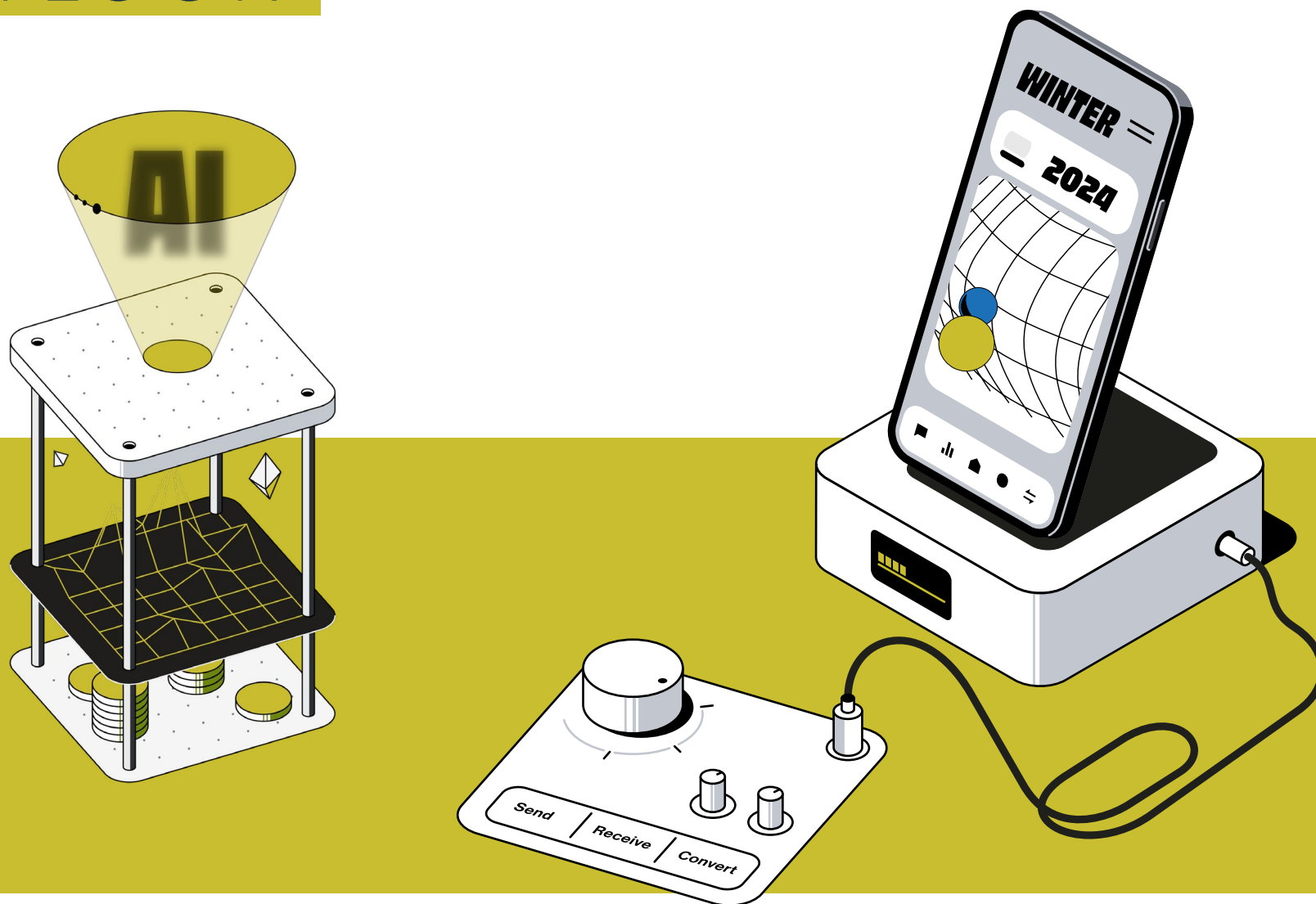


MARKET OUTLOOK

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WM



HELLO@HOWEANDRUSLING.COM • (585) 325-4140 • 165 CULVER ROAD, ROCHESTER, NEW YORK 14620



On Our Minds

As we start 2024, we make the following observations about what we believe are the most important uncertainties that will impact investments in 2024.

