2024: The Year Ahead

Annual Market Outlook

MV Financial Research & Strategy Group

January 23, 2024

MVCM 2024 0005
DOFU: January 2024

`

The Year Ahead: 2024 Annual Outlook

I. Games, Vibes and the Post-Post-Industrial Age 3

A. Speculation for Its Own Sake 3

B. The Fed Succeeds, and the Vibes Don't Care 6

C. Defining the Post-Post-Industrial Age 10

II. 2024 Investment Thesis 12

A. Executive Summary 12

B. State of the World 14

C. Concluding Thoughts 22

III. Important Disclosures 23

Note to our readers: On page 12 you can find an executive summary presenting the key themes of our outlook for 2024. Of course, we invite you to read the full document for an understanding of the economic, capital market and other forces shaping our thought process.

______

I. Games, Vibes and the Post-Post-Industrial Age

A. Speculation For Its Own Sake

From Pete Rose to Draft Kings

As we write this in early January, there is a full menu of exciting contests for sports fans of all types: NFL playoffs, NCAA men's and women's basketball, the English Premier League for football (soccer) fans, and the many antipodean tennis tournaments leading up to the marquee Australian Open, just to name a few. As always, the contests are full of stunning moments of athletic prowess and nail-biting finishes. But there is another element to this plethora of sporting events that recently has become nearly impossible to avoid. Call it the Gaming of the Games, if you will, or call it by its bland industry nomenclature: sports betting.

A long time ago, sports betting was a casual pastime – something you and your friends might do to add a frisson of excitement to Super Bowl Sunday, or an office "bracketology" pool for the NCAA basketball tournament. If you thought about it in business terms, perhaps you had the image of some kind of Las Vegas operation wedged in between slot machines and craps tables. Those dated images have nothing to do with what has become a highly professional industry generating more than $80 billion in annual revenue, with forecasts estimating double-digit annual growth to $231 billion by 2032, according to a recent study by Acumen Research and Consulting. Sports betting is no longer a sideshow – in many cases, it is the show.

Familiarity with the lexicon of betting is practically a requirement for making sense of those articles in the New York Times or Washington Post previewing the coming weekend's NFL contests. Over/under, the spread, the player prop market, adjusted value over average…and here we thought the investment industry had impenetrable jargon! When you switch on the game itself, you'll be enticed by super-slick ads from the likes of FanDuel and Draft Kings about how easy it will be to tap, click and bet – on just about anything remotely having to do with the game at hand. Will there be a field goal from more than 40 yards out sometime in the final five minutes of the game? Will the kicker make the FG? Will a delay of game force them back five yards and make them try again? Take a bet! Here's $100 in "free" wagers one you pay for your first one! Oh, and a fleeting disclaimer at the bottom of the ad giving you a phone number to call if you think you might have a gambling problem, in the smallest font size the company's lawyers would allow.

The sportscasters, whose job used to be simply to call the game as it was happening, are in on the hype, at the behest of their networks and the advertisers who fund them. The big sports bet at this year's Super Bowl, apparently, is whether or not a retired star wide receiver will kick a successful field goal. That may sound weird (it is objectively weird and bizarre, since wide receivers as a matter of professional occupation don't kick field goals), but the announcers covering the first week of the NFL playoffs couldn't stop plugging it as the most awesome thing since sliced bread, and encouraging everyone tuned in to sign up for FanDuel and get in on the action.

Back on August 24 last year, as it happens on August 24 of every year, news outlets reminded us that this was the day, in 1989, that former Cincinnati Reds superstar Pete Rose was banned from baseball for life for having bet on Reds games during his time as a player and manager for the team from 1985 to 1987. How quaint. You've come a long way, MLB! Just last year, baseball commissioner Rob Manfred primly insisted that he had no intention of reversing the ban on Rose (which ban also precludes him from being named to the Hall of Fame, despite a major league record that otherwise would make him a shoo-in for the honor). With apparently no sense of irony, Manfred intoned that MLB's extensive commercial dealings with gambling companies had "no impact" on the fate of the exiled Rose. Of course not. Those commercial dealings pay for many administrative salaries at Baseball, Inc. $80 billion in annual revenue goes a long way.

To be perfectly clear, we have no problem whatsoever with the existence of legalized gambling, in sports or otherwise. People should be free to choose their modes of entertainment, and for some people that means punting on the outcomes of athletic contests. There are risks and consequences, just like there are for plenty of other choices one can make in life, and individuals need to take responsibility for their

actions. That is all well and good. Freedom and responsibility are two sides of the same coin. You can learn about how the law of small numbers makes betting a loser's game where the house always wins – or you can ignore that inevitable fact and be in the moment with the adrenaline rush. Freedom of choice.

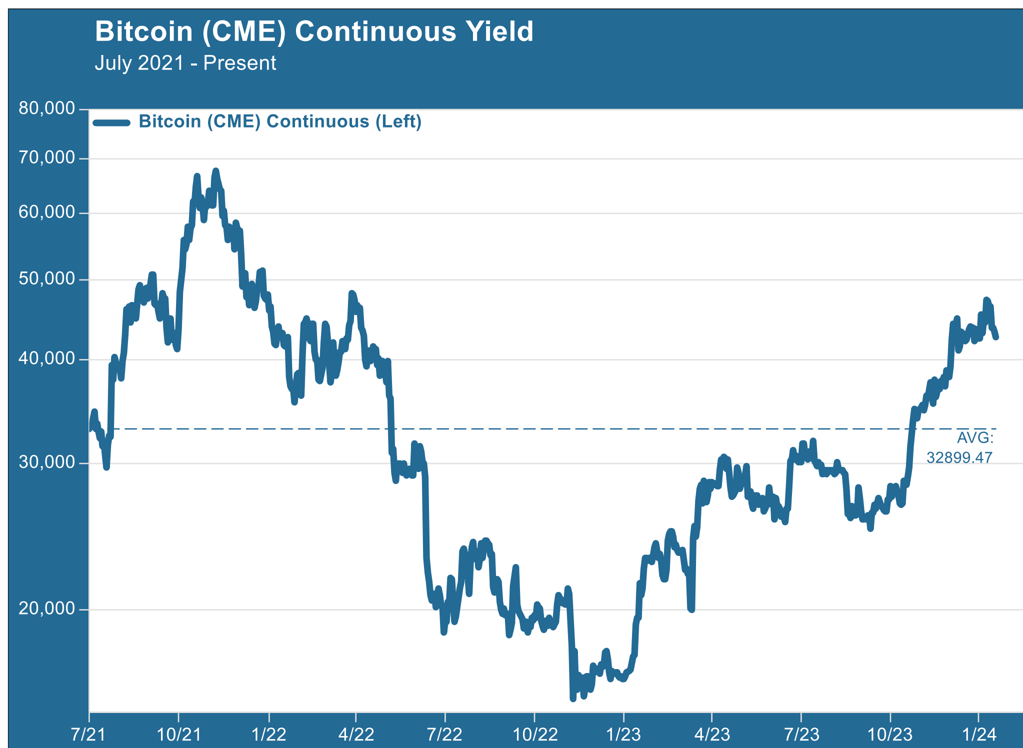
But what we have noticed in recent years is that speculation for its own sake has become a central feature of economic life, in a way that spills out of the localized corners of the economy where it once stayed put. We chose to open with a spotlight on the sports betting industry, because that is a very clear and present example of what we call the professionalization of speculation. But it also exists in a very major way in a segment of the economy much closer to our own daily lives: the investment industry. We are concerned that the mainstreaming of speculation for speculation's sake, as it applies to the market for investment assets and portfolio management, is dangerous to the financial health of the individuals, families and businesses who have long-term financial goals. Perhaps nowhere today is our concern higher than in the mainstreaming of cryptocurrencies.

For Crime or for Speculation

Our clients and long-time readers of our regular market commentaries know that we have never been fans of cryptocurrencies. Our distaste for this asset class is not ideological or based on some abstract moralistic principle; it is simply that we have studied the value proposition over a number of years and found that it comes up wanting. In our way of thinking, an asset should demonstrate that it serves a revenue-generating purpose. A share of common stock gives you a vote and a slice of an enterprise's earned cash flow. A bond is a legal obligation to pay a fixed stream of interest and principal over a defined period. Energy and industrial commodities represent resources consumed for specific activities. Currencies are stores of value, means of exchange or units of accounting, backed by the full faith and credit of the issuing government.

Cryptocurrencies are none of those things. The only thing one can say about a mainstream cryptocurrency like bitcoin or ethereum is that they perform the function of a currency in a clunkier, more volatile and less fungible way than national currencies, and are backed by the full faith and credit of nobody. Who would want to use an asset this volatile as a unit of accounting or a means of exchange?

Chart #1: Bitcoin Price Movements, July 2021 - Present



Source: MVF Research, FactSet

The only useful function cryptocurrencies have been able to demonstrate to date is to facilitate black market and criminal activity, where their decentralized mechanics help bad-faith actors eschew legal scrutiny. Until that changes, we will continue to avoid inclusion of cryptocurrency exposures in the portfolios with long-term financial objectives entrusted to our stewardship.

But there must be something else to crypto, right? Otherwise, why would billions of dollars' worth of bitcoin and its ilk be trading hands every day? Why would the fact that the two largest cryptocurrency exchanges in the world – FTX and Binance – both have gone bust not put a permanent black mark on this asset class? Not to mention the sordid tale of excessive fraud involving FTX's erstwhile head Sam Bankman-Fried, who is likely to spend the rest of his natural life behind bars? Why did the value of bitcoin soar by 166 percent last year, while all these peccadilloes in the crypto industry were coming to light?

