**Breaking The Mold: Mastering Market Upswings Amidst Economic Challenges**

2024 Economic & Market Outlook Summary – January 13

## ***Summary of Macroeconomic Views***

Entering 2024, the economic narrative has shifted from a potential “hard landing” to a “no landing” scenario. This is reflected in the recent rise of asset prices across higher-risk segments of the financial markets. While we think it is likely that the impact of tight monetary policy will lead to slower growth, we don’t believe this will result in a material recession. Presidential election years also create unique risks and opportunities.

Understanding our role as stewards of capital, we take a more nuanced view of the next twelve months, wrapping in insights from our strategy, fixed income, and equity research teams. The tables below summarize our outlook and positioning within asset classes as we start the year. We also provide a more detailed recap of 2023, our analysis of the macroeconomic and financial market landscape ahead, as well as the potential investment implications for client portfolios.

| BUSINESS CYCLE INDICATOR | ASSESSMENT | CURRENT TAKEAWAY | TAKEAWAY Q4 2022 |
|---|---|---|---|
| ISM Manufacturing PMI | Key leading indicator of output with high correlation to corporate earnings. It has been in contraction since late 2022, but more stable moving through 2023. Specifically, while new orders remain depressed, directionally they have shown improvement, especially when compared to inventories. | NEGATIVE | NEGATIVE |
| ISM Services PMI | Despite remaining in expansionary territory, the most recent two-month trend for non-manufacturing services has been downward. It's difficult at this point in the cycle to determine if this is normalization from an area that has held up strong, or an early sign of stress. | NEUTRAL | NEUTRAL |
| Average Hours Worked | Weekly hours are trending lower, a sign that layoffs could be forthcoming given that cutting hours is typically a first step toward layoffs. | NEGATIVE | NEGATIVE |
| Jobless Claims | Despite a modest increase in certain industries, initial jobless claims (unemployment insurance) have remained suppressed throughout this year pointing to continued labor market strength. With current readings historically low, a prolonged uptick would be needed to reflect material weakness in the labor market. | NEUTRAL | NEUTRAL |
| Durable Goods Orders | New orders for nondefense capital goods, excluding transportation, has surprised to the upside this year. | POSITIVE | NEUTRAL |
| NAHB Housing Market Index | A move lower in recent months came as higher mortgage rates impacted affordability despite undersupply in many areas. Homebuilders have been creative in offering rate concessions, but we are uncertain about the resilience of the housing market in the current rate environment. | NEUTRAL | NEGATIVE |
| Yield Curve | Yield curve - our preferred measure being the 3-month treasury to 2-year treasury spread - is still in negative territory. An inverted yield curve like we are seeing today is typically a harbinger of an economic recession. | NEGATIVE | NEGATIVE |
| University of Michigan Consumer Sentiment | Recent falling consumer confidence represents a host of risks - from higher borrowing costs to changing political landscapes. Lower income consumers have been particularly hard hit as Pandemic-related stimulus and related savings dry up. Still, current readings are above those from this time last year. | NEUTRAL | NEGATIVE |
| Conference Board Survey | In looking at current and future conditions, the conference board found both deteriorating to a degree. Although disinflationary pressures are currently present, consumers still continue to view inflation as a major influence on the economy. | NEUTRAL | NEUTRAL |
| Senior Loan Officer Survey | Lending conditions have tightened since the banking concerns became evident in March of this year. | NEGATIVE | NEGATIVE |
| NFIB | Small business optimism has trended in the right direction over the course of 2023 while still remining below its long-term average. | NEUTRAL | NEGATIVE |
| **EQUITY FUNDAMENTALS** | **ASSESSMENT** | **CURRENT TAKEAWAY** | **TAKEAWAY Q422** |
| Valuations | The S&P 500 Index trades at roughly 18.5 times the next 12 month earnings. At current valuations, the market is modestly expensive compared to history (past 25 years). | NEGATIVE | NEUTRAL |
| Earnings Estimate Revisions | Earnings growth was 4.1 percent in the third quarter of 2023 and is expected to slow to 3.2 percent in the final three months of the year. The 2024 consensus view is for earnings growth of 12 percent, which is a bit above our internal expectations. We expect earnings estimates to be revised modestly lower throughout the year, which is typically the norm. | NEUTRAL | NEGATIVE |
| Profit Margins | Operating profit margins peaked in 2022 so a normalization toward the long-term average was expected in 2023. Margins have stabilized thus far at a level above the entire 2011 to 2019 period. | NEUTRAL | NEGATIVE |
| Leverage | Various measures of financial leverage (total debt/equity, interest coverage, etc.) do not currently indicate that corporate sector debt poses a significant risk to the economy and financial markets. | POSITIVE | POSITIVE |
| **EQUITY TECHNICALS** | **ASSESSMENT** | **CURRENT TAKEAWAY** | **TAKEAWAY Q422** |
| S&P Put/Call Ratio | A rising or falling ratio here tells us that participants are becoming bearish or bullish and is often viewed as a contrarian signal. The ratio has decreased from the beginning of the year. While not to the degree that gives us concern, it is something to watch closely. | NEUTRAL | POSITIVE |
| Bullish/Bearish Sentiment | A rising ratio since the beginning of 2023 produces the same signal as the Put/Call Ratio. Market participants are getting more comfortable putting capital in the equity market as the percentage of bullish investors has risen. Again, this can be a contrarian indicator. | NEGATIVE | POSITIVE |
| High vs Low Beta | This ratio staged a massive upswing early in 2023, then trended lower before making another run to again match a six-month high. Higher beta outperformed as investors chased a narrow group of stocks exposed to trends such as AI. | POSITIVE | NEUTRAL |
| Small Cap vs Large Cap | For most of 2023, Small Cap stocks considerably lagged their larger counterparts. However, Small Cap equities have fared better since November, coinciding with a peak in interest rates. | NEUTRAL | NEUTRAL |
| | **CONCLUSION** | **CURRENT TAKEAWAY** | **TAKEAWAY Q422** |
| Economic Growth Slows but Moderate/Severe Recession is Avoided | The consensus as we begin 2024 is for economic growth to remain comfortably above contractionary territory. While we are slightly less optimistic than some expectations, we agree in thinking that economic growth will remain above a point that puts material downward pressure on corporate earnings or the market as a whole. As the data above indicates, there are plenty of mixed signals heading into 2024. As monetary policy appears ready to shift, we will be closely monitoring various data points to access the impact and help direct investment policy. | NEUTRAL | NEGATIVE |

***Sources:*** *ISM® Report On Business®, US Bureau of Labor Statistics, US Employment and Training Administration, US Census Bureau, National Association of Home Builders, FactSet, University of Michigan, The Conference Board, Board of Governors of the Federal Reserve System, AII Investor Sentiment Survey*

