2023 Equity Review and 2024 Outlook

February 2024

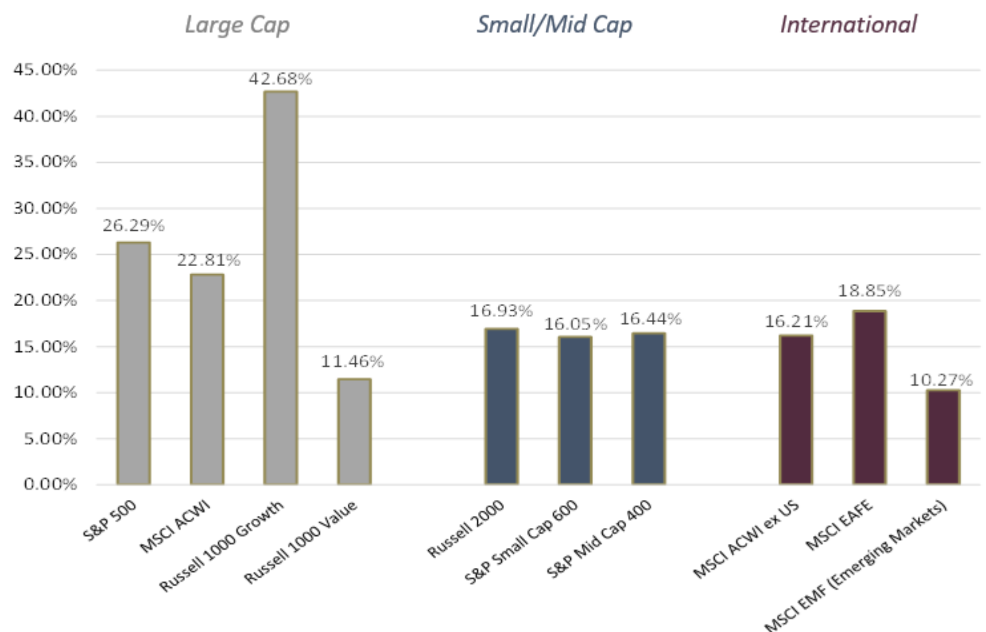
FRANKLIN STREET PARTNERS

Despite entering the year off the back of a historically difficult 2022 and a largely consensus expectation of economic weakening, global equities roared back with an outstanding year of performance in 2023, as the benchmark S&P 500 recorded a total return of +26.3%. While smaller U.S. stocks trailed their larger counterparts for the sixth time in seven years (2020 the exception), the mid-cap S&P 400 and small-cap Russell 2000 posted solid gains of +16.4% and +16.9%, respectively. International stocks also advanced in 2023, as the MSCI ACWI ex-U.S. index gained +16.2% while the MSCI Emerging Market Index was up +10.3%.

Growth stocks led the way, reversing the outperformance of value counterparts in 2022. For 2023, the Russell 1000 Growth index gained an impressive +42.7% versus a more pedestrian +11.4% return for the Russell 1000 Value index. While growth clearly bested value on a full-year basis, the environment did shift at the beginning of November following a relatively dovish FOMC meeting and a growing market assumption that monetary policy easing would be the next step for central banks. For the final two months of 2023, the narrowness of returns broadened and more sectors participated in the upward move.

