January 2024

INVESTMENT UPDATE

Executive Summary

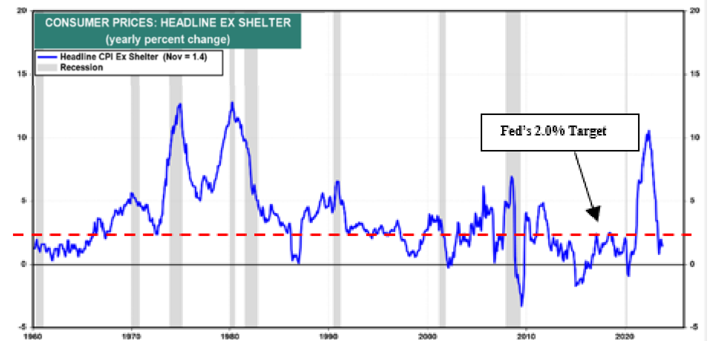
- Both stocks and bonds posted solid gains in the fourth quarter, culminating in strong full-year returns, as the Fed signaled the likely end of the interest rate hiking cycle.
- Inflation remains well under control with "real-time" inflation below the Fed's target of 2.0%. As a result, after raising the Fed Funds rate at a record pace and magnitude, the Fed signaled the likely end of the hiking cycle.
- The U.S. economy continues to grow fast due to strong underlying fundamentals. As the Fed starts lowering rates, easing financial conditions will further support continued economic and corporate earnings growth.
- The strong underlying fundamentals will increasingly come back into focus, as multi-year pandemic-related disruptions and economic shocks move further into the past.
- For equity investors, return prospects remain attractive despite the rapid recovery in the fourth quarter, due to the solid outlook for long-term earnings growth, while equity valuations remain fair. For fixed income investors, yields are down from their peaks but remain attractive.
- We believe long-term investors should stay invested in the mid-to-high end of the range in equities, and towards the low-to-mid range in fixed income, relative to their targets.

Inflation Continues to Fall Quickly Leading to the Fed Signaling the Likely End of the Interest Rate Hiking Cycle

With continued high interest rates and very tight financial conditions, both the money supply (M2) and inflation continued to fall in the fourth quarter. The money supply, one of the key leading indicators for inflation, declined by -2.9% on a year-over-year basis in November, marking the 12th consecutive month of shrinking money supply. Accordingly, inflation continued to slow as well. While the CPI (Consumer Price Index) was up +3.1% year-over-year in November, it includes the notoriously lagging change in shelter costs. When excluding or adjusting for shelter costs, inflation remains well below the Fed's target of 2.0%. As shown in Graph 1 in the next column, CPI excluding shelter costs increased only +1.4% year-over-year in November and the fall in inflation is even more pronounced when adjusting for "real-time" changes in shelter costs, with "real-time" inflation increasing only +1.3%.

The Fed has clearly done a great job of getting inflation back under control. Hence, the Fed signaled the likely end of the interest rate hiking cycle in December, by stating that the current levels of interest rates are very restrictive and implying that rate cuts are appropriate going forward.

Graph 1: CPI Excluding "Lagging" Shelter Costs Below the Fed's Target



Source: Yardeni Research, LSEG DataStream and Bureau of Labor Statistics

Overall, it has been a record fast and high hiking cycle consisting of 11 hikes, increasing the Fed Funds rate by over 500 basis points to 5.25-5.50%, in just 16 months. The pace and magnitude of hikes were necessary in order to combat the multidecade high inflation caused by the extraordinary fiscal and monetary pandemic stimulus, as well as keeping rates too low for too long in 2020 and 2021. We are encouraged that the Fed acknowledges the importance of easing monetary policy soon, given the long and lagging effects between monetary policy actions and their effects on the economy. They also made it clear they want to avoid putting the economy into a recession now that inflation is under control. Going forward, the combination of price stability - an imperative for sustained long-term economic progress and prosperity - along with easing financial conditions will continue to support economic and corporate earnings growth. This will enable the stock market to continue to move higher over time.

The U.S. Economy Remains Strong and Growing While Economic Conditions Continue to Get Back into Balance

The U.S. economy continued to grow robustly with lower inflation in the third quarter. Real GDP (nominal minus inflation) grew +4.9% year-over-year, notably above long-term averages. While several areas of the economy contributed to growth, including strong business fixed investment led by the shift towards onshoring manufacturing and production capacity, the lion's share of growth continues to be driven by the strong consumer which makes up two-thirds of the economy. Solid consumer spending continues to be supported by a combination of record high net worths, growing incomes, as well as low debt-service costs.

Nonetheless, despite a strong economy, high interest rates are continuing to bring economic conditions back into balance, which is very positive long-term. This includes the continued shrinking of the "gap" between demand and supply of labor,

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where the excess demand for workers, which peaked at over 5 million, is now down to 2.4 million as of November. Despite a smaller imbalance, the labor market clearly remains strong, and we believe it will remain so going forward. Additionally, while nominal wage growth is slowing, purchasing power is increasing, with real (nominal minus inflation) disposable personal income continuing to grow faster than expenses, as wage increases are catching up while inflation is falling. The consumer savings rate is also increasing back towards historical levels after temporarily falling due to high inflation. Lastly, consumer incomes are being boosted by higher interest income that reward savers and investors in ways not experienced in years. In summary, we believe the economy is well positioned for continued growth due to strong fundamentals, aided by easing monetary policy by the Fed.

