

2024 Outlook

Q4 2023 Review and 2024 Outlook



Optimism Amidst Economic Crosswinds

At the outset of 2023, investor sentiment was predominantly shaped by apprehensions regarding escalating interest rates and the looming threat of a significant economic downturn. However, the year saw surges in mega-cap technology stocks that drove a narrow rally in the S&P 500 while leaving the majority of companies behind. In the latter part of 2023, as bond yields fell, investors seized the opportunity to buy into the sectors and companies that were out of favor. Real estate, banks, and small-cap stocks posted strong returns in the final months of the year.

This market optimism largely stems from the growing belief that the Federal Reserve might successfully curb inflation without triggering the conventional recession typically associated with rate hikes. As the probability of a soft landing has increased, investors have become more bullish on equities and fixed income.

Entering 2024, the pivotal question for investors revolves around the timing and rationale behind the Federal Reserve's anticipated interest rate reductions. The crux of investor speculation hinges not just on when but why the rates will be cut. A reduction driven by a weakening economy, invoking the Fed Put, contrasts sharply with a scenario where the Fed maintains a more stringent stance and adheres to its projected rate cuts in the latter half of the year, which is later than the market is currently forecasting. Rate reductions under favorable conditions of lower inflation would signal a positive market outlook, reinforcing the potential for a continued upward trajectory in equity markets.

The lagged effect of interest rates has likely not entirely played out in the credit markets, as defaults and bankruptcies have not risen above historical levels. Should inflation rates steadily decline towards the Fed's long-term targets, allowing for rate cuts without precipitating a recession, it could be a strong year for earnings and GDP growth.

In contrast to the Federal Reserve's dovish stance and the anticipation of rate cuts in 2024, other global central banks have adopted more varied approaches. For instance, Norway's Norges Bank has increased rates, while the Bank of England has tempered expectations for impending cuts. The European Central Bank (ECB) has escalated its quantitative tightening policy by offloading bonds, thereby elevating yields.

Despite the growing optimism for a soft landing as we step into 2024, a note of caution prevails. Persistently high wage growth and substantial liquidity in the hands of consumers and businesses continue to fuel the Fed's inflationary concerns. The Federal Reserve faces the intricate challenge of balancing the timing of easing financial conditions and moderating the labor market without exacerbating unemployment rates.

This precarious balancing act poses a risk of economic missteps, making strategic portfolio adjustments crucial. Prioritize high-quality, diversified equities and consider higher-yielding fixed income for ballast. In the event of a looming recession, defensive sectors such as utilities and consumer staples could serve as a refuge.

Detailed Asset Class Analysis (2024 Expected Compound Annual Returns)

Asset Class	Central Return Estimate	Uncertainty Range	Investment Considerations
Global Equities	7.80%	+/- 2.5%	Favor value and cyclical sectors; diversify across regions to mitigate risks.
Developed Market Equities	9.20%	+/- 2.0%	Be cautious in sectors vulnerable to rising rates and economic slowdown.
Emerging Market Equities	8.80%	+/- 3.0%	Consider long-term growth potential and attractive valuations.
U.S. Equities	7.00%	+/- 2.2%	Focus on defensive sectors and income-generating companies.
US Large Cap Equities	7.00%	+/- 2.5%	Slowing earnings growth, high valuations, sensitivity to macro shocks.
US Small Cap Equities	7.20%	+/- 2.8%	Economic uncertainty, potential for credit defaults.
European Equities	4.00%	+/- 2.0%	Manage exposure to geopolitical and economic risks.
Fixed Income	5.05%	+/- 1.5%	Consider extending duration to lock in higher yields.
U.S. Aggregate Bonds	5.10%	+/- 1.2%	Monitor interest rate changes and adjust portfolio accordingly.
Emerging Market Debt	6.80%	+/- 2.5%	Diversify sovereign and corporate debt; assess currency risks.
High Yield Bonds	6.50%	+/- 3.0%	Evaluate potential for higher income, but manage credit risk.
Inflation-Linked Bonds	4.60%	+/- 1.0%	Provide inflation protection, but offer lower yield than nominal bonds.
Commodities	3.80%	+/- 2.0%	Monitor supply chain disruptions and geopolitical developments.
Energy	5.00%	+/- 3.0%	Consider long-term energy demand, particularly in emerging markets.
Gold	4.10%	+/- 2.0%	Can serve as a safe haven asset during market volatility. Price volatility, limited income generation.
Real Estate	6.50%	+/- 2.5%	Assess interest rate sensitivity and potential economic slowdown.
Alternatives	5.50%	+/- 3.0%	Evaluate potential for alpha generation and risk management strategies.

For illustrative purposes only. Estimates are based on historical asset class returns over 20 years, capital market assumptions and projected expected returns for selected general market asset classes. Certain historical analysis and research has been obtained through Morningstar Direct and while Freedom believes the data to be reliable, no representation is made as to, and no responsibility, warranty or liability is accepted for the accuracy or completeness of such information.

Domestic Fixed Income

The Federal Reserve's commitment to maintaining elevated interest rates longer than market expectations is a pivotal factor. This policy aims to temper labor market dynamics and inflationary pressures sufficiently. Ideally, a soft landing would entail a resilient economy backed by solid consumer financial health, moderated nominal economic growth, geopolitical stability, and a seamless election year. Nonetheless, these elements collectively introduce volatility, necessitating strategic recalibration in fixed-income asset allocation.