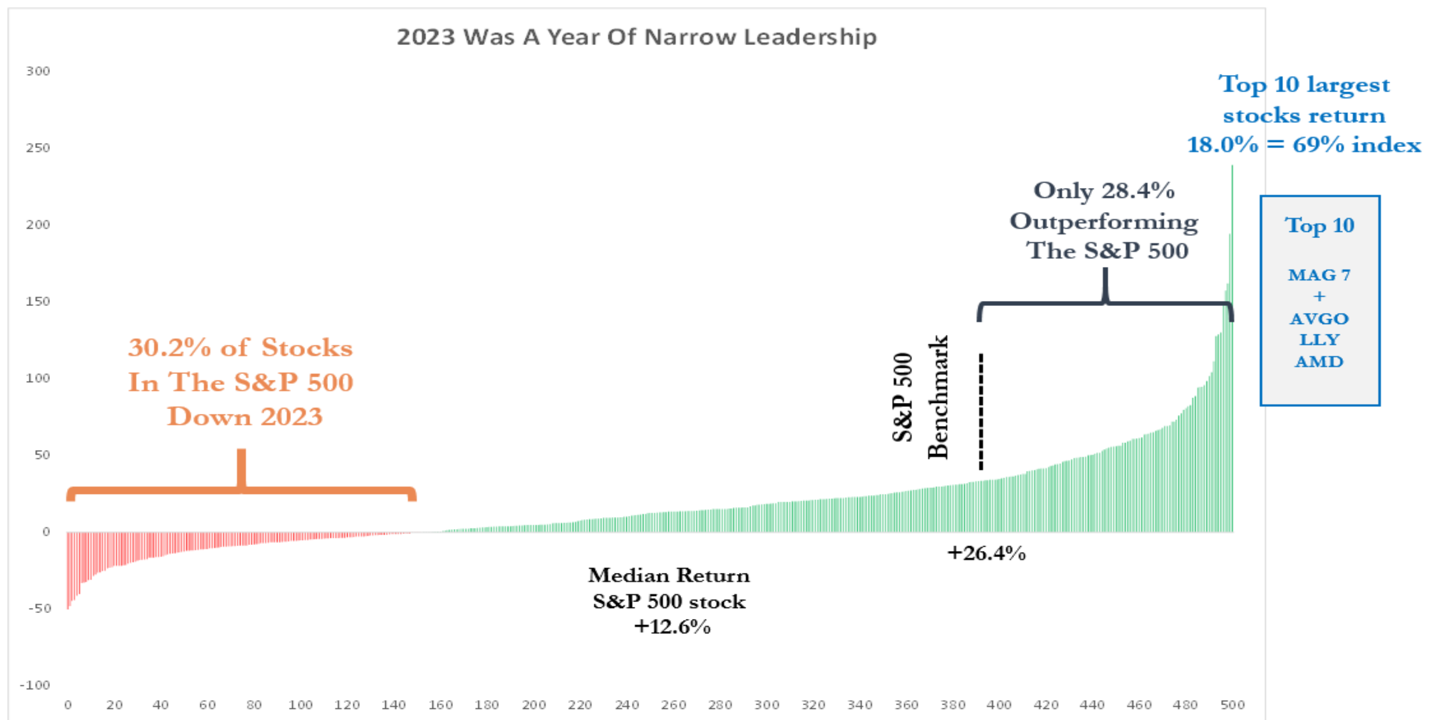
Much was written and discussed about the outsized contributions of the so-called "Magnificent 7" grouping of Apple, Microsoft, Alphabet, Amazon, NVIDIA, Tesla, and Meta; in aggregate, these seven companies comprised nearly 28% of the S&P 500's entire market capitalization at the end of December, yet collectively accounted for 62% of the index return for the year.

For 2023, each of these giants recorded total returns of at least +49.0%, with NVDA (+239.0%) and META (+194.1%) leading the way. It is important to note that each of these seven names were down greater than the S&P 500 benchmark in 2022 with an average decline of -46%; the best performer, Apple, lost more than -26% itself.



One of the most common questions facing investors regards the ability of the Magnificent 7 to maintain its leadership; we would suggest that each of the businesses has its own individual business drivers and should be evaluated on its own merits – one of which is their fortress balance sheets. As of the end of December, AMZN and GOOG sit on a combined $198 billion in cash and short term investments. Those two, along with big tech peers MSFT, AAPL, and META, hold the highest such balances among nonbanking companies in the S&P 500. We owned six of the seven companies in most FSP internally-managed strategies throughout 2023 and continued to do so as of the end of January 2024.

The extreme concentration of market leadership in 2023 helped create an imbalance of returns through the rest of the market. Since moving to 500 companies in March 1957, the S&P 500 has returned an annualized +10.5%; at +26.3%, 2023 was obviously well above that average. However, last year, the median total return for an S&P 500 constituent was only +12.6%. More than 30% of the stocks in the index posted a negative return despite such strong performance by the benchmark.



