MALVERN CAPITAL MANAGEMENT

4th Quarter 2023 Commentary and 2024 Market Outlook

January 2024

4th Quarter 2023 Review

Following a negative year in 2022 for all the major stock and bond indices, the major indices rebounded sharply in 2023. The 4th quarter of 2023 was particularly strong due to language coming from the Federal Reserve regarding interest rates leaving investors anticipating that rates would soon be lowered. The S&P 500 index jumped 11.69% in the 4th quarter and 26.29% for the year. The stellar performer for the year was the technology-heavy NASDAQ 100 Index which advanced 55.13% for the full year and 14.60% for the 4th quarter. Roughly 44% of the NASDAQ 100 Index is invested in the so-called "magnificent seven stocks" which accounted for almost two-thirds of the total return for the NASDAQ 100 Index in 2023. The seven stocks include Apple, Amazon, Microsoft, Nvidia, Google, Meta and Tesla.

Interestingly though, small-capitalization stocks as measured by the Russell 2000 Index rose by 22.38% in the last two months of 2023 compared to the S&P 500 Index's rise of 14.09% over the same time frame. Small Cap stocks have been laggard performers over the past three years. The three-year annualized return of the Russell 2000 index was 2.22% compared to the S&P 500 Index's 10.0%. Real Estate Investment Trusts (REITs) also had a good final two months of 2023 rising by 21.84% for the last two months of the year. REITs were poor performers for most of 2023 before their surge at the end of the year.

High-quality or investment-grade bonds had attractive returns in the 4th quarter. High-quality bonds, as measured by the Bloomberg U.S. Aggregate Bond Index rose by 6.82% for the quarter. Junk bonds did well for the quarter advancing by 7.16%. It was an interesting year for interest rates as the Federal Reserve

Indices Performance

Category	Representative Index	4th Qtr 2023	Full Year 2023	Six Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	13.09	16.18	10.72	9.38	12.47	11.08
Broad US Large Companies	S&P 500 Index	11.69	26.29	8.04	10.00	15.69	12.03
US Small Cap Companies	Russell 2000 Index	14.03	16.93	8.18	2.22	9.97	7.16
US Mid Cap Companies	Russell Mid Cap Index	12.82	17.23	7.54	5.92	12.68	9.42
Largest 100 NASDAQ Companies	NASDAQ 100 Index	14.60	55.13	11.32	10.18	22.66	17.91
Large "Value" Stocks	Russell 1000 Value Index	9.50	11.46	6.03	8.86	10.91	8.40
Large "Growth" Stocks	Russell 1000 Growth Index	14.16	42.68	10.59	8.86	19.50	14.86
Developed International	MSCI EAFE Index	10.42	18.24	5.88	4.02	8.16	4.28
Emerging Markets	FTSE All Emerging Markets	6.57	8.64	4.82	-3.57	4.40	3.22
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	6.82	5.53	3.37	-3.31	1.10	1.81
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	7.16	13.44	7.66	1.98	5.37	4.60
Commodities	Bloomberg Commodity	-4.63	-7.91	-0.14	10.76	7.23	-1.11
Total US Market (all cap stocks)	Russell 3000 Index	12.07	25.96	8.43	8.54	15.16	11.48
Real Estate Investment Trusts	Wilshire US REIT Index	16.30	16.10	8.85	7.52	7.56	7.72
Cash	US T-Bill 90 Day	1.41	5.11	2.78	2.07	1.84	1.20

** 3 year, 5 year and 10 year returns are annualized. All periods ending December 31, 2023.*
All returns include the reinvestment of dividends.

Source: Morningstar Direct.

continued to raise short-term interest rates at the beginning of the year causing a sell-off in bonds. The Fed would pause raising rates by mid-year allowing the bond market to stabilize. Market-driven, longer-term rates also rose and then dropped. The 10-year U.S. Treasury Note yield peaked just slightly under 5% on October 22, 2023, after gradually increasing all year through October. Coincidentally, however, the yield on the 10-year U.S. Treasury Note finished the year almost exactly where it started the year (3.866% on December 29, 2023 versus 3.879% on December 30, 2022).

