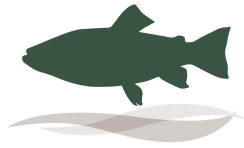

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WEALTH MANAGEMENT

The HBWM Quarterly Roundup

4Q 2023

Market Overview

2023 was a year when many equity market observers predicted recession. Yet the concerns of the third quarter, when markets declined as economic activity remained strong and interest rates rose, were left far behind in the fourth quarter. Investors concluded that interest rate increases were over as inflation data softened in the developed economies, and that rates would be quickly cut in 2024, despite maintained economic growth. The soft-landing view prevailed.

> A recent study by the Fed concluded that over the thirty years between 1989 and 2019, 40% of the real growth in profits in the US could be accounted for by lower interest rates and lower taxes…we must ask how likely it is that these following winds are repeated.

Global equity markets produced their best returns since 2019. In the US, the S&P500 rallied for nine weeks, gaining 14% in the quarter, and 24% for the full year. Global equity markets joined in. The MSCI World index gained 22% for the year. Bond markets rallied too as longer-term interest rates fell. Despite the terrible situation in Israel and fraught conditions in the Middle East, oil prices softened. The price of gold continued its gradual ascent. China, however, remains a cause for concern. Its troubled real estate market and the related debt problems and slowing growth, and heavy-handed efforts by the government to assert more control politically, economically, and financially have meant that it has been safe to avoid Chinese financial markets. The broader consequences for the global economy in terms of global growth, financial conditions, labor costs, capital expenditures and productivity remain to be seen.

Looking behind the aggregate equity market data, much has been written about the disproportionate importance of a few big US technology companies (dubbed the Magnificent Seven) to market returns. As an illustration, the NASDAQ index gained 43% in the year, fueled largely by the optimism over Artificial Intelligence. Capturing these returns in 2023 would have required very concentrated holdings of the sort that an indexed portfolio offered. Conventional wisdom has it that concentrated portfolios are riskier and indicate market fragility. It is a valid topic to debate whether indexed portfolios are riskier. Do the returns of a few big stocks drive the process of indexation, because diversified active managers usually cannot outperform narrowly driven markets, or does indexation drive the share price performance of the biggest stocks as the mathematics of indexation ensure that they receive more and more of capital flows into equity indices? Interestingly, although equity indices advanced strongly in 2023, company profits did not. Equity market advances can largely be accounted for by higher valuations.

Between the beginning of 2022 and the end of 2023, indexed investors, despite regaining much of their 2022 losses in 2023, would still have had negative returns over the full period. Actively managed portfolios that avoided much of the losses of 2022, and captured only some of the gains of 2023 would have had positive returns over the full period.

Investment Outlook

The questions for investors at the beginning of 2024 in our opinion remain the same as at the beginning of the fourth quarter of 2023. Is inflation beaten or reduced to lower, but sticky levels? If the latter, can interest rates be cut significantly? If not, how will higher interest rates (compared to the last decade) play out across the economy and financial markets? If slower growth leads to lower inflation, what are the prospects for financial markets? Will loose fiscal

policy affect interest rates? Will financial markets discipline loose fiscal policy? How important are structural and secular issues? What is the interplay between the physical and the digital economy? Is the absence of capital investment in the physical economy a bottleneck? Is the energy transition, which requires huge capital investment, both a driver of the capex cycle and a bottleneck? What are the implications for margins and profits if the capex cycle accelerates? How realistic is it to assume that AI can significantly enhance productivity in and of itself, and in the face of physical economy bottlenecks? Financial markets have so far turned a blind eye to deteriorating geopolitics. Can they continue to do so? Will the global election cycle and domestic politics matter for investors? This is a long, fascinating, and challenging list.

At current levels, financial markets appear confident of benign outcomes. Equity market valuations, especially in the US, aren't cheap compared to history. US equities are expensive compared to international equity markets, but arguably major international markets are facing big structural challenges without the technological leadership of the US. Credit spreads remain tight compared to history, which seems an anomaly in the face of higher rates and growing credit pressures. And long-term interest rates have already fallen in front of anticipated sharp cuts in official rates.

