

# Stapp Financial Investment Letter

Stapp Wealth Management, PLLC

Fourth Quarter 2023

*“People buy the most at the top and the least at the bottom, and we, the professionals, are here to help to do exactly the opposite.”*

*- Felix Zulauf*

## Market Recap

2023 was another year to add to this series of interesting and volatile years we are living through. The environment that 2023 was set in was one of elevated interest rates and high inflation. Given that the previous environment was one of low interest rates and low inflation, this shift has brought about unexpected occurrences in markets and the economy. Early in the year, we saw a series of bank failures that reminded us of the 2008 bank failures, but fortunately, the reforms and regulations that followed the 2008 banking issues worked, resulting in the 2023 banking issues being mostly isolated events that did not spread to the rest of the financial system. Following this period, the usual summer lull ended with a new conflict emerging between Israel and Hamas. Like the earlier banking crisis, the Israel Hamas conflict has also remained contained, but it reminds us that we are living through uncertain times.

Up until the 4<sup>th</sup> quarter, markets saw a few winners but mostly a lot of losers. Then, in December, the Fed signaled that in 2024 they are likely to begin rate cuts and may begin to curtail their quantitative tightening program. This reversal in stance from the Fed, combined with the Treasury’s accommodative quarterly refunding announcement that came in late October, gave markets the fuel they needed for a strong 4<sup>th</sup> quarter. For many investments, this surge in the 4<sup>th</sup> quarter outpaced the performance they had seen in the previous three quarters. Among the different investment asset classes, large-cap US stocks were the best performers. The S&P 500 was up more than 26% for the year. The index finished the year at 4,770, just below the previous all-time high of 4,818 that was achieved in early 2022. US small caps trailed the larger caps, up just under 17%. Non-US stocks in developed countries did well, up more than 18%. Stocks in emerging markets lagged, but still had positive performance, up just under 10%. The emerging markets index that excludes China, the one that is more relevant for how we are investing in emerging markets, fared much better and was up 19% for the year. Bonds were extremely volatile during the year but ultimately finished the year positive. Investment-grade bonds were up 5.5%, and the riskier high yield bonds were up just under 13.5%. Alternatives were mixed. Gold was up about 14.5%, and trend/managed futures was the sole negative performer for the year, down more than 7%. In a diversified portfolio, it should be expected that at least one investment zigs when the others zag.

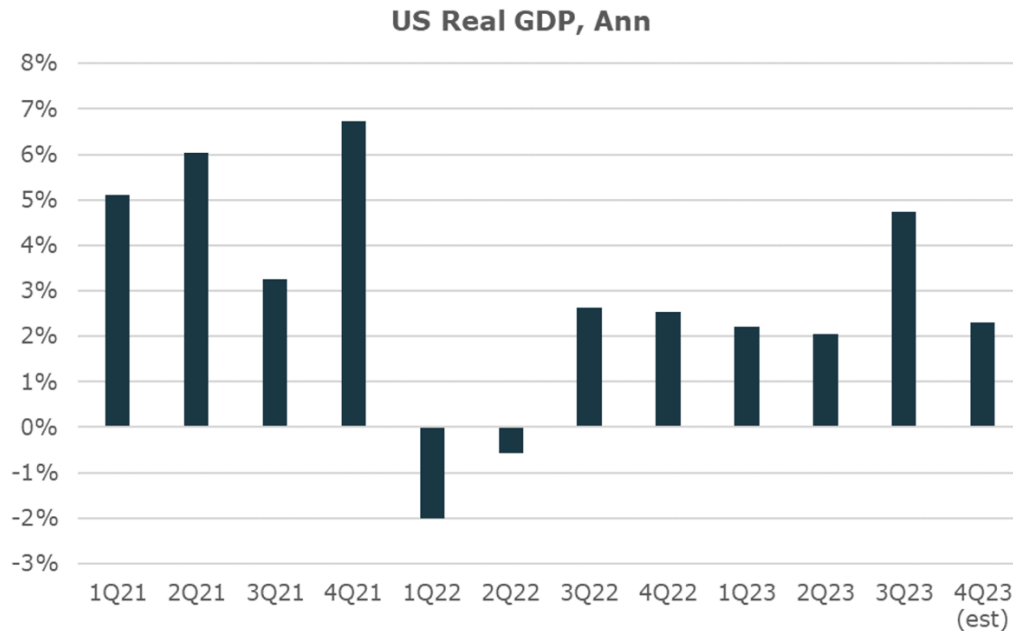
Asset Class Performance		
	4 <sup>th</sup> Quarter	2023
Investment Grade Bonds	+6.82%	+5.53%
High Yield Bonds	+7.16%	+13.44%
US Large Cap Stocks	+11.69%	+26.29%
US Small Cap Stocks	+14.03%	+16.93%
Developed International Stocks	+10.42%	+18.24%
Emerging Market Stocks	+7.86%	+9.83%
Gold	+11.11%	+14.59%
Managed Futures	-3.99%	-7.25%

