Threading the Needle

"I try to get rid of people who always confidently answer questions about which they don't have any real knowledge."
—Charlie Munger

One of my flaws is that I do not suffer fools lightly. The above quote by the renowned Charlie Munger sums up my feelings about the world. Many of you will recognize the name, but for those less familiar, Charlie was Warren Buffett's integral partner at Berkshire Hathaway for many decades. He was the impetus for Buffett's transition from buying cheap stocks to buying quality, and recently passed away at the ripe old age of 99.

False knowledge can be fatal. If you don't know the answer, say "I don't know." Even better, say "I don't know, *but I will find out*." What happens next in the markets, in the economy, or in the world? I don't know, but I will find out. Please enjoy this quarter's letter.

What a Year

Coming into 2023, we believed the US equity market would recover from its pullback in 2022. We charted a course for the S&P 500 to be slightly up for the year, but the market's performance substantially exceeded our expectations. Artificial intelligence drove the difference. Several Bernstein portfolios owned big winners in the cycle—partly benefiting from the AI halo and partly having flagged them as possible rebounders from the prior year. If you equal-weight these AI outperformers with other index constituents, the market finished the year up 11%, in line with our expectations laid out in our quarterly deck 12 months ago.

Yet perhaps most notable in 2023 was the market's tendency to shrug off crisis after potential crisis. It trembled slightly at the regional bank stress in the spring, absorbed another percentage point increase in the Fed Funds rate, and flirted with the chance of a US recession all year long. Still, the market moved higher. And while the horrific terrorist attack on Israel and the ensuing conflict in the Middle East are an enormous human tragedy, the market barely blinked at them.

Not only was the market resilient, but so was the economy. Having kicked off the year with recession alarm bells ringing across Wall Street, investors expected the worst. Corporate earnings ultimately grappled with their own recession, but economic growth surpassed expectations, even as inflation eased. Indeed, the calls for transitory inflation preceding Russia's invasion of Ukraine are looking increasingly justified, along with those for a soft landing. What prevailing conventional wisdom will be turned on its head a year from now?

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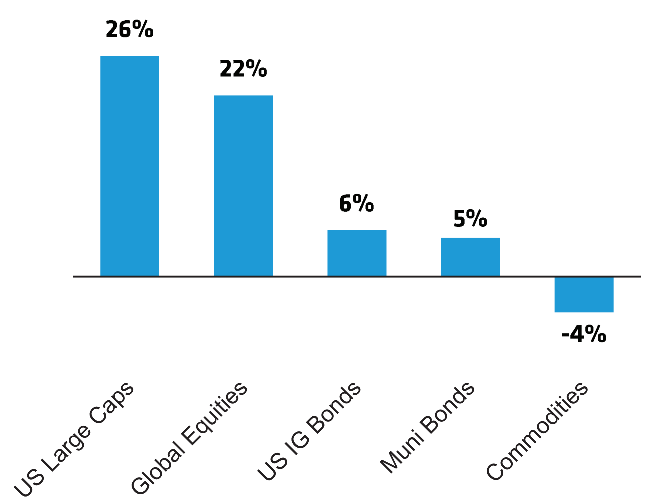
A Positive Year for Assets

Despite several ups and downs—and narrow leadership from the "Magnificent 7"—the S&P 500 finished the year up 26% including dividends.[1] Global stocks weren't far behind, with a total return of 22%.

Some of the markets' toughest turbulence came in bonds. As the 10-year Treasury ran all the way to 5%, it briefly appeared that 2023 would repeat 2022's bond winter. But November proved the turning point, with rates consistently falling over the past two months. Along the way, municipal bonds generated a 4.6% return while high-quality taxable bonds delivered 5.5%.

YEAR-TO-DATE RETURNS OF MAJOR ASSET CLASSES

Percent



As of December 31, 2023. Past performance does not guarantee future results.
Source: Bloomberg and Bernstein analysis

The Year in Review

Two stories mattered more for the markets than any other this year. First, the rise of AI boosted several of the largest companies, generating outsized returns for their shareholders and the market overall. Second, the US economy proved remarkably resilient, driven by the persistent strength of the US consumer.