The answer to these questions is simple, and it is powered by the same motivation that has driven sports betting into the core business plans of Sports Media, Inc. – speculation for its own sake. The *Economist* magazine – not a publication given to splashy headlines for the sake of clicks – in a recent article likened cryptocurrencies to cockroaches. As in: something that is distasteful for humans to behold, yet able to survive and propagate no matter what happens. It's a good analogy. Bitcoin and other cryptocurrencies rose by as much as they did last year for no reason that had anything to do with a fundamental change in the asset's properties, but because of speculation and concerted efforts by crypto promoters to generate and sustain hype among the investing public. The mainstream investment organizations touting the "benefits" of crypto, from Silicon Valley behemoths like a16z to the ARK complex of investment vehicles operated by crypto über-enthusiast Cathie Wood to financial news channels eager to look as much as possible like sports channels – these mouthpieces perform essentially the same function as those NFL announcers at playoff games trying to get the sportswatching public excited about whether a former New England Patriots wide receiver is going to kick a field goal during the halftime lollapalooza of the Super Bowl.

Speculation is big business, in sports and in the investing world. It takes an increasing amount of discipline to resist the siren song, especially when the efforts to promote it are so successful. Consider that one of the big news stories in the early weeks of 2024 is the apparent blessing by the Securities and Exchange Commission of bitcoin. The SEC – the federal agency responsible for regulating the securities industry – gave its approval for an ETF providing direct exposure to bitcoin (making crypto trading as easy for the average Joe and Jane as signing up for FanDuel…but we digress). The new ETFs, managed by the same Wall Street behemoths that manage other mainstream asset classes in the giant ETF market, debuted on the New York Stock Exchange, the Nasdaq and the CBOE Global Markets exchange, and racked up $4.37 billion in trading on the first day alone. That's big business, and it pays for lots of administrative salaries.

It was actually kind of interesting to see the reaction to the SEC's announcement and the bitcoin ETF launch by those who style themselves as "true believers." Remember, before cryptocurrencies hit the mainstream radar, they were very much an offbeat backwater peopled by an eclectic collection of personalities ranging from rabid anti-state libertarians to self-styled "cypherpunk" techies with a penchant for privacy and a distaste for centralized networks. The origin story of bitcoin is a paper produced in 2008 by someone going under the name Satoshi Nakamoto, whose actual identity to this day remains a mystery. This kind of gleeful anti-establishment sticking it to the man is just about the polar opposite of institutional Wall Street. In a recent *Financial Times* article a crypto founder in the UK named Xavier Nukajam was quoted as saying "If you create this alternative [to the big institutions] and have to submit to what already exists…you've failed." Well, it wouldn't be the first time that the counterculture has gone corporate. After all, the Rolling Stones teamed up with Bill Gates and Microsoft in the 1990s to launch Windows 95 (Start Me Up!).

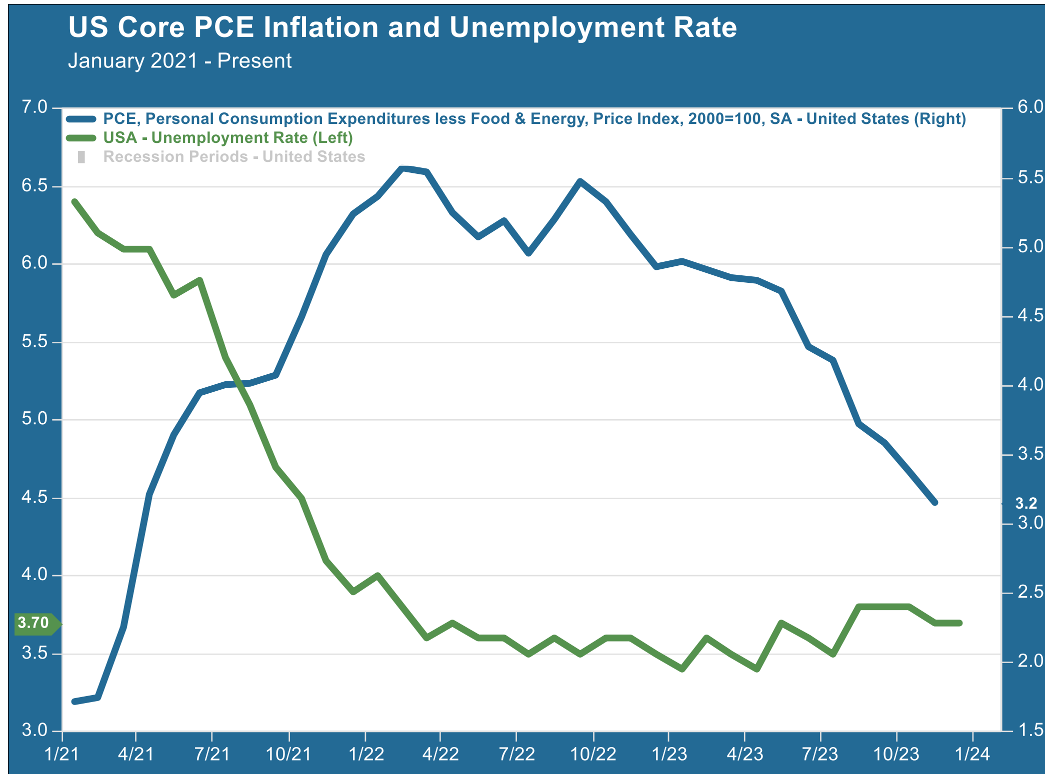
But then again, the Rolling Stones at least had good tunes. Bitcoin still has no viable use case outside the murky world of the dark Internet, black market dealings and ransom payments.

B. The Fed Succeeds, and the Vibes Don't Care

Recipe for a Soft Landing

The Fed has a dual mandate: to promote stable prices and full employment. By that yardstick, the Fed has had a very successful experience since beginning its monetary tightening program to fight inflation two years ago. Here's evidence of that success.

Chart #2: US Inflation and Unemployment Rate, 2021-24



Source: US Bureau of Labor Statistics, MVF Research, FactSet

One year ago, we along with the vast majority of mainstream economists were predicting that the US economy would experience a cyclical recession. Not a deep one, not a cataclysm like 2008 or a manufactured one like 2020, but a regular old end-of-the-business-cycle recession. After all, interest rates had gone up by more than at any time since the draconian "Volcker shocks" of the late 1970s and early 1980s. Household savings were dwindling down to their lowest levels in decades as those extra cushions from pandemic-era stimulus payments wore off. Corporate management teams were warning of trouble ahead: "uncertain macro conditions" was one of the most frequently-heard phrases in quarterly earnings calls. Credit conditions would tighten on already-indebted households.

As those charts above suggest, the Great Recession of 2023 never happened. What did happen was that inflation came down steadily over the course of the year, and the jobs market stayed strong. The Fed achieved goal one of its mandate – promote stable prices – while not causing harm to that second goal of keeping employment at healthy levels. The economy kept growing. With GDP growth numbers for the fourth quarter not yet in, economists are predicting that the US economy will have grown by around 2.5 percent for the full year. In the third quarter, the annualized growth rate was 4.9 percent, well above historical norms. Yes – inflation was still higher than it had been throughout the 2010s, but it was well below the peak of nine percent the Consumer Price Index touched in 2022. The 2023 holiday season was robust,

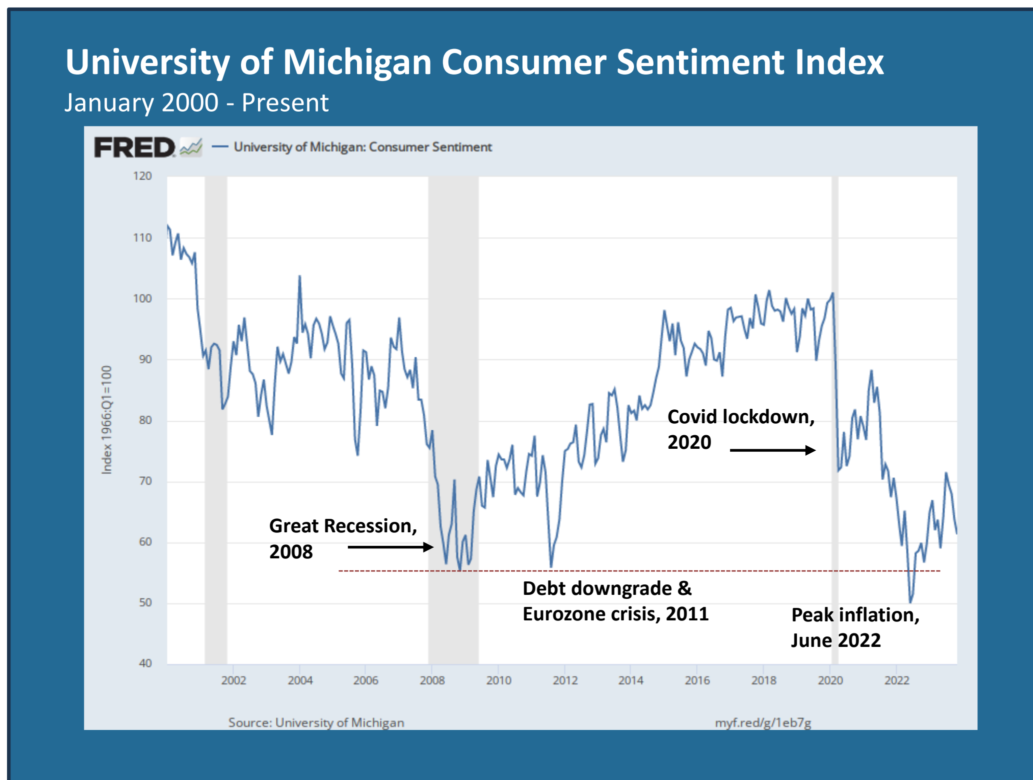
with no slowdown in consumer spending despite lower levels of household savings and higher debt burdens.

