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PRIVATE WEALTH

BKS Select Investment Group 2023 Commentary and Outlook

Reflections on 2023: Surprising Stock Market Strength Amid Challenges

"Every bull market climbs a wall of worry." — classic Wall Street adage

Entering 2023, few had the foresight to predict that the S&P 500 Index ("S&P 500") would approach all-time highs by the end of the year.[1] The market appreciated significantly despite the failure of several financial institutions, continued restrictive monetary policy, and the risk of a widening of the war in the Middle East.

At its November meeting, the Federal Reserve (the "Fed") indicated it had probably hiked rates enough to control inflation, and many Fed governors expected the Fed to reduce rates in 2024. This led to a sharp decline in market interest rates, driving the yield of the closely-watched 10-year Treasury from a peak of 5.0% in late October to 3.9% at the end of the year.

Investors began to anticipate higher odds of a "soft landing" and stocks rallied, with the S&P 500 increasing 11.7% in the fourth quarter of 2023 and a remarkable 26.3% for the year. Returns were heavily skewed toward large growth companies, particularly the "Magnificent Seven" (Alphabet/Google, Amazon, Apple, Meta/Facebook, Microsoft, NVIDIA, and Tesla), which dramatically outpaced small-cap and value-oriented stocks. The average stock in the S&P 500 appreciated only 13.9% for the year, evidencing the large disparity of return between the Magnificent Seven and most other stocks.[2]

Fearing a potential recession, we began 2023 with a particular focus on companies that we believed possess higher-quality, more resilient earnings streams. One element of this strategy included a continued large exposure to the healthcare sector. Regarding the Magnificent Seven group of stocks, we held shares in five of these companies, some with relatively large position sizes. However, our portfolio was modestly underexposed due to the absence of two stocks: Meta/Facebook and Tesla. This smaller exposure to the Magnificent Seven, combined with the underperformance of several smaller-cap stocks, resulted in performance that atypically lagged the large-cap market benchmarks.

Interest Rates and Inflation: An Improving Picture

The Fed made significant progress fighting inflation in 2023, raising its target interest rate aggressively. Since the Fed's initial rate hike in March 2022, the Fed Funds target rate increased from nearly zero to approximately 5.25%. The growth of the money supply also slowed dramatically from 2022. These actions helped to decrease inflation from 6.5% at the beginning of the year to 3.4% in December. While it may be premature to conclude that inflation is no longer a problem, recent trends have been encouraging. In fact, the Fed recently announced that they believe monetary conditions are sufficiently restrictive to reduce inflation towards their goal of 2%. They now forecast a change in course towards cutting interest rates in 2024. A pivot toward monetary easing is typically viewed as favorable for the stock market if a recession is not imminent.

[1] U.S. stock performance for 2023 as measured by the S&P 500 Index, total return.

[2] Total return for the Equal Weighted S&P 500 Index for 2023.

Outlook for the Economy: The Soft-Landing Scenario Becomes Consensus

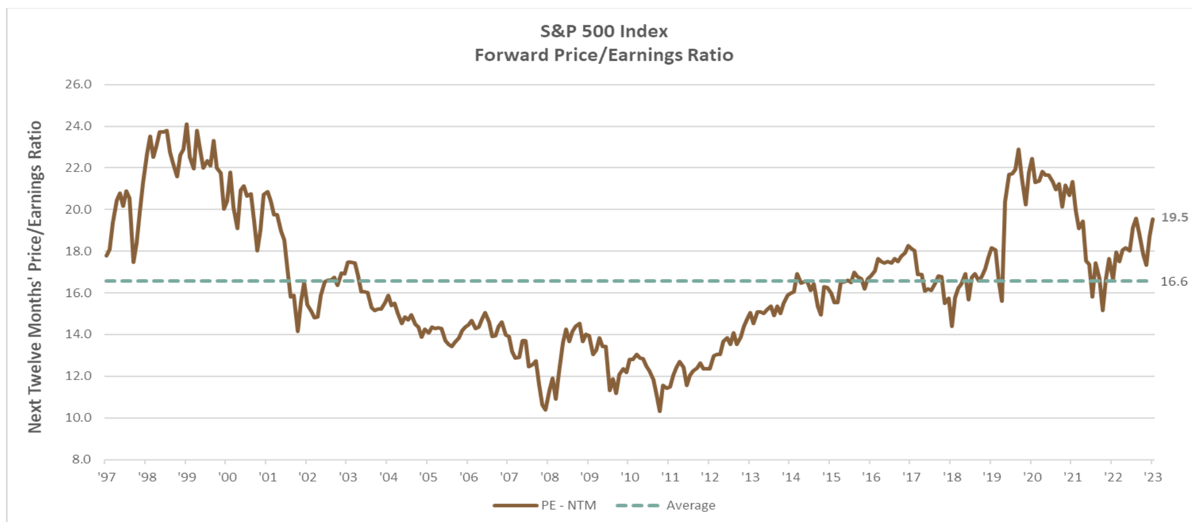
"Monetary changes have their effect only after a considerable lag and over a long period, and that lag is rather variable." — Milton Friedman

Most economists had expected that the U.S. would enter recession in 2023 due to the detrimental impact of the rapid rise in Fed rates. Yet, in perhaps the largest surprise of the year, the economy continued to grow at a solid pace. Explanations why the traditional economic "rules of thumb" failed (or were at best premature) are many: households and corporations had already "locked in" low interest rates, excess consumer savings from pandemic-related relief programs, the growth of non-bank lending markets, and continued stimulus from government deficit spending. As a result, a "soft landing," which a year ago seemed an unlikely scenario, is increasingly becoming the base case. The strength of the labor market, combined with robust gains in household net worth, point to continued solid consumer spending. Productivity was an important driver of economic growth in 2023. Artificial intelligence offers the potential for long-term increases in labor productivity, particularly in knowledge-oriented jobs. However, as with the early days of the Internet, predicting the ultimate impact of these promising technologies is challenging.