Each S&P 500 Stock Sorted By Year-To-Date Performance

During 2023, there were no shortage of worries facing equity investors – a perception of slowing economic growth, global central banks continuing to tighten monetary policy, U.S. debt ceiling concerns, etc. Adding to investor anxieties in the spring were the second (First Republic Bank), third (Silicon Valley Bank), and fourth (Signature Bank) largest bank failures in U.S. history, not to mention the failure of one of the world's largest diversified financial institutions in Credit Suisse. The list of concerns grew in the fall with the drama surrounding the confirmation of a new Speaker of the House of Representatives, the vicious Hamas attack on Israel, and the subsequent geopolitical impacts around the globe, and Houthi attacks on global shipping in the Red Sea.

Given all of the bricks in the "Wall of Worry," it's reasonable to wonder how global equity benchmarks performed so well in 2023.

We would point to several important causes: 1) Oversold conditions entering the year led to a powerful change in market leadership back to familiar giants. 2) Labor conditions remained resilient, bolstering the consumer and delaying any potential recession. 3) The emerging theme of artificial intelligence (AI) exploded faster than nearly anyone could have anticipated, as a nearer-term visibility of meaningful revenue and expectations of a new technology "super cycle" drew investors to a small group of giant companies, creating historically narrow leadership.

However, it was the relative resilience of corporate earnings that we believe was the most important factor – and likely holds the key to equity upside in 2024. Entering 2023, we suggested that S&P 500 earnings estimates needed downward revisions to better match buy-side investor sentiment. This indeed occurred, as the 2023 EPS estimate moved from $229 a share to approximately $218 by the end of December. However, these downward earnings revisions were nowhere near as severe as some market prognosticators, who forecasted earnings below $200 a share, originally feared. Continued resilience in corporate earnings will be crucial, as 2024 estimates entering the New Year projected nearly +12% EPS growth over 2023 levels. While $243 in EPS for 2024 may ultimately prove too high, we believe most investors have already considered some downward adjustment – the level of fine-tuning will be a key point of debate.

What to Expect Moving Forward

As we began the New Year, the most frequent inquiry that we received was straightforward – after an extremely disappointing year for stocks in 2022 followed by an outstanding year in 2023, what do equity markets have in store for 2024? Bluntly, we remain constructive on the asset class. Our base case considers a potential return of +8% to +15% for the S&P 500 in 2024, equating to a year-end target price range between 5100 and 5400.

How do we get there? We believe 2024 will be an experience of a "return to normal," whereby economic and business patterns continue to smooth when compared to the pandemic-induced volatility that began in the first quarter of 2020. This year should truly be the first full year in which we are not only past the disruptions of the pandemic, but also most of the dislocations caused by those disruptions – supply chain issues, "yo-yo" spending, etc. For stocks, this will also mean a further return to analyzing actual fundamentals.

Equities - Outlook

- Our Base – Best case considers a 2024 year-end S&P 500 target of 5100-5400, or +8 to +15% YoY.
- After poor 2022, strong 2023, we believe 2024 will be an experience of a "return to normal," as we move past pandemic disruptions and the associated dislocations. This also suggests a return to analyzing company fundamentals rather than mere macroeconomic changes.
- We expect corporate earnings growth to improve and estimate S&P 500 earnings of approximately $235, or +7-9% growth over 2023. Our estimate is lower than the $243 consensus.
- S&P 500 begins 2024 trading at 19.6x 2024 consensus EPS; we believe multiples have some room to expand given economic conditions, potential for Fed rate cuts.
- In internally managed portfolios, we recommend a balance of growth and income to take advantage of compelling valuations across the economic landscape.
- We believe the end of a zero interest rate policy makes the environment particularly attractive for active equity management – owning advantaged businesses over the longer-term.

Thankfully, we expect corporate earnings growth to return to improved levels in 2024. We anticipate S&P 500 EPS growth of +7-9% for the year, which implies $235 to $240 a share.

