

KEY TAKEAWAYS

2023 Was a Good Year for U.S. Stocks thanks to a handful of companies. The top 7 stocks collectively returned 76% in 2023 and accounted for 62% of the S&P 500's 2023 performance.

Fed Shifts Policy: It will be important to monitor the trajectory at which the Fed cuts interest rates. The Fed has signaled a 0.75% reduction in rates, while the market is pricing in 1.50%.

Corporate Earnings: Expectations for 11.8% EPS growth for the S&P 500 in 2024 may be optimistic.

Election Year: The political party that wins the White House has historically had no impact on long-term investment returns.

Investors Will Closely Scrutinize the Latest Economic Data to determine if the Fed will be successful in taming inflation without causing a recession. Expect volatility for both equities and bonds to pick up in 2024.

After a weak start in October, financial markets staged an impressive fourth quarter rally due to expectations that the Federal Reserve (the "Fed") will cut interest rates sooner than previously expected. During the quarter, Fed officials clearly signaled that its current rate hiking campaign was over and set expectations for three rate cuts in 2024. This projection includes one more cut than previously forecasted and was conveyed to the market following reports of improving inflation data. This helped push stocks sharply higher and sent the S&P 500[®] Index to a level not achieved for over two years while posting an 11.68% return for the quarter. For the year, the S&P 500 rose 26.26%. Internationally, foreign markets lagged the S&P 500 in the fourth quarter due to muted gains in emerging markets in the wake of increased geopolitical tensions in the Middle East and continued lackluster Chinese economic growth. Foreign developed markets outperformed emerging markets on better-than-expected inflation readings and rising expectations that the Bank of England and the European Central Bank will follow the Fed's lead and cut rates in 2024. Foreign developed markets, represented by the MSCI EAFE Index, increased 10.47% during the fourth quarter (+18.95% for 2023), while emerging markets, represented by the MSCI

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Emerging Markets Index, finished the quarter up 7.84% (+10.12% for 2023). Switching to fixed income markets, declining levels of inflation combined with the surprise outlook for lower interest rates caused the Bloomberg Barclays U.S. Aggregate Bond Index to post its biggest two-month gain in over 30 years. For the months of November and December, the leading benchmark for bonds was up 8.53%. For the quarter, the index returned 6.82% and finished up 5.53% for the year. The strong performance this quarter was also noteworthy in that it prevented bonds from posting three consecutive years of negative returns (which has not occurred in the past 95 years according to U.S. Treasury data).

THE MAGNIFICENT SEVEN

For most investors, 2023 produced a much-needed comeback when it came to stock market performance after a challenging year in 2022. While at first blush, it was a “good year” for U.S. stocks, the details paint a far more complex picture as most of this year’s returns were attributable to only a handful of stocks, which have been dubbed by pundits as “the Magnificent Seven”. Not to be confused with the 1960 Western movie starring Yul Brynner, the Magnificent Seven stocks are represented by Apple, Microsoft, Alphabet, Amazon, Meta, Nvidia and Tesla. These seven stocks now comprise 28% of the total value of the S&P 500 and collectively returned 76% in 2023. The remaining 493 stocks in the index returned only 11%. As a result, these seven stocks accounted for 62% of the S&P 500’s 2023 return.

Why did these stocks dramatically outshine the rest of the market? We believe the primary reason is related to a lack of profit growth during the year. According to FactSet, the earnings per share (“EPS”) growth for the S&P 500 for fiscal year 2023 is expected to be less than 1% (fourth quarter earnings will be released during the first quarter of 2024), while EPS growth is expected to be 12% for the Magnificent Seven (calculated on a market cap weighted basis). This means that without these seven companies, the earnings growth for the remaining 493 is expected to be negative in 2023. When the profit cycle decelerates, investors gravitate to the fewer and fewer companies that can maintain growth during an increasingly adverse backdrop. The Magnificent Seven are especially popular, in part, because they are perceived to have the structural fundamentals to achieve sustained earnings growth during periods of slow growth. In addition, these companies have strong market shares in many of the economy’s most important sectors (artificial intelligence/computing power, data storage, eCommerce, software, electric vehicles, social media, smartphones, and media streaming).