Withdrawing the yellow caution flag may be premature, however. Previous rate tightening could still push the economy into a recession in 2024. Yet, prospects have certainly improved from a year ago; we believe continuing, though moderating, economic growth appears most likely. While current consensus projections of 11% earnings growth for this year may be optimistic, absent a recession, earnings could potentially grow mid-high single digits.

Equity Market Valuation: Less Favorable, But Skewed by Large Tech Stocks

Given the substantial price appreciation in the past year, the market enters 2024 with a higher-than-average valuation. As shown in the graph below, the S&P 500 Index is trading at 19.5x forward estimates versus a historical average of 16.6x. Accordingly, significant market upside from current levels likely depends upon accelerated earnings growth into 2025.



Source: FactSet

An important mitigant to the current elevated valuation, however, is the large disparity between the Magnificent Seven tech stocks and the rest of the market. The Magnificent Seven collectively trade at an elevated level of 28.5x forward estimates.

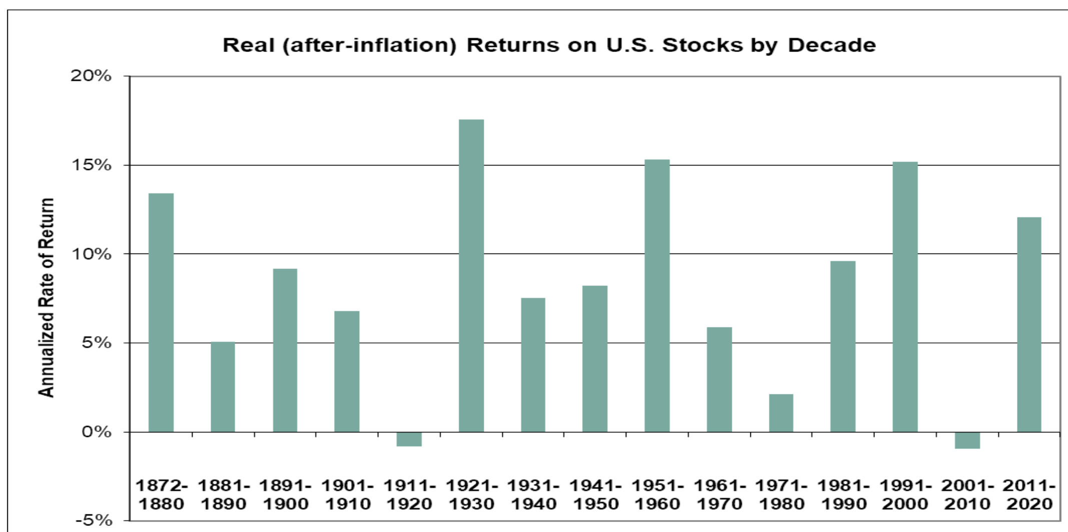
Adjusting to exclude these seven stocks reduces the price / earnings ratio by over two points, closer to historical norms. Therefore, it appears reasonable to view the prospects for the "rest of the market" more favorably.

We have slightly reduced our investment in the Magnificent Seven stocks while maintaining our overweight stance in the healthcare and consumer staples sectors. We believe this positioning is prudent in a market where speculation may be appearing in certain sectors. In terms of exogenous risks, we note that this is a presidential election year, with all the attendant uncertainties. In addition, risks from geopolitical events appear heightened at this juncture. We have increased our exposure to energy stocks reflecting these elevated risks.

Summing It Up: Stocks for the Long Run, Bonds for Safety

"I never became wealthy by buying at the lows or selling at the highs. I was merely there for the middle 60%."
– John Pierpont Morgan

We still believe it is likely that stock market returns exceed those of bonds over the long-term. After-inflation annual long run returns on U.S. stocks have averaged 6.7%, a very positive outcome for investors.[3] However, as shown below, some decades are far better than others.



Source: Empirical Research, Fama, E.F. and Kenneth R. French, 2001, "The Equity Premium," The Center for Research in Security Prices, Working Paper No. 522, Neuberger Berman.

Ten-year forward returns for stocks are heavily influenced by valuations at the beginning of the period. While the potential reward for stocks relative to their risk still appears positive, by our measures, it is now at its lowest level since before the financial crisis of 2007-2008. Given these considerations, we believe that, at a minimum, investors should anticipate somewhat lower than average historical returns over the next decade.

Bond yields today are much improved from recent years. With the Fed likely to cut rates in the next few quarters, bonds could deliver returns above inflation. In addition, high quality bonds represent a good hedge against stocks. Accordingly, in our opinion, for many investors, a balance between stocks and bonds makes sense: stocks for long run growth, bonds for safety.

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[3] U.S. stock performance as measured by the S&P 500 Index, total return.

A Few Final Remarks

As you may have noticed, this letter is titled as "The BKS Select Investment Group." Our combination with the Bolton team is well underway, and we look forward to providing further updates.

We know that the geopolitical events over the past several months have been disconcerting for many. As the new year begins, we hope for more positive circumstances in 2024. We appreciate your continued confidence in our team. If we can be helpful in any way, please do not hesitate to contact us. Our warmest regards and best wishes for the upcoming year.

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The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance. As of September 16, 2005, S&P switched to a float-adjusted format, which weighs only those shares that are available to investors, not all of a company's outstanding shares. The value of the index now reflects the value available in the public markets.

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