### *Summary of Asset Allocation Positioning Entering 2024*

| | | |
|---|---|---|
| **Equities vs Fixed Income/Cash** | **Neutral** | Similar to last year, we do not recommend tactical tilts away from longer-term strategic allocations for investors holdings a mix of stocks and bonds. The interest-rate path is likely lower in 2024, which is favorable for fixed income. At the same time, our outlook for corporate earnings is positive, which may bode well for equities. There are plenty of upside/downside scenarios given the atypical nature of this business cycle. We don't believe directional shifts in favor of bonds over stocks, or vice versa, are warranted. |
| | | **Relative Weight within Equities** |
| **US** | **Overweight** | We believe the U.S. equity market offers the best growth prospects and is best positioned, for example, to take advantage of the potential productivity enhancements associated with AI. With a least some of this optimism reflected in prices and valuations of Large Cap Growth stocks, we beleive the risk/reward is more favorable farther down the market cap spectrum compared to the start of last year. |
| **International Equities (Developed Markets)** | **Equalweight** | Many European countries are on the verge of recession or have entered one. Japan appears on more favorable footing. We would like to see leading economic data bottom before we make significant positioning changes. Elevated geopolitical uncertainty is another factor that prevents us from having an overweight allocation despite the valuation advantage offered by many International Developed Markets. |
| **Emerging Markets** | **Equalweight** | Emerging Market equities were negative outliers in 2023. There are plenty of downside catalysts still in play, but we think the probability of a global hard landing is lower than this time last year, making the risk/reward slightly better. Similar to International Developed, significant underperformance in 2023 sets the stage for potential mean reversion in 2024, especially if the dollar weakens. |
| **"Unconstrained"** | **Underweight** | This allocation is least correlated to the broad equity markets and, as such, often outperforms in down markets. We have slightly scaled back our exposure because we don't think an overly defensive posture is warranted at this time. |
| **Invest Style/Market Cap** | **Shift towards Mid/Small Cap** | We look to reduce our overweight to "quality" Large Cap Growth and add exposure down the market cap spectrum. Select mega-cap companies drove results in 2023, and we don't have the same expectation in 2024. A rotation away from the "Magnificent Seven" and normalizing interest rates would likely create favorable flows into smaller high-quality companies largely ignored last year. In addition, if the market experiences a significant selloff, we think it's likely that investors could harvest gains in the area that has performed the best (Large Cap Growth), similar to 2022. We realize Small- and Mid-Cap stocks typically exhibit greater cyclicality and face more downside when economic fundamentals worsen. |
| | | **Relative Weight within Fixed Income** |
| Duration | **Tilt towards longer duration** | We will continue to modestly increase the duration of fixed income in portfolios to take advantage of our view that interest rates will likely decline in 2024 - a positive for bond prices. |
| Yield Curve | **"Barbell" Posture** | While we have increased average maturity to lock in higher yields, the inverted interest-rate environment (short-term rates greater than long-term rates) presents compelling opportunities. Shorter maturities are yielding more, although this yield advantage has slightly dissipated over the final quarter of 2023. Shorter-dated maturities provide capital flexibility and less interest-rate risk for investors looking for near-term liquidity. |
| Credit Quality | **Tilt towards higher quality** | We still believe there is room for credit spreads to widen going forward. In 2022, we lightened up on our credit exposure, thus becoming more defensive. We think this position is still warranted as we head into 2024. |

## ***Introduction***

*Reflecting on 2023: A Resilient Economy in a Year of Challenges*

As is often the case, unforeseen events drive financial markets and the global economy in shorter periods. Last year, optimism surrounding Generative Artificial Intelligence ("AI") and the resilience of the U.S. consumer were two unanticipated factors that drove equity returns and positive economic surprises. Throughout the year, numerous areas of the economy provided mixed signals. The ISM Manufacturing PMI (a survey of purchasing managers at over 300 manufacturers) weakened while jobless claims only showed minor steps higher. Large sectors, like Technology and Consumer Discretionary, demonstrated relative strength, while Health Care, for example, saw limited traction. Amidst a backdrop of persistent inflation and rising interest rates, 2023 was emblematic of resilience in the face of economic adversity.

Within U.S. equity markets, large-cap companies and, specifically the "Magnificent Seven" (Microsoft, Amazon, Meta Platforms, Apple, Alphabet, Nvidia, and Tesla) played a pivotal role in the market's above-average return for the year. As we will discuss later, the larger universe of stocks contributed very little to the overall return. Additionally, fixed-income investors navigated heightened interest rate volatility, influenced by the Federal Reserve's (Fed) interest rate hikes. Despite these challenges, there was an undercurrent of stability, supported by higher coupon payments and low perceived default risk. Globally, while some markets grappled with increased risks, others, particularly emerging markets, hinted at early signs of recovery. Within our balanced portfolios, we allocated toward quality growth in U.S. equities and took a neutral stance on both international developed, and fixed-income investments.

## ***Looking Ahead to 2024: A Landscape of Opportunity and Caution***

As we enter 2024, our base case scenario centers around a slow, lazy economic softening, with lower probabilities evenly balanced between the tails of the distribution of a moderate recession and accelerating economic growth. We are unconvinced the U.S. economy is impervious to the most aggressive rate-tightening cycle in four decades. We also understand that COVID-related stimulus insulated household balance sheets throughout the rate increases. Notably, the effective mortgage rate on outstanding debt in the U.S. is 3.7 percent, significantly lower than current rates, shielding many consumers. Long-term rates trended downward during the final quarter of 2023, a dynamic we believe will continue in the first half of 2024. This should provide a tailwind for interest rate-sensitive segments of the economy more negatively impacted by higher rates.

The economic push and pull that has taken place recently is likely to continue in our opinion. Some of the worst recessions since World War II have been preceded by periods like those investors have just faced, characterized by high inflation, tight monetary policy, and inverted yield curves (where short-term interest rates exceed those further out on the curve). Conversely, falling inflation and easing monetary policy often spur economic activity - reminding us of the late 1990s. Coupled with higher productivity, partly driven by the broadening use of AI, and pro-economy policies in an election year, there is a strong case that the overall environment will remain attractive.

In the equity market, we project solid earnings growth (9 to 10 percent) with operating margin expansion for the S&P 500 Index, driven by the broadening base of market participation and a reacceleration in pockets of the economy hampered by rising rates. The fixed-income market is poised for change, with the 10-year U.S. Treasury yield expected to end the year between 3.75 and 4 percent, reflecting the Fed's anticipated rate cuts and slower economic growth.

As we chart a course through 2024, we remain committed to an approach that is both flexible and informed, leveraging insights and data to make decisions that align with our clients' long-term financial objectives and risk profiles. Our focus on the quality of investments, risk-adjusted returns, diversification, and tactical positioning will continue to guide our process.

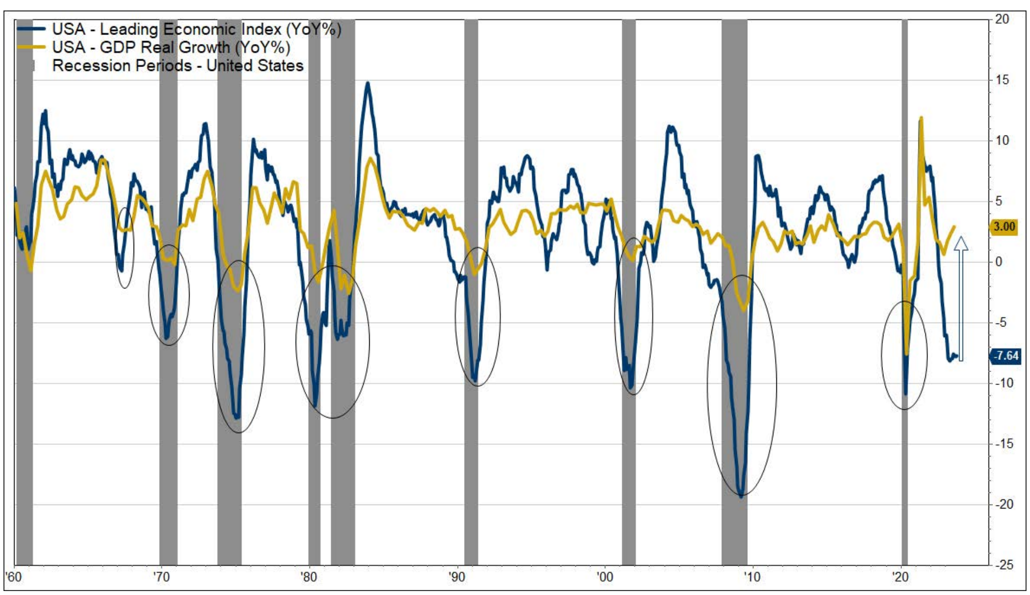
## *U.S. Macro Backdrop A Deeper Dive*

The consensus view heading into this past year was based on historically reliable leading economic indicators (below 50 Manufacturing PMI, inverted yield curve, negative year-over-year change in The Conference Board Leading Economic Index®) foreshadowing a challenging macroeconomic environment. While we didn't expect the economy to spiral down, in hindsight, our view also ended up overly pessimistic.

