STRATIGRAPHIC ASSET MANAGEMENT, INC.

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To the Clients of Stratigraphic Asset Management:

For U.S. stock market investors, 2023 was an unexpected banner year. The S&P 500 Index had a total return of 26.0%. In December 2022, Bloomberg reported that of the 22 leading strategists of major banks and brokerage firms projecting the level of the S&P 500 Index at year-end 2023, 19 analysts missed the actual results by 10% or more. Only one analyst in this group (Tom Lee of Fundstrat) projected the S&P 500 correctly. While the strategists ended up being significantly off the mark, there were good reasons for caution: the S&P 500 Index lost 19% in 2022, which undoubtedly dampened expectations; inflation was rising with no end in sight; interest rates were poised to increase sharply; an economic recession seemed a near certainty; and stock market valuations were not cheap.[1]

Here is what happened. Inflation as measured by the consumer price index peaked in June and then experienced a steep decline, easing some fears of protracted inflation. While interest rates rose markedly during the year, investors became increasingly more optimistic that rates would fall in the near term, and indeed long-term rates declined significantly in the fourth quarter. The economy did not tank as widely expected. Instead, the labor market remained tight and real growth was remarkably strong through the first nine months. Finally corporate earnings rebounded from depressed 2022 levels with reasonable prospects for further growth in 2024 and 2025. The point is that a much better than expected macro environment contributed importantly to the exceptional market performance in 2023.

Some qualifications to this market performance should be noted. The top ten companies of the S&P 500 Index ranked by market capitalization accounted for an astonishing 86% of the market return.[2] Six of the ten were tech companies that are expected to benefit from their exposure to artificial intelligence, a key market theme in 2023. To participate in the market appreciation last year, investors had to own meaningful exposure in these companies. The price return of the 10 largest companies last year was 62% versus the return of only 8% for the remaining 490 companies. It is interesting to note that S&P 500 Index performance, measured on an equal-weighted basis,[3] had a total return in 2023 of only 13.7%. In short, the overall stock market was not

[1] What was Stratigraphic's 2023 forecast? We wrote as follows in our client letter dated January 10, January 2023: "We are moderately optimistic. Maintaining a positive view of the future has consistently paid off in the investment world. Our investment strategy is centered on established, large-capitalization, multi-national U.S. companies. This is where we have been invested over the last 10 years to our good fortune and where we will primarily focus our attention in the future." Our strategy certainly paid off in 2023!

[2] The ten companies are: Apple, Microsoft, Amazon, Nvidia, Google, Berkshire Hathaway, Meta, Exxon, UnitedHealth, and Tesla. J.P.Morgan Asset Management, *Guide to the Markets, U.S. / 1Q 2024*, *As of December 31, 2023*, page 10.

[3] In computing performance, the component companies of the S&P 500 Index are weighted by their market capitalization: number of shares outstanding x share price. Hence Apple and Microsoft have a disproportionate impact. When performance is calculated on an equal-weighted basis, each company contributes 1/500th of the total, which reduces the importance of the top ten.

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as good as the S&P 500 Index indicated, but adjusted returns were still far better than expectations.

The Stratigraphic accounts realized a total return on equities in 2023 of more than 30%. Portfolios benefitted from a significantly overweight position in information technology companies. One of the biggest surprises was the performance of the fixed income holdings that returned around 8% versus the 5.5% return of the Bloomberg US Aggregate Bond Index. During the year, the average maturity of portfolios was lengthened in anticipation that interest rates would be coming down in the near term. As previously noted, long-term interest rates fell sharply in the fourth quarter. The U.S. Government 10-year bond rate declined from 4.6% on September 30 to 3.9% at the end of the year, a decrease of 15%, which is huge in the bond world. Substantially all the bond holdings are investment grade.

**2024 Investment Outlook**

Notwithstanding their dismal performance last year, I checked to see what the leading strategists are currently saying about 2024. The average forecast is for a flat year. The range of forecasts for 2024 is within +/- 10%. Most notably, Bank of America, Citigroup, and Goldman Sachs are among the most positive, while J.P.Morgan was the most negative. Michael Wilson of Morgan Stanley, who was one of the biggest market bears in 2023, now expects the market to wind up unchanged in 2024. Alas, we know one-year forecasts are not worth much. The main takeaway is that these seers expect that the market this year will hold its gains from 2023 and potentially realize a low single-digit total return in 2024.