Financial Conditions

It is tempting to try to explain market action, but simple narratives have trouble with complexity. At the moment there is a growing view that even if inflation driven by supply constraints (the Covid era) is behind us, inflation due to rising labor costs, especially in the services sector, may be sticky. Wages always catch up with a lag, and labor markets remain tight. If this is true, there will be fewer interest rate cuts in 2024 than were anticipated only a few weeks ago. This is certainly too simple, and the data from many different definitions of inflation isn't conclusive.

Avoiding negative asymmetries helps portfolios deal with downside risk both as financial conditions are uncertain and as long cycle changes slowly and inevitably impact consensus views on the economy and markets.

In the analysis of financial conditions, we prefer to look for asymmetries. If rates are not cut much, then higher interest rates will work their way slowly through the economy. Higher rates for longer are at least a headwind for profits and margins, and with financial assets at historically expensive levels, this is a negative asymmetry. If, through the same process, interest rates at these higher levels impair leveraged assets and over-indebted companies, and cause economic and financial stress, rates would be cut. This too is a negative asymmetry, both because financial markets would be stressed and because inflation could accelerate again. The favorable case is that inflation is defeated, that economic activity stays strong, and that interest rates can be cut sharply. But why? Through the 1990s, a period of good growth and low inflation, real interest rates were typically about 2%. A similar real interest rate today would imply nominal rates at inflation plus this margin, say 4.75-5%. Why should real rates today be lower? Is there a reason other than that financial markets participants are used to this after the last 15 years? We believe that central banks would like to return to positive real interest rates, which discourage financial excesses (leverage and rent seeking) and which give them room to maneuver. But even if they are marginally lower than in the 1990s, the economy is much more indebted. We think that it is unlikely

that real interest rates return to zero, or lower, other than in the case of financial and economic stress.

An additional element is the size of central bank balance sheets. Developed country central banks are trying to reduce their balance sheets through quantitative tightening (QT). Here the intersection with fiscal policy is important. How realistic is it to imagine that QT and financing expansive fiscal policy can go successfully hand in hand without affecting long term interest rates negatively? QT also makes monetary policy tighter than it appears. So far there have been no signs of stress. Domestic institutional buyers appear to have replaced foreign sovereign investors. But the gilt market accident in the UK in 2022 is a recent example of what can happen, and the role of the USD as the global reserve currency is being eroded slowly. There is a negative asymmetry here too.

A recent study by the Fed concluded that over the thirty years between 1989 and 2019, 40% of the real growth in profits in the US could be accounted for by lower interest rates and lower taxes. We might ask if company management are as clever as they suggest. But more importantly, we must ask how likely it is that these following winds are repeated. Can interest rates fall for the next 30 years? Can taxes be cut further? (Global minimum taxes that are now being implemented worldwide are forecast to produce effective tax rates about 8% higher for global corporations). This is hard to imagine. On the contrary, the analysis must suggest another unfavorable asymmetry.

In credit markets, there are signs of growing pressure in credit card debt and auto loans. Mortgage rates are the highest for a generation. For the time being, it seems that private credit, which is not subject to the pressures of secondary market prices, may have been a viable alternative source of finance as banks restrain lending. The question now is whether all sorts of private financial assets can continue to avoid the rigors of marking prices to market. The phenomenon of adding leverage to already leveraged assets is only of very finite utility and perhaps a symptom of stress. Distressed credit investors have investable capital but have not yet had the opportunity to deploy it. We believe the opportunity is coming. Little by little asset prices are becoming subject to the discipline of the hard information based on the reality of a higher interest rate regime.