A slower growth narrative did not play out, although our outlook for relative performance across financial market asset classes added considerable value. For example, being overweight Large-Cap Growth and underweight Small- and Mid-cap Value was advantageous, even if it happened for unforeseen reasons. When a handful of Large-Cap Growth stocks rocket higher because they are seen as beneficiaries of the optimism surrounding AI, it's hard to take full credit. While fundamentally solid in many cases, these companies were not outliers because investors coveted stable growth as the economy slowed.

Last year, at this time, we also underestimated the resilience of the U.S. consumer going forward. The effects of higher interest rates and tighter bank lending standards take time to work through the economy, hence the proverbial saying "long and variable lags." The atypical nature of the economic cycle is shown in the chart below, which juxtaposes the year-over-year growth rate in Real Gross Domestic Product (GDP) (yellow line) alongside the year-over-year percent change in The Conference Board Leading Economic Index [1]("LEI" blue line). This is the first time since the early 1960s that the one-year growth rate in LEI reached negative 5 percent and the economic growth rate did not decelerate further.

**Chart 1: Leading Economic Indicators**



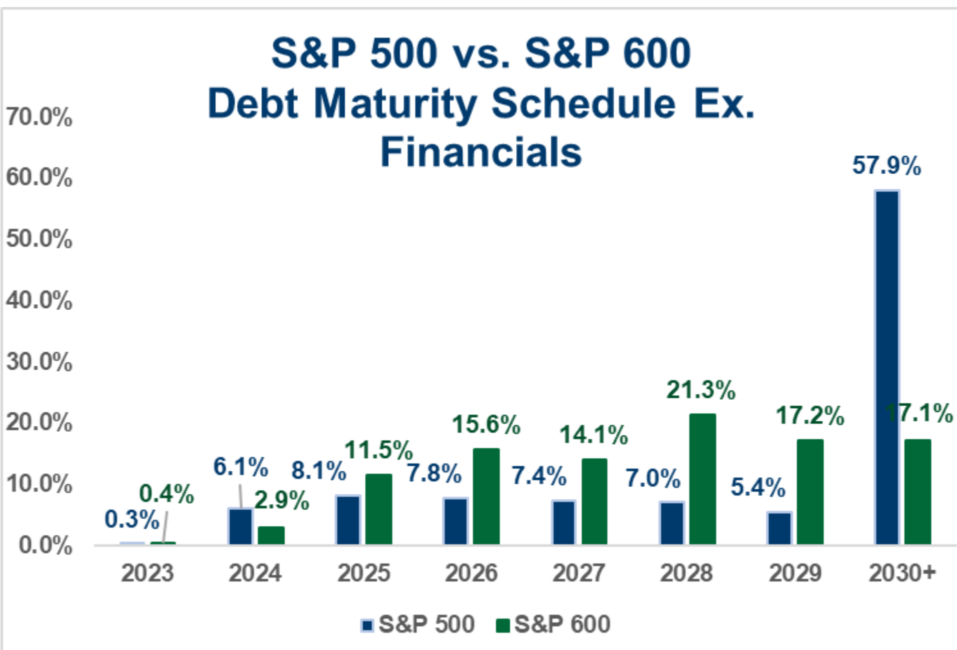

Source: Bryn Mawr Capital Management, FactSet

[1] Conference Board Composite Index of Leading Economic Indicators. Economic variables include average weekly hours worked by manufacturing workers, initial unemployment claims, manufacturing new orders, building permits, steepness of the yield curve, among other variables.

The unprecedented fiscal and monetary response to COVID-19 surely complicated the business cycle evolution. While the Fed has been busy raising rates by over 500 basis points (5 percent) since early 2022, the U.S. government almost simultaneously rolled out nearly $4 trillion of additional spending packages (i.e., The American Rescue Plan Act, Infrastructure Investment, and Jobs Act). Higher rates curtail economic activity, while elevated levels of fiscal spending support growth, at least over the short term. Keep in mind that Personal Consumption Expenditures (consumer spending) account for more than two-thirds of GDP in the U.S. The household savings rate rose rapidly following the pandemic, reaching the highest level recorded since at least the late 1940s.

The willingness of consumers to spend and draw down their excess savings was a key factor that enabled the economy to keep humming over the last 12 months. It's not surprising that the "soft landing" narrative is gaining traction as the services portion of the economy (ISM Services PMI) has continued to expand, the labor market is not showing any significant cracks, consumer sentiment is improving, and homebuilder confidence remains steadfast despite higher mortgage rates. This occurred as inflation cooled and real wages rose. Corporate balance sheets were solid ahead of rising rates, given the lengthy low-rate environment before 2022 provided ample time to refinance debt obligations.

**Chart 2: Debt Maturity by Market Cap**

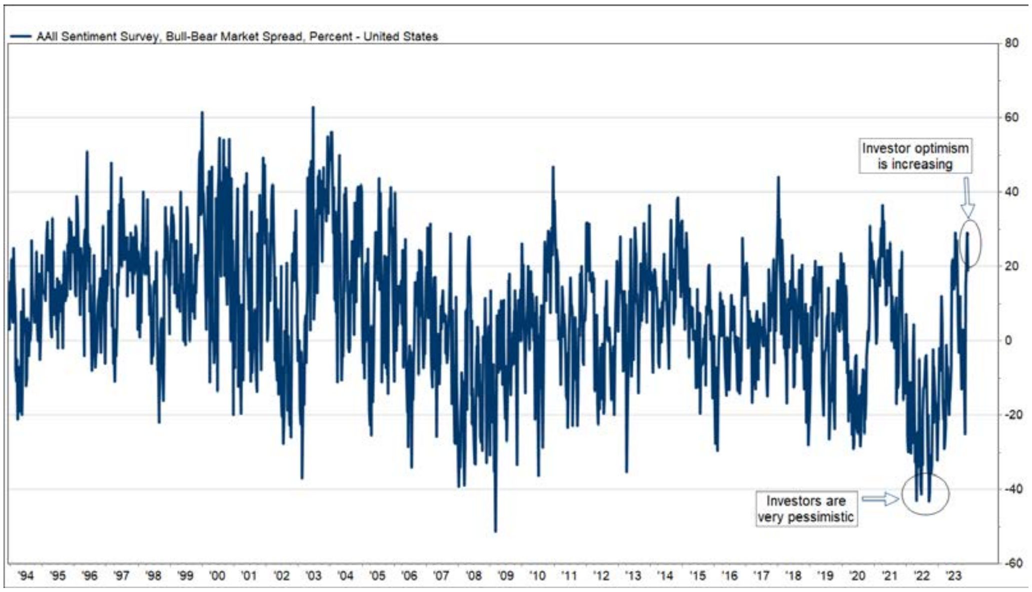



Source: Strategas Research Partners

At the time of this writing, investors must weigh the improvement in business cycle data we analyze with a modest decline in the equity fundamental and technical indicators illustrated below.

- **Bullish/Bearish Sentiment:** Going into the final quarter of 2022, extreme pessimism was priced into the markets based on this ratio. Investors are usually this bearish while in the depths of an economic recession. Today, investors are much more optimistic about the future, which can be a contrarian indicator regarding the future direction of the market.

**Chart 3: American Association of Individual Investors Sentiment Survey**



Source: Bryn Mawr Capital Management, FactSet

- **Equity Valuations**: Although valuations are a poor market timing tool, they can be useful in conjunction with other indicators. Assuming 10 percent earnings growth in 2024, the S&P 500 (as of mid-December 2023) is trading at roughly 19 times earnings, which is moderately expensive when compared to the previous 25 years.

