
INVESTMENT OUTLOOK

A P E A P A C K P R I V A T E P U B L I C A T I O N

FOURTH QUARTER 2023: EMBRACING WABI SABI

Perfection is terrible, it cannot have children

-Sylvia Plath

Some things in this world are perfect.

In baseball, there's a perfect game, in which a pitcher retires the opposing team without allowing a single batter to get on base. In music, there's perfect pitch, the ability to identify or reproduce a given musical note without the benefit of a reference tone. In mathematics, there are perfect squares, positive integers that are the product of some integer with itself. And in gymnastics, there's a perfect ten, a performance so flawless that no points are deducted.



But it's no great revelation that life, itself, is not perfect, that it's more like the antique gilded vessel in Henry James' novel *The Golden Bowl*, with its hidden or not-so-hidden crack—fragile, breakable, flawed. Life is imperfect, messy, nonlinear, fecund. Markets don't operate with perfect smoothness. Economies don't manifest perfect balance and stability. Investors are not perfectly rational actors.

Which brings us to wabi sabi—the Japanese phrase that expresses an awareness of the transient nature of earthly things and a corresponding pleasure in the things that bear the mark of this impermanence. The beauty of imperfection, if you will. This aesthetic world view provides a thoughtful way to understand an economy that gives the current appearance of having achieved a soft landing, and stock and bond markets that appear to have interpreted this soft landing as a perfect backdrop for further gains. And it helps us contemplate the question: are markets priced for perfection?

A NEARLY PERFECT QUARTER

*I met this perfectly marvelous girl
In this perfectly wonderful place
As I lifted my glass to the start of a marvelous year
-Fred Ebb*

It was a perfectly marvelous quarter for all assets. Progress in bringing inflation down, followed by a softening of the Fed's multi-month mantra of higher-for-longer interest rates, provided a lift to equity and fixed income markets.

Asset Class	Index	4th Quarter Results	Full Year Results
US Large Cap Stocks	S&P 500 Total Return	11.7%	26.3%
US Small-Mid Cap Stocks	Russell 2500	13.4%	17.5%
International Developed Markets Stocks	MSCI EAFE	10.4%	18.2%
Emerging Markets Stocks	MSCI EM	7.9%	9.8%
Real Estate Securities	MSCI US REIT	16.0%	13.7%
Commodities	Bloomberg Commodities Futures	-4.6%	-7.9%
Bonds	Bloomberg Barclays US Aggregate	6.8%	5.5%
Cash	FTSE USBIG 1-month Treasury Bill	1.4%	5.1%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

US stock markets generated double digit returns for the quarter, with particularly elevated returns from the interest rate sensitive real estate sector. Overseas equity markets also posted strong returns. Falling interest rates lifted bond prices, and the rally reversed prior year-to-date negative returns.

For the year as a whole, markets performed brilliantly, led by US large cap stocks which rose a dazzling 26%. Of course, much of that rocket return was the result of extraordinary out-performance of the so-called Magnificent Seven—megacap tech growth companies (Amazon, Alphabet, Apple, Meta Platforms, Microsoft, Nvidia, Tesla) whose haloes were burnished by artificial intelligence associations. These stocks rose anywhere from 50% to 200%, versus the average stock up a much more modest 11.6%.

Weakness was hard to spot. West Texas intermediate crude oil futures fell 21.1% in the fourth quarter and 10.7% for the year, contributing to commodities' decline in both periods.

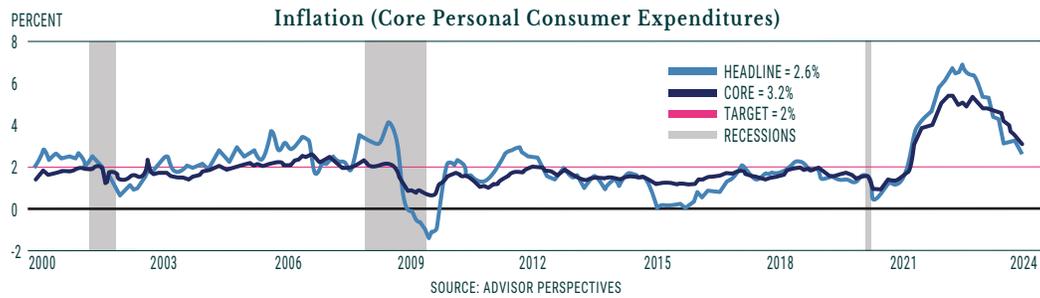
Still, let the rare exception not mar the overall near-perfect market returns that followed in the footsteps of so-called immaculate disinflation.

