MONTHLY MARKET UPDATE
January 2024

Madison INVESTMENTS

- The conclusion of 2023 was marked by positive inflation news and a dovish Federal Reserve presentation, leading to a 4.5% rise in the S&P 500 for the month and robust annual returns of 26.3%.
- Bonds also had a positive year, with the Bloomberg U.S. Aggregate Bond Index up 5.5%.
- Market performance in 2023 varied significantly by sector; Technology soared 57.8%, Communication Services and Consumer Discretionary outperformed the market, and Energy and Utilities experienced negative returns.
- Looking ahead, there are reasons for both optimism and caution, including skepticism toward predictions for 10-14% profit growth in 2024 and concerns about the housing sector, manufacturing decline, and consumer spending.

All it took to finish 2023 with a flourish was positive inflation news and a dovish Federal Reserve presentation in December that raised expectations for aggressive rate cuts in 2024. The S&P 500 Index rose 4.5% for the month, taking the fourth quarter return to 11.7% and the annual return to a surprisingly robust 26.3%. While one of the notable trends towards the end of the year was the broadening of the market, particularly among smaller stocks, the year will be remembered for the remarkable performance of the "Magnificent Seven," the mega-cap technology stocks that powered the market's return. Boosted by the spirited expectations for artificial intelligence, these seven stocks soared between 49% and 239% for the year, accounting for nearly two-thirds of the S&P 500's 2023 return. Bonds also had a positive year, with the Bloomberg U.S. Aggregate Bond Index up 5.5%.

While all of this was wonderful news for investors, it is important to keep the exuberance in perspective. At the risk of being accused of finding a dark lining in a silver cloud, a quick look backward is warranted. Perhaps already fading from memory is the mood of a year ago, when we were coming off one of the dreariest annual periods in memory, with both stocks and bonds falling double digits in 2022, the first time in modern history when stocks and bonds both declined double digits in the same year. As a result, the two-year cumulative return for the S&P 500 is merely +3.4%, while the Bloomberg Aggregate Bond Index is still down 8.2% since the beginning of 2022.

The equity market has seen twenty percentage point swings every calendar year for the past eight years. The volatility of the equity market is a reminder of the importance of a committed investment strategy and that equity investing is not for the faint of heart.

The markets also reflected the avoidance (to date) of a widely anticipated economic slowdown, which included many credible predictions for a recession. At the start of the year, consensus expectations for GDP growth were at 0.3%, while current estimates for the trailing year are eight times higher at 2.4%.

As has been true for most of 2023, looking beyond the flashy index returns is essential. For the year, the equal-weighted S&P 500 trailed the weighted index by a substantial 12.4%, returning 13.9%. Small stocks, as measured by the Russell 2000, had a banner month in December, returning 12.2%, but that index still trailed the S&P 500 by almost 10% for the year. The action was decidedly on the growth side of the spectrum, with growth stocks returning 42.7% to 11.5% for value. There was an unusual dispersion of returns in 2023 by S&P sector, from Technology, up 57.8%, to negative returns for Energy and Utilities. Returns from Consumer Staples and Health Care were lackluster, while Communication Services and Consumer Discretionary heartily outperformed the market. In other words, where you were in the market in 2023 mattered a great deal, and while diversification may have been a plus for risk management, it was not likely a boost for returns.

Going forward, we see reasons for both optimism and caution. We look at the highly optimistic Wall Street predictions for a broad 10-14% profit growth in 2024 with some suspicion. Take housing, for example. By most estimates, housing and its associated activities constitute some 15% of GDP. By the end of 2023, the median price for an existing single-family home was around $390,000, a price beyond the means of most Americans, even when mortgage rates were historically low. With lending rates pushing 8% in 2023, the housing sector was in a slump. Even if rates come down to 6% in 2024, they will still appear unattractive to four out of five homeowners who are sitting on mortgage rates below 5%, many under 3%. This keeps homes off the market, and a low supply keeps prices high. While artificial intelligence has sparked a boom in server farms, it is hard to see how it will help the housing market and associated businesses such as large appliances and the construction trades. Likewise, the manufacturing sector continued a steady decline throughout 2023 and has been at recessionary levels since the fourth quarter of 2022.

The end-of-year stock rally was powered by anticipated cuts by the Federal Reserve, with expectations for five to seven such events. This optimism will likely require a continued trend for Core Personal Consumption Expenditures (PCE), the Fed's preferred inflation measure, which has dropped from 5.6% in February 2022 to 3.2%. But it is at least equally likely that the economic data will give the Fed pause and support higher rates for longer. As we've been pointing out throughout the year, the rise in credit card debt and, more lately, the holiday boom in buy-now-pay-later purchases suggests a consumer reaching its spending limit with Covid savings long depleted. The consumer constitutes some 70% of GDP, so any downturns there can have a significant impact. One scenario that doesn't seem embedded in the ebullience around future rate cuts is the possibility that they will be necessary in response to economic woes and spiking unemployment. All of which drives us to recommend a careful review of a diversified asset allocation, especially when the risk-versus-reward tradeoff of bonds relative to stocks hasn't been this attractive in years.