- (1) Will inflation continue to fall as expected towards the Fed's 2% target?
- (2) Will there be a recession?
- (3) Will artificial intelligence adequately deliver on its promise in 2024?

Notably, investors' opinion on the first question is resoundingly "yes." Investors' opinion on the second question has shifted during the last several months and there is now a strong consensus opinion that the answer is "no." Based on the performance of technology stocks in 2023 and high relative valuations, it seems clear that investors expect a lot from artificial intelligence in 2024.

Read along as we explore these questions in more detail.

IS THIS TIME DIFFERENT?

Forty years ago, the famous American-British investor John Templeton wrote that the four most costly words in the annals of investing are "this time is different." During the decades following its publication, the wisdom of Templeton's observation has been proven repeatedly. As 2024 begins, a consensus belief among investors is that inflation is on a sure path back to 2%, the Fed is done hiking rates, and a recession will be avoided. Investors have this view despite many economic and financial indicators that have long and very strong predictive track records warning of an impending recession. So, will this time really be different?

RECESSION INDICATORS FLASHING RED

For all of 2023, most data metrics that have historically been strongly predictive of recessions were flashing red. This includes an inverted yield curve (when short-dated Treasury bonds pay a higher interest rate than long-dated Treasury bonds), a negative index of leading economic indicators, negative money supply (M2) growth, negative manufacturing survey data, rapidly rising credit card and auto loan delinquency rates and tighter bank lending standards. Historically, some of these metrics have occasionally given a false recession signal, but that has been quite rare. However, there has never been a period when all these indicators falsely warned of an impending recession at the same time.

THE "GODOT" RECESSION OF 2023

Based on the indicators described above, we and many other investors thought recession risk was high for much of 2023. By late 2023, financial media labeled it the "Godot" recession; like Samuel Beckett's title character in his 1952 play, it simply never showed up.

IS THIS TIME DIFFERENT?

CONSENSUS GIVES UP ON ITS RECESSION FORECAST

In recent months, consensus opinion has changed significantly as inflation readings have been lower than expected, and in December, the Federal Reserve indicated that it expects to cut rates in 2024. Nearly all the recession indicators are still sending warning signals, but investors have become convinced that this time is different.

PANDEMIC DISRUPTIONS AND DISTORTIONS

Investors now believe that disruptions in the supply of both labor and goods caused by the pandemic are to blame for the spike in inflation. Labor and supply chains are in the process of returning to normal and inflation is falling rapidly as a result. Investors believe that the pandemic caused distortions to many economic and financial metrics, including the ones we previously described that have preceded most recessions. Many investors believe these metrics have been giving false recessionary signals for a year or more because of these distortions.

LABOR MARKET RESILIENCE AND A “GOLDILOCKS” ECONOMY

Meantime, the labor market has been surprisingly resilient as the U.S. added 2.7 million jobs during 2023 and the unemployment rate remains near a 50-year low. Job openings and wage inflation data indicate that the labor market is slowly cooling off, and at its December Federal Open Market Committee (FOMC) meeting, the Fed’s comments on labor data and inflation marked a significant change from its previous position. Previously, the Fed’s comments indicated that it believed that the unemployment rate would have to increase for inflation to fall back down to its 2% target. At the December meeting, the Fed’s comments indicated that a rise in unemployment was not a necessary condition for it to cut interest rates. Investors

had been worried that the Fed wanted to engineer a small increase in unemployment, but that any increase in unemployment would quickly escalate to a much larger than intended increase, throwing the economy into recession. Based on the Fed’s comments in December, this risk has declined in probability. Investors believe the economy is not too hot to risk a reacceleration in inflation, and not too cool to risk unemployment spiking higher.

