PENOBSCOT
FINANCIAL ADVISORS

MARKET COMMENTARY

Q4 2023

MARKET REVIEW

As we close out 2023, we look back on a year marked by changing expectations. Conventional wisdom had it that the Fed's unprecedented round of restrictive rate increases from 2022 were likely to throw the US economy into a recession on the back half of 2023. That sparked speculation that interest rates had peaked and would likely be on the way back down in later in the year.

Obviously, looking back, both assumptions proved to be off. The FOMC announced four consecutive interest rate increases from February through July, raising the Fed Funds rate by a full 1% and pouring cold water on the recovery. Further, growing expectations that rates would be higher for longer tempered both stock and bond market returns into and through October. Outside of the 'magnificent seven' stocks (Tesla, Alphabet, Meta, Amazon, Microsoft, Apple and Nvidia) US equities languished most of the year and bond prices faced headwinds from still-rising rates. Strains on the banking system revealed themselves early in the year with the failure of two banks.

The fourth quarter, however, marked yet another change in trajectory for market expectations. A cooling in the rhetoric from the Fed, coupled with inflation numbers moderating steadily and a still-robust labor market injected some expectations for the Fed to 'pivot' to a more accommodative policy of rate reductions as early as March 2024. The possibility of a 'soft landing', with inflation potentially normalized and the economy not dropping into recession, started to look like it had a better shot at becoming a reality.

Owing largely to this change in sentiment, stock and bond markets both rallied impressively in November and December. The 10-year treasury, which had nudged up against a 5% yield in October, closed out 2023 yielding 3.86%, just about exactly where it had started the year. The bounce in the stock market was extraordinary, with the S&P 500 gaining in 9 consecutive weeks, its longest such streak since 2004, giving the benchmark index a 16% boost to end the year. The year-end rally extended beyond stocks and bonds to include other assets, with gold regaining $2,000 per ounce after dropping below $1,835 in early October. Other commodities, including oil, slid to price levels that were lower than where they started 2023. WTI Crude started the year near $80/barrel and ended the year near $70. This was remarkable in light of the still-booming US economy, the continuing Russo-Ukrainian conflict and the war between Israel and Hamas.

The result of moderating energy and food prices brought Core CPI inflation readings down more sharply than expected for the month of November and this added fuel to the end-of year rally. Coupling that with declining interest rates, the US Dollar slumped during the 4th quarter when measured against currencies such as the euro and the Japanese Yen. In total, the greenback had its worst year since 2020. Bucking the dollar's trend, Bitcoin's value, which started the year at $16,500, ended 2023 priced at over $42,000.

LOOKING FORWARD

HUNKER DOWN?

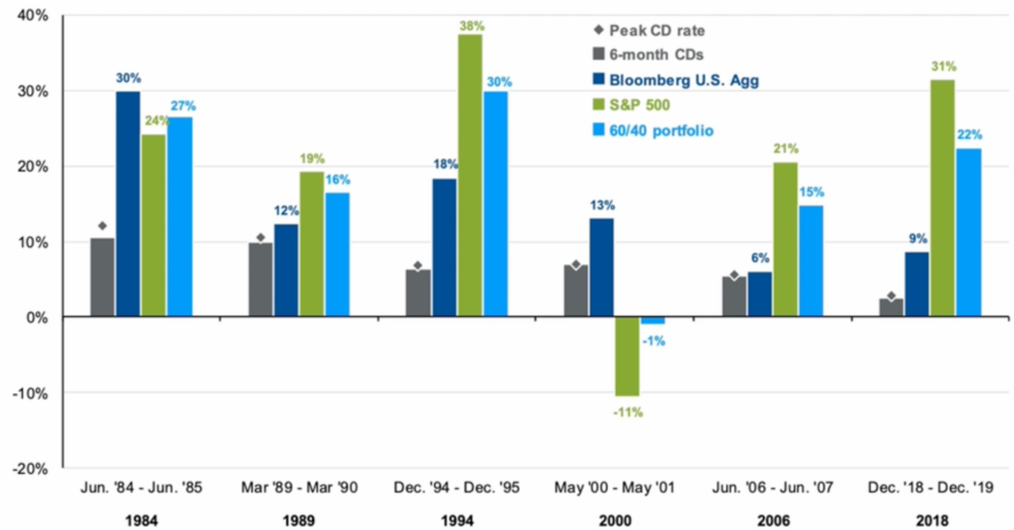
We finish 2023 with certain FDIC-insured savings vehicles, including high-yield savings accounts and shorter-term CDs yielding in the 4-5% range. At the same time, we're coming into a year where many analysts are raising expectations for a slowdown in economic growth, and muted market returns. This leaves some to question the wisdom of taking on market risk. The Siren's call of sleeping on cash, while seemingly attractive, has proven to be a less-than-optimal solution in the six prior rate-hiking cycles, with bonds outperforming cash in all six and stocks and balanced portfolios outperforming cash in the 12 months following the peak in bank rates.

