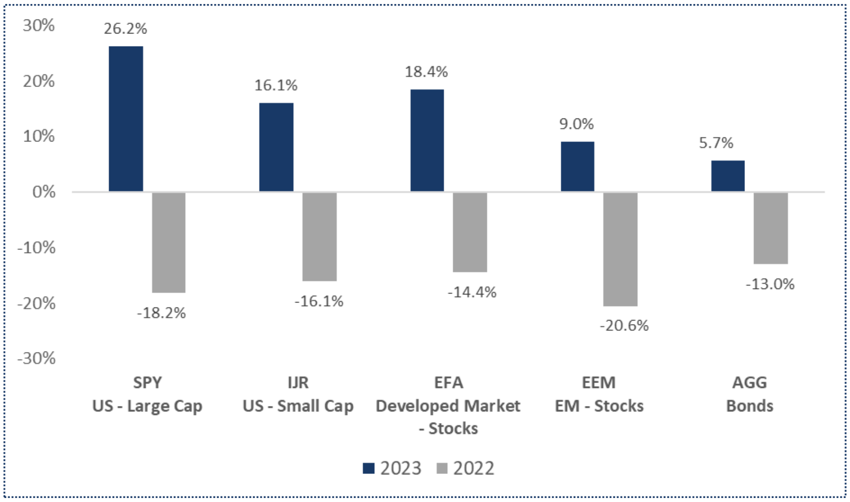
When you least expect it…

"Live within your income and save so that you can invest. Learn what you need to learn."
– Charlie Munger

Almost no one thought 2023 was going to be a phenomenal year for stocks, but nearly all markets rebounded with many up over 20% on the year. Just like the consensus opinion of the "experts" missed the dramatic declines of 2022, most were overly negative for 2023 and many were convinced of a recession that has yet to happen. Despite the fastest interest rate increase in three decades, a near banking collapse in March, and a new war in the Middle East, stocks are back to all-time highs.



The S&P 500 finished the year up 26%, the Dow (DJIA) was up 14%, and the mania around artificial intelligence and large technology companies helped the Nasdaq increase by 43%. After experiencing the worst year in modern history, bonds also rebounded and ended the year up over 5.5%. The bond performance was aided late in the year by a large decline in the 10-year treasury yield after the Federal Reserve indicated it was finished raising rates for this cycle.

Diversifying Strategies had another strong year. Despite numerous warnings around Private Credit, the asset class once again proved to be very resilient with double digit returns. Commercial Real Estate has certainly faced headwinds as a result of rising rates, but for the most part has not seen any major issues. Although transactions were down, and it was increasingly more difficult for owners to refinance, valuations only dipped mildly outside of office and certain large metropolitan areas.

Below we provide a brief recap of 2023 and our views as we move into 2024 and beyond.

2023 Recap

The investment outlook was bleak at the start of 2023. We were coming off the worst performance of stocks and bonds in many years, inflation was still elevated, and the Fed showed no signs of slowing down its rate increases. War in Ukraine, combined with fears of a Chinese invasion of Taiwan, led to a somber geopolitical outlook. Based on the historic increase in interest rates, a recession seemed unavoidable. So, what happened? In our outlook last year, we turned to history, which doesn't always repeat itself, but it does

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tend to rhyme. We said, "Since 1950, there have been 19 negative years in the stock market. In the following year, returns have been positive about 84% of the time, but surprisingly, returns have been over 20% the following year over half the time." Obviously, we did not know the key events that would drive stocks higher, but we do know that reversion to the mean is very important in investing.

Despite the recession calls, inflation continued to decline, consumers kept spending, and the unemployment rate fell to 3.4%, which is the lowest since 1969. In March, there was a major scare in the banking sector and several regional banks filed for bankruptcy within days as depositors rushed to get their cash out of the most troubled banks. Similar to the financial crisis, the Federal Reserve came to the rescue in record time to backstop the whole system and provide the confidence to stop a run on any other banks. Although it went mostly unnoticed at the time, the Fed went from taking money out of the system to being quite stimulative to the markets.

