Tarheel Advisors Newsletter

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2024 Investment Outlook

Higher interest rates, a banking crisis, and the slow spread of war across the globe...all things that one would expect to be a recipe for disaster in stocks. However, most equity indexes ended up double digits for the year, and the Nasdaq tech-heavy index went up a whopping 52%. 2023 was a statistically great year, proving that investment returns don't necessarily mirror the underlying news cycle.

Year in Review– Our primary thesis for this past year, and much of the last decade has been that the Federal Reserve's policy on interest rates has been the largest driver of investment returns. Accordingly, we felt that inflation would trend down from generational highs, but remain above the Federal Reserve's (Fed) target of 2%. We thought this environment would give the Fed very little wiggle room to pull back on interest rates and that borrowing costs for everyone would remain elevated for longer. Our assumption was spot on, as year over year inflation pulled back significantly during 2023 (from 6.5% to 3.1%). This caused the Fed to pause further interest rate hikes and hold steady since August at 5.5%.

Where we were less accurate was in our outlook for equities. We came into the year neutral on equities, expecting positive returns unlike 2022, but thinking that higher interest rates would create a bit of a headwind. It turned out that the appetite for stocks would outweigh this sentiment coming out of a bear market. Led by the largest companies in the U.S., stocks pushed through a fall sell-off and closed the year up double digits. The buzzword for the year was definitely Artificial Intelligence (AI), and anything that was perceived to have a ball in that court was rewarded, whether or not that ever affects their bottom line. On the flip side, the banking and utility sectors severely underperformed. International stocks did well directionally, but once again underperformed relative to domestic stocks.

It is easy to forget at this point, but we experienced a banking crisis just 9 months ago that caused three of the largest bank failures in U.S. history (Silicon Valley, First Republic, and Signature Banks). The banking crisis was directly related to the direction of interest rate moves and the multi-year selloff in long-term bonds. Perhaps this played into the Fed's playbook and was another reason to only hike rates 4 times in '24 versus 10 times in '23. Either way, bonds did as we expected and produced above-average returns, most of which materialized in the last two months of the year.

We suspected real estate would be another victim of high interest rates. With mortgage rates hovering around 7% and hitting a high of 7.8% in October, we expected and saw a very stagnant housing market. Many homeowners with sub 4% mortgages are hesitant to move and jump into a new property with a much higher payment. This stagnation has resulted in historically low volumes for home sales and refinancing. Surprisingly though, housing prices actually stayed fairly strong for the year in the bulk of the country.

2024 Predictions– Once again we are basing our 2024 market thesis on the Fed's interest rate policy. Ever since the Fed's December policy meeting, market pundits have started predicting anywhere from 3 to 6 quarter point rate cuts in '24. This conjecture is based on what is known as the "dot plot" forecast, which is a chart updated quarterly that records each Fed official's projection for the central bank's key short-term interest rate.

We believe that the consensus will once again be wrong, and that we are most likely to see very few cuts if any this year. With an unemployment rate of 3.5% and positive GDP growth in each of the last 4 quarters, it seems unlikely to us that the Fed would risk stoking the economy and re-igniting inflationary pressures. As we argued in last year's article,

2023 SCORE CARD

Prediction	Grade
Inflation Trends Slightly Down	A+
Neutral Outlook for Equities	C
Positive Year for Bonds and Rates Stay Higher	B
International Underperforms	A
GDP Growth of 1%	B

2023 Market Wrap

S&P 500	+23.4%
DOW	+13.8%
NASDAQ	+52.3%
RUSS 2000	+15.1%
MSCI World	+15.6%
BONDS	+5.3%
GOLD	+13.3%

Mortgage Rates

15-Year	6.2%
30-Year	6.8%

Did You Know?

* Nvidia was the best performing stock in the S&P 500 with a 236% return. Enphase Energy was the biggest loser with a 50% loss.

* Growth stocks outperformed Value by the largest margin since 1999.

* Half of mortgage brokers have left or are expected to leave the industry due to low refinancing volumes.

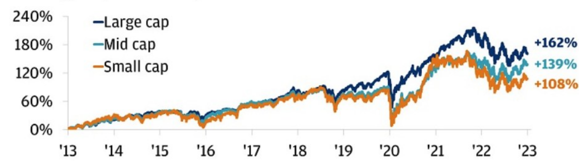
* For 2024, the IRS has raised the contribution limits for several retirement plan contributions. For a 401(k), 403(b) or 457 plan, the new limit is $23,000 with those over age 50 eligible for an additional $7,500 catch-up contribution. IRA and Roth IRA contributions also jumped up a bit to $7,000 with a catch-up contribution of $1,000 for those over age 50.