As we proceed into 2024, we will see if the markets can continue to move higher. It's an election year which is nearly always positive and the Federal Reserve may certainly be in play. As follows, we will look at the issues impacting both stocks and bonds and give our opinion as to how we see 2024 shaping up

Federal Reserve & Interest Rates

The Federal Reserve's Federal Open Market Committee (FOMC) met in mid-December with the expectation that it would leave interest rates unchanged and it did leave them unchanged. However, all attention would focus on the language in the post-meeting statement indicating if or when it may begin to cut interest rates. Every quarter the Fed releases its so-called "dot plot." The dot plot is a chart showing where each Fed governor expects that the FOMC will be with the midpoint of the target range for the Fed Funds Rate by the end of each year. The consensus officials showed in the dot plot that the Fed would cut interest rates by as many as three times in 2024. Investors liked the trajectory for interest rates when the dot plot was released on December 13, 2023, and stocks and bonds rallied.

The dual mandate of the Fed is to seek maximum employment and promote stable prices. The Fed's target inflation rate is 2%. The current inflation rate in the United States was last released as 3.1% for the 12 months ending in November 2023. The rate has been declining steadily all year (in December 2022, the annual inflation rate was 6.5%). The Fed governors and investors see that the rate of increase in prices is falling. The declines in prices lend support to the Fed and investors that interest rates can be reduced because they can say that it is "mission accomplished."

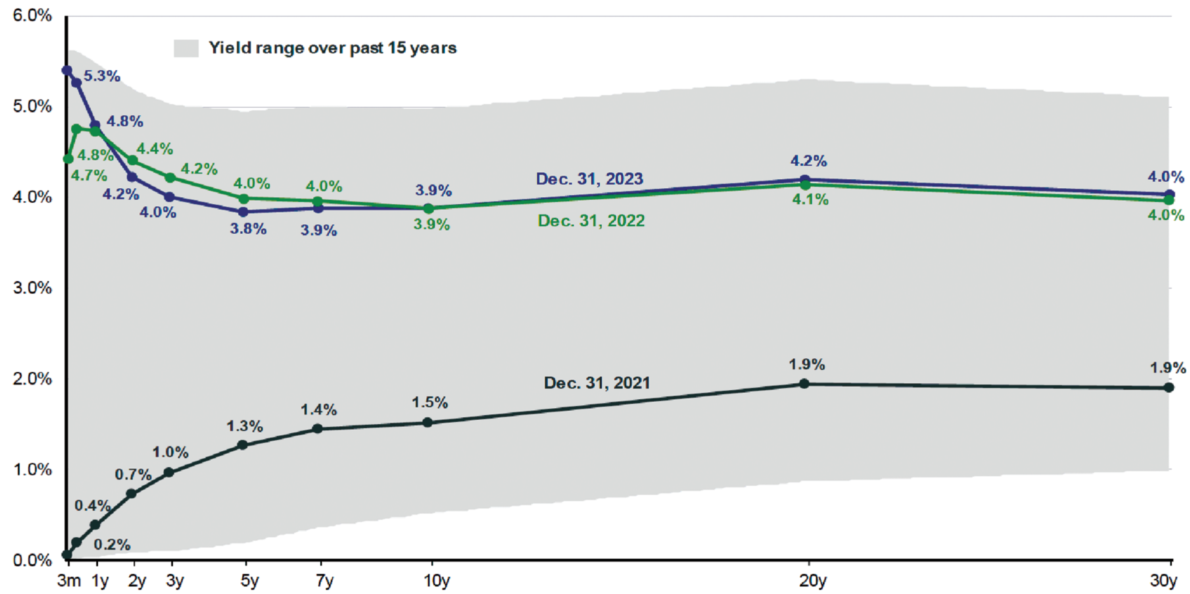
However, Fed Chairman Jerome Powell is certainly cognizant of the fact that in the 1970s then chairman Paul Volker had taken the foot off the pedal too soon with raising interest rates and inflation got out of control. Volker eventually had to raise interest rates aggressively sending the economy into a deep recession. Powell most likely will not want to risk having the same result this time. Investors, eager to buy stocks and bonds on every sign of stabilizing prices, should probably be more cautious of worse inflation news still being ahead of us and not behind us. We expect that the inflation rate will gradually continue to fall but we know more work may eventually have to be done if we are wrong in our prediction.