Fed officials have signaled a downward adjustment in the benchmark interest rate from 5.25%-5.50% to approximately 4.6% by the close of 2024, anticipating three rate cuts. The unemployment rate stabilizing at 3.7% and a quits rate reverting to pre-2019 figures suggest a loosening labor market. This shift and decelerating wage growth contribute to the declining quits rate.

A key indicator in 2024 will be shelter inflation, which significantly influences overall inflation expectations. As of November, consumer prices increased by 3.1% year-over-year, primarily driven by a 6.5% hike in shelter costs, which constitute 35% of the Consumer Price Index (CPI). Excluding shelter, inflation would fall below the Fed's 2% objective. The anticipated slowdown in rental and owner's equivalent rents, converging to a 3.3% increase (below the 2018-2019 average), may prompt the Fed to implement rate cuts, as the shelter component of the CPI is projected to dip to 3.75% by year's end.

In terms of performance, leveraged loans, convertible debt, and high-yield bonds excelled, delivering double-digit returns for 2023. The short end of the government bond curve outperformed for the year, while longer-dated Treasuries rallied in the fourth quarter.

Rates	4Q23	2023	Sector Performance	4Q23	2023
USTREAS T-Bill Cnst Mat Rate 1 Mon	1.36%	5.07%	Bloomberg US Treasury 20+ Yr TR USD	13.39%	2.66%
USTREAS T-Bill Cnst Mat Rate 3 Mon	1.38%	5.08%	Bloomberg US Corporate High Yield TR USD	7.16%	13.44%
USTREAS T-Bill Cnst Mat Rate 2 Yr	2.69%	4.96%	Bloomberg US Convertible Comp TR USD	6.59%	13.49%
USTREAS T-Bill Cnst Mat Rate 10 Yr	6.97%	3.78%	Morningstar LSTA US LL Perf Index TR USD	2.91%	13.66%
USTREAS T-Bill Cnst Mat Rate 30 Yr	13.34%	2.52%	Bloomberg Treasury 7-20 Yr TR USD	8.84%	3.69%
Benchmark 1: Bloomberg US Treasury Bills TR USD	1.42%	5.13%	ICE BofA US Corporate TR USD	7.90%	8.38%
			Bloomberg Municipal TR USD	7.89%	6.40%
			Benchmark 1: Bloomberg US Agg Bond TR USD	6.82%	5.53%

Source: Morningstar Direct

The impending year could witness a yield curve steepening as rate normalization causes longer-dated Treasury yields to surpass short-term counterparts. This trend is probable in both recessionary and extended high-rate scenarios, potentially elevating the longer end of the yield curve.



Source: <https://www.capitalgroup.com/advisor/insights/articles/2024-bond-outlook.html>

Agency Mortgage-Backed Securities (MBS) emerge as an attractive option for income generation with minimal credit risk, buoyed by an implicit government guarantee. Their value is shaped by variables such as the Fed's balance sheet dynamics and housing market conditions, including supply constraints and affordability challenges.

Investment-grade corporate bonds, underpinned by robust balance sheets and minimal refinancing requirements, offer a blend of yield potential and lower downside risk. Their longer duration relative to high-yield bonds positions them to potentially capitalize on Treasury yield declines, counterbalancing spread widening. They are poised for success in both soft landing and recession scenarios, exhibiting limited drawdowns compared to lower-rated bonds.

The high-yield bond sector, despite inherent risks, continues to demonstrate resilience and income-generation capacity, particularly in a positive economic growth context. The sector has experienced a credit profile enhancement, with numerous companies postponing debt issuance in anticipation of falling rates, having secured low rates during the pandemic.

International Fixed Income

Central banks' interest rate policies remain pivotal in the international fixed income landscape. December saw the Federal Reserve, Bank of England (BoE), and European Central Bank (ECB) unanimously maintain their policy rates. Inflation in the Eurozone and the UK has receded to two-year lows, suggesting a potential shift towards monetary easing in 2024. Analysts anticipate the ECB and BoE will reduce key policy rates by 75 basis points by year-end.

Economic growth in Europe and the UK is tepid, with GDP growth projections hovering around 0.5%. Manufacturing and service Purchasing Managers' Indexes (PMIs) in these regions are in contraction territory while consumer confidence declines. Consequently, European government bonds, especially German ones, have rallied towards the end of 2023. This uptick, fueled by subsiding inflation, sluggish regional growth, and the allure of safe-haven assets amid geopolitical unrest, underscores the bonds' attractiveness.

