

## 2023: A Year in Review

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*Even if I told you the future, you wouldn't believe it!*

Investors are constantly trying to read the economic tea leaves, attempting to decipher, digest, and predict what's going to happen next. This is a difficult prospect at best and a fool's errand at worst. The takeaway I hope readers extract from this piece is that it's extremely hard to predict and forecast; however, even if the future could be known, anticipating how markets will react to certain events approaches the impossible.

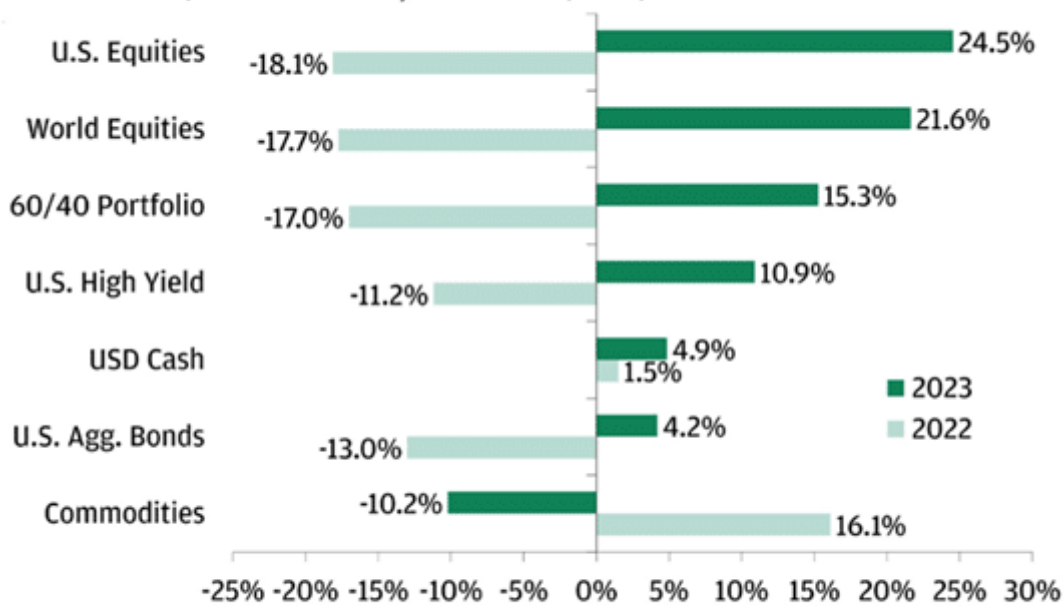
As 2023 began, investors were licking their wounds after a painful 2022. The tried-and-true 60/40 (stocks/bonds) portfolio had turned in one of its most dismal years on record, declining 16% the year prior largely due to the pummeling taken by scores of unprepared bond investors. The Fed tightening campaign was in high gear as many investors grappled with the suddenness and severity of these hikes. Many market observers were championing the Fed's efforts, calling it long overdue and necessary pain to fan the flames of inflation that they had long been stoking. It was only a few quarters ago that inflation was still running far above the "target" rate of 2% and few investors could imagine a world, where the Fed could tighten enough to stem the tide of inflation without tipping the U.S. economy into a serious recession. In fact, many investors were losing faith that interest rate hikes were going to have any cooling effect on inflation whatsoever.

The outlook to start the year was bleak at best. The famed (for reasons that escape me) financial pundit, "Dr. Doom" Nouriel Roubini outlined a scenario in line with his nickname. Roubini was calling for 2023 to be the "Perfect Storm." He predicted a severe economic recession in 2023 and went on to call for a 30% decline in stock prices. He was not alone.

Jamie Dimon, a typically less alarmist figure on Wall Street, said that an economic hurricane lay on the horizon. Even Mohammed El-Arian, the former CIO of Pimco, was warning of dangerous seas ahead. Take a look at the following data comparing 2023 and 2022 across varying asset classes and grade their predictions for yourself.

## Then and now: Markets flex strength in 2023 – a reversal of 2022's pain

Total return, 2022 vs. 2023 year-to-date, USD, %



Source: Bloomberg Finance L.P. Data as of December 14, 2023. Note: U.S. Equities represented by S&P 500 Index, World Equities by MSCI World Index, 60/40 Portfolio by 60% MSCI World and 40% Global Aggregate Bond Index (both in USD terms), U.S. High Yield by Bloomberg U.S. High Yield Corporate Index, USD Cash by Bloomberg U.S. Treasury Bills (1-3M), U.S. Agg. Bonds by Bloomberg U.S. Aggregate Index, and Commodities by Bloomberg Commodity Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

In 2023, it turns out that it was almost impossible to lose money investing in the U.S., basically a complete reversal of what we saw in 2022. It is not my intention to rub their noses in what turned out to be wildly inaccurate predictions. No one gets it right all the time, or even most of the time. Yet, there is a lesson to be learned about how one weights predictions made by so called “experts.”