Data as of 12/31/2023. Source: Kwanti Analytics<sup>1</sup>

<sup>1</sup> Indexes used: Bloomberg US Aggregate Bond Index, Bloomberg US Corp High Yield, S&P 500 TR, Russell 2000 TR, and MSCI EAFE TR, MSCI Emerging Markets Index TR; Gold represented by the change in the gold spot price; Managed futures represented by a 50/50 allocation to ASFYX and PQTIX set to rebalance quarterly.

## Investment Outlook and Portfolio Positioning

At the beginning of 2023, the consensus for the year from economists and market strategists was that we would see a recession in the first half of the year, followed by a recovery in the second half. Along with this, we were supposed to see the Fed pivot from their hawkish stance and start cutting rates. It is now safe to say that the consensus was wildly off the mark. We won't receive 4<sup>th</sup> quarter results until later this month, but nowcasts and the results of the previous three quarters give us a pretty clear picture that economic growth in 2023 was strong. GDP growth ended up being above the previous decade's trend and we most certainly did not see a recession. We also did not see any rate cuts from the Fed in 2023. In fact, we saw the opposite. The Fed hiked four times.



*Source: Unlimited Funds, FRED, Atlanta Fed*

With all the shifts caused by Covid, 2023 was a particularly bad year for those that try to predict markets and the economy. We're not trying to pick on anyone in particular, but Sean Williams of the Motley Fool might make the best example of this. He published a piece at the beginning of 2023 titled "12 Stock Market Predictions for 2023." Checking in on those predictions now, he only got one out of the 12 predictions right. Yes, only one out of 12 correct.

Now, as we enter 2024, the consensus forecast appears to be as follows: inflation will continue to decline, soon reaching the Fed's target of 2%. As a result, there won't be any more rate hikes. This will ultimately result in a soft landing, which is an environment of either slow growth or a mild recession. This will result in rates coming down, and it will be good for the economy and core investment assets like stocks and bonds.