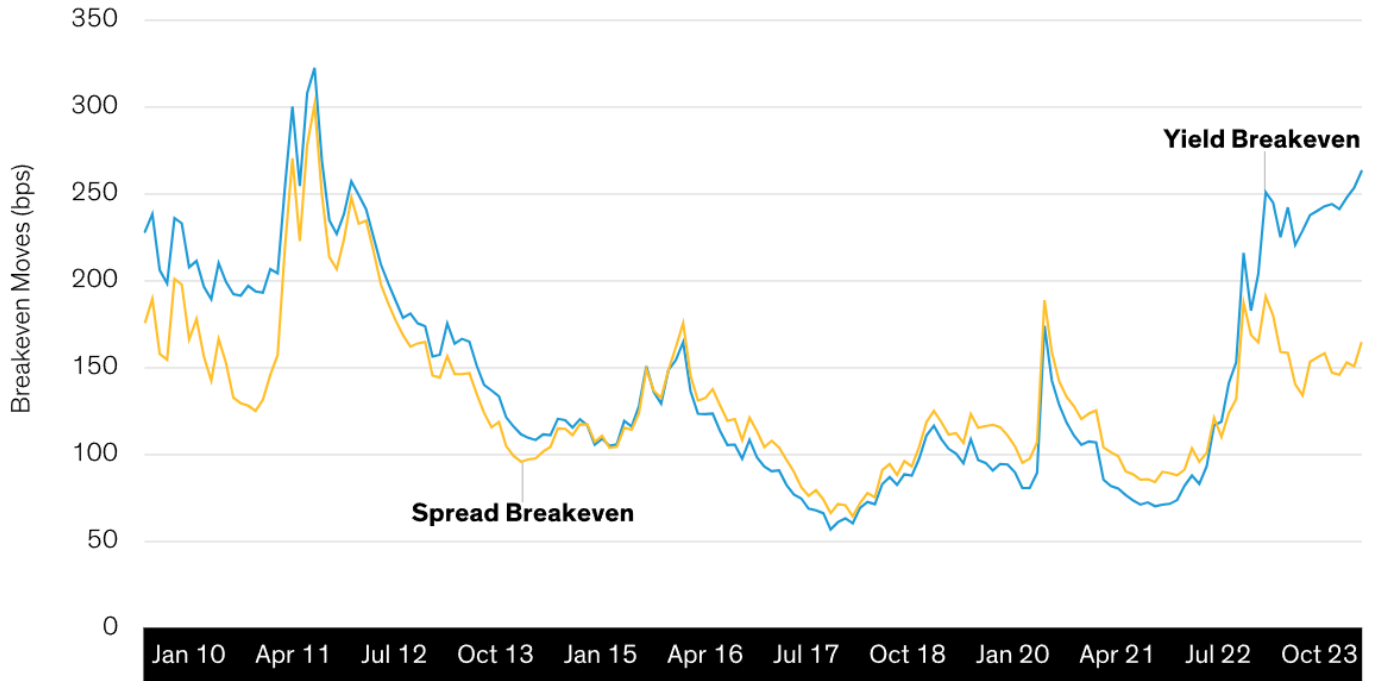
The performance of corporate bonds has been varied, with a preference for high-grade investments reflecting the ongoing economic uncertainty and tighter financial conditions. Notably, peripheral bonds, like those from Italy, demonstrated resilience. The S&P Italy Sovereign Bond Index concluded the year with an 8.8% gain. The shift from negative to positive yields near 3% in AAA-rated assets offers promising yield compression and price appreciation prospects.

Should economic growth falter, a downturn in equity and credit markets might bolster the performance of Euro and UK sovereign bonds. Corporate balance sheets appear robust, entering the tightening phase from a position of strength. Default rates have remained low and are expected to be contained within 3-4% through 2024.

Alliance Bernstein analysts highlight compelling opportunities within Euro BBB investment-grade and high-yield credit sectors. Presently, BBB-rated bonds are yielding around 5%, mirroring CCC-rated bond yields, while junk bond yields hover near 7.25%. Analysts note that "a starting yield of 7.25% provides a substantial cushion against downside risks. Adjusting for interest-rate sensitivity, yields would need to increase by over 250 bps to wipe out that high income and produce negative returns. And to underperform sovereign bonds, spreads would need to widen from the current 483 bps by over 150 bps".

Current Yields Provide a Cushion for Euro High-Yield Downside Risks

Breakeven Levels for Euro High-Yield Market



Current and historical analyses do not guarantee future results.