All of this should be good news. The fabled "soft landing" of monetary tightening without a recession happens only rarely; yet, that is now the most likely scenario for the economy. In the last 2023 policy meeting for the Federal Open Market Committee, in December, Fed officials expressed enough confidence in the downward direction of inflation to put the possibility of 2024 rate cuts into their Summary Economic Projections materials that accompanied the meeting. Those rate cuts may or may not happen – they are just guesses by FOMC members at this point and do not represent official policy. But they reflect a level of confidence in the economy by the people closest to its beating pulse.

Not Impressed

Good news? Tell that to the citizenry of this country. In recent polls, the number of Americans saying that they have confidence in the economy routinely comes in lower than 20 percent. Some polls reflect a widespread and completely wrong belief that we are actually in a recession today. One widely followed index of consumer sentiment published monthly by the University of Michigan shows that consumers in recent months have been about as negative on the state of things as they were during the Great Recession in 2008. Recall that during that cataclysm the unemployment rate soared to ten percent, millions of homeowners lost their homes due to foreclosure and the S&P 500 lost more than 50 percent of its value from peak to trough. And things today are worse than that?

Chart #3: Michigan Consumer Sentiment Index, 2000-24



Source: University of Michigan, Federal Reserve Bank of St. Louis, MVF Research

The consistently negative views expressed by ordinary citizens on the economy have been a puzzle to economists and other observers. One easy go-to answer, of course, has been the bite of inflation. It's important to remember how long it has been since Americans experienced a level of inflation commensurate with thar of the past two years. Most people in the workforce today did not experience the inflation of the 1970s in a direct way, if at all. And the inflation of the last two years really has hit people where they live – in the price of shelter, groceries and gas. Add to that the perennial (and existing well in

advance of 2022) skyrocketing costs of healthcare and education, and then throw in for good measure one of the toughest environments ever for the buying a new home, and the popular discontent with the economy's progress becomes more understandable.

Understandable, maybe. But aren't the facts still the facts? Here's one fact: the average growth rate for hourly wages, according to the Bureau of Labor Statistics, has outpaced the rate of inflation for the past year. In other words – yes, the prices of eggs and cereal are higher today than they were four years ago, but so is the amount of income in your monthly paycheck. Plus, you (more than likely) still have a job, or maybe even you have taken advantage of the consistently hot jobs market by trading up to a better-paid position. You're still dining out at restaurants every now and then and taking family trips to Disney World, according to the data. This is not, and has not been, a repeat of the Great Recession or anything close to it. But the facts don't seem to make much headway into the collective consciousness.

Vibes and FOMO

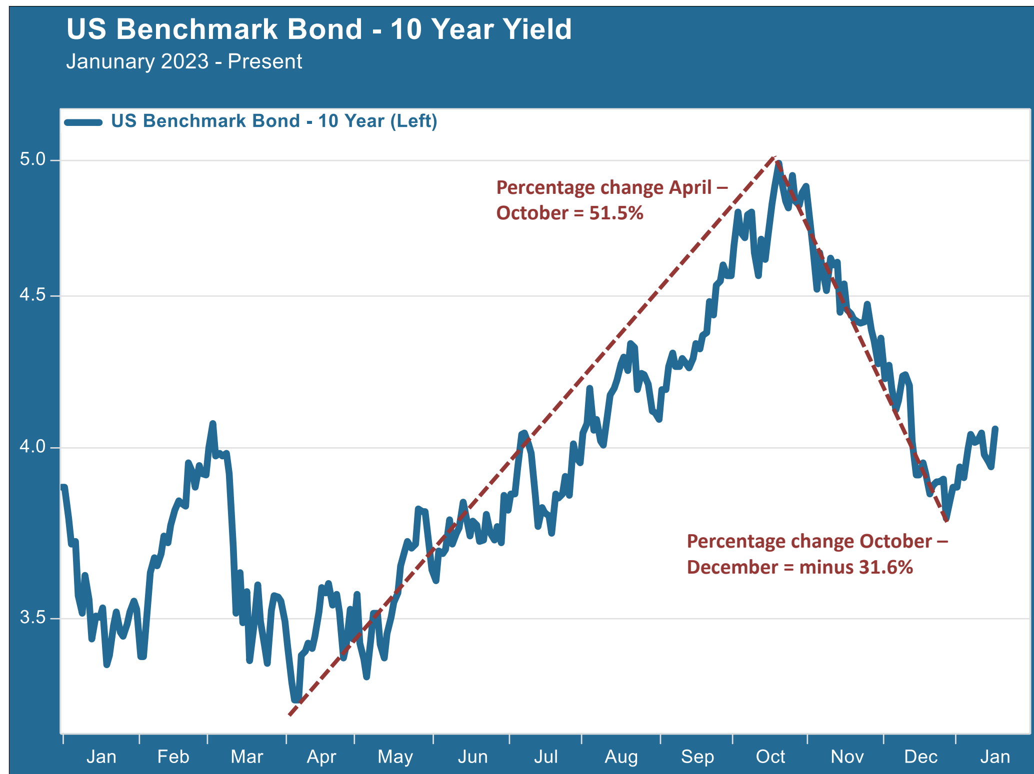
Even five years ago, it would have been odd to hear credentialed economists with advanced degrees from MIT and Stanford using the term "vibes" in their analysis of the economy. But the "vibes economy" has entered the lexicon as a catch-all term, a non-explanation for why sentiment about the economy is as weak as it is. What exactly is the vibes economy? It's supposed to be a sentiment based on feeling, unburdened by a consideration of the facts. Why has this become a thing? Social media, say some critics – look at all the people getting all their news from Instagram and YouTube and (especially) TikTok, where doomscrolling about the economy thrives. Others say it's political polarization – that no matter what the economy is doing, half the country is going to say that it's terrible because their political party is not in charge. Another explanation is that the discontent is not narrowly focused on the economy itself, but rather proceeds from all the many troubles in the world these days –wars, climate change, post-traumatic stress from the Covid lockdowns, the threat of artificial intelligence turning out to be as terrible as the worst case scenarios imagine.

We are not necessarily convinced by any of those arguments, though we see the logic behind them. But while we cannot lay claim to an overriding master theory for the vibes economy, we have in recent times had a front-row seat for the spectacle that came before it. Before the vibes economy, there was the FOMO stock market – a phenomenon based on the same sentiment of "something out there" that had nothing to do with facts, or free cash flow, or net debt to total equity or some other quaint valuation mechanism that equity analysts have used since time immemorial to ply their trade. Remember GameStop, the company with a 1980s-era business plan for video games that became for a time the hottest stock of 2021? FOMO (fear of missing out) became the go-to metric for summing up the day's market activity on CNBC. And what was FOMO if not vibes – an entirely emotion-driven way of looking at the world and making decisions, based more on takeaways from social interactions than on hard data (much of the FOMO stock market action, you will recall, took place on social media forums like Reddit).

When Vibes Came for the Bond Market

The FOMO stock market of 2021, the vibes economy of 2023 and…what can we say about the bond market? The US Treasury market is supposed to be home to the safest securities anywhere in the world, with yields called the "risk free rate" by investment professionals, the foundational edifice upon which they build their cost of capital assumptions to value other assets. Last year, though, the Treasury market was anything but boring – and also anything but rational.

Chart #4: US 10-Year Treasury Yield, January 2023 – Present



Source: MVF Research, FactSet

On several occasions last year, the percentage change in the 10-year Treasury yield was of a far greater magnitude than the price percentage change in the S&P 500. The chart above shows a change of 52 percent in the yield from a low in April, in the wake of fears about a banking crisis following the collapse of Silicon Valley Bank and a handful of other financial institutions, to a high point in October when it seemed the Fed's persistently grim "higher for longer" mantra about interest rates had sunk in. Then, in a reversal driven initially by some technical resistance algorithms in trading models and then juiced up by a confident read on inflation by the Fed in the December FOMC meeting, the yield plunged more than 31 percent to a post-FOMC low. Along the way in both these peak-trough events was plenty of interim volatility.

These wild fluctuations would not be hard to explain if they were accompanied by actual data that forced investors to contemplate a reset. But the only real surprise event during this period was the near-crisis in the banking sector – and the Fed was very quick to deny any intention of cutting rates once it became clear that the problems were isolated to a small number of banks.

The bond market, it seems, just kept making up its own narrative about interest rate cuts. After every FOMC meeting in which Jay Powell did not back down from insisting that rates were going to stay elevated, yields would spike up for a brief period, then fall back down as traders once again priced in those illusory rate cuts. This happened even in December last year, when the Fed gave a hint that it might be in a position to cut rates given the favorable pace of decline in inflation. In that December meeting the Fed posited the possibility of three rate cuts in 2024 for a total of 0.75 percent. The market immediately doubled down on that and priced 1.5 percent of decline in the Fed funds rate, in other words six rate cuts versus the Fed's three.

In an important sense, the manic swings in US Treasury yields share a piece with the silliness of GameStop and its ilk three years ago. Every time yields went back up, the chatter – on social media, among the talking heads on CNBC and Bloomberg News, at investment conferences – would pronounce this as the "absolute last time" to lock in a yield at levels that had not been seen in decades. The Vibes/FOMO machine would

swing into action, sending prices up and yields down. Reality would eventually seep back into the mix and rates would jump back up, over and over again. And once again it is worth emphasizing that in 2023 this was all happening – not in some off the wall small cap stock but in the world's safest asset.

