

4th Quarter 2023 Market Commentary

The Bulls overcame the Bears in the 4th Quarter to Deliver Strong 2023 Results

In last quarter's commentary, we forecasted the 4th quarter "promises to be an eventful 4th quarter". This prognostication proved true. A third quarter pullback in markets spilled over to a bearish result in October as well. However, the bulls took over starting October 27th and the market rallied through year end to finish with strong 2023 results. The year started with a banking crisis, which markets largely took in stride. As the year developed, major factors included geopolitical concerns (mainly Russia/Ukraine, Israel/Palestine, and China/Taiwan), persistent inflation, and higher interest rates driven by the Federal Reserve. With most TOPS portfolios (beyond the two most conservative) experiencing double digit returns, and the most aggressive portfolios surpassing +16%, it was an above-average year and a welcome recovery from the 2022 pullback across markets.

The recession many feared in 2023 never materialized. Yet the risk of recession is not totally behind us for 2024. The Federal Reserve of New York's Probability of Recession within the next 12 months sits at 62.94%, down from estimates earlier in 2023 of over 70%, but up from a low of 46.11% on October 31, 2023. We will talk about the return opportunity below; however, only time will tell if we do see a recession in '24 and the effect it could have on markets. Important to note, a mild recession does not necessarily mean doom for markets for the year overall.

Regardless of how markets perform in '24, it promises to be entertaining. CNBC recently reported that over half of the world's population will cast a vote in a major election this year. It goes without saying that our own Presidential election will garner considerable interest. The election will definitely dominate media, if it ever really slowed down since the last election.

With all these distractions, we remain focused on delivering appropriate risk-adjusted returns to our investors. We have started our third decade of managing portfolios on a strong note, and in this report we will examine why we remain optimistic in the long term as well.

After discussing Q4 2023 financial market results, we will address three general themes important to TOPS portfolio returns and strategies:

- 1) Inflation Softening Opens the Door to a Rally
- 2) The Federal Reserve Pivots in December
- 3) Dissecting the Return Opportunity Ahead

Fourth Quarter and Year-To-Date Markets Review

Most equity indexes saw positive returns in the fourth quarter. Value stocks (S&P 500 Value) outperformed growth stocks (S&P 500 Growth), returning +13.6% and +10.1%, respectively. Small cap (S&P 600, +15.1%) outperformed midcap (S&P 400, 11.7%). Developed international (MSCI EAFE) returned +10.4%, outpacing emerging markets (MSCI Emerging Markets), which returned +7.9%. Real estate (MSCI World Real Estate, -18.1%) was up in the fourth quarter, while natural resources (S&P GSSI NA Natural Resources, -1.2%) was the only equity that saw negative returns.

After a strong finish to the year in the fourth quarter, equities finished the year with positive returns. Growth stocks (S&P 500 Growth) outperformed value stocks (S&P 500 Value), returning +30.0% and +22.2%, respectively. Midcap (S&P 400, +16.4%) slightly outperformed small cap equities (S&P 600, +16.1%). Developed international (MSCI EAFE) returned +18.2% and outpaced emerging markets (MSCI Emerging Markets) for the year, which returned +9.8%. Real estate (MSCI World Real Estate) was up +10.1%, while natural resources (S&P GSSI NA Natural Resources) are the laggard for the year, but still positive, up +3.7%.

Fixed income also had positive fourth quarter returns. The Barclay's US TIPS Index has a +4.7% return, while the Barclay's US Aggregate Bond Index was up +6.8% for the quarter. Credit (ICE BofA US Corporate Index, +7.9%) outperformed government (ICE BofA US Treasury Index, +5.7%). In the fourth quarter, investment grade corporates (iBoxx USD Liquid Investment Grade Index, +9.9%), high yield (Solactive USD High Yield Corporates, +7.1%), and international bond indexes (Bloomberg Global Aggregate ex-USD, +6.4%) were all positive. The 10-year US Treasury yield decreased from 4.59% to 3.88% in the fourth quarter.