There are, however, ample reasons to believe that inflation has further to fall, even without further Fed tightening. A large component of headline CPI is shelter costs, and a convincing trend reversal seems to be underway in housing and rent costs.

Outside of shelter costs, transportation services (including new and used vehicle purchases) have begun to soften, and that softening is expected to continue in light of a stretched US consumer.

Investment opportunities outside of CDs

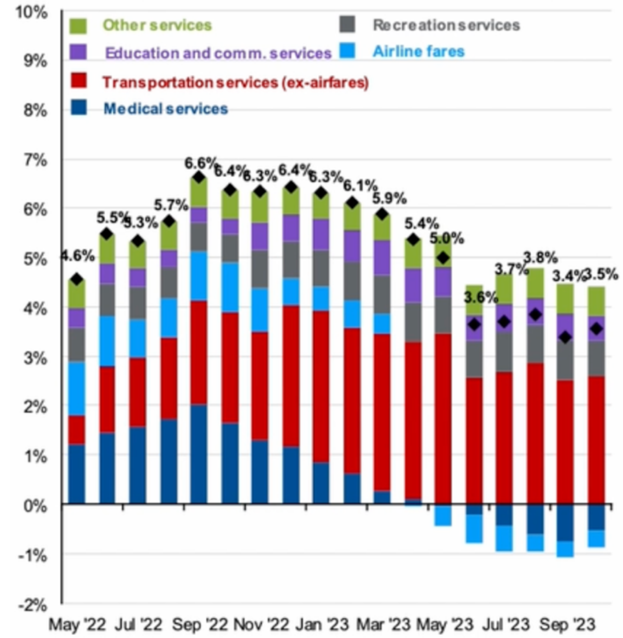
Peak 6-month certificate of deposit (CD) rate during previous rate hiking cycles and subsequent 12-month total returns



SOURCE: JP Morgan Guide to the Markets, Q4 2023

Contributors to core services ex-shelter CPI inflation*

Contribution to y/y % change in custom CPI index, non-seasonally adj.



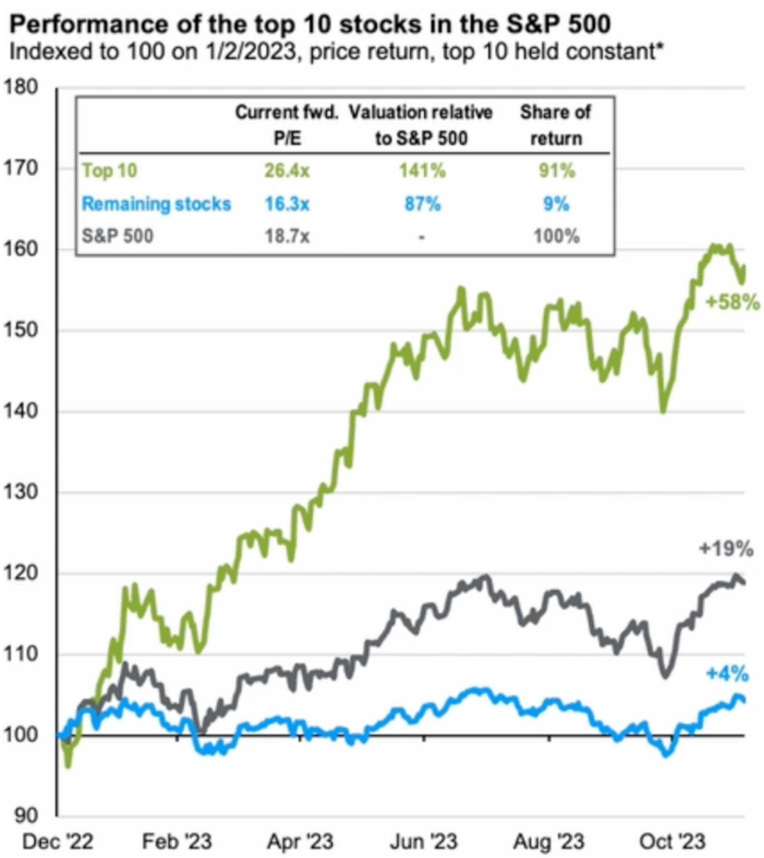
SOURCE: JP Morgan Guide to the Markets, Q4 2023

IS IT TOO EARLY TO DECLARE VICTORY VS INFLATION?