In addition to post-pandemic normalization and earnings growth, other tailwinds exist to assist equity markets in 2024. First, the race for the White House has largely meant solid returns for stocks; beginning in 1960, the S&P 500 has posted positive returns in fourteen of the last sixteen presidential years with an average total return of +10.5% (this average includes 2008's disastrous -37.0% return). In addition, a sizable amount of cash remains on the sidelines and out of equity markets altogether.

In 2023, nearly three times as many dollars flowed into money market funds as did equity ETFs. According to Blackrock, nearly $7 trillion is currently sitting in money market funds. When investors believe the FED is committed to monetary easing, we expect money will begin to flow into stocks again with significant momentum.

We continue to closely watch the all-important U.S. consumer. There have been countless attempts to call the end of U.S. consumer strength, most of which have been categorically wrong over a lengthy period of time. Based on both economic data and company reports, there is certainly some weakness in lower-income consumer spending, and we remain vigilant in monitoring data for signs that softness has spread upward. In our opinion, the tight U.S. labor market remains the best friend to the consumer.

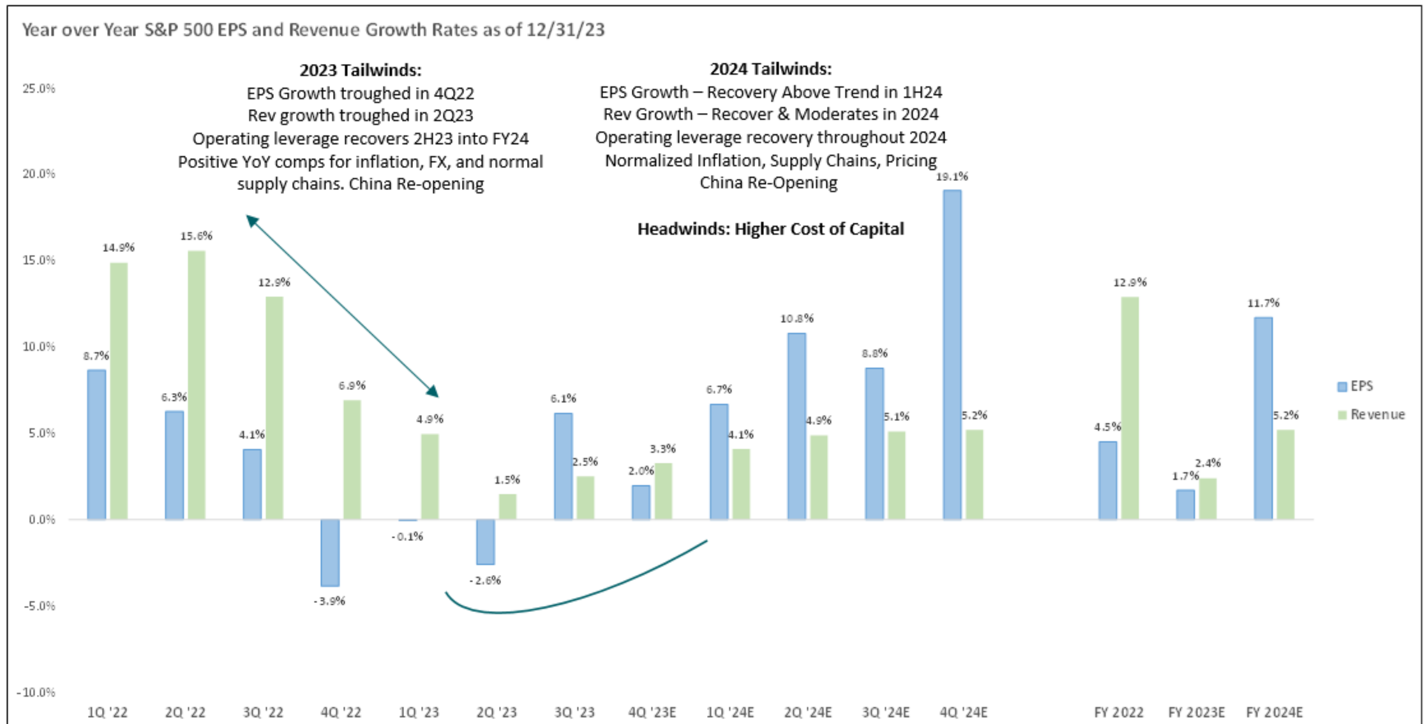
As always, investors should anticipate periods of market volatility; we believe equity volatility will prove greater in 2024 than in the previous year. What does that mean? According to Carson Investment Research, since 1928, the S&P 500 and its immediate predecessors have averaged 1.1 corrections of at least -10% every calendar year. Corrections of at least 15% have occurred approximately once every two years.

