January 8, 2024

I have often referred to commentary offered by Howard Marks of Oaktree Capital Management, L.P. Once again, Howard succinctly identifies the nature of the uncertainty we confront in the new year in his most recent interview contained in *Oaktree Insights*. A few of the more impactful / relevant observations include:

- *"You have to be working in this business for more than 43 years, before 1980, to have ever seen anything other than declining interest rates and ultra-low interest rates. So, it's only natural to conclude that declining and ultra-low interest rates are normal. But maybe they're not. You have to understand history and understand where the current period fits into history and understand how it's different from normal, and what it is that shaped those differences.*

- *Earlier this year, in a memo titled, "Fewer Losers or More Winner's, Marks invoked the wisdom of Charlie Ellis, founder of investment consulting firm Greenwich Associates, who coined the reference to money management as "the Loser's Game" – winning by making fewer errors, as he illustrates by analogy to amateur tennis or golf. Marks noted that to be a successful investor one must have fewer losers or more winners, on average. This begs the question, "How does one fundamentally define "success" as an investor"?*

- *Marks' colleague, David Rosenberg, notes, " Look, there's no great bargain if you're going to make more money by taking more risk. Anybody can do that…. The art of this business is to manage the risk down."*

- *"… the great economist Paul Samuelson once said, " When events change, I change my mind. What do you do?"* [i]

The equity and bond markets were buffeted all year by concerns that inflation was not abating and the economy's persistence, at least on the services side, would necessitate prolonged higher interest rates, further exacerbating the likelihood of a slowing economy likely leading to a potential recession. Events such as the regional banking liquidity crisis in March, exposing large unrealized losses in bank balance sheets, drove the market's first downdraft of the year, before improving inflation data during the second quarter led the market higher though July when the Federal Reserve's hike took interest rates to a 22-year high. Although holding rates steady at their September meeting, the accompanying narrative was hawkish, triggering a second strong downdraft, driving 10- year interest rates toward 5%. The Fed's second consecutive rate pause in November, coupled with the broad-based sentiment that the Fed rate hiking cycle is at an end fueled a sharp rally into the end of the year that saw the S&P 500 more than doubling its year-to-date return in just 41 trading days.[ii] As has been noted throughout the year, this extraordinary

market was predominately a function of a handful of mega-tech stocks that had been bludgeoned in 2022; subsequently referred to as the "Magnificent Seven". These seven stocks alone accounted for 78% of the S&P 500 return for the entire year.[iii]

Similarly, the bond market experienced extraordinary volatility with 10-Year U.S. Treasury yields ranging from a low of 3.3% on 4/6/2023 to a high of 4.98% on 10/19/2023, ultimately closing the year exactly where they had closed the prior year at 3.88%![iv]

As the New Year dawned, investors were intent that the Federal Reserve would affect numerous rate cuts in 2024, beginning as early as March. This enthusiasm drove the market into an over-bought condition; meaning, it got ahead of itself, driven by investor emotions rather than fundamentals. Anticipating the Federal Reserve's interest rate movements and the probability /severity of a recession has proven a popular game over the past year and, in the absence of other more compelling news items, captures the headlines. What is lost in this euphoria surrounding a "Fed pivot"?

- The Fed doesn't know when it is going to pivot. The Fed's "dual mandate" of full employment and stable prices means the Fed's role is to prop up the economy when growth stagnates, not prop up the stock market, which is not always the same thing. The Fed will pivot when something bad happens….[v]

The conventional wisdom is that we have avoided a significant economic slowdown and the consumer remains resilient. On the other hand, we have never had a Covid-like event in modern history with such a dramatic effect on the market. Much of the potential damage from a severe recession was "pulled forward" during Covid; downsizing, business closures, credit defaults and real estate problems. Consequently, the impact of the 500+ basis point increase in interest rates over the past 18-months coupled with quantitative tightening, has been smoothed over time. The goal of 2% inflation appears to be on the horizon; however, that does not mean the Fed will ease rates upon its attainment. That would serve to only rekindle inflationary tendencies.

While market forecasts are a Fool's errand, the changed circumstances from the past 40+ years', including the need to finance a massive federal deficit, suggest interest rates are likely to remain more elevated than the in the recent past, volatility is likely to continue, and the stock market will grind higher, albeit with far more modest return expectations, given the headwinds of higher interest rates and more modest economic growth.

So how do we define success in this environment? We focus on our game plan, monitor our status with Wealthcare's Comfort Zone, ensure that we have made reasonable assumptions about the future, and invest with the confidence that, over the long-term, our belief in our economic system and government will continue to provide opportunities to participate in the economic success of the free-enterprise system.

Thank you for your continued confidence.

Sincerely,

Jim

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[i] *Oaktree Insights*, January 2024

[ii] First Trust *Market Minute,* January2024.

[iii] Wealthcare Capital management Fourth Quarter 2023 Quarterly letter.

[iv] Federal Reserve of St. Louis Research; **Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis** **(DGS10)** https://fred.stlouisfed.org/series/DGS10

[v] ibid