2024 Investment Outlook (Continued)

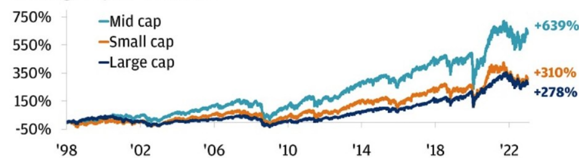
inflation is not transitory. It wasn't just caused by the supply/ demand imbalance coming out the Covid re-opening of our economy. There are a lot of factors to blame, including the irresponsible long-term government spending by most of the developed world. That side of the ledger has not changed recently, and is unlikely to change especially in an election year, where whatever party is in control typically uses all the resources they can to juice the economy and improve their re-election chances. With that in mind, if rates are not cut as many times as expected, then some of the recent double digit resurgence in the equity markets is likely just pulling future returns forward. Thus, we remain neutral on stocks, but still expect positive returns.

Large cap outperformance: The exception or the rule?

Trailing 10-year return, %



Trailing 25-year return, %



Source: Bloomberg Finance L.P. Data as of March 2, 2023. Note: Large cap represented by S&P 500 Index, mid cap by S&P Midcap 400 Index, and small cap by Russell 2000 Index. Past performance is not indicative of future results. It is not possible to invest directly in an index.

We don't think that every investment class and sector are created equal. We've written about this over the past 5 years, and we have cast aside sectors such as international bonds and emerging markets. While large cap domestic stocks have been the beneficiary of many societal shifts since 2020, we don't think that this relative out-performance will continue unchecked. A reduction in interest rates, even less than expected, should benefit small-cap and mid-cap companies by reducing borrowing costs. Couple that with a reversion to the mean for valuations and historical returns, and we anticipate out-performance.

Along those same lines, international stocks have been out of favor for more than a decade. There are quite a few significant reasons for this under-performance including much higher corporate taxes and regulations abroad, lack of tech-centered businesses, and a weakening currency. Many of those factors haven't changed, but the euro / dollar relationship has finally shifted. After reaching it's lowest point since 2008, the exchange rate has now switched direction and the Euro appreciated against the dollar in 2023. If the Fed lowers interest rates in '24 and the European Central Bank (ECB) maintains or further hikes their official short-term rates, then we will likely see a continuance of this trend. And while not having as many tech-oriented business hurt returns in '23 and

US Equity vs. International Equity 5-Year Monthly Rolling Returns (1/31/75-9/30/23)

The chart shows the values of the S&P 500 Index's returns minus the MSCI World ex USA Index's returns. When the line is above 0, domestic stocks outperformed international stocks. When the line is below 0, international stocks outperformed domestic stocks.
Data Sources: Morningstar, Bloomberg, and Hartford Funds, 10/23.

throughout the last decade, a shift towards value and dividend stocks could reverse the international stock markets abysmal underperformance. However, the periods of outperformance for the international sector have been fairly brief and shallow, so we will be inclined to sell into strength in this sector.

Another direct result of our interest rate thesis is that bonds will do OK, but won't have above-average returns. Still, with short-term interest rates hovering around 5% for up to one year, they are worth including in your portfolio as a great risk reducer. A year ago the 60-40 portfolio was declared dead, but now bond investors should be expecting annual returns between 4-6% going forward.

60/40 annual return decomposition
Total returns, 1950 – 2023

Source: Bloomberg, FactSet, Ibbotson/Strategas, Robert Shiller, Standard & Poor's, Yale University, J.P. Morgan Asset Management.
The 60/40 portfolio is 60% invested in S&P 500 Total Return Index and 40% invested in Bloomberg U.S. Aggregate Total Return Index. S&P 500 returns from 1950 to 1970 are estimated using the Shiller S&P Composite. U.S. fixed income total returns from 1950 to 1975 are estimated using data from Strategas/Ibbotson. The portfolio is rebalanced annually.
Guide to the Markets – U.S. Data are as of December 31, 2023.

J.P.Morgan ASSET MANAGEMENT

Lastly, this year has the potential to be one of the most toxic political environments in modern US history. So, buckle up and expect some volatility in the stock market along the way. As various candidates drop out or seem more likely to succeed, investors are likely to take out their frustrations on the stock market. Use that as an opportunity rather than reason to panic. We've written about this several times in the past, but we think it is worth re-iterating. The political party in control of the White House and Congress is not a good predictor of investment returns. Instead, follow the bread crumbs left by the Fed's interest rate policy which are much more likely to keep you on the trail to solid long-term returns.

-**Ryan Glover, CFP® & Walter Hinson, CFP®**

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2023 ADV Part 2 Changes— None