It is a dangerous game to look at the current state of economic conditions and extrapolate the current environment into the future. What’s even more hazardous is to look at “predictions” about the future and then determine how markets may react if certain events do happen. What makes this so difficult is market participants are still largely humans and, if we know one thing about humans, they are emotionally fueled creatures that rarely exist in equilibrium but instead bounce between a state of fear and greed. Good investors don’t predict future economic conditions, they react strategically to how market odds have changed for or against them.

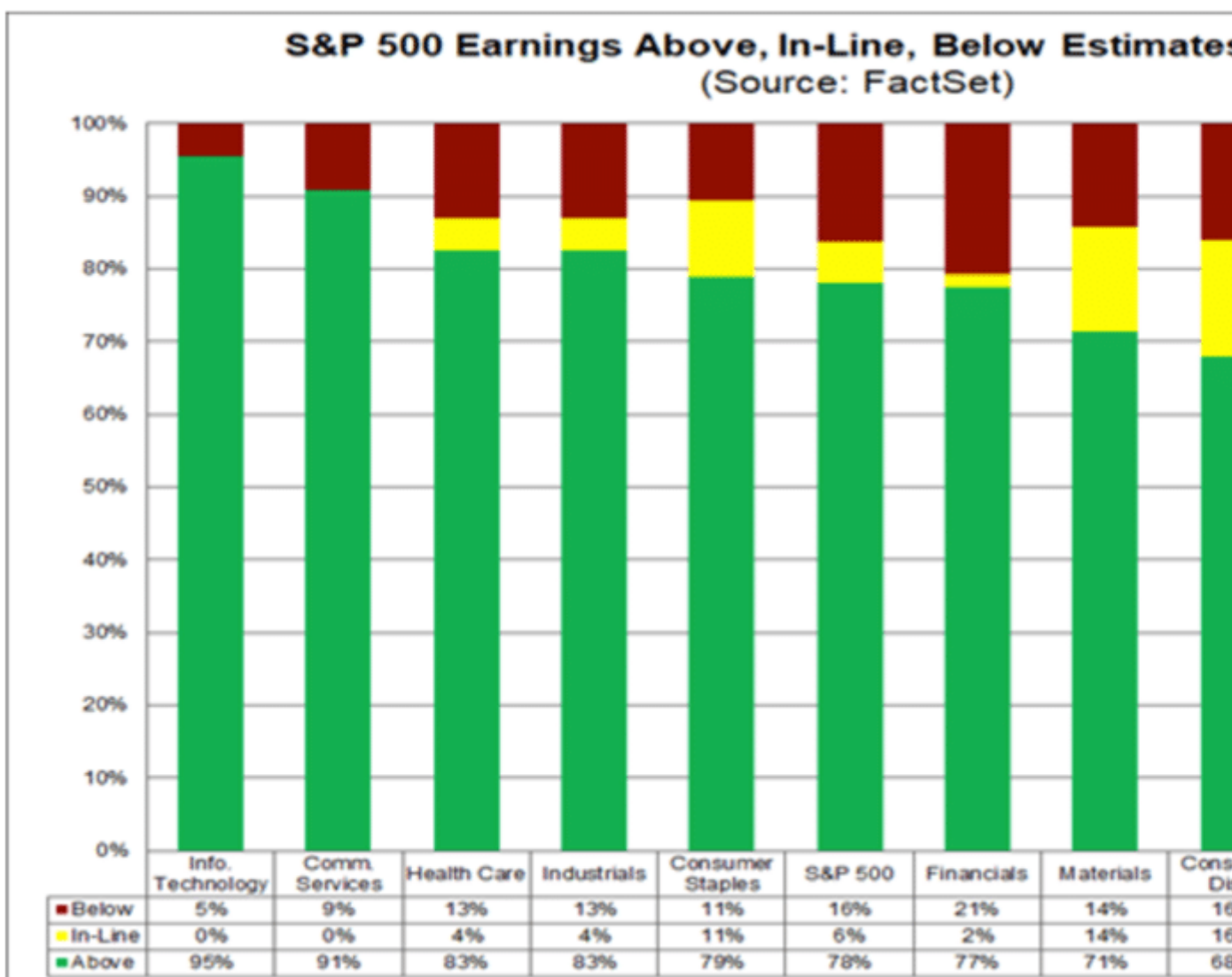
As we embark into 2024, let’s take a step back and consider where things stand. We have likely seen the last of this cycle’s rate hikes, though that is not a certainty. Yes, inflation *looks* to be subsiding, but remember it wasn’t that long ago that the consensus belief was that we had entered a period of prolonged, high inflation that could not be controlled with rate hikes. Additionally, I expect that the full brunt of these rate hikes may have yet to be fully felt by the economy.