As mentioned earlier, the U.S. economy has meaningful crosswinds supporting both growth and restraint. Although job openings have declined based on Job Openings and Labor Turnover Survey (JOLTS) data compiled by the U.S. Bureau of Labor Statistics, they are still comfortably above pre-pandemic levels. Household checking account deposits are at record levels north of $4 trillion, roughly $3 trillion above levels before 2020, which bodes well for consumer spending power. It’s possible that given the atypical events over the past few years, it will take longer for the effects of higher rates to permeate through the economy, thus delaying the impact. Another scenario is that the neutral rate of interest, which brings the economy into equilibrium, is higher than what the Fed is projecting. If so, the Fed may have to impose tighter monetary policy, thus running the risk of a more abrupt halt to economic growth in the distant future.

We would be remiss to not mention the upcoming 2024 presidential election. We don’t take a view on who will ultimately be elected or put much, if any, trust in the related forecasts. We also don’t believe investors should shift strategy ahead of these events. In 2016, the uncertainty surrounding Brexit and the election of Donald Trump did not result in a feared disastrous outcome for financial markets. The S&P 500 Index rose over 27 percent from mid-2016 through the end of the following year. Our biggest takeaway for this election cycle is that equities have fared better on average in the year of an incumbent president’s victory versus an incumbent president's loss. Also, over the last one hundred years of election cycles, no president has lost a reelection bid while avoiding a recession within the two previous years leading up to the voting.

## ***A lot of the Same Macro Themes Overseas***

Like in the U.S., inflation levels have continued to abate across various European economies following aggressive monetary tightening campaigns from central banks (i.e., European Central Bank and Bank of England). Also similar are negative readings from various leading indicators, such as Manufacturing PMI, which has been in contraction territory since the third quarter of 2022. The consensus view is that there is a greater likelihood of a recession within the Eurozone compared to the U.S. Again, like here in the States, we believe that much of the impact of 2023s rate hikes has yet to be felt.

Eurozone Real GDP fell 0.10 percent during the third quarter of 2023. On average, European countries, especially Germany, exhibit greater cyclicality given their sensitivity to fluctuations in manufacturing and global trade. More services-focused economies, like France, have fared better. Geopolitical tensions, which were making headlines this same time last year, remain in place. On the positive side, European households have absorbed higher rates, at least up until this point. Household debt service ratios have declined across most countries even after central banks began hiking interest rates at a rampant pace[2].

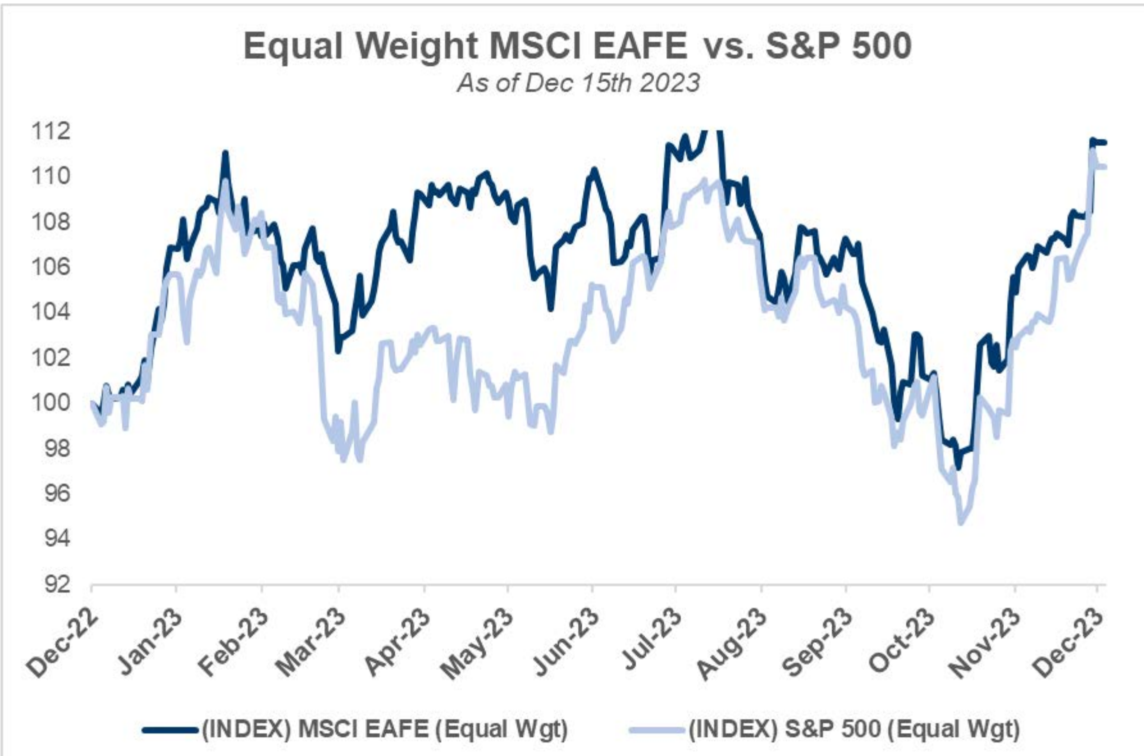
Japan is experiencing improving trends from both economic and financial market standpoints. The region has seen real wage growth, an upward-trending economy, and only a modest uptick in inflation levels. For context, the country has been grappling with deflationary pressures for three decades. The Japanese government is also trying to address corporate governance issues with the Tokyo Stock Exchange, going so far as to threaten the delisting of any stock that trades at a price under book value. The Bank of Japan still has the unenviable task of trying to claw back yield-curve control following negative interest rate policies, without causing a larger disruption to financial markets.

Emerging market investors remain squarely focused on China and India, given that combined both countries represent roughly 40 percent of the MSCI Emerging Markets Index. An expected Chinese economic boom following the country's COVID-19 reopening did not materialize, and weakness persists in the housing market and highly leveraged corporate sector. Potential government intervention in the private sector is another ever-present risk. Still, fiscal stimulus initiatives announced this past year should prevent a more protracted economic slowdown in 2024. India, by contrast, has been a bright spot in terms of emerging economies with the International Monetary Fund recently raising its 2023 GDP growth forecasts from 6.1 percent to 6.3 percent.

The "Magnificent Seven" simply does not exist in overseas indexes. Aside from the small cohort of U.S. stocks that drove equity market returns in 2023, the average International Developed Market stock (MSCI EAFE Equal-Weighted) has performed in line with the S&P 500 Index, assuming all constituents are weighted equally (see chart below). Our work leads us to believe that international markets may have a tailwind going into this year, assuming the global economy avoids a "hard landing" scenario, and we are reserving the flexibility to opportunistically add more exposure throughout 2024 if merited.

[2] Jeffrey Kleintop, 2024 Global Outlook: The Big Picture (Charles Schwab), 7-8.

**Chart 4: MSCI EAFE Index Equally Weighted vs S&P 500 Index Trailing 1-Year**




Source: Bryn Mawr Capital Management, FactSet

We are watching the path of the U.S. dollar given the relative performance impact for U.S.-based investors with international asset exposure. At least for the first half of 2024, a combination of a more dovish Fed and a lack of material weakness in the global economy will likely put downward pressure on the greenback. Given the countercyclical nature of the currency, an improvement in global growth often results in a lower U.S. dollar with the opposite true during times of economic stress. For example, equity and fixed-income markets sold off in 2022 as fears mounted over inflation and overly hawkish monetary policy. If the U.S. dollar weakens in 2024, which we expect it will, this should bolster both earnings for U.S. multinational corporations and international equity returns for dollar-based U.S. investors.

## Relative Macro–Level Positioning within Equities

*Overweight U.S. Equity Markets*

From a geographical perspective, our slight overweight to U.S. equities coming into 2023 will remain intact for the beginning of 2024. The no change in positioning is reflective of the balance between risk and reward regionally. Technological breakthroughs witnessed in the form of Generative AI should help propel capital spending in that sector in the U.S. However, valuations look elevated, especially within Large Cap Growth, potentially providing a lid on excess returns relative to the broad market's historical average return. Our overweight to US equities is attributed to our more favorable view of the potential investment opportunities within the Mid/Small Cap segment of the market (see below).

