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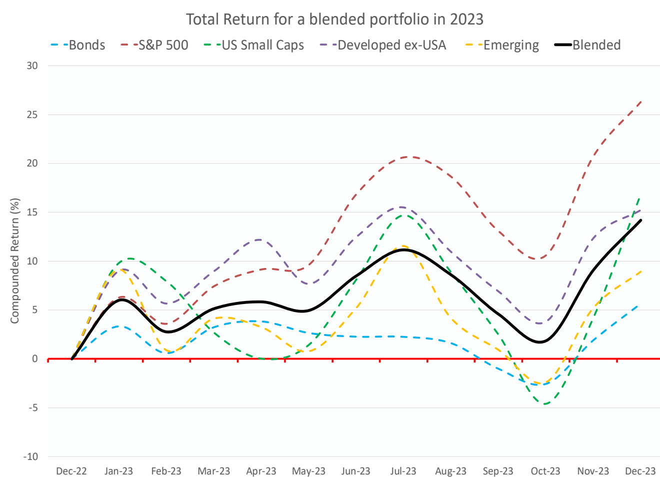
RYE, NY
914.282.0941
WWW.BLUMBERGADVISORS.COM

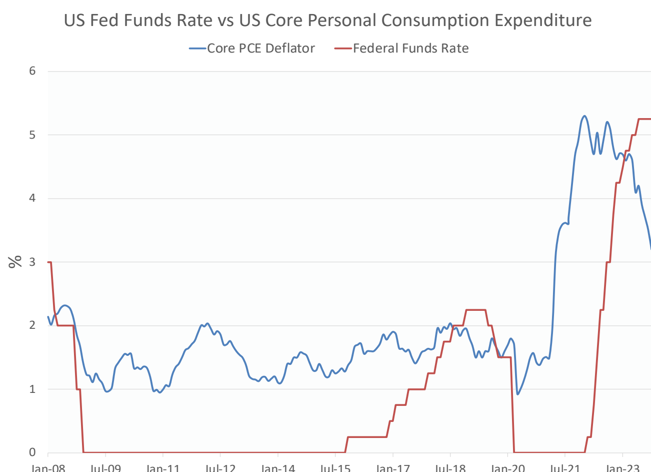
WHERE WE STAND – Q4 2023

In Q4 of 2023, a typical blended portfolio* of securities had a total return (capital appreciation plus income) of 9.2%. For the year, such a portfolio was up 14.2% (black line in the chart below). Leading advances were US Large Caps with a +26.3% return on the year. In a sharp turnaround in Q4, US Small Caps, second with a 16.8% return. Then, Developed Markets ex USA (+15.2%). Emerging Markets (+8.9%) and even Bonds, up 5.6%. See the colored broken lines in the chart.

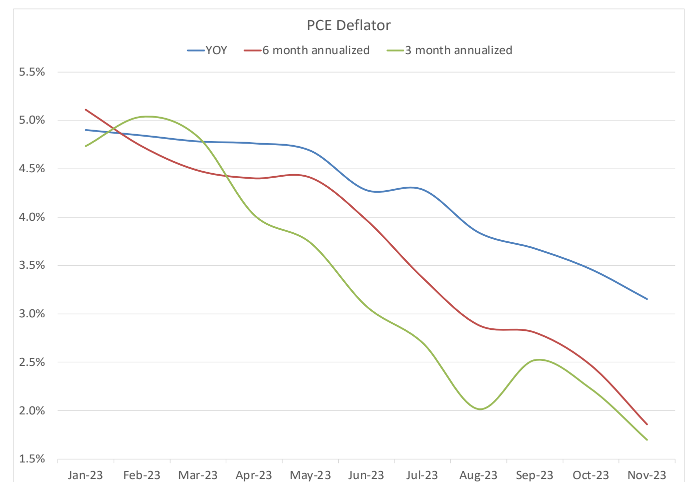


*A typical blended portfolio would be comprised of 60% equities and 40% bonds. For a benchmark, such a portfolio would arguably be 30% large cap US stocks, 10% US small caps, 10% developed markets ex-US, 10% emerging market stocks and 40% US government, investment grade corporate and GSE bonds.