There is still a staggering amount of Commercial Real Estate debt coming due in the next two years. I first wrote about these concerns back in June 2023 in a piece titled [“Why You Shouldn’t Care So Much Where Stocks are Headed....”](#) 60 Minutes [recently highlighted](#) some of the challenges facing commercial real estate. In addition, on January 17<sup>th</sup>, the Wall Street Journal voiced their own concerns in an article titled [“The Bill Is Coming Due on a Record Amount of Commercial Real Estate Debt.”](#) According to the Mortgage Bankers Association, over the next

two years, roughly \$1 trillion dollars of debt still needs to be refinanced at drastically higher rates than originally issued.

Anecdotally, we have been hearing lots of banks who are in active discussions to provide loan “workouts” with borrowers who find themselves over a barrel. We expect Industrial Real Estate and Multi-family (apartments) to prove far more durable than office, however, if a recession were to materialize next year, even those asset classes could take it on the chin. The reality is the tide hasn’t fully gone out when it comes to the effects of higher rates on Real Estate but also the economy more broadly. We will be watching these developments closely and will be prepared to make further appropriate portfolio adjustments, should it become prudent.

Overall, economic activity has proven surprisingly resilient even in the face of higher rates. A quick look at earnings reports in Q32023 show broad strength across most sectors of the stock market.



Take for instance two of the nation’s largest home builders: Lennar and D.R. Horton returned 66.9% and 72.1% respectively in 2023, far outpacing the market itself. At the outset of the year, if I had told you that mortgage rates were going to be above 6% and home affordability would be near all-time lows, I am not sure many would have predicted such strong returns for these

stocks. This highlights just how hard it is to predict market behavior. However, analyzing the “why”, there are several factors that contributed to this seemingly counter-intuitive outcome. For one, the US housing market is massively undersupplied, partially due to pandemic-era production slowdowns but also because many builders were spooked by the fear of building into a hiking cycle that drove mortgage rates sky high. Secondly, the overall health of the US economy has continued to surprise to the upside. Unemployment is still very low. Consumer sentiment still looks healthy. Corporate earnings have continued to look better than expected.

Despite this optimism, the resilience of the US economy is not a rose without its thorns. During 2023, we witnessed the biggest year of bank failures in U.S. history. First, we saw Silicon Valley implode in March, which was quickly followed by the collapse of First Republic in May.

These failures reminded investors that no matter how much you regulate banks, they are not immune to making profoundly poor investment mistakes. There were anxious days in 2023 as many wondered if US regulators would backstop depositors who lackadaisically ignored the limits of their deposit insurance, which they eventually did. The shareholders of these banks were wiped out, but deeper concerns emerged as some wondered if these failures were a preamble to a reenactment of the Great Financial crisis. Thankfully, this fear did not materialize as JP Morgan and Citizen’s Bank stepped in and stabilized these failing institutions.

Beyond bank failures in 2023, the geo-political backdrop was nothing short of tumultuous. The war in Ukraine continued to drag on with no end in sight. New tensions exploded in the Middle East and remains anything but stable. Perhaps these conflicts will ease in 2024, which would be a welcome development for humanity and markets alike. However, hope that these tensions are nearing a peaceful resolution is anything but a certainty.

A recent election in Taiwan has reignited fears in that region. China has said in no uncertain terms that it views Taiwan as part of China but 96% of Taiwanese people do not see themselves as subjects of China. The Taiwan situation is not news, but the recent election re-affirmed Taiwan’s commitment to remaining independent of Chinese rule. This was the third consecutive presidential election where the people of Taiwan elected the “pro-independent” party.