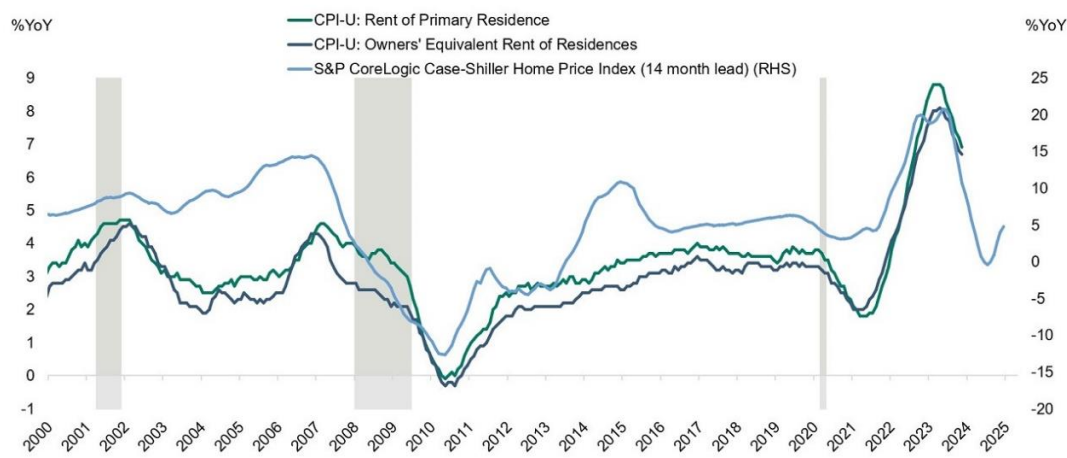
The quote from Bob Farrell that we used in last year's newsletter looks like it was incredibly prescient - "When all the experts and forecasts agree - something else is going to happen." That was certainly the case for 2023. Now, should we dismiss the consensus view for 2024? If we examine the 2024 consensus forecast of a soft landing, it does look like a reasonable forecast. Inflation has been steadily coming down, and if the current growth trend continues, that is exactly where it would put us.



The main issue we see with this forecast is that it assumes that the trends we have seen recently are going to be the trends we will continue to see. If all the craziness of the last few years has taught us anything, it is that things continuing along how they are today may be the least likely outcome.

If we break it down piece by piece, on the inflation front, the positive news is that we are no longer at the civilization-shattering levels of inflation that we saw in 2022. The not-so-positive news is that we are still above the Fed's 2% inflation target. Inflation declined down to 3% in June, only 1% away from the target, but it appears that it has formed a bottom there and is lingering above 3%. If we look at the components of inflation, many of those components look to have bottomed as well. Housing, for example, looks to have put in a trough and may be back on the rise. Housing is the largest component of the consumer price index, making up about a third of the contribution, and many of the forecasters that are expecting inflation to continue to decline have it penciled in that home prices will continue cooling off. So far, home prices don't appear to be cooperating, but that could change.