While 2023 featured a steeper-than-anticipated reduction in the rate of inflation during the first half of the year, the headline Consumer Price Index went largely sideways during the second half. This leads some to concerns that the Fed will need to continue to at least leave rates elevated for a longer period, or even to need to potentially raise rates more, if inflation fires back up again.

WILL 2024 BE THE YEAR WHEN VALUE CATCHES UP?

The price performance of the largest US stocks significantly exceeded that of the average US stock in 2023, driving good performance on market-weighted benchmarks like the S&P 500. This kind of outperformance raises valid concerns about valuations becoming unsustainable. However, outside the largest companies, the remaining stocks are showing valuations that are far more reasonable.



SOURCE: JP Morgan Guide to the Markets, Q4 2023

For every compelling argument favoring why these larger companies are poised for continued outsized growth, there are at least as many reasons to believe that some amount of reckoning is overdue, and that the relative performance advantage of mega cap stocks is facing some degree of headwinds.

Among the most compelling reasons to favor more value-heavy stocks is the fact that, while the top 10 stocks in the S&P 500 have grown to represent an unprecedented 33% of the market capitalization weighting of the index, their contribution to the actual earnings in the S&P 500 is far less impressive, at only 21%.

SOURCE: JP Morgan Guide to the Markets, Q4 2023

If these trends continue, it may be wise to concentrate more heavily on quality stocks with good cashflow and profitability, whose valuations may not have been caught up in last year's mega cap run-up.

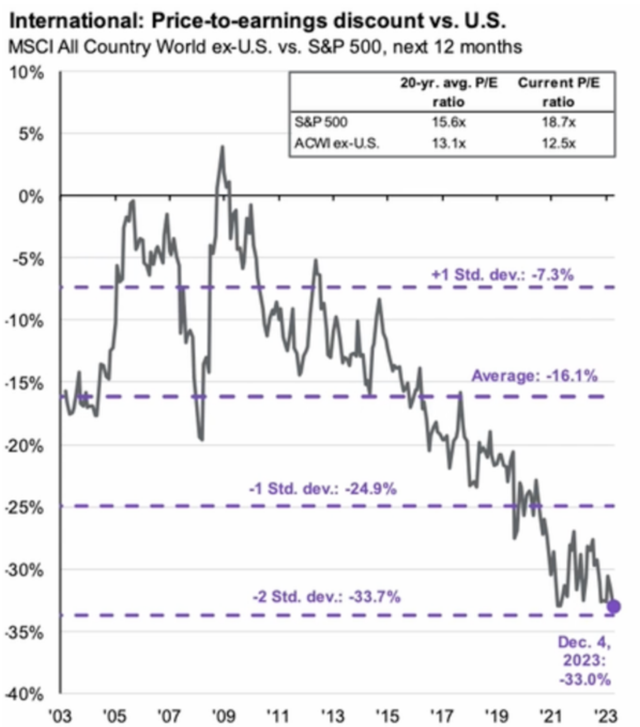
WILL GLOBAL DIVERSIFICATION STILL MAKE SENSE?

US stocks have outperformed international stocks significantly over the 15 years since the global financial crisis. While some analysts and asset managers continue to favor this trend for the upcoming year, there are ample reasons to approach this with caution.

Relative to U.S. stocks, foreign assets have certainly outperformed during several of the recent years. While the intermediate-term trend has favored a U.S.-centric approach, investors who diversify along geographic and market-cap criteria have arguably experienced a smoother ride than those who have relied solely on the S&P 500 for their market exposure.

GLOBAL VALUATIONS AND DIVIDEND YIELDS

Going into 2024, we are seeing discounts in the valuations of non-US stocks versus those of domestic companies. While U.S. companies do tend to trade at higher price-to-earnings ratios than their non-U.S. counterparts, the gap has widened to a level not seen in recent history.



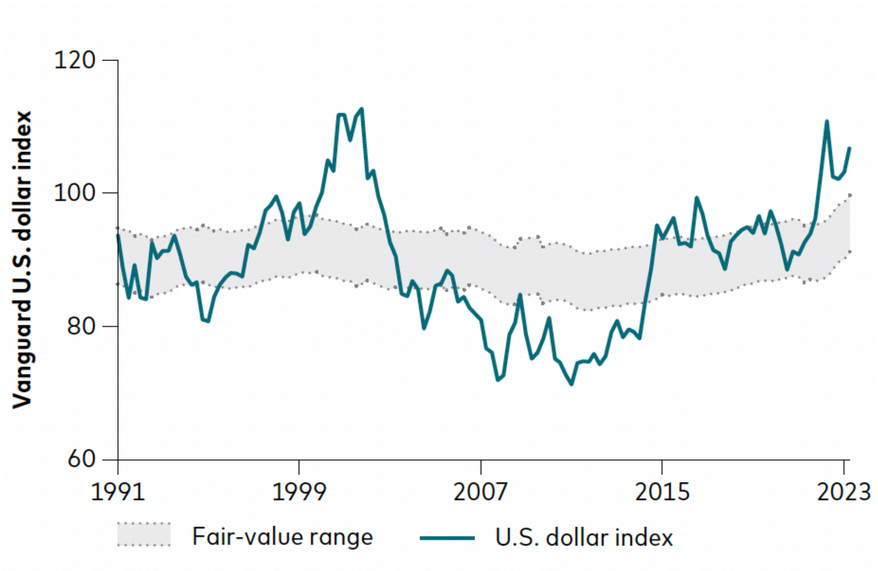
SOURCE: JP Morgan Guide to the Markets, Q4 2023

