VICTORIA
Capital Management, Inc.

Financial Markets Perspective

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A Look Back; a Look Ahead

As most of our followers know, we offer a forecast of the economy and financial markets for the coming year as well as evaluating our prior year's prognostication. This year is no different so, let's see how our forecasts for 2023 turned out (note italics for the predictions) and what we envision for 2024.

"There will not be a recession in 2023. The fundamentals of the underlying economy are too strong to fall into a traditional recession forecasting trap. Unemployment declined in December to 3.5%, job openings are estimated in the tens of millions and minimum wages have surged. As a result, there will likely be continued demand for at least basic provisions, i.e., food!"

Although we were among a minority of forecasters, we accurately predicted that there would not be a recession in 2023. Not only did we state that expectation, but we also provided the rationale for that forecast!

"A newly elected Congress will be antagonistic as each party has a very different agenda. The outlook is likely to be continued gridlock with few major policy decisions to be made over the next two years. As a result, fiscal policy will become less expansive and reduce the pressure on prices caused by the excessive government spending programs related to COVID."

One would be hard-pressed to identify any positive decisions emanating from Congress last year. Given the historic dumping of the Speaker of the House, Kevin McCarthy, and the continued trepidations over the growing popularity of ex-President Trump, there was not much accomplished last year.

"Inflation is unlikely to be a problem in 2023 as prices have been softening since mid-year 2022 and will now be compared to elevated year ago levels. Watch out for a downside blip that will take inflation below zero for one or two months as the economy moves back toward equilibrium from a government-induced period of financial exuberance."

The Federal Reserve's persistence in implementing a tight money/high interest rate policy broke the back of inflation in 2023 and by the end of the year, the rate of inflation as measured by several indicators fell below the Fed's 2% target rate.

"From the war in Ukraine to the threats over who governs Taiwan to pending tensions between North and South Korea, the world is becoming a more dangerous place. These are one-offs that are difficult to incorporate into economic and financial market forecasting."

The dangers associated with conflict rose measurably in 2023 spearheaded by the Hamas attack on the state of Israel. The Mid-East quickly became a cauldron of boiling hatred and the year ended with various anti-Jewish factions launching attacks on Israel. Houthi attacks on Western shipping in the Suez Gulf brought further concerns that global conflict will accelerate in 2024.

“Global energy tensions will benefit U.S. energy producers. A dramatic increase in exports of liquified natural gas to Europe is expanding our favorable trade balance. Europe will continue to buy energy from the U.S. to replace the natural gas that was imported from Russia. Domestic oil production, via fracking, continues to expand and is returning to record levels—a trend that is likely to continue in 2023 and beyond.”

Global oil prices remained muted in 2023 due to several factors. The Administration released millions of barrels of oil to prevent prices from going higher. By the end of 2023, due to record domestic oil production, prices stabilized in the range of $70-$75 per barrel. Domestic oil production reached record levels in 2023.

“Corporate profits should continue their rebound this year as companies take precautions against a decline in margins due to a slowdown in demand. While layoffs are likely to increase, the demand for labor continues to be strong and competent workers will not find it difficult to stay employed.”

After a temporary dip in corporate profits for the second quarter of 2023, profits resumed an uptrend that began in the second quarter of 2022. This rise in profits for the third quarter of 2023 shows that U.S. companies have been able to adjust to the post-COVID operating environment, which includes higher wages and higher borrowing costs.

“With state governments having experienced overwhelming amounts of tax inflows, there will also be growing demand for workers in state and local municipalities.”

In 2023, job growth in the government sector at the state and local levels averaged 56,000 per month, more than double the average monthly gain of 23,000 in 2022.

“The bear market likely bottomed in October last year when the value of the U.S. dollar peaked—-probably not a coincidence. Yet, the S&P 500 has been basically range-bound for the last six months and market internals have been steady.”

Last year‘s stock market performance was mostly led by select large capitalization growth stocks otherwise known as the “Magnificent Seven”. The dichotomy between these seven stocks and the rest of the market was unusual until the beginning of November when their small and mid-cap brethren took off and brought then year-to-date single-digit returns to double-digits by the end of December. The result? A broad-based rally at year-end.

