UBS Financial Services, Inc.
Private Wealth Management
One Post Office Sq., Floor 35
Boston, MA 02109

Sullivan Martin Partners

William J. Sullivan
Managing Director-Wealth Management
Private Wealth Advisor

Sarah M. Sullivan
Senior Vice President-Wealth Management
Private Wealth Advisor

Trammel A. Martin
Managing Director-Wealth Management
Private Wealth Advisor

www.ubs.com

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ANY BEARS STILL OUT THERE?

If there were a lot of bears on Wall Street at the end of 2022, they've probably changed out of their old garb and slinked away to their dens. Last year was definitely a surprise to many investors and pundits who continued to forecast a recession. One of the most well-known bears on Wall Street, Jim Chanos, shut down his hedge funds after four decades in the business. Of course, we've always thought that short sellers were a different lot. Most of us don't wake early in the morning looking for things that can go wrong. We tend to be optimistic by nature. Sort of like Jerry Jones, who was probably optimistic that his Cowboys would handle the Packers before the wild card game on 1/14/24.

The market (S&P 500) made up for the punk results achieved in 2022, by advancing 26.29% in 2023. That brought the average for both years combined to a little over 3%.

The S&P 500 is a weighted index, meaning certain stock groups can create a significant imbalance, which can distort the true picture of the overall market. For example, the published 2023 weighted performance number came in over 26%, but the equal weighted S&P 500 came in at 13.87%, or 12.42% less than the weighted S&P (Morningstar).

You may have already suspected the culprits. Yes, the so-called "Magnificent Seven," which we mentioned in a past letter (July 31, 2023). In case you've forgotten their names, they are Alphabet, Google, Apple, Meta Platforms (formerly Facebook), Microsoft, Nvidia and Tesla. Those stocks were responsible for an extra 12.42% in the S&P 500. They are fueled by the AI craze and the belief that they will continue to be the market leaders in the growth sector. These are very successful companies having achieved something akin to legend status. Maybe so, but they aren't cheap and can subject investors to significant volatility. And as the battle ensues to control the digital universe the price for mistakes can be very costly for companies and investors alike. Caveat emptor.

The chart below provides an overview of the performance for the year 2023 and the fourth quarter for some of the major indices.

	4Q 2023 (%)	YTD 2023 (%)
Dow Jones Industrials	13.09	16.18
Standard & Poor's 500	11.69	26.29
NASDAQ Composite	13.79	44.64
Russell 2000	14.03	16.93
Russell MidCap	12.82	17.23
Russell 1000 Growth	14.16	42.68
Russell 1000 Value	9.50	11.46
Barclays Capital Govt./Corp. Bond	6.63	5.72
Barclays Capital 5 Year Municipal Bond	5.22	4.31

Morningstar

The sharp improvement in the last quarter of the year compares favorably to mostly negative numbers printed in 3Q. Wall Street raised their earnings estimates and companies came in with numbers that exceeded expectations. GDP releases also showed numbers that were ahead of expectations. Real GDP for the third quarter came in at 4.9% (that was the third estimate). The upward revision of the third quarter benefited from stronger consumer spending and investment. Government spending also had a positive effect on real GDP. Don't worry about deficits, we're heading into a presidential election year! Frugality is hard to find in DC in an election year.

We have included in today's letter a **hyperlink** to access John Savercool's "Special Washington Update." John heads up UBS' Public Policy Office in Washington. He's a very articulate fellow and has been in the middle of that milieu for decades. He publishes his paper generally on a weekly basis. John is very "plugged into" what policy makers are likely to be focusing on. We find his commentary to be very informative and useful. We look forward to his insights in this presidential election year.

But we digress, back to the quarterly chart.

We have commented on a pattern that has been with us for the past few years. That is, growth stocks have generally taken the lead over value. The spread between them has widened in 2023, with growth appreciating 42.68%, while value similarly appreciated "only" by 17.23%. What's noteworthy is that there are signs that value may be finally gaining some legs here.

Although not featured in the chart above, we would point out that the Russell 3000 Growth and Russell 3000 Value, which cover a much larger sample of the market including large cap, mid cap, small cap, and a few other things appreciated by 41.21% and 11.66%, respectively in 2023. Value therefore has continued to lag growth and is presenting an opportunity for investors.

Remember what happened to value stocks after the 2000/2001 market correction (crash may be a better term). Folks were piling into growth stocks indiscriminately (we've mentioned this many times in the past). Often, it was just pure speculation with little or no earnings. A great many of these stocks fell by more than 50%. Following that debacle, value stocks took off on a four-year bull market as investors bailed out of their growth stocks and into value.

When one looks back at these kinds of market dislocations its always important to look at the lesson learned. Diversification was not on many investors' minds. Greed took over and as always, it's one way to go broke on Wall Street, particularly when one gets a lust for what's hot! There's was seldom adequate research done. We've had calls from folks who just simply asked us if we knew about a certain company. When we would ask, what do they do? The answer was usually something like, "I dunno, I just know the name." Why the silly story? Because we're about, over the years just ahead, to enter the "digital revolution" where rumors will fly around about which AI (artificial intelligence) company is about to go through the roof. We can see the potential for yet another "gold rush" developing as the digital age expands. It will be a time of great opportunity and also great risk (2000-2001 redux?). Our team will endeavor to inform and hopefully protect our clients.