The US policy response was curious and seemed to confuse the previously stated position of standing firmly with Taiwan and against China. First, the U.S. applauded the democratic process of the election but then perplexed many when President Biden said about Taiwan that “we do not support independence.” If nothing else, this highlights just how delicate the situation is that exists in that region. China responded with less ambiguity, first scolding the US for congratulating Taiwan on their democratic election process, then more poignantly stating “reunification is inevitable.” At some point this simmering pot will spill over into a boil, and I wonder if markets will be caught flat footed should this transpire in 2024.

One thing that won’t catch anyone off guard is the upcoming US presidential election in November. The American political scene can be described, if nothing else, as volatile. We are not in the business of offering political perspectives and leave that to others. Instead, we focus on how political events could shape financial conditions. Unfortunately, there is a huge bipartisan problem facing our country that, in my opinion, eclipses the risks of all other worries combined.

For the past century, the US has served as the bastion of financial stability. Wall Street is the financial epicenter of the world. Our currency, due to our financial strength, is the default

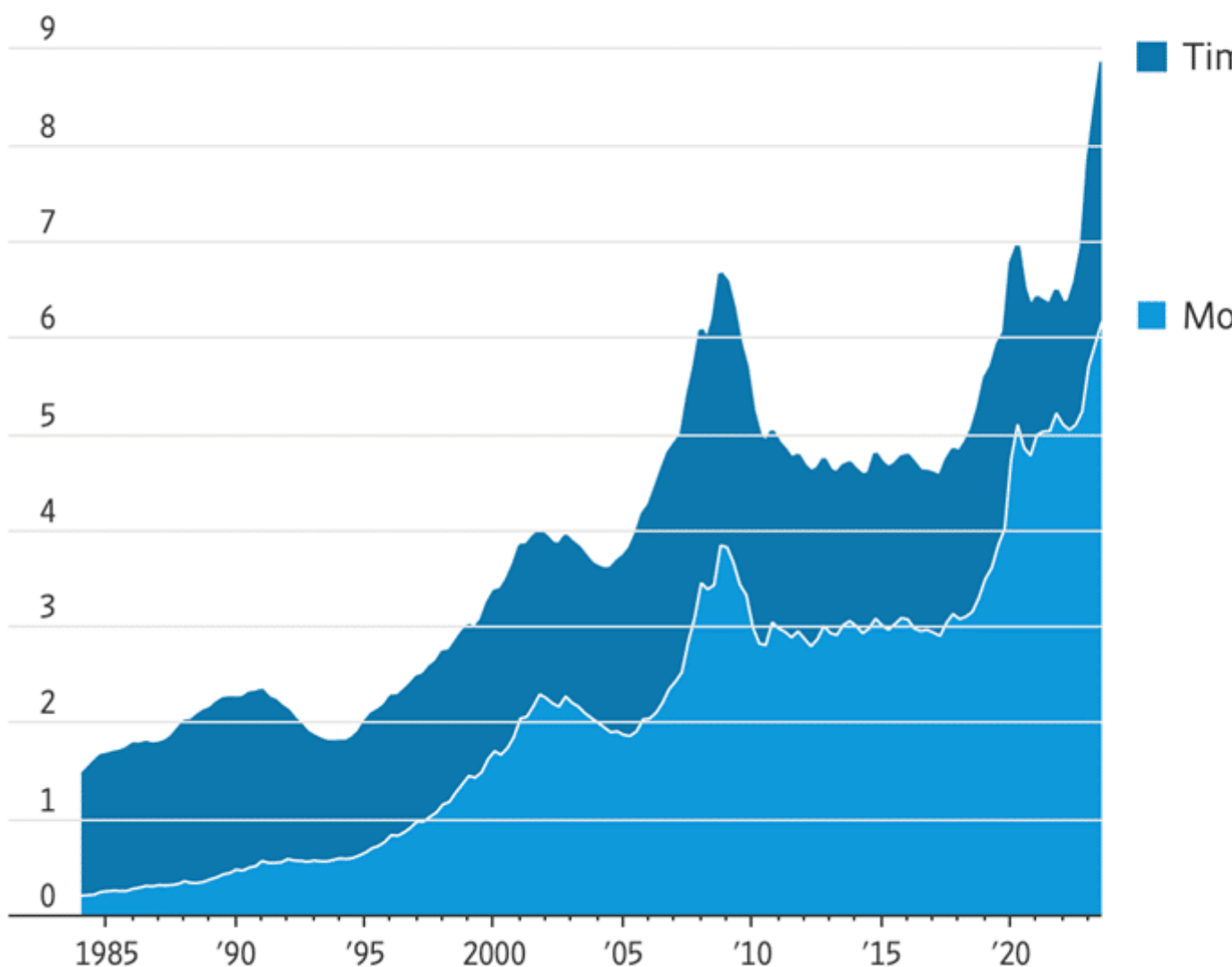
currency in which almost all global trade is conducted. In times of crisis, the most stable financial market asset that investors flock to for safety is U.S. government bonds. This financial position has allowed us to borrow (issue bonds) at the lowest rates of almost any country in the world, which is an enormous competitive advantage. For reasons that both the left and the right have contributed to, our fiscal position as a nation is quickly spiraling into very dangerous territory. For the past century we have been the world's largest superpower. Should we continue to ignore the implications of our fiscal problem, many of the political issues we find polarizing today will seem small in comparison to tomorrow's problems.