For the year, Bloomberg US Aggregate Bond Index returned +5.5%, outpacing the Bloomberg US TIPS Index, which returned +3.9%. Credit (ICE BofA US Corporate Index, +8.4%) outperformed government (ICE BofA US Treasury Index, 3.9%) for the year. High yield (Solactive USD High Yield Corporates, +13.1%), investment grade corporates (iBoxx USD Liquid Investment Grade Index, +9.4%), and international bond indexes (Bloomberg Global Aggregate ex-USD, +8.7%) were all positive this year.

Inflation Softening Opens the Door to a Rally

We have written quite a bit this year about conflicting factors affecting markets. As factors shifted in the 4th quarter, markets rallied through year end. In the coming sections we will review some of these in detail, including the recent stance of the Federal Reserve and what market inputs foretell for 2024. None of this would be possible, however, without a recent softening in inflation as a dominant factor relieving market stress.

The Fed's preferred inflationary measure is the Personal Consumption Expenditures Deflator (PCED). According to Yardeni Research, "the headline PCED inflation rate peaked at 7.1% y/y during June 2022. By December 2022, it was down to 5.4%. It fell below 3.0% to 2.6% (ahead of schedule) during November of this year." Anyone who knew that information ahead of time would have been able to reap unending profits. However, throughout the ongoing inflationary cycle, no one knew for sure how persistent inflation would be or how much artillery the Fed was going to be willing to (or required to) deploy.

As it turned out, the Fed did unleash a significant quantitative tightening package over the last two years. Fortunately for investors, two key things happened though. First, recent signs show inflation is actually subsiding. So, the medicine worked. Second, it appears the collateral damage of the medicine (quantitative tightening) is relatively contained. Those factors, along with a building story that the Fed will have a chance to ring the victory bell in 2024 as they lower rates amidst a soft-landing inflationary environment, proved to be the recipe for an old-fashioned rally. Now that stocks have rallied, it is important to look ahead and ask, "what next?" We will do that in the following sections.

The Federal Reserve Pivots in December

We have been following the Federal Reserve's ongoing battle with inflation since they started to raise their Fed Funds Rate target in March of 2022, and we have consistently highlighted the meaningful

impact Fed positioning has had on stocks and bonds. Throughout much of the year, we have been on a Fed tightening plan, where the Federal Reserve has raised rates about another 1%, on top of the increases of over 4% in 2022.

While 2022 was a story of clear weakness in stocks and bonds amidst marked rate increases and little sign of an end in sight, 2023 has been a year of consistent speculation regarding when the Federal Reserve will “pause” or “decrease” rates. As intuition may lead you to surmise, markets were hoping for at least a pause and dreaming of a decrease in 2023. Well, we got our pause in 2023, as July 2023 was the last increase the Fed has made, to a rate target of the current 5.5%.

Driving the yearend rally we experienced in stocks and bonds, in late October market sentiment started to shift towards expectations of coming rate decreases by the Fed. A combination of bond markets, consensus analysts and eventually dovish comments by the Fed in December, provided the architecture necessary for markets to build a positive momentum story. November returns were tremendous, with U.S. large cap, mid-cap, small cap, and international stocks all gaining about 9% for the month. December was a strong month as well, with small caps gaining an astounding nearly 13%, followed closely by mid-caps adding another nearly 9%.

Where does the Fed go from here? Well, markets have priced in a rosy picture. While the Fed is predicting about three rate decreases in 2024, markets have built in as many as six rate cuts (CBSnews Moneywatch— January 5, 2024). The Fed’s predictions have historically been relatively inaccurate though, and markets often get ahead of things. As leading indicators, stock and bond markets have generally had a mixed record of being on the leading or bleeding edge.

We would caution investors from taking big bets on either the Fed’s or market’s (bond or stock) indications. We agree the data does point towards likely rate decreases in 2024; however, the Fed has repeatedly reminded us they are data dependent. Likewise, they tend to be more reliant on historical data. Similarly, we believe Chair Powell is more concerned about decreasing too early and inflation returning than he is about staying in a pause and causing a mild economic slowdown. We have covered this reasoning in previous messages.