In addition to interest rate policy, the Fed has a program called Quantitative Tightening (QT) whereby the Fed is reducing its balance sheet by selling bonds. The QT program is reversing the Quantitative Easing (QE) Program where it increased the size of its balance sheet to help push down longer-term, market-driven interest rates. The QT program is intended to help raise longer-term interest rates to help further slowdown the effects of inflation. The current size of the Fed's balance sheet is $7.2 trillion, down from $9 trillion when the QT program began in May 2022. In addition to possibly cutting interest rates, will the Fed end the QT program effectively taking pressure off of longer-term interest rates? According to the minutes of the December meeting, there seem to be some Fed governors who would like to alter the current QT program if not end it.

Our view is that the Fed will begin lowering the Fed Funds rate by June 2024 and will cut interest rates a total of three times in 2024 as the dot plot suggests. It will also suspend reducing its balance sheet by mid-year. We are in an election year and the Fed does not want to seem political with its Fed policy. Lower interest rates can be seen as boosting the incumbent in the White House. But the Fed also does not want to risk throwing the economy into a recession by keeping restrictive monetary policy in place longer than necessary.

Should interest rate cuts be on the way, the markets will see this as a positive, and prices likely will continue to bid upward. The markets will be susceptible to every piece of data regarding inflation. Interest rates, along with earnings, will be the main drivers of stock prices in the near future.

U.S. Treasury Yield Curve



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Guide to the Markets, Data as of 121/31/2023.

Will We Finally Slip Into a Recession?

At the start of 2023, many economists and investment analysts were predicting a recession in 2023. We were not among them and remained cautiously optimistic about the economy all year. Our primary reasons for thinking there would be no recession were the strong job growth all year, solid wage growth, and expanding Gross Domestic Product (GDP).

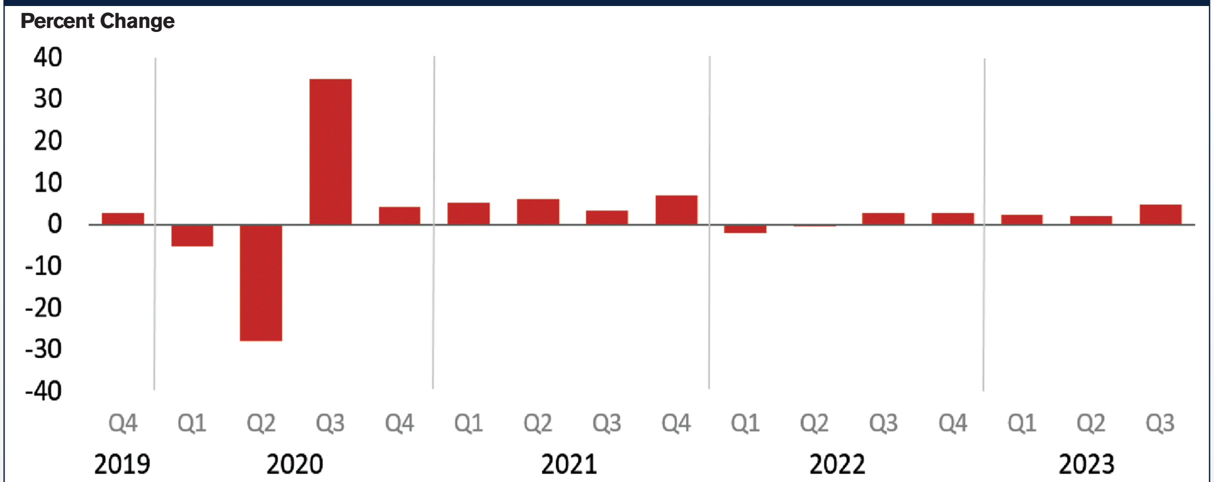
Going forward, we see more of the same. We believe that with the expected Fed Funds interest rate cuts in 2024, a falling 10-year U.S. Treasury Note yield, continued job and wage growth, inflation coming down further, and expanding GDP, the economy will avoid a recession in 2024. The December jobs number reported by the Bureau of Labor Statistics showed a gain in jobs of 216,000 for the month. In total, 2.7 million jobs were created in 2023, or an average of 225,000 jobs per month. As we mentioned earlier, we expect the Fed Funds rate cuts and declining longer-term interest rates in 2024. Inflation will continue on its downward path. We are encouraged by the monthly CPI reports in 2023 and we think these positive reports will continue in 2024. Real GDP grew at an annual rate of 4.9% in the third quarter of 2023. This is an impressive number. With more fuel on the fire in the form of falling interest rates, we do not see how the trend will be broken. Corporate earnings will also remain healthy and growing in 2024.