C. Defining the Post-Post-Industrial Age

The Industrial Age

You may have thought it was a typo when you read "post-post-industrial age" in the headline title for this Section I of our report. It was not a typo. We see the global economy as currently being in an important transition stage, but one where it is still unclear what is going to come next. We believe that games and vibes – the phenomena we described above – are a significant part of what is going on in this transition, but we do not yet have a comprehensive word for it. So let's unpack the phrase "post-post-industrial." For a beginning, we travel back to the late nineteenth century, starting around 1870. This was the period of the Second Industrial Revolution, a period which consolidated the transition of the US economy from the Jeffersonian ideal of yeoman farmers and their homesteads as the basic unit off economic activity to the urban factory. The Industrial Age for all intents and purposes began here. As the inventions of electricity and the internal combustion engine became commercially viable at scale, the US economy accelerated from being one among many "emerging markets" of the day to the global market's largest manufacturer by the beginning of the twentieth century. Following the First World War, which ravaged the advanced economies of Europe, the US was not only the largest economy but the dominant one (though, politically, the country was not ready to accept the responsibility that came with this station until a quarter-century later, after the Second World War).

Manufacturing physical goods was, of course, the heart and soul of the Industrial Age, and it continued through the first two decades after the Second World War. The US economy was dominated by large industrial concerns that supplied a growing domestic consumer market with increasing levels of discretionary income, and exported to rebuilding nations eager to acquire best-in-class products (and, in many cases, reverse-engineer them to build what would in time become their own world-beating products in Japan, Germany and elsewhere). As the country grew wealthier, though, with the rise of a middle class of avid consumers, manufacturing's share of the economy declined and that of non-manufacturing services grew. Services from restaurant franchises to diverse retail outlets blossomed in the suburbs to which Americans moved in droves in the 1950s and 1960s. The old economic chestnut of Say's Law appeared to be true: supply creates its own demand.

The Post-Industrial (Information) Age

In the 1970s some of that demand gravitated towards the early offerings of devices powered by a relatively new technology – the semiconductor chip. Businesses were the first big market for desktop computers, mostly connected to each other through a mainframe network, but by the end of the decade, the personal computer was finding its way into homes as well. The clunky boxes of 1970s-era information systems, though, provided only a hint as to the explosion that took place in the succeeding decades. During this time the economy transformed, both in the US and globally, as the regulated, managed trade environment of the postwar era's first three decades gave way to the globalization era. And what was globalization, after all? It was the unfettered movement of capital and information around the world, powered by increasingly capacious memory and logic chips, and by the rise of financial services as the economy's most important sector. Now, calling this the "post-industrial" age does not mean, of course, that industrial activity ceased to exist. But manufacturing itself increasingly relied on advanced information systems to improve productivity, from the computer-aided design (CAD) systems of the 1990s to the intricate, virtually connected global supply chains that flourished in the early 2000s. The providers of information services to support manufacturing, in effect, took up a larger share of the economy than the industrial firms they were supporting.

The Information Age was about putting the vast amount of now-accessible information to work for enhanced business productivity. This reached a peak in the 1990s when productivity did turn up after

two decades of decline. But it was short-lived. Productivity began to decline again in the 2000s, with the 2010s being the worst decade for productivity growth since the 1950s.

At this point something important happened: the Information Age converged sharply with the market for popular entertainment. For the most part, up to the very late 1990s, these two areas of the American economy had progressed in parallel without really meeting. Radio, television, phonographs, cassette players (table-top and then portable) and the first generation of video games followed one vector while, on another, giant mainframes yielded to workplace desktop computers, home PCs and laptops. With the development of the commercial Internet in the mid-1990s (built on a technology that had been around, unbeknownst to the public, since the late 1960s), these two lanes converged. A small number of companies found themselves in the vortex of that convergence and would go on to become the behemoths of the early twenty-first century: Apple, Microsoft, Amazon and Google, followed in short order by others such as Netflix and Facebook. These companies would end up comprising an outsize share of the total market value of the US equity market.

And Just Like That, the Post-Post-Industrial Age

So here we are today, in the economic age of which the signature event seems to have been the grand convergence of exponentially powerful information processing capabilities with the equally powerful American predilection towards entertainment. As we said earlier, we don't know what this age is going to eventually be called. Here is what we do know. We know that productivity is substantially lower in this period than it was in the heyday of the Industrial Age and the Information Age. From 1950 to 1969 the average rate of productivity growth was 2.74 percent. During the peak years of the Information Age, from 1990 to 2009, the commensurate rate of growth was 2.51 percent. The average growth rate from 2010 to 2023, on the other hand, is a paltry 1.30 percent.

Why do we harp on the metric of productivity so much? Mostly because, as population growth wanes and the composition of the population shifts away from the prime-age labor force towards a much older demographic, productivity is the only means to economic growth. And what we have seen so far in the age of streaming, social media, delivery apps, games and vibes doesn't seem to offer much of a recipe for meaningful growth. Nor does all that speculation we were talking about earlier – making bets, whether on the outcome of a field goal or the future price of Dogecoin, doesn't add economic value – it just shifts existing money from one place to another.

One school of thought out there, perhaps led most visibly by the economic historian and Northwestern University professor Robert Gordon, believes that productivity's best days are permanently behind us. Gordon's core argument is that there was one big productivity boost from electricity and the internal combustion engine in the nineteenth century, a smaller bump from computer-aided business process improvement in the 1990s, and nothing else since then to hang your hat on for productivity-based growth.

But maybe that school of thought is dead wrong. One of the biggest developments of 2023 was the arrival of generative artificial intelligence into the popular consciousness. Maybe it's too soon to write off productivity given the stunning range of capabilities genAI has already demonstrated, with more almost certainly to follow. 2024 may be an important year in this regard. After the hype of ChatGPT, Dall-E and their ilk a year ago ignited the genAI mania, the year ahead is likely to be a more sober appraisal of what the technology can really do for businesses. Show us your use cases, the market may say.

Perhaps AI will come to look more like Enterprise Resource Planning – the huge, resource-consuming IT projects so popular a decade or more ago that always go over budget and rarely deliver on their imagined capabilities – and less like a radically transformative paradigm shift with a broad reach across industry sectors and a deep reach from multinational behemoths to small and mid-size businesses. Perhaps it will remain the exclusive domain of the Big Tech names that also dominated the rise of games, social media, streaming and the like, without diffusing out into the world of middle market and small businesses. Maybe AI will be just more vibes, without compelling use cases evidenced by hard data. And maybe, through such already-visible threats as politically motivated deep-fakes that go viral, it will pour more fuel on an already

combustible geopolitical environment where the norms of democratic processes around the world are vulnerable to the currents of populism, ethno-nationalism and authoritarianism.

This is what uncertainty means. Uncertainty – risk – has both upside and downside potential in the way we as investment professionals use the word. Which means that we have to be equally ready to take advantage of the opportunities, and to guard against the threats. Bring it on, 2024.

II. 2024 Investment Thesis

A. Executive Summary

The biggest economic story of 2023 was about something that didn't happen. There was no recession in the United States or, for that matter, in the global economy at large. Against the predictions of most mainstream economists (ourselves included), the American consumer put the pedal to the metal and spent, spent, spent. The jobs kept coming, month after month. Gross Domestic Product rose in the third quarter by an annualized rate of 4.9 percent, a pace way above historical trends. All this happened while interest rates kept going up and consumer prices kept going down. In the early days of 2024, it looks increasingly likely that the Fed's monetary tightening program, begun nearly two years ago, will result in the often hoped-for but seldom achieved "soft landing."

The economy's better than expected situation could prove to be a tailwind for risk assets this year; however, there are plenty of potential challenges that could trip up performance as well. Businesses will have to deal with the twin obstacles of a likely slowing pace of demand, and of a loss of pricing power as inflation continues to recede. There is also the chance that China's ongoing economic troubles reach a critical point this year. Finally, the geopolitical landscape looks to be anything but ordinary. More than two billion people in more than seventy countries are likely to cast ballots in nationwide elections this year, the most ever. Some of these will be highly consequential, and arguably none more so than our own presidential contest this November. Meanwhile, destructive wars rage on in Ukraine and the Middle East, and Taiwan is never far from the mix when the question of the next major flashpoint comes up. In short, there are reasons to be optimistic this year, and there are also reasons to be cautious.

Here is how we see the year progressing (as always, please remember that these views are subject to change, based on imperfect and incomplete information, and may not correspond to actual outcomes). The economy will continue to grow, although at a slower rate than in 2023. In our opinion the two big macroeconomic stories of the year will be (a) the ongoing strength in the labor market, with the unemployment rate not likely to rise much above four percent; and (b) a continued decrease in consumer prices with the core Consumer Price Index falling below three percent by the end of the year. If this happens, it will constitute a textbook soft landing.

A soft landing, though preferable to a recession, is still what it says: soft, as in, not a period of robust growth. That will make for challenging conditions for businesses. A combination of softer demand and lower inflation will make it more difficult for businesses to achieve strong top line sales growth. With limited room for top line upside, these enterprises will need to find ways to achieve operating efficiencies to shore up their profit margins.

This spotlight on ways to improve profitability in the absence of strong sales will center around that other big story of 2023: artificial intelligence. Last year we witnessed an abject fascination by investors with the emergence of generative AI, popularized by accessible platforms like ChatGPT. This year, we expect the market will be a bit more discriminating about the hype, and more interested in the practical question of what generative AI can do for businesses as they attempt to grow profits in a slowing economy. This brings us to an analysis of what the equity market may have in store for us this year.