There are many small cap companies that have lagged the market. Among other reasons, small cap companies can have a tough time raising capital in an environment like last year when the Fed ran rates up 5%. These rates have fallen slightly, and the Fed has stated that they should be able to take some of the pressure off rates if inflation continues to decline. It got as high as 9% some months ago and now is back down to 4-5% area. Even mortgage rates (30-year) have pulled back about 1.5% into the high 6% area recently.

Liquidity is not bad; it may be a little tough to get the banks to write a loan as they're being very careful following the failings of Silicon Valley Bank (March 2023) and First Republic Bank (May 2023). We're happy to say that UBS has a very strong balance sheet and our loan window never closed to our clients seeking credit.

ECONOMICS GROUP CAUTIOUS

While cautious, they're expecting to see GDP growth slow from the current 4+% area, but don't expect a recession.

One of the most difficult obstacles for companies is what we were speaking of above, that is, having a need for capital and not being able to get it. The good news is most companies, and many homeowners, refinanced their balance sheets when rates were low. Many of our clients obtained mortgages under 3.5% a few years back. We may not see those kinds of rates again, maybe in our lifetime. The point of mentioning this is that a large percentage of people and companies have balance sheets that are in good shape. Therefore, spending levels continue to help power the economy. Unemployment is still down around 3.7%. The Fed may want to see that number go a little higher before they cut rates this year. But inflation has been somewhat self correcting.

Unemployment is low at 3.7%, cash flow is okay, and most businesses are doing reasonably well, if occasionally spotty. That's what several of our friends who own restaurants tell us. The environment is okay but somewhat unpredictable. This economy feels to us to be in decent shape. Even some of the PMI data (Purchasing Managers Index) is improving, albeit slowly.

Some of you have kept some liquidity on the sidelines to observe how the economic winds were blowing. And many have put a significant amount of portfolios in bonds. That's not too hard to understand. Inflation's been pulling back and we're seeing rates at attractive levels (4.75-6.5%). A level that has not generally been available for some time with the Fed keeping rates so low for many years. That's changed, but we don't see the Fed initiating another wild spike in rates against a more benign level of inflation. Remember, a lot of the inflation issue occurred in the COVID-stressed environment, where manufacturing globally was shut down. Shortages became a serious issue for all manufacturing. We appear to have solved many if not most of those issues and corporate balance sheets are generally okay.

Many investors on the "equity," sidelines, after adding some fixed income securities for ballast, are now asking us "what about the stock market here?".

We had a very nice conversation a couple of days ago with one of our favorite strategists, David Leftkowitz, whom we've quoted many times in the past.

The market (S&P 500) is not "cheap." What a surprise! But the outlook is okay. David has earnings estimates for the S&P 500 of $240 and $255 for 2024 and 2025 respectively. David is not a fellow known for "gilding the lily." He's a pretty straight forward and pragmatic guy. Importantly, we've not seen him have to sharply change many of his numbers historically. We're not fond of analysts who change their minds frequently. There's little value in that to us, as most of you know, we are long term, secular cycle players. We are concerned about the geopolitical landscape particularly in the Mideast. Additionally, politics has become a pretty nasty business here and abroad (is that really new?). One of the perhaps perverse things about capital markets is that they tend to see beyond anything we may observe. Note how those markets have done since the October 7, 2023, attack on Israel. The S&P 500 dropped less than 200 points days later toward 4150 and the S&P 500 is today just over 4900.

Nevertheless, business in Europe is improving; China's still got issues. We are producing more oil in this country than before Biden started his attack on the oil industry. He must be aware. Maybe he's just being mum?

There's a hope that leadership may change or that the current leadership may attempt to help the business community create more jobs. Maybe that is fanciful stuff, but we have been living with a less-than-optimal environment and yet the economy is likely to still be able to run GDP in the 2.5-2.75% area; lower than the current level over 4% real GDP.

Corporate America has done a great job of dealing with adversity over the past several years and is likely to do reasonably well this and next year.

David sees an S&P 500 target of 5000 (currently around 4900) by year-end 2024. That's about 2%. Not a barnburner, but he doesn't see a major decline. Companies are similarly cautious and have over the past couple of months reduced their earnings forward estimates. We know that in Presidential election years markets generally go up, but so can the volatility as investors attempt match their asset structure to the perceived environment.

We would rather be buyers than sellers but on weakness. The S&P 500 is now at 18.5 x earnings looking out two years. That's better than the 20.5 x earnings number last summer. It's reasonable to expect a trading range to develop, say 4500-5200 over the next few months, but if companies do grow at David's level the market may trade back and forth for a time until there is greater clarity. We note that the UBS investment bank currently has a year end '24 target if 5150 for S&P 500.

In the meantime, short term cash can earn around 5-5.5%, and munis 4.5% tax free (federally) on a current yield level. There are some other attractive places for cash for those who wish to stay on the sidelines.

The thing that has not changed is the necessity to maintain a balanced portfolio to offset downside volatility. There are other things this team is currently reviewing that we will pass along where suitable.

As always, please call us with any questions or concerns. Given the diversified positioning in most portfolios, it is anticipated that potential volatilities can be managed acceptably.

We look forward to speaking with you soon to discuss any needed adjustments to your FGAs (Financial Goal Analysis), any other special issues of interest to you.

In the meantime, our team sends our best wishes for a healthy and successful 2024.

Cheers!

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