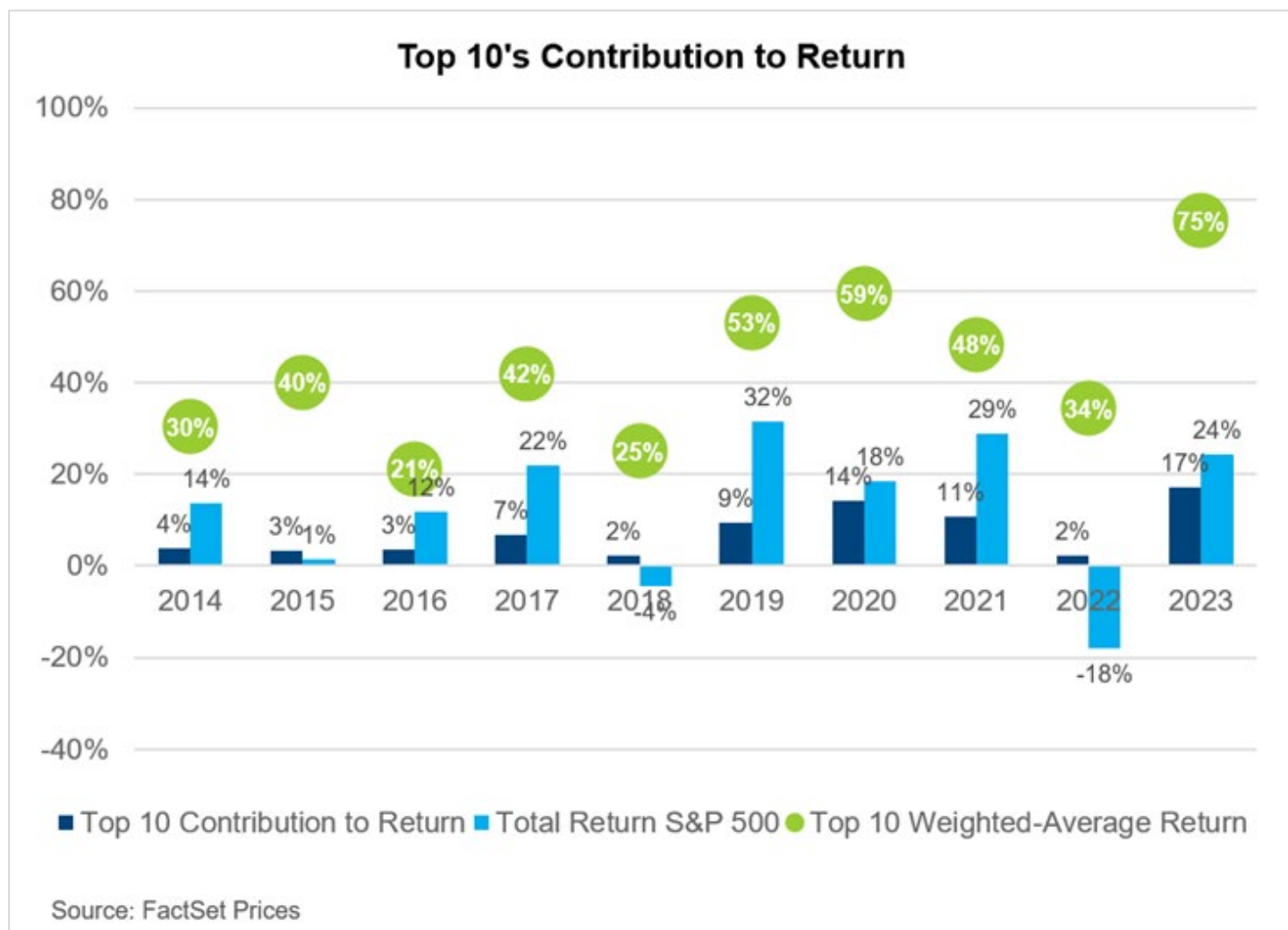
As of October 31, 2023

Source: Bloomberg and AB

Source: <https://www.alliancebernstein.com/corporate/en/insights/investment-insights/european-fixed-income-outlook-fair-winds-for-2024.html#:~:text=Around%207%25%20of%20the%20market,rated%20CCC%20bonds%20in%202017.>

US Equity Markets

The US equity markets experienced a remarkable year, with major indices recording significant gains: the S&P 500 surged by 26.3%, the Nasdaq by 44.6%, the Dow Jones Industrial Average by 16.2%, and the Russell 2000 by 16.9%. A noteworthy feature of this year's market was the dominance of a group of high-performing technology stocks, often called the "Magnificent Seven." These companies, representing a historically high concentration level, accounted for nearly 30% of the S&P 500's weight by year-end. Adding Alphabet, Eli Lilly, and Broadcom shares, this group was responsible for 75% of the S&P 500's total return for the year.



Source: <https://insight.factset.com/the-days-that-moved-the-us-market-in-2023>

Sector-wise, the dispersion was stark, with technology soaring by 56.1%, while utilities lagged at -7.1%. However, the final quarter saw a broader rally encompassing real estate, technology, financials, and industrials, each posting double-digit returns of 18.8%, 17.7%, 14.0%, and 13.0%, respectively. This diversification of the equity rally, particularly notable in value and dividend factors, enhanced the performance of the S&P 500 equal-weighted index in the last quarter.