### Home price inflation rebounding



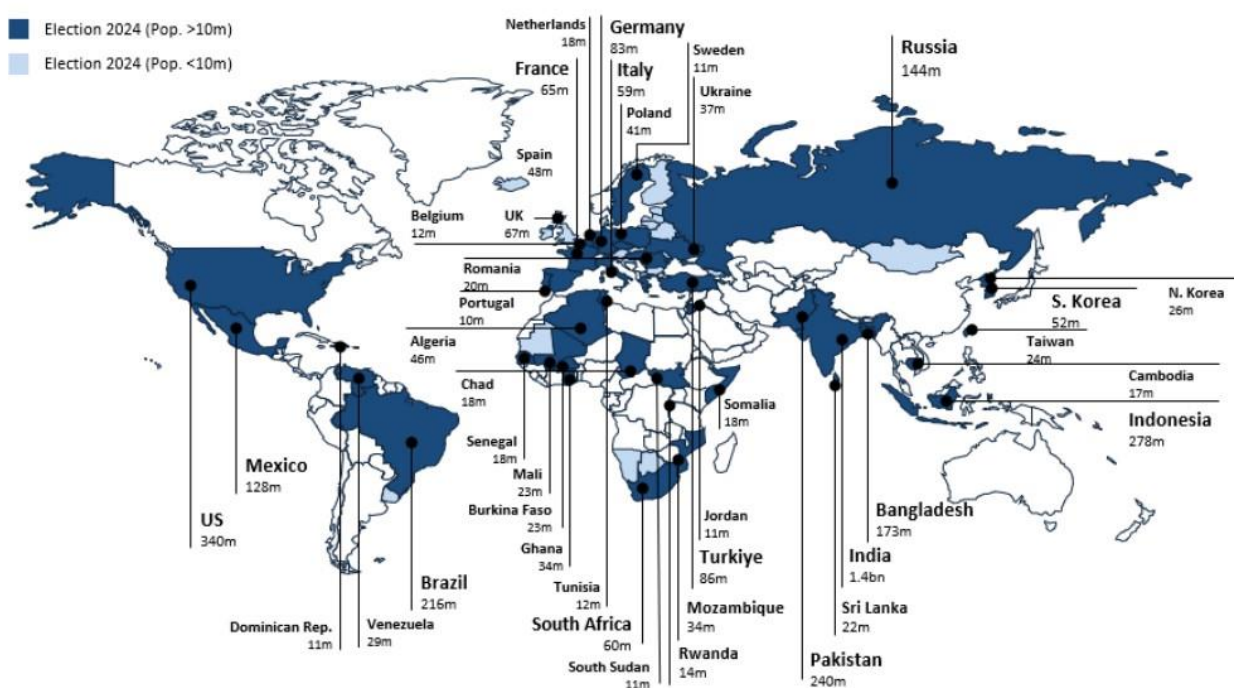
Source: Apollo

We don't expect inflation to return back to 2022 levels, but we believe that we are in a world where inflation is likely to remain structurally above the Fed's target of 2%. We have what are called the four D's of inflationary undercurrents in place:

- **De-carbonization** and commodity underinvestment
- **Demographic ageing** of working age population
- **De-globalization** and supply chain re-shoring
- **Dominance of fiscal policy** over monetary policy

We believe these structural undercurrents will continue to keep inflation elevated.

One of the key factors of the inflation story will be at the forefront this year. This may seem obvious, but our guess for the big theme of 2024 is that it will be politics. We have the upcoming US election, of course, but we are also looking at what could be the biggest global election year ever in 2024. The chart below by Mehlman Consulting shows all the countries that have major elections this year. One theme that we have discussed is a political shift from pro-capital oriented policies to pro-labor oriented policies. Most elections over the last few years have gone the way of the more pro-labor oriented candidates, so we will have to see if that continues into 2024. Just to touch on the US election, assuming the election comes down to Trump and Biden, this is one thing they have in common with each other. They are both candidates that have demonstrated a skew toward pro-labor policies.



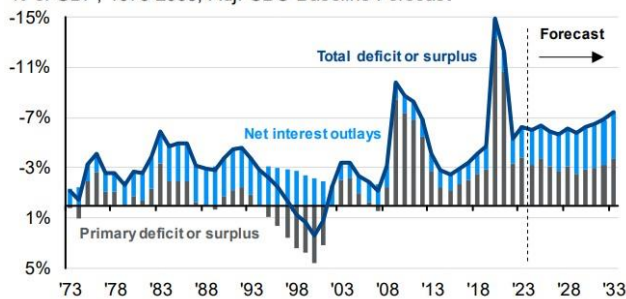
Source: (1) Economist Intelligence Unit, United Nations, V-Dem 4, European countries included because of EU Parliamentary elections. UK general election could take place as late as January 2025, though 5-year Parliamentary term will end in 2024.

MEHLMAN  
CONSULTING

On the recession front, we have previously discussed how the inversion of the yield curve almost always leads to a recession. If the economy were to align with historical averages, the yield curve tells us that we should be in a recession sometime in the first half of 2024. This has our guard up, but there are two big reasons why we might not see a recession this year: 1) The level of deficit spending is close to

### Federal deficit and net interest outlays

% of GDP, 1973-2033, Adj. CBO Baseline Forecast\*

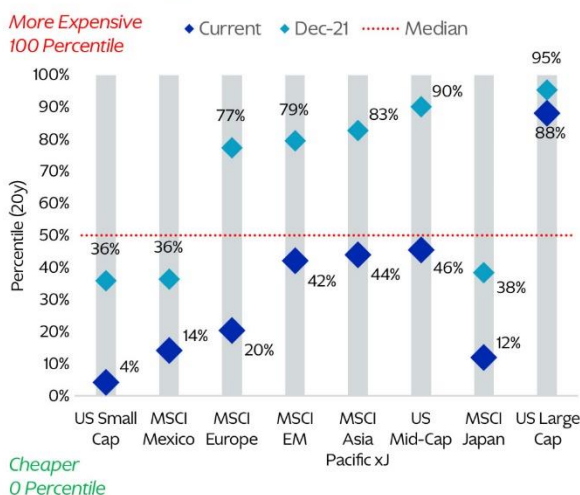


protect themselves. By acting in this manner at the aggregate economy level, this could prevent the recession from happening altogether. When it comes to things that could drag us down into a recession, the big one would be weakness in China. Additionally, if the Fed is unable to cut rates because inflation doesn't move in the direction they want, that could challenge the economy as well.

