

Year-In-Review – Every decade throughout history seems to have its own theme, and our current decade is certainly carving out its own unique storyline. COVID kicked things off in March 2020 and triggered unprecedented personal, social, and economic challenges. COVID also triggered a dramatic fiscal and monetary response and record setting medical advances. Then a contentious election in November 2020 was quickly followed by the storming of the capital building in January 2021. There were a couple more waves of COVID that year plus more government spending programs around the world to combat the economic fallout. The following year saw inflation spike higher due in part to COVID triggered supply problems (plus all the fiscal spending), and Russia invaded Ukraine in February 2022. The Fed started raising interest rates in March 2022 to belatedly battle inflation, and stocks and bonds suffered a painful bear market that year.

As 2023 began, the general attitude towards the markets and the global economy was pretty gloomy. A global recession was widely expected and Wall Street analysts generally thought the markets would have another down year. This view was bolstered by a few well publicized bank failures early in the year. But the pessimism was misplaced. Growth proved to be surprisingly resilient, inflation slowed more than many expected, and global central banks called an end to their rate hike cycle. As a result, the markets rejoiced and the typical 60/40 allocation had one of its best two month runs *ever* in November and December last year. This isn't to downplay the negatives. The Chinese and European economies underwhelmed once again, and the attack against Israel on October 7th and the strikes against shipping in the Red Sea in late December reminded us that terrorism remains a real threat. And regardless of one's political affiliation, Super Tuesday on March 5th of this year seems a little more foreboding than usual.

Filtering Out the Noise – We are only four years into the decade and that's quite a list. Of course, every decade has its litany of highlights and lowlights, but a lot of the events over the last four years seem particularly momentous. We aren't qualified to comment on the geopolitical

Market Benchmarks			
Market Indices	4Q23	YTD	3-Yr An
Global Equities	+11.3%	+22.0%	+5.8%
S&P 500 Index	+11.7%	+26.1%	+9.9%
Russell 2000	+14.0%	+16.8%	+2.1%
Int'l Index (EAFE)	+10.7%	+18.4%	+4.2%
Emerging Mkts	+6.1%	+8.7%	-2.7%
Other Indicators	12/31/23	9/30/23	12/31/22
Fed Funds Rate	5.25%-5.5%	5.25%-5.5%	4.25%-4.50%
2-Year Treasury	4.25%	5.06%	4.43%
10-Year Treasury	3.88%	4.58%	3.88%
S&P 500 P/E Ratio*	19.5	17.8	16.7
Crude Oil	\$71.31	\$90.90	\$80.35
Core Inflation	3.2%	3.9%	4.7%

*Forward 12-month operating earnings per S&P

or societal implications, but when it comes to the markets, we think there are a couple broad lessons to draw from the events of the last four years that may help us going forward.

The first is that over relatively long periods of time what generally matters for the markets are economic and earnings trends, inflation, and the level of interest rates. Terrorism, elections, banking problems, etc. can all have an impact, but generally, only to the extent they affect these four things. For example, the failure of Silicon Valley Bank in March 2023 garnered a lot of bearish press, but it didn't sway the real economy because the Fed implemented a backstop to prevent a wider fallout. The table at the bottom of the page highlights that most asset classes have done pretty well this decade despite the numerous cross currents. Why is this lesson particularly important looking forward? The looming election comes immediately to mind. Regardless of your affiliation (or if you've given up on politics altogether), it's all too tempting to think that if events in November swing in a particular way, the markets are doomed.

But for the elections to matter for the markets we will need to see a material impact on the economy, earnings, inflation and/or interest rates. It could certainly happen, but our suspicion is any fallout won't be known until well after inauguration day on January 20th, 2025. And even then, our long-term view has been, and remains, that the natural state of American

Index	Total Return this Decade 12/31/2019-12/31/2023
S&P 500 (IVV)	+57.6%
S&P 500 Growth (IVW)	+60.6%
S&P 500 Value (IVE)	+45.8%
Russell 2000 (IWM)	+27.7%
International Stocks (EFA)	+21.5%
REITS (VNQ)	+10.6%
Barclays Aggregate Bonds (AGG)	-3.0%

Source: Bloomberg

government is gridlock. This doesn't mean that economic and market changes won't occur because of the election, only that there will be time to adapt.

The Power of Policy Decisions – The second lesson builds on the first. To the extent policy does change in the years to come, we should not underestimate the impact on the markets. Both monetary and fiscal policy decisions this decade have played a huge role in setting the tone for the markets, and this isn't likely to change in the second half of this decade. Take monetary policy. The Fed started hiking rates on March 16th, 2022, and between that date and September 30th, 2023 (when it was clear the Fed was done hiking), most asset classes went nowhere, as you can see below.