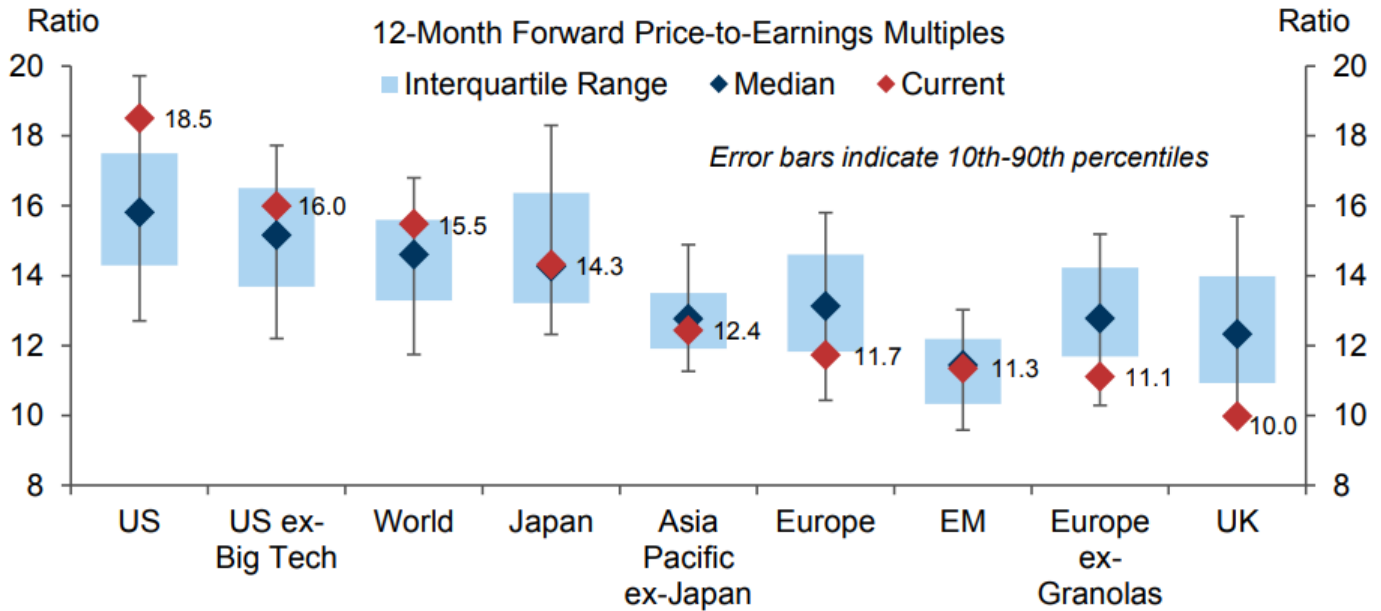
Sector Performance	4Q23	2023	US Equity Size	4Q23	2023
S&P Cons Staples Select Sector TR USD	5.47%	-0.79%	Russell 1000 Growth TR USD	14.16%	42.68%
S&P Consumer Disc Select Sector TR USD	11.33%	39.81%	Russell 1000 TR USD	11.96%	26.53%
S&P Energy Select Sector TR USD	-6.35%	-0.59%	Russell 1000 Value TR USD	9.50%	11.46%
S&P Financial Select Sector TR USD	14.03%	12.15%	Russell Mid Cap Growth TR USD	14.55%	25.87%
S&P Health Care Select Sector TR USD	6.41%	2.06%	Russell Mid Cap TR USD	12.82%	17.23%
S&P Industrial Select Sector TR USD	13.05%	18.13%	Russell Mid Cap Value TR USD	0.12%	12.71%
S&P Materials Select Sector TR USD	9.68%	12.54%	Russell 2000 Growth TR USD	0.13%	18.66%
S&P Real Estate Select Sector TR USD	18.83%	12.36%	Russell 2000 TR USD	14.03%	16.93%
S&P Technology Select Sector TR USD	17.71%	56.13%	Russell 2000 Value TR USD	15.26%	14.65%
S&P Telecom Select Industry TR USD	12.94%	-0.82%	Benchmark 1: Russell 3000 TR USD	12.07%	25.96%
S&P Utilities Select Sector TR USD	8.56%	-7.08%			
Benchmark 1: S&P 500 TR USD	11.69%	26.29%			

Source: Morningstar Direct

Despite looming recession concerns for 2024, analysts project robust earnings growth for the S&P 500, with an estimated increase of 11.7%—surpassing the previous decade's average of 8.4%. Analyst consensus is that Health Care, Communication Services, and Information Technology sectors are poised for significant growth.

The high concentration in US equities poses risks for investors with passive index strategies. However, the broadening of stock performance observed at the end of 2023, especially beyond the technology sector, is expected to persist into 2024. Equity valuations, excluding technology stocks, appear more aligned with historical norms. The 12-month forward Price-to-Earnings (P/E) ratio, standing near its 20-year median, and the equal-weighted S&P 500's forward P/E ratio at 15.3x compared to its 10-year average of 16.4x, suggest relatively attractive valuation levels.

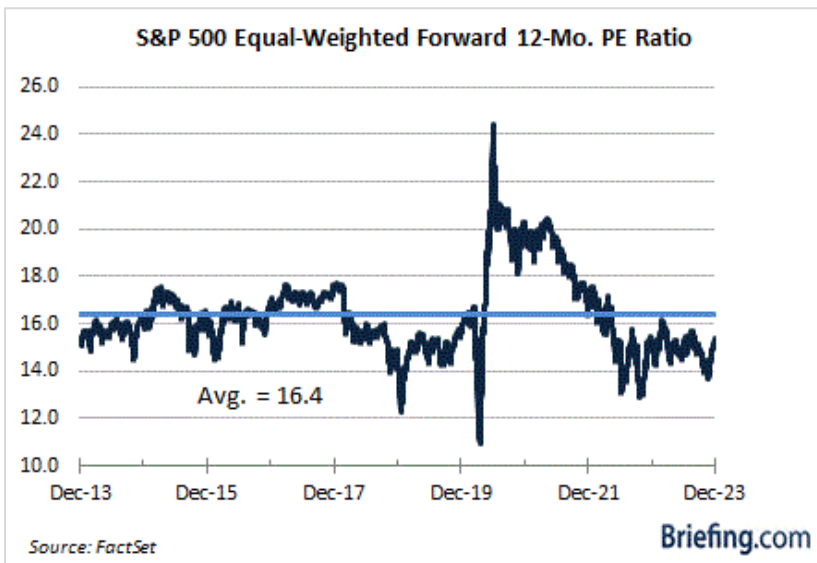
Exhibit 23: Aside From Tech, Absolute Equity Valuations Do Not Look Particularly Elevated



Note: Interquartile ranges and median are calculated from 2003-2023. GRANOLAS refers to 11 European stocks: GSK, Roche Holding, ASML, Nestlé, Novartis, Novo Nordisk, L'Oréal, LVMH, AstraZeneca, SAP, and Sanofi.