As we enter the 2024 election, my hope is that both left and right will abandon their long-held strategy of kicking the can down the road and leaving these problems for someone else to fix. I often think of the quote that is attributed to England's Winston Churchill where he stated, "American's can always be trusted to do the right thing, once all other possibilities have been exhausted." I am hopeful that we are nearing or have reached the point of exhausting all other possibilities. I would view it as a very positive development if a significant point of debate in the upcoming election focuses on restoring our fiscal solvency.

Throughout last year, many took comfort in what appeared to be a "free lunch" for investors. However, a smart person once said something that I think a lot about: "nothing in life is free." Yet, many thought investing in money markets was exactly that, a slam dunk investment with seemingly no downside. This chart helps drive home just how massive the flood of money has been into this area.

## Assets in money-market funds and CDs

\$10 trillion



Note: Quarterly, as of third-quarter 2023

Sources: Federal Deposit Insurance Corp.; Federal Reserve

I think that this move by many investors looking for a no-brainer investment will prove to be a costly mistake and here's why. Stocks have historically earned 9%, a sizeable improvement to bonds and money markets over the long run and, in 2023, investors made roughly 5% investing in money market vehicles. However, as I've pointed out above, stocks returned 24% over the same period, so there was tremendous opportunity cost to the "free lunch." Second, and a bit more subtle, is the idea that you can make significantly more than the 5% in money markets by buying longer duration bonds that too pay you 5%. Stick with me here for a simplistic example that hopefully illustrates my point. If you bought a money market vehicle last year, you made exactly 5% for the year. If you bought a 7-year government that also yielded 5% you made roughly 5% as well. Now let's imagine that we have in fact seen the end of rate hikes and we are now re-entering a period where the Fed will lower rates. If the Fed lowers rates back to zero by

the end of next year (admittedly an extreme assumption), your money market will go back to paying you next to nothing. Yet, if you bought a 7-year bond, there's still six more years where you're owed 5%. This bond has become extremely valuable and will appreciate substantially in price.

At Evergreen, we spent much of last year balancing the attractiveness of short-term bond yields with the realization that interest rates likely will not remain at these elevated levels permanently. To some this may seem overwhelmingly obvious, but many investors opted to sit exclusively (or largely) in money markets and missed key investing opportunities.

I started by saying that even if one knew what would transpire in 2023 with aggressive rate hikes by the Fed, escalating geo-political tension, inflation fears, and the continued national debt burden, I wonder, how many would have reached the conclusion that nearly all asset classes would turn in terrific returns? Likely very few... This is why we believe it is absolutely critical to deploy a diversified and flexible investment approach across both public and private asset classes. Such an approach allows investors to chart a course and effectively navigate markets instead of simply floating adrift at sea.

Fortunately, 2023 was a good year for many Evergreen clients. In many ways, it reinforced one of our key concepts as a firm. We don't seek to operate using "on-off" light switch style investments, leaping all into and completely out of different asset classes. Instead, we prefer to use a dimmer switch, tactically increasing or decreasing our exposure across different areas of the market based on risk/reward scenarios.

Of this I'm sure: the year ahead will be filled with uncertainty, unknowns, and surprises. I have some thoughts as to what some of those events may turn out to be but I am far from certain. In a coming piece, I will attempt to outline some of the most critical issues facing the markets in 2024. I apologize for repeating this but, even knowing with a crystal ball what the future holds doesn't tell investors how market participants will digest those events. Good investing is the goal of tactically reacting to changing odds offered by the markets, betting more when the odds are in your favor and knowing when to fold a losing hand. Hardly an easy strategy to perfect but one that's served us well over the decades in financial markets.

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