Globalization

Why might wages be sticky now? Labor markets are tight by any measure. But they may become even tighter as the structural trends of the last thirty years reverse. Central banks were quick to claim control over inflation over this period, but it now seems that low inflation was as much the result of globalization, which brought cheap labor and goods into the global economy, as it was a function of skillful monetary policy. Today globalization is no longer a following wind and may be a headwind. Immigration, whatever the societal challenges, has the economic advantage of supplying the labor market (15% in the US) and keeping wages low. The control of immigration may also be an economic headwind.

Margins and profits are also affected by the change in momentum and direction of globalization. In retrospect we can also see that outsourcing since the 1990s essentially replaced capital with cheap labor. This permitted global companies to focus on their highest value-added functions, normally intellectual property, distribution, and the relationship with the customer. The Covid supply chain crisis and changing geopolitical relationships are driving a huge accelerating and delayed capex cycle as supply chains are restructured.

Big Tech & AI

Big technology companies are a critical part of any equity portfolio, both because they have been the

drivers of returns for many years, and because of the promise of AI which could drive returns in the future.

Portfolio investors have so far been able to capture returns driven by the enthusiasm for AI through owning the big tech companies. They have the capital to acquire the emerging technology, the capital to muster and manage the huge data sets behind large language learning, and the platforms to deliver AI to customers. But beyond the promise, as with any new technology, of AI, there are important questions.

Can AI deliver the economy wide productivity gains that will underpin growth, and permit the economy to pay down debt over time? We don't know, but we can observe that productivity gains so far this century, when digital technology and the internet were adopted broadly across the economy, have been significantly lower than during the last 20 years of the last century.

Is AI becoming a source of more direct competition between the big technology companies? If so, what might be the effect on their returns? Arguably the big tech companies that rely on network effect have grown in separate parts of the industry – the operating system, search, social media, internet retail and so on. Now it is possible to argue that they are becoming direct competitors. For example, Microsoft, by embedding ChatGPT in its search engine, is competing more effectively with Google which is fighting back with Bard. They are already competing more directly in cloud computing (AWS and Azure as an example).

Is regulation a growing friction for big tech? The European regulator is aggressive, with privacy and data ownership as a main concern. The Chinese government is aggressive for reasons of political control. The Turkish government, in advance of elections, is restricting internet access for the same reason. In the US, data ownership is being contested in the courts as traditional media reacts. Growing social media regulation is a harbinger as the unintended consequences of a new technology have become apparent and are remedied. There is also the argument that digital functions such as the operating system or search are fundamental essentials to the digital economy, like water or power in the physical economy. Is it reasonable to assume that big tech returns are unaffected?

"We were hoping that you could work from work today."

Can corporations outside tech achieve productivity gains through the adoption of AI? Most promise this, signaling extensive middle class job replacement. Besides the social angst, what are the investment implications? AI consultants have told us that, like enterprise resource planning (ERP), implementing AI will be difficult and take time for corporations. They may have extensive proprietary data sets accumulated over many years now, but those data sets are "dirty" and need time consuming cleaning to be useful.

Is the self-reinforcing loop in equity markets between indexation and market domination by big tech companies a risk? Indexation has been the best

way to capture most of big tech company returns in a portfolio as these stocks have risen. It may also be that the phenomenon of indexation has been driven because of this and so distorted financial markets. This is a topic for another discussion. But if big company share prices fall, the self-reinforcing loop works powerfully in reverse, as we saw in 2022.

Is the technology industry already in some sort of recession? More and more employees, numbering well over 100,000 so far, are being laid off in most areas of the industry. Is this evidence of increasing competition? Are companies trying to protect margins?

Are there constraints in the intersection of the digital and physical economy to the ability of tech companies to grow their AI activities? Large language training models require huge computing power to manage bigger and bigger data sets, and to produce additional synthetic data that optimizes the models. This is visible in the proliferation of new data centers. Interestingly, companies such as Microsoft are planning independent energy sources outside the utilities which are unable to supply these power needs. Microsoft's interest in small nuclear reactors is not a coincidence. The juxtaposition of these power needs with the energy transition and rising energy costs is a factor of growing importance.