IS JEROME POWELL THE PERFECT FED CHAIRMAN?

*Perfection itself is imperfection.
-Vladimir Horowitz*

And what, exactly, do we mean by immaculate disinflation? The phrase refers to a condition in which inflation cools without an attendant jump in unemployment. At this juncture in time, that appears to be what has ensued.

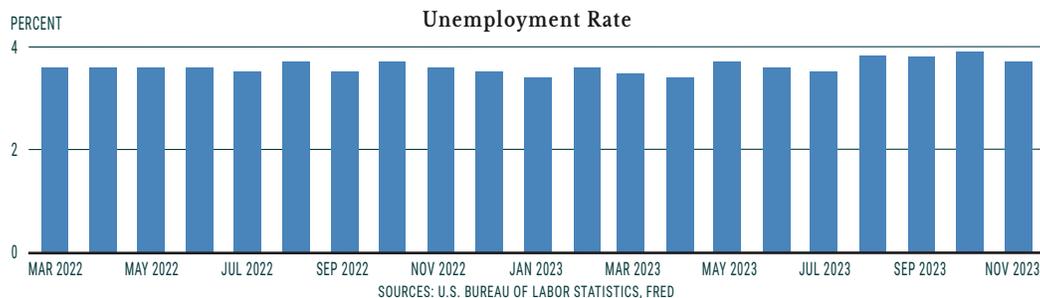
Using the Fed's preferred inflation gauge of core personal consumption expenditures, the annualized rate of inflation fell to 3.2% in its most recent reading. As the chart below shows, core PCE has plummeted since peaking 18 months ago, and the anticipated 'stickiness' of inflation—the idea that rates of inflation fall more slowly than they rise—has not played out in this cycle.



The drop in inflation has been as precipitous as the previous rise; inflation is now running at the lowest rate since February 2021.

The Fed appears to be on track to meet one of its two mandates, price stability (accepting that the Fed defines it as averaging 2%). Economists widely expect inflation to fall, closer to the Fed’s target, in the upcoming months.

The Fed’s second mandate is maximum employment, which may be defined as an economy in which nearly everyone who wants to work has a job. The most common measure of this objective is the unemployment rate. As of November 2023, the Fed can take a bow. As the chart below indicates, the unemployment rate hasn’t budged since the Fed began raising rates in March 2022.



The unemployment rate fell below 4% in December 2021 and, despite a 525 basis point cumulative increase in interest rates, has remained at this optimally low level.

So. Has Chair Powell stuck the landing, as Nadia Comăneci did when her performance on the uneven bars in Montreal 1976 earned her the first perfect 10 in Olympic history?

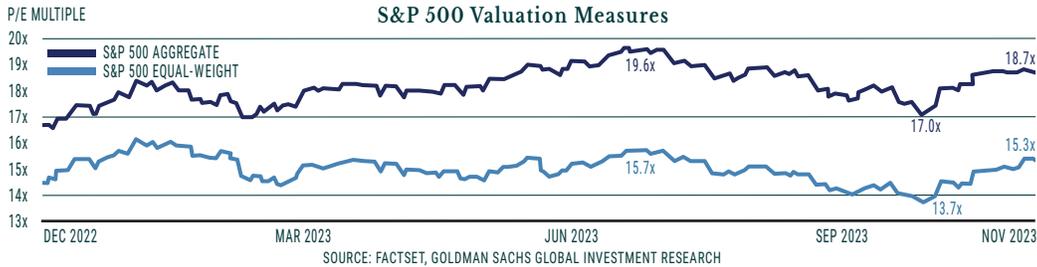
A LESS THAN PERFECT MARKET PRESCRIPTION

*Le mieux est l'ennemi du bien
(The perfect is the enemy of the good)
-Voltaire*

The backdrop for financial markets at the beginning of 2023 was less than promising. The Fed had begun to raise rates at the most aggressive pace in over 40 years. The economy appeared to be slowing. The outlook for corporate profits was for them to fall, by mid-single digits. Investor sentiment was, unsurprisingly, leaning bearish.