Equities: Proof of Concept for AI

Equities in 2023 largely boiled down to seven words: Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. These were the "Magnificent Seven" – the mega-cap tech stocks that for much of the year accounted for the entirety of the S&P 500's price appreciation. The common thread between all these companies was artificial intelligence. Early last year, AI burst into the public imagination in a way that it had not previously, largely due to the arrival of generative AI platforms like ChatGPT and Dall-E with their user-friendly applications for the generation of textual and visual content. Investors quickly latched onto the Magnificent Seven as they all had features of GenAI at the core of their value propositions, with Microsoft and Nvidia perhaps the most prominent beneficiaries due to the former's early embrace of ChatGPT and Dall-E progenitor OpenAI (not a publicly tradable company) and the latter's dominant position as the supplier of the graphic processing units that enable GenAI applications to run.

We expect 2024 will be a different environment for AI, one less about hype and more about proof of concept. Beyond the novelty of AI-generated college essays or Impressionist paintings, the focus will shift to what businesses can do with GenAI to improve efficiencies and shore up profits. This is likely to be a particularly important issue this year as companies face a macro environment of cooling demand; operating efficiencies could potentially offset slower top line sales growth. But first, these businesses will have to show conclusively that these potential efficiencies exist.

Outside of large cap US equities, we do not see a compelling set of reasons to aggressively extend positioning. Our reasons for staying underweight in US small caps, non-US developed and emerging markets are structural, and nothing of recent note has changed our thinking.

Fixed Income: Less Drama, Please

If it took seven words to describe equity markets in 2023 (see above), it took just one word to encapsulate the bond market: Drama! Normally the most boring place in a diversified portfolio, offering safety and perhaps a predictable stream of income, the bond market was all over the place last year. The yield on the 10-year Treasury note, which plays a critically important role in investment markets as the "risk-free rate," went up and down by greater magnitudes of percentage change than equities throughout much of the year. What made the bond market's gyrations particularly puzzling was that the Fed was giving crystal-clear guidance throughout the year about its intentions with regard to interest rates. "Higher for longer" was the message reprised over and over again. In March, when an abrupt spate of insolvencies at several prominent banking institutions briefly raised fears of a full-scale banking crisis, the Fed continued to insist that it wasn't done with raising rates. Yet the bond market immediately priced in a spate of rate cuts that were never going to happen. The same thing happened on two or three other occasions – traders furiously bought bonds and drove yields lower, the Fed came out and said "higher for longer" and yields spiked back up.

The central bank appears to be at the end of its monetary tightening program, and that could portend a somewhat calmer year ahead in fixed income. The short end of the yield curve in particular should not contain too many surprises. The Fed may cut rates a couple times, but then again it may not, depending on whether the economy is running hotter or colder than what is now the mainstream view of a middle-of-the-road soft landing. In the middle of the yield curve, assuming we manage to avoid a recession, the persistent inversion between 2-year and 10-year maturities should revert to a normal upward-sloping curve at some point, but how and when that happens is still very much up in the air. We think a wide range of yields from around three percent to five percent is appropriate for maturities within the 2-10 year band, and that should give investors a chance to lock in positive purchasing power, potentially for a number of years to come.

Tune Out the Noise

We always tell our clients that we are not in possession of a crystal ball any more than anyone else is. We do foresee a great deal of uncertainty around elections, particularly as our nation's attention starts to fixate on the upcoming election during the primaries this spring and when the parties hold their conventions

this summer. Markets may experience short-term fluctuations up or down during this period and in the immediate aftermath of November 5, but we believe it would be foolish for one to think that the timing, magnitude or direction of any such move could be capitalized on for tactical portfolio gains. The aftermath of the 2016 election should be a reminder to anyone who thinks they can divine that “if X happens, Y will surely follow.” Remember the famous “infrastructure/reflation” trade of late 2016 and early 2017 and its predictably sad demise? Buyer beware.

As has been the case in recent years, our asset allocation weights in 2024 will be divided between fixed income and equity asset classes for the most part representing liquid, relatively high-quality names (governments, agencies and investment grade corporates on the fixed income side, US large cap stocks for equity allocations). We do not see a compelling reason to venture into more exotic terrain as the year unfolds. Our approach to delivering long-term value for our clients is based on equities for growth, fixed income for safety, and keeping security selection decisions as simple as possible within the context of prudent diversification (Occam’s Razor – don’t make things any more complex than necessary to arrive at an informed conclusion). Our 2024 allocations, as noted elsewhere throughout this report, will reflect an outlook based on a moderately positive environment for equities and more stable conditions for bonds than was the case in the past two years, implying incremental repositioning of fixed income away from short-term floating rate to intermediate fixed-coupon issues. As for all the things out there known and unknown that could trip up our assumptions, we believe we will be in a better position to countenance them if we refrain from making aggressive bets too far in one direction or another. We have little doubt that there will be surprises in store.

B. State of the World

i. The China Question

We previously called this section of our annual report the “State of the Economy” by talking about some key macro statistics in the US economy. This year we are changing the title to “State of the World.” The US economy is an important part of that, of course, but so is much else that is happening outside our national borders, and that is not limited to trends in macroeconomic data points. We start with China, which could be a major variable this year both in economic and in geopolitical terms.

Let’s start with the economic situation. China, as we all remember, was the first country to go into lockdown mode over Covid-19 in 2020, for the obvious reason that the virus originated there. It also seemed to move past the crisis before anywhere else in the world, and drew some admiration from outside the country for its draconian (many said necessary) actions to keep people inside their homes, with severe punitive consequences for noncompliance. But China went back into lockdown in 2022, refusing to budge from the official policy of “zero Covid” even while something resembling normalcy was resuming nearly everywhere else. Finally, Beijing buckled to growing domestic pressures and re-opened the economy late that year. A presumed China rebound was a big theme among observers as 2023 got underway.

That rebound did not happen, for reasons that were not altogether surprising. Throughout its spectacular growth cycle in the twenty-first century, China’s core economic engine was property and infrastructure investment. Much of that investment, especially early on in the growth cycle, was useful and created a large number of hypermodern urban areas connected by an advanced high speed rail network that by comparison makes the US Amtrak network resemble a ramshackle horse-and-buggy operation. But at least from the middle of the 2010s, the incremental benefits of new investment peaked and started to decline. The government’s long-stated intention to “rebalance” China away from property and infrastructure to a more consumer-oriented economy, after several fits and starts, never really played out.

The boom times for property and infrastructure created their own excesses, and these became painfully apparent in 2021 when a crushing debt load forced one of China’s major property developers, Evergrande, to for all intents and purposes fail to stay solvent (in a long and at times comically drawn out attempt to maintain the façade of technical solvency, the company would not officially file for bankruptcy until August 2023). Other major property developers followed. All the while China’s rate of fixed investment, which

up until the mid-2010s grew consistently at double-digit year-on-year growth rates, dwindled down to the low single digits.

Chart #5: China Fixed Rate Investment, Last Twenty Years

Source: MVF Research, FactSet

As dire as the picture looks from the standpoint of property and infrastructure, which still accounts for around one-third of China's total GDP, it is probably far too early to pronounce the "Japanification" of the country as some economists have taken to doing – the comparison being the long, cold period of deflation, debt and unfavorable demographic changes that derailed Japan in the 1990s after its own "supercycle" growth period. China is a major player in many of the raw materials needed for green economy growth areas like electric vehicles. One could also argue that the very visible and heavy hand of Beijing in 2021 to rein in the consumer Internet sector will eventually bear strategic fruit as the country seeks leadership in more value-creating sectors like semiconductors, biotechnology and, yes, the green economy (compare this with the games, vibes and speculation for its own sake we talked about at length in the first section of this report). China's largest carmaker, BYD, surpassed Tesla as the world's largest producer of purely battery-powered cars in the final quarter of 2023, selling 526,000 EVs versus 484,000 for the much more widely-known (outside China) Tesla.

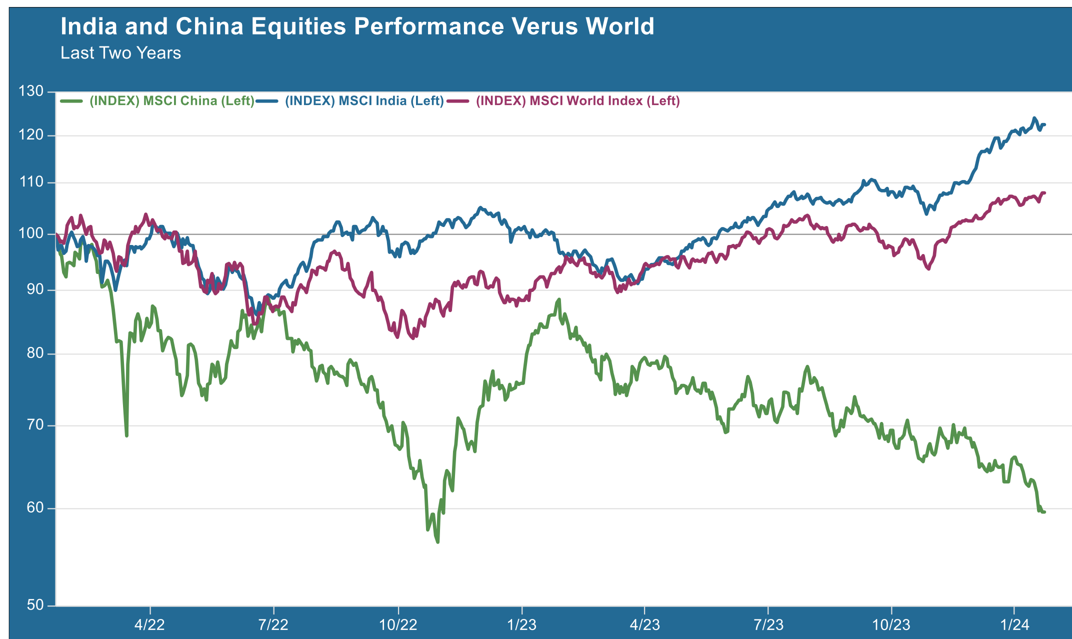
All this is happening, of course, as geopolitical relations between China and its main trading partners deteriorate. On January 13 Taiwan held presidential elections that were won by Lai Ching-te, who represents the Taiwanese political party most outspoken in its insistence on independence for the small island. Beijing was not amused (and had tried all kinds of interference tactics both high tech and low tech to produce a different outcome). Taiwan remains a geopolitical flashpoint that has yet to happen but that is very much on the minds of Western policymakers. The stakes are high for many reasons. China's uncertain economic direction and its increased bellicosity could prove to be a major global X-factor this year.

