Newsletter

MCS Family Wealth Advisors
Managing Risk to Increase Wealth®

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2023 Year-End Newsletter and Outlook

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2023 was a topsy-turvy year in the market: a banking crisis, economists predicting a 70% chance of a recession, a resurgence in inflation, a war in the Middle East added to the war in Ukraine, and **two months** before year-end, a blowout rally in stocks, bonds, Bitcoin, and gold. Welcome to *interesting* times.

For the full year of 2023 (if MCS clients' investments were treated as one large portfolio including their cash), on average clients gained 4.16%, after fees. For comparison purposes, the S&P 500 Total Return Stock Index (S&P 500) and the Bloomberg Barclays Aggregate Bond Index which rebounded from last year's double-digit losses, gaining 26.29% and 5.53%, respectively. The range of MCS individual client returns was from a gain of 10.65% to a gain of 2.64%.*

The clients with the lowest returns had overweight exposure in inherited, low-basis financial stocks that fared poorly after the Silicon Valley Bank failure. Clients with the highest returns had higher stock exposure, especially in technology stocks. Overall, MCS client portfolios have much less volatility due to a very large allocation to state income tax-exempt, US Treasury Bills yielding 4.6% to 5.5%.

As I write this, the market commentators have been spewing opinions about lower interest rates and lower inflation for 2024. The big year-end rally in stocks, bonds, Bitcoin, and gold was triggered by a massive shift in sentiment about the end of the interest rate hikes and soon-to-come rapid reduction in interest rates. OK….

Here is what the well-known Consumer Price Inflation Index (CPI) looks like through 2023.

* MCS Family Wealth Advisors (MCS) consolidated client returns are dollar-weighted, net of investment management fees unless stated otherwise, include reinvestment of dividends and capital gains and represent all clients with fully discretionary accounts under management for at least one full month in 2023. These accounts represent 99% of MCS's discretionary assets under management as of 12/31/2023 and were invested primarily in US stocks and bonds (1.6% of client assets on 12/31/2023 were invested in tax-exempt municipal bonds). The Stock Index values are based on the S&P 500 Total Return Index, which measures the large-capitalization US equity market. The Bond Index values are based on the Bloomberg Barclays US Aggregate Bond Index, which measures the US investment- grade bond market. Index values are for comparison purposes only. The report is for information purposes only and does not consider the specific investment objective, financial situation, or needs of any recipient, nor is it to be construed as an offer to sell or solicit investment management or any other services. Past performance is not indicative of future results.

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Figure 1

Consumer Price Index (CPI)

Trending sideways, above target.

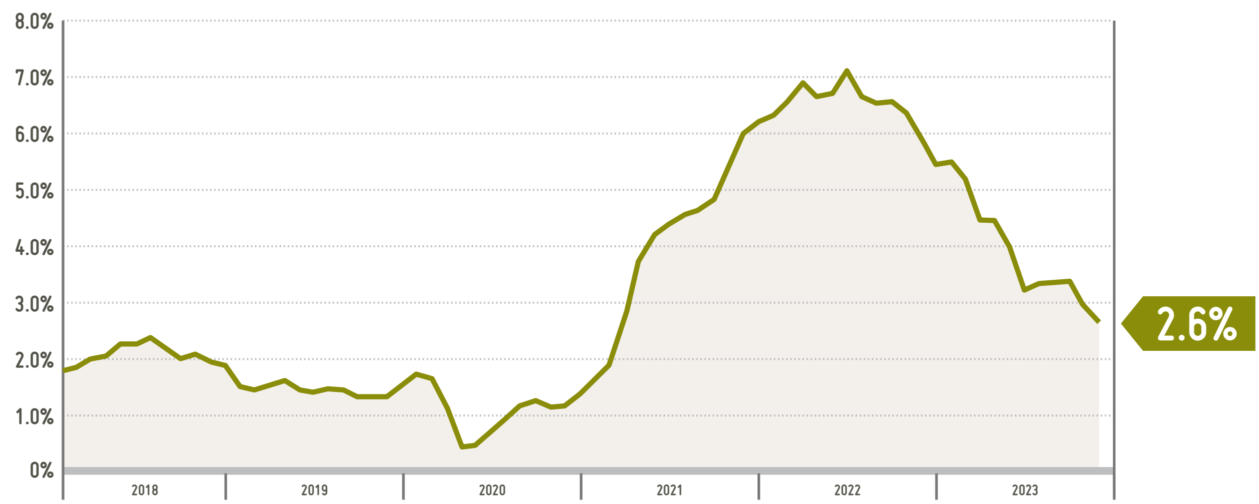
Source: Bloomberg, MCS

A lesser-known inflation index, that is **preferred** by the Fed, is the PCE, Personal Consumption Expenditures Index.

Figure 2

Personal Consumption Expenditures Index (PCE)

Trending lower, still above Fed target.



Source: Bloomberg, MCS

Long term Inflation as measured by Core PCE

However, the Fed's most favored measure of the underlying inflation trend is the US Core PCE Price Index (see Figure 3, below). The Fed especially likes the Core PCE because it removes the volatile food and energy components of the PCE. Currently, the Core PCE Index is roughly .5% higher than the overall index (Core PCE at 3.15% vs PCE at 2.6%) and well above the Fed's 2% target.

