



Market Update

4th Quarter 2023 Commentary and 2024 Outlook

Our Most Common Year-End Questions Answered

Rather than the usual annual review and forward outlook, we thought a direct Q&A-style commentary might be more beneficial to clients and investment advisors. Feel free to send any additional questions to clientservices@oakassociates.com for use in future commentaries.

Do you think the Federal Reserve will be investor-friendly in 2024?

This is a trick question. The majority of the time, the Fed acts independently of the stock market and investors. It will monitor the stock market as yet another measure of economic confidence, but it is mostly concerned with creating slow and steady economic activity, low inflation, and a healthy job market. The volatile stock market is a leveraged barometer of these issues, but prone to being more emotional, and suffering from investment ADD.

That said, the current investment environment does look investor-friendly. While interest rates are higher, the Fed has signaled that if inflation remains curtailed, it could lower interest rates throughout 2024. This would essentially remove the restrictive measures it put in place and free up bond yields to move lower over the medium term. The Fed deserves credit for successfully suppressing inflation without upending employment or producing a depression.

As far as the outlook for monetary policy is concerned, we will know more about Washington's contribution to the economy as we get closer to the November 2024 election and clarity over the parties' nominees' viability. However, it is unlikely either party will be able to enact policies that drive up the deficit given its massive increase over the past 6 years and the recent history of inflation.

Will the 2024 Presidential Election have an impact on the stock market?

The stock market is much more apolitical than most want to believe. The empirical evidence confirms that we have had good markets and bad markets under both political parties. While any one party may claim to be more pro-business, the actual results are more ambiguous and spurious. Occasionally, a bad economy produces a change in Washington that simply coincides with

the final stages of a bear market, making the next president seem like an economic genius. Or a robust economy overheats, prompting tighter policy from the Federal Reserve, thwarting both the stock market and a politician's reelection prospects. At times, a divided Congress has been better for investors, while at other times, a fully functioning government has been beneficial. Given the ballooning deficits, the desire for fiscal austerity is building.

In general, the stock market is less concerned with which party is in power. Tax cuts can be stimulative, but so too is government spending, and both parties spend money and generate deficits. Overall, we believe a more important factor is what investment environment will be in effect over the next four years. The current backdrop is significantly more impacted by Fed policy and whether Washington is going to be restrictive or stimulative moving forward.

What macroeconomic data are we watching closely in 2024?

The unemployment rate is by far the most important metric for 2024 in our opinion. With the lag time in monetary policy and cumulative effects of the Fed's tightening cycle still stalking the economy, we remain vigilant for companies looking to protect profit margins by reducing labor costs. During this cycle, however, employers may be more reluctant than usual to cut staff given the difficulty retaining workers during the tight labor market that followed the pandemic. Nevertheless, an uptick in unemployment is usually a reliable indicator that the economy is poised to contract.

The other important metric we are watching is the yield curve. An inverted yield curve is generally a historically reliable indicator of a recession, although its timing is less than helpful. More telling is when the ratio of 2yr-10yr yields un-inverts, or drops below 1. This tends to give a timelier warning that a recession is near.

If a recession is going to happen at some point, why not get defensive now?

There is always something to fear in the stock market. Being overly cautious or getting defensive too early is a great strategy to miss out on periods of strong returns. Therefore, we believe that it is better to be fully invested and participate in a rising market as much as possible, rather than lag the market and be right eventually. Trying to time the market can be very detrimental to wealth creation. The performance in 2023 is an opportune reminder of this. Despite a poor market in 2022 and the Fed aggressively raising interest rates, exiting the equity market out of fears of a deep recession would have missed out on a solid 26% gain this year.

Will Artificial Intelligence (AI) remain the driving force for the technology sector in 2024?

Artificial Intelligence certainly propelled the tech sector in 2023, but tech trends often come with hype that vacillates over time. In 2023, the public launch of ChatGPT raised awareness of AI and essentially instigated an arms race in semiconductor processing power. While we remain intrigued by the AI opportunity, we have seen many similar frenzies; from commercial scale digital printing, virtual reality/metaverse, cryptocurrency, telehealth, virtual assistants, autonomous driving, robotics, big

data, quantum computing, and machine learning. AI is essentially the maturation of machine learning, big data, and chatbots. Like other emerging tech opportunities, the mega-cap tech stocks offer good optionality on AI success, while their core businesses support the deep pockets required until AI revenue develops. New companies will likely emerge as key AI players, but the path to success (and profitability) can be extremely challenging and the competitive landscape is significant.

Are the mega-cap stocks still attractive after a strong 2023?

