



# Capital Markets Review

Q4 2023

## The Advantage of Building Returns from Higher Starting Points

The post-pandemic economic recovery has produced a unique set of circumstances defying many historic models that analysts, economists and market practitioners have utilized as guiding principles. The past year featured several harbingers of recession such as a mini banking crisis, an inverted yield curve, and restrictive monetary policy. To date, these factors have not led to severe market declines. However, the risks are again rising. The economy is now showing increasing signs of weakness as the full weight of the Fed's interest rate hikes comes into view and valuation risks have returned to levels not seen since right before 2022's steep price declines.

Navigating such a challenging environment requires a disciplined approach focused on capturing consistent profits and avoiding large losses. To us this means not riding with financial markets, but selectively investing in assets that offer compelling returns over the next 18-24 months with high margins of safety. Equally important is to avoid assets with unacceptable risks that can lead to debilitating losses. By doing this, we believe we can consistently compound returns, which is key to building and maintaining wealth.

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**The first rule of compounding: Never interrupt it unnecessarily.**

*Charlie Munger*

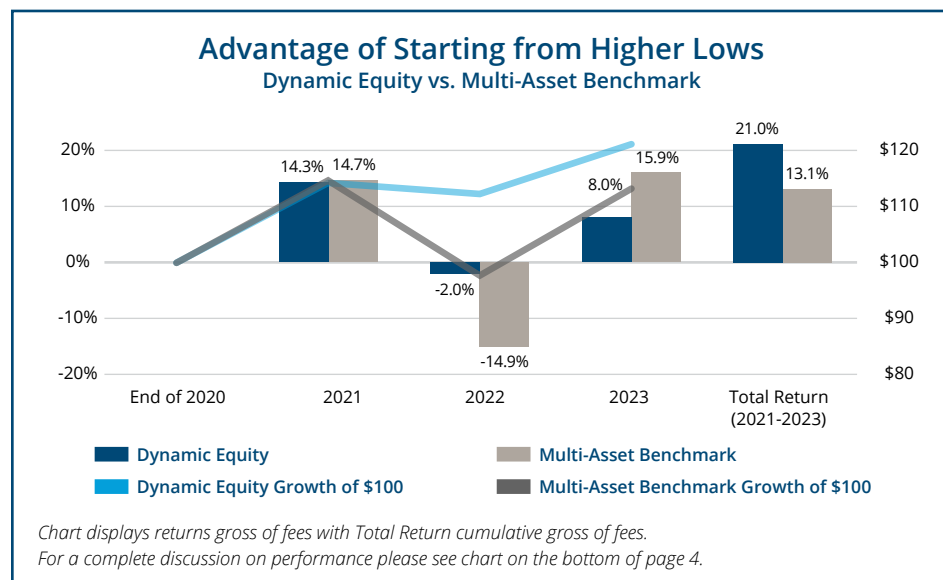
An important aspect of our approach is to avoid significant losses so we can build your next return from a more advantageous starting point. Not only does the portfolio recover faster, but it allows us to avoid chasing risky assets in difficult environments and help meet your objectives. This is because even if performance lags during sharp upward moves in markets, the advantage of starting from higher lows can still create better overall results. Chart 1 illustrates the point using the results of our Dynamic Equity Portfolio.

## Year-End Market Rally Seems Premature

Turning to the financial markets, both the equity and bond markets speculatively rallied into close of the year on better inflation data and the Federal Reserve's statement that further interest rate increases may not be necessary in its fight against inflation. In its commentary, the Fed signaled that real rates (Fed Funds Rate minus inflation) had tightened enough throughout the fall to justify up to three rate cuts totaling 0.75% for the upcoming year.

Many heralded this as a seismic shift in monetary policy and interpreted it as a green light to jump head-long into risk investments. In support of this view, the interest rate market moved to levels indicating it

Chart 1



expected six cuts instead of the prescribed three and market prices rallied. It is our belief that markets were getting ahead of themselves and while inflation is improving, the war has not been won. We do not believe there will be a change in monetary policy until it is well behind us.

Instead, we view the Fed's announcement as no more than a tweaking of its "higher for longer" interest rate stance. The concern was that monetary policy may have become too tight and needed to loosen to avoid a damaging recession. Mary Daly, President of the San Francisco Federal Reserve Bank put the Fed's announcement in perspective when she stated that even with a 75 basis-point reduction in the benchmark rate in 2024, monetary policy will still be "quite restrictive".

