Markets in Review:
A Recap of 2023 Performance

1. Understanding the Economic Weather

The US economy performed better than expected in 2023, to say the least. What started the year as the market's expectations of an inevitable recession in the United States, ended the year as nearly full acceptance of a 'soft landing' of the economy or another delay of recession clouds into 2024. With that said, let's look at what occurred in the 'sky':

- Although the overall pace of job growth slowed compared to 2022, the US economy averaged monthly job gains of over 250k in 2023, and the unemployment rate moved up only marginally to 3.7 percent from the 3.5 percent recorded in December 2022. Wage growth was also inspiring, improving 4.3 percent year-over-year.
- A downward trend in inflation was firmly established in 2023. Year-over-year readings of the Consumer Price Index (CPI) showed that inflation fell to 3.4 percent in December from 6.5 percent a year ago, with a drop in oil prices leading the decline. The Core CPI (which strips out volatile components such as food and energy) also declined in 2023 but fell less sharply to 3.9 percent from 5.7 percent a year earlier as the price of services (primarily shelter and transportation) increased by 5.3 percent. In line with slowing price growth, the US Federal Reserve has held interest rates steady at 5.25 – 5.50 percent since July and it appears unlikely that rates will move higher in the absence of rising inflation.
- The manufacturing sector looked dull throughout the year. Economic activity recorded by the Institute for Supply Management's Purchasing Managers Index (PMI) showed that the sector contracted in December for the 14th consecutive month, highlighting one of the few weak spots in the economy as demand within this sector remains soft.
- The housing sector struggled in 2023 as mortgage rates soared above 7 percent and inventory remained low. Preliminary estimates show that sales of existing homes fell by over 18 percent in 2023 as homeowners locked into low interest rates were reluctant to sell their homes and assume higher mortgage payments.

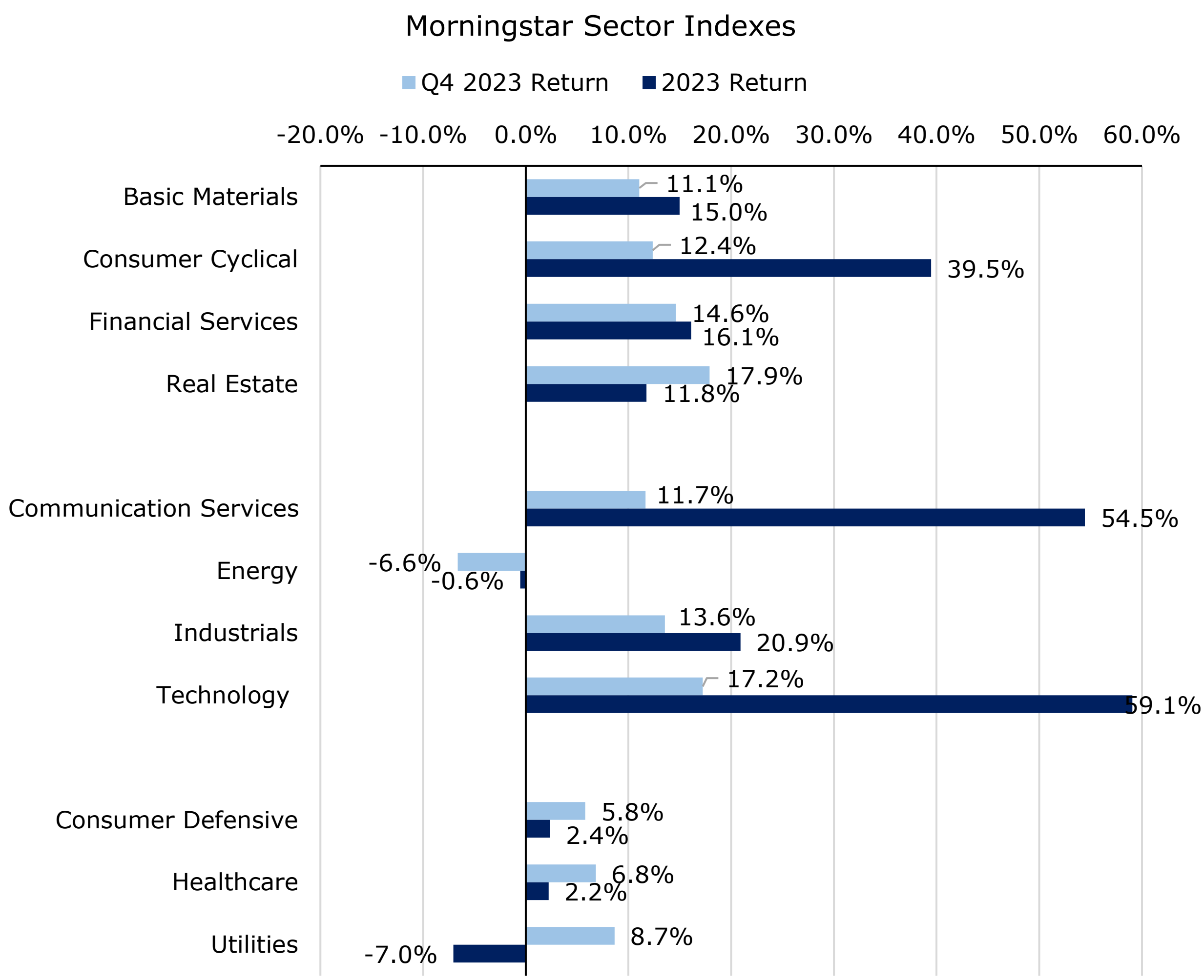
What does all this mean? We can summarize the data above with three key takeaways:

1. Weakness in a few areas of the economy does not always translate to a recession. The job market cooled but remained virtually unharmed.
2. Inflation has decelerated enough for interest rates hikes to end for now. In 2022, the US Federal Reserve increased interest rates by a whopping 4.25 percentage points, compared to only 0.75 percentage points in 2023; there have been no interest rate increases by the Fed since July 2023.
3. On the fiscal side, the US Government maintained economically supportive policies. Although the US Federal Reserve enacted a more restrictive monetary policy aimed at cooling the economy, these policy changes can take months or even years to fully take effect.

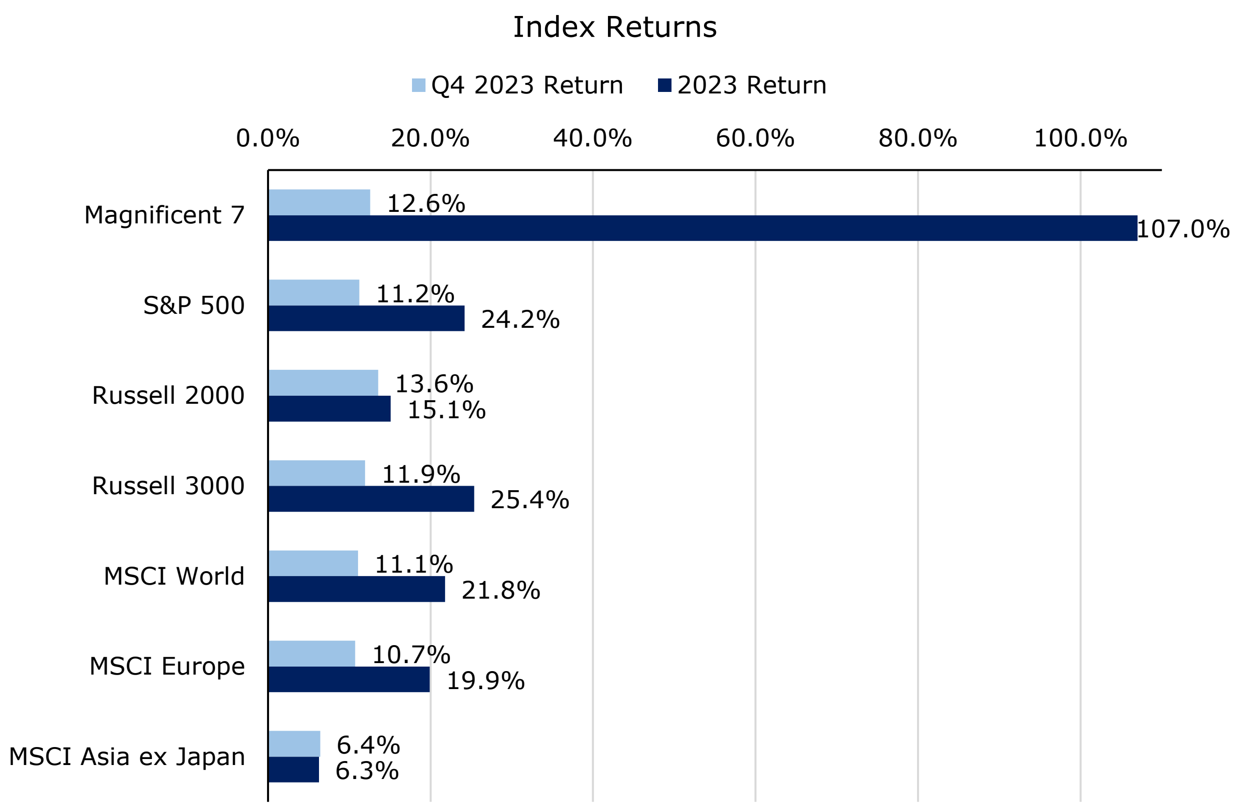
These takeaways provide important context for market returns in 2023.