<u>Index</u>	<u>Total Return</u> <u>3/16/2022 – 9/30/2023</u>
S&P 500 (IVV)	+0.7%
S&P 500 Growth (IVW)	-4.1%
S&P 500 Value (IVE)	+4.6%
Russell 2000 (IWM)	-10.2%
International Stocks (EFA)	-0.5%
REITS (VNQ)	-22.9%
Barclays Aggregate Bonds (AGG)	-9.0%

Source: Bloomberg

Over 500bps of rate hikes from the Fed combined with rate hikes in all the major economies (with the exception of Japan) will do that. A higher cost of capital is a headwind for everyone from highly leveraged real estate investors to those buying blue chip value stocks or government bonds. It's tough to prosper when the wind is in your face. Conversely, the rally in the fourth quarter of last year was triggered by really just one thing – Chairman Powell and the rest of the Fed board simply raising the prospect of cutting rates at some point in 2024. Note that they didn't cut rates or promise to cut rates at some specific date, they simply mused about the possibility. Monetary policy matters!!

And fiscal policy is starting to really matter as well in the post-COVID world. Why did the Fed need to raise rates to begin with and why did the U.S. economy positively surprise in 2023? Government spending soared during the COVID crisis and has proved to be far more pro-cyclical than it has in decades past. For example, the CHIPS and Science Act, the Inflation Reduction Act, and the Infrastructure Act will all

influence the economic and inflation trends for years to come.

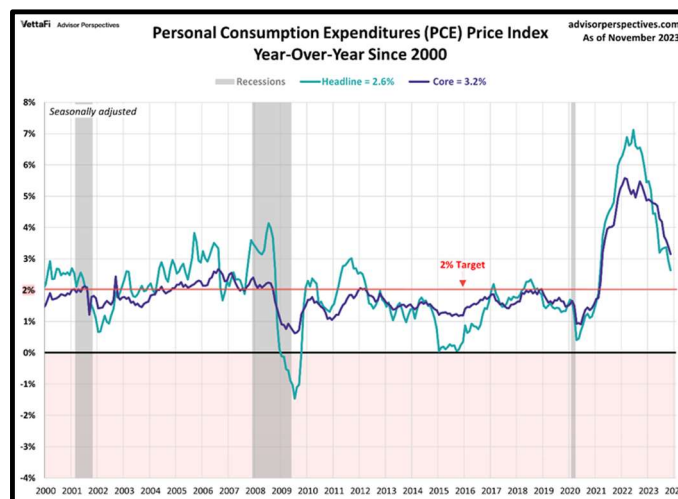
What's in Store for 2024? – With this as a backdrop, what does it mean for the markets this year? Are we likely to see further market gains as central banks cut rates, or will the volatility of 2022 return? Interesting questions, but probably just as interesting, and maybe more answerable, is what have the markets priced in. Let's try to answer these questions by looking at three idealized scenarios.

Scenario #1: The Soft Landing – Over the last few months all the various measures of inflation have come off the boil. For example, the Fed's preferred gauge has been essentially cut in half since late 2022 to just over 3% (chart below). A key part of the soft-landing scenario is that this trend continues. Another component to the scenario is that inflation moderates at the same time growth remains positive. At the moment this outcome looks pretty plausible. For example:

- The housing component in the inflation measure is notoriously slow to adjust. Based on where rents are today we could see sub-2% CPI inflation sometime this year.
- The consumer's ability to continue spending appears robust. The unemployment rate remains historically low and jobs are relatively plentiful. Wage growth is once again exceeding inflation, and consumer balance sheets are in solid shape.
- Those calling for a recession in 2023 due to rising interest rates missed the fact that most consumers have locked in mortgage rates well below 5%. Many consumers (and corporations) are relatively insulated from higher financing costs.
- As noted earlier, fiscal spending has been a meaningful tailwind for economic and employment growth the last couple years, and this is unlikely to change. Certainly, the rate of change may slow in 2024, but we almost certainly won't see a reversion to the fiscal austerity we experienced after the financial crisis. This is less

true in Europe given euro wide budget constraints, but in the U.S. there is little popular support for another tea party movement.