Energy

The energy transition alone, even if political objectives for it are being pushed back, is ushering in a period of high and sustained capital spending, at odds with nearly thirty years of relatively less capital spending, other than in technology. High capex by definition lowers immediate financial returns.

As discussed in the previous section on technology, we wish to understand the possible bottlenecks in the intersection between digital technology and the physical economy. Besides capital investment needs, another real constraint in both electricity generation and distribution and the oil and gas industry is the ageing and declining current workforce and the future availability of skilled engineers to realize the necessary capital investment. Utilities and the hydrocarbon industry have difficulty in competing for skilled workers against fashionable tech jobs, a problem exacerbated by the ESG concerns of younger workers. Labor costs will inevitably rise to deal with preferences that limit availability. Hydrocarbon industry recruitment campaigns are evidence.

This is hardly being discounted by financial markets at high valuations outside the energy complex. The question of the cost of energy inputs is fundamental. All economic activity is energy transformed. Higher long term energy costs, which are very possible, will have a profound negative effect on economic activity, productivity, and returns.

Geopolitics & Politics (Populism)

The result of the Taiwanese election is a challenge to China. How will China react? The hot crisis in the Middle East is spreading from Israel to the Iran backed Houthis in the Red Sea, and Iran backed Hezbollah in southern Lebanon. Putin's patience seems to be gaining the advantage in Ukraine as US support fades in the fiscal political battle. China continues to promote its alternative world order. The US is answering with technology trade restrictions. As the Chinese economy weakens and imports less, so China is beginning to fight back with cheaper exports. An increasingly confident and decreasingly democratic India fueled by the economic successes of the Modi regime is charting a course independent of the west.

International arrangements are changing because participants in the system aren't satisfied. The parallel move to populism and authoritarianism in

domestic politics is similarly a symptom of voters growing dissatisfaction with the prevailing liberal democratic consensus since the fall of the Berlin wall. 2024 is a big election year around the world, especially in the US.

Investors have been happy so far to stay calm in the face of political developments, even those as severe as current events in the Middle East. But the fact that political developments, both international and domestic, haven't yet had big investment consequences doesn't mean they can be ignored as investment factors.

Portfolio Positioning

Our investment approach is to exploit favorable asymmetries, and to avoid negative asymmetries where we can identify them. This takes our focus away from attempting to trade around market changes in the short term. Avoiding negative asymmetries helps portfolios deal with downside risk both as financial conditions are uncertain and as long cycle changes slowly and inevitably impact consensus views on the economy and markets. This means that portfolios are designed to absorb market volatility. Our asset allocation model, which reflects our aggregate views on asymmetries, is positioned to limit downside.

We focus on long cycle change in order to position portfolios to gain advantage from long-term wealth creation. The transition we envisage is gathering pace. Mindful of risks to the status quo, we're building portfolio positions in ideas that we think will benefit from the following winds of the new long cycle which will define the investment context of the next decades.

- We do not believe the next 10 years will be like the last 10 years. We approach the successful investments of the last decade with caution. Some have a place in the portfolio, but not to the dominant extent of the past. (Narrow market leadership is a warning flag).

- We avoid leverage and leveraged financial assets (rent seeking). In our asset allocation model, these are called engineering returns and exploiting inefficiencies. We also avoid investment in the financial industry. We avoid banks. Problems may not be systemic, but they are symptomatic of the ways in which higher rates, which are in fact, slowly work their way through the economy.

- We seek genuine innovation (as opposed to growth with no financial returns).

- We favor investments predicated on long-term, prudent capital management, both in companies and financial intermediaries.

- We maintain elevated levels of cash and precious metals while this long cycle change gathers momentum, and the related geopolitical and political pressures that are its symptoms remain elevated.

- We are comfortable being away from the crowd/consensus.

- We like the energy transition (infrastructure, carbon capture, nuclear), and Japan could be very interesting if they start repatriating capital and companies begin to return capital to investors.