Simultaneously, a new technology emerged with the release of an updated version of ChatGPT and the potential for many technology firms to use large language models to make businesses of all kinds more efficient. Big technology companies were the biggest beneficiaries and led markets higher on hopes of increased future profits for years to come. These companies were dubbed the Magnificent Seven and include Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta. As a result of their weighting in indexes, nearly 1/3 of the S&P 500, they pulled markets higher into late summer, despite all of the underlying risks, and ultimately accounted for 70% of the return of the S&P 500.

As is typical, markets began to sputter in the fall on renewed inflation fears and the 10-year treasury hit 5% for the first time in 16 years. War broke out in the Middle East, but the impact on markets was limited as Brent Crude Futures ended the year down 10% to $77/barrel. Ultimately, the path of inflation continued to decline and the pressure on rates subsided as the 10-Year finished the year at 3.86%. This move in rates during the 4th quarter was one of the largest and fastest moves in history and every major asset class benefited. Moving forward, many of the major risks we faced in 2023 are behind us, but going into an election year we are still faced with many unknowns.

2024 Outlook

"Fear? What has a man to do with fear? Chance rules our lives, and the future is all unknown. Best live as we may, from day to day." – **Sophocles**

We believe recession risk has mostly been taken off the table and interest rates will once again drive markets. Below are our views for 2024.

Stock Outlook

As we did last year, let's take a look at what history says about markets. Since 1950, there have been 28 years in which the S&P 500 has gained more than 15%. In the following year, stocks have been positive 20 times (71%), they have been up over 10% 14 times (50%), and up over 15% nine times (32%). So, history says there should be a follow through to 2023's rebound and potentially a very strong one at that.

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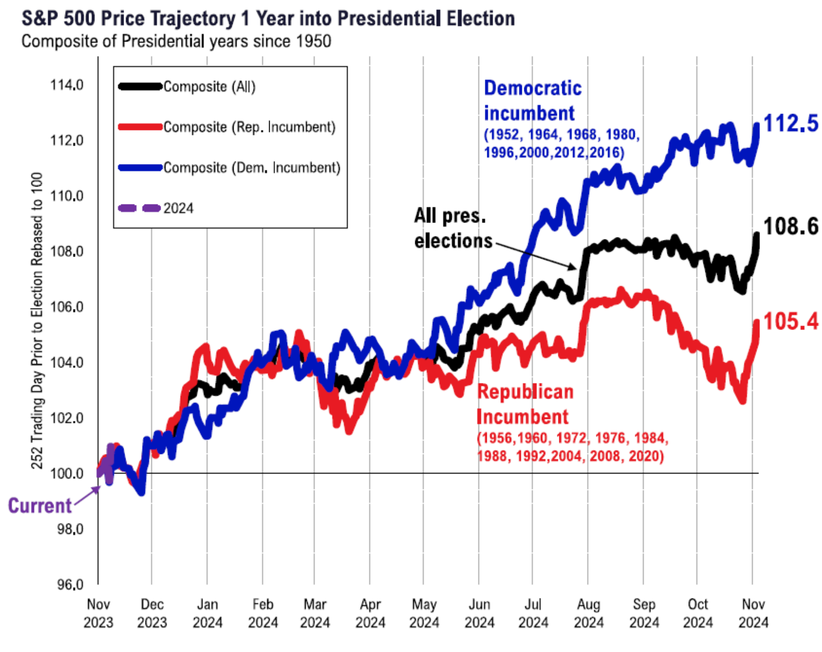
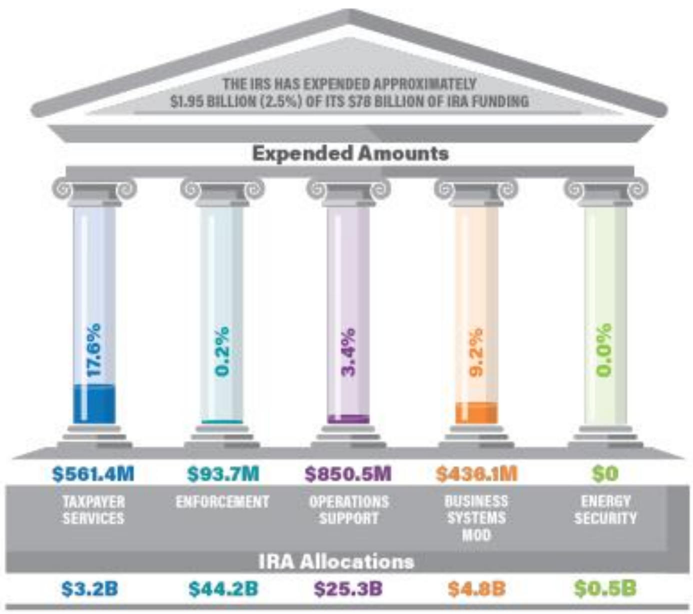
Election years also tend to be strong for markets. The chart at right shows the average return in all election years (Black Line), and the accompanying returns when there is a Democratic Incumbent (Blue Line) and when there is a Republican Incumbent (Red Line). Interestingly, our current situation with a Democratic Incumbent paints the rosiest picture and markets have historically risen by 12.5% going into elections.



