INVESTMENT PERSPECTIVE Q4 2023

STILL DANCING?

"As long as the music is playing, you've got to get up and dance. We're still dancing."
—Charles Prince, CEO Citigroup, July 2007

In the book of Revelations, the false Prophet is thrown into the lake of fire which burns with sulfur. Mr. Prince's descent was considerably gentler. Four months after his immortal quote, he stepped down with a $12.5 million exit bonus, $68 million in stock, a $1.7 million pension and a car and driver. He might have simply exited as one of a faceless cast of Wall Street CEOs who torpedoed their institutions. But his singular self-congratulatory remark has gone into the pantheon of epic misjudgments. Subsequently, he did himself no favors. Prince told the Financial Crisis Inquiry Commission that the collapse in housing prices had been "wholly unanticipated." Unfortunately, Richard Bowen, Citigroup's Chief Business Underwriter in consumer lending also testified. In June of 2006, Bowen assessed that 60% of Citigroup's mortgage loan production was defective. He sent a memo to the executive committee of the bank's board of directors titled "URGENT READ IMMEDIATELY" in which he elaborated the potential liabilities to the bank. Not knowing the truth is one thing;

not wanting to know is another altogether. Furthermore, the Commission estimated that Citigroup's leverage (total assets to capital) in 2007 was 48:1 compared to JP Morgan's of 22:1. Perhaps it was not the best time to dance.

I am reflecting on the all-time worst market predictions, because 2023 will surely add a new chapter to the annals. Now that we have unloaded a bag of stones on the unfortunate Mr. Prince, it's time to look back at our January 2023 outlook. First, the bad news. I described the "primary direction of the economy and corporate earnings [as] downward." I wrote some later gibberish about skiing across a saddle, to shade that harsh judgment. But you won't buy that. My "primary direction" was WRONG. I also wrote that equities were "fairly priced." That means stocks should earn their long-term expected return of 7-8%. With the hindsight of a 22% return for global stocks, another mea culpa. On the other hand, I was sanguine on the outlook for the longer-term earnings, writing "even if the Fed's restraint drags earnings comparisons this year, the outlook for 2024 and beyond is bright." The bottom-up analyst consensus forecast for 2023 S&P 500 earnings per share was $228. The actual results are not finalized but are likely to be around $222. The 2024 forecast as of last January was $242 and it's now $239. So, our 'bright' outlook was substantiated.

But the overarching message was cribbed from Peter Lynch: "Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves." Stay the course, in other words. We followed that advice by maintaining a full exposure to equities and a tilt to the U.S. Those choices were well advised. Within the U.S. however, we had a slight bias towards more defensive equities. That was punished by the headlong rush into long duration growth.

Looking ahead, what do we see? The U.S. is undergoing an immaculate disinflation, where prices revert to trend without a sacrifice in terms of growth/employment. That allows the Fed to cut rates while maintaining some monetary restraint. The base case is for a moderate pace of economic growth with continued disinflation. This is a good environment for both bonds and stocks. And the Fed is in a strong position to respond to deviations on either side. So, the macro case is positive.

There are three risks that trouble me. First, the view I just described is virtually universal. That means everyone is positioned in the markets according to that view. U.S. equities, in particular, on 20x forward 12-months earnings, are priced at about 1 standard deviation expensive to their 10-year average. Second, the U.S. government budget deficit is absurdly large for the state of the economy. Where would we be without that thumb on the scales? Third, conflict in the Middle East is rising. There are by my count 4.5 nuclear powers bristling next to each other, with a plenitude of proxies taking pot shots at each other.

For the most part, our job is to invest among normal risks. If we don't accept them, there will be no normal return. At the same time, our critical task is to carefully measure the return and risk. Clearly, we are nowhere near the precipice that Citigroup danced on in 2007. But it's now the time to be mindful and deliberate rather than complacent.

—*T. Brad Conger, CFA*
Chief Investment Officer

Please join us in congratulating our long-tenured colleague, Brad Conger, on his promotion to Chief Investment Officer.

Brad has been a leader in our investment team for nearly 15 years and served as Deputy CIO for the past six years. His collaborative leadership style has earned tremendous respect within our organization. As Deputy CIO, Brad was heavily involved in decisions related to asset allocation and portfolio construction. He also brings a depth of experience in manager selection across asset classes, including public equity, fixed income and private credit. Brad is a frequent contributor to the financial media, the host of our regular investment webcasts and the author of this quarterly Investment Perspective.

Brad is taking over the CIO role from Mark Hamilton, who will be leaving the firm after six years. We are extremely grateful for Mark's many valuable contributions and wish him the very best.