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Whether wholesale outperformance of the Magnificent Seven will occur in 2024 will likely depend on overall earnings growth for these 7 companies as well as the remaining 493 (more on that below). Normally size becomes a limitation as the companies in the top 10 one decade are rarely still there in the next decade. Twenty-four years ago, at the end of 1999, the top 7 stocks by market cap in the S&P 500 were Microsoft, General Electric, Cisco Systems, Walmart, ExxonMobil, Intel, and Lucent. One of these 7 no longer exists, and only Microsoft is still among the top 7 today. Ten years ago, the list was Apple, ExxonMobil, Microsoft, Alphabet, Berkshire Hathaway, General Electric, and Johnson & Johnson. Tesla was still a start-up and Amazon was primarily an eCommerce company. As far as the fundamental characteristics of the current top 7 companies, they remain extremely strong. Margins are generally best in class, their market position is enviable, and their track records are impressive. We continue to like several of these companies, but experience has taught us that outperformance is often followed by underperformance. Mean reversion happens and investors need to recognize that the margin for error for these 7 companies is likely narrower after a period of such strong outperformance.

LOOKING AHEAD—WHAT WE ARE WATCHING FOR

The U.S. economy defied expectations in 2023, growing at a pace stronger than almost anyone (including the market pundits) predicted, bolstered by a surge in federal government spending. As a result, the budget deficit expanded to levels only seen during times of deep recessions or war. Absent this fiscal stimulus, data suggests that economic growth remains anemic (as witnessed by the earnings growth of the bottom 493 companies in the S&P

500). As we head into 2024, debates remain focused on whether the U.S. will avoid a recession as the full effects of monetary tightening are still working their way through the economy. In the next few sections, we’ll focus on what we’re watching for in 2024.

FED POLICY AND INTEREST RATES

The Fed signaled a long-awaited policy shift following its December meeting. As expected, the central bank held its key interest rate steady for the third consecutive time at 5.25%-5.50%, however, the bank indicated that this was likely the end of the current rate hiking cycle. In addition, the Fed updated its outlook for future interest rates which implied three 0.25% rate cuts. Again, this was one more rate cut than was previously forecasted, and as such, both equities and bonds rallied as investors welcomed this information. The key driver of the pivot in Fed policy was the steadily improving inflation data. Since the Fed initiated its rate hiking campaign in March of 2022, the Consumer Price Index (“CPI”) has fallen from a high of 9.1% in June of 2022 to 3.1% in November 2023. Looking ahead, investors are even more optimistic about the future path of interest rates and are expecting more rate cuts than the Fed is currently projecting. As of year-end, the Fed Funds futures market is pricing in six 0.25% rate cuts for next year. That is quite a divergence in expectations, and likely to cause some volatility in both equity and fixed income markets should the Fed cut less than six times.

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The pace at which the Fed will cut rates will likely depend on the path of inflation. While progress continues to be made in fighting inflationary pressures, CPI is still above the Fed’s target of 2%. We believe the Fed will try to keep interest rates at current levels until they can achieve their goal of getting inflation down to their target. The last thing the Fed wants to do is cut rates too soon and risk reigniting inflation. This is exactly what happened in the 1970’s and it took Fed Chairman Paul Volcker raising rates to 20% to finally get inflation under control. Chairman Powell does not want to risk this happening again.

Another factor that could impact the pace of interest rate cuts by the Fed would be the health of the economy. Since monetary policy typically operates with a lag, the full effects the current tightening cycle have yet to be felt in the economy. Incoming data still points to weakening conditions, and we maintain our view that the odds of a recession occurring here in the U.S. remain elevated. Numerous data points that have historically been precursors to recessions such as the inverted yield curve, declining Leading Economic Indicators, contracting manufacturing activity, and tighter bank lending standards continue to suggest the likelihood of a recession occurring sometime in the next twelve months (we detailed these figures for you in our Q2 Market Insights this past summer). We believe that if the U.S. economy were to enter a recession, the Fed would aggressively cut interest rates (possibly more than six cuts) as stabilizing the economy would take precedence over concerns about reigniting inflation.