With all the uncertainty around what may or may not happen in 2024, our main position that we are taking as investors is to be maximally diversified. This call comes at a time when most investors appear to be doing the opposite by crowding into the S&P 500 and ignoring all other asset classes. The S&P 500 had one of its best years in 2023, and the result of that stellar performance is the highest degree of performance chasing that has ever been seen.

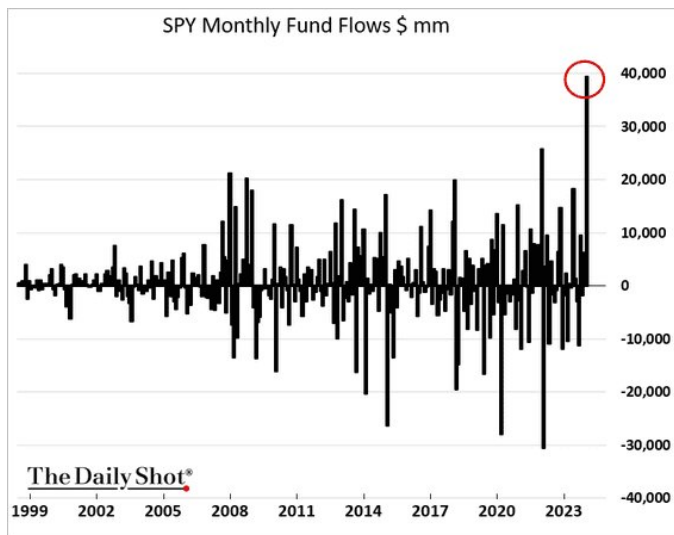
### One of these is not like the others

#### Cross-Asset Valuation Percentiles, Relative to 20-Years Average, %



Notes: Equity indices refer to NTM P/E. Data as at November 30, 2023. Source: Bloomberg, Haver Analytics, S&P, MSCI, KKR Global Macro & Asset Allocation analysis.

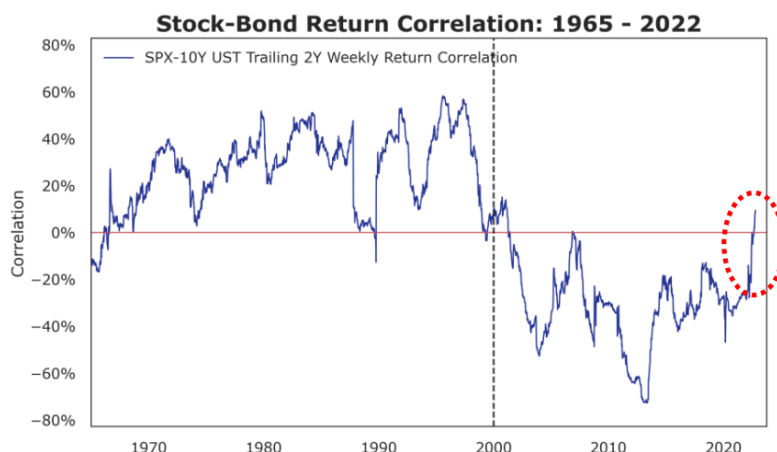
recession spending levels. It would be very difficult to go into a recession when the US government is already spending the amount of money it would spend to bail the economy out of a recession. 2) The economy and markets are reflexive. Previously, the inverted yield curve was not regarded as a useful tool for forecasting a recession, but now everyone views it as a harbinger of a looming recession. This means that various economic actors will act in a manner to protect themselves. By acting in this manner at the aggregate economy level, this could prevent the recession from happening altogether.