On the bond side of our portfolios, we placed some trades in the first few days of 2024 for most investors to begin a shift away from a defensive interest rate risk position. However, we remain relatively defensive, as we don’t feel the marginal reward opportunity outweighs the risk to fully normalize our interest rate standing towards our long-term target yet. Fortunately, with short term rates remaining elevated for now, we are earning a nice yield in our current portfolios and still stand to benefit to some degree from potential rate decreases, even if they occur at the short end of the yield curve.

On the equity side, our assumptions are that the rate environment will be friendlier overall to stocks in the short and intermediate term than we have experienced over the last two years. It is unlikely for interest rates to return to pre-pandemic rates, where low rates were a significant contributor to growth stock outperformance. However, things should be more friendly to stocks than the rate rise environment of much of the last two years.

Dissecting the Return Opportunity Going Forward

While we are consistently tracking performance, which enables us to review things through the rearview mirror, our focus remains on looking through the windshield. What is done is done, and the value we can add for our investors now lies in our decisions going forward. Mark Twain once said, “history does not

repeat itself, but it rhymes.” We would not argue with Mr. Twain that many things are likely to rhyme, as our review of past markets is a valuable input in our decision-making process. However, as we look ahead to markets in the next 3-10 years, we feel some of the major recent themes are unlikely to repeat themselves in the same manner. We can look at this from the viewpoint of bonds first, then stocks.

Three years ago, the 10-year U.S. Treasury yield was about 1%. This point was near the bottom of a long downward trend in rates from nearly 16% in 1981. As a reminder, when yields fall, bond prices for existing bonds rise. Therefore, bond holders were able to enjoy relatively favorable bond returns for over two decades. However, as rates fell below 3% in 2011, new bond buyers were unable to repurchase bonds at attractive rates. As yields fell further to 1%, the benefits for existing bondholders continued to fall off and bond investors were largely left with a relatively dismal bond investing opportunity. Not only were bondholders receiving low rates of interest during this period, but they also risked losing value if/when bond yields eventually rose again.

Fortunately for our investors, we recognized the risk of potentially higher yields. To protect our investors from risk of significant loss, we reduced our interest rate risk by shortening the duration (a measure of interest rate risk heavily driven by maturity of the bond), diversifying heavily and utilizing unique tools like TIPS bonds and floating rate bonds, which proved to add value when rates eventually did rise. This strategy worked remarkably, turning out to be the largest outperformance vs. the U.S. Aggregate Bond index we have had in TOPS since inception.

Looking forward, the bond market promises a different experience. The 10-Year U.S. Treasury currently yields a respectable 4%. At 4%, investors are receiving a decent yield. Likewise, there is generally less risk of severe rate increases when the 10 year is at 4% than when it is at 1% (there’s simply 3% less rates can mathematically go up). We feel the current environment provides a brighter picture than we were able to paint three years ago. Even if we see the Federal Reserve cut short term rates, the current yield curve still provides much more opportunity than the last cycle. We feel prepared to continue to balance risk and reward for our investors in the coming years, with more juice to work with in the oranges.

The equity side of the equation is equally different. We are coming off a very strong year for stocks, and another year of leadership from the MegaCap-8 largest stocks in the S&P 500 (Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla). According to Yardeni Research, the MegaCap-8 advanced 75.2% over the course of 2023, outpacing the 24.2% gain logged by the S&P 500. This strong performance has many asking, has the MegaCap-8 risen too far, too fast? Well, the +75.2% return of 2023 was largely a recovery from the 41.1% loss of the M8 in 2022 to finish +1.7% over the two-year period. Yardeni highlights that the M8’s total market capitalization is almost exactly where it was at the beginning of 2022, a two-year period where forward earnings have increased +23%.