CORPORATE EARNINGS

After a year in which earnings for the S&P 500 are expected to grow less than 1% (almost exclusively due to the top 7 stocks), Wall Street analysts are expecting EPS to grow 11.8% (to \$244 per share) for fiscal year 2024. This estimate assumes that revenues will grow by 5.5% this coming year and that profit margins will expand by 0.60% to approximately 12.6% (for a frame of reference, please note that profit margins peaked in the first quarter of 2022 at 13.3% due to companies optimizing costs in the aftermath of COVID; for the past five years, profit margins have averaged 11.4%). These numbers imply a sharp rebound in the coming year; however, U.S. consumers and corporations are facing some headwinds that could challenge these estimates. There are several factors that may impact consumer spending patterns in the months ahead. Despite the talk of the Fed cutting rates, interest rates are still higher than where they were a year ago. Consumer

spending is a major driver of growth here in the U.S., and higher mortgage, auto, and credit card rates may limit future demand for goods and services. For example, consumers looking to buy an automobile are facing a double whammy of higher vehicle prices and higher financing costs. Compared to pre-COVID, the average new car price has risen by 30% and the average interest rate has increased from 5.5% to 8.5%, which implies about a 40% increase in monthly car payments. In addition, credit card rates have risen to a 50-year high of 23% from 17% pre-COVID. Another impact on consumers is the exhaustion of the pandemic-era stimulus. When the pandemic hit, household spending plummeted as people stayed home and businesses temporarily shut down. At the same time, many of those households saw a dramatic increase in income because of massive federal government spending: higher unemployment payments, universal

stimulus checks, and expanded child tax credits. As a result, Americans accumulated more than \$2.1 trillion in savings. According to estimates from J.P. Morgan, this excess savings is forecast to run out by mid-2024, possibly creating an additional headwind to consumer demand. Shifting our focus to Corporate America, softening consumer demand, coupled with lower levels of inflation, could impact pricing power for a lot of companies. As inflationary pressures decline, companies can no longer raise prices without curbing demand. A good example of this phenomenon is Pepsi. Recently, Carrefour, the global supermarket chain, has pulled Pepsi products from its shelves in response to Pepsi trying to raise prices. Carrefour stores in France, Italy, Spain, and Belgium have posted signs saying the store will no longer be stocking Pepsi's brands "due to unacceptable price increases." Similarly, many companies could be forced to cut prices, or

offer promotions and incentives, as a way to lure consumers into buying their goods and services. This ultimately causes profit margins to contract. Typically, margin compression is a significant driver of earnings declines due to operating and financial leverage. Lastly, speaking of financial leverage, much like the consumer, corporations are also facing higher borrowing costs, which can pressure profit margins as well.

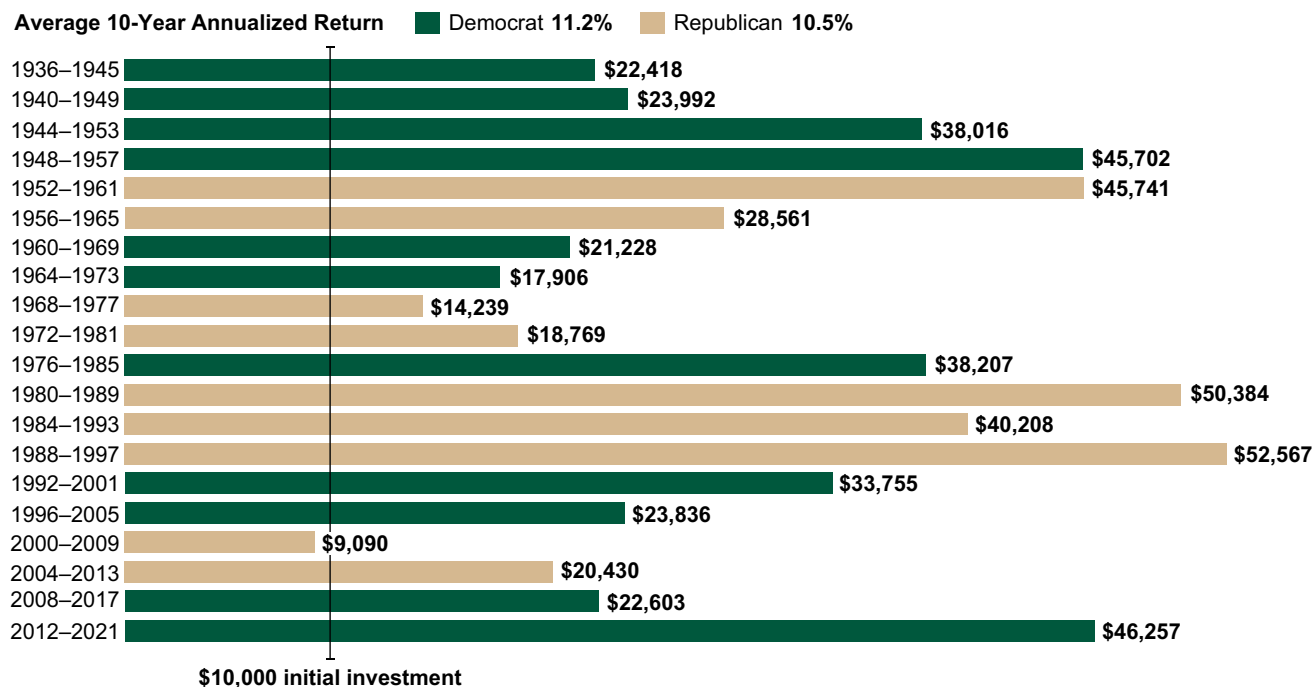
If future Fed rate cuts are unsuccessful in offsetting the dynamics outlined above, then earnings growth of 11.8% seems somewhat unrealistic in our opinion. As such, investors should be prepared for earnings estimates to be revised lower. Likewise, if we were to enter into a recession, we would expect earnings to contract. In the twelve recessions that have occurred since 1948, S&P 500 earnings have fallen on average by 14.5%.