RISKS TO THE CURRENT CONSENSUS OPINION

One risk to the current “Goldilocks” economic and interest rate forecast by consensus is the potential for unexpected difficulty keeping inflation on its downtrend towards the Fed’s 2% target. Geopolitical events could upset the “Goldilocks” inflation forecast as a broader war in the Middle East would likely trigger renewed inflationary pressure on oil, gas, and other goods. Another risk is that the labor market does in fact prove too tight for inflation to return to 2% and instead of easing monetary policy, monetary policy must be more restrictive for longer. Worse inflation readings would likely pressure both equity and fixed income securities. On the other hand, there is also a risk that economic conditions deteriorate materially, and the long-anticipated recession finally shows up. That risk would likely have a negative impact on equity prices, but fixed income securities would likely produce positive returns in that scenario.

HOWE AND RUSLING VIEW

In our opinion, the decline in inflation, bond yields and the change in the Fed’s comments on the relationship between employment, inflation and Fed policy are very important developments. Consequently, we believe recession risk has fallen, but the risk has declined from a high level and is not yet low. We will continue to closely monitor inflation and other economic metrics and our investment outlook will evolve with the data.

IS ARTIFICIAL INTELLIGENCE GOING TO DELIVER ON ITS PROMISE?

Bill Gates has called artificial intelligence (AI) as revolutionary as the development of the graphical user interface for computers in the 1980s, and large technology companies appear to agree. The launch of ChatGPT on November 30, 2022, was like a starting gun, marking the beginning of a race among cloud computing, social media, and software companies to build new AI computing infrastructure as fast as possible. NVIDIA, which sells semiconductor chips that power AI computers, saw its sales rocket higher in 2023 and its stock soared 239%, the biggest gainer in the S&P 500 index last year. Excitement about AI was not confined to NVIDIA as the technology sector gained 58% last year, the best year since the peak of the infamous tech bubble in 1999. In fact, tech stocks were the engine that drove the entire U.S. equity market higher in 2023. After this tremendous performance, are tech stocks in a bubble like 1999, or is this the beginning of a longer period of strong returns? If it is the latter, artificial intelligence is going to have to begin to deliver on its promise in 2024.

WHAT IS THE PROMISE OF ARTIFICIAL INTELLIGENCE?

Like manufacturing and transportation technology that was introduced during the industrial revolution, and personal computing and internet technology that was developed in the 1980s and 1990s, artificial intelligence technology is expected to materially increase labor effectiveness and efficiency. A more productive labor force can accelerate GDP growth and corporate profit growth. How will artificial intelligence do that? AI will assist humans in writing new software code, speed up development of new healthcare treatments, create new literary and art content, improve the effectiveness of advertisements, and improve analysis and problem solving, among many other future applications.

IS ARTIFICIAL INTELLIGENCE GOING TO DELIVER ON ITS PROMISE?

HOW WILL THE SUCCESS OF AI BE MEASURED?

Among the most highly anticipated AI technology applications for 2024 are Microsoft's Copilot, Adobe's Firefly, and ServiceNow's Now Assist software add-ons. Each of these applications automates and improves functions that previously required manual effort. Investors are monitoring the percentage of each company's customers that adopt AI-assisted software as well as the price increases associated with the new offerings. Investors are also monitoring capital spending plans of large technology companies and assume that there is a relationship between capital spending and return on (AI) investment. Semiconductor companies such as NVIDIA, AMD, Broadcom, and Marvell are expected to benefit from strong demand growth for their AI technology hardware.

HOWE AND RUSLING VIEW

We believe Microsoft, Adobe, ServiceNow, and other software companies will see strong demand for their new AI software in 2024. We also believe media companies such as Meta (Facebook) and Alphabet (Google) will see gains from AI-assisted content generation, and advertising targeting and measurement in 2024. Large cap tech companies will likely continue spending aggressively on AI infrastructure, benefiting some semiconductor and networking equipment companies. The valuation multiples of technology stocks are quite high, so the bar has been set high, especially for infrastructure vendors that do not have a recurring revenue business model. However, AI technology and associated applications are in a very early stage of development, significant improvements are likely for many years and ultimately, we expect AI to deliver significant benefits to many businesses and economies.