Here is why I think this view is probably right.

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|---|---|---|---|---|---|
| **Table 1** | | | | | |
| **Economic Data, 2021 & 2022 Actual, 2023 -2025 Projected** | | | | | |
| | | | | | |
| | 2021 | 2022 | 2023 | 2024 | 2025 |
| GDP, Real Annual Growth | Actual | Actual | Projected | Projected | Projected |
| Bloomberg Consensus | 5.8% | 1.9% | 2.4% | 1.3% | 1.7% |
| Federal Reserve | 5.8% | 1.9% | 2.6% | 1.5% | 1.8% |
| Unemployment at Q4 | Actual | Actual | Actual | Projected | Projected |
| Bloomberg Consensus | 3.9% | 3.5% | 3.7% | 4.2% | 4.3% |
| Federal Reserve | 3.9% | 3.5% | 3.7% | 4.1% | 4.1% |
| Inflation, PCE Index * | Actual | Actual | Projected | Projected | Projected |
| Bloomberg Consensus ** | 4.2% | 6.5% | 3.8% | 2.4% | 2.1% |
| Federal Reserve | 4.2% | 6.5% | 2.8% | 2.4% | 2.1% |
| Bloomberg consensus consists of roughly 70 to 80 estimates | | | | | |
| Federal Reserve data taken from the Summary of Economic Projections, Dec 2023 | | | | | |
| * Personal Consumption Expenditures is the price index that the Fed relies on in setting monetary policy. | | | | | |
| ** The 2023 PCE estimate in 2023 seems to be an anomaly. | | | | | |

The macro picture continues to be positive. While real GDP annualized growth is believed to have slowed considerably in the fourth quarter of 2023 to around 1%, the outlook over 2024 and 2025 is for expansion to range between 1.5% and 2.0% per annum. A recession[4] seems doubtful, but if one does take place, it is likely to be shallow and of short duration. Unemployment is expected to remain at historically low levels of around 4%. Inflation is projected to fall into the 2% to 3% range next year and to reach the Fed's target levels of 2% by 2025-2026. It has been our contention that corporations, which are well financed, can comfortably manage with a 3%+ inflation rate. While we expect interest rates will decline, the rate at which the Fed reduces the target rate for Federal Funds (short-term rates) is difficult to project with certainty and may lag the decline in long-term rates that are set by the market. Nevertheless, it is widely anticipated that the Fed will reduce rates to below 4% by the end of 2024. The point is that the economy is heading in the right direction and will provide an important boost to corporate profits!

The outlook for corporate profits is favorable. We expect that 2023 S&P 500 Index earnings will show a mid- to high-single-digit return with similar gains expected in 2024 and 2025. Standard & Poor's is forecasting 2024 earnings per share for the Index at around $233, which represents about a 9% growth rate. The Bloomberg consensus is estimating $244, implying a 12% growth rate from its 2023 consensus estimate, which seems high. While the margin of error in these forecasts is large, there appears to be broad agreement among analysts that near-term earnings prospects are favorable.

| **Table 2** | | | | |
|---|---|---|---|---|
| **S&P 500 Index Levels, Earnings and Price/Earnings** | | | | |
| **Current Price Earnings Ratios** | 2021 | 2022 | 2023 | 2024 |
| S&P 500 Index (at December 31) | 4,766 | 3,849 | 4,770 | |
| S&P 500 Index Year-Over-Year Change (Price Appreciation) | 26.9% | -19.2% | 23.9% | |
| S&P 500 Earnings, 2021 & 2022 Actual, Standard & Poor's | $208 | $0 | $214 | |
| S&P 500 Price/Earnings | 23.6 | ..........19.5 | 22.3 | |
| **Forward Price Earnings Ratios** | | | | |
| S&P 500 Index (at December 31, 2023) | | | | 4,770 |
| S&P 500 Earnings, Estimated, Standard & Poor's | | | | $233 |
| S&P 500 Price/Earnings | | | | 20.5 |

Equity valuations, though not cheap, are reasonable. The current forward price/earnings multiple for the S&P 500 Index is around 20.5x as shown in Table 2, which is considerably higher than the 30-year average of 16.6x. However, as noted, the market is bifurcated. The top 10 companies ranked by capitalization have a forward P/E of 26.9x while the remaining stocks have a forward P/E of 17.1x, which is only slightly above the long-term average. One could conclude that most of the market is fairly valued and that the market risk is concentrated in the top ten companies.