THE PRESIDENTIAL ELECTION

We are less than ten months away from electing the next President of the United States, and investors might be feeling anxious about how markets will react to a potentially volatile campaign season and the possibility of a close vote, not unlike the 2020 election. Voters' attention will likely be drawn to key issues such as foreign policy, immigration, social matters, and fiscal responsibility over the coming months.

It can be tempting to get caught up in political narratives. There is nothing wrong with wanting your candidate to win, but investors can run into trouble when they place too much importance on election results. That is because the political party that wins the White House has, historically speaking, made essentially no difference when it comes to long-term investment returns. The chart below, courtesy of the Capital

10-Year Growth of Hypothetical \$10K Investment Made at Start of Election Year (USD)



Source: Capital Group, Standard & Poor's. Each 10-year period begins on January 1 of the first year shown and ends on December 31 of the tenth year. For example, the first period covers January 1, 1936 through December 31, 1945. Figures shown are past results and are not predictive of results in future periods.

Group, shows the 10-year annualized return of an investment made in the S&P 500 at the start of an election year. As you can see the average 10-year annualized return of an investment made at the beginning of an election year when a Democrat won was 11.2%, and the return when a Republican prevailed was 10.5%.

Based on the historical data, U.S. election results have very little impact on the financial markets over time. Yet, politics and investing have always been intertwined. Market commentators, and even presidents themselves, have often linked the performance of the stock market as a sort of “barometer” of the effectiveness of a president’s policies. The data presented on page four clearly does not support this link, and investors should be cautious before making investment

decisions based on who is occupying the White House. Over the decades, long-term performance of the market has shown almost no correlation to government policies. Instead, the key drivers of equity market performance have been corporate earnings, economic growth, and interest rates. Much of our collective memory about the performance of the economy under previous presidents stem from historical narratives, not hard data. Other factors, like the decisions made by the Fed, have a much greater impact on market sentiment than any sound bite we hear from politicians. If there is one key point to keep in mind for the upcoming election year is that we should avoid listening to all the political headlines and rhetoric, and simply focus on the underlying macroeconomic fundamentals.

OUTLOOK 2024

Taken together, there are many crosscurrents that we need to monitor in 2024. The key dynamic that bears watching is whether the Fed is successful in taming inflation without causing a severe slowdown in economic activity. If the U.S. economy can avoid a recession, equities should perform well, buoyed by solid earnings growth and loosening monetary conditions. This will likely mean that the Magnificent Seven will underperform relative to the remaining 493 companies. However, if growth remains sluggish, or a recession materializes, then earnings growth will weaken or contract, and the Magnificent Seven would likely continue their outperformance. Given these crosscurrents, we believe it is best to own high quality companies that can produce higher returns on capital in excess of their cost of capital and, over time, can sustain and grow those returns. These companies have strong competitive moats and often have a commanding market share position in their respective industry. They also possess proven track records for growing their returns on invested capital and have consistently performed well throughout different stages of the economic cycle. They typically have strong balance sheets, which is important, because excessive levels of debt during a market downturn can put a company at risk of insolvency. In essence, these companies usually offer sustainable free cashflow growth and provide the potential for downside protection if the macroeconomic environment deteriorates.