Source: FactSet, Goldman Sachs Global Investment Research

Source: Goldman Sachs, Macro Outlook 2024



Source: <https://www.briefing.com/in-depth-analysis/content/article?ArticleId=NS20231208120503TheBigPicture>

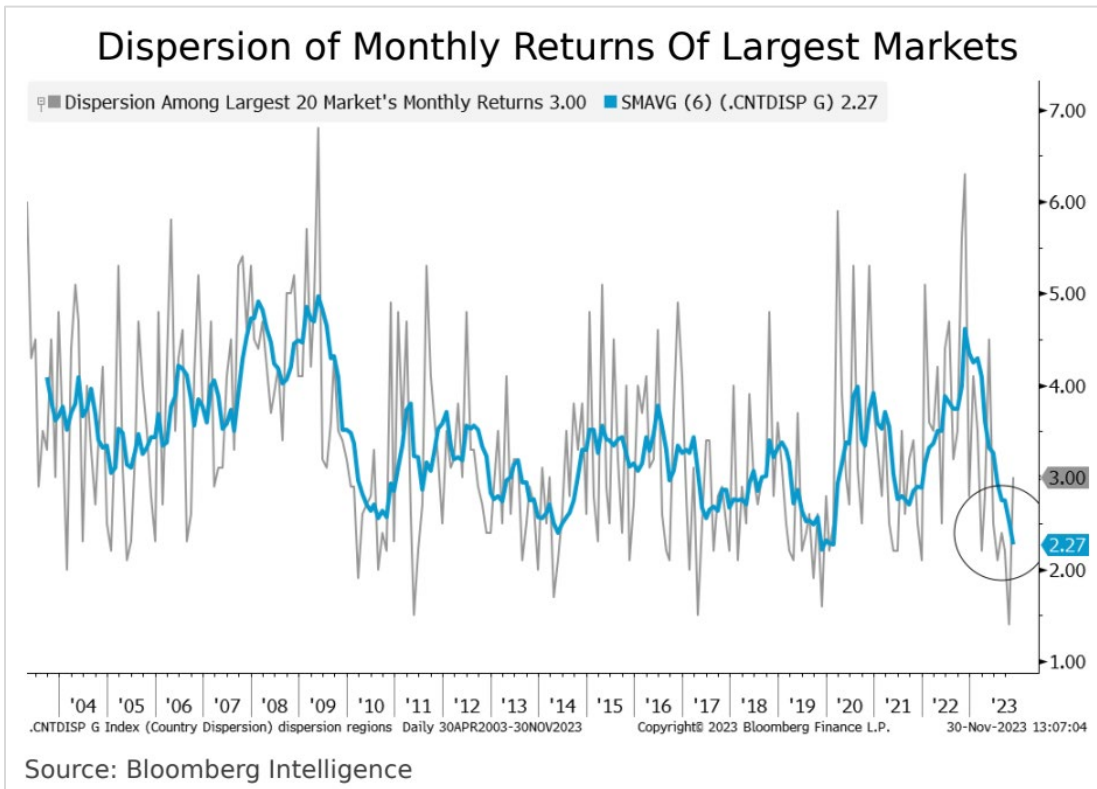
International Equity Markets

In 2023's final quarter, global equities, as represented by the MSCI All Country World Index ex USA, saw robust returns, posting a 9.7% increase. Europe and Latin America recorded double-digit returns of 11.0% and 17.5%, respectively. Despite varying inflation levels, an interesting trend was the narrow dispersion across individual country returns. Countries with below-average inflation yielded an average return of 6.8%, while those with above-average inflation saw returns of around 6.3%. This disparity between inflation levels and equity returns signals a potential misalignment between market valuations and underlying economic conditions.

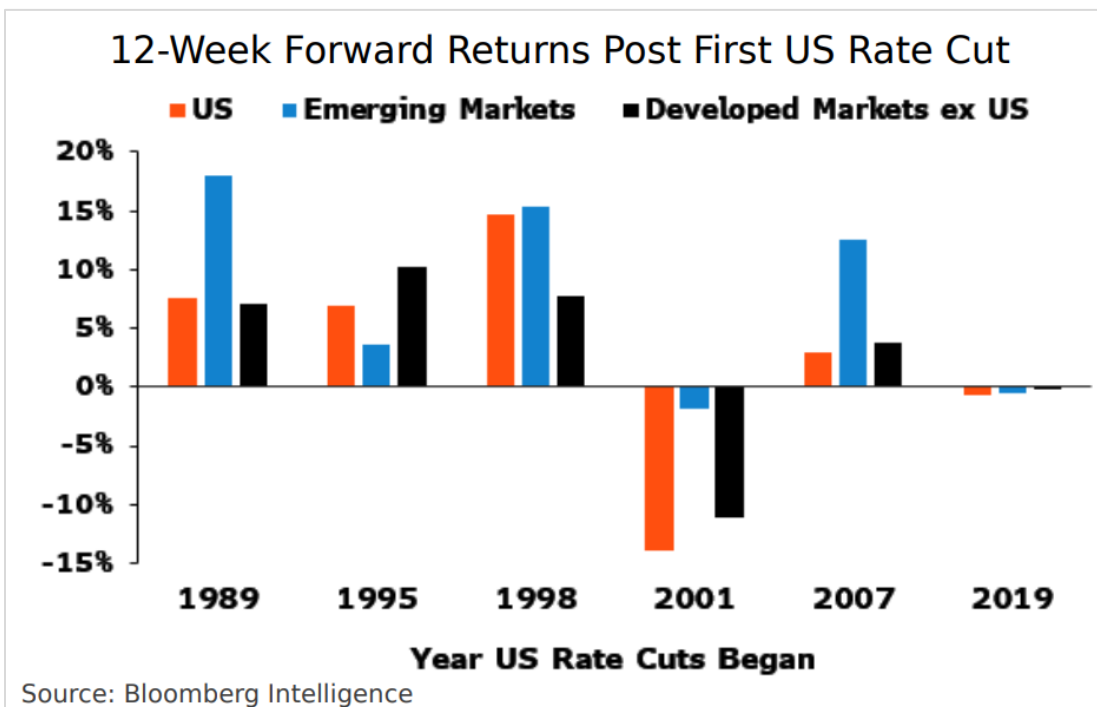
Intl Equity	4Q23	2023	UK & EU Select Country Returns	4Q23	2023
MSCI China NR USD	-4.22%	-11.20%	S&P France BMI NR USD	10.07%	20.87%
MSCI AC Asia NR USD	7.08%	11.07%	S&P Germany BMI NR USD	12.89%	21.58%
MSCI EM Asia NR USD	6.71%	7.76%	S&P Ireland BMI NR USD	14.62%	37.91%
MSCI FM Asia NR USD	2.55%	7.73%	S&P Norway BMI NR USD	5.19%	6.11%
MSCI ACWI NR USD	11.03%	22.20%	S&P Spain BMI NR USD	12.17%	30.18%
MSCI World ex USA NR USD	10.51%	17.94%	S&P Switzerland BMI NR USD	10.18%	16.19%
MSCI EAFE PR USD	10.09%	15.03%	S&P United Kingdom BMI NR USD	7.49%	14.03%
MSCI Europe NR USD	11.05%	19.89%			
MSCI EM NR USD	7.86%	9.83%			
MSCI EM Latin America NR USD	17.55%	32.71%			
Nikkei 225 Average NR JPY	5.19%	30.40%			
Benchmark 1: MSCI ACWI Ex USA NR USD	9.75%	15.62%			