Stocks and Bonds Posted Strong Gains Following the Likely End of the Fed's Hiking Cycle

Stock and bonds had strong and broad recoveries in the fourth quarter, quickly adjusting to the Fed's shifted monetary policy stance. This led to strong market returns for the full year, including a broadening of equity returns which up until the end of October, were largely driven by a select few large cap technology stocks. Overall, large cap stocks (S&P 500) were up +11.7% in the fourth quarter and +26.3% for the year. Small cap stocks (Russell 2000) had the strongest recovery in the fourth quarter and were up +14.0% and up +16.9% for the year. International stocks (MSCI EAFE) were up +10.5% in the quarter and +18.2% for the year. Bonds (USBIG) were up +6.8% in the quarter and ended up +5.6% for the year, a solid recovery after having negative returns through September.

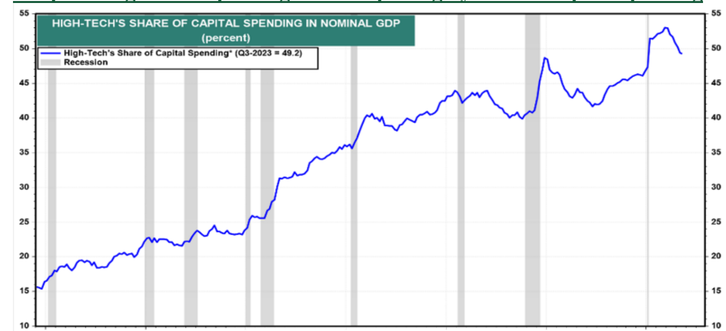
Long-Term Growth Fundamentals and Return Prospects Remain Attractive for Long-Term Investors

Despite the solid recovery in the quarter and strong gains for the year, return prospects continue to be attractive for long-term investors. While there has been an intense focus on the short-term in the last two years, including getting inflation back under control and the potential recession risk due to very high interest rates, this is now in the past. Going forward, in addition to easing financial conditions, we find three important reasons for long-term investors to remain constructive as we believe a combination of long-term structural dynamics and shorter-term cyclical benefits will continue to drive solid economic and earnings growth this year and beyond.

Near-term, we believe the economy and corporate earnings growth will continue to benefit from the cyclical normalization of business conditions, after dealing with almost four years of pandemic-related disruptions and economic shocks tied to supply chains, soaring freight and input prices, foreign exchange, rapidly rising costs of capital, and major variability in demand, to name a few. While business conditions have already improved and earnings are growing again in aggregate as of the second half of 2023, this cyclical normalization and momentum will continue to benefit earnings growth in 2024.

Though these cyclical trends help earnings growth near-term, the major reason why long-term investors should remain constructive for sustained economic growth and future returns prospects is due to the pace and impact of technological innovation, where trends are largely driven by the exponential growth in computing power and digitalization of the economy. Though developments have been well underway for a long time, the pace of investments and adoption of new technologies accelerated meaningfully during the pandemic and have sped up major technology shifts within industries and for consumers. As shown in Graph 2 below, U.S. high-tech spending now makes up close to 50% of capital spending (long-term investments) doubling its share in the last four decades, to roughly $2 trillion annually and growing fast. We continue to believe technology and innovation spending will be some of the most critical and major forces to continue to boost productivity, lower costs, and increase competitiveness to ultimately drive further economic prosperity and profit growth.

Graph 2: High-Tech Spending Makes Up Roughly Half of Capital Spending



Source: Yardeni Research, LSEG DataStream and Bureau of Economic Activity

Lastly, while the Fed will lower interest rates from the restrictive levels today, we believe rates will remain higher than during the period post the Great Financial Crisis when rates were at their lowest levels in recorded history. As long-term investors, we are highly encouraged by this development and believe it will keep the economy on a path of more sustainable and healthy economic growth. Overall, normalized interest rates, including positive real yields, keep economic conditions more in balance, disincentivizing unsustainable borrowing, excess speculative behavior, and misallocation of capital, while rewarding long-term investors and savers.

These strong underlying fundamentals for growth will increasingly come into focus again, as pandemic-related headwinds move further into the past. We continue to believe that the companies we invest in are some of the best positioned to benefit from these structural trends and dynamics. Many of them have already benefited and increased their competitive advantages through the last few years of rapid change and are very well positioned for strong future earnings growth. In addition, valuations remain fair, despite the recent market recovery. Overall, we believe both long-term equity and fixed income investors should position themselves for attractive returns over the next 3 to 5 years and beyond. We believe long-term investors should stay invested in the mid-to-high end of the range in equities, and low-to-mid range in fixed income, relative to their targets.

In accordance with SEC Rule 204-3(b), our Form ADV is available upon request. Please call or write to Susan C. Beaver, North Star Asset Management, Inc., 134 E Wisconsin Ave, One Neenah Center, Suite 300, Neenah, WI 54956.