "pedestrian" 13.7%, while Gold was up 13.3%. Bonds ended up in the positive with the Barclays Aggregate returning 2.34% after a big Q4. On the downside, Crude Oil fell 10.7%, Lean Hogs -22.5% and the biggest loser was the Argentine Peso off -78.1%.

Among cap sizes and styles, Large Growth (+28.4%) trounced Large Value (+19.9%). Large cap S&P 500 (+24.2%) outperformed Midcap (+16.5%) and SmallCap (+16.2%). The Russell 2000 SmallCap lagged but still returned 14.9%.

Index	% Rtn	Index	% Rtn
S&P 500 Growth	28.4%	S&P Midcap 400	16.5%
S&P 500 Value	19.9%	S&P SmallCap 600	16.2%
S&P 500	24.2%	Russell 2000	14.9%

Finally on a sector basis, Technology jumped 52.4% followed by Communication Service +48.4% and Consumer Cyclical 34.3%, while the underperforming sectors included Utilities (-8.2%) and Consumer Defensive (-0.91%).

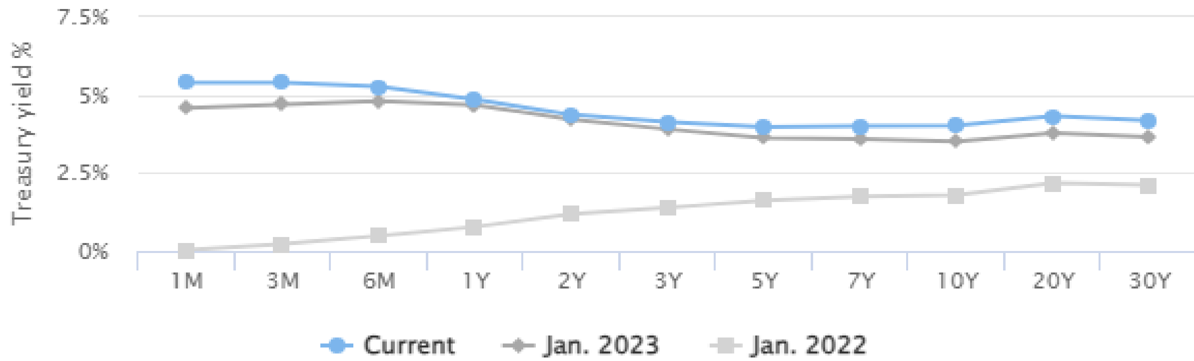
Sector	% Rtn	Sector	% Rtn
Technology	52.4%	Real Estate	6.1%
Comm Services	48.4%	Healthcare	3.1%
Consumer Cyclical	34.3%	Energy	1.3%
Industrials	17.5%	Consumer Defensive	-0.9%
Financials	15.9%	Utilities	-8.2%
Basic Materials	12.1%		

KEY TAKEAWAYS AND LOOKING AHEAD

Last year the overwhelming consensus view was that the first half of 2023 would be difficult with the US heading to recession and then the 2nd half would be better. I had stated that since it was the overwhelming consensus, I almost guaranteed it wouldn't happen. Sure enough, the consensus was wrong again. For 2024, the consensus is expecting a soft-landing to be engineered by the Fed for the economy, with up to 6 rate cuts during the year. It is not as overwhelming as it was last year so I'm going to hedge my bet and state that there is a good probability that the consensus could be somewhat right. More on my thoughts in a bit. First let's look at some key takeaways for 2024. All this assumes the government doesn't shut down in coming weeks and a funding deal is reached. That is a risk near term.

1. Remember that 2024 is an election year. Markets tend to rise in an election year but tend to be more volatile. **The average annual return in an election year since the 1920's is 11.2%.** Will it be Trump vs Biden redux? As the election approaches stocks could weaken but most often stocks see a relief rally regardless of who wins. It is not automatic, but election year market returns say you want to be long the market this year.
2. Inflation is turning lower and has a good chance to get back to the 2% Fed goal. It's been a steady decline in inflation the last year and this week on Thursday we get the next important CPI reading. We are now in the 3%+ range for inflation year-over-year as supply chain disruptions since the pandemic have eased on goods. Service inflation needs to follow. Inflation remains the key data point for rates and the market.
3. Consumers have purchasing power with the unemployment rate still below 4%. Earned income is at a record high and the labor market offers some job security. With stocks near record highs, consumers and businesses have some excess cash.

