CAPSTONE
WEALTH ADVISORS

Outlook on the Markets

Mid-Year Winter-Spring 2024 Issue

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