Are the MegaCap-8 overvalued now? Well, the 27.9 forward P/E for the M8 does exceed the 19.5 for the S&P 500. And the forward P/E for the M8 has actually fallen 13.6% from 32.3 in January 2022. Despite the fact that revenue and earnings for the M8 companies are growing faster than the S&P 500 overall, the forward P/E for the S&P 500 (excluding the M8 stocks) has only fallen 7.3% in the last two years from 19.1 to 17.7. (Yardeni: Forward P/E” refers to the multiple calculated using forward earnings. “Forward earnings” is the time-weighted average of analysts’ earnings estimates for the current and following years.)

Admittedly, there is some risk in providing data on any subset group of stocks. Nvidia is a chipmaker who was up +238.9% in 2023 and finished up +68.4% annualized for the last 2 years. Netflix is a media provider who was up +65.1% in 2023, but down -19.2% over the last 2 years. The returns for the S&P 500

in the last one and two years were +24.2% and +0.1% respectively (Yardeni). As we look at the story of the M8 and the S&P 500, trying to extrapolate out what lies ahead, we can see why the picture is not so clear. It is not a clear story of multiple expansion that will revert or earnings growth that cannot repeat. Likewise, as we have posited before, if these are some of the greatest companies in the history of the world, shouldn't they be trading at higher multiples than the average S&P 500 stock? That would make sense.

So, we do not have the answer to whether the M8 will continue to lead the S&P 500, and the world, higher in 2024 (or beyond). If we look at the S&P 500 overall, the numbers do portend repeating the abnormally strong performance it has had over the past 10 years would be very difficult. Jordan Brooks, co-head of the macro strategies group at AQR Capital Management recently did some important S&P 500 math. Here is an excerpt regarding Brooks' research from *Chief Investment Officer (December 2023)*: "According to Brooks' findings, over the past decade the excess-of-cash return on the S&P 500 averaged 11.9% per year. This puts the past decade well above the 90th percentile of rolling 10-year performance across global developed equity markets since 1950. The risk-adjusted return, or Sharpe ratio, of the market over this period, Brooks writes, was 0.82—nearly double the postwar average for global developed equity markets." Further, "Over a longer horizon, what matters is the income you get from dividend yield as well as how much firms grow earnings by, and ultimately the valuation investors are willing to place on those earnings. If you expect stocks to outperform cash by 12% over the next 10 years, you would need a combination of real earnings growth on par with the best-ever decade, and you'd need to see P/E [price-earnings] ratios well above the tech bubble. Monetary policy doesn't change that equation."

The main point is it would be really hard for the S&P 500 to repeat the experience of the last ten years over the next decade. Not impossible, but unlikely. Does this mean 2024 will be a dud for the S&P 500? Not necessarily. As we have often highlighted, valuations are historically a leading predictor of long-term relative returns, but a poor predictor of short-term returns. Momentum can be a strong factor and there is a lot of momentum for the economy and stocks coming out of 2023. Dr. Jeremy Siegel thinks we could see returns of 8-10% for the S&P 500 in 2024 (according to 1/2/2024 CNBC interview). However, this is where we get to the main point of our story. Dr. Siegel also highlighted that the P/E ratio of the Russell 1000 Growth is nearly double that of the Russell 1000 Value. Given this historically wide dispersion, he feels value stocks could see 15% in 2024.

Like Dr. Siegel, we feel the moral to the story is there may be more opportunity in many of the other major asset classes, as opposed to the S&P 500. Research we run through Bloomberg shows the S&P 600 small cap index is trading in the 29th percentile for Forward P/E ratios, compared to the monthly values going back each month to July 2005. The S&P 500 Growth index is in the 93rd percentile. International stocks, represented by the MSCI EAFE index, are similarly more attractive, trading near the 50th percentile. Emerging markets appear toward the 80th percentile, yet we place less reliance on notoriously difficult to predict Forward Earnings for EM. Small caps look much more attractive than large caps, based on valuations alone.