4. Interest rates are still above normalized on the short end but from 3-years to 30-years are closer to flat. The Yield Curve is still inverted. I've been talking in the past about how the curve needs to normalize.



Either short rates must decline, or long rates must rise. The Fed dot-plot forecasts a chance of 3 rate cuts in 2024. Currently the Fed Funds rate target is 5.25%-5.50%. A 100 basis-point reduction (1%) would bring the FF Rate to 4.25%-4.50%, closer to where the rest of the yield curve is. The inverted Yield Curve still is predicting a recession. Investors are expecting 5-6 rate cuts. If the Fed more emphatically signals less rate cuts, markets could react negatively.

5. Housing has been mixed with existing home sales weak and new home sales more resilient. Lower rates would help both markets but especially existing home sales. Many homeowners are reluctant to give up their current 3% mortgages, but lower mortgage rates should boost sales as well as housing related retail sales.
6. Corporate cash flow is pretty strong, and profits are forecasted to rebound in 2024 as the year progresses. 2023 S&P earnings are expected to be flattish (+0.6%) but then rise 11.5% in 2024. At the beginning of 2023 analysts expected a 4.8% increase in profits while economists expected a 2.7% decline. Is the worst behind us? As the year progresses, quarterly comps will get easier. Stock prices should follow earnings .
7. Stocks are valued above average as the market roared ahead while earnings did not in 2023. The S&P 500 currently trades at a forward PE ratio of 19.3x EPS compared to the 5-yr average of 18.8x and the 10-yr average of 17.6x. The PE's are dominated by the earlier mentioned Magnificent 7 which tend to trade at higher multiples. The rest of the market underperformed the cap-weighted S&P 500 (+24.2%) as evidenced by the Equal Weighted SP 500 which gained 11.7%. But in the 4th quarter, the equal-weight outperformed as smaller stocks gained. So, if the rest of the market continues to normalize, stocks can move higher powered by these companies even if the Magnificent 7 pauses.
8. Bond yields are above 5% on the very short end up to 9 months and mostly above 4% beyond out to the long term. A yield of 4% is OK but not necessarily a great alternative to stocks. But it does offer a decent hedge in a balanced portfolio.
9. Geopolitical challenges are still there but seem contained. A change here could be a risk to markets. There are still 2 wars being fought but they seem to be regionalized. However, the Hamas/Israel war has some potential of spreading. China economic woes reduces the chance of it invading Taiwan, but this is a big wild card.
10. Finally, recession risk seems to be lower than it was in 2023. Can the Fed finally engineer a soft landing of low inflation and maximum employment with a growing economy? Last year I did not forecast a recession and this

year I will stay the course. Barring some unforeseen major issue, the Fed may finally get its wish of a soft landing. Worst case, any recession should be mild. There are signs of slowing including the ISM Mfg. index below 50 and decreasing jobs gains. Also, as I mentioned, the yield curve is still inverted and has predicted 13 of 13 recessions. The Fed ability to lower rates if inflation comes under control can forestall the recession.

BONDS

The Treasury yield curve has been inverted for over a year now and I don't see long-term yields rising as a means of normalizing the curve, so short-term rates will need to come down. Muni bonds can offer a better tax-equivalent yield in some states. Meanwhile the UST yield spread to Corporate bonds is extremely low, so it is hardly worth the risk for yields unless you go down in credit, then you must take on additional risk. High yield bonds offer a nice yield difference assuming we don't enter a credit recession. Given the yield curve inversion, I don't see longer term bonds earning much more than their current yield until the curve normalizes. I now prefer a barbell and laddering approach coupling short and intermediate bonds with some longer-term bonds with yields above 4%. Overall, bonds should return their yield with flat prices until short rates come down over 1.5%. I don't see much movement in yield or price from 3 yrs maturity out to the long term this year. I'd expect a 50 basis point trading range up or down from current levels. Preferred stocks and convertible bonds also offer a decent return opportunity. Cash yields will decline but should still stay above 4%.

