OCTAVIA
WEALTH ADVISORS

# 2024 Outlook: Prepare, Don't Predict

January 2024

*Building a Lifelong Partnership*

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A year ago, our outlook for 2023 was cautiously optimistic while outlining three primary themes that would influence asset prices in 2023. Those expectations generally came to fruition, though not exactly as anticipated.

- **Continued volatility** was certainly present this year, but was masked by strong headline stock market returns. The securities underlying market indices, however, were widely dispersed between losers, such as failing regional banks, and winners, such as companies linked to artificial intelligence. Bonds generated solid returns in 2023, but only after enduring interest rate volatility not seen since the Global Financial Crisis.

- **Moderating inflation** played out almost exactly as predicted, with headline Consumer Price Index (CPI) falling from its 9.1% peak in June 2022 to 3.1% in November 2023. However, "moderating" remains the operative word—inflation is still above the Fed's target and has remained stubbornly high.

- Lastly, **the bear market bottom** may have occurred a bit earlier than we expected. The S&P 500 price index rallied in 2023, ending 24.2% higher than the beginning of the year and 32.9% above its October 2022 lows.

Of course, our outlook did not foresee a banking crisis, a U.S. debt downgrade, a military conflict in the Middle East, and an AI supercycle that sent markets soaring. As we look to 2024, we reiterate the humility mentioned in our last outlook, and acknowledge that we aim to build resilient portfolios across market cycles rather than trying to time the market or predict unpredictable events.

## 2024 Themes

Our themes for the year ahead are all quite distinct, each with its own catalysts and circumstances. A common thread running through each of them is that markets may be poised for a bit more normalcy, especially in the long-neglected bond market. Over the past decade, investor views of fixed income shifted from complacency to indifference or even outright animosity. Now, as we look forward, we foresee three primary themes that may restore bonds to their rightful place in investor portfolios, while emphasizing the need for prudent risk management and thoughtful portfolio construction.

## 1. The Messy Middle

Recent months have brought lots of back patting and handshaking at the Federal Reserve as inflation (as measured by the CPI) has tumbled from its June 2022 peak of 9.1% to 3.1% in November 2023. Some market participants remain concerned that further tightening will be needed to achieve the Fed's target of 2% inflation, but we note that level is an arbitrary goal, and is quite a bit lower than where consumers begin to feel a squeeze (around 3%).

We also believe that the Fed is unlikely to continue hiking rates due to potential collateral damage, such as further strain on the banking system and the beleaguered commercial real estate sector. The potential scale of damage from further hikes likely would not justify the modest benefits of decreasing inflation from 3% to 2%.

We predict that inflation will end up somewhere in the "messy middle," bouncing in a range of 2% to 5% for quite some time. The days of asleep-at-the-wheel 2% inflation thanks to deflationary tailwinds of globalization are likely over, but so too are the supply-side shocks and massive consumer spending of the post-COVID resurgence. We believe this range of inflation will compel vigilance from the Fed to prevent prices from getting out of control, but may also justify holding rates steady or even cutting them in the near future.

## NUMEROUS WAYS TO REDUCE INTEREST RATES

| | Rate of Inflation | | Terminal Fed Funds Rate |
|---|---|---|---|
| May-74 | 10.10% | → | 13.00% |
| May-81 | 10.00% | → | 20.00% |
| Aug-84 | 4.20% | → | 11.75% |
| Feb-84 | 4.70% | → | 9.75% |
| Feb-95 | 2.80% | → | 6.00% |
| May-00 | 3.10% | → | 6.50% |
| Jun-06 | 4.20% | → | 5.25% |
| Dec-18 | 2.20% | → | 2.50% |
| Sep-23 | 3.70% | → | 5.50%* |

*Even with inflation stuck in the "messy middle," interest rates may have room to move lower.*

*Since 1954, the average real Fed Funds rate (Fed Funds Rate minus Rate of Annual Inflation) is 1.01%[1]. Today, the real Fed Funds rate is 1.8%[1], and rising because inflation has fallen as the Fed holds rates steady. Therefore, not only are interest rate hikes likely at their end, but there may be room to cut.*

*5.5% is the Fed Funds Rate as of Dec. 31, 2023. It may not be the terminal rate for this cycle.