2. Equities – A Closer Look Under the Hood

With the 'economic weather' not being as gloomy as predicted, the corresponding outcome for businesses was corporate earnings that surprised to the upside. However, most of the US equity market's returns were attributable to the same sectors that dragged the market lower in 2022: Technology and Communication services. These sectors are highly sensitive to interest rate movements, and coupling a slowdown in rate hikes with promising developments in artificial intelligence delivered the perfect fuel for these stock prices to soar throughout the year. While these sectors performed well through 2023, most of the other sectors in the US lagged in comparison for most of the year. In fact, most or all gains for the remaining sectors occurred in Q4 2023:



At the index level, the story is similar. The Information Technology sector makes up nearly 30 percent of the S&P 500 and about 24 percent of the MSCI World Index, so the high-flying tech sector did most of the heavy lifting in 2023. Perhaps more significant than the sector performance, however, was the grandiose performance of the 'Magnificent 7.' The Magnificent 7 is a collective of seven of the largest companies in the S&P 500 (Microsoft, Amazon, Meta, Apple, Nvidia, Alphabet, and Tesla), and together these cutting-edge, technology-based companies constitute nearly 30 percent of the S&P 500 Index and 19 percent of the MSCI World Index by market capitalization. These large-cap growth stocks have performed exceptionally well over the years, and an equal-weighted index comprised only of the Magnificent 7 returned a massive 107 percent in 2023. In other words, seven stocks accounted for nearly all the stock market's gain in the first half of the year and about half of the stock market's full year return. Therefore, last year's returns can mostly be credited to the technology sector and a sensational Q4 that involved a much more inclusive market rally.

