HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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We were skeptical during most of 2023 about the prospect for a booming stock market, given our prediction for a modestly positive year. Like so many other market pundits, we happily erred on the negative side. At the outset of 2023, the consensus forecast was for the S&P 500 to trade in the low 4,000 range. Instead, it ended the year at 4,768.

So what happened? The dominant concern a year ago was that the Federal Reserve's battle against inflation would push the economy into recession. But, almost remarkably, inflation appears subdued, and the economy is buoyant. So indeed, the market celebrated in the fourth quarter.

The major institutional money managers are now upbeat about 2024. Of the 10 biggest institutions, the median year-end forecast for the S&P 500 is 5,068. That would be a 6.3% increase for the year: a healthy but not overblown outlook.

At Hudson Advisors, we want to share this optimism. But we do not live in Barbie Land. We have caveats and concerns. First, a slew of economic things could still disrupt the Goldilocks soft landing scenario. Some of those concerns have crept into the market in the early trading days of January. Second, more than in most years, "black swan" events such as turmoil in the Middle East or in the U.S. elections potentially could negatively impact the market.

Our clients at Hudson Advisors know that we exercise caution in their portfolio strategies. We are defensive in the short-term while we look for winners in the long-term. That approach will continue to guide us in 2024.

MARKET TRENDS

The accompanying chart summarizes stock and bond market trends in the fourth quarter and full year of 2023. The stock market had a banner year. The bond market struggled but ended positively.

Equity Market: The market was positive in the first half but took a pause in the third quarter. Then the Federal Reserve announced it was done with interest rate increases and might look at gradual reduction in 2024. Upon this news, the market surged ahead in November and December, led by the heralded Magnificent Seven which includes Nvidia, Meta. Tesla, Amazon, Apple, Microsoft, and Google. The market capitalization of these seven stocks is now bigger than the combined stock markets of Japan, Canada, and the U.K.

The strong performance of technology is seen in the Nasdaq Composite Index which was ahead 13.37% in the fourth quarter and 44.64% for the year. The S&P 500 was ahead 11.69% for the quarter and 26.29% for the year.

The leaders in the S&P 500 have been Information Technology and Communications Services. The Russell 2000 index of small stocks was positive by 16.93% for the year: with most of the gain 14.03% in the fourth quarter. The Dow Jones Industrial Average also had an amazing gain of 13.09% in the quarter and ended the year ahead at 16.18%.

Fixed Income Market: The bond market struggled most of the year with the effect of higher interest rates. The yield on the 10-year U.S. Treasury note – which moves inversely to prices – rose to over 5% in October. Bond prices then recovered with the Fed announcement and the yield was down to 3.88% at year end. The typical long government bond fund soared 11.9% in the quarter but only gained 3.0% for the year as yields crept higher over the first nine months.

MAJOR MARKET INDEXES

	4Q 2023 Return	YTD Return
Dow Jones Industrial Average TR	13.09	16.18
S&P 500 Index TR	11.69	26.29
Russell 2000 Index TR	14.03	16.93
NASDAQ Composite TR	13.79	44.64
EAFE Index NR	10.42	18.24
Bloomberg Aggregate Bond Treasury TR	5.66	4.05

Source: Morningstar® as of December 31, 2023

THE OUTLOOK

The Economy: The U.S. economy has been oddly unpredictable in the post-pandemic period. Inflation had surged to over 9% in 2022. In response the Federal Reserve moved interest rates higher by 500 basis points in a brief period. Such aggressive monetary policy historically has produced at least a mild recession. But the GDP is expected to show growth of 2.6% for the full year 2023. Labor markets are strong with unemployment consistently under 4%. Consumer spending is healthy. Inflation is now in about a 3% annualized range.

Higher interest rates can have a lag effect. The economy will slow in 2024 to between 1% and 1.5%. But very few economists or market forecasters are talking about recession now. The so-called soft- landing projection is dominant, and the expectation is for the Fed to start a tapered lowering of interest rates.

However, some commentators have a "too soon to relax" perspective. We share this perspective at Hudson Advisors. The Fed may not move rates lower until it reaches its 2% inflation target. Should inflation ratchet back up, the Fed would raise rates yet again. That situation would bring potential recession back into view. In short, we are hopeful but not ready to declare that sustainable economic recovery has been achieved.

The Market: Corporate earnings in the S&P struggled in 2023. The full-year forecast is for a modest 3.1% growth. Earnings are now expected to increase to about 11% in 2024. (LSEG DataStream). We note that earning growth needs to be strong enough to support the lofty valuations in stocks. The S&P 500 Index is now trading 19.8 times forward 12-month earnings estimates – well above the long-term average of 15.6 times. We do not believe the market can move too far ahead if stocks are too richly priced.

Beyond this conventional issue of stock valuations, we have somewhat special concerns for 2024 about larger geo-political events that can affect the market negatively. The wars in the Middle East and Ukraine could unfold in ways that have negative outcomes on trade and energy flows. The election cycle in the U.S. also has circumstances we previously have never managed, and the impacts are unknown. We do not know how markets will react to a highly disputed election process.

On balance, we like the consensus forecast of 6% growth in the stock market. But we are vigilant about economic, political, and international events that can scuttle that positive outlook.

OUR STRATEGIES

Asset Allocation: Most clients should stick to portfolio strategies previously identified. We advise against an increased allocation to equities at this time. For some clients, we may recommend taking some money off the table right now. For new clients, we will recommend a 60% allocation to equities to be phased in over a 12- to -18-month period. The other 40% of assets will be short to intermediate term bonds, cash, and alternative investments.

Preferred Equities: As always, despite market conditions, we look for long-term equity opportunities. Our focus is on companies that can weather both the short-term period and flourish in a longer time frame. We want fundamentally sound companies with reasonable valuations and that pay dividends. In that context, we are looking at these sectors with special interest:

HEALTH CARE: This sector lagged in 2023 but has comeback potential in the period ahead.

UTILITIES: Companies in this sector have provided consistent earnings and good dividends.

CONSUMER DISCRETIONARY: Affluent shoppers have made the discretionary category a consistent good performer.

INDUSTRIALS: Federal government investment in infrastructure should work in favor of basic materials and construction companies. The need for military supplies is also an advantage.

FINANCIALS: The balance sheets of regional and super-regional banks should be strong in the current economic and interest rate environment.

SMALL BUINSESS: The stocks in the Russell 2000 index have attractive values and we are interested in funds that invest in this sector.

Other Assets: Our aversion to long-term bonds remains. But we explore various maturities through laddered investments with a mix of U.S. Government, municipal, and high- quality corporate bonds. We also like the current opportunities in money market funds.

Also, for some clients. we look at alternative investments through Broadly Syndicated Loan vehicles and Collateralized Loan Obligations which can provide investors with greater security through collateral, yields, and a hedge against inflation through floating rate structures.

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