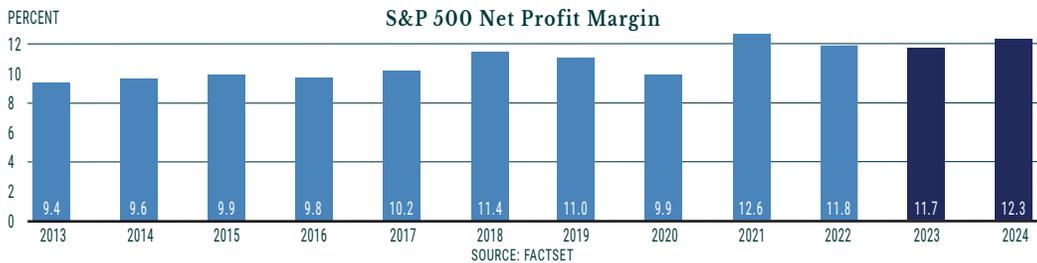
But markets, even if they are not perfectly efficient, are forward looking. And market participants factored in, whether prematurely or not, the likelihood of lower interest rates and the expectation of a profits recovery in 2024. And the explosive enthusiasm for developments with generative artificial intelligence helped propel technology stocks to extraordinary gains.

One other factor also contributed to the market’s sharp rise in 2023. At the start of the year, the S&P 500 was valued at a comparatively modest multiple of less than 17 times estimated earnings for the next 12 months, and the average stock less than 15 times. Over the course of the year, earnings did not rise but the price, or multiple, investors were willing to pay for those earnings did.



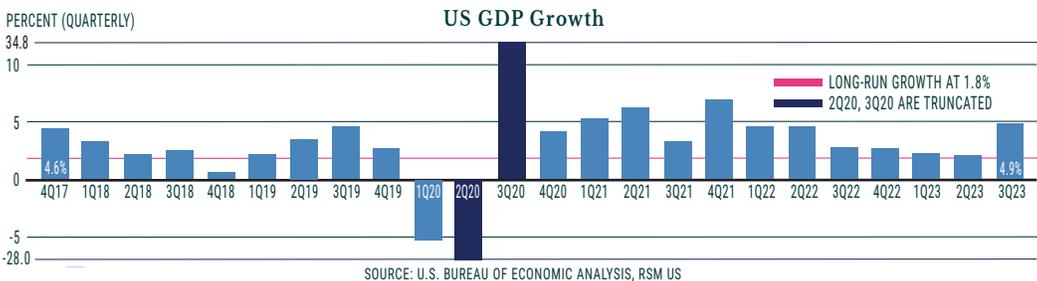
At year end, the multiple for the S&P 500 was almost 19X, driven by elevated technology valuations. An analysis of the market that equally weights all the stocks in the S&P 500 (rather than the capitalization weighted standard measure) indicates a much smaller increase in the market multiple. This confirms the narrowness of the market’s advance.

If there is to be a next leg up for this bull market, it may need to come from earnings growth. It seems likely that equities have priced in much of the gain to be had from prospective lower interest rates. On that point, analysts expect earnings to grow 11.8% in the new year—a projection that could prove challenging. To achieve that target, companies will need to generate revenue growth in a less inflationary environment and protect profit margins. Estimates, according to FactSet, are for 5.5% revenue growth and for net profit margin of 12.3%.



Such wide margins, if achieved, would represent the second strongest result of the past decade. If companies experience a loss of pricing power (the ability to raise prices without losing customers/sales), they may need to rely on cost cutting to meet lofty expectations.