In market speak, she seemed to be saying that it will be a tough environment to meaningfully grow earnings that justify today's higher prices. In fact, monetary policy is currently at the most restrictive level we have witnessed since 2007, as can be seen in Chart 2. To us, this is a big reason why the Fed will be easing back on rates.

## The Folly of Rosy Forecasts and Prognostications

It is common for the financial markets to wrongly forecast the direction and movement of interest rates. So, we seek to place them in the proper context. Here are two recent examples where the markets got it wrong: Entering 2023, the interest rate market implied a touch more than 2 rate hikes in the first half of the year followed by an equal number of

cuts in the back half. Instead, the Fed raised rates by the equivalent of 4 hikes and has held rates at the current 'higher for longer' level of 5.25% - 5.50% since July.

One year earlier, at the end of 2021 interest rates were still near zero and the Fed had not yet started its hiking cycle. Expectations were calling for an interest rate increase of 0.75% during calendar year 2022. Instead, the Fed followed through with rate hikes of 4.25% for the year leading to significant declines in both the equity and fixed-income markets.

## Valuations and Portfolio Positioning

With a few exceptions (energy and quality) the recent rally in equity prices raised valuations to increasingly unattractive levels. Our work suggests that the price-to-earnings ratio (P/E) for the S&P 500 ended 2023 at about 23 times next year's earnings. As illustrated in Chart 3, this is a level that in the past has meant subsequent ten-year returns that are generally flat to negative. This does not mean that there will not be opportunities to invest in the general market on weakness, it simply means that we may need to patiently wait for the markets to provide an attractive entry point.

With that said, a tenet in our investment process is the understanding that while you can't

Chart 2

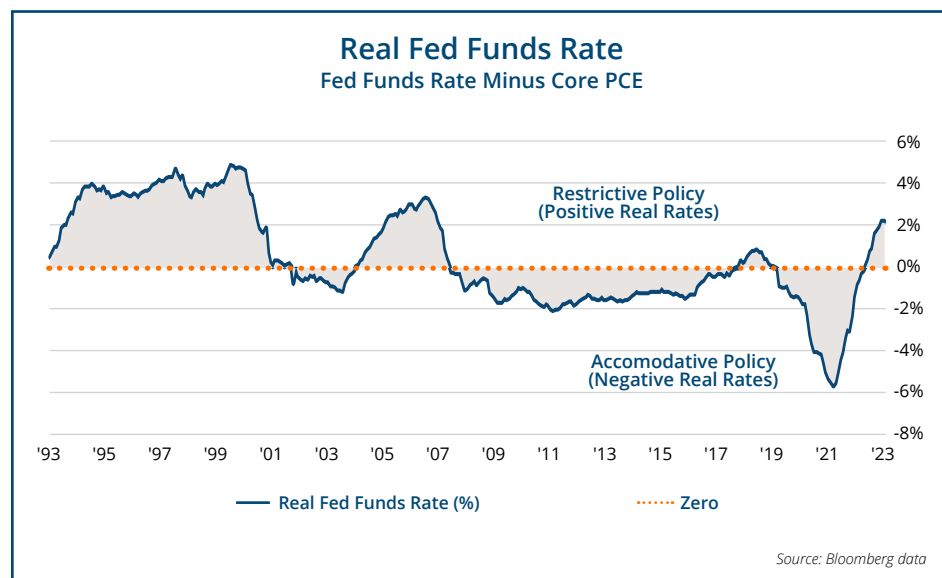
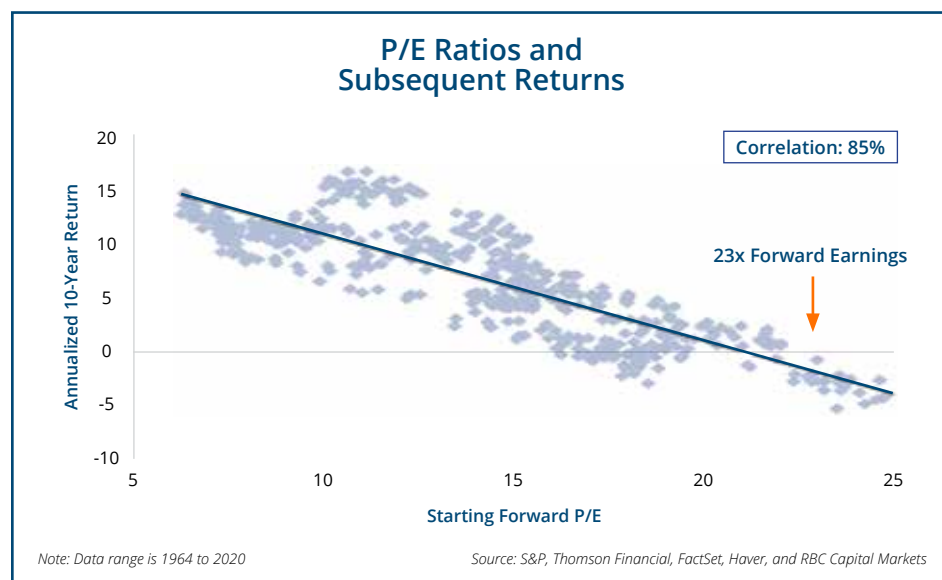