*Remain Equal Weight in Developed Markets and Move up to Equal Weight in Emerging Markets*
Although we feel the U.S. markets offer more compelling growth opportunities heading into 2024, certain specific regions of the globe offer attractive areas to invest. Countries like Japan and India should have tailwinds for their respective economies and markets. Japan is experiencing a more friendly business climate, and India's economy could be supported by increased capital expenditures and credit growth going into 2024. To take advantage of certain global opportunities in a risk-managed manner, we are maintaining our equal-weight stance in developed markets but changing the complexion of that equal weight by dipping slightly down in market capitalization. Parallel to that change, we are increasing our positioning in Emerging Markets to equal weight from underweight as we start 2024. Both maneuvers are reflective of our positive thoughts on certain regions of the world and the likelihood for mean reversion based on relative underperformance over the past several years. If forecasted economic tailwinds do not transpire as expected, we feel the relative valuation discount provides a degree of cushion going into 2024.

*Underweight "Unconstrained"*
This portion of our equity portfolios is reserved for investments that do not neatly fit into a particular investment style box (Growth, Value, International, etc.). Our "Unconstrained" allocation often has a low and potentially negative correlation to the market as a whole and can add value in down markets with higher volatility. Our base case scenario is that a "hard landing" economic environment has a lower probability of occurring relative to this time last year. Therefore, we have modestly scaled-back exposure in favor of more conventional equity asset classes that more closely track the global equity market.

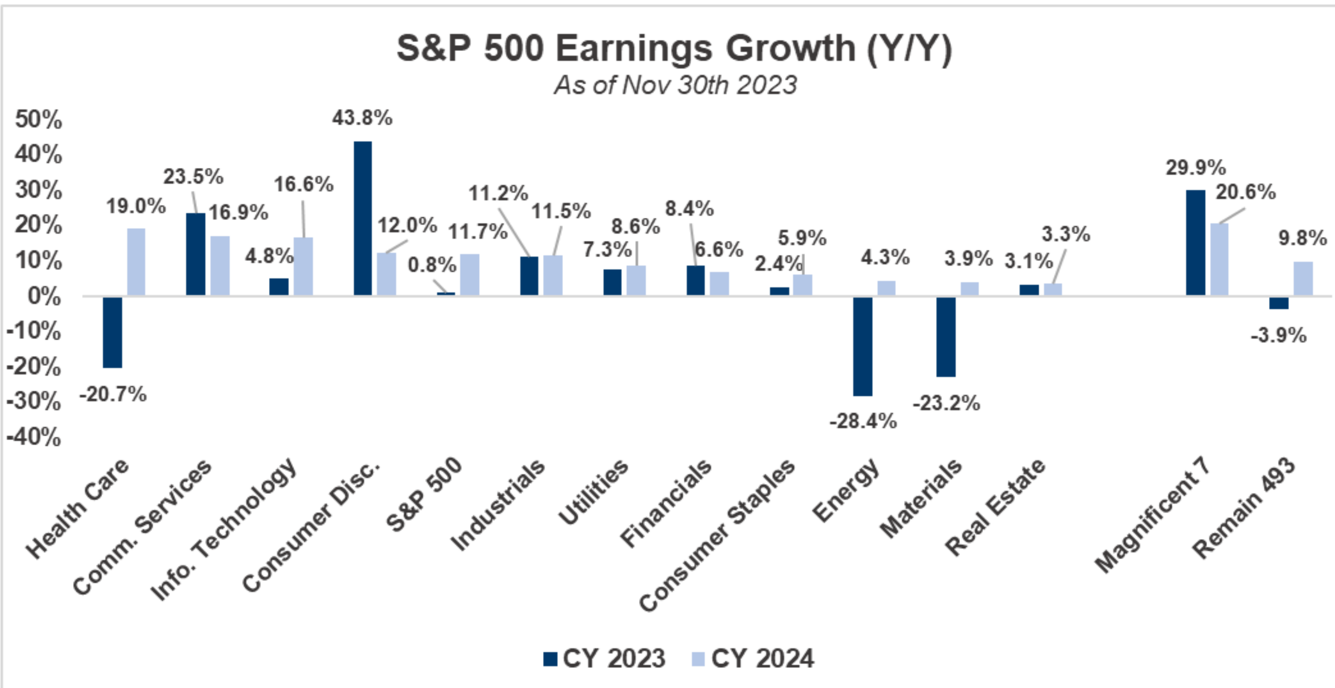
*Tilt Lower in Market Capitalization*
Going into 2023, our base case was for a period of earnings deceleration as the economy grappled with higher interest costs. Those interest costs had an impact on earnings, but not to the severity we expected. Nonetheless, based on that backdrop, we tilted our portfolios higher in market capitalization and towards growth as a factor, essentially believing market participants would favor stocks with the highest relative earnings growth. That area wound up being the "Magnificent Seven" stocks, mentioned throughout this paper. With the probability of hard landing diminishing as we enter 2024 and the substantial outperformance of Large Cap Growth relative to Mid/Small Cap, we feel a thoughtful way to manage our client portfolios is to pocket a portion of those gains from last year's tilt and place those proceeds in mid and small cap investments. If our base case for the economy proves to be incorrect and growth turns for the worse, our comfort with these maneuvers lies in the relative valuations between Large Cap Growth and Mid/Small Cap. In addition, many of our mid/small cap strategies have more exposure to the "quality" factor, which should offer downside protection if markets become more volatile throughout 2024.

## Outlook for U.S. Equities – Above Average Returns for the "Non-Magnificent" Stock

With the calendar entering a new year, equities, and the individual businesses they represent, find an operating environment not dramatically different from how this past year ended. Changes to overall returns will, in our opinion, be more linked to fundamentals as broadening market leadership encourages investors to migrate toward growth that isn't yet reflected in stock prices. We don't believe valuation alone drives returns, but we do think that the growth prospects in select areas outside of the narrow group of mega-cap stocks that led indexes last year are improved and merit attention.

Working at a company-by-company level leads us to believe that earnings estimates, using the S&P 500 Index as a proxy, will see modest revisions lower as we progress through 2024. Estimates currently sit at $246 per share, representing a new record for earnings and a year-over-year increase of roughly 11 percent. This compares to the 9 percent compound annual growth rate the Index achieved in the prior five years. Our earnings backdrop is built on revenues increasing by 5 percent, expectations for nominal GDP growth, and profit margin expansion. While margin expansion isn't a given every year, we see supply chain improvements and inventory normalization leading to less discounting and promotional activity, partially offset by sticky wage inflation. From a sector standpoint, Energy and Health Care are likely to be meaningful earning contributors following declines last year.

**Chart 5: S&P 500 Earnings Growth 2023/2024**




Source: Bryn Mawr Capital Management, FactSet

It is typical to start the year with Wall Street overhyping the earnings growth landscape. In fact, in 17 of the past 25 years, pundits have overestimated the growth rate by an average of roughly 7 percent. Missing by that amount isn't quite as shocking as one might think, given it includes outliers where geopolitical and macroeconomic shocks occurred (the 9/11 terrorist attacks, the 2008/2009 Financial Crisis, and, more recently, the COVID-19 pandemic's impact on 2020). Excluding these from the baseline, the average difference between analysts' estimates at the start and end of a given year is two percentage points.

Using this as a guide implies Index earnings should grow about 9 percent in 2024, from $221 to $242. We are cognizant that this growth rate is above the historical average and implies margin expansion. It also reflects many of the impacts included in our overall strategic positioning, including the fact that election years typically see pro-market economic actions ahead of voters heading to the polls. Election years when there is a sitting incumbent see GDP increase almost 30 basis points (0.30 percent) more than when new candidates are involved. The average S&P 500 Index returns are even more dramatic, with an average gain of 13 percent in year four when a sitting president seeks re-election compared to a decline of 2 percent when newcomers are on the ballot.

 *See important disclosures on page 18*

*Valuation*

We believe the S&P 500 Index's current valuation is reasonable, but modestly expensive based on historical averages. The Index is currently trading at roughly 19 times 2024 earnings, about one and a half turns above its ten-year average of 17.6 times. Our assertion is based on both the average earnings growth projected among its broad components as well as the impact that extraordinarily narrow market leadership has had on valuation metrics.