- Corporate capital spending is also another key tailwind. You can chalk it up to a number of things – reshoring, hardening supply chains, alternative energy investments, infrastructure buildouts, etc. – but regardless of the driver, this appears to be a long-term trend that is

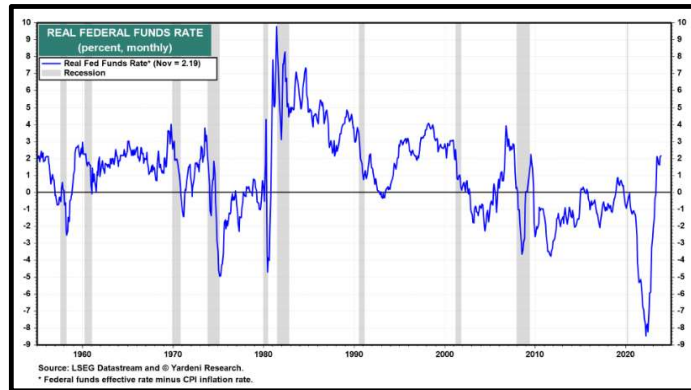


likely to support growth and employment over the second half of this decade.

There's one other component to the soft-landing scenario that is important and a key reason the markets shot higher late last year. Lower inflation means the Fed has room to cut rates, at least given the way they view the world. The chart to the right shows the real Fed Funds rate over time (adjusted for inflation). You can see that real rates were deeply negative during the COVID crisis as the Fed tried to support the economy and the financial markets. In the last few months real rates have swung back into positive territory as inflation has come off the boil. The Fed looks at this chart and concludes that rates are as restrictive as they've been since 2007, hence Chairman Powell's musings about cutting rates this year. There's no question rate cuts would increase the odds of a soft landing in 2024.

Scenario #2: Prelude to Recession – Market performance during prior rate cutting cycles is a mixed bag. The chart below goes back to the 1980s and shows how the S&P has performed both before and after the first rate cut. Unsurprisingly, stocks struggle if the Fed is cutting because a recession is imminent, but rally if growth remains resilient. So obviously the \$64 trillion question is whether we experience a recession in 2024?

What could trigger this? An oil shock out of the Middle East could do it, but it would need to be substantial. The U.S. is now a net exporter of crude, and so the historical sensitivity to oil prices isn't what is used to be. Fiscal austerity would be another driver, but as we noted earlier, it's hard to see any major changes on the fiscal front until after inauguration day, and even then, neither party is making this part of their campaign promises yet. Maybe the most plausible trigger for a recession in the coming months is simply the lagged impact of the Fed's policy tightening so far this cycle. They have moved rates higher by 5% over a relatively short period of time, and already we are seeing the fallout hit the commercial real estate markets. Prices have adjusted significantly lower and this is weighing on bank loan portfolios. In prior cycles higher rates has



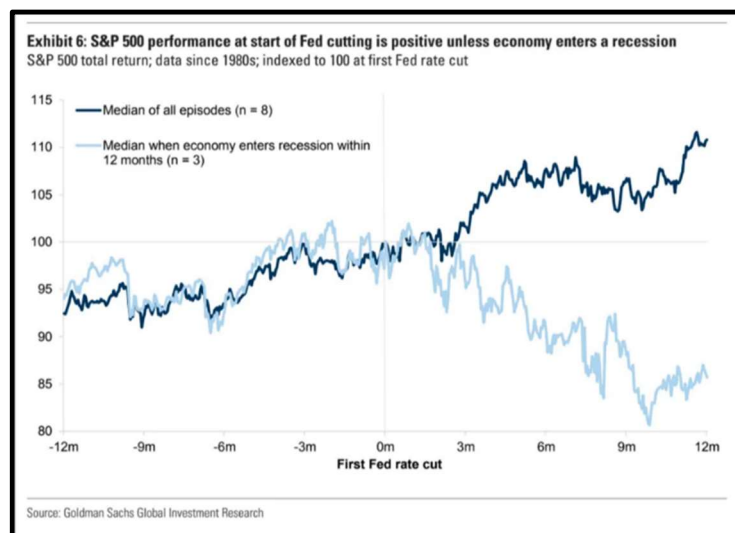
we've never seen fiscal deficits this large when unemployment is this low (procyclical spending). This fact alone argues against a deep recession anytime soon, but it certainly could preclude a weak quarter of growth here or there. But barring a shock to the system from somewhere unexpected, the odds don't seem to favor a deep recession in 2024 (subjective odds of say 15%).

Scenario #3: Inflation's Return – In our mind, the more likely scenario that will upset the apple cart over the coming months would be another swing higher in inflation. This isn't our base case scenario (subjective odds of say 30%), but the chances could increase as the year progresses. The chart at the top of the next page overlays inflation between 2014 and today and the experience between 1974 and 1982. You always have to be careful looking at comparisons like this because the past is rarely prologue. The economic backdrop in the late 1970s and early 1980s was very different from today. Take just one example. In 1977 close to 50% of U.S. oil consumption was imported. Today the U.S. is the world's largest producer of crude oil. Obviously, an oil shock in the months or quarters to come would have a very different impact today than it did in the 1970s.