The 2023 market was dominated by the “Magnificent 7” (Apple, Google/Alphabet, Tesla, Microsoft, Nvidia, Netflix, Amazon). These are some of the largest companies in the world and their performance in 2023 was also massive, propelling US indexes higher, despite more lackluster performance elsewhere in the broader market. Driven by hype over AI, perceived safety in size, and their dominant market positions, these select mega-caps soared during the year. Note, that this was the opposite in 2022, when they dropped sharply and led the stock market lower with them.

Whether wholesale outperformance will occur in 2024 is anyone’s guess. We continue to like several of the Magnificent 7, but experience has taught us that outperformance is often followed by underperformance. Mean reversion happens. It is also extremely unusual that the Top 5 or 10 names in the index outperform the rest of the 495 other stocks in the S&P 500. Normally size becomes a limitation and the companies in the top 10 this decade, are rarely still there in the next decade. Yet, the largest-of-the-large have been steady outperformers for the last decade. Knowing that the phenomenon is not only rare, but that mean reversion happens, we advise being selective amongst the mega-cap stocks.

As far as the fundamental characteristics of the mega-cap tech group, they remain extremely strong. Margins are generally best in class, their market position is enviable, and their track records are impressive. Valuations, however, are stressed in some cases. We continue to own some of these massive wealth creators but recognize that the margin for error is narrower after a period of outperformance and at higher valuations. As always, we will make changes to our exposure to reflect the change in risk factors as needed.

How is the consumer looking?

Higher interest rates are having the intended effect on slowing economic activity. The surge in mortgage rates is a pain point for home buyers. Despite these constraints, the consumer has weathered the tighter conditions rather well. Ultimately, a good job market and other consumer confidence-building factors, such as rising home values and stock prices, still support a happy and healthy consumer. As long as the unemployment rate doesn’t surge, the consumer should remain a reliable source to support the economy. Certain data series do bear watching, such as credit card delinquencies and initial unemployment claims, but the majority of the consumer’s impact on the economy is generated by the upper tiers of the income spectrum that are less affected by these metrics.

In light of the 2023 regional banking crisis, is the sector investable yet?

The sharp rise in interest rates in 2022 created a crisis at some regional banks, which struggled with retaining deposits and maintaining capital requirements, depending on whether loans/assets were carried at cost or at current market values on their balance sheet. The high-profile collapse of Silicon Valley Bank, Signature Bank, and First Republic Bank prompted unprecedented actions by the FDIC to contain the crisis and reassure depositors to prevent additional bank runs. While the FDIC efforts were successful, the Regional Bank ETF still lost 10.7% in 2023.

Similar to the process of grieving, with financials, time cures many wounds. Banks have stabilized deposits by offering better yields. Additional risk controls have been implemented and holes in balance sheets have been repaired. When your neighbor's house catches fire, all the other neighbors check to make sure their fire insurance is up to date. With sentiment now improved and balance sheet issues addressed, the regional bank stocks appear to have weathered the crisis. But with bank stocks, we have typically preferred the competitive advantages that come with size and a national presence.

Small-caps underperformed in 2023, is their outlook any brighter in 2024?

Small-cap stocks lagged their larger peers for several reasons in 2023. As mentioned, the Magnificent 7 soared and dragged the market-weighted indexes higher with them. Small-cap stocks are more levered to interest rates than their larger-cap peers due to higher interest expenses and refinancing risk. This is just one reason why we advocate a strong quality bias in small-cap stocks and warn the segment is littered with unprofitable business models.

During extended periods of near-zero interest rates over the past two decades, smaller companies benefited from cheap funding from venture capital and private equity firms, along with a tolerance towards time to profitability. As a result of the easy money era, the number of small-cap index members who fail to earn more than their cost of capital or who are unprofitable has surged. This does not mean there are no opportunities in the small-cap segment, simply that active management and a strong quality overlay are important. We believe the segment is an attractive contrarian investment, is littered with acquisition candidates, and offers a strong relative valuation argument.

You did not like Energy this year, has the outlook for Energy stocks changed?

We predicted Energy's underperformance this year based on demand issues in the global economy and falling inflation. We also concluded that after two consecutive years of 50%+ returns, the sector was likely to underperform. Additionally, with the demise of inflation and tighter monetary policy globally, the environment was not conducive to rising demand for oil. For 2024, this assessment has not changed that much. Certainly, the sector's aggressive return of capital has benefited investors, but without excess profits to distribute, this boost might also deteriorate. Turmoil in the Middle East or Russia can always shift the supply dynamic, but absent demand growth or inflation, we do not consider geopolitical events as an attractive long-term investment thesis.

Again, if any questions were missed in this update, please send in your questions and we will do our best to answer all of them.

Happy New Year and thank you for investing with Oak Associates!

A handwritten signature in black ink that reads "Robert D. Stimpson". The signature is fluid and cursive, with a long horizontal stroke at the end.

Robert Stimpson,
CFA Co-Chief Investment Officer
Oak Associates, Ltd.

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