J.P.Morgan calculated that the top 10 stocks at December 31, 2023, represented 32% of the total market capitalization of the S&P 500 Index and contributed around 23% of the last 12 months' earnings to total Index earnings.[5] Table 3 below attempts to show the earnings growth and P/Es of nine of the companies based on analyst consensus forecasts for 2024 and 2025. Berkshire Hathaway was excluded because its portfolio investments and derivative contracts can distort earnings.

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[4] A recession is defined as two consecutive quarters of negative growth.
[5] These data are taken from J.P.Morgan Asset Management, *Guide to the Markets, U.S. / 1Q 2024, As of December 31, 2023*. https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/insights/market-insights/guide-to-the-markets/mi-guide-to-the-markets-us.pdf

| Table 3 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Earnings Per Share, S&P 500 Index Top Nine Companies | | | | | | | | | |
| | Current Mkt Cap $B | Weighting % Total | 2023 | 2024 | % Change | Weighted | 2025 | % Change | Weighted |
| Apple FY 9 | $2,817.8 | 22.5% | $6.12 | $6.61 | 8.01% | 1.8% | $7.14 | 8.02% | 1.8% |
| Microsoft FY 6 | $2,733.2 | 21.8% | $9.78 | $11.31 | 15.64% | 3.4% | $12.97 | 14.68% | 3.2% |
| Amazon | $1,500.9 | 12.0% | $3.66 | $4.53 | 23.77% | 2.8% | $5.58 | 23.18% | 2.8% |
| Nvidia FY 1 | $1,212.7 | 9.7% | $12.31 | $20.44 | 66.04% | 6.4% | $23.79 | 16.39% | 1.6% |
| Alphabet | $1,709.0 | 13.6% | $5.93 | $7.13 | 20.24% | 2.8% | $8.30 | 16.41% | 2.2% |
| Meta | $904.5 | 7.2% | $14.96 | $18.06 | 20.72% | 1.5% | $20.17 | 11.68% | 0.8% |
| Exxon | $411.1 | 3.3% | $9.45 | $9.50 | 0.53% | 0.0% | $9.41 | -0.95% | 0.0% |
| UnitedHealth | $497.0 | 4.0% | $24.96 | $27.89 | 11.74% | 0.5% | $31.47 | 12.84% | 0.5% |
| Tesla | $755.0 | 6.0% | $3.07 | $5.31 | 72.96% | 4.4% | $7.21 | 35.78% | 2.2% |
| | | | | | | | | | |
| Total | $12,541.2 | 100.0% | | | | 23.6% | | | 15.1% |

The weighted average earnings per share gain in 2024 is projected at nearly 24% and at around 15% in 2025, which is close to 3x and 2x, respectively, greater than the forecast of total S&P 500 Index earnings gains. Not all the components of the top ten exceed the S&P 500 Index average for earnings growth. Apple and Exxon, for example, are lagging. There is clearly market risk, particularly if these companies disappoint. Their attractive earnings prospects, however, seem to warrant their premium valuations. Most of the companies have enviable branded market positions, protected by strong technology moats, with sustainable long-term growth potential.

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One of the big disconnects over the past year has been the pessimism among Americans about the economy and the future in general. In September, Gallup reported a survey on the U.S. economy in which 73% of the respondents stated economic conditions were getting worse.[6] The Michigan Index of Consumer Sentiment, considered one of the best barometers of public attitudes, in its most recent reading of 61.3 in November 2023 was still considered depressed though higher than the 50.0 level of June 2022.[7] In September 2023, the Pew Research Center, a well-regarded non-partisan think tank, published a study that indicated Americans are more pessimistic than optimistic about many aspects of the country's future.[8] This followed a Pew study in 2019 that concluded Americans are pessimistic about: the growing income gap between rich and poor; our ability to deal with environmental issues; the negative impact of job automation (a function of