The chart below shows the Federal Reserve's preferred measure of inflation (Core Personal Consumption



Expenditure Deflator in blue) plotted against the Fed's primary monetary policy tool, the Federal Funds target rate, in red. Critical: as the inflation rate falls, and the gap between it and the Fed's target rate widens, monetary policy is de facto becoming more restrictive. The chart below shows the same PCE data also on a 6-month annualized and 3-month annualized basis. Both these readings are below the Fed's target of a 2% inflation rate.



Therefore, in a sudden and surprising development, the last mile to reach the Fed's first mandate (inflation management), which entering the quarter was expected to be the hardest mile, turned out to be anything but.
Suddenly, the Fed's policy rate, at over 3% higher than the inflation rate is becoming far too restrictive and, if nothing is to be done about that, threatens the Fed's second mandate, ensuring full employment. This, owing to the constricting effect it will have on the economy. During the quarter, the Fed acknowledged this development and indicated that they will be cutting their Fed funds rate in 2024. In a rush of adjusted forecasts, the market began to discount the first Fed easing in March 2024 and that the Fed will cut rates by as much as 1.5% in the year.
Of note too, was the ongoing strength in the US economy: Q3 2023 — 4.9% (Actual); Q4 — 2.6% (Expected); 2024 — 1.3% (Forecast by St. Louis Fed). So, no recession and the forecast for 2024 PCE deflator:

1.6%. A veritable victory for the soft landing (declining inflation, whilst no recession) prognosticators.

Of course, such an outlook was extremely good news for the 60:40 traditional portfolio. Especially because entering the quarter, the sticky-inflation-probable recession argument was carrying so much sway, resulting in completely off-sides portfolio positioning.
And so it went:
US Treasury bonds at a 5% yield, with the fed about to cut interest rates sharply? 'Buy!'
493 of the S&P 500 stocks (those excluding the so called 'magnificent 7') at a 14.5% PE ratio in a no-recession, Fed easing environment? Small cap stocks that are cheaply valued after lagging for years and are about to have a high interest rate noose released? 'Buy!'
$6.5 trillion in money market funds earning 5.2%, that may only be earning 3.7% in a year's time? 'Maybe we sell and move into longer duration assets?'.

Where We Stand

We concluded the last report as follows:

'Our strategy is to be fully invested in a balanced portfolio of stocks and bonds. Our equity investments are fairly priced, have excellent free cash flow, pay dividends and promise good returns over the medium term. Our fixed income investments have been primarily very short duration, and we intend to extend that duration at the beginning of October to take advantage on the now attractive long term interest rates.

Any notion that the Fed is done with tightening and is going to begin easing, will again change the narrative towards deployment of capital out of money market funds into longer duration assets with both yield and the potential for capital gains. '

This has been an easier environment for us because we have been able to employ traditional valuation metrics that we found more difficult in the zero-interest rate environment of previous periods. And as late 2022 and all of 2023 unfolded we found excellent medium-term opportunities as value investors.

The rally in Q4 2023 has not fully discounted the notion of a continued soft landing in 2024, but both equities and bonds are obviously not as cheap as they were 3 months ago. Therefore, the expected forward returns are somewhat diminished.

Our proprietary equity risk premium* model for the S&P 100 has declined from 8% (13% return for stocks over the next two years less 5% for bonds) to 4% (8% for stocks less 4% for bonds) during Q4.
*The excess return stocks promise over bonds for taking the added risk.

But this continues to be a bifurcated market between market sectors (say, pharmaceuticals cheap; some technology expensive); market indices (small caps cheaper then large caps) and individual stocks (Dow, Inc vs Texas Instruments). All the above just examples to illustrate a point.
In addition, various opportunities exist in fixed income markets which still are not overpriced if in fact the Fed does ease 160bpts as the market expects.

Of course, the outcome in 2024 will be different to the expectation as we enter the year. Soft landing is not cast in stone. Geopolitical are, by definition, not correctly discounted as of now: for good or for bad.

I don't envisage much change to our portfolios for now. I feel the portfolios are well structured to benefit from the next — fed easing — cycle.

Value investments such as ours prevail over time, even if that time must be extended somewhat because of adverse short-term influences.