Source: Morningstar Direct

Emerging markets are expected to benefit in the aftermath of anticipated Federal Reserve rate cuts in late 2024. Historically, emerging markets have shown outperformance in the initial months following US rate cuts. Bloomberg's Chief Equity Strategist, Gina Martin Adams, highlights that in four of the last six US rate-cut cycles, emerging markets outperformed the US and developed markets, excluding the US. However, China remains a concern due to its ongoing real estate crisis, which could pose a downside risk.



Source: Bloomberg Intelligence, Global Equities 2024 Outlook

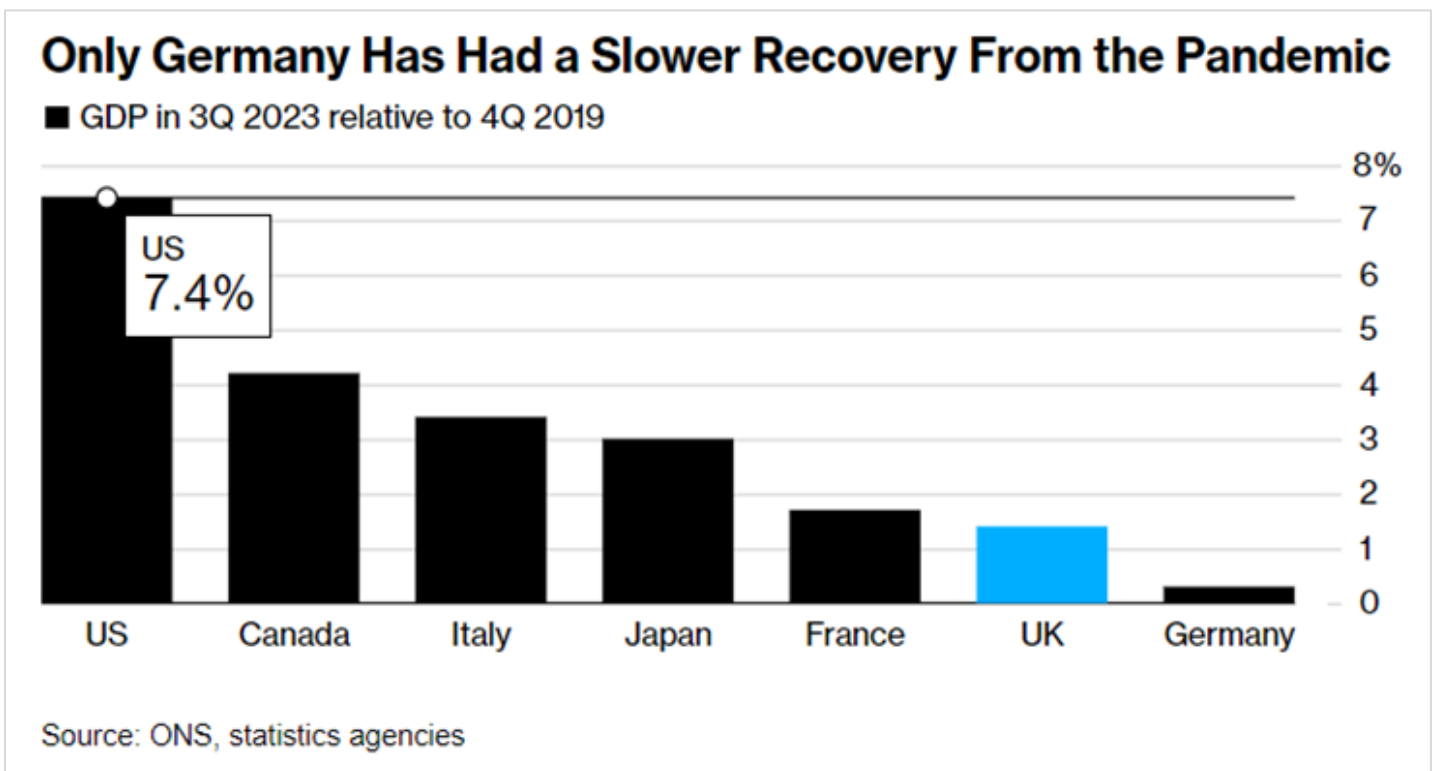


Source: Bloomberg Intelligence, Global Equities 2024 Outlook

China's market began 2023 optimistically, with COVID-19 restrictions lifting and growth expectations rising. Real estate and technology sectors initially thrived but faced headwinds from a slower-than-anticipated economic recovery and geopolitical tensions, leading to a year-long selloff. The MSCI China Index reported a negative 11% return for the year. China's market outlook remains uncertain, hinged on government policies to stimulate growth and stabilize the market.

European markets ended the year positively, with the MSCI Europe Index returning 19.9% for the year. This growth, driven by expectations of relaxed monetary policies in 2024, saw Ireland, Italy, and Spain posting the highest returns. European equities, currently trading below long-term average valuations, indicate investor caution amid weakening macroeconomic indicators and uncertain earnings momentum. However, sectors such as industrials, technology, and luxury goods offer promising investment avenues supported by structural trends like decarbonization and technological advancement. The risk of recession, though, casts a shadow over the region.

In the UK, equities demonstrated resilience amidst a challenging economic landscape, influenced by changing interest rate expectations and persistent inflationary pressures. Economists are optimistic about a potential soft landing, forecasting 0.3% growth. The UK equity market, particularly the FTSE 100, trades at a forward price-to-earnings multiple of 10.5, below its long-term average, suggesting potential upside amid decreasing inflation and increasing consumer spending power.



Source: <https://www.bloomberg.com/news/articles/2023-12-28/uk-economy-outlook-for-2024-signals-falling-inflation-end-of-living-cost-crisis>

Investment Strategy and Positioning

We are observing a nuanced shift in market dynamics in the current financial landscape. There is a growing consensus that the technology and mega-cap sectors, which have been market leaders, may face potential headwinds, leading to opportunities in recently out-of-favor sectors. Cyclical stocks, known for their strong performance in robust economic conditions, are drawing attention. Additionally, value-oriented stocks present an attractive investment proposition, as their valuations show promising signs when juxtaposed with current market prices.

