Good evening,

It's been some time since my last communication, so let’s catch up! I hope the holiday season was great for you and your family. As hectic as the season can be, I find it one of the best times of the year!

I've been busy updating the portfolio over the past couple of weeks and recently completed the semi-annual rebalance. I’ll go over those changes and provide context on where I believe the financial markets will be headed this year. It should be an interesting year, to say the least. We currently have two significant wars going on in Ukraine and Israel, the Federal Reserve is contemplating interest rate decreases this year, a recession could still be in the cards, and of course, we have the Presidential election in the U.S. There are plenty of situations that could disrupt the markets.[47] If you thought 2023 was a rollercoaster of a year, the potential for 2024 to be even wilder is undoubtedly present.[47] I am greatly looking forward to what this year will bring. In the words of the former Roman Emperor, Marcus Aurelius, "*The happiness of your life depends upon the quality of your thoughts; therefore, guard accordingly* ." It can be so easy to let all the negativity in the news alter our perspective on the world, including the financial markets, in a decidedly negative way. Let's approach 2024 without any trepidation as to what the future might bring and embrace all opportunities that can deliver as much happiness and prosperity to our lives as possible!

<u>Executive Summary</u>:

- Two of the three main risk charts turned positive in mid-December, making all three positive now.[1] Following are the target allocations for the different portfolios after the rebalance:

    1.
    2. Aggressive: 95% stocks, 5% cash.

    2.
    3. Moderately Aggressive: 80% stock, 15% bonds, 5% cash.

    3.
    4. Moderate: 65% stock, 30% bonds, 5% cash.

    4.
    5. Conservative: 50% stock, 45% bonds, 5% cash.

- The seven stocks in the portfolio have stayed the same since the last rebalance in June. They are Advanced Micro Devices, Amazon, Google, Merck, Republic Services, Marsh & McClennan, and Williams Companies.
- The exposure in the portfolio is weighted more towards mid- and large-cap companies with both a growth and value perspective.
- I reduced the weighting in floating rate bonds in case the Fed starts to lower interest rates this year. However, it still seems that longer-term interest rates may

move higher even with shorter-term rates moving lower.[2] Therefore, the portfolios also gained exposure to shorter-maturity bonds and some exposure to short-term corporate high-yield bonds.

- The market's health looks the best it has since the beginning of August 2023.[3] With all three risk charts firmly positive and the market's health looking good, the path of least resistance appears to be to the upside. As long as corporate America doesn't wildly miss Q4 earnings expectations and express dire warnings about their corporate outlook for 2024, I think we could be looking at new all-time highs in the markets soon.[48] We aren't that far away now![4]
- While there are several things I am keeping on my radar, one of the biggest is the liquidity stress occurring in the banking sector[5], which could pose some problems for the financial markets come spring. Paradoxically, any resurgence of the banking/repo crisis could result in the financial markets responding positively if the Fed decided to cease the current Quantitative Tightening program.[6] It might herald in another version of Quantitative Easing along with interest rate cuts.[6]

Seeing two of the three main risk charts turn positive back in mid-December was a welcome sight. The unrelenting rise in interest rates between the beginning of August to late October sent the financial markets into a noticeable decline.[7] Fortunately, as quickly as those rates started to rise over the fall, they just as quickly dropped from November until the end of December, [8] saving the portfolio's yearly performance. The portfolio's performance did not keep up with the major indices, mainly due to the performance of the Magnificent 7, which I discussed numerous times last year.[49] Unless a portfolio was almost entirely composed of just those seven stocks, it was difficult to approximate the performance of the NASDAQ, SP500, or the DJIA.[9] Nonetheless, the addition of the three tech stocks (AMD, AMZN, and GOOGL) back in June proved to be accretive to the portfolio and helped provide a respectable showing by year end.

The semi-annual portfolio rebalance was recently completed and the portfolio has a strong line-up of healthy investments.[10] The domestic stock market exposure retains a prominent position in technology, with the growth style being slightly favored over value. The portfolio includes some exposure to international stocks since that asset class sits in the second spot behind domestic stocks in the D.A.L.I (Dynamic Asset Level Investing) matrix.[11] Those two asset classes exhibit a significant lead over the next closest asset class - commodities.[12] Somewhat surprisingly, bonds are still in last place within D.A.L.I.[13]

Many of you probably have some angst as we head into 2024, especially given that this is a presidential election year, and if this year is like prior presidential elections, the atmosphere surrounding the election could be contentious. It is too early, in my opinion, to have any inkling as to how the election will affect financial markets.[50] I think we'll only get some insight as we head into the second half of this year when the presidential candidates become more obvious as it is not a foregone conclusion who those candidates will be. Also, remember that the makeup of Congress will play a significant role in how markets react to the November elections. If there is a split between Congress and the Executive branch, the markets will probably like that. While markets don't like uncertainty, they do tend to like gridlock![14] So, it is way too early to tell how the overall election will affect the financial markets until the results are finally in.

