WESCOTT
FINANCIAL ADVISORY GROUP LLC

Fourth Quarter 2023
Economic and Market Outlook

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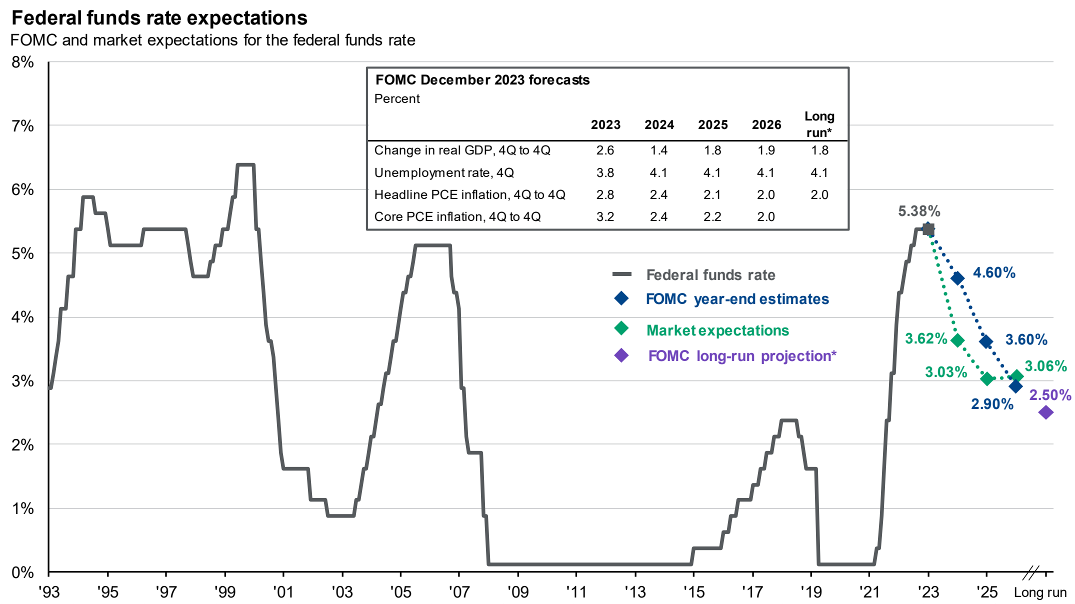
FOURTH QUARTER 2023 ECONOMIC OUTLOOK

Economic conditions in the U.S. improved in the latter half of 2023 as evidenced by solid consumer spending and a robust labor market. Most importantly, inflation pressures eased significantly. This allowed the Federal Reserve to signal an end to their aggressive hiking cycle for now and even suggest that rate cuts may be necessary in the coming months. This was all the market needed to generate strong results as hopes of a potential "soft landing" began to take shape.

The market is expecting significant monetary policy easing with consensus estimates for the Federal Reserve's policy rate (Fed Funds Rate) falling from its current level of 5.4% to a range between 3.5% and 4.0% in 2024 as shown in **Figure 1**. These market expectations are even more aggressive (and more positive for markets if true) than those from the Federal Open Market Committee (FOMC) itself. However, the FOMC estimates their policy rate will return to 2.5% over the long-run (next 5-6 years) which suggests that the market's inflation expectations have been tempered for now. We have seen evidence of this easing in lower mortgage rates recently. While forward expectations regarding rates and inflation are important drivers of sentiment and markets, they can change quickly.

Figure 1: The Market Anticipates Significant FOMC Rate Cuts in 2024 and Beyond



*Source: J.P. Morgan Asset Management, Bloomberg, FactSet, Federal Reserve, Market expectations are based off of USD Overnight Index Swaps. *Long-run projections are the rates of growth, unemployment and inflation to which a policymaker expects the economy to converge over the next five to six years in absence of further shocks and under appropriate monetary policy. Forecasts are not a reliable indicator of future performance. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections or other forward-looking statements, actual events, results or performance may differ materially from those reflected or contemplated. Guide to the Markets – U.S. Data are as of December 31, 2023.*