What economic backdrop could enable companies to achieve such robust revenue, profit margin, and earnings targets? You guessed it. A near-perfect economy in which inflation is tame, the work force is fully employed, and productivity gains drive profitability and wage growth without driving up prices.



The chart on the previous page depicts quarterly growth of US GDP. It shows that GDP growth has been averaging 1.8% annualized. (It spiked in the third quarter this year, as consumer spending and private inventory investment accelerated.)

The outlook for economic growth in 2024 is decidedly tepid. According to a survey by Bloomberg of economic forecasts, US GDP growth is expected to decelerate to 1% this year. Should that prove to be directionally accurate, corporate revenue and profit estimates appear to be optimistic.

THE PAST IMPERFECT...

*With this wine and with this music
How can anything be clear
Let's wait and see
It may just be
The perfect year
-Andrew Lloyd Weber*

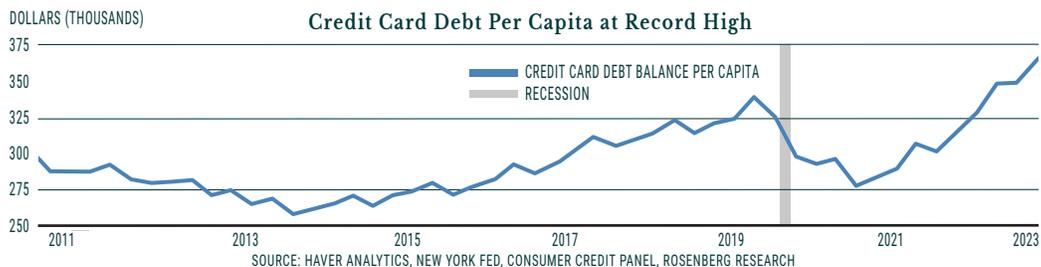
The past imperfect tense is used to describe a past action which is incomplete. Some examples of the past imperfect: "I *was raising* rates when the economy fell into recession" or "I *used to think* that full employment and stable prices were incompatible." This tense is used to indicate an action that has transpired over a period of time, or has happened frequently.

We view the Fed's efforts to conquer inflation as incomplete—in that sense, imperfect, if you will—something that has been happening but has not perhaps been finished. Annual inflation is still appreciably above the Fed's target, and a range of possible future events—oil supply challenges, elevated labor costs, exogenous shocks—could occur to prevent the Fed from driving a stake through inflation's heart. Additionally, economic growth could continue to slow, past what is needed to stabilize inflation, and stall or slide into recession.

To be sure, this is a healthy economy at the moment, even an economy that at this very particular moment in time may seem to be nearly perfect.

But economies are dynamic. And it should be noted that the two-dimensional price stability/full employment focus for the Fed is hardly comprehensive for the economy as a whole. Additionally, as economist Hyman Minsky noted in 1936, stability breeds instability. Where might instability occur? Several items of potential concern are worth monitoring:

Consumer Spending: With consumption comprising 70% of the US economy, the financial health of consumers is always important to monitor. A full employment economy suggests strong support for consumption. But rising automobile loan and credit card defaults suggest trouble under the surface.



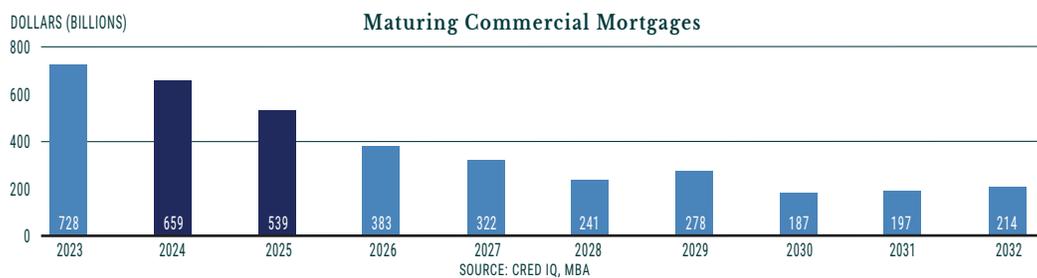
Holiday spending rose an unspectacular, not-inflation-adjusted 3%, and a quarter of American consumers availed themselves of 'buy now, pay later' loans, according to LexisNexis Risk Solutions. Many retailers noted that consumers are cautious and bargain hunting.