ii. India Ascendant

China is far from the only economic story in Asia worth paying attention to. As Beijing's troubles seem to increase, one very clear beneficiary to date is India. Among other areas of note, India's population is reckoned to have passed China's as the world's largest in the middle of last year (the official population numbers for 2023 have yet to be published). Also, the country's economy is growing at a rate that China has not seen for many years now. Against a backdrop of global growth predicted to slow from 2.6 percent in 2023 to 2.4 percent in 2024, according to the International Monetary Fund, India's economy is

projected to have grown by 6.3 percent for 2023, and it is expected to maintain an average growth rate of at least six percent for the remainder of the decade. Small wonder, perhaps, that India's rising fortunes are attracting the notice of portfolio capital that has been flowing out of China.

Chart #6: India and China Equity Market Performance, Last Two Years



Source: MVF Research, FactSet

Like China, though, India is also in the mix geopolitically. India's prime minister Narendra Modi is coming up on a decade in power this year, and his Bharatiya Janata Party (BJP) is set to dominate the outcome of national elections that will be held over several weeks in April this year. Modi has governed with a deft mix of economic reforms pleasing to the Davos class and an increasingly authoritarian Hindu nationalism at home (about 80 percent of the country is Hindu, and during Modi's rule things have become ever more difficult for India's Muslims, making up around 14 percent of the total population, as they have suffered mob attacks and mosque closings across the country).

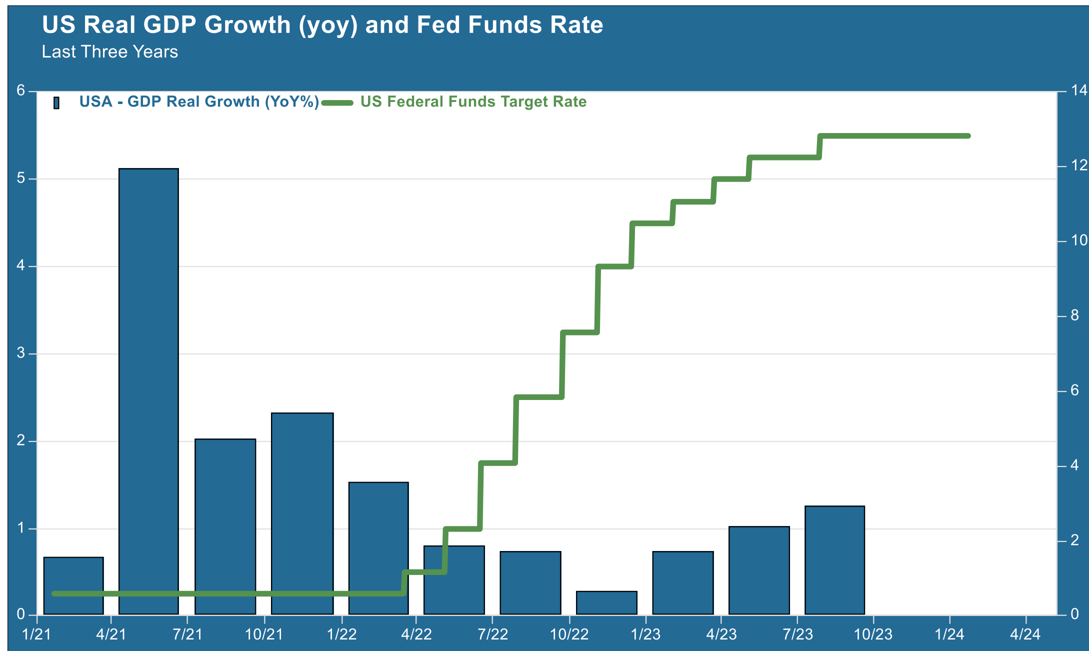
The economic reforms made by Modi's government to date are substantial, including a national sales tax that has made it far easier for international companies to do business in India. Many of these global multinationals are looking seriously at further direct investment in India as a way to offload some of the dependence of their global supply chains on China. To date, these reforms and the ethno-religious red meat Modi has been throwing to his base of Hindu BJP supporters have more or less comfortably coexisted. But they could also lead to more internal discontent and pushback against incipient authoritarianism, particularly given that much of India's industrial wealth is in the southern regions of the country, while the core of its Hindu base is mostly in the north. And the threat of internal political discontent spilling over into the economy is likely to be a global theme in this year of many significant elections.

iii. The Fed, the US Economy, and the Bond Traders

China and India matter greatly in the world, but here in the opening weeks of 2024 there is still no alternative to the plain fact that, for the global economy, the US matters most. How things play out this year depends in part on how much more fuel the domestic economy has left after the hotter-than-expected performance in 2023, and partly on what the Fed ultimately decides to do, and not to do, about interest rates. Perhaps the only part of this equation one can predict to a high-probability degree is that whatever happens, the bond market will cheerfully ignore the evidence and invent its own reality.

The Fed deserves credit for navigating the economy through the sharpest increase in interest rates since the early 1980s without – so far – bringing about a recession. In the period from 1979 to 1982 the US economy experienced two recessions, often lumped into one event as the "double-dip" recession. Unemployment soared as the Fed focused single-mindedly on killing off for once and all the double-digit inflation that had stubbornly persisted throughout the 1970s. This time around, growth has stayed positive and the unemployment rate has stayed within striking distance of its lowest levels since the late 1960s.

Chart #7: US Real GDP Growth and Fed Funds Rate, Last Three Years



Source: MVF Research, FactSet

So where do rates go from here? That is the big question that lacks a definitive answer. History suggests that one or two rate cuts this year would not be surprising. In past tightening cycles, the first rate cut typically occurred some four or five months after the peak for that cycle was reached. This is not always the case, though. After reaching a peak of 5.25 percent in August 2006, for example, the Fed funds rate stayed at this level for more than a year (in hindsight it probably should have eased off some prior to October 2007, when worsening conditions in the financial sector led to a full 0.5 percent Fed funds rate cut at that month's FOMC meeting).

We think the current FOMC median expectation (based on projections from last December's FOMC meeting) of three 0.25 percent cuts in 2024 is probably as much as anyone could expect unless conditions in the economy take a marked turn for the worse. A little easing of credit conditions would make sense if, as we believe, consumer demand cools off from last year's strong levels. This is similar to what the Fed did in 1995, after a year-long monetary tightening that took the Fed funds to a peak of six percent. Between July and December 1995 the Fed cut rates twice, then cut for a third time in early 1996 as economic growth cooled, but stayed positive. At that point the central bank was convinced that the economy was not about to tip into recession (it wasn't), and there were no more rate cuts until the fall of 1998 (and that rate cut was more about the one-off financial treat from the collapse of hedge fund Long Term Capital Management than about anything else).

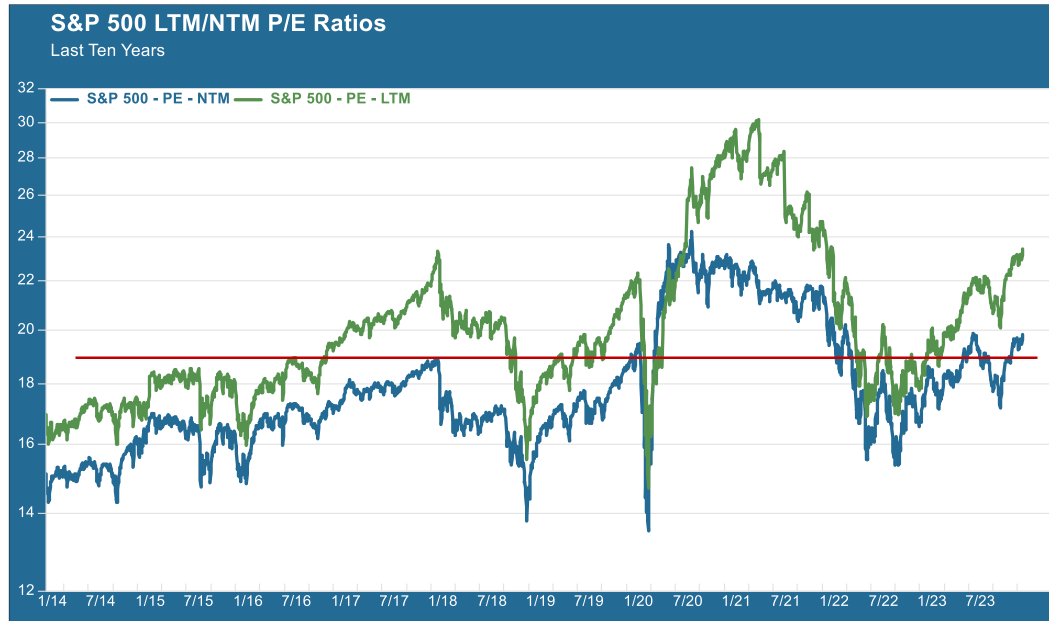
No two economic environments are the same, but if there is any past playbook that perhaps bears some resemblance to conditions today, one could do worse than refer to the series of decisions made between 1995-96: back off a bit from peak rates, assess, and hold. We still don't know with certainty, of course, that there will not be a recession this year. We also don't know for sure that inflation won't tick back up for some reason, and perhaps that reason will be either geopolitical pressure on commodity prices or another instance of global supply chain failures, both of which possibilities are beyond the Fed's ability to control.