PORTFOLIO MANAGER Q&A - MIKE SANDERS

What were the primary drivers of lower interest rates in the fourth quarter?

The move down in interest rates can be attributed to two developments. First, the Treasury pushed off issuance of further-out-the-curve bonds in favor of more Treasury Bill and shorter duration issuance, which altered the supply/demand balance. In addition, the Federal Reserve, citing better inflation data, talked for the first time about how they may have attained peak interest rate levels and shifted their focus from inflation concerns to economic growth. That, coupled with the expectation of three cuts in 2024, set rates on a downward trajectory. As rates fell, risk assets such as credit spreads and equities fully priced in a soft landing scenario.

The big question for 2024 is whether inflation will continue to move down in a way that allows the Fed to follow through on its rate cuts. The other offshoot of that is whether the Fed will meet the market's expectations in terms of rate cuts. There is about 75 basis points of difference between what the market is expecting, roughly 150 basis points, and what the Fed is indicating through their economic projections, which is 75. How that reconciles, whether it's the Fed moving towards the market or the market moving towards the Fed, will be a significant driver in 2024. And then, what will an economic slowdown look like? Every hard landing looks like a soft landing at some point. So, time will tell how the tight policy from the Fed will impact various parts of the economy.

How do you approach portfolio construction with rate cuts on the horizon?

I think there is a slight misnomer about rate cuts: if interest rates fall, rates across the yield curve will all fall by the same amount. Realistically, it is much more nuanced than that. Short-term bonds are influenced much more by Fed policy than longer bonds, where there is much more uncertainty. Falling interest rates signify that we're closer to economic growth down the line; therefore, inflation could rise. So, long-term bonds could actually move up. When building a portfolio, you must think about all parts of the yield curve. It's not as clear-cut as simply buying duration, assuming that longer duration will outperform. Given our expectations of when and how many cuts we think the Fed will make, we are positioning bonds across the curve. If the Fed doesn't have to cut all the way back down to 2-2.5% and they only have to get to 3-3.5%, that could have pretty significant consequences for longer-term bonds, given where they are trading today.

What themes or ideas should investors be considering in 2024?

Mike Sanders, CFA, FRM
Head of Madison Fixed Income, Portfolio Manager

The investment themes we're looking at in 2024 include how to position portfolios for a disinversion of the yield curve. We believe the Fed will be cutting rates 75 to 125 basis points in 2024, and we will likely have a flat to positively-sloping yield curve by the end of the year. So, yield curve positioning is one of the things we are focusing on. I think there is a likely outcome that the Fed doesn't have to cut as much, in aggregate, and that rates further out the curve move higher. Positioning more conservatively in the front end versus the back end, I think, will be a positive attribute for performance in a portfolio. Another thing worth watching in 2024 is credit spreads, given how much performance has been pulled forward with the expectation of a soft landing. We're not saying that there will be a recession, but we have to be aware of the possibility, and right now, credit spreads are extremely tight, reflecting certainty in a soft landing. If the soft landing becomes a hard landing, we think being higher quality will help weather that type of environment. Finally, if your investment mandate allows it, we see value in certain securitized bonds, such as mortgages and asset-backed maturities, given where spread levels are relative to history. But in all, fixed income's role in an asset allocation is much more relevant today than when rates were sub-1%, particularly for those investors that need income.

U.S. EQUITIES (%)

	Dec	QTD	YTD	1 Year	3 Year	5 Year	10 Year
DJ Industrial Average	4.9	13.1	16.2	16.2	9.4	12.5	11.1
S&P 500	4.5	11.7	26.3	26.3	10.0	15.7	12.0
Russell 1000	4.9	12.0	26.5	26.5	9.0	15.5	11.8
Russell 1000 Value	5.5	9.5	11.5	11.5	8.9	10.9	8.4
Russell 1000 Growth	4.4	14.2	42.7	42.7	8.9	19.5	14.9
Russell Midcap	7.7	12.8	17.2	17.2	5.9	12.7	9.4
Russell 2000	12.2	14.0	16.9	16.9	2.2	10.0	7.2

U.S. EQUITY CHARACTERISTICS - S&P 500

	December	2022
Price/Earnings Ratio (NTM)	19.7	17.0
Weighted Avg. Market Cap ($B)	721.7	417.5
Dividend Yield (%)	1.5	1.7