Earnings – what have we learned thus far in 2024?

In our view, the first test for continued U.S. equity strength started in mid-January during the traditional fourth quarter earnings reporting season. While profits reported for the December quarter have largely been slightly better than expected, the commentary on 2024 profitability has been more insightful. We expected companies to "lower the bar" on earnings expectations – with a little less than half of the S&P 500 having reported, the 2024 estimate has only moved slightly lower and currently stands a little over

$242, or +11% growth over 2023. Lowered estimates are consistent with our outlook for the rate of economic growth slowing throughout most of the year, as we believe overall 2024 earnings growth will finish in the 7% to 9% range.

On a specific sector or company basis, some 2024 profitability clues have emerged: 1) Despite fears to the contrary, bank profitability has been better than expected and estimates have moved higher. 2) The fundamentals of mega-cap technology remain intact and are accelerating in the case of companies like META and AMZN. 3) Industrials companies are balancing demand from the healing of global supply chains with concerns over slowing economic growth. 4) Consumer spending continues to focus on services such as restaurants and events rather than on goods.

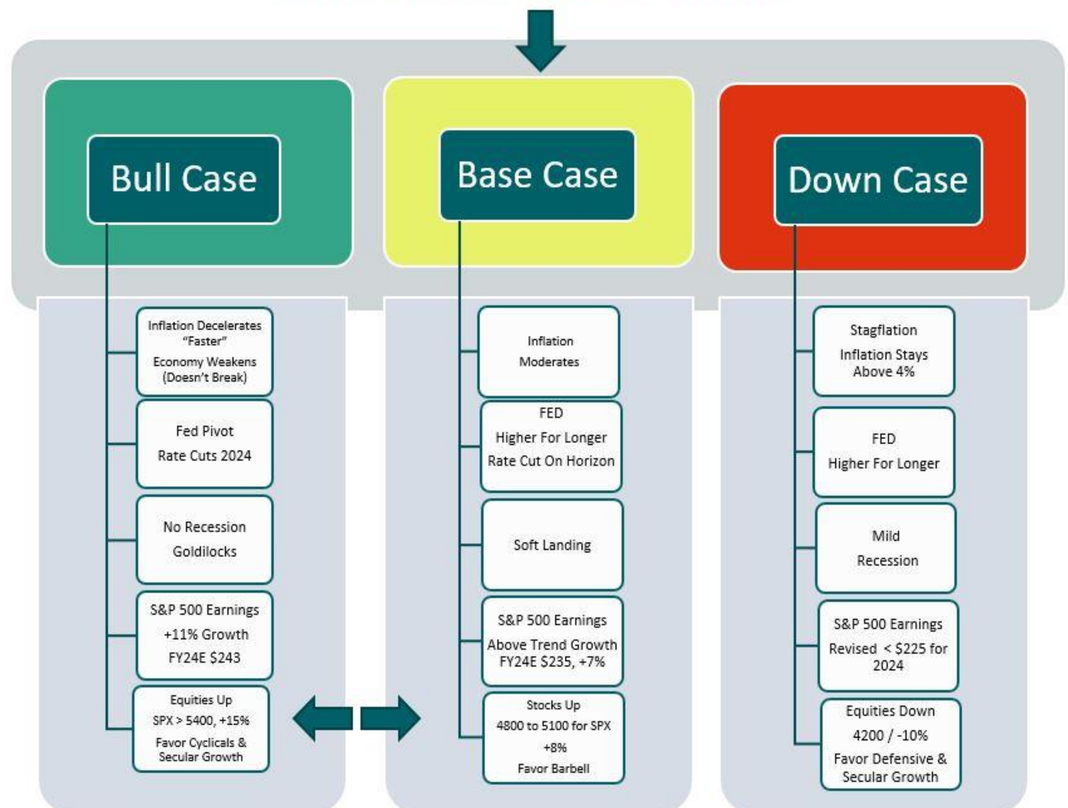


Source: FactSet as of 12.31.2023

What else could contribute to a market downturn in 2024?

Another test for the market will be closely tied to the Federal Reserve's actions and language on the path of interest rates over the course of the year. Slowing economic growth and declining inflation will prompt the Fed to begin easing monetary policy and lowering the federal-funds rate; this should ultimately prove positive for stocks overall. However, we believe equity markets are already pricing in several rate cuts in 2024, and therefore are highly sensitive to potential changes in rate expectations that challenge the "soft landing" narrative. Given our long-term fundamental view that the normalization backdrop is ultimately positive for equities, we believe any selloffs would be relatively shallow. We invest with an awareness of current macro conditions, but our investment decisions are always based on bottom-up fundamental analysis of companies and securities. In such a pullback, we would be opportunistic and continue to buy better businesses at better prices for client portfolios.

What is the base case for 2024?



Base Case: We expect near-term volatility as equity markets digest continued economic and corporate data. A soft landing scenario is on the table; rate cuts are on the horizon, but the timing and order of magnitude are less than the current forecasts. We estimate S&P 500 earnings of $235, a YoY growth rate of +7-8%. In this scenario, we expect P/E multiple expansion to lead the market higher before a recovery in both earnings and revenue growth materialize in the back half of 2024.

What would cause downside to our base case scenario? Reacceleration of inflationary measures would be a clear headwind given the firm commitment from the Fed and other global central banks to reducing inflation; it seems very unlikely that the Fed would reverse course, thereby the "higher for longer" narrative remains sticky. Further, any significant weakening in household spending activity could shake investor confidence given the importance of the consumer to U.S. economic activity.