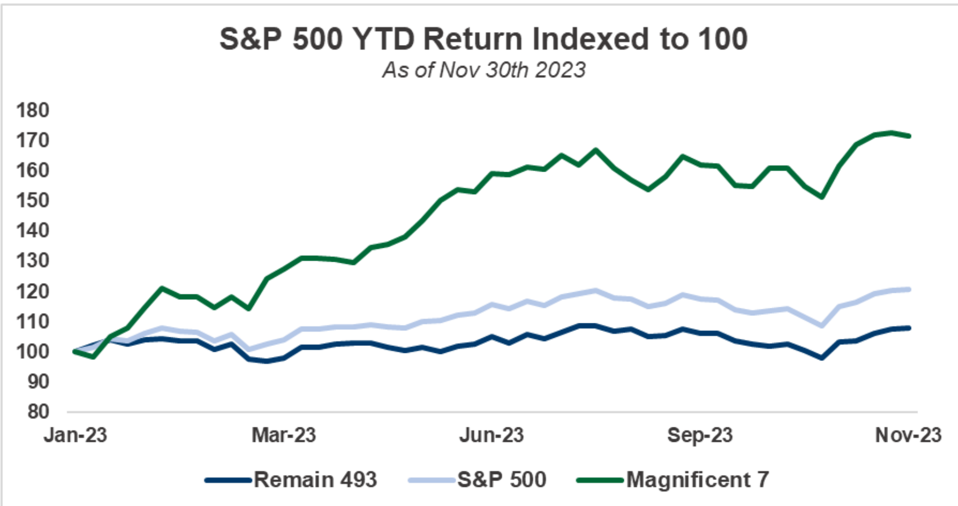
First, given the higher-than-historical earnings growth anticipated for 2024, we see that a higher valuation may be justified. Assuming the benchmark achieves our $242 earnings-per-share estimate and that the price-to-earnings (P/E) multiple stays constant, implies a 9 percent return next year or roughly 11 percent with dividends included. Second, early last year the Bank of America analyst Michael Hartnett coined the phrase "Magnificent Seven," borrowing the title from a 1960s Western to describe a group of high-profile, technology mega-caps propelling the overall market higher (Microsoft, Amazon, Meta Platforms, Apple, Alphabet, Nvidia, and Tesla). These gunslingers had a combined market capitalization that topped 30 percent of the S&P 500's overall market value late last year and traded at 29 times (rich in our opinion given a combined high teens growth rate) the next-twelve-month earnings estimates – 1.7 times the Index as a whole. Backing them out, the valuation for the Index falls by more than two turns. Additionally, we anticipate that earnings growth could slow for these seven as 2024 progresses versus a potential acceleration for the rest of the Index components.

We would note that equities look more expensive when compared to bonds on a risk-adjusted basis. We arrive at this conclusion by using the earnings yield (1 divided by the current P/E ratio) and comparing it to yields on corporate bonds. For example, as interest rates have risen, Baa corporate bonds in the U.S. Aggregate Index now yield 5.7 percent versus an S&P 500 Index earnings yield of 5.4 percent. This yield advantage for bonds is the most since the 2008/2009 Financial Crisis.

*Sector Perspective*

Diversification by market cap across equities didn't add value in 2023, evidenced by the wide disparity in weighted returns. As of December 18, 2023, the market-cap-weighted S&P 500 Index is up over 25 percent year-to-date, which compares to a 12 percent gain for the equal-weighted Index. Looking at this differently, the Magnificent Seven contributed 70 percent of the S&P 500's return in 2023 (up 14.4 percent year to date) with a median return of over 72 percent as of November 30, 2023.

**Chart 6: S&P 500 Returns YTD: Top 7 vs. Remaining 493**




Source: Bryn Mawr Capital Management, FactSet

We expect market returns to broaden in the new year with a more normalized distribution curve of returns from the "non-magnificent" stock universe. Unexpected gains last year were tied to companies exposed to Generative AI and new GLP-1 weight-loss drugs, which are reflected in expectations. Additionally, the return disparity between growth and value indexes (across all market caps) is the largest since 1999. While this spread can continue, we note that value tends to snap back after periods of such wide underperformance, with 2000 and 2021 being examples.

Given interest rate sensitivity, companies in the Utilities and Staples sectors could garner support should rates moderate from here. These stocks trade at compelling P/E valuations below their five- and ten-year averages and exhibit low earnings volatility. Select Consumer Staples companies also screen well, oversold on fears related to the impact of GLP-1 weight loss drugs that aren't yet quantifiable. The Health Care sector also looks attractive from a valuation and growth perspective. Following a significant decline this past year, select Health Care companies are primed with some of the highest expected earnings growth, attached to generational trends, higher quality health care, and new technological advances. The sector has historically suffered in election years as topics like drug pricing and healthcare availability become fodder for partisan debate. The stage is set, at least at the current moment, for competition between candidates that have already sat in the Oval Office, rendering rhetoric less impactful given the policy implications are known.

The Renewable Energy industry could stage a comeback amid lower rates and constructive policy on subsidies. The group sold off in 2023 as debt issuance is a large component of financing for the large projects typical of the space. Banks and financial institutions appear to enter 2024 in better shape than at the start of last year, even though we expect some headwinds to persist as credit normalizes. Our work shows deposit outflows stabilizing and capital ratios improving as securities portfolios runoff. For consumer-oriented names, our current thinking aligns with our larger view that economic conditions avert a deep recession, putting retailers offering affordable value in a better position than those counting on trade-down purchases.

We expect AI as an investment theme to continue in 2024. However, we caution that outside the mega-cap names such as Nvidia, Microsoft, Google, and Meta the tangible impact on income statements is limited as real use cases are still developing. Further out, we see AI's potential for improved labor productivity. Microsoft's rollout of AI productivity tools should provide an early indicator of the technology's real-world impact on bottom lines. Our efforts are aimed at the companies either enabling the use of AI or best positioned to harness data and create tangible outcomes.

*Opportunities in 2024*

We're very encouraged by our ability to identify companies where we see unique opportunities for growth going forward that aren't reflected in a price tag. We believe that over full cycles the market rewards fundamentally sound companies with a premium. Businesses with strong balance sheets, limited competition, and that can protect their profitability, whether costs rise or fall, should attract attention in 2024. Conversely, unprofitable companies and those with substantial amounts of debt will continue to feel the pressure of higher interest rates and tighter lending constraints.

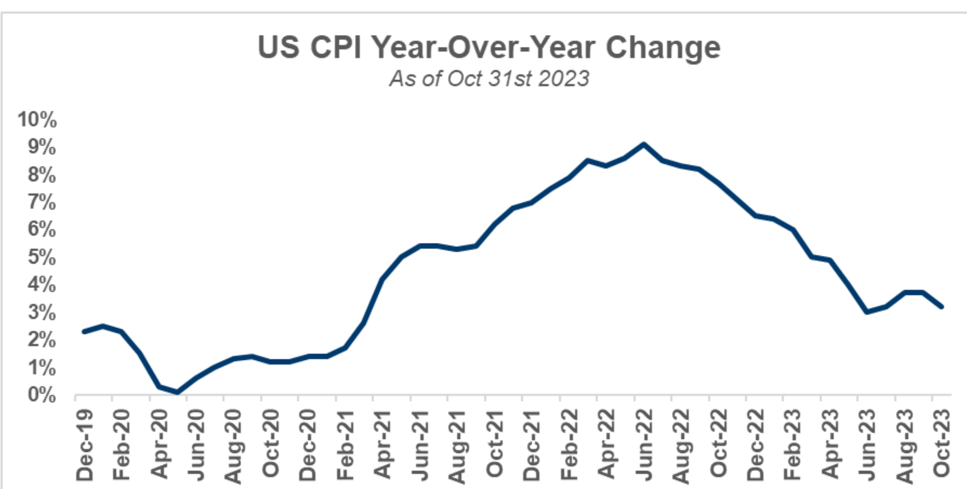
The equity research team remains disciplined in our work to uncover high-quality companies with sustainable competitive advantages in growing end markets. We expect that our individual holdings will continue delivering above-average returns on the capital they employ. In our view, the broadening of equity markets, including outside of the "Magnificent Seven" and down the market cap spectrum, will highlight individual stock selection, research intensity, and diversification across our equity strategies.