Source: Fundstrat, Bloomberg

Although the US Deficit is growing at an unprecedented clip and the government is incapable of achieving a balanced budget, there appears to be plenty of fuel to add to the fire in 2024. As shown in the chart below, only a fraction of the Inflation Reduction Act money has been spent. In addition, the Chips Act, which was also signed into law in 2022 has spent only a fraction of the money appropriated under that bill. Thus, the economy should see continued government stimulus heading into the election.



As we have discussed before, interest rates are still the most important driver for assets of all types. Today, there is a clear disconnect between market expectations and current Fed forecasts for interest rates. Although both point to lower rates in 2024, the timing and magnitude are quite different. Futures say there will be six or seven cuts beginning in March, which would take the Fed Funds rate into the mid-3s by the end of the year, while the fed is suggesting only three rate cuts, which might not begin until late summer. Most importantly, the spread in mortgage

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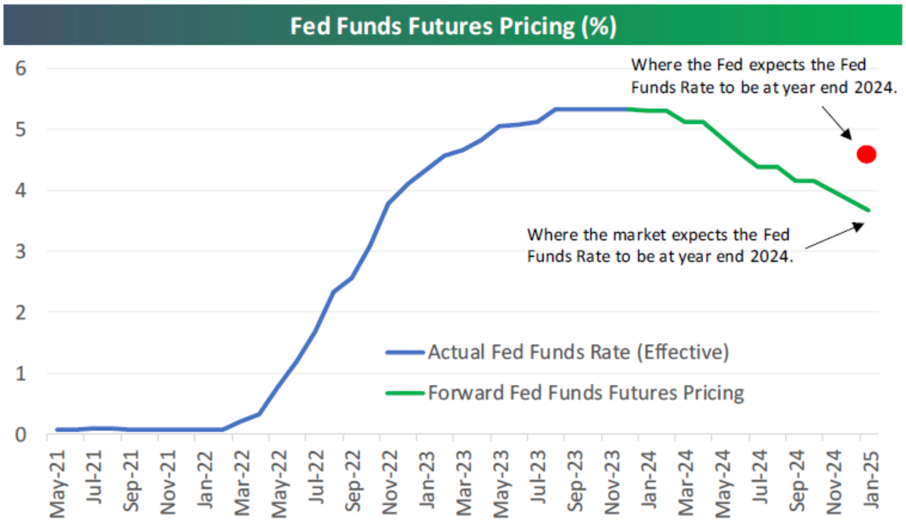
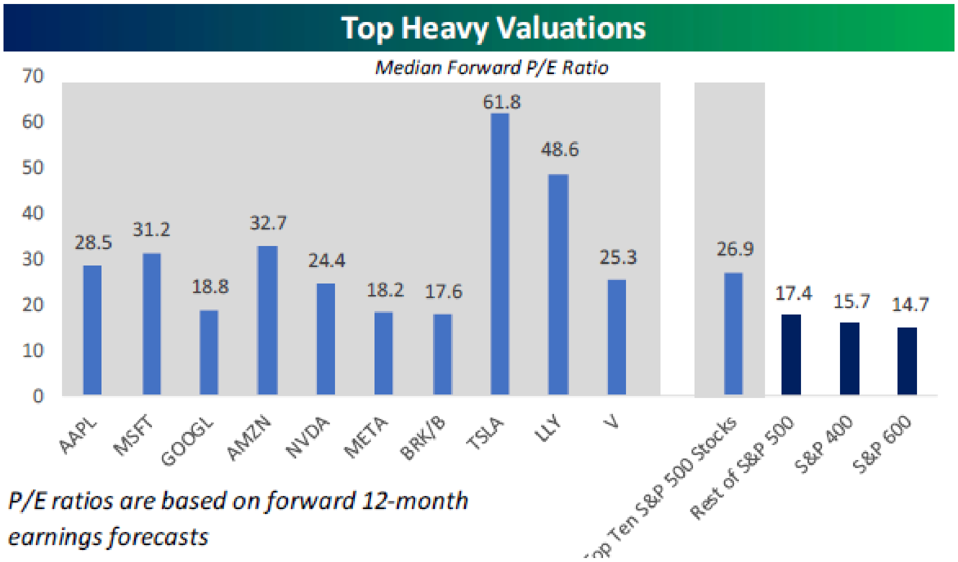
rates and the 10-year treasury yield appears to be declining. This spread reached nearly 3% over the last couple of years because of economic uncertainty and fears that the Fed would raise interest rates further. To put this into perspective, the spread has not been this high since the global financial crisis and typically averages around 1.7%. Today, the 10-year is hovering around 4%, which suggests mortgage rates could get back into the 5s at some point this year, which is a major improvement from the nearly 8% mortgage rates seen last year. Lowering borrowing costs would be stimulative for everything real estate and debt related.