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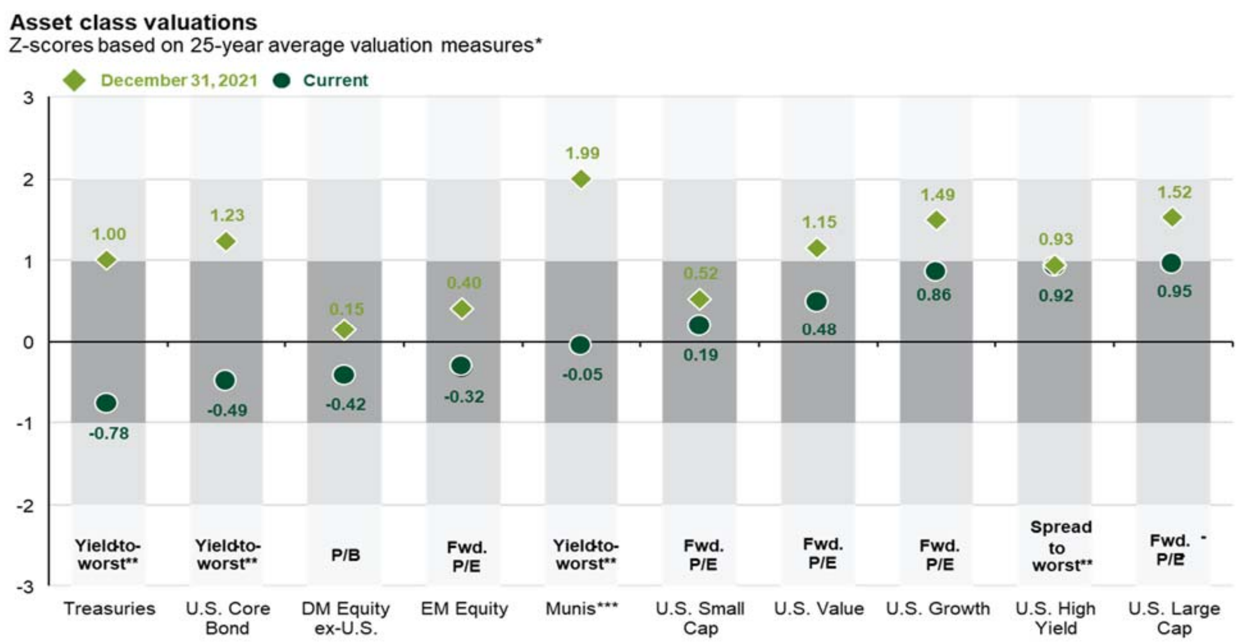
For example, if the U.S. economy and inflation does not slow as much as anticipated or if the labor market remains stronger than expected, there is a chance that rates remain higher for longer. On the other hand, if the labor market weakens and unemployment rate rises, the chances of a recession grow and the Federal Reserve will likely have to cut rates sooner rather than later. Both scenarios are possible since the U.S. economy is operating at or near full employment and small changes can make a difference.

GLOBAL MARKETS REBOUNDED IN 2023

Both stock and bond markets rebounded strongly in 2023, supporting the case for the traditional balanced 60/40 portfolio, which came under pressure as the Federal Reserve reset the level of interest rates in 2022. Going forward we see value in the U.S. and non-U.S. stock markets as well as the U.S. bond market, although it is likely that investment leadership will continue to shift.

From a valuation standpoint, small-cap stocks, value stocks and international and emerging market equities are trading at attractive levels both relative to the U.S. large cap sector and relative to their own histories. In **Figure 2** we include analysis provided by JP Morgan Asset Management showing how a range of asset classes, from U.S. Treasuries to U.S. Large Cap stocks, ranks from a valuation perspective relative to their 25 year histories as well as to where they were trading on December 31, 2021 – the most recent market peak.

Figure 2: A Look at Valuations Across Multiple Asset Classes



*Source: J.P. Morgan Asset Management., Bloomberg, BLS, CME, FactSet, MSCI, Russell, Standard & Poor's, U.S. Large Cap: S&P 500, U.S. Small Cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, U.S. Value: Russell 1000 Value, U.S. Growth: Russell 1000 Growth, U.S. High Yield: J.P. Morgan Domestic High Yield Index, U.S. Core Bond: Bloomberg US Aggregate, Treasuries: Bloomberg U.S. Aggregate Government – Treasury, Munis: Bloomberg Municipal Bond. *Averages for U.S. High Yield and U.S. Small Cap are since January 1999 and November 1998, respectively, due to limited data availability. **Yield-to-worst and spread-to-worst are inversely related to fixed income prices. ***Munis yield-to-worst is based on the tax-equivalent yield-to-worst assuming a top-income tax bracket rate of 37% plus a Medicare tax rate of 3.8%. Guide to the Markets – U.S. Data are as of December 31, 2023.*

The values in the chart are standardized to allow for comparison and the valuation measures selected are unique to the specific asset category (i.e. Yield-to-Maturity for bonds and Forward Price/Earnings for stocks). The lower the score, the cheaper the category is relative to its history. The asset classes on the left-hand side of the chart are trading at lower valuations relative to their history while those on the right are trading at higher-than-average multiples today. While the S&P 500 Index is trading at 19.5 times forward earnings as of December 31, 2023 and is higher than its historical 25-year average, it is still below where it was at the latest market peak in 2021.