[6] "Americans' Weak Economic Ratings Slip Further in September," Economy, Gallup, September 29, 2023 https://news.gallup.com/poll/511868/americans-weak-economic-ratings-slip-further-september.aspx

[7] In July 2022, we wrote: "The University of Michigan publishes a monthly index of consumer sentiment. The current reading at 50.0 is the lowest level since the 1970s… if one were to compute the appreciation or depreciation of the S&P 500 Index in the 12 months following a significant low point in the University of Michigan index, you would find the average gain was in the high teens versus a small loss from the peaks when everyone was most optimistic. It pays to be a contrarian, but it is oh so difficult!" **The return on the S&P 500 Index from June 30, 2022, to June 30, 2023, was 19.4%. (Confession: I had serious doubts that this relationship between consumer sentiment and market performance would work out, but it really did!)**

[8] "Americans are more pessimistic than optimistic about many aspects of the country's future," Pew Research Center, September 18, 2023. https://www.pewresearch.org/short-reads/2023/09/18/americans-are-more-pessimistic-than-optimistic-about-many-aspects-of-the-countrys-future/

artificial intelligence); America's diminishing role on the world stage; the growing political divisions in the country; among other concerns.[9]

Scholars at the Brookings Institution developed a simple econometric model that indicates biased sources of information in reporting economic news have become systematically more negative beginning in 2018. This, in part, explains why consumer sentiment appears to be divorced from the macroeconomy and why some survey respondents inaccurately describe the U.S. economy to be in a recession.[10]

The distinguished commentator, Fareed Zakaria, in a recent article in *Foreign Affairs,* underscored the disconnect that Americans have of themselves. "Despite all the talk of American dysfunction and decay, the reality is quite different…." Zakaria pointed out that while the American and eurozone economies were roughly the same size in 2008, today, the U.S. economy is nearly twice as large as the eurozone. In military capability, in technology, even in demographics, the U.S. is still far out ahead of all other advanced economies. Zakaria concluded that "as long as America does not lose faith in its own project, the current international order can thrive for decades to come."[11]

Every January, the highly regarded Eurasia Group publishes its assessment of the top risks for the year just begun. Incredibly, the number one risk cited in its current report is "The United States vs. Itself." "While America's military and economy remain exceptionally strong, its political system is more dysfunctional than that of any other advanced industrial democracy. The U.S. presidential election will worsen the country's political division, testing American democracy to a degree the nation hasn't experienced in 150 years and undermining US credibility on the global stage."[12]

In my view this dysfunction and polarization will in time impact the enviable U.S. investment environment unless we find a way to address pressing domestic issues. Our government must deal with the budget and burgeoning federal debt in a bilateral, disciplined manner that obviates the periodic threat of a shutdown. There is an obvious need to restructure immigration so that entry into this country is orderly and adequate to meet future labor needs. Finally, over the intermediate term legislators must come up with a viable plan to sustain Medicare and Medicaid.

It is discouraging to end this note on the investment outlook with a downer when I feel so good about last year's performance and cautiously optimistic about this year. While the prospects for the U.S. economy and corporate profits seem favorable, and the sustainable long-term growth potential of our major corporate holdings seems attractive, there are always risks. The principal risk is that we are unable to address our own challenges to get our house in order. As Pogo put it so memorably: "We have met the enemy, and he is us!"[13]

*Alan S. Bernstein*

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[9] "Looking ahead to 2050, Americans are pessimistic about many aspects of life in U.S.," Pew Research Center, March 21, 2019. https://www.pewresearch.org/short-reads/2019/03/21/looking-ahead-to-2050-americans-are-pessimistic-about-many-aspects-of-life-in-u-s/

[10] "Why are Americans so displeased with the economy?" Ben Harris & Aaron Sojourner, Brookings, January 5, 2024. https://www.brookings.edu/articles/why-are-americans-so-displeased-with-the-economy

[11] "The Self-Doubting Superpower," Fareed Zakaria, *Foreign Affairs*, December 12, 2023. https://www.foreignaffairs.com/united-states/self-doubting-superpower-america-fareed-zakaria

[12] Eurasia Group, *2024 Top Risks*, January 2024, page 4.

[13] Apparently this pronouncement originated on a poster for the first Earth Day in 1970. https://davidostewart.com/2012/07/26/we-have-met-the-enemy-and-he-is-us/