U.S. EQUITY SECTORS - S&P 500 (%)

	Dec	QTD	YTD	Weight
Communication Services	4.8	11.0	55.8	8.6
Consumer Discretionary	6.1	12.4	42.4	10.9
Consumer Staples	2.7	5.5	0.5	6.2
Energy	0.0	-6.9	-1.3	3.9
Financials	5.4	14.0	12.1	13.0
Health Care	4.3	6.4	2.1	12.6
Industrials	7.0	13.1	18.1	8.8
Information Technology	3.8	17.2	57.8	28.9
Materials	4.6	9.7	12.5	2.4
Real Estate	8.7	18.8	12.4	2.5
Utilities	1.9	8.6	-7.1	2.3

INTERNATIONAL EQUITIES (%)

	Dec	QTD	YTD	1 Year	3 Year	5 Year	10 Year
ACWI	4.8	11.0	22.2	22.2	5.7	11.7	7.9
ACWI ex USA	5.0	9.8	15.6	15.6	1.5	7.1	3.8
MSCI EAFE	5.3	10.4	18.2	18.2	4.0	8.2	4.3
Emerging Markets	3.9	7.9	9.8	9.8	-5.1	3.7	2.7
China	-2.4	-4.2	-11.2	-11.2	-18.4	-2.8	0.9
Japan	4.4	8.2	20.3	20.3	0.7	6.9	5.0
Germany	4.4	13.0	23.0	23.0	0.2	6.3	2.0
United Kingdom	4.5	6.9	14.1	14.1	8.8	6.9	2.5
India	8.1	11.9	20.8	20.8	12.0	11.8	9.9

KEY ASSET PRICES

	Dec	2022
USD/EUR	1.11	1.06
CAD/USD	1.32	1.36
JPY/USD	140.92	132.78
USD/GBP	1.27	1.21
Bitcoin ($)	42,265.2	16,514.0
Gold ($/oz)	2,066.0	1,827.0
Crude Oil (WTI) ($/bbl)	75.8	80.4

FIXED INCOME (%)

	Dec	QTD	YTD	1 Year	3 Year	5 Year	10 Year
Government Bond	3.3	5.6	4.1	4.1	-3.7	0.6	1.3
Municipal	2.3	7.9	6.4	6.4	-0.4	2.3	3.0
U.S. Aggregate Bond	3.8	6.8	5.5	5.5	-3.3	1.1	1.8
Investment Grade Corporate	4.2	8.2	8.2	8.2	-3.2	2.4	2.8
High Yield	3.7	7.2	13.4	13.4	2.0	5.4	4.6

U.S. TREASURY YIELDS (%)

	Dec	2022
3-Month	5.4	4.4
6-Month	5.3	4.8
2-Year	4.2	4.4
5-Year	3.8	4.0
10-Year	3.9	3.9
30-Year	4.0	4.0

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In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond’s maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

The Dow Jones Industrial Average® (The Dow®), is a price-weighted measure of 30 U.S. blue-chip companies. The index covers all industries except transportation and utilities.

The S&P 500® Index is an unmanaged index of large companies and is widely regarded as a standard for measuring large-cap and mid-cap U.S. stock-market performance. Results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

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The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

The MSCI EAFE (Europe, Australasia & Far East) Index is a free-float adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. and Canada.

Emerging Markets - MSCI Emerging Market Index captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,138 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

China - MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

Japan - MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market.

Germany - MSCI Germany Index is designed to measure the performance of the large and mid cap segments of the German market.

United Kingdom - MSCI United Kingdom Index is designed to measure the performance of the large and mid cap segments of the UK market.

India - MSCI India Index is designed to measure the performance of the large and mid cap segments of the Indian market.

Government Bond - Bloomberg US Government Index measures the performance of the U.S. Treasury and U.S. Agency Indices, including Treasuries and U.S. agency debentures. It is a component of the U.S. Government/Credit Index and the U.S. Aggregate Index.

Municipal - Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

U.S. Aggregate Bond - Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and corporate securities, with maturities greater than one year.

Investment Grade Corporate - Bloomberg U.S. Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

High Yield - Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

Weighted Avg. Market Cap: measures the size of the companies in which the portfolio invests. Market capitalization is calculated by multiplying the number of a company’s shares outstanding by its price per share.

Price-to-Earnings (P/E) Ratio: measures how expensive a stock is. It is calculated by the weighted average of a stock’s current price divided by the company’s earnings per share of stock in a portfolio.

Dividend Yield: the portfolio’s weighted average of the underlying portfolio holdings and not the yield of the portfolio.

A basis point is one hundredth of a percent.

Bond Spread is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

Yield Curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward-sloping curve), inverted (downward-sloping curve), and flat.