ECONOMIC DATA & INVESTMENT OUTLOOK

KEY POINTS

Inflation is declining and will likely fall below 3% in the first half of 2024.

Credit card and auto loan delinquencies are still rising but are unlikely to be broadly problematic unless unemployment increases.

Interest rates on Treasury bonds are down significantly from Q3 2023 due to cooler inflation and Federal Reserve communications about rate cuts in 2024. However, we do not expect the Fed to cut rates as aggressively as implied by futures markets unless economic conditions surprise to the downside.

Stock valuations remain above long-term averages, but that is entirely due to the high valuation of growth stocks.

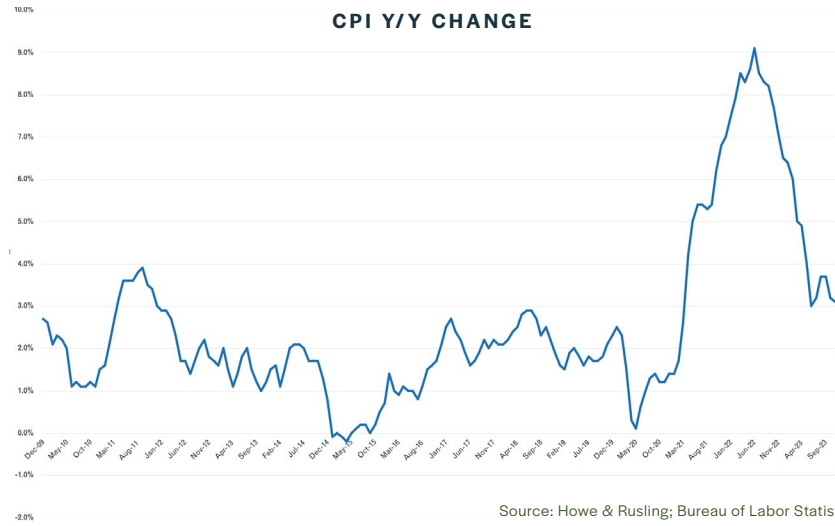
Unemployment remains near a 50-year low. Labor inflation is down significantly from the mid-2022 high, but it remains far above the level from 2010-2020.

While lower inflation and interest rates, and labor market resiliency have reduced the risk of a recession, the risk is not low. Most economic and financial metrics indicate we are in the later stages of an economic cycle. We are currently slightly overweight bonds vs. stocks and are invested in high quality securities.

Geopolitical risks are high. The conflict in the Middle East could spread, which would likely cause upward pressure on oil prices.