What could have more of an impact on financial markets are the machinations of the Federal Reserve,[51] as they usually do. For a large part of 2023, the movements, both up and down, in the financial markets were partly in response to the movements in interest rates.[15] When rates spiked higher in late summer and early fall we saw a precipitous drop in the bond and stock markets.[16] Towards the end of October, the yield on the 10-year Treasury rose north of 5%,[17] which caused a considerable amount of consternation within the financial markets.[18] Then, in November, rates started to drop, and the bond and stock markets began to move up once again.[19] The move in interest rates continued downward in December as a result of the sudden shift by the Federal Reserve at the December meeting, which caught most market participants offguard.[20]

You may or may not be aware of this, but on December 1st, Fed Chair Powell came out and said that it was 'premature' to speculate on interest rate cuts.[21] However, two weeks later, on December 13th, after the Federal Reserve's last meeting of the year, Powell said the Fed was starting to discuss rate cuts in 2024.[22] When that was announced, the market saw substantial advances in stocks and bonds from mid-December to the end of the year.[23] So, what happened within the two-week timeframe that caused the Fed to do an about-face? The economic data over that timespan wasn't too market-moving. The data was neither cold nor hot so that data couldn't be the cause of the sudden pivot.[52]

The answer may very well lie in a rather esoteric part of the financial system that usually only comes to light when problems arise in that area, and that is what was starting to happen in early December with SOFR.[24] SOFR is the Secured Overnight Financing Rate and is a broad measure of the cost of borrowing cash overnight via collateralized Treasuries.[24] When the SOFR rate spikes, it can be a sign of stress in the system if the cost to borrow cash starts to rise significantly,[25] which started to happen in December.[26] The rate rose to an all-time high,[27] although it has only been around since April 2018.[28] SOFR began to increase rapidly because the liquidity, aka cash, in the system started to dry up,[29] and it became a simple supply/demand relationship. Less supply and more demand for cash can cause the cost of borrowing cash to rise, which appears to be what was happening[53] . This liquidity drain can be seen by observing the overnight reverse repo balance at the Fed, which was at over $2T at its height back in 2022 and is now down to approximately $600M.[30] Most of the $1.4T drop in the overnight reverse repos is due to the issuance of more T-Bills over the past year.[31] Money Market funds and other large institutions are taking their money out of overnight reverse repos and buying T-Bills (Treasuries), which results in more collateral in the system (Treasuries) and less cash, which leads to the supply/demand imbalance I just noted.[32] A liquidity crunch is ultimately not a good thing for the Federal Reserve to have occur. Nearly the same thing happened back in 2019 when the repo market experienced turmoil, and the Fed started to expand its balance sheet by restarting another version of QE but insisting it wasn't QE![33]

If liquidity is draining in the financial system due in large part to the issuance of nearly $2T in debt in 2023,[34] which caused large financial institutions to use their available cash to buy Treasuries,[35] then the Fed is probably going to be forced to curtail its current program of Quantitative Tightening (QT) of nearly $95B per month.[36] QT is a drain of liquidity in the financial system,[37] and the Fed will likely have to either stop or reduce the amount of monthly QT they are currently doing.[38] The Wall Street Journal recently articulated this in a piece on January 15th.[39] If the WSJ is correct, and the Fed does walk back its QT program, the next step would likely be to begin adding liquidity back into the system via, you guessed it, another version of Quantitative Easing.[40]

I am touching upon such an obscure area like SOFR because the ramifications of the Fed pivoting to such a dovish stance could be significant. Even though inflation rates aren't down to the Fed's desired 2% area, they are moving in the right direction and getting closer to the target than they have in the past year and a half.[41] That should give the Fed the cover they need to start lowering rates, which should loosen monetary policy.[42] In conjunction with a possible reduction in QT and a possible re-initiation of QE, the Fed may be able to sidestep a potential banking/repo crisis like the one they faced in 2019.[43] If the Q4 2023 earnings season, which is now upon us, sees decent earnings and has a positive outlook for this upcoming year, then in synchrony with Fed policy moves, we could see the stock market making new all-time highs in the next month.[54] Time will tell if I am right, but there have been a few Fed officials hinting at what I just outlined,[44] and the recent WSJ article is hinting at the same moves by the Fed.[45] I believe this scenario will have a much more significant influence on the direction of stocks and bonds versus who wins the presidency this year.[45]

To wrap it up, I am optimistic about the financial markets in 2024. Currently, the technical data looks strong, and as earnings season progresses, the corporate stock buyback window will likely also re-open,[46] which could be a welcome tailwind for the stock market. We need to hear from corporate America that earnings look good and will grow throughout 2024 and that a recession is not in their sights. Couple that with the workings of the Fed, and we may have a recipe for a good year in the markets!

As always, thank you for the faith and trust you have put in me to manage some, if not all, of your investments. It's a privilege and a responsibility that I take very seriously, and if you have any questions or want further clarity on any of the above, please do not hesitate to reach out to me.

Here's to a great 2024!

Jim

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We provide proactive and personalized service to help you define objectives to:
- **Simplify and solve complex financial issues**
- **Preserve your assets and your lifestyle**
- **Stay abreast of financial opportunities and strategies**

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