Certain sectors stand to benefit as we navigate a period where interest rates are held steady before the commencement of a rate-cutting campaign. These include real estate, consumer discretionary, and financials. The backdrop of a weakening dollar further bolsters the case for Emerging Market (EM) equities, which are well-positioned to yield substantial returns in the event of a Fed rate-cutting cycle.

Despite a prevailing optimism among economists and strategists for a soft landing by the Federal Reserve, one must not overlook the downside risks. These risks could potentially tip the economy into a recession. The foundation of this cautionary outlook lies in the belief that consumer activity, which drives approximately 70% of the economy, may face challenges. Factors such as diminishing savings, the resumption of student loan repayments, and a cooling labor market could collectively exert pressure on consumer spending. Furthermore, the lagging effects of the Fed's rate-hiking cycle are likely to impact borrowers needing to refinance debts at higher rates.

While there are warnings of a potential recession in the upcoming year, it is crucial to contextualize these expectations. The anticipated downturn is not expected to mirror the severity of the early months of the COVID-19 pandemic, which saw a 15% unemployment rate, nor is it predicted to be as prolonged as the 2007-2009 financial crisis. Nonetheless, the possibility of a recession, albeit milder than initially feared at the start of 2023, remains a pertinent risk. This risk could be exacerbated if labor markets weaken and US consumer spending declines, increasing the likelihood of a recession. However, a dovish pivot by the Fed could mitigate the severity of any potential economic downturn.

Historically, our annual market outlook has been closely aligned with a rebalancing of our EQIS models. However, this year presents a unique scenario. We have recently completed a rebalancing of these models, and we are currently in a phase of observing how the prevailing macroeconomic trends develop. In light of this, we have decided to defer any further rebalancing until these trends have had a chance to manifest more clearly. This approach ensures that our strategies are attuned to the latest economic landscape, allowing for more informed and effective decision-making.

Asset Class - 2024				Change in Opinion
Asset Class	Concern	Neutral	Constructive	
Equities		0		
Bonds		0		
Equity				
Geographic Exposure				
US		0		
Intl Developed	-1			
EM		0		
Size				
Large			1	
Mid		0		
Small		0		1
Style				
Growth		0		
Value		0		
Fixed Income				
Geographic Exposure				
US		0		
Intl Developed	-1			
EM	-1			
Credit Exposure				
Treasuries		0		
IG Corporates			1	
High Yield		0		1
Interest Rate Exposure				
Duration			1	1
Alternatives				
Liquid Alts (F)		0		-1
Commodities		0		
Real Estate		0		

Key	-2	-1	0	1	2
Relative Weighting	Very Underweight	Underweight	Neutral Weight	Overweight	Very Overweight



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Except as otherwise specifically stated, all information and portfolio manager commentary are as of January 10, 2024.