Chart 3



choose the environment in which you invest, you can choose how to invest in every circumstance. The Fed's move to higher interest rates has now made credit investments very attractive and we are positioning portfolios accordingly.

We continue to find value in short-term treasuries, which offer returns above 5%/year. More recently, we have been taking positions in structured credit which offer higher yields than

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treasuries with the potential for capital appreciation. In fact, at current price levels, we believe structured credit offers the potential for equity-like returns with much lower risk. This proved to be the case in November and December when their prices rallied from strongly discounted levels.

## Summary and Outlook

We continue to believe that asset prices will be volatile for the foreseeable future and our dynamic approach to asset allocation will be favored in this environment. As the economy and markets evolve, we continue to search for attractive entry points to add to risk assets. If history is an indicator, new opportunities should emerge as the full effects of monetary policy flow through the economy.

As always, we are grateful for the privilege of allowing us to guide your assets forward. Should you have any questions or observations, please don't hesitate to contact us.

### Dynamic Equity Performance - Trailing Periods Ended 12/31/2023

| Trailing Period             | DE Composite (Gross) <sup>1,2</sup> | DE Composite (Net) <sup>1,2</sup> | DE Multi-Asset Neutral 70/30 <sup>3</sup> |
|-----------------------------|-------------------------------------|-----------------------------------|-------------------------------------------|
| 1 Year                      | 8.00%                               | 7.25%                             | 15.94%                                    |
| 1 Year Standard Deviation   | 5.79%                               |                                   | 12.74%                                    |
| 3 Years Annualized          | 6.56%                               | 5.81%                             | 4.20%                                     |
| 3 Years Standard Deviation  | 8.24%                               |                                   | 13.01%                                    |
| 5 Years Annualized          | 7.39%                               | 6.61%                             | 9.12%                                     |
| 5 Years Standard Deviation  | 9.12%                               |                                   | 13.84%                                    |
| 10 Years Annualized         | 6.74%                               | 5.93%                             | 6.61%                                     |
| 10 Years Standard Deviation | 9.12%                               |                                   | 11.18%                                    |

<sup>1</sup> Dynamic Equity is benchmark free and has an objective of exceeding inflation by 4%-6%/year over a complete market cycle. The portfolio involves risk and there is no guarantee that it will accomplish its objectives.

See the Portfolio's Statement of Characteristics contained in its Statement of Investment Policy for more information about its investment objectives, investment policies and asset allocation guidelines.

<sup>2</sup> Performance is presented both gross and net of Hamilton Capital advisory fees. All returns are net of external manager's fees and expenses, and account custodian fees and expenses. The results include the reinvestment of capital gains, dividends, and income. Past performance is not indicative of future results; all investments involve risk including loss of principal.

<sup>3</sup> Dynamic Equity Multi-Asset Neutral (70/30) is an expression of the Portfolio's typical risk characteristics and how it may be constructed to accomplish its objectives over time. While it is not a benchmark, it may serve as an additional market reference when evaluating returns. It is a customized blend of market returns comprised of 45% Morningstar Large Cap Blend Category, 7.5% Morningstar Mid-Cap Blend Category, 5% Morningstar Small Cap Blend Category, 4.5% Morningstar Diversified Emerging Markets Category, 8% Morningstar Foreign Large Blend category, 23% Morningstar Intermediate-Term Bond Category, 5% Morningstar High Yield Bond category, and 2% Morningstar Taxable Money Market Fund Category. An investor cannot invest directly in an index.

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