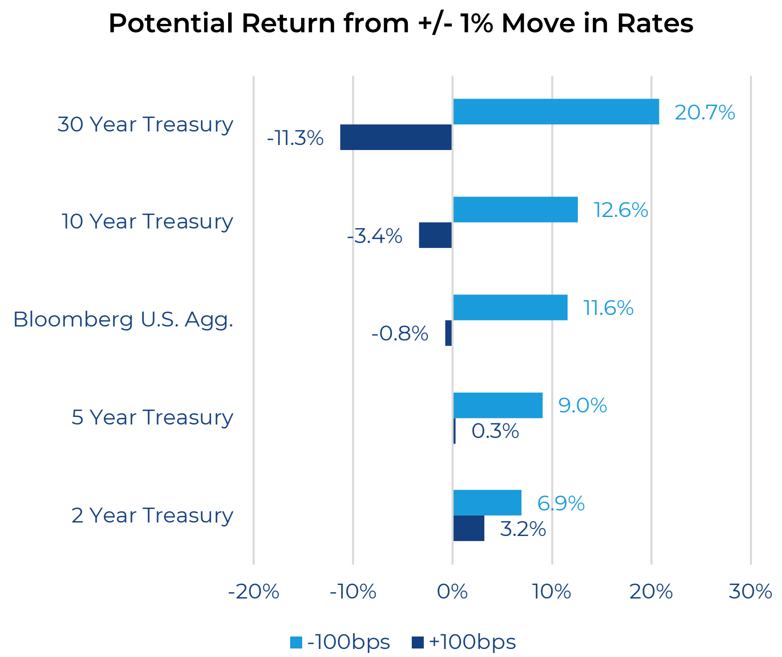
[1]Source: Federal Reserve Bank of St. Louis, July 1954 – November 2023.

## HOW MAY THE FED'S DECISIONS IMPACT YOUR PORTFOLIO?

A sustained "messy middle" level of inflation is not necessarily a negative for markets. Investors have made money in periods of far higher inflation in the past. But certain asset classes may benefit more than others if inflation were to persist in the 3-4% range, most notably real assets like commodities and real estate.

We also look beyond inflation to potential interest rate action by the Fed. An environment in which interest rates are either reduced or stable at higher levels may favor high-quality fixed income, especially longer duration instruments, as explained below. We expect these considerations to help drive our portfolio decisions in the year ahead.

### MAY THE SKEW BE IN YOUR FAVOR




*Range-bound inflation offers opportunities for interest rates to move lower. Examining relative fixed income returns from lower and higher rates reveals the opportunity at hand.*

*Higher current yields help mitigate downside risk through current income, while potential rate decreases disproportionately favor longer duration assets.*

Source: FactSet as of October 2023. Assumes parallel shift in interest rate curve.

## 2. Concentrated Consequences

A peculiar aspect of the 2023 financial markets is the significant influence wielded by only seven stocks on equity markets. A portfolio's return may have been excellent or modest, depending largely on its weight in those few companies. On November 30, the "Magnificent Seven" (Apple, Alphabet, Meta, Microsoft, NVIDIA, Amazon, and Tesla) made up a record-setting 28% of the S&P 500 index and 48% of the Russell 1000 Growth index. Now, as we look forward, we must question what impact this group of securities may have on future outcomes. Of course, these tech titans may continue their dominance and lead markets for years to come, which would make indices even more unbalanced. But we must also be aware of possible reversion to market-level (or below-market) returns as other securities close the gap.

As shown on next page, market leadership tends to shift over time, from the oil peak in the '80s, to Japanese stocks in the '90s, to the tech bubble just before 2000. Some will say that this time is different because the "Magnificent Seven" are exceptional and dominant companies, which is certainly true. But great companies do not always make great stocks. Cisco Systems was a gem of the tech bubble and remains one of the world's most influential tech companies over two decades later. Yet its trading price today is still more than 35% below its peak in 2000. A great company purchased at a bad price can make for a bad investment. Additionally, a narrow band of market leadership tends to create more fragility moving forward. Much like a sports team, it is hard to fill the gap when one or multiple star athletes go down.

## MARKET LEADERSHIP IS NOT A GIVEN

**Largest Market Cap Securities by Decade**

| 1980: Peak Oil | 1990: Japan Dominance | 2000: Tech Bubble | 2010: Rise of China | Current[1] |
|---|---|---|---|---|
| IBM<br>U.S. \| Technology | NTT<br>Japan \| Technology | Microsoft<br>U.S. \| Technology | Exxon Mobil<br>U.S. \| Energy | Apple<br>U.S \| Technology |
| AT&T<br>U.S. \| Communications | Bank of Tokyo-Mitsubishi<br>Japan \| Financial | General Electric<br>U.S. \| Industrial | PetroChina<br>China \| Energy | Microsoft<br>U.S. \| Technology |
| Exxon<br>U.S. \| Energy | Industrial Bank of Japan<br>Japan \| Financial | NTT DoCoMo<br>Japan \| Communications | Apple<br>U.S \| Technology | Amazon<br>U.S. \| Consumer Dis. |
| Standard Oil<br>U.S. \| Energy | Sumitomo Mitsui Banking<br>Japan \| Financial | Cisco Systems<br>U.S. \| Technology | BHP Biilliton<br>U.K \| Energy | Nvidia<br>U.S. \| Technology |
| Schlumberger<br>U.S. \| Energy | Toyota Motors<br>Japan \| Automotive | Wal-Mart<br>U.S. \| Consumer Dis. | Microsoft<br>U.S. \| Technology | Alphabet<br>U.S. \| Technology |

Source: Factset, "Largest market capitalization companies by decade" (excluding Berkshire & Saudi Aramco) as of Oct. 31, 2023.