As ever, we are grateful for your trust and confidence. We continue to invest heavily in our people, technology, and investment resources. As always, we welcome the opportunity to discuss your financial plan, the markets and your portfolio at any time. Also, please remember that we are here for you for all your financial needs including securing new accounting, tax, legal and/or estate planning services. Our team is wishing you and your family all the best in the New Year.

Sincerely,

The HBWM Team

Alan Bazaar
Co-Chairman,
CEO & Partner

Philip E. Richter
Co-Chairman,
President & Partner

Wayne Nordberg
Co-Chairman & Co-CIO

Andrew Norris
Co-CIO

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Equity Indices	Price	MTD	QTD	YTD
S&P 500	4,769.83	4.53%	11.68%	26.26%
Nasdaq	15,011.35	5.62%	13.84%	44.70%
Dow Jones Industrials	37,689.54	4.93%	13.09%	16.18%
Russell 2000	2,027.07	12.23%	14.02%	16.88%
Russell 3000	2,748.21	5.29%	12.06%	25.93%
S&P 500 Sectors				
Utilities	321.92	1.91%	8.56%	-7.08%
Consumer Disc.	1,418.09	6.10%	12.42%	42.30%
Telco	246.00	4.81%	10.95%	55.80%
Consumer Staples	762.32	2.67%	5.54%	0.52%
Industrials	964.73	6.96%	13.00%	18.08%
Technology	3,397.16	3.83%	17.17%	57.84%
HealthCare	1,590.36	4.30%	6.41%	2.06%
Materials	539.62	4.56%	9.69%	12.55%
Financials	626.35	5.36%	13.98%	12.10%
Energy	640.05	-0.08%	-6.99%	-1.42%
Real Estate	248.30	8.46%	18.76%	12.27%
US Interest Rates				
3 Month	5.33	-1.03%	-2.09%	22.78%
2-Year Note	4.25	-9.19%	-15.74%	-3.98%
5-Year Note	3.85	-9.83%	-16.53%	-3.92%
10-Year Bond	3.88	-10.34%	-15.14%	0.11%
30-Year Bond	4.03	-10.35%	-14.28%	1.65%
Commodities				
Crude (WTI)	71.65	-5.67%	-21.08%	-10.73%
Brent	77.04	-6.99%	-19.17%	-10.32%
N. Gas	2.51	-10.28%	-14.17%	-43.82%
Gold	2,062.98	1.30%	11.60%	13.10%
Silver	23.80	-5.84%	7.29%	-0.66%
Currencies				

Source: Bloomberg as of 12/31/2023

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HBMW Quotes of the Quarter

Interest rates are to the prices of all assets like gravity is to the function of the earth.

Warren Buffett

Nobody ever lost their job for buying 10-year Treasuries at 5% when they've been half a percent for years.

Jean Ergas

Tigress Capital Partners

October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.

Mark Twain

It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent.

Charlie Munger

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4Q 2023: What Happened and What Mattered

McCarthy Ousted
For the first time in U.S. history, house members voted out their leader when Rep. Kevin McCarthy was ousted as House Speaker in a 216-210 vote.

Hamas Attacks Israel
In October, the militant group Hamas launched a surprise attack on Israel killing over 1,000 and taking 240 people hostage. This attack launched Israel to declare itself at war with Hamas.

Biles Makes History
Olympic gymnast Simone Biles made history when she won her 27th world championship medal this Fall and became the most decorated gymnast of all time.

Ferrari to Accept Crypto
Luxury car brand Ferrari announced it would start accepting cryptocurrency as a form of payment in the U.S. to try and reduce its carbon footprint and at the request of many of its clients who are investors in the cryptocurrency market. The company is expected to expand this payment practice into Europe as well.

College Leaders Face Backlash
College presidents from UPenn, Harvard, and MIT all faced backlash, and in some cases firing, after their response to the war in Israel and a congressional hearing regarding antisemitism on college campuses.