The monthly inflows into the SPY S&P 500 ETF for December were the largest monthly inflows that have ever been recorded for the SPY ETF. These record monthly inflows come at a time when the index is close to as concentrated as it has ever been, with the top 10 stocks making up more than 32% of the index, and when valuations are in the upper percentiles relative to history. This is not an argument against having any money invested in US large-cap stocks; it is an argument against having all your money invested in US large-cap stocks, which appears to be how many investors are choosing to position themselves. One interesting dynamic of markets is that when there is a vacuum of money into one asset class, it creates opportunities in other areas. Just focusing on equities, most every other area outside of US large caps is below its average historical valuation. To us, this presents opportunities that many investors are ignoring.



Additionally, we continue to be in an environment where stocks and bonds may no longer be good diversifiers for each other. Inflation uncertainty is still high, and when inflation uncertainty is high, stocks and bonds become correlated. The 60% stocks/40% bonds portfolio that is industry standard doesn't work when stocks and bonds move in the same direction. We have recognized this and believe that investors need to have alternatives in their portfolios that zig when stocks and bonds both zag. If the four D's of inflation we outlined earlier remain in place, this may be a theme for the next 5+ years or longer.



Source: Bloomberg

Looking at our portfolios and how we are positioned, our strategies generated returns for our clients in 2023, but relative to benchmarks we track, our active strategies underperformed. The winning strategy for 2023 was to hug the indexes and have as little diversification as possible. This goes against our philosophy for how we construct portfolios, so it was a year where we were out of favor. Additionally, many of the positions we had that helped the portfolios in 2022 ended up being detractors in 2023. Given the large swings we have been seeing in markets these past few years, it is highly possible that 2023's winning strategy ends up being 2024's losing strategy. Flows data shows that investors have crowded into what worked in 2023, and that tends to be a contra-indicator for what to expect moving forward. The investment themes of our portfolios remain essentially unchanged since the previous quarter. We are still underweight stocks and bonds, as the expected returns for stocks are not great here and inflation uncertainty weighs on bonds. We have a good chunk of the portfolio in alternatives like gold and managed futures. We expect both gold and managed futures to perform well over the next few years, and they also add additional diversification to portfolios at a time when diversification is very valuable. Within equities, we have an emphasis on emerging markets, value, and commodity sectors. The market environment is highly fluid, so our positioning could easily change, but as you can see by these themes, we are decidedly not following the herd. We believe this differentiated positioning could pay off in a big way in 2024 and for years to come.

## Closing Thoughts

As we mentioned, this is going to be the year of elections. As investors, we recognize that elections certainly have some impact on markets, but it is also important to note that the impact is often overstated. When thinking about future events, there are three types of events that can occur. There are the known knowns, the known unknowns, and the unknown unknowns. The known knowns are the things that we know with certainty will happen in the future. We can say with near 100% certainty that there will be a US election this year, for example. Known knowns generally have no impact on markets as they are already priced in. The known unknowns would be the events that we know will occur but that

we do not know the outcome of. The result of the election would fall into this category. Known unknowns have some impact on the market, but they are not something to be overly concerned about. For the known unknowns, all kinds of market participants will have probability tables set up for these events, hedges in place, and bets on either outcome. All this rigmarole ultimately makes it so that whatever the result is, it isn't as severe as you might expect. The unknown unknowns are the real market movers. These are the events that we don't know will occur and that we don't know the outcome of. Covid would be an example. The unknown unknowns are the real events we should be concerned about. The problem is that we don't know about them! We expect some unknown unknowns over the next few years, so that's why it makes sense to remain disciplined and diversified.

As always, we thank you for the trust you place in us to be the stewards of your capital. We are extremely grateful to all our clients. We wouldn't be here without you. If you have any questions, comments, or if you want to discuss your specific situation, please reach out. We're happy to meet any time.

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