## HOW MIGHT CONCENTRATED EXPOSURE INCREASE PORTFOLIO RISKS?

We note two important impacts of narrow market leadership. First, investors tend to extrapolate recent history at the expense of all other sectors. This concept can be applied to the tech sector, to U.S. vs. foreign stocks, or to large vs. small companies. Chasing returns may lead to loading up on yesterday's best performers and missing tomorrow's opportunities.

The second impact is that a narrow market creates more fragility and, potentially, more risk. With large cap U.S. securities making up the majority of most investor allocations, it is important to recognize that potential risk and manage it accordingly. Octavia's portfolios allocate to equities across the market cap and geographical spectrum, and are not solely reliant on the largest U.S. technology companies. From time to time, we will evaluate opportunities to add to our positions in small caps or non-U.S. stocks if warranted by market conditions.

## 3. Don't Predict Recession—Prepare

Economists may have to mark 2023 as one of the greatest headfakes of all time. A Bloomberg article titled "Here is (Almost) Everything Wall Street Expects in 2023" went live at the beginning of the year, compiling outlooks from 51 financial institutions. The vast majority called for a recession in 2023, with quotes like "a recession is all but inevitable" and "one of the worst years for the world economy in four decades." Yet here we sit with U.S. real GDP 4.7% higher over the past three quarters. What went wrong?

In short, the tenacity of U.S. consumer spending and moderating inflation led the economy and markets higher. We do believe that it is too early to declare victory and shelve all fears. If anything, the odds of an upcoming economic slowdown may have increased. But we must plainly acknowledge that a recession is always coming, as evidenced by decades of data. It may be right around the corner or several years away, but it is futile both to run from it and to precisely time its beginning and end. Thus, we seek to build portfolios that are resilient across the market cycle while making adjustments to properly position when markets show weakness.

### EMBRACE THE INEVITABLE

**Frequency of Certain Market Events Since 1950**

| Market Event | -5% or more | -10% or more | -15% or more | -20% or more | Recession |
|---|---|---|---|---|---|
| Average Frequency | About three times per year | About once per year | About once every three years | About once every six years | About every six and a half years |
| Average Length | 43 days | 109 days | 251 days | 370 days | 317 days |

Source: Capital Group. Recessions as defined by National Bureau of Economic Research.

### HOW IS A RECESSION-RESILIENT PORTFOLIO CONSTRUCTED?

Over the last decade, expected returns on fixed income securities have been substantially lower than equities. That dynamic has finally shifted, as the pain of higher interest rates in 2022 sets bonds up with a path to higher returns in the future at the same time that elevated valuations temper equity forecasts. We believe this may restore fixed income to its historical role as the resilient income producer during periods of economic uncertainty.

However, we don't want to jump fully aboard the bond bandwagon. We believe that substantial allocation shifts in any given year should only accompany significant changes in investor objectives or time horizons. We see the coming years as an opportunity to return to prudent, diversified allocations where both stocks and bonds can contribute total returns, all while making modest adjustments as the market environment dictates.

## Final Thoughts for 2024

After three consecutive years of anomalies in financial markets, the years ahead may finally restore some normalcy (if there is any such thing as a "normal" market). Recent increases in interest rates may help reconnect stock market prices to company fundamentals, preventing the speculative growth bubbles that welled up throughout 2020 and 2021. In addition, the future for fixed income looks significantly brighter than at most points over the past decade as the Federal Reserve prepares to ease monetary tightening.

Of course, not every impact of higher interest rates will be a positive one. Bond investors were forced to slog through a miserable 2022, and valuations for commercial properties and more speculative companies remain under pressure. But over the long term, we believe this regime shift will ultimately prove beneficial, as investors will no longer need to indefinitely extend risk in pursuit of reasonable rates of return. The years ahead may allow a shift from extreme allocations back to more balanced portfolios that provide greater resiliency in case of economic downturns.

As always, we are here to help you navigate the potential risks and opportunities in the year ahead. Feel free to connect with us to help position yourself for success in 2024.