Wealth Management Newsletter

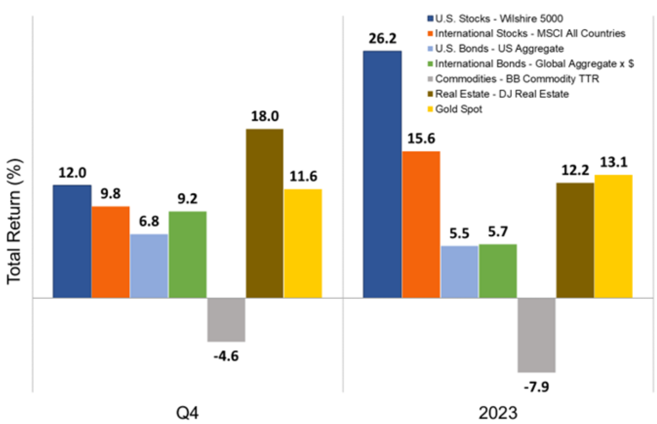
Winter Issue 2024

KEY POINTS

- Despite numerous headwinds and widespread anticipation of a recession as we entered 2023, the economy and markets proved resilient, rewarding investors who stayed invested throughout the volatility
- An 'almost everything rally' during the final quarter of the year resulted in double-digit full year returns for equities. Fixed income markets also produced positive investment returns after two consecutive down years
- As we head into 2024, a combination of solid economic activity and cooling prices has left investors increasingly confident that the Fed's tightening campaign has ended, and a soft landing is in reach
- Investor optimism and market pricing have left little room for error. We remain vigilant with respect to the current risks and enter the year with a measured investment outlook

2023: BY THE NUMBERS

Recency bias refers to the tendency to overweight recent events when making decisions about the future. After a historically poor 2022 for both stocks and bonds, many investors entered 2023 with defensive portfolio positioning that reflected the plethora of challenges that the economy and markets faced. These challenges continued to mount throughout 2023 with the failure of five U.S. banks, two land wars, heightened geopolitical tensions, U.S. sovereign debt downgrades and a prolonged and deeply inverted yield curve. Through it all, the U.S. economy grew above its long-run trend, bolstered by the strongest labor market in more than 50 years and resilient consumer spending. Years of easy monetary policy and massive fiscal spending along with historically low investor expectations created the perfect storm for an unexpected market rally (See Figure 1).



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

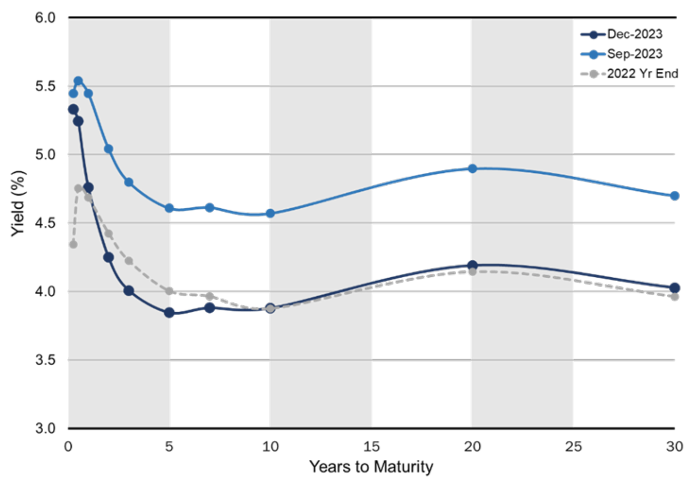
Investors received a slight reality check in capital markets from August through October in the form of a 10 percent correction in the S&P 500, in response to spiking U.S. Treasury yields. By the end of the year, however, there were strong returns across most major asset classes, driven by the hope that the Federal Reserve would cut interest rates in 2024 sooner than originally anticipated. The broad stock market rally in Q4 was a welcome change of pace relative to the first half of 2023, when enthusiasm around artificial intelligence (AI) advancements propelled just seven mega-capitalization tech stocks to comprise 90% of the S&P 500's return. The impressive annual S&P 500 return, driven by the Technology and Communication Services sectors was nearly double the equally weighted S&P 500 return of +13.9%. U.S. Mid Cap and Small Cap companies finished the year +16.4% and 16.9%, respectively while the tech-heavy Nasdaq 100 rose +55.1%. Further highlighting the historically wide dispersion among stocks in 2023, U.S. growth-oriented stocks finished the year +38.5%, outperforming value stocks by more than 26%, according to Morningstar data.

Turning to international equities, the broader group delivered +15.6% returns for 2023, after rallying +9.8% during the fourth quarter (See Figure 1). Developed international equities outperformed their emerging market counterparts, finishing the year +18.2% and +9.8%, respectively.

Led by lower interest rates, the DJ Real Estate index rallied by +18% during the quarter to finish the year up +12.2%. Buoyed by geopolitical risks and central bank action, gold was up +13.1%. Commodities were the lone outlier for 2023, returning -7.9% after a robust performance in 2022.