For perspective, here is a long-term view of Core PCE.

Figure 3

Core PCE Index

Trending lower, yet at 3.15%, the Fed is not satisfied that their job of reducing inflation is completed.

Source: Bloomberg, MCS

So, Is Inflation Whipped?

I don't know, but I doubt it's going to drop to 2% and stay there. I am not inclined to risk your money chasing the 'inflation is over' bet.

I outlined the case for higher inflation in my previous newsletter, but that does not mean that inflation will constantly rise in a straight line. In other words, inflation may drop to 'acceptable levels' at some point during an inflationary cycle. *The risk for investors is that if the acceptable levels of inflation are temporary, it means investors will lose money betting that it's permanent.*

I believe that we are in the early stages of a significant transition away from the ultra-low inflation and interest rates of the past decade. Although zero/near-zero interest rates are a huge anomaly when compared to the past 5,000 years, they may seem normal because we experienced negative interest rates (globally). Interest rates this low are far from normal (more on that later).

Experts Get It Wrong on a Recession (again)

On December 20, 2022, Bloomberg reported that economists put the chances of a recession at 70% in 2023. Said another way, economists put the chances of no recession at 30%. There was no recession in 2023. There was a banking crisis. There was a bout of unexpectedly higher inflation that pulled the rug from the bond and stock market through October 2023. So, lots of 'interesting events,' but no recession.

Two critical bond market measures which have historically provided reliable, but not perfect, signals of future economic conditions are pointing in opposite directions. We're in a very confusing environment, even for experts!

- The yield curve is inverted; meaning short term rates (6 month) were higher than long rates (10 year): *a 'recession is coming' signal*.
- Credit spreads (the difference in yield between high quality and lower quality bonds of the same maturity) were tight (not much extra yield for the lower quality, higher risk bond); *a 'recession is not coming' signal*.

Given this volatility and uncertainty, my goal is to increase your annual income while maintaining the stability of your portfolio.

Yet, to make good long-term decisions, one must think long term and not get jerked around by the latest turn in investor sentiment. Will large and increasing US debt levels lead to higher interest rates? That's a risk. While I'm aware of the arguments about how government debt levels don't matter, I'm inclined to believe that large deficits will put upward pressure on interest rates. I'm not alone.

> *"Right now, the market is just obsessed with the Fed Cycle", says Padhraic Garvey, head of global debt and rates strategy at ING Financial Markets. "Once the novelty of that fades away, we'll start to worry more about the deficit" Source: "A $2 trillion Pile of Debt Poses Threat to Bond Rally"*
> *—Bloomberg News, Jan 10, 2024*

Recency Bias and Investor Expectations

Recency bias describes the human behavior of favoring recent events over historic ones. The past decade of zero to near-zero interest rates altered the minds of investors because it made up eleven years of their recent life experience, so it has been normalized. Investors aren't considering that this was a once-in-5,000-years event, and that it is unlikely to happen again any time soon.

Here's how recency bias is expressed today when investors are asked about their future investment returns.

Figure 4

Gap in Expectations Between Investors and Financial Advisors

2023 Natixis Global Survey of Individual Investors

	Individual Investors	Financial Professionals	Difference	% Difference
US	15.60%	7.00%	**8.6%**	**136%**
Global Average	12.8%	9.0%	**3.8%**	**42%**

Source: Natixis

There is a gigantic gap in expectations between the two groups. Financial professionals are expected to have a deep understanding of how long-term returns vary over time, and they expect 7% long-term average returns (well below historical average returns of 11%).

They expect a long-term return lower than the 11% average because investors have been through a period of much higher-than-average returns. These higher-than-average returns were the result of interest rates that were the lowest in 5,000 years.

While the investment industry encourages risk taking based on long-term average returns of over 50 years or more, it can be an unrecoverable mistake for investors at or near retirement to assume they will earn the 50-year average return when they don't have 50+ years of investing ahead of them.

Many years ago, I was testifying as an expert for the claimant (investor) in a trial. The investor had lost a lot of money. The respondent's (brokerage firm) counsel was cross examining me. As is often the case when investors lose money, the broker blames the client for not sticking with the higher-risk strategy for the long term.

> *Respondents' counsel: "Isn't it true, Mr. Stalker, that stocks on average earn about 10% per year?"*
> *My response: "Yes, but that's like going on a camping trip to the mountains and the guide saying the average temperature is 48 degrees, so pack accordingly."*
>
> *Implying, of course, that an average of 48 degrees is meaningless: bitter mountain weather can be life threatening.*

Bottom Line

We encourage investors to keep conflicts of interest in mind when relying on expert advice. Wall Street's goal is to encourage investors to move out of high-yielding, low-risk, short-term investments because they provide little profit for most investment firms. Wall Street players need to sell risk-taking to make the big bucks, and very safe, very liquid investments like T-Bills 'ain't gonna do it' for them. For them to make money, they need to sell higher risk investments.

At this point, when investment professionals project a 7% long-term stock market return with significant near-term risk, why expose your life savings to that risk when the safest available investment (US Treasury Bills) is yielding 5.4%? There will be a time when long-term investing rewards investors. That time comes when investors are more pessimistic about the future and demand higher returns to be compensated for the uncertainty and risk. Right now, it's just the opposite.

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