INFLATION

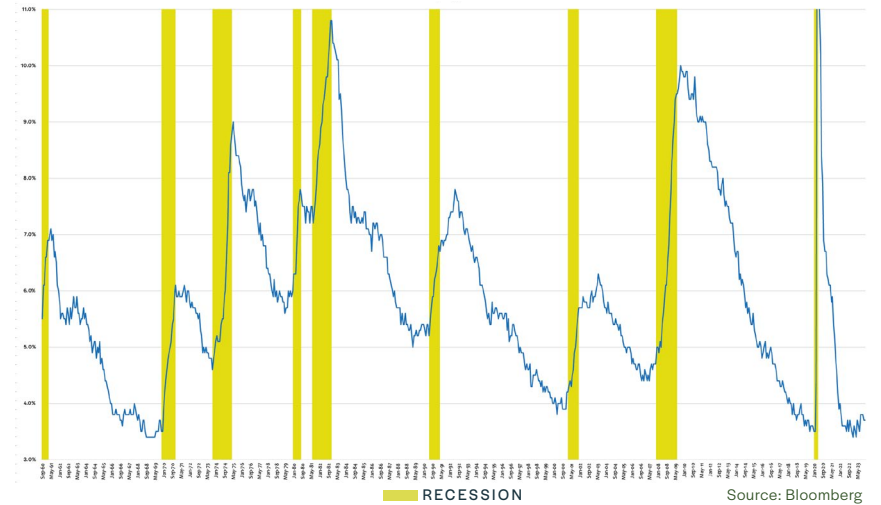
CPI Y/Y CHANGE



Source: Howe & Rusling; Bureau of Labor Statistics

LABOR MARKET

U.S. UNEMPLOYMENT RATE



Source: Bloomberg

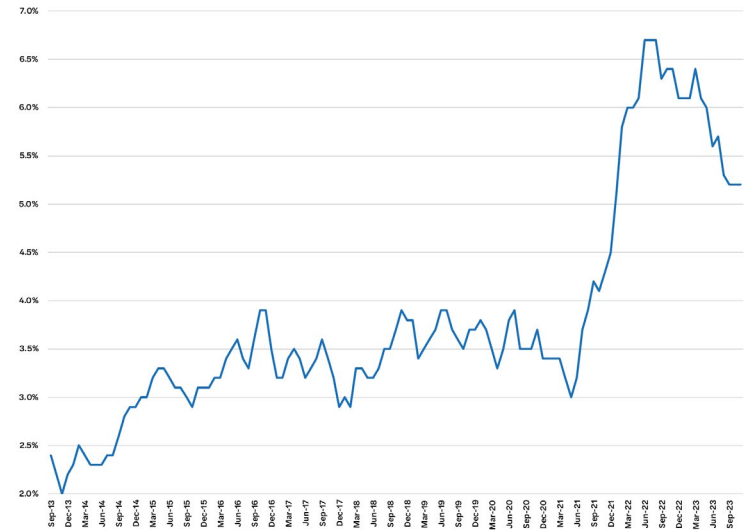
CONSUMER CREDIT DATA

U.S. CREDIT CARD DELINQUENCY RATE



Source: Bloomberg

MEDIAN WAGE INFLATION



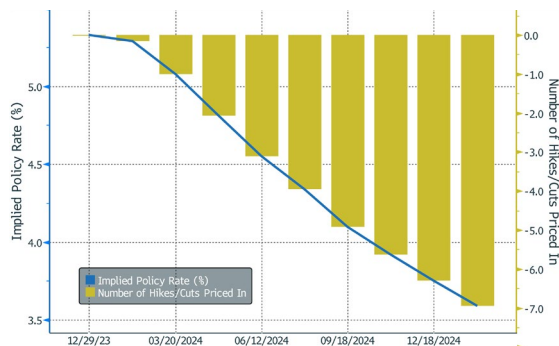
Source: Federal Reserve Bank of Atlanta, Bloomberg

Fixed income investments showed broad gains on growing market confidence that inflation is falling to the Fed's 2% target without the economy tipping into a recession.

It was a hawkish Federal Reserve FOMC meeting in September, but the FOMC stopped hiking in July. At the December FOMC meeting, a dovish pivot by Chairman Powell suggested the focus for 2024 will shift to deciding when to end Quantitative Tightening (QT) and start cutting the fed funds rate. Moreover, the Fed's 2024 dot plot forecasted a 0.75% decrease in the median federal funds rate by year-end.

Chairman Powell's December shift caused interest rates to plummet, but we believe the market reaction to Powell's reversal was a little too much too soon. The bond market is now pricing an approximately 1.50% decrease of rate cuts in 2024, as seen in the chart below.