Earnings will once again be a focal point in 2024 and after a flattish 2023, they are set to rebound. The large technology companies (Magnificent 7) are expected to grow their earnings by 19% this year, while the rest of the S&P 500 is expected to grow earnings by 10%. If the AI craze ends up being too rosy, or these profits are pushed off into the future, technology valuations could be too high. However, when you take the excessive valuations of these seven companies out of the equation, the market appears to be fairly valued, and valuations could certainly go higher (see chart). Mid Cap and Small Cap stocks look even more attractive after a couple of years of significant underperformance and are historically beneficiaries of lower rates.



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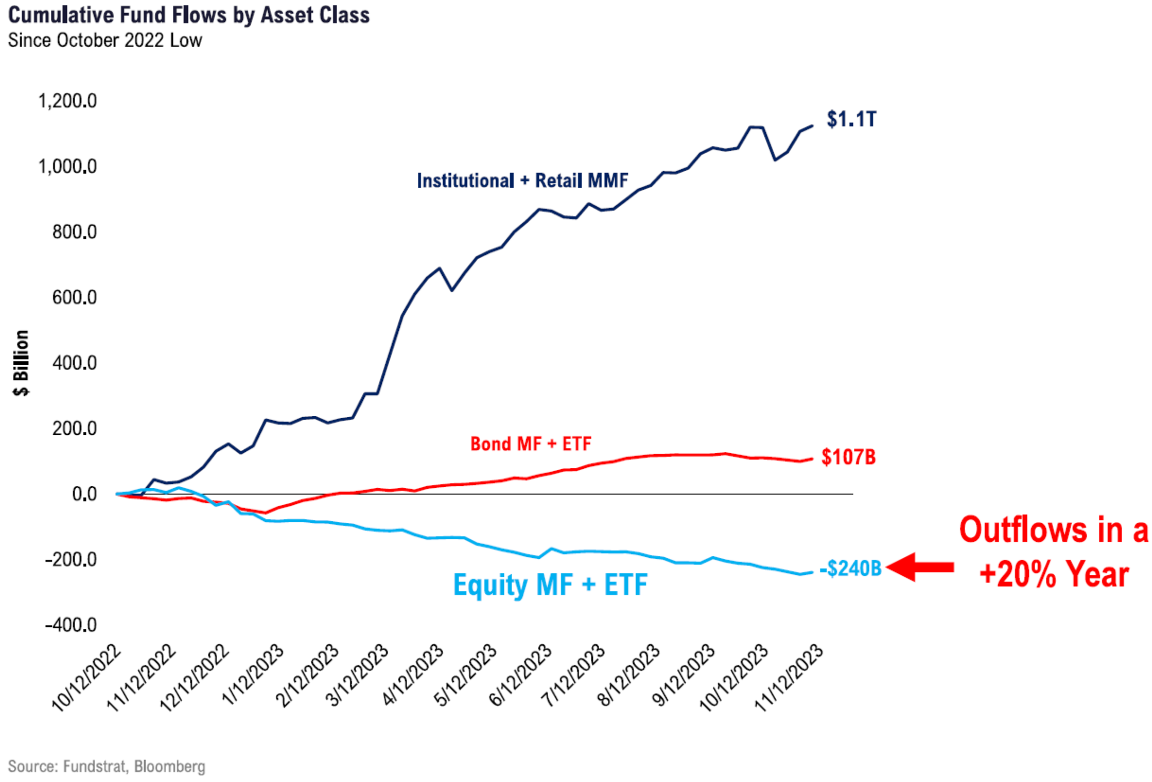
Today, there is over $6 trillion parked in money market funds, which is the highest in history. This has been driven by COVID stimulus, higher rates creating a return on cash, and general fear. Flows into money markets increased by over a $1 trillion in 2023, while money flowed out stocks by $240 billion. This is the first time on record that the market was up over 20%, while flows into stock ETFs and mutual funds