However, not everything is positive and other signs cannot be ignored. The U.S. Leading Economic Indicators (LEI) are currently signaling a recession is on the way. The LEI is an early warning sign for the economy and indicates shifts in the business cycle. The LEI declined by 0.5% in November and shrank by 3.5% between May and November 2023. These indicators are currently signaling a recession.

The Institute for Supply Management publishes two surveys; the Manufacturing Purchasing Managers' Index (PMI) and the Services PMI. The December Manufacturing PMI recorded a number under 50 at 47.4. Any number under 50 is considered an economy in contraction. The Services PMI for December was 50.6.

Despite there being warning signs about the economy, we believe the strengths outweigh the weaknesses and we will avoid a recession once again.

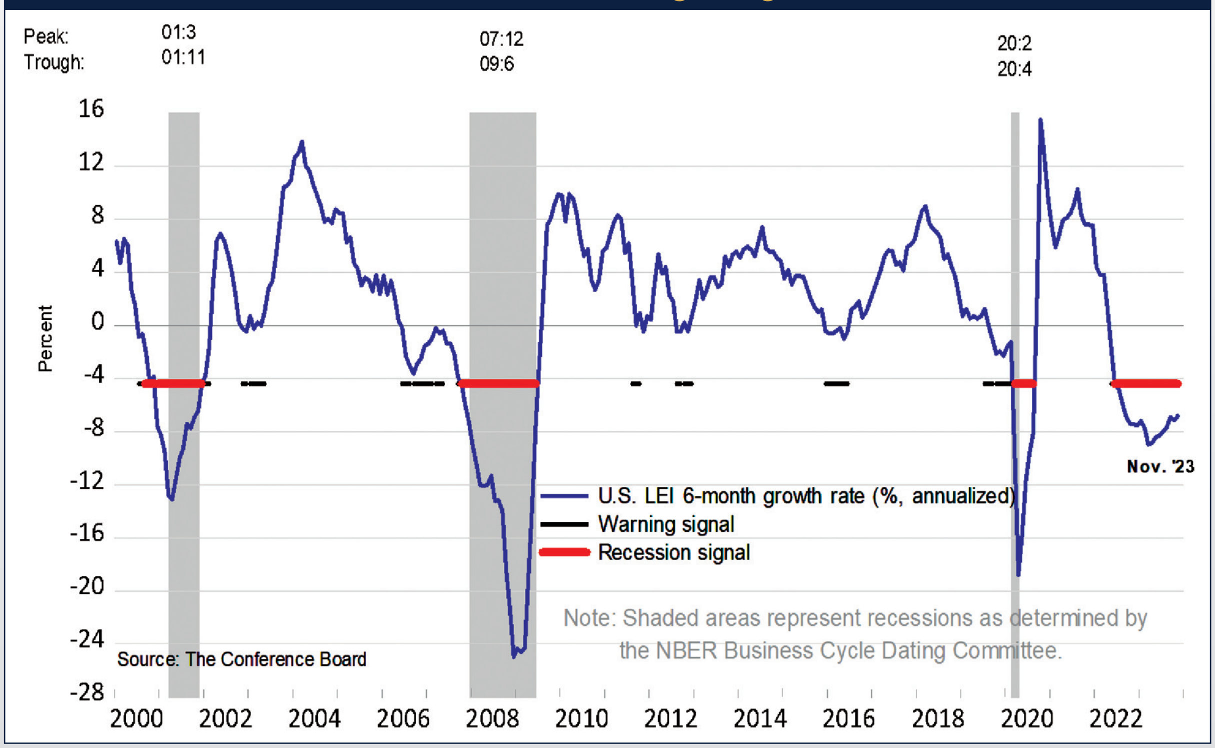
Real GDP: Percent Change From Preceding Quarter