IMPLIED OVERNIGHT RATE & NUMBER OF HIKES/CUTS

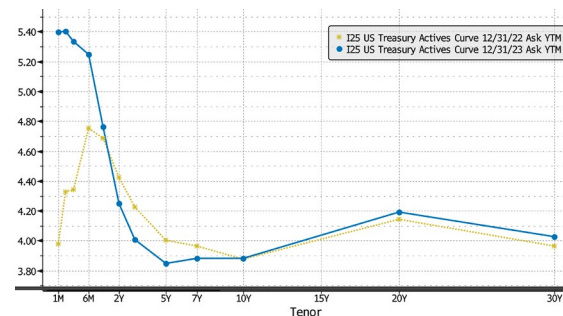


Source: Bloomberg as of 12/29/2023

Interest rates rose so much in September and October that it appeared 2023 was shaping up to be as bad as 2022 for the bond market. The last two months completely reversed the loss and Treasury yields ended 2023 lower than where they began. In both cases, the market clearly got ahead of itself.

The benchmark Bloomberg Treasury index gained 3.37% in total in the last month of the year, enough for a 4.05% total return in 2023.

US TREASURY CURVE



Source: Bloomberg

The US Treasury yields from the end of 2022 are represented by the yellow line, while the changes through December 2023 are shown by the blue lines.

Market interest rates fall when the Fed cuts rates, especially through the first several rate cuts. In 2024, we expect interest rates will generally fall and the yield curve will begin to get back to a normal shape.

Despite the significant decline in interest rates from the peak in October, we believe rates remain at attractive levels. The yield ("carry") of today's market, coupled with the convexity (non-linear relationship between interest rates and bond prices) of today's market offers potential protection.

There is a risk of near-term interest rate volatility, driven by either gyrations in inflation readings on the path to the Fed's 2% inflation target or a potential reversal of the recent move in interest rates. We believe positioning for rates is less likely to add long-term value and instead remain duration neutral across our strategies and seek to add value through asset allocation and security selection.

CREDIT MARKET OUTLOOK

Investment grade corporate bond yields are attractive on a historical basis, although they currently have lower credit spreads than long-term averages. Tighter credit spreads compared to recent averages suggest expectations of a soft landing, and if successful, could lead to attractive total returns due to coupon and discounted prices. We anticipate a modest credit spread widening in a weaker economic environment.

2024 should see reasonable growth, lower inflation, central bank easing, and the beginning of the end of QT. It just may not arrive immediately. Credit technicals should be good, as demand for credit should be strong while the forecasted supply is expected to be modest. We continue to favor more defensive higher quality issuers over higher risk bond allocations. Positive total returns are expected as both income and lower expected interest rates would likely mitigate the impact of modest spread widening.

Investment grade spreads are expected to be range-bound, generating positive excess returns and strong total returns due to income and price appreciation. We will seek tactical opportunities to increase exposure at more favorable valuations.

FIXED INCOME CONTINUED

MUNI MARKET OUTLOOK

Long term municipal bond issuance should increase slightly in 2024 to roughly \$375 - \$400 billion. 2023 issuance was \$365 billion. Taxable municipal bond issuance is expected to be slow again in 2024.

Our preference continues to be 5% coupons capturing a strong option-adjusted spread and good convexity. 4% coupon bonds are less interesting. 3% coupon bonds are on our radar if the Fed pivot happens, and the cycle moves to lower yields over the intermediate term.

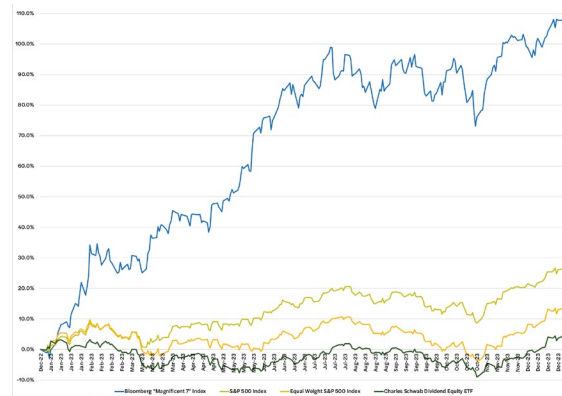
Credit fundamentals should remain strong with a small increase in tax collections for state and local issuers. Upgrades should slow from the 2023 levels though still beat downgrades in 2024. We continue to prefer higher quality issuers as the potential for a recession in 2024 remains.