were negative. This sets up another good backdrop for 2024. If rates continue the projected path lower, yields on those money markets will start declining and investors may look to other assets for returns, pushing riskier assets like stocks higher.



Although we have discussed a lot of positives, markets have come a long way in a short amount of time since October. Many analysts believe the first half of the year could be weaker, while the second half could be stronger. Other analysts believe we will see continued gains in the 1st half with a weaker 2nd half of the year. Short-term forecasts are nearly impossible, which is why it is so important to look at the underlying fundamentals and data on a longer-term basis.

Fixed Income Outlook

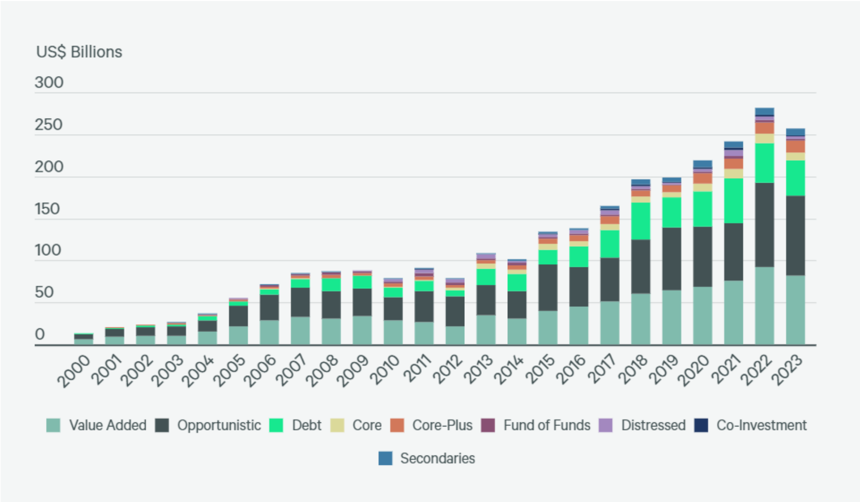
Bonds will once again be driven by the direction of interest rates (10-year Treasury), and they will certainly not move in a straight line. After such a large decline in the 4th quarter, most analysts are predicting an uptick in rates over the first half of 2024. In general, bonds of all types are in good health from a credit standpoint. The number of maturities coming due in 2024 is far lower compared to 2025 and 2026, when rates should most certainly be lower.