Source: U.S. Bureau of Economic Analysis

Seasonally adjusted at annual rates

The U.S. LEI Continues Signaling Recession



A Small Cap Stock Resurgence in 2024?

As an asset class, small-capitalization stocks (companies generally defined as having a market capitalization of under $2 billion), have trailed their large-cap counterparts over the past three years. In 2016 and 2020 (both election years) small-cap stocks were the best-performing of the major asset classes. In 2023, small caps (as measured by the Russell 2000 Index) were up 16.9% with much of their gains coming in the 4th quarter of 2023 (or specifically the last two months of the year as mentioned earlier). Large-cap stocks as represented by the Russell 1000 Index were up 26.53% for the year. In the down year for the stock market of 2022, small-cap stocks were near the bottom of all major asset classes falling 20.4% for the year.

But is now the time to take another look at small-cap stocks and their potential to do better than large-cap stocks for the foreseeable future? Why might small-cap stocks do well? Higher interest rates are not good for the balance sheet of small-cap stocks. Small-cap companies tend to have low relative cash levels compared to larger companies and will often have more debt on their books. Often that debt is a floating rate or variable rate meaning that as interest rates rise, the rate of interest being charged will also rise. On the other hand, when interest rates fall, that debt becomes cheaper to hold and more of a company's revenues will fall to the net income line of the income statement. As mentioned earlier we believe that interest rates will begin to fall in 2024 and investors are believing that as well. In anticipation of falling rates, these stocks have been rising recently. There is also a belief that the economy will do well in 2024 as inflation subsides, the job market remains positive and consumers continue to spend. Small-cap stocks should do well in a good economy.

Lastly, small-cap companies make for attractive acquisition targets. Lower interest rates along with improved earnings for this asset class make these companies poised to be acquired by larger companies.

The rationale for a resurgence of small capitalization seems to be in order.

Corporate Earnings

Of interesting note, Berkshire Hathaway which represents 1.62% of the S&P 500 Index and is its 9th largest holding, had an unrealized investment loss of $23.5 billion resulting in a reduction of approximately $2.82 per share from the S&P 500 Index's earnings. It had an unrealized investment loss ($66.9 billion) in the 2nd quarter of 2022 resulting in a reduction of around $4.74 per share of S&P 500 Index's earnings for that quarter. That being said, the projected earnings per share for the full year of 2023 are $213.84 as estimated by the Standard & Poor's Corporation. Back in September 2023, those same analysts were projecting a full year 2023 earnings of $220.03 per share. Certainly, part of the reason for the decline in earnings is due to Berkshire Hathaway's recognition of its unrealized loss but we believe it goes a little further indicating that guidance from companies has been lowered. Of the 499 (out of 503) companies that have reported for the 3rd quarter of 2023, 397 did beat their estimates, 81 companies missed and 21 met their estimates. 310 companies beat their sales estimates for the quarter.

Moving into the year 2024, Standard & Poor's estimates full-year 2024 earnings to be $242.44 per share. This represents a growth of 14.3% from the full year 2023 to the full year 2024. Operating margins also continue to be strong with the estimate for the 3rd quarter 2023 at 11.15%. Since the 1st quarter of 1993, operating margins have averaged 8.76%. The strong current levels of operating margin indicate that companies are more profitable today than in prior years.

The current level of earnings and projected growth in earnings are indicative of healthy companies. This is also further evidence of no recession on the horizon.