REVERSAL IN THE BOND MARKET - YIELDS FINISH 2023 CLOSE TO UNCHANGED

After moving consistently higher for the past 3 years, bond yields peaked in the fourth quarter in response to continued disinflation and the Federal Reserve's pivot from tight monetary policy to potential rate cuts in 2024. U.S. Treasury yields reached their highs in October near 5% across the yield curve as markets grappled with ongoing increases in supply to fund the Federal deficit. As economic data weakened and pricing pressures abated, markets were quick to front-run Fed policy expectations with yields dropping from 5% to 4% on the U.S. 10 Year Note in less than two months. Except for the shortest maturity bonds, U.S. Treasury yields were nearly unchanged on a year-to-date basis (See Figure 2). All fixed income sectors posted positive returns for 2023 with riskier high-yield and investment-grade bonds outperforming risk-free assets. The U.S. Aggregate Bond Index returned +5.5% for the year (See Figure 1), partially reversing the prior two years of negative returns.



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

U.S. fixed income markets have recently repriced to significantly lower yields and are currently expecting 150 basis points of Fed rate cuts in 2024, beginning with March Federal Open Market Committee meeting. However, the Fed's own monetary policy projections only call for half of that amount of policy easing, which may lead to increased fixed income market volatility until that pricing divergence is resolved. While leading economic indicators such as the shape of the yield curve, business sentiment surveys, and lending standards still highlight the potential for challenging economic conditions in the future, the U.S. labor market remains historically tight which may continue to drive above trend growth and inflation. Additionally, vastly increased supply of U.S. Treasuries could weigh on bond market pricing as the Department of the Treasury needs to fund record government deficits. More specifically, U.S. Government interest expense is expected to approach $1 trillion in 2024 as sizable portions of the $34 trillion of outstanding national debt is refinanced at higher rates. As a result, annual interest expense on the Federal debt now only trails outlays for Social Security and Medicare.

THE ECONOMY – FED CUTS OR SOFT LANDING?

Financial conditions eased significantly in Q4 driven by lower interest rates and equity markets that approached all-time highs. Primarily driven by the Federal Reserve's tight monetary policy, resilient global supply chains, and sharply improved U.S. Productivity measures, inflation metrics continued to decline throughout the year, but are still well above the Fed's stated 2% target rate. Strength in the labor market continued with the unemployment rate and jobless claims near all-time low levels. Conversely, national manufacturing activity surveys remained in recessionary territory, and while the service sector continued to do well it has also shown recent signs of deterioration. Despite that overall economic landscape, markets remain focused on expectations of an aggressive Fed easing cycle in 2024 regardless of consensus forecasts that the economy will experience a soft landing. We are acutely aware of these divergent economic and monetary policy expectations and therefore, we remain vigilant with respect to the risks that are present in markets.

MARKET VIEW AND PORTFOLIO CHANGES

As we enter 2024, there has been a major shift in investor psychology as last year's excessive skepticism has turned into growing confidence that an economic soft landing and higher asset prices are assured. Our concern is that contrary to 2023 when the economy and markets were able to beat incredibly low investor expectations, is that 2024 valuations are much higher. Accordingly, there will be increased pressure for the 11 percent consensus earnings growth estimates currently priced into equity markets to be realized to meet investor return expectations in 2024. However, those earnings estimates may be challenged by higher financing costs, persistent inflation, geopolitical tensions, deglobalization, and shifting supply chains. A contentious 2024 U.S. presidential election year could also result in heightened market volatility.

Should the Fed achieve the often-elusive soft landing, equities should produce positive, though more modest investment returns than we experienced in 2023. While large capitalization equity market valuations are presently a concern, the equally weighted S&P 500 P/E ratio is more in line with long-term averages than the market-weighted index, highlighting the many equity securities away from the Magnificent 7 that are much more attractively priced. Therefore, as an investment team, we remain focused on buying high-quality companies with reasonable valuations, clear earnings visibility, and durable cash flows. We also continue to maintain a domestic bias relative to developed and emerging markets given the U.S.'s economic resiliency, stronger earnings, and greater exposure to near-term technological advancements such as AI.

Fixed income markets should also perform well this year as bonds offer attractive yields and the potential for capital appreciation as the Fed eases monetary policy, or if the economy slows more than anticipated. However, if inflation remains persistent, fixed income market returns may be challenged, and yields could potentially retest the recent highs that we experienced in October 2023.

Most importantly, 2023 once again highlighted the necessity of having – and sticking with – a long-term financial plan. Despite numerous headwinds and widespread recession predictions, the economy and markets proved resilient, rewarding those who stayed invested. Remaining invested through market cycles can be challenging, however, 2023 once again proved that time in the market beats timing the market with respect to achieving your long-term financial goals. As always, please do not hesitate to reach out to our wealth management team to review your financial goals, and to ensure that your investment portfolio is properly aligned with your risk tolerance and time horizon.