EQUITIES

Earlier I talked about the stock market being valued at above historical averages. This year has started off with some selling the first few days of last year's biggest winners. The selling of the winners is not unusual as investors didn't want to take big gains at year-end so waited until 2024 for tax purposes. Also, the selling was orderly and not extreme. In the next few weeks, we will get company Q4 profits and 2024 outlooks. Many companies tend to be conservative as the year starts so we may see some big moves up or down in individual stocks. I view this as a good opportunity to add to or buy new positions in companies that may temporarily see their stock price decline. Last year gains were very concentrated among mega-caps until the Nov/Dec rally. I preferred the equal-weighted index as the year progressed and this year, I still prefer a more equal-weighted approach but with exposure also to the mega-caps. If the Fed does indeed start lowering rates, Value stocks could gain an upper hand over Growth. Mid and small cap stocks lagged the last 2 years and are cheaper than large caps. So, I continue to want to allocate money to these areas. On the international front, Europe as a whole seems to be lagging the US by a few quarters in terms of fighting inflation and economic growth. China has economic issues while Japan seems to be doing better. International stocks did well last year, and I also want to continue to allocate several percent to this asset class, but you need to be selective in which areas you invest. Overall, I believe it will be a stock-pickers market this year and prefer the diversified approach of owning individual companies that will produce strong cash flows, recurring sales and solid balance sheets. On a sector basis, I prefer technology, comm services, cyclical stocks and financials as the Fed lowers rates. I also like Health Care as an equal-weight since it largely underperformed last year.

SUMMARY AND CONCLUSION

It's time to assign some probabilities to forecast scenarios for 2024. As you know I tend to be an optimistic long-term investor and that is not changing. I think 2024 will be an up year for stocks and a collect-the-coupon year for bonds. Here are my scenarios:

- My highest probability and base case like last year is that the Fed pulls off a soft landing and we do not have a recession. I do see market volatility with up and down months. I don't see the Fed lowering rates until after March as it continues to be data dependent. I think investors expect too many cuts at 6 and believe 3-4 is more likely especially in an election year. Overall, I forecast stock returns of 10-13% coinciding with what I think S&P earnings will grow. The S&P 500 target at that level would be 5300 – 5450. For Bonds, we forecast returns in the 4-5% range for the Bond aggregate. I assign a 75%+ probability to this scenario.

- My bear case scenario is that the Fed can't cut rates because inflation lingers and drives us to a mild recession where the Fed must then eventually lower rates. Corporate profits decline 5% or more and stocks drop 10%+ until rebounding late in the year after the election but still in the red. I assign a 10-15% chance of this or a more bearish scenario than my base case.
- My best-case scenario from last year is the one that actually came closest. In this scenario, inflation data is better and slows to a 2% range within 3 months. The Fed begins to cut rates and does indeed do so for 5-6x while keeping the economy growing above 2% for the year. Corporate profits rebound and are stronger in the 2nd half, rising 15% for the year. Stocks follow in a broad-based rally with returns greater than 15%. Bonds also rally as prices rise and yields drop. I assign this a 15-20% probability and cyclical stocks lead the rally.

In sum, I think equities outperform bonds, but bonds should be held for income and protection in balanced accounts and should produce positive returns. I continue to favor a diversified equity portfolio with exposure to mid, small, and international stocks. Stock-picking will be key as you can't just own the "Magnificent Seven".

Have a wonderful 2024 and feel free to contact me with any comments.

I will be out soon with the 2023 Forza survey results and our winner as well as the 2024 Survey. Cheers!

Bob

PS: I haven't sent an ***Italian wine tip*** *in quite a while, so here goes a quick one. The 2018 and 2019 vintages in Northern and Southern Italy were excellent vintages and many of the Reds are now on the shelves. From Tuscany, Bolgheri and Piedmont in the North to Southern Italy Reds such as Aglianico and Taurasi you can find both drinkable- now wines and those to hang onto for several years.*