Market Valuation

Based on a year-end price for the S&P 500 Index of 4783.35, the market may be a little higher than fair value right now. The current "trailing" price-to-earnings (P/E) ratio for the S&P 500 index is 22.37 times. The 30-year average "trailing" P/E ratio is 19.70 times (the average of 30 years of quarter-end trailing P/E ratios). The current "forward" P/E ratio on the S&P 500 Index is 19.73 times. According to JP Morgan, the 30-year average forward P/E ratio is 16.59 times.

Another way to determine whether the market is over-valued, is to look at the "Fed Model" (that has no relation to the Federal Reserve) which looks at the relationship of the earnings yield of stocks to the yield on the 10-year US Treasury Note. When yields are higher on the bond market, we get a bearish reading on stocks. Conversely, when yields on stocks are higher, we get a bullish reading on stocks. At present, the earnings yield is higher than the bond yield which is a bullish signal. Thus, when we also consider the level of the P/E ratio on the market, the Fed Model gives conflicting signals as to whether the market is over-valued at least in the short term.

Looking forward, where do we see the S&P 500 Index going over the next 12 months? One way to assess the future value of the market is to look at the earnings estimates 12 months out and apply a price multiple to those earnings. Further, we add the expected dividend yield to get an estimated total rate of return. Assuming the year-end 2024 earnings projection on the S&P 500 Index of $242.44 and applying the current trailing P/E ratio of 22.37, we get a price target of 5423. Further, if we add the dividend yield (currently 1.48%) to the price return, we get a total return on the market of 14.9%. With expected falling interest rates in 2024, we believe that the current trailing P/E ratio is justified to use in our assumption.

Although we use a lot of assumptions in our forecast, we reevaluate these assumptions on an ongoing basis throughout the year.

The "Magnificent Seven", Can They Continue to Lead?

A lot of attention has been given to the aforementioned magnificent seven stocks and their performance in 2023. These stocks individually returned between 50% and 240% in 2023. In the aggregate, they were up some 71% for the year. Their weight in the S&P 500 Index is a little over 25%. Their total gain made up almost two-thirds of the total return of the S&P 500 Index last year while 72% of the Index's component stocks underperformed the Index. The magnificent seven companies are not cheap. The seven companies have an aggregate forward P/E ratio of 33.6 times according to LSEG DataStream versus the S&P 500 Index at 19.7 times.

Although earnings should remain strong for the magnificent seven, we believe that we will see a broadening out of the market in 2024. With declining interest rates and an economy that will still be doing well in our view, we see a continuation of the market we saw in November and December of 2023 where the equal-weight S&P 500 Index outperformed the S&P 500 Index and small-cap stocks shined.

The magnificent seven may not necessarily lead the market but we still believe that they will add significant value to a client's portfolio.

Summary

The equity markets rallied in the last two and a half months capping off a strong 2023. The NASDAQ 100 led the way with a return of 55.13%. The so-called magnificent seven stocks accounted for most of that gain. The magnificent seven stocks accounted for almost two-thirds of the return for the S&P 500 Index in 2023 while much of the rest of the market lagged most of the year. We expect the magnificent seven stocks to continue to perform well but that the overall market will broaden. Leadership in the market may be more dispersed.

We believe that the Federal Reserve will begin cutting the Fed Funds rate by June 2024. It will also suspend the Quantitative Tightening Program by midyear. Interest rate policy will be an important driver of stock prices this year in addition to positive earnings growth. There are also many encouraging signs about the economy including strong job growth and wage growth, declining inflation, and robust GDP growth, along with the expected decline in both short and long-term interest rates. These factors should allow us to avoid a recession.

Further, a good economy with lower interest rates should help fuel small capitalization stocks. The earnings projections for larger companies that comprise the S&P 500 Index are expected to be good and are indicative of healthy companies and give us further evidence of no recession coming in 2024. The S&P 500 Index's P/E ratio suggests the market is a little higher than "fair value" but the Fed Model portrays a market that is under-valued at this time.

We are optimistic for the year 2024. As such, we are here to listen, counsel, and provide direction to all of our clients.

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