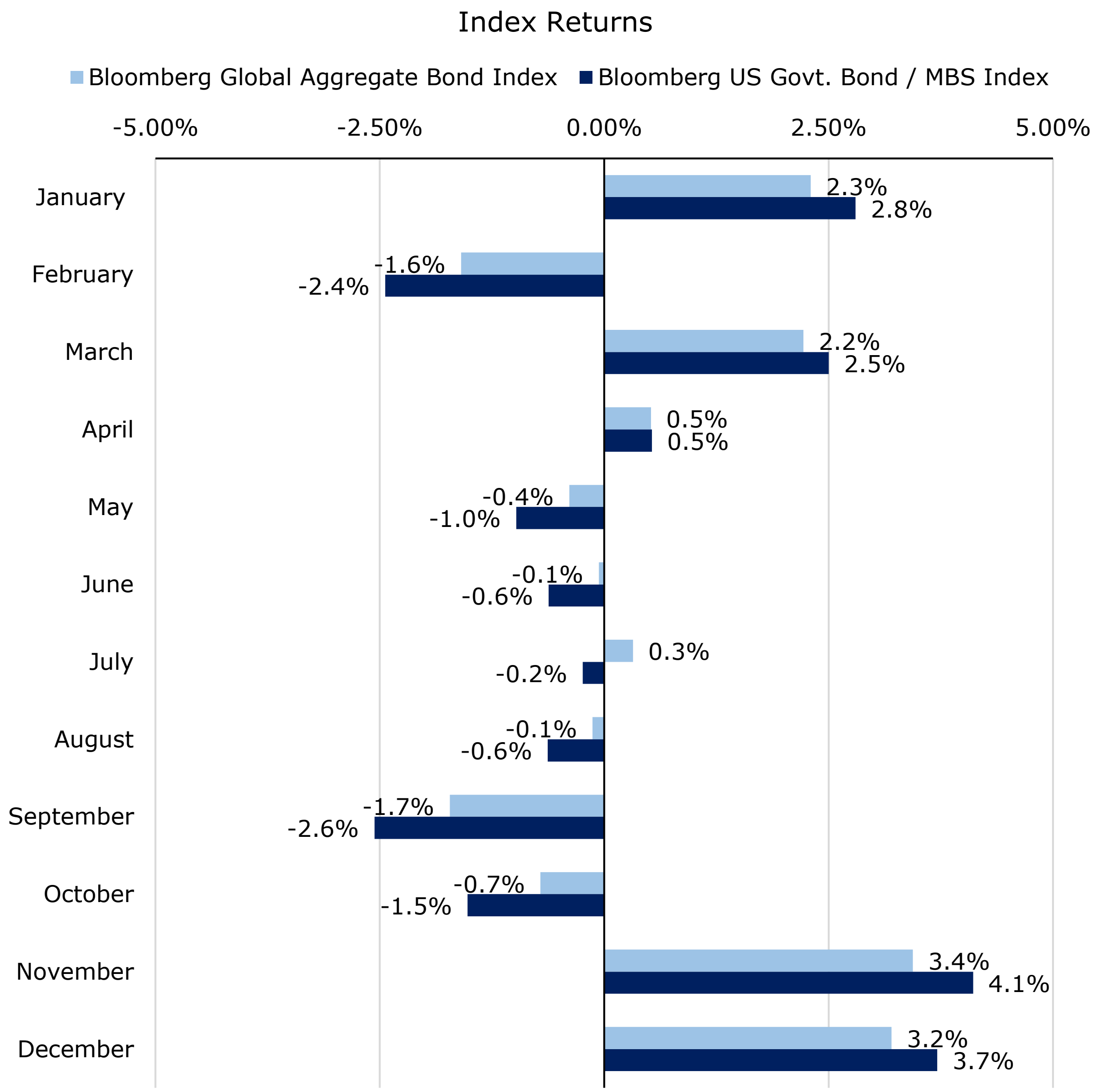


Prior to Q4, markets experienced a downturn during Q3 that spooked most investors, but this volatility turned out to be more of a necessary correction than the beginning of a new bear market. Moreover, what the late-year rally across indexes suggests is that the broader market did not gain confidence to fly higher until interest rate expectations were lowered toward the end of the year and recession concerns dwindled, despite the economic weather being sunnier than anticipated.

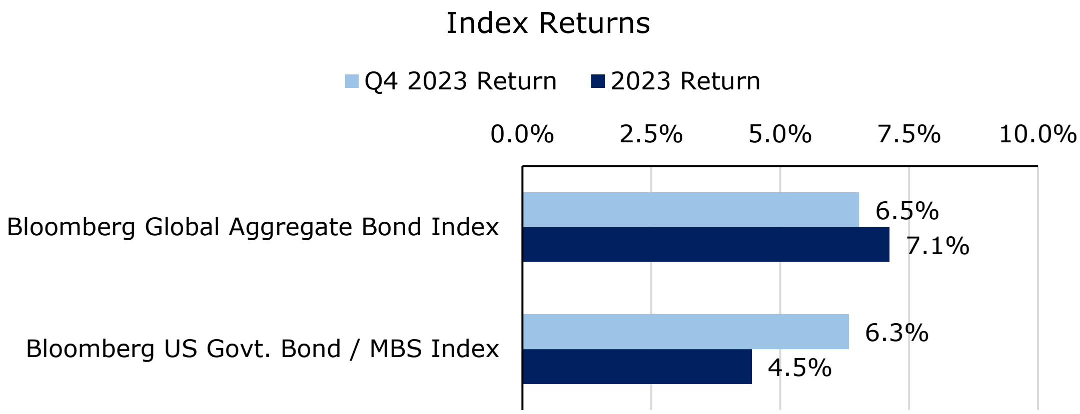
Notwithstanding the impressive index performances, the concentrated equity market returns meant that many fund managers focused on value-driven, active management struggled to keep up with their benchmarks as they tend to prioritize 'growth at a reasonable price', which unfortunately excludes comparable positions in many technology companies and growth stocks with relatively higher valuations.

3. Bonds – Turbulence before Tranquility

As for the bond market, 2023 was more turbulent than most would have anticipated. Rising interest rates, inflation holding real interest rates captive in negative territory, and a surprisingly good economy meant that investors did not fully commit to the safety of the bond market right away. Despite the US Federal Reserve holding interest rates steady in June, the federal government's increased borrowing in Q3 contributed to a diminished demand for bonds. The yield on the US Treasury 10-year note shot upward in August, peaking around 5 percent in October before a sharp drop to 3.8 percent where it began the year. As a result, most of the monthly returns in 2023 were relatively unattractive until then.



However, tranquility landed in November and December when virtually all the year's gains were achieved as investors began to accept that interest rates may have peaked once the US Federal Reserve communicated the possibility of rate cuts in 2024. As a result, the bond markets finished the year with appealing gains following two consecutive calendar years of negative returns.



Going forward, higher interest rates have set the stage for attractive long-term returns for fixed income.

Closing Notes

In summary, we can leave 2023 with a few conclusions about the markets that are not new, but nevertheless important to remember:

1. Markets spend more time going up than they do going down. Zooming out to view the long-term can offer valuable perspective in performance expectations. Remember that pensions are long term vehicles by nature, so your investment decisions and asset allocation should be driven by your time horizon and risk tolerance, not by what occurs in the market over the short term.

2. Although downturns may turn out to be good buying opportunities, timing the market is exceptionally difficult. Rather than choosing when to buy and sell within the market, maintaining consistent monthly contributions into your portfolio allows investors to dollar cost average and mitigate the impact of short-term volatility. Over the long term, this strategy proves suitable for most people.

3. The potential for more attractive bond returns suggests that blended portfolios are positioned for a more balanced return profile over the long term. Over the past decade, low interest rates meant that expected bond returns were comparatively less attractive than equities. Now that interest rates are much higher and expected to remain that way for some time, bonds can now play a vital role in a balanced portfolio by reducing volatility and delivering a greater portion of total return.

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