## ***Fixed Income 2024 Outlook: Compelling Opportunity for Income***

*From How High to How Long?*

The Federal Reserve, or Fed, administers monetary policy to achieve maximum employment and stable prices (2 percent inflation target). This dual mandate often garners an equal amount of attention from Fed officials. However, the inflation surge following the outbreak of COVID-19, brought about by a consortium of events (supply chain disruptions, unprecedented monetary/fiscal accommodation), captured the Fed's attention in a manner not seen since the late 1970s and early 1980s.

**Chart 7: U.S. Consumer Price Index ("CPI") December 31, 2019 – October 31, 2023**




Source: Bryn Mawr Capital Management, FactSet

Since the beginning of 2022, the Fed's focus has been to quickly bring policy rates to a level restrictive enough to maintain constant downward pressure on inflation, without significantly hampering the labor market and impeding economic growth. Economists as well as the investment community at large, debated the level the federal funds target rate would need to reach to arrest inflation. Eighteen months and over five hundred basis points of rate hikes later, it seems as if that question may have been answered. Although it is too soon to declare that the inflation dragon has been vanquished, monetary policy has been successful in getting headline inflation to trend towards the 2 percent inflation target stipulated by the Fed. We believe today's policy rates have reached their peak level for this cycle.

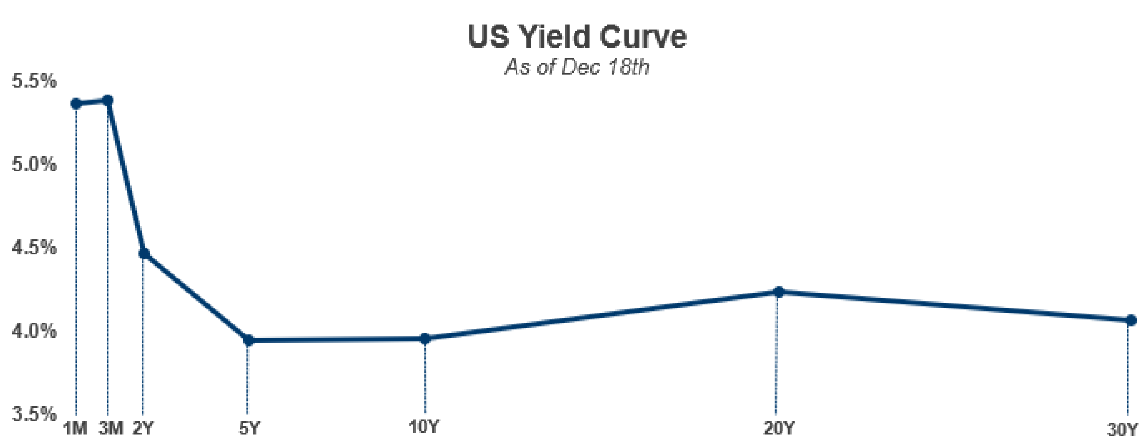
Shifting away from how high policy rates will go to how long they need to stay at elevated levels will be the primary focus for the Fed and investors like us, as we enter 2024. Tight monetary policy has taken longer than what we would have anticipated to fully work its way through the economy. Years of low borrowing costs, coinciding with COVID-related factors, have resulted in excess consumer savings, which in turn has contributed to today's resilient economy. We believe the Fed will have a more balanced focus between bringing annual inflation down towards 2 percent and trying to maintain U.S. economic growth.

As discussed in our larger view of the economic landscape, we believe the normal channels of high borrowing costs weighing on economic growth are still relevant, just delayed, given the unprecedented monetary and fiscal response to the pandemic. Rate cuts are possible and expected to some degree, but not at the expense of inflation reasserting itself. We believe the Fed will shift policy gears this year, but the process will be slow and deliberate to ensure that inflation doesn't reassert itself. Monetary officials do not want to repeat the same mistakes made in the 1970s when they loosened the inflation reigns too soon. Higher for longer will be the key theme as we begin 2024.

*U.S. Treasury Yields Likely Peaked In 2023 With Rate Cuts on The Horizon*

Last year, many parts of the yield curve rose to levels last seen in more than 15 years. In addition, today's yield curve is inverted (short rates higher than long rates) and looks nothing like the normal upward sloping one. This year begins with the area of the yield curve between the 2-year and 10-year U.S. Treasury maturity range still being inverted, an ongoing occurrence for the past 18 months.

**Chart 8: U.S. Yield Curve as of December 18, 2023**




Source: Bryn Mawr Capital Management, FactSet

Consistent with our expectations that policy rates and inflation levels reached peak levels in 2023, we believe U.S. Treasury yields may have also traded near peak levels last year. We expect the U.S. Treasury curve will shift lower in 2024 driven by a more benign inflationary environment. In our view, short-term yields, the part of the yield curve that tends to be most sensitive to U.S. monetary policy decisions, will lead U.S. yields lower as investors anticipate future rate cuts. Currently, the federal funds futures market is pricing in five rate cuts this year. The need for policy rates to remain at today's restrictive levels will subside if inflation continues towards the 2 percent objective.

Longer-term yields should follow the same downward direction as those on the short end of the curve but at a more gradual pace in our base case scenario that avoids a significant economic slowdown. We think 10-year Treasury bond yields will likely end 2024 within a range of 3.75 to 4 percent. This number combines a 3 percent neutral rate, or a fed funds interest rate level that neither accommodates nor restricts economic growth, as well as a modest term premium for extending out on the yield curve.

We expect interest rates will be volatile this year as economic data, central bank policy, fiscal concerns, and geopolitical events keep investors busy interpreting data. Overall, we expect the trend will be to the downside as evidence for slower economic growth, a less aggressive Fed, and subsiding inflation will be the dominant factors weighing on the U.S. Treasury curve in 2024.

With any forecast, there is a reasonable chance of downside or upside surprises in long-term bond yields. First, a more material economic slowdown could cause yields to fall below the lower bound of our target. An upside surprise may occur if we underestimate the U.S. economy's ability to operate within a higher interest rate environment relative to years past. Longer-term yields will also have to confront anticipated U.S. Treasury bond issuance, a factor that pressured yields higher in 2023. We expect deficit and Treasury issuance concerns will linger in 2024, acting as a headwind to lower yields but not enough to alter our expectations for lower longer-term bond yields.

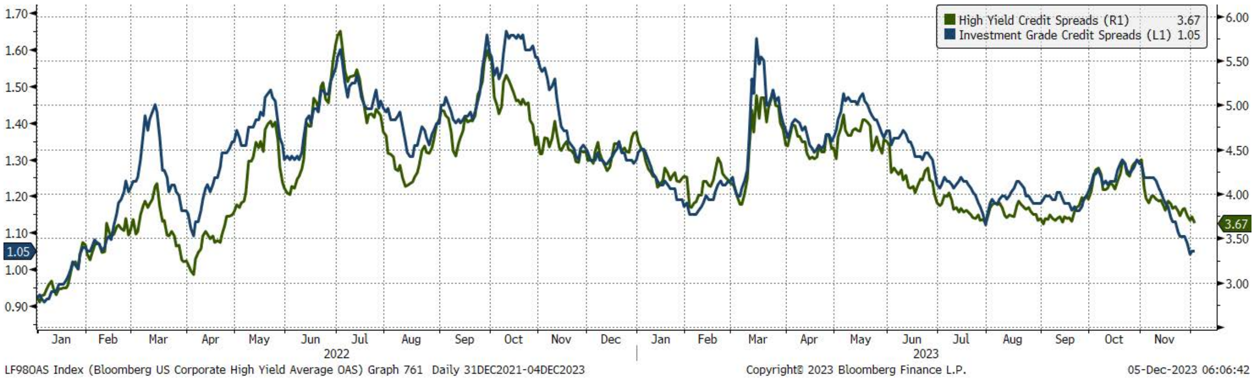
*Slower Growth Could Pressure Credit Spreads Wider*

Credit spreads were volatile in 2023, hitting peak levels in March 2023 before trending lower for the remainder of the year. Subsiding inflation and a dovish monetary policy outlook contributed to increased investor expectations of a soft economic landing. Investor demand for credit increased throughout the year given the above trend of economic growth and bond yields that traded at levels last seen since 2009.