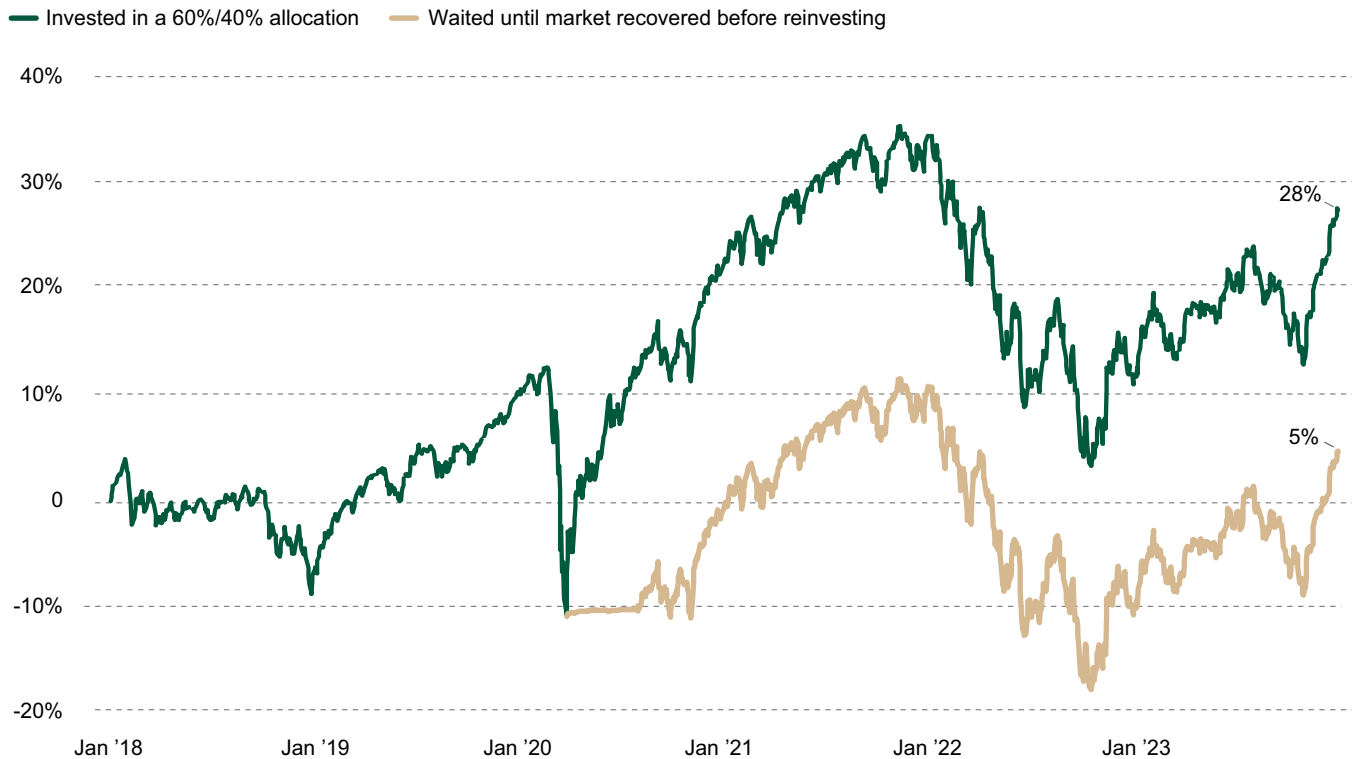
In our last quarterly update, we discussed the potential for extending duration in fixed income. Remember, that duration is a measurement of a bond’s interest rate risk, and bonds with longer maturities and lower coupon payments have a higher duration than those with shorter maturities and higher coupons. The higher the duration of a fixed income portfolio, the more sensitive its value is to changes

in interest rates. This means if you have two separate fixed income portfolios, the one with the higher duration will rise in value by a greater amount when interest rates fall (the opposite is true if rates rise, the portfolio with the higher duration will decline in value by a greater amount). After the historically robust performance of bonds during the months of November and December, we believe the opportunity to achieve positive risk adjusted returns by extending duration has passed. Given the elevated risks of a recession, and the inflationary impact of the Fed’s expected response (by cutting rates and risking a reacceleration of inflation), we are more inclined to take advantage of the high yields that short duration U.S. Treasuries currently offer.