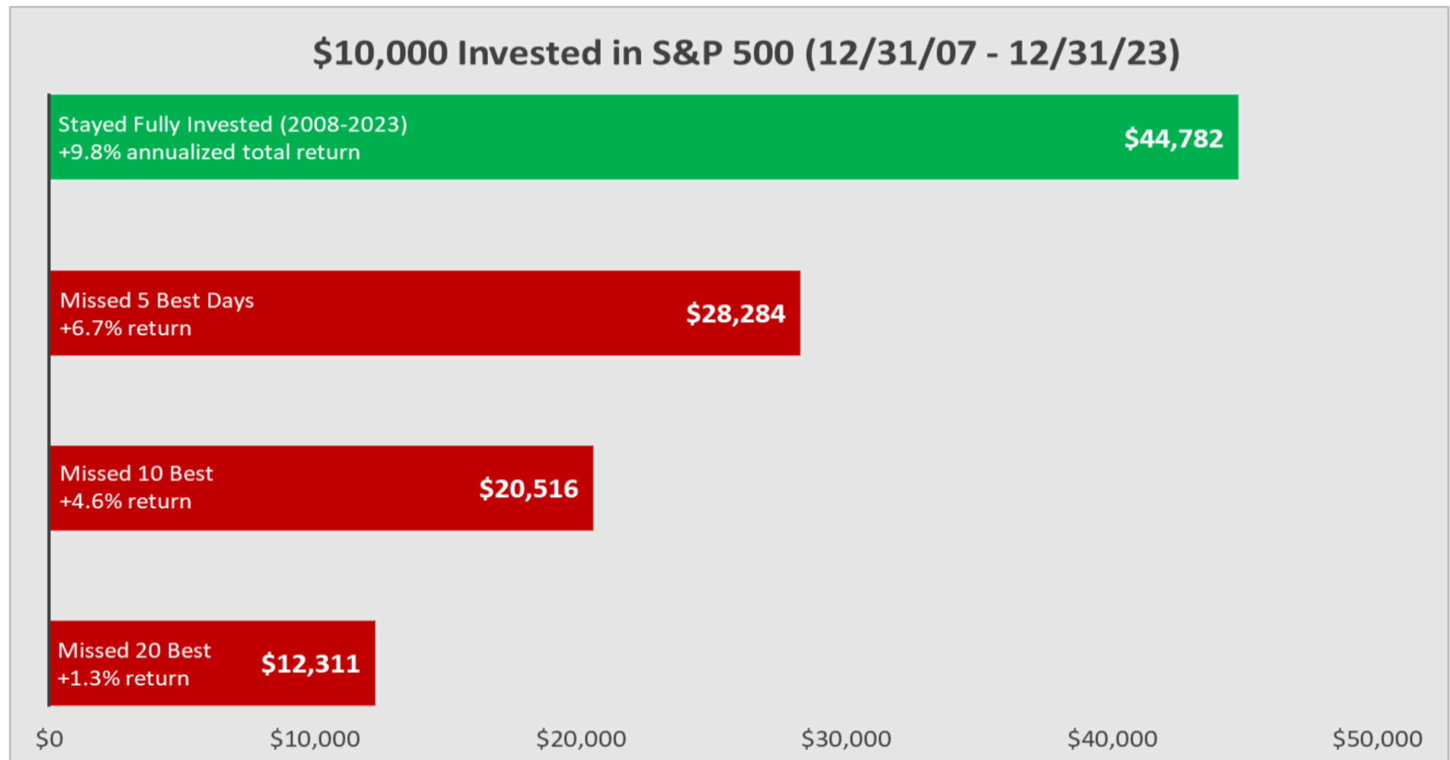
It is also important to consider catalysts for an upside case; in our opinion, a consistent, faster than expected deceleration of inflation measures combined with a slower growth economy and a shift to easing monetary policy would be a scenario that could fuel a greater than expected response from risk assets. The no recession, goldilocks scenario would take us to the higher end of our S&P 500 target price range of 5400 by year-end.

Benefits of Investing for the Long Term

We have often discussed the benefits of remaining invested, of time in markets and not timing markets themselves. Between the end of 2019 and 2023, we've experienced the first global pandemic in over a century, the largest land conflict in Europe since World War II, the highest level of inflation since the early 1980s, the worst quarter of GDP decline in modern U.S. history, two bear markets in the S&P 500, the largest one-year increase in the Fed Funds rate since 1985, the highest level of 30-year fixed mortgage rates since 2002, the highest level in WTI crude since 2008, the 2nd, 3rd, and 4th largest bank failures in U.S. history, and the first calendar year EVER (2022) in which both the S&P 500 total return and the Bloomberg Aggregate indices were both negative.

Despite all of that, between December 31, 2019 and December 31, 2023, the S&P 500 delivered a total return of +57.5%, or +12.0% on an annualized basis.

While veteran FSP clients understand well the power of longer-term investing and compounding returns, specific illustrations can be helpful over time. For example – in the period between the end of 2008 and the end of 2023 (4,027 trading days), an investor achieved an annualized return of +9.8% by staying fully invested over the entire period. This compares quite favorably to an investor who missed only the best ten days of S&P 500 performance over the entire period and achieved an annualized return of +4.6%. Over that same 2008-2023 stretch, nine of the ten best days occurred within two weeks of the ten worst days.



Sources: Franklin Street Advisors, Bloomberg, 12.31.2023

Importantly, the 2008-2023 span covered bear markets including the Great Financial Crisis (-56.8% peak to trough) and the 2020 Covid-19 pandemic (-35.4%). In fact, the period included two of the four worst (2008 and 2022) calendar year performances since the end of World War II.