Mutual fund flows will continue to be negative but at least taken up by SMA portfolios and ETFs as demand overall remains strong. Total returns for intermediate munis for 2024 could beat the gains of 2023. The roughly 5-6% expected returns will come from coupons and price appreciation.

COMPOSITION OF 2023 STOCK RETURNS: NARROW BREADTH

2023 equity returns were disproportionately driven by a small number of the biggest technology companies due to excitement about artificial intelligence technology. The Magnificent 7 index, which includes Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, NVIDIA, and Tesla, increased about 110% and accounted for a majority of the appreciation of the S&P 500 index.

2023 TOTAL RETURN



Source: Bloomberg

In contrast, dividend paying stocks were very out of favor in 2023 due to the rise in bond yields. Bonds compete with dividend paying equities for investors' cash and became more attractive.

EQUITY VALUATION

The valuation of the S&P 500 remains higher than its long-term average and this is entirely because growth stocks are expensive. Value stocks trade below their long-term average valuation multiple.

S&P 500 12 MONTHS FORWARD PE MULTIPLE



Source: Bloomberg

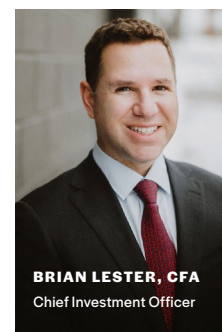
Our Outlook

We expect the Federal Reserve to hold interest rates at the current level through at least Q1 2024. The path of interest rates for the remainder of 2024 will be dictated by inflation and economic data. In 2023, good economic news releases often caused weakness in stocks due to the concern that strong economic data would prevent inflation from falling and cause the Fed to hike interest rates even more. Due to the decline in inflation in 2023, we expect investors to react differently to good economic data in 2024 compared to last year. If inflation keeps falling towards 2%, good economic news will be good for equities, in our opinion. The key risks to equities in 2024 are stubborn inflation and/or material weakening of economic data.

We expect high quality fixed income securities to perform well during this period. Rates on fixed income are more compelling than they have been in many years and bond prices should benefit from a further decline in inflation.

The valuation of broad stock market indexes, such as the S&P 500, are high compared to history, solely on account of elevated valuations on growth stocks. However, the valuations of many high quality, dividend-paying stocks are comparatively attractive.

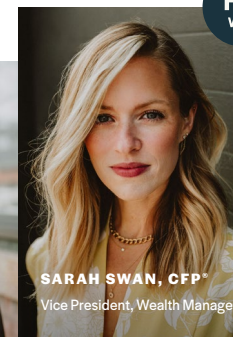
Based on this view, we are slightly overweight in fixed income vs. equities. Both our fixed income and equity securities are positioned according to our assessment of inflation and economic risks and are high quality.



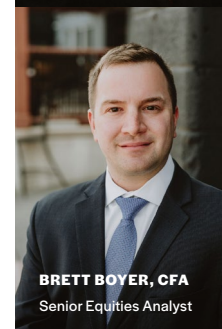
BRIAN LESTER, CFA
Chief Investment Officer



TODD ARTWELL
Director of Fixed Income



SARAH SWAN, CFP®
Vice President, Wealth Manager



BRETT BOYER, CFA
Senior Equities Analyst



CHARITY DICOLA
Fixed Income Associate



DYLAN POTTER, CFA, CFP®
Vice President, Wealth Manager



MARK THOMPSON
Equities Analyst



JOHN TRENTACOSTE
Senior Fixed Income Analyst



GREGORY T. FARRELL
Vice President,
Senior Wealth Manager

HR
WM

MACRO TEAM

QUESTIONS? LET'S CHAT
585.325.4140 | hello@howeandrusing.com

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