Housing: High interest rates and high home prices are inherently incompatible. Why incompatible? Because they each drive down housing affordability. As the graphic below indicates, in 2023 housing affordability has plummeted, down 47% from 2020 and near the lowest level since 1986.



Mortgage rates have fallen from over 8% to less than 6% and may fall further, but absent a return to 3% mortgage rates, home prices look vulnerable.

Commercial Real Estate: The office sector has been stressed by work from home and hybrid office/home work schedules. Companies have reassessed their space requirements and are shrinking their footprints. Limited demand in turn is depressing rent rates. And commercial mortgages that are coming due and require refinancing are likely to be replaced with substantially higher rates.

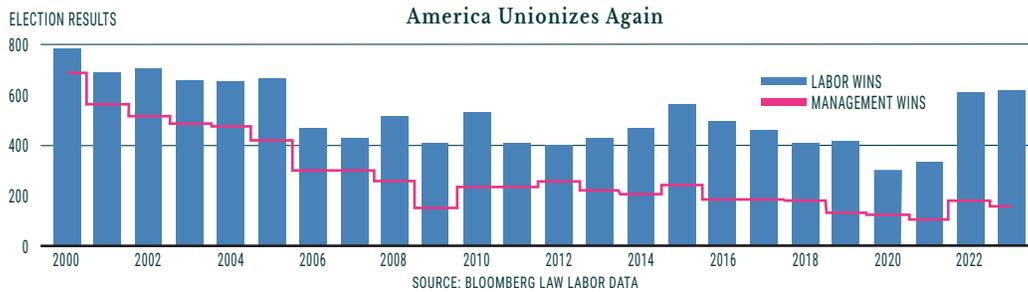


It is estimated that \$1.2 trillion of mortgage debt will need to be refinanced this year and next. It's a perfect storm for lower valuations, loan defaults, and foreclosures. Other commercial real estate sectors facing some potential weakness include industrial/warehouse and apartment/multifamily, both of which may be in oversupply due to substantial development activity.

More Robust Organized Labor: Auto workers, Hollywood actors and screenwriters, and New York nurses are among the more than half a million workers who staged more than 400 strikes in 2023, according to Cornell University's Labor Action Tracker. Strikes were narrowly averted at UPS and several airlines. In general, striking workers succeeded in winning substantial contract gains, including higher wages and increased benefits. These are multi-year contracts, and the extent to which substantial additional wage gains could impact overall inflation may be underappreciated.

While it is true that union members are a small portion of the US workforce, terms struck in union contracts often carry over into the nonunionized labor market. Also noteworthy: union organizers have notched the most union election victories in twenty years.

Labor's successes in the form of considerable wage concessions have consequences for corporate profits. Corporate profits are divvied up among shareholders, management, and employees, and for much of the past 40 years labor's share has fallen. But if labor's negotiating strength should prove to have legs, corporate profit margins may be reduced.



And then there are issues beyond the economy. We end the year with wars raging in the Middle East and eastern Europe. With the hottest temperatures on earth since records have been kept. With supply chains again at risk as shipping is challenged by armed conflict and terrorist attacks in the Suez Canal and by climate change at the Panama Canal. With an upcoming presidential election cycle that appears likely to feature two polarizing candidates with equal record-high 'unfavorable' ratings.

So, lean in and embrace an imperfect, but perhaps good enough, economy. While remaining watchful for potential cracks to develop.