In our opinion, it is essential for investors to understand that equities are leading, not lagging indicators, and that history has repeatedly illustrated equity markets bottom prior to meaningful improvement in underlying economic and corporate data.

During the Great Financial Crisis, the S&P 500 bottomed in early March 2009 and had gained approximately +37.9% by the NBER's declared recession end in June 2009. Likewise, the S&P 500 hit its pandemic low in March 2020 and gained +30.4% by the end of that brief recession in April 2020.

FSP Asset Allocation and Internal Equity Strategies

We believe Franklin Street's asset allocation process stands ready to respond to these differing outcomes. Our Asset Allocation Committee is all in our Chapel Hill headquarters and meets often to weigh the constantly evolving investment environment.

As a reminder, we have maintained a more conservative posture for some time now – we primarily manage to 3 differing risk models, with our Moderate allocation targeting 50% equities, 44% fixed income, and 6% alternative assets of the beginning of 2024 relative to the traditional 60/40 portfolio commonly discussed in financial media. Included within the aforementioned

allocation to alternatives is a dedicated position to strategic "cash." These funds are held in a liquid, short-term U.S. Treasury Bond ETF with an average yield to maturity in excess of 5%. Our Committee intends to deploy these assets into U.S. large equities on any significant pullback in the S&P 500 in excess of -10%.

Further, we remain strong advocates in active management and think a volatile rate environment supports that confidence. We believe we have attractive active management opportunities at a number of different points – at the security level, at the asset class level, and at the overall asset allocation level.

Within FSP, we actively manage five primary large cap equity strategies with a range of return and risk objectives that represent style tilts – Strategic Growth, Partners Advantaged, Equity Income, Growth & Income, and Sustainable, Responsible Equity. Growth & Income uses a barbell approach, combining stocks from our core growth-oriented strategies (Strategic Growth and Partners) with our core value conservative strategy (Equity Income); and Sustainable, Responsible strategy is a thematic ESG approach to our Partners strategy.

In the actively managed, internal large cap equity strategies, we continue to focus on companies with distinct advantaged business models and longer-term secular opportunities, making changes in accordance with the style, risk, and reward objectives for each individual strategy. We continue to favor advantaged companies with secular growth opportunities, strong balance sheets, high free cash flow generation, and capital flexibility. Advantaged businesses are uniquely positioned to potentially emerge as stronger competitors over the longer term as well as weather severe economic challenges.

We believe an excellent example of a secular grower is American Express (AXP), which has been a long-term holding in FSP internally managed equity strategies. While structured as a bank holding company, AXP's diversified business significantly differentiates the firm from "true" banks. The premier card payment company in the world, AXP can rely on a "three-legged revenue stool" of merchant transaction fees, cardholder fees, and net interest income. The company's premium cardmember base is more generationally and geographically diverse than commonly believed, and stands better positioned to maintain spending during periods of economic weakness. 70% of cardholders paying an annual fee, providing the company with attractive recurring revenue. Finally, we believe AXP's longer-term targets of 10% revenue growth and mid-teens EPS growth, as well as its consistent 30%+ return on equity performances, justify a higher valuation than current trading levels. We continue to favor the shares.

Another advantaged business to highlight is Lockheed Martin (LMT), which reported its fourth quarter results in January. The company sizably beat expectations, but issued 2024 financial guidance that was slightly lower than expected. While revenue guidance was fine (suggesting solid demand for its products), LMT's internal earnings forecast was below expectations due to a number of factors including margin pressures and higher than expected pension expense. Moving forward, we believe a structural change in demand for defense spending has emerged, not just from the US, but from around the world due to a spike in global instability (Ukraine, Israel, the Red Sea, etc.). This increase in demand will take time to flow from orders to deliveries, but we expect (as does management) that margins will start to improve. LMT trades at only 16.5x 2024's current EPS estimate, a sizable discount to the S&P 500's 22.6x multiple. The stock also has a 2.9% dividend yield and adds diversification to portfolios, as its demand is not directly tied to the consumer (which drives 70% of the U.S. economy and therefore the demand of many of the stocks in the Index).

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