At the same time, dividends on international stocks exceed those of U.S. stocks to a degree that hasn't been seen recently.

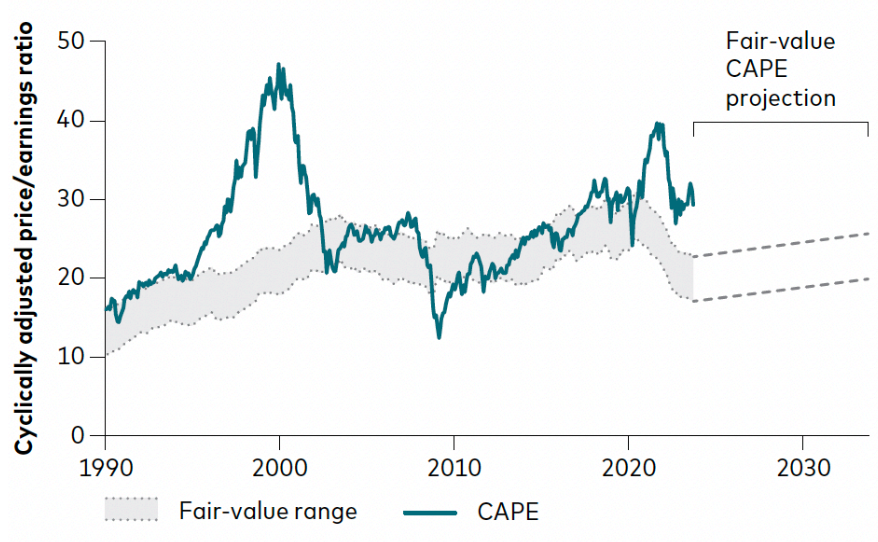
SOURCE: JP Morgan Guide to the Markets, Q4 2023

DOLLAR SIGNS

Adding to the argument for non-U.S. stocks is the softening dollar. Relative to many other currencies, the dollar has begun to weaken. Relative to a 'fair-value' measure, and given expectations for further softening in inflation and interest rates in the U.S., many economists project that the dollar has further to fall. This accrues to the benefit of U.S. investors holding non-U.S. assets.



SOURCE: Vanguard Economic and Market Outlook for 2024: A Return to Sound Money



If one focuses solely on where earnings growth is likely to be higher, they may want to stick with a primary allocation to U.S. stocks. There are plenty of reasons to expect that earnings growth in the U.S., while maybe lower than in the past year, will continue to outperform that of global equities outside the U.S.

Still, on average, there are growing indications that, owing to the high valuations of a select few companies in the U.S. market, domestic stocks on average may be at higher valuations than justified.

If we combine the three fundamental elements of valuation change, dividends, and earnings growth, an argument emerges for maintaining non-U.S. stock exposure going into 2024. If the U.S. dollar continues to weaken as well, this only makes that argument stronger.

The components of our forecasts of equities' total returns

	Valuation change	+	Earnings growth	+	Dividend yield	+	Currency effect	=	Total return
U.S. equities	–1.2%		4.4%		2.0%		–		**5.2%**
Global ex-U.S. equities	–0.1%		3.4%		3.7%		1.1%		**8.1%**

SOURCE: Vanguard Economic and Market Outlook for 2024: A Return to Sound Money

OUR TAKE

2024 could very well be a year with numerous crosscurrents to navigate. On the positive side, expectations of continued cooling in inflation, and a Fed who has signaled that they will likely grow more accommodative, both provide reasons to be optimistic. All the while, high valuations on domestic stocks coupled with rising geopolitical tensions in Europe and the Middle East warrant caution. A slower growth environment will make the global economy more prone toward shocks, which could arise from news abroad or domestically, particularly in an election year. Still, there are arguably good areas of value and growth both in the U.S. and abroad, and compelling yields on both bond and stock investments leave us, on balance, cautiously optimistic that this new year will provide opportunities for patient and disciplined asset allocators.