If something dramatic happens to alter the current state of play, then maybe the bond traders get their due with their aggressive pricing in of six rate cuts. But in the absence of a whopper of a black swan, we think the six-cut narrative is fanciful and highly unlikely to come to pass. We very much hope that conditions will settle down in the bond market so that this asset category can go back to being the boring slice of the portfolio we have all come to know and love. But we are not going to count on it.

iv. The Sales and Earnings Challenge

Will valuations matter in 2024? We ask that question every year, and as much as it would be rational for the answer to be "yes" every year, we know from experience that it doesn't always turn out that way. Now, we have said this before and turned out to be wrong, but we will say it again: we think that 2024 is going to be a challenging year for corporate sales and earnings growth, and that has the potential to make already-high valuation multiples even higher. Which, in turn, could mean – all together now – that valuations will matter in 2024. Let's take a look first at current valuations, and then discuss the growth challenges this year. The valuation data will require some unpacking, because they got wildly distorted during the pandemic.

Chart #8: S&P 500 Last Twelve Months and Next Twelve Months P/E Ratios, Last Ten Years



Source: MVF Research, FactSet

In Chart 8 we have the ten-year trend for the trailing (last) twelve months (LTM) and forward (next) twelve months (NTM) price-to-earnings ratio. Our goal here is to determine whether valuations at their current levels are expensive, cheap or somewhere in between The problem with making that determination is that we have about two years' worth of data in 2020 and 2021 that probably should be excluded from our analysis. In 2020 the economy effectively shut down, and with that company sales and earnings fell sharply. At the same time, largely because of the Fed's aggressive liquidity moves, risk asset markets soared.

Here is a very specific example of a period in which valuations did not matter. Earnings went down, prices went up, and valuations soared close to the Icarus-like levels of the great Internet bubble of 2000. Compared to the 2020-21 P/E peaks, today's levels don't look particularly expensive. But compared to every other period in the last ten years, they do. The horizontal crimson line we drew in Chart 8 shows the pre-pandemic peak for the forward (NTM) P/E, which occurred in early 2018. The NTM P/E then was around 18.8x. The NTM P/E today is 19.9x. The trailing (LTM) P/E is also higher today than its pre-pandemic peak in 2018. So yes, valuations today are expensive. Not bubble-level expensive, but expensive nonetheless.

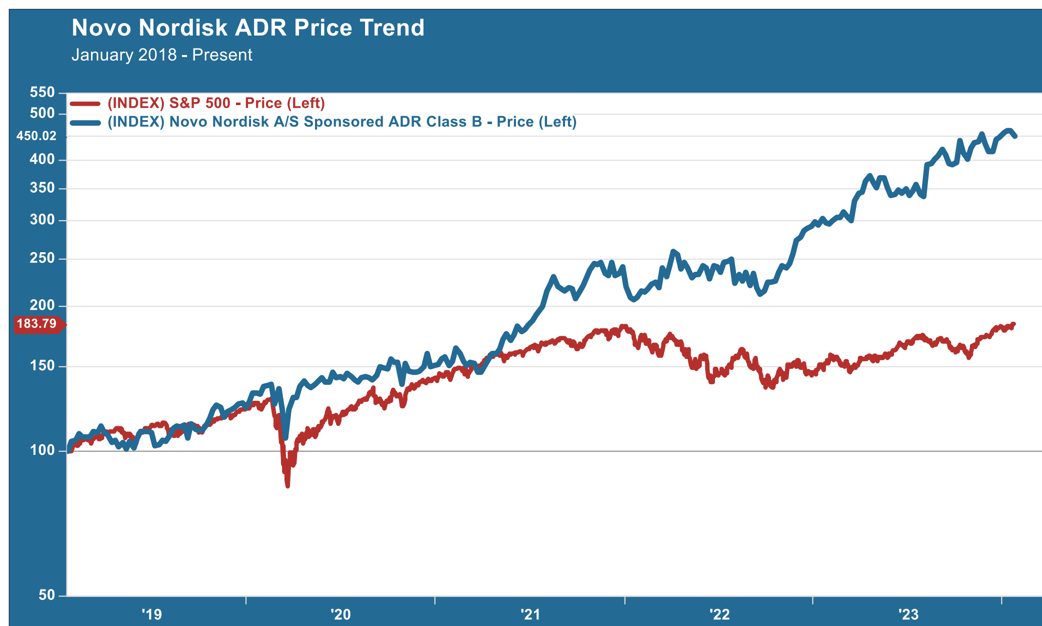
Now we get to the sales and earnings challenges. Let's start with the top line, sales. Businesses face two obstacles to sales growth at the same time: likely cooling demand, which will reduce unit sales, and loss of pricing power. Unit times price equals revenue, and both contributing variables will be under pressure. In earnings call after earnings call, we are hearing the phrase "uncertain macro conditions" as management teams reduce their forward guidance. At the same time, and perhaps ironically given that it is the thing we have all been hoping for these past two years, lower inflation will take away from the leeway businesses have to offset declining volumes with higher prices.

If the top line is under pressure, then companies have to discover operating efficiencies to protect their profit margins, as revenues flow down into operating income and after-tax net income. How are they going to achieve that? Well, as we have talked about elsewhere in this paper, the big innovation story in 2023 was generative artificial intelligence. In 2024, we think, analysts will look at genAI and put the question directly to management teams: What is genAI doing specifically for your ability to achieve operating efficiencies? In other words, the AI story this year will be less about general hype over its potential in the abstract, and more about proof of concept, demonstrated in practical use cases by companies adopting the technology. How that plays out has yet to be seen. It will matter, we think, because valuations will matter.

v. Obesity Drugs and the Perils of Healthcare Investing

Maybe we should have been less quick to switch the TV channel when those insipid ads for Ozempic came on a couple years ago: Oh-oh-oh, Ozempic! (Particularly annoying for those of us who were teenagers in the 1970s and had to put up with the original version of that song by that one-hit-wonder band Pilot when it came on the radio). Right from the get-go, those ads were touting the weight-loss benefits associated with this drug, the primary purpose of which was to treat diabetes (Oh! Twelve pounds!). Eventually, word came back from the cool kids that this thing actually works. For losing weight, that is, and maybe it's also good for diabetes? It certainly worked for Novo Nordisk, the Danish company that developed the drug.

Chart #9: Novo Nordisk ADR Share Price, Last Twelve Months



Source: MVF Research, FactSet

Ozempic came out in 2018, but the weight loss buzz really didn't kick in until late 2022 (the drug is now marketed under two different brand names: Ozempic for the original Type II Diabetes purpose, and Wegovy for obesity; and perhaps unsurprisingly, sales of the weight loss brand are outstripping those of the diabetes treatment by a magnitude of more than four times). Naturally, as almost always happens when a new drug hits the market with such an obvious mass of built-in potential demand, investors have lots of enthusiasm

about what else might be out there in a market that could plausibly be worth $100 billion ten years from now, according to some Wall Street research (cynically, we note that this projection falls far short of the $231 billion estimate for the sports betting market we described earlier in this report).

It is always tempting for an investor to want to be in on the ground floor for the next – well, take your pick going back a long time: IBM, Apple, Microsoft, Google, Apple (again), AbbVie (when Viagra came out)…there will always be something that gets the animal spirits going. But the market for obesity drugs, like the market for virtually any drug, is quite a bit more complicated than a simple growth chart from sales today to sales ten years from now.

The Novo Nordisk drugs make use of a specific category of a broad class of medications called glucagon-like peptide-1 agonists (GLP-1). The GLP-1 category used by Ozempic and Wegovy is semaglutide. But there are a handful of other GLP-1 categories that perform similar functions, and they are already coming to market for competitors to Novo Nordisk. These include Zepbound, a product developed by drugmaker Eli Lilly that employs tirzepatide, an analog that activates the GLP-1 receptors. Another company called Zealand Pharma (also Danish, like Novo Nordisk), which specializes in peptide-based medicines, is said to be in late-stage trials with its own anti-obesity offering.

There is little question that the obesity drug market appears promising from a growth standpoint. The factors that will determine the ultimate winners (and indeed, whether that number will be a small concentration of first movers or a free for all with lots of competitors) include terms of exclusivity, the ability to work around existing patents to bring new offerings through the approval pipeline (which itself is a highly involved undertaking that has to be dealt with in multiple regulatory markets, each with their own rules and standards), the role of insurance companies (weight loss treatments are currently out of pocket expenses in the vast majority of cases), possible emergence of unknown side effects (or coming up with a better product that reduces already-known side effects)…the list goes on.