In our view, the additional yield picked up in corporate bonds over U.S. Treasuries is on the tighter side with risk aversion declining late in 2023 and reducing the additional yield compensation. Although we aren't forecasting a hard economic landing, we believe slowing economic growth should pressure credit spreads wider from current levels. In our view, current corporate bond valuations have room to cheapen with better opportunities to increase exposure in 2024.

**Chart 9: U.S. Credit Spreads**

**Bloomberg U.S. Agg Corporate Average OAS and Corp. High Yield Average OAS (Dec. 31, 2021 – Dec. 4, 2023)**




Source: Bloomberg, Inc.

Corporate fundamentals start the new year solid, having benefited from multiple years of resilient consumer spending as well as corporate-friendly COVID-related policies. However, slowing economic growth in 2024 will likely weigh on corporate profitability as financing costs and wage pressure negatively impact margins. We anticipate corporations will have less pricing power this year as consumers have little tolerance for materially higher prices given the run-up in inflation. Although we still believe modest economic growth should support company balance sheets, we anticipate a more challenging environment for corporations lies ahead.

While we expect credit spreads to widen this year, we also recognize the high starting point for yields and the compelling opportunity for fixed income. The additional yield pick-up over U.S. Treasuries provides some cushion if our spread-widening expectations materialize. With this in mind, we continue to maintain a healthy weighting to corporates within our fixed-income strategies and stand ready to adjust depending on how our economic outlook evolves over time.

*Tax-Free Municipal Bond Valuations Look Stretched While Absolute Yields Remain Attractive*

We expect tax-free municipal bond yields to trend lower in 2024, in line with our expectations for U.S. Treasury yields. Slowing economic growth and projected Fed rate cuts in 2024 are the primary drivers of lower yields. Overall, with municipal bond yields potentially peaking in 2023, we believe investors will continue to look to lock in yields across the yield curve, leading to steady demand for the tax-free sector throughout the year.

Municipal valuations ended the year on the tighter side, with the 5-year AAA municipal bonds trading at 61 percent of the yield equivalent to U.S. Treasury Bonds as of the end of November – a little below the 3-year average of roughly 64 percent. Credit quality currently looks favorable with reserve funds in aggregate at healthy levels. However, given our expectations of slowing economic growth, we will be closely monitoring incoming revenue streams.

*BMCM Fixed Income Portfolio Positioning - Balancing Reinvestment and Price Risk While Maintaining Diversification*

Yields ended last year well off their mid-year highs, opening the door to the possibility that rates may have already peaked for this cycle. After multiple years (2020-2023) of rising yields that followed a decade of depressed yields, today's interest environment looks compelling. Yields can certainly go higher; however, it's difficult to overlook the significant yield repricing that has already taken place and the amount of income that is available via fixed-income investing.

For the reason noted above, we have a more defensive bias within portfolios. For purely investment-grade bond strategies, our focus tilts toward the high-quality areas of the market. We maintain a healthy exposure to corporate bonds but are tilted towards shorter-term and higher quality. For PLUS strategies that look to offer more yield, we still like having exposure to higher-yielding sectors such as non-investment grade corporates and bank loans, as well as the weaker segment of investment grade issuers, but at more defensive concentration levels.

One of the more challenging questions within today's fixed-income environment is simply where to invest along the yield curve. Today's yield curve remains inverted, although the level of inversion has lessened. Visually, maintaining a short-duration portfolio looks appealing given the yield premium, while taking on a more limited amount of price risk. However, if rate cuts occur in 2024, shorter-term bonds are subject to higher levels of reinvestment risk, or the chance of capital redeployment at lower interest rates.

For this reason, we believe balancing price and reinvestment risk will be important in 2024. For investors whose risk tolerance is titled towards a longer-term view, some portion of the fixed income portfolio into longer-dated securities appears appropriate. We believe modestly extending duration makes sense given today's yields, coinciding with the scenario that the Fed's next rate decision is not higher. Consideration for any unique investor needs such as liability constraints and known liquidity events is very important.

Overall, we believe fixed income is an attractive asset class that provides a meaningful source of income and contributions to a portfolio's return. Staying diversified with a balanced approach toward price and reinvestment risk will help guide our decisions as we move through 2024.

## ***Risks and the Outlook***

As mentioned throughout, we feel economic growth will slow overall, just not to a point that increases the likelihood of a significant deterioration in markets. Our base case scenario for 2024 represents a risk asset rotation, whereby some of last year's laggards (Small/Mid-Cap, International Equity) will likely gain ground in relation to the narrow group of equities that drove more recent returns. We also believe that there is a potential, albeit not a likely outcome, that both the economy and higher-risk assets surprise to the upside (no landing at all). On the flipside, economic conditions could deteriorate to an extent that ushers in a moderate recession.

On top of any forecast is the potential unforeseen disruptive forces or larger unpredictable "Black Swan" events. Geopolitical tensions are always top of mind for many economists as they ponder what's ahead. The conflict in Gaza and Israel is causing immense human suffering but has had a minimal impact on most markets. Further escalation in this part of the world could produce a risk-off mentality across global markets. Recent developments related to U.S.-China relations could also reverse course quickly. Geopolitical tensions of this nature can lead to trade disruptions, political instability, and supply chain disruptions. The upcoming U.S. presidential election, in addition to highlighting these tumultuous situations, will include policy debate on everything from international trade to domestic drug pricing. The outcome is likely to impact markets in yet unknown ways.

Although it's difficult to gauge the exact level of excess savings compiled by the U.S. population following the aftermath of the pandemic, most reports point to savings being exhausted at some point in 2024. There is the risk that consumer spending slows considerably. On the corporate side, the lagged effect from higher interest rates historically is long and variable. Risks to the resilient consumer would most certainly equate to risks to corporate earnings. Pricing power would be in question if the consumer closes the wallet and wage growth materially slows.

 *See important disclosures on page 18*

Our base case is cognizant of the positive forces also in play domestically and globally. The impact of more normalized monetary policy across the world can be powerful as can be the productivity-enhancing effects of Generative AI, the increasingly sophisticated nature of supply chain dynamics, and the increasing use of onshoring. AI potential use cases continue to develop rapidly. As we watch the world adopt this technology into business models, we prefer to be flexible and adaptable in where we invest, gauging where utilization adds value.

The current investment outlook reflects a landscape marked by a delicate balance of opportunities and challenges. Crosscurrents from multiple avenues within the economic and investing landscape support a disciplined yet flexible approach to navigating 2024. Our process is focused on high-quality investments, diversification, and other risk mitigation, with tactical positioning aimed at taking advantage of dislocations that create opportunities over market cycles.

On the equity side, the return disparity across multiple market capitalization and investment style categories justifies a tactical tilt toward lower market capitalizations. On the fixed income side of the ledger, interest rate volatility allows for opportunities further out on the yield curve, incrementally extending duration. These risk-reward dynamics will evolve over time, and our repeatable strategy puts us in a position to participate.

Successful investing in any environment requires blending optimism and caution with a long-term perspective. By staying informed and aligning investment strategies with individual risk tolerance and financial goals, investors can navigate the complexities and capitalize on opportunities that arise in the ever-evolving economic and market landscape.

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