We believe one of the biggest surprises of the year could be when conservative investors realize that those 5% interest payments are gone. Today, we can still earn over 5% in short term Treasury Bills and Money Markets, but the clock could be ticking. As discussed earlier, both the Fed and the futures markets are predicting lower short-term rates, which would ultimately drive those yields lower and potentially much lower. Now could be the time to look at longer-dated bonds.

Although the consensus is calling for lower rates, we should be aware of the factors that could keep rates higher for longer. Inflation is probably the number one concern. It has come down remarkably from its' peak in 2022, but it will be hard to get from 3% inflation to 2% inflation. Currently, we are on a great track, but with so many geopolitical risks, this could change quickly. The other concern is the United States' growing debt, which now sits at $34 trillion and is growing by the day. As the government continues to fund the debt through new Treasury issuances, the buyers (individuals, pensions plans, foreign governments, etc.) may require higher rates if they are concerned about the government's ability to pay back that debt. We have seen some of this in the government Treasury auctions over the last six months.

Private Markets Outlook

We believe private markets potentially offer investors better risk and reward characteristics than traditional stock and bond markets. In particular, real estate and private credit should continue to perform well into 2024. Although there were many doom and gloom calls for commercial real estate in 2023, they never fully materialized. While the number of transactions suffered a major decline, the overall valuations in real estate never really adjusted to what many thought would be a distressed sales environment. As a result of the low number of transactions, the amount of uninvested capital ("dry powder") in commercial real estate has ballooned to over $250 billion as can be seen in the chart at right. The forecasted decline in rates should also be a positive in the space as it will allow sales and refinances to pick up and encourage developers to get back in the game.



Source: Preqin, CBRE Research, November 2023.

Private Credit had a record year in 2023 and with recession risks kicked down the road or maybe eliminated, 2024 should be another good year. As a reminder Private Credit has been around for many years but has become easier to access for individual investors over the past decade. When a public company borrows money, it goes to the bond markets and when a private company borrows money, it goes to the credit

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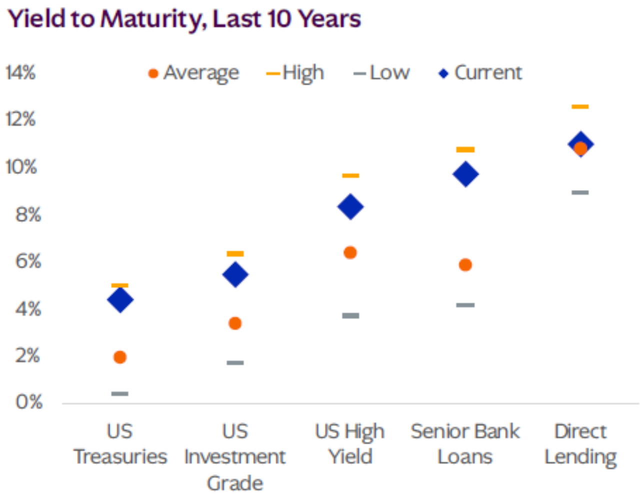
markets. Before the Global Financial Crisis in 2008, Private Credit was primarily provided by large banks, but in today's world, private credit loans are funded from investor money versus bank money. The accompanying chart from KKR compares yields over the last 10 years to various types of bonds, bank loans and Private Credit (Direct Lending).



Private Credit has provided investors with superior yields compared to traditional fixed income investments. Although perceived to have stock-like risk, Private Credit has proven very resilient through both COVID and the declines of 2022, posting positive returns in both years. Since 2007, there has only been one down year and that was in 2008 at the depths of the Financial Crisis. Historically default rates on these loans have been lower than traditional high yield bonds and the recovery rates on those defaults have been stronger. Across the sector, most lenders have adjusted underwriting standards and lending requirements to mitigate potential risks in this uncertain economic environment.

Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time of year to set up a review meeting.

Sincerely,

Canal Capital Management

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