When one considers the broader U.S. equity market (excluding the top 10 names) the valuations look more attractive. However, strong earnings growth expectations for the consumer technology sector and those companies that directly, or indirectly, benefit from the boom in demand for generative Artificial Intelligence (A.I.) technology suggest that the U.S. equity market remains attractive, even at higher than average valuation levels.

Importantly, portfolios remain well diversified and include allocations to most of these asset classes. Fixed Income, including U.S. Treasuries and Investment Grade Bonds, offer attractive yields today. International markets, while challenged with slowing economic growth and inflation pressures as well, are trading at levels well below their historical averages and offer interesting opportunities for active management.

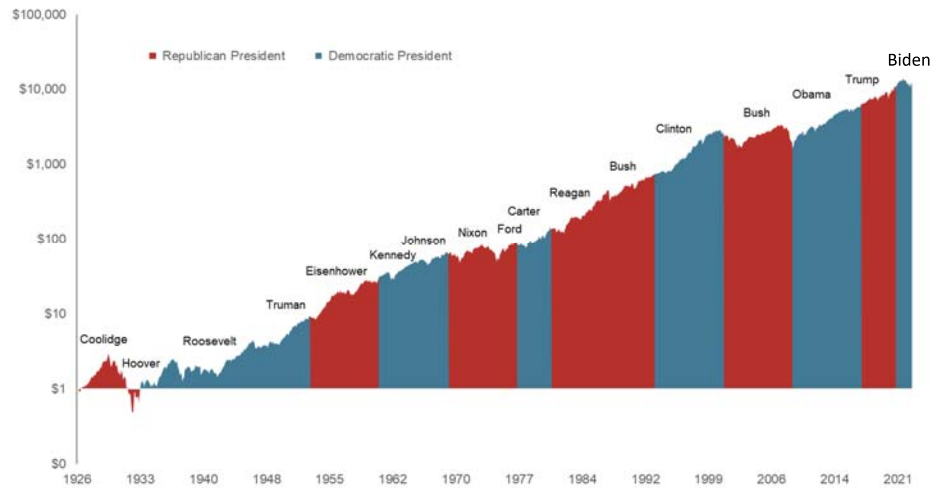
POLITICAL AND GEOPOLITICAL RISKS

In addition to economic conditions such as interest rates and inflation, ongoing geopolitical conflicts and the lead up to the 2024 U.S. Presidential Election will most likely lead to policy uncertainty and ultimately market volatility. Wescott does not manage or position portfolios to benefit from a particular or expected political or geopolitical outcome. However, we are thoughtful about how we balance risks across asset classes, investment styles, geographies, sectors and individual companies.

That being said, history suggests that U.S. stock market returns have trended higher regardless of who is President, which party controls the House or Senate, or whether control of Congress was split (see **Figure 3**).

In a risk-off environment that may develop based on increased uncertainty, we would expect the fixed income components of balanced portfolios to provide valuable diversification and income, particularly given the higher level of yield available in the market today. Within the equity portfolio we maintain allocations to defensive investment strategies that tend to hold up better in uncertain environments. We may also see a shift in leadership among sectors depending on the outcome of the election. As a result, we maintain balance in that regard, with exposure to commodity-related sectors such as energy and materials as well as to defensive sectors such as utilities, infrastructure, consumer durables, healthcare and consumer technology.

Figure 3: What History Tells US about U.S. Presidential Elections and the U.S. Market



Source: Dimensional Fund Advisors. Past performance is not a guarantee of future results. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. In USD. Growth of wealth shows the growth of a hypothetical investment of $1 in the securities in the S&P 500 index. S&P data © 2023 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Data presented in the growth of wealth chart is hypothetical and assumes reinvestment of income and no transaction costs or taxes. The chart is for illustrative purposes only and is not indicative of any investment.

OUR OUTLOOK

Headline inflation in the U.S. continues to fall and we expect further declines in the months ahead. We believe the Federal Reserve is at the end of its historic rate-hiking cycle for now given easing inflation and stable labor market. U.S. Equity markets recovered from their lows in 2022, but leadership remains narrow given the excitement surrounding the latest advances in artificial intelligence. We have seen the market broaden and expect it will continue as economic, geopolitical and market forces shift. Wescott fixed income portfolios provide diversification benefits to stocks and are offering attractive yields. This is important given increased political and geopolitical risks introduce more uncertainty into the outlook, which supports having a diversified portfolio given how quickly leadership can change.

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