...AND THE FUTURE IMPERFECT

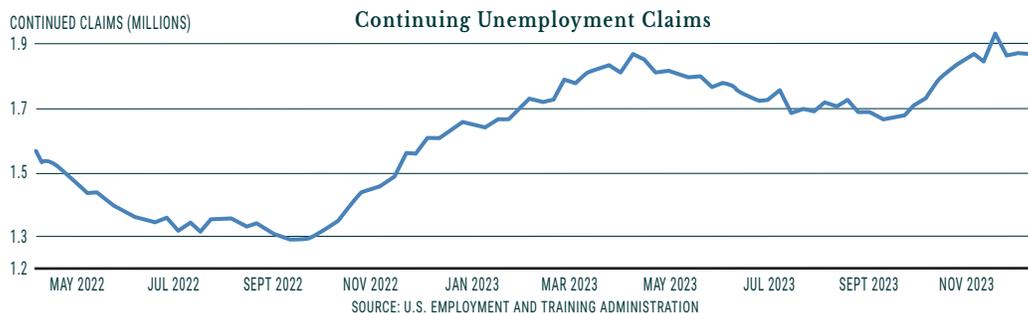
If the world were perfect, it wouldn't be.

-Yogi Berra

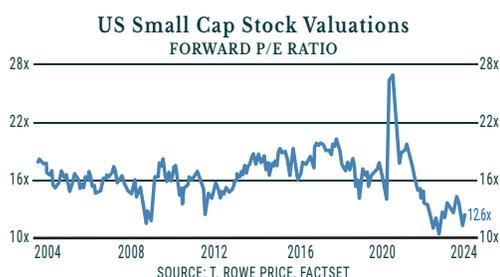
The future perfect tense is a verb form that describes an event that is expected or planned to happen before a time of reference. For example, "The Fed *will have begun* to lower rates by midyear 2024" or "The labor market *will have softened* in 2024" or "The economy *will have slowed* materially over the course of 2024."

The future perfect implies a certainty that seems inappropriate when looking ahead to or forecasting economic and market developments. So we'll adopt the future imperfect tense, which is used to describe an ongoing or continuous action that will happen in the future (often, at a specific future time), or to make a prediction about the future.

For example, it appears reasonable to anticipate that the economy *will be slowing* over the six months, and the deceleration, even if it does not lead to recession, *will be impacting* the labor market. Rising continuing unemployment claims, shrinking job openings, and slower payroll growth all suggest this outcome.



In this anticipated environment, bonds *will be expected* to perform well—to earn a coupon well in excess of the average over the past 15 years, and to experience some price appreciation as well. That is to say, bond prices are poised to rise in the face of predicted Fed rate cuts. Fixed income markets may experience a bull steepener—wherein short-term rates drop the most—in which case further modest extension of duration will be rewarded. We continue to favor higher rated bonds in view of the historically tight spreads (extra yield offered) for lower quality bonds.



In equity markets, significantly more compelling valuations for small cap and international stocks render these equity asset classes more attractive than US large cap stocks.

Their comparative under-performance over the past year provides an opportunity for them to play catch-up. Extreme under-performance by value stocks in 2023 against growth stocks again positions them well for a relatively better 2024. Laggard sectors such as industrials and healthcare look interesting; so do financials if rates drop but a recession is averted.

As we begin the new year—the Year of the Dragon according to the Chinese zodiac—we need to embrace imperfection.



A crack may not ruin a bowl. It may enhance its beauty. An uncertain economic environment, a data dependent Fed, an investment climate defined by overly enthusiastic investor sentiment, a body politic that is divided and restive—all give pause to investors contemplating how and where to deploy their precious capital. Yet imperfect conditions, as we faced last year, can give rise to perfectly lovely results.

In this presidential election year, it is noteworthy that equity market returns have landed in positive territory in every presidential election year going back to 1944.

So perhaps we should take our lead from the dragon, a legendary magical beast that is the luckiest and most auspicious in Chinese astrology. The dragon signifies unprecedented opportunities, and astrologers expect the upcoming year to be favorable for risk takers.

As risk managers, we are inherently cautious. That said, as long-term investors we embrace risk taking within the parameters of investors' risk tolerance. Market fluctuations are impermanent, transient, blips along a journey to achieving financial goals. Peering into the future to ascertain the direction of the economy and financial markets is an intrinsically fraught and, let's admit, imperfect exercise. Whatever the new year brings, *we will be wishing* all investors a peaceful and healthy as well as prosperous 2024.



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