We thought it was important to share this "science" with our investors. The most important science of investing is simply that the main driver of growth is compounding though, not stock picking or market timing. Investing is both an "art" and a "science" though. As Morgan Housel recently highlighted in his tremendous book *Same as Ever*, "If you've relied on data and logic alone to make sense of the economy, you'd have been confused for 100 years straight." It's important, as professional investors, for us to apply the "art" we have learned in managing portfolios across multiple decades.

Lastly, we plan to continue to control risk in our portfolios, as we prepare for what we call “Z factors.” These are surprise events that will inevitably occur. Just like no one predicted the pandemic and few expected Russia to invade Ukraine so aggressively. Investor Jim Grant, who at one point nearly became the Fed Chair, put it this way in warning investors from putting too much emphasis on the science:

“To suppose that the value of a common stock is determined purely by a corporation’s earnings discounted by the relevant interest rates and adjusted for the marginal tax rate is to forget that people have burned witches, gone to war on a whim, risen to the defense of Joseph Stalin and believed Orson Wells when he told them over the radio that the Martians had landed.”

We are very likely to encounter Z factors and we can be almost assured investors will act irrationally. The famous economist John Maynard Keynes said, “the market can stay irrational longer than you can stay solvent.” What we have done and strive to continue to do is steer our investors through this maze of numbers, predictions, surprises, victories and failures towards appropriate long-term results by using both science and art in our strategies.

TOPS Portfolio Strategies

The TOPS portfolios are managed through a disciplined, proven, strategic allocation process. As our investors are aware, this process is implemented primarily using index-based exchange traded funds (ETFs). Indexes have historically outperformed most actively managed mutual funds strategies. According to the most recent S&P Index vs. Active Mid-Year 2023 report (SPIVA), 93.1% of active funds have lost to the S&P 1500 index over the past 20 years on an absolute basis and 97.4% have lost on a risk-adjusted basis (risk-adjusted results account for volatility of the investment). This research continues to support our premise to utilize index-based ETFs to implement our risk adjusted strategies. In other words, when we decided over 20 years ago to start investing in ETFs, we chose the solution which has been successful over 97% of the time in the last 20 years (other asset classes vary, but nearly all are over 90%), as opposed to the preeminent choice at the time of traditional actively managed mutual funds (which ended up with nearly all of those choices losing). We could not be more pleased that we turned out to be correct in this regard. This decision has benefited our investors and helped us to continue to grow as one of the longest running and largest independent ETF portfolio strategists in the country. Our portfolio management team has direct responsibilities of approximately \$7 billion in assets now, and oversight responsibilities of approximately \$9 billion in total.

As we look forward, we don’t see any reason to expect these numbers to shift direction. We continue to be proponents of index-based ETFs for their many merits, including index tracking, liquidity, transparency, tax efficiency and relatively low cost. We are, however, focused on the risk adjusted nuance of index investing. Likewise, we believe our approach of diversified index portfolios provides a better risk adjusted opportunity going forward than the simplest broad indexes alone.

According to AB, the largest 7 stocks (often called the “Magnificent 7”) now make up 28% of the broad Russell 1000 index and 19% of the broad MSCI World index. As such, the incredible success of these stocks has resulted in these broad indexes becoming more weighted towards larger market cap, heavier concentration, more growth orientation, and more U.S. weighting. In other words, the decision to purchase these simple broad-based indexes alone is a much different choice now than it was 10 years ago.

In our process, we place a significant amount of effort on balancing the risk of our allocations by further diversifying our portfolios into value and growth, small and mid, and various international and other asset

classes. Also, we utilize our proven system of ranges and targets to adjust our exposure to each sub asset class based on thousands of variables we monitor through various research strategies we employ. We believe this system provides our investors not only with a better risk-adjusted return opportunity, but, given valuations, it may provide a better absolute return opportunity than simple broad based global indexes (such as MSCI World).

As an example, in only the first trading day of 2024, value stocks outperformed growth stocks by over 2%. We have a lot more trading days left, but we are continuing to see opportunity in our style of investing. Now in our third decade of managing client portfolios, with consistent staff over that time, we are likely to lean heavily on our experience in 2024. Thank you for your continued trust in us to manage your assets.

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