One obvious oversight in the “A Look Back; A Look Ahead” for last year was the absence of any forecast for interest rates. Looking back, forecasting rates would have been a treacherous endeavor. In one sense, assuming a continued tight Fed policy, interest rates were likely to rise. However, the falling inflation indicator encouraged a marginal interest rate decline at the end of 2023 even though the Fed did not commit to lower interest rates. Another mistake was not considering the impact on interest-sensitive businesses that would be subject to a surge in short-term interest rates such as when, in the first quarter, Silicon Valley Bank failed, and a few other banks found themselves in a similar position due to the mismanagement of balance sheets. Fortunately, few remember the financial catastrophe that could have involved many more banks if the Federal Reserve had not stepped in and assumed responsibility for those banks’ liabilities. Onwards and Upwards!

With that review, here are our broad predictions for 2024:

The good news is that there are many positives both from an economic and financial markets perspective. Generally, current economic statistics reveal an economy that has just about recovered from the effects of COVID-19 and the resulting factors that introduced unusual distortions into the economy and financial markets. Even though the Federal Reserve embarked on a record-setting pace of increases in the Fed funds rate, the economy did not crumble, employment remained steady, and corporate profits continued an upward path. Credit for this soft landing should be given to the government's willingness to maintain an easy fiscal policy -- in other words, continue to spend aggressively to keep the economy from falling into recession.

From a financial markets perspective, companies that recognize how artificial intelligence (AI) could positively impact the way we live, and work will come out on top. As a primer to AI, Wikipedia offers the following:

> "ChatGPT is credited with starting the AI boom, which has led to ongoing rapid and unprecedented development in the field of artificial intelligence. ChatGPT (Chat Generative Pre-Trained Transformer) is a chatbot developed by OpenAI and launched on November 30, 2022. Based on a large language model, it enables users to refine and steer a conversation towards a desired length, format, style, level of detail, and language. Successive prompts and replies, known as prompt engineering, are considered at each conversation stage as a context. By January 2023, it had become what was then the fastest-growing consumer software application in history, gaining over 100 million users and contributing to the growth of OpenAI's valuation to $29 billion. ChatGPT's release spurred the development of competing products, including Bard, Ernie Bot, LLaMA, Claude, and Grok. Microsoft launched its Bing Chat based on OpenAI's GPT-4."

Artificial intelligence ("AI") has been on our radar for a long time given our thematic approach to managing growth equities. Over the years, our Productivity Facilitators theme has become more dominant and inclusive of companies involved with AI. Along these lines, many, many years ago, we wrote a forecast about how the personal computer would enhance our lives. This optimistic forecast was made before the creation of the Internet and the mobile phone, two inventions that have changed everyone's lives. Imagine being lost in a city and trying to find a telephone booth. Good luck! The implementation of AI across industries is the next step in significantly improving our lives.

Another one of our key investment themes is Quality Healthcare which identifies breakthroughs in medicine that make a revolutionary contribution to standards of living. One recent example is drugs like Ozempic and Wegovy which have contributed to weight loss and improvements in cardiology even though they were targeted to help control diabetes! Advances in genomic and proteomic analysis and the launch of many modalities of drugs are life-changing. There are new therapies today that are designed to engineer how the body recognizes and treats diseases that extend lives while generating billions of dollars in revenues for companies developing them successfully.

So, what is the potential bad news? Mostly, expected market volatility relating to our national Presidential election. There have never been circumstances in national elections that parallel the "debates" that we have witnessed thus far and will likely witness up to voting day. Decisions about who will represent each party could change with the pen of a Supreme Court justice. We will see. Aside from the election, foreign wars could continue and even escalate which would pressure financial markets around the world, not to mention potential unforeseen actions taken by rogue regimes.

Domestically, we are returning to relatively normal financial markets within the context of returns. Interest rates will end the year lower as the Fed appears committed to lowering the fed funds rate. In an easier Fed policy environment, and lower inflation, long-term bonds should experience further gains along with a traditional stock market return in a 9-12% range with obvious divergencies brought about by circumstances. As usual, this outlook encourages diversification among varying asset classes.

Corporate profits will likely continue in a positive trajectory given falling interest rates and mildly positive fiscal policy. However, changes in future tax laws could impact that expectation and in an election year, such changes are unlikely. Also, the generation of profits could be skewed by the outsized gains expected in artificial intelligence and biotechnology.

We think we have covered most of the economic and financial market bases for 2024 but there is always some unidentifiable event that could emerge to upset this prediction. More importantly, Stay Healthy and Happy!

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