Broadly speaking, there are a couple ways to invest in the pharmaceutical sector. One is to take a punt on a company with a promising but yet-unproven drug. This is highly risky – all you have to do is chart the waxing and waning of fortunes among publicly traded focused biotech firms to see how a single press release can send share prices soaring or plummeting to earth. The second way, and the one that we follow when we make investment decisions about healthcare companies, is to study the overall portfolio, the exclusivity terms of existing patent-protected drugs, the presence in key generic markets, the track record of getting pipeline products through the approval process, and a great deal else. No doubt we will study the anti-obesity market closely, and it will be one factor that goes into our overall evaluation of whether a particular name appears to be an attractive long-term investment candidate. For us, though, this is not a quick-hit opportunity.

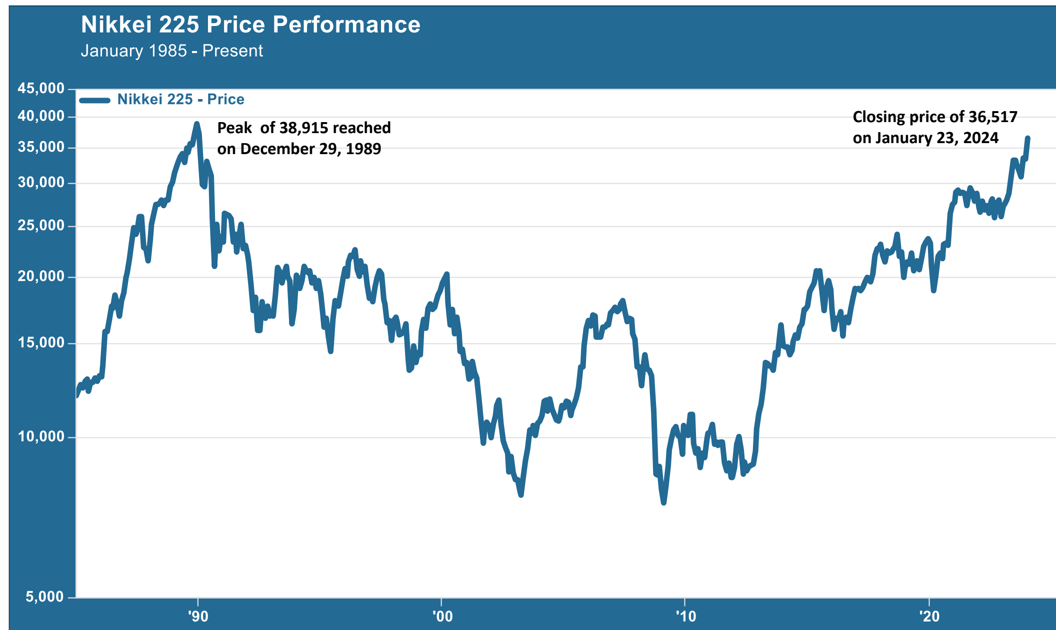
vi. Japan’s New Old Look

Speaking of one-hit wonders back in the news, is there anything exciting going on in Japan? The answer to this question is: usually not. Not since the 1980s, anyway, when Japan was the hottest economy in the world, the five square kilometers around Tokyo’s Imperial Palace was on paper worth more than the state of California, and business school classes at Harvard and Stanford were full of case studies about the likes of Sony, Toyota and the Ministry of International Trade and Industry. The Nikkei 225 stock index, Japan’s rough equivalent to our own S&P 500, reached an all-time high of 38,915 on the last trading day of 1989. And then it all went bad, with a decades-long economic contraction, periodic deflation and a population in decline, among other ills. Japan went from “number one” to “chronically ill”.

Until now. The Nikkei 225 still has not yet reached that December 1989 all-time high, but it has come tantalizingly close. In 2023 a growing chorus of international investors and asset allocators, led by none other than Warren Buffett himself, sang the praises of Japanese equities. Now in the early days of 2024, Japan is one of the world’s equity market leaders with the Nikkei up more than nine percent for the year to date. Is it time to give Japan a new look? Or is there too much of the old look – the stifled lack of innovation from an overly conservative business culture, the also-ran status to more dynamic Asian economies like

India, Korea, and Vietnam (not to mention China, but we covered that country extensively a few pages above), the chronic problems of too much debt and too few working-age humans?

Chart #10: Nikkei 225 Stock Index, January 1985 – Latest



Source: MVF Research, FactSet

Count us in that second camp. We do acknowledge that there have been some home-grown improvements in that economy in recent years, including some long-overdue moves to improve governance and transparency in Japan's famously opaque large companies with their persistent mindset of the *keiretsu* cross-holdings that worked well for a while in the 1970s and 1980s. When inflation picked up and actually exceeded the Bank of Japan's target rate last year it suggested that maybe the economy was on the verge of moving past its sclerotic pace of the past quarter-century. Perhaps the Bank of Japan was even ready to undo the stimulus it had been pumping into the economy for years via negative interest rates, yield curve control and outright purchases of domestic equities.

Alas, no. Third quarter GDP contracted by 2.9 percent, more than expected, the BoJ deferred any decision on yield curve control (which basically amounts to keeping a firm cap on intermediate-term government bond yields), consumer spending is weak and the domestic political situation is unstable, with yet another in a seemingly interminable line of financial scandals plaguing the ruling Liberal Democratic Party that has ruled for nearly the entirety of the postwar period. As for that nine percent gain in the stock market this year, half of that gets lost when you translate the gains back to US dollars, as the greenback is up more than five percent against the yen this year. We are content for now to remain out of this market.

vii. The US Election (and All Elections, Actually)

We don't really have much to say about the upcoming US presidential contest. Not here, anyway, because this is not an electoral commentary or a forum for political debate. But we know that the election is on the minds of most people who will be reading this report, and in some cases it may be the topic at the front of their minds. So we do feel obligated to say a few words about it.

There really is only one fundamental point we tend to make when talking about markets and politics – and this we believe has universal application. It is truly impossible to know, any time leading up to an electoral contest, what the outcome is going to be in the market. And we always cite from the case study of 2016. Recall what happened on election night: as the returns came in and it became increasingly clear that Trump was going to win, US stock futures markets plummeted. They kept going south until Trump gave a victory

speech that included a vague reference to infrastructure spending. Within minutes futures turned around, and when markets opened the next day stocks started to take off – and so did interest rates, all because of a new narrative based around "infrastructure and reflation." Well, infrastructure never happened, inflation stayed subdued, and the narrative fizzled out. The point is that (a) predicting the actual outcome is nothing more than a throw of the dice, and (b) even if you get the outcome right, you still are unlikely to have all the right positions in place to benefit from how the market responds.

Predictive valuation methods rely on quantifiable data. If a government announces a tax hike or a tax cut, that is something models can price in. Same goes for raising or lowering interest rates. Outside of a high assurance of either a change in tax rates or a new direction for interest rates, there is not much in Washington that can exert a meaningful influence on asset prices, and our advice is always to not try. Will that stop so-called political futures markets from trying? Of course not – what we said in the very beginning of this report about the sports betting complex has its twin in the existence of financial futures exchanges for just about any imaginable thing investors might want to bet on (at some point, we imagine that CNBC and ESPN are going to simply give up the pretense of being separate networks for separate audiences and merge, and we are only somewhat joking).

C. Concluding Thoughts: Risks and Opportunities for Portfolio Positioning in 2024

To sum up how we see 2024 unfolding at this early point in the year:

- A successful "soft landing" by the Fed is increasingly likely, avoiding a recession this year, as short-term interest rates top out at present levels and perhaps come down a couple times if, as we expect, inflation continues to come down while consumer demand also cools.
- Lower inflation and cooling consumer demand may present a double challenge for corporate sales and earnings, which in turn may stretch already-high valuations even further. Companies will need to demonstrate operating efficiencies to shore up profit margins.
- One possible key to unlocking those efficiencies will be AI, and this year we expect the AI narrative to shift from the "wow factor" of last year to a more skeptical "show me" stance for establishing tangible proof of concept.
- The bond market is still more volatile than we consider healthy for what is supposed to be the boring part of the portfolio, with the market narrative continuing to push more rate cuts than the Fed is likely to deliver. We would hope (but not necessarily expect) that at some point bond traders stop fighting the Fed.
- China's economy continues to look troubled, and that presents a challenge to the global economy (though with more of an impact to other parts of Asia, Africa and Europe than to the US, in our opinion). Until there are signs of a solution to the slow-burning property and infrastructure crisis there, we don't see those problems going away.
- China is also in the mix for geopolitical tensions that, while normally ignored by markets, are conspicuous this year. War in the Middle East is threatening to expand beyond the crisis in Israel and Gaza, the war in Ukraine churns on, and there are other flashpoints in Africa with the potential to add to the instability. Taiwan must be monitored closely on a continual basis.
- 2024 is a national election year for more than half the world's population. We think it is never a good idea to make portfolio decisions on the basis of electoral predictions; however, the results of these elections will factor into the world beyond 2024, and close attention is merited.
- In short: we see a year with the potential for at least modest gains in equities, a rationale for extending duration in fixed income, a preference for quality assets over things farther out on the risk-return frontier, and a balance between asset class weightings that keeps us from going too far in any one direction. We see reason to be optimistic, and reason to be cautious.

Important Disclosures

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by MV Capital Management, Inc.), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful.

Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from MV Capital Management, Inc. All charts and graphs used above are for illustrative purposes only as they relate to the context of the discussion and do not represent a recommendation to buy or sell any specific investment or strategy. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing.

MV Capital Management, Inc. is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice.

A copy of the MV Capital Management, Inc.'s current written disclosure statement discussing our advisory services and fees is available for review upon request.

www.mvfinancial.com