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# A Longer View Can Help Manage Market Emotions

"Recency bias is the tendency to overweight recent events or trends, projecting them into the future." Advisor Perspectives, 4/21/23

The recent passing of legendary investor Charlie Munger has prompted many prominent investors to publicly reflect upon his wisdom. The human element was often central to Munger's insights concerning investment decision-making, and he was a pioneer in the field of behavioral finance. Looking back on 2023, adhering to a diversified asset allocation strategy was ultimately rewarded in the aftermath of a very difficult prior year, although staying the course required perspective and foresight.

## Balanced Strategies Reassert Their Value

Seven Fed Funds rate hikes totaling 425 basis points coupled with recessionary fears roiled the capital markets in 2022, leading to an unusual confluence of highly negative equity and bond market returns. Balanced strategies have long been designed to generate income while moderating risk, in part due to a relatively low historical correlation between stocks and high-quality bonds. Bear markets in 2022 in both asset classes (the S&P 500 fell -18.1% and the Bloomberg US Aggregate Bond Index produced a -13.0% return) led to assertions that the "60/40" portfolio construct was flawed, if not dead.

Why with the long-term record displayed in the accompanying graph was the viability of traditional balanced strategies questioned? An explanation lies in the extent to which cognitive distortions affect investment decisions. Throughout 2022 and into 2023, surging yields drove down bond prices at the same time equity returns were weak, an anomalous relationship rather than the norm. Many assumed this would persist indefinitely, an understandable reaction to current conditions, but one disconnected from objective probabilities.

Such behavioral responses are similar to how we feel about our favorite sports teams at a given moment, or a "hot hand" at casino games involving independent dice rolls. Human beings often overweight the most recent information they receive rather than the bigger picture, a contributor to the investment industry's "fear and greed" dynamic. Abandoning the diversification, income, and risk mitigation benefits of balanced portfolios may not have been a good idea in retrospect, as the S&P 500 and Bloomberg US Aggregate Bond Index posted +26.3% and +5.5% returns this past year.

## Momentum Can Be a Double-Edged Sword

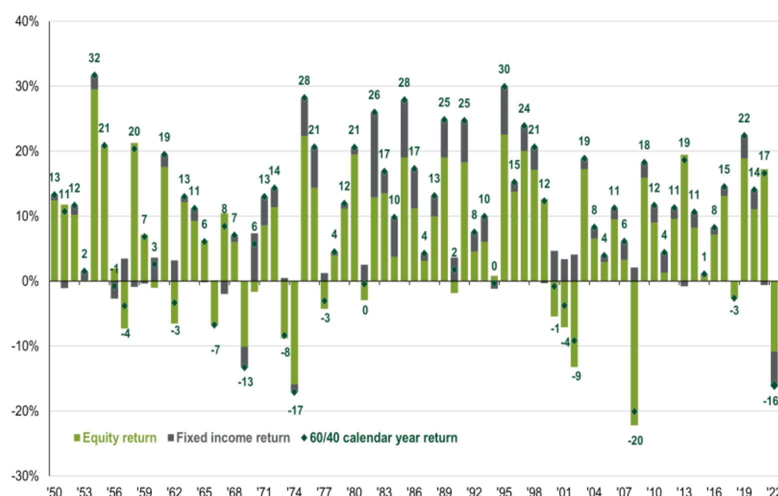
The unfortunate tendency of retail investors to buy high and sell low is well chronicled, yet avoiding this scenario is easier said than done. An explanatory factor is that investors often project recent momentum to future expectations. Doing so can add considerable risk should hot performance turn or lose out on subsequent gains when bear markets rebound, while also potentially impacting asset allocation. The best remedy may lie in sticking to a long-term investment strategy designed with risk tolerance and return objectives in mind.

The tremendous recent performance of the so called "Magnificent Seven"[1] offers another vivid example. Over the course of 2023, the average return of these seven stocks was +107%. These are enormously successful businesses, and our conclusion is not that high-flying stocks should necessarily be shunned, but rather arbitrarily buying what is hot without assessing intrinsic value is a flawed approach. The converse may also be true - quality, out of favor companies at times present attractive investment opportunities.

## Stay Grounded in Fundamentals

Circling back to Charlie Munger, he once cited patience, discipline, and long-term thinking as characteristics strongly associated with successful investing. We agree and often remind ourselves and clients to try and act accordingly. Today's storylines will inevitably be prominent in our minds; the challenge lies in not allowing them to distort our decision-making. Focusing on fundamentals such as earnings growth, balance sheet strength, and management acumen offers a better approach.

60/40 Annual Return Decomposition:
1950 – present




Source: J.P. Morgan Asset Management, "Guide to the Markets," 9/30/23.

1. Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla

## MARKET OBSERVATIONS & IMPLICATIONS

### Tax-Exempt Investment Grade Municipals

- The tax-exempt markets had a volatile year as the AAA Muni/UST ratio rose to 75% to end October and municipal yields rose almost 100bps from the start of the year. A weak October jobs report and dovish Fed messaging triggered strong performance to end 2023 and left 10-year ratios at a relatively rich 58.8%.
- The yield curve remains inverted and will likely not unwind until well into 2024.

| | 9/30/23 | 12/31/23 | QTD change |
|---|---|---|---|
| 2-yr AAA Muni | 3.66% | 2.52% | -114bps |
| 10-yr AAA Muni | 3.45% | 2.28% | -117bps |
| 30-yr AAA Muni | 4.34% | 3.42% | -92bps |

- Fed Funds rates have not increased since July's FOMC meeting and the next move will likely be a cut sometime in 2024. Investors anticipate up to 6 cuts in 2024, although our base case calls for only 3 beginning in Q2 or Q3.
- Net municipal fund flows were negative in Q4 at -$10.5B, while municipal ETFs took in net assets of +$6.4B.
- Strong demand drove Q4 MMD credit spreads tighter, as AAA-AAs ended the year at 7bps, down from 12bps on 9/30, and AAA-As at 27bps, down from 34bps. With credits spreads through their 5 and 15-year averages, we retain a high-quality focus.
- Issuance lagged for much of 2023 before spiking in Q4 to finish at $380B, only 2.8% off 2022's level. Increased cost of borrowing and yield volatility slowed issuers. We expect a modest increase in new supply in 2024 and will seek secondary market inventory to complement the primary market.
- A sharp drop in Q4 yields caused longer duration to outperform, while tightening spreads rewarded credit. The Long Index (22+ years) was the best 2023 performer at +9.35%, whereas the 1-year Index rose +3.39%. The "BBB" rated segment was up +8.93% vs. +5.80% for AAAs.
- Despite Q4's rally, yields remain elevated and demand intact. We also expect maturities, calls and coupon payments to be supportive of municipals in 2024.
- The curve should begin to normalize in the latter half of 2024 with the front-end coming down and stability in the longer end. Therefore, we are maintaining our 1 to 4-year exposure while focusing new purchases on the 9 to 12-year portion of the curve.
- Our 10Yr UST forecast for early 2024 is 3.75% - 4.25% and we are working to maintain 4.60 to 4.70-year Intermediate duration.

### Investment Grade Corporates & Treasuries

- After hitting YTD yield highs in mid-October, the 10Yr UST rallied to close the year at 3.92%. The balance of the curve beyond 1-year followed and deepened the inversion.
- The yield outlook for 2024 will largely depend on growth and the much discussed "soft landing." The 10Yr market consensus is about 3.88%, in line with our target range of 3.75 - 4.25%.
- IG credit spreads closed December on a positive note. Spread compression that began at the end of October gained momentum in November as the OAS on the Bloomberg Barclays US Corporate Bond Index dropped 5bps to 99bps, only 18bps above the 10-year low of 80bps set in June 2021.
- Credit strength was bolstered by falling yields and a slight slowdown in new supply. We anticipate a range bound UST market unless the consensus economic view and expectations for Fed Funds rate cuts beginning in mid-year 2024 is altered.
- US High Grade Corporate issuance in Q4 of $208B raised 2023's total to $1.185 Trillion, greater than anticipated earlier in the year and close to 2022. Given a favorable current cost of funding, we expect about $160B to come to market in January.

### Equities

- Stocks rallied sharply in Q4 with gains concentrated in November and December following three months of declines. Nasdaq led the way at +13.6%, with the S&P 500 gaining 11.2% to close the year just shy of its all-time high.
- Breadth improved considerably as ten out of eleven S&P sectors finished higher on the quarter. For the year, the growth-oriented Technology, Communication Services, and Consumer Discretionary sectors powered the market higher, with only Energy and the defensive Consumer Staples sector posting negative 2023 returns.
- An easing of financial conditions fueled risk appetite in Q4 as declining UST yields essentially reversed nearly all the monetary policy tightening since mid-July. A more dovish Fed signaled a likely end to rate hikes and sparked expectations of 2024 cuts.
- A year marked by the dominance of a handful of mega-cap tech companies known as the "Magnificent 7," finally showed signs of leadership change as the equal-weighted S&P 500 rose +6.4% in December, well ahead of both its market-cap weighted counterpart and the "Magnificent 7" (+3.9%).
- Election years are prone to elevated volatility and this year should be no different. Notable near-term risks include acute geopolitical tensions, and the prospect of a weaker consumer and more rapid economic slowdown than is anticipated.
- Fundamentals underpin our stock selection, and we remain focused on corporate earnings. Broadly speaking, earnings look solid with a consensus expectation of double-digit growth in 2024.

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