'Friends' Star Passes
Matthew Perry, the beloved star of the iconic show 'Friends' passed away at 54 of an accidental drug overdose.

Disney Completes Hulu Purchase
The Walt Disney Company completed its takeover of Hulu by purchasing Comcast's stake for $8.6 billion. The deal values Hulu at $27.5 billion and ends a takeover that began back in 2019.

NYC Marathon Record Set
Ethiopian Tamirat Tola, the winner of the men's competition at the New York City Marathon this year, broke the course's record by eight seconds completing the race in 2 hours, 4 minutes, and 58 seconds.

WeWork Files For Bankruptcy Protection
WeWork, the once hot startup valued at almost $50 billion, filed for Chapter 11 bankruptcy after struggling throughout the pandemic as demand for office space faltered. In its filing it plans to undertake a 'comprehensive reorganization'.

Charlie Munger Passes
Charlie Munger, Warren Buffett's long-time business partner and friend, died in November at the age of 99. Munger started his career in law and had been part of Berkshire Hathaway since 1978.

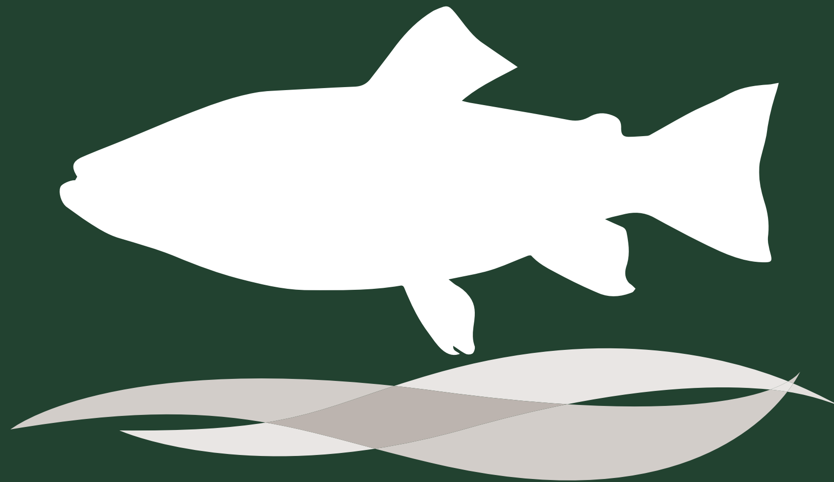
Fed Signals Interest Rate Cuts in 24'
In December, the Federal Reserve kept interest rates unchanged but projected three rate cuts in 2024.

Santos Expelled
New York Republican George Santos was formally expelled from Congress following a number of criminal charges and financial misdeeds. Santos became the sixth House member to ever be expelled from Congress in U.S. history.

Mortgage Rates Fall
The 30-year fixed-rate mortgage fell to 6.67% in December, the lowest since June.

Honda Recalls Millions of Vehicles
Honda recalled 2.5 million Honda and Acura vehicles in America to address a fuel pump defect. The issue can cause the engines of affected cars to fail or stall.

Texas Rangers Win First World Series
The Texas Rangers won their first World Series championship in franchise history when they defeated the Arizona Diamondbacks 5-0 in Game 5.



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Past performance is no guarantee of future results. Inherent in any investment is the potential for loss of all or any portion of the investment. This information is for discussion purposes only. It is not intended to supplement or replace the disclosures made in Part 2 of HBWM’s Form ADV.

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Market index information was compiled from sources that HBWM believes to be reliable. However, HBWM does not guarantee the accuracy or completeness of such data.

Since HBWM manages its actual client portfolios according to each client’s specific investment needs and circumstances, HBWM cannot affirm that the returns of the account are similar to other accounts managed by HBWM. This is due in part to differences in investment strategy, guidelines and restrictions, the timing of trades by HBWM, market conditions, cash or cash equivalent balances maintained by the client, and the timing of client deposits and withdrawals.

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