Debates focused on whether the economy will avoid a recession, whether inflation will stay on its moderating path, and whether the Fed will cut rates as aggressively as investors currently expect will be on investors radars this coming year. Every statistical release will be closely scrutinized by investors to see if it represents something positive or negative for the economy. As a result, we expect volatility to pick

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What If You Shifted To Cash At The Bottom of the COVID-19 Downturn And Waited For The Market To Recover?



Source: Bloomberg

Note: Stocks are represented by the MSCI All Country World Index; Bonds are represented by the Bloomberg U.S. Aggregate Bond Index. Cash is represented by the Bloomberg U.S. Treasury 1-3 Month U.S. Treasury Bill Index. Returns are in nominal terms. You cannot invest directly into an index.

up meaningfully in 2024. While nobody likes volatility, the unpredictable nature of the markets, characterized by clusters of upward and downward swings, is something that investors must be willing to accept. Gyration in the markets can test even the most seasoned investors, however, making impulsive investment decisions amid stock market volatility is never a recipe for success. Emotions like regret and loss aversion often influence timing decisions, leading investors to sell out when losses occur, which may seem intuitive and appealing. However, it is important to recognize that these decisions can be detrimental, as strong bull market recoveries often follow, leading to subsequent regret. As an example, the chart above shows what would have happened if you shifted all your investments to cash from a 60% stock/40% bond portfolio at the bottom of the COVID-19 downturn in March of 2020, and then waited until the market recovered in July of 2020 to reallocate to the 60%/40% portfolio.

As you can see, investors who stayed invested in a 60%/40% allocation realized a 28% return (green line) through the year end 2023, while those who tried to time the market and wait until it recovered before reinvesting achieved only a 5% return (gold line). The importance of investing for the long-term, and not the next three or six months, is a strategy we continue to endorse. Trying to be “all in” or “all out” of the market at any given time can present meaningful timing problems. That’s why it remains critical to stay invested, remain patient, and establish an asset allocation based on your financial position, risk tolerance and time horizon. Successful investing is a marathon, not a sprint. Concerns about volatility should not alter an established, diversified approach designed to meet long-term investment goals.

We thank you for your ongoing confidence and trust. Please rest assured that our entire team remains dedicated to helping you successfully navigate these financial markets.

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The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the US & Canada. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays US Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

The MSCI All Country World Index (ACWI) captures large and mid cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries. With 2,921 constituents, the index covers approximately 85% of the global investable equity opportunity set.

The Bloomberg U.S. Treasury 1-3 Month U.S. Treasury Bill Index is designed to measure the performance of public obligations of the U.S. Treasury that have remaining maturity of greater than or equal to 1 month and less than 3 months. The Index includes all publicly issued zero coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and at least 1 month, are rated investment-grade, and have \$300 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and non-convertible. Excluded from the Index are certain special issues, such as flower bonds, targeted investor notes, state and local government series bonds, inflation protected public obligations of the U.S. Treasury, commonly known as "TIPS", and coupon issues that have been stripped from bonds included in the Index. The Index is market capitalization weighted.

The Consumer Price Index (CPI) is issued by the U.S. Bureau of Labor Statistics and is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

Leading Economic Indicators (LEI), a composite of economic data points put together by The Conference Board designed to signal peaks and troughs in the business cycle. The Conference Board is a global independent business membership and research association working in the public interest.

Artificial intelligence (AI) is a wide-ranging branch of computer science concerned with building smart machines capable of performing tasks that typically require human intelligence. While AI is an interdisciplinary science with multiple approaches, advancements in machine learning and deep learning, in particular, are creating a paradigm shift in virtually every sector of the tech industry.

Artificial intelligence allows machines to model, or even improve upon, the capabilities of the human mind. And from the development of self-driving cars to the proliferation of generative AI tools like ChatGPT and Google's Bard, AI is increasingly becoming part of everyday life — and an area companies across every industry are investing in.

Please contact us at 781-400-2800 for more information on how we can assist you with your financial needs.

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