That being said, one thing we need to be attuned to as the year progresses is how the Fed reacts to slowing inflation. At the moment the Fed says they plan to cut rates three times by a total of 75bps. This doesn't seem unreasonable

if inflation is on the path towards 2%. However, the market is pricing in seven cuts this year totaling almost 200bps. We don't think we will see such large rate cuts this year, but if the Fed chooses this path they will increase the odds of inflation's return sometime in the second half of the year.

Strategy for 2024 – Our base case scenario to kick off this year is the soft-landing outcome. This

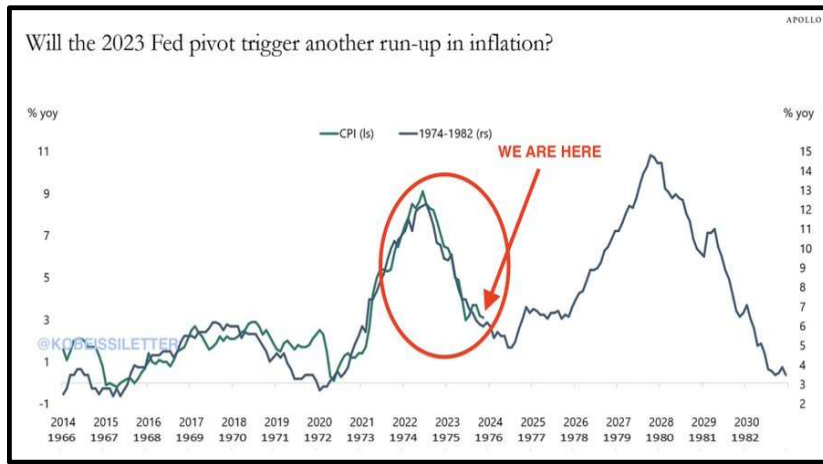


means positive but somewhat slower growth, a continued moderation in inflation, and more accommodative global central banks, especially in the back half of the year. Now granted, this is exactly the scenario the markets started to price in late last year. This shouldn't preclude

further gains in 2024, but we suspect we are in for a period of so called 'fat-but-flat' returns for a while. This is where prices chop around in a wide range but don't go anywhere. As a bond investor this isn't terrible as you earn the coupon on the bond portfolio. But as a stock investor you have to guard against the temptation to bail on your investments when markets swoon for a few weeks, or alternatively, chase rallies too enthusiastically. Political headlines will add volatility to the year, and while it never feels good, corrections are normal. For example, historically the S&P has gone through a 10% correction every eighteen months or so, although they have been more frequent in recent years. But the soft-landing scenario that includes monetary easing should ultimately be constructive for both the stock and bond markets.

The scenario where growth disappoints may not be particularly bearish for stocks because it would imply that the market's expectations for large rate cuts is reasonable, or if anything, conservative. Certainly, earnings would suffer in a recession, but massive monetary easing would boost multiples (barring a financial crisis). Fixed income would stage a large rally in the recession scenario as deflationary risks would be back on the table.

Our bigger worry is a surprising uptick in inflation. This would undermine both bonds and stocks because the odds of any rate cuts in 2024 would evaporate quickly, and we might even be talking about renewed rate hikes. It's too soon to position for this scenario, but we need to be



sensitive to it as the year progresses because this is where the biggest disconnect in market pricing seems to be. Stocks and bonds are priced for the goldilocks scenario (slower inflation leading to a series of rate cuts at the same time underlying growth remains reasonably robust). But if the Fed is too

aggressive cutting rates in this environment they risk another cycle of accelerating growth feeding through into a tight labor market, which drives wages and prices higher. Rinse and repeat. Again, this isn't our base case, but something we are attuned to.

Final Thoughts – The U.S. economy and the markets surprised most people last year in a good way, but as 2024 begins, nervousness seems to be setting in again. Maybe the Fed will refuse to cut rates. Could the conflict in Gaza turn into a broader regional conflict? And what about November? This election season is almost certainly going to be as divisive as anything we have seen in modern memory. All obviously important questions, but what will matter for the direction of the markets in the months and quarters to come is how will growth, earnings, inflation, and interest rates be impacted by any of these issues. In our mind, the biggest threat for the markets is probably more mundane – a scenario where policy eases too much and inflation rebounds. But that is likely a story for later in the year or even 2025. For now, we believe the odds favor a benign economic scenario. Granted, this probably won't mean gains like we experienced in the fourth quarter of 2023, but we do think investors will be rewarded over the long term for not overreacting to the attention grabbing headlines in the months to come.

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