I commented on AI's market impact in my second quarter letter and our team explored its broader ramifications in this blog, so I won't dwell on it here. Suffice it to say we believe AI will have a significant economic impact over the coming decades and the spoils will be distributed quite unevenly. Separating the winners from the losers will occupy major investor mindshare in the coming years.

When it comes to the other story, the US consumer has remained exceptionally strong in 2023, with the labor market holding up well and the aggregate paycheck growing steadily even after inflation. What's more, as inflation has eased, real wage growth has returned to the positive levels more commonly seen in past economic expansions. That consumer strength has been dutifully channeled back into spending, supporting corporate sales and profits throughout the year.

Yet cracks are beginning to show. According to a study from the Federal Reserve, lower income segments have spent down their excess savings from the pandemic. Credit card and auto loan delinquencies are picking up from all-time lows and are now approaching or above their pre-pandemic expansion levels. Plus, we're hearing retail corporate management teams discuss trading down. Where they can, consumers are downshifting in price and quality while holding off on large-scale purchases like appliances. The lone anomaly appears to be travel and experiences, where spending remains strong. Yet overall, consumers are materially pulling back.

Cracks are forming in the labor market, too. At first glance, the labor market appears robust; total payrolls are not only growing but doing so at a rate above the level of workers entering the economy. But beneath the surface, both initial and continuing jobless claims have come in higher throughout most of 2023 compared to 2022—a classic late-cycle indicator. What remains to be seen is whether claims rise further in 2024, creating a headwind for net hiring rates, or if they merely level off.

Debts, Deficits, and the Distant Doom Loop

The massive surges and dips in Treasury yields have been a key feature of 2023, one which we think carries a warning for 2024 as well as the years and decades ahead.

From June until mid-October, the 10-year Treasury yield rose by around 120 bps, from 3.8% to 5.0%. What's more, the run from 4.1% to 5% occurred in a mere month and a half. That's an enormous move in such a short period of time and two elements of it strike us in particular. First, you can deconstruct the Treasury yield into two

1 The "Magnificent Seven" includes Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla.

parts. One reflects the expected future path of interest rates, while the second—called the "term premium"—denotes the compensation investors demand for macroeconomic uncertainty. The move this fall was almost entirely driven by the term premium. And it's probably no coincidence that it unfolded as the dysfunction in the House of Representatives reached a crescendo.

Currently, the major macroeconomic risk unsettling investors is the uncertainty around inflation. The Fed's quantitative tightening has prevented them from being Treasury buyers, and Fed assets have fallen from almost 9 trillion dollars to 7.8 trillion in the past year and a half. With other price-insensitive buyers stepping back, federal budget deficits lined up for decades forward, and uninspiring events in Congress, it's no surprise that the market has doubts about the risks in longer-dated Treasuries.

As we look ahead to the 2024 election and the potential impact on the federal deficit and the national debt, we don't see much daylight between the most likely candidates. Whether via higher spending or lower taxes, neither party seems inclined to tackle the path of the national debt. That's not a present danger, but it is a clear one, and it will be something that we will come back to in future letters as we watch what, if any, progress is made.

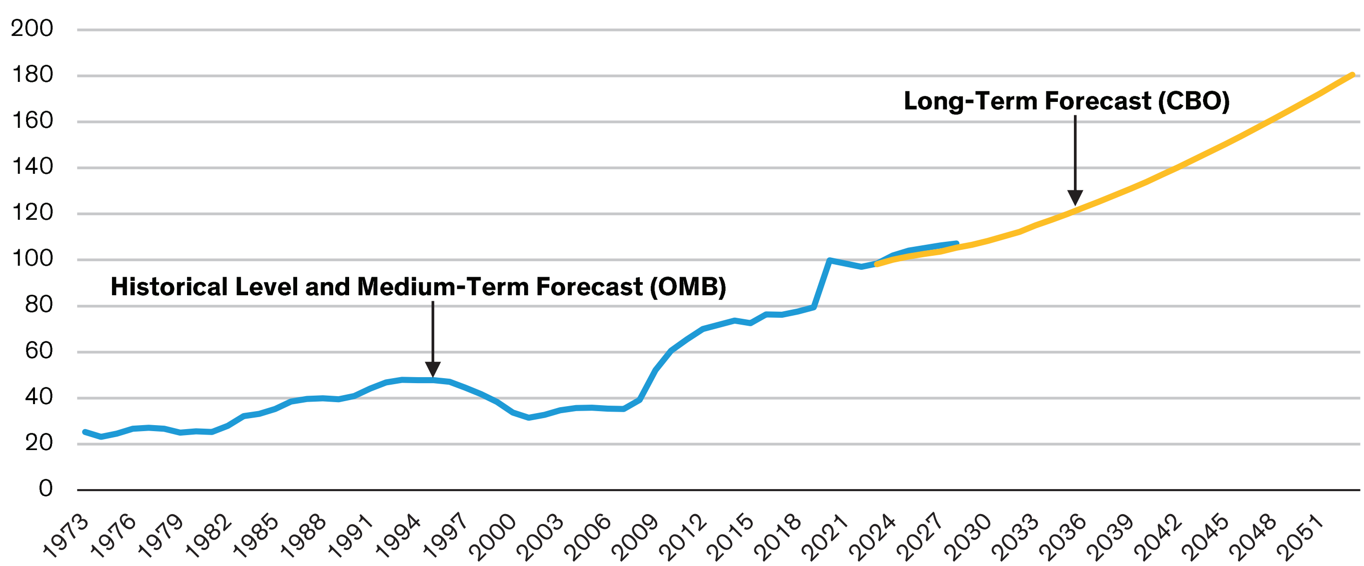
Looking Ahead

While the economy has been more resilient than we expected, we still foresee it slowing in 2024 as pressure ramps up on the consumer and profit margins are squeezed amid weaker sales growth. That said, there's still a healthy chance that we avoid recession during the year.

What does that mean for portfolios? Being generous, we could say our call to shift cash from the sidelines was early, though both municipal bonds and stocks ended up outperforming money market funds over the year. That said, the October blowoff in rates cleared several hurdles and the Fed signaled in December that they believe they're done hiking for the cycle. The path now looks clearer for cash-heavy investors to move into high-quality intermediate duration bonds, which can churn out income in a steady environment and boost portfolios if the economy weakens and rates fall.

For those with a higher risk tolerance, we see attractive reward potential stepping into the void left by banks in the face of higher capital constraints. These opportunities exist across multiple areas of the private markets. Private credit stands out in particular, from lending against commercial real estate and making middle market direct loans to offering customized financing solutions or opportunistically buying existing privately traded debt.

FEDERAL DEBT HELD BY THE PUBLIC AS PERCENT OF GDP



As of December 31, 2023.
Source: Bloomberg and Bernstein analysis

Other private markets, including private equity, will also benefit from the bank disruption radiating outward. Your advisor can help you determine whether leaning into private markets makes sense for you, as there are liquidity trade-offs involved. In fact, a large part of the opportunity set available in private equity today stems from some investors misjudging their liquidity needs. Bernstein is capitalizing on multiple ways to win here.

When it comes to public markets, the picture for stocks is less inspiring. After this year's run, public equities could face more challenges in 2024—especially in a slowing economy. But they still play a role in long-term allocations and, barring a recession, could surprise to the upside. Within stocks, we prefer quality companies in this economic environment, particularly in the healthcare sector. Also, while we have a generally constructive view on the US, especially over the long run, we also see opportunities for investors in international markets, notably Latin America and Europe.

We're not sure what surprises 2024 will bring, but we will find out. And we'll be responsible stewards of your capital whatever comes next.

Happy New Year,

Alex Chaloff
Chief Investment Officer

Alex Chaloff is the Chief Investment Officer and Head of Investment and Wealth Strategies at Bernstein. In this role, he leads a national team of strategists across investments and wealth planning—including asset allocation advice, investment platform oversight, model portfolio construction, new product development, manager research, tax planning and solutions, and estate planning research—while remaining continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Alex has spent his Bernstein career refining our investment platform, listening to clients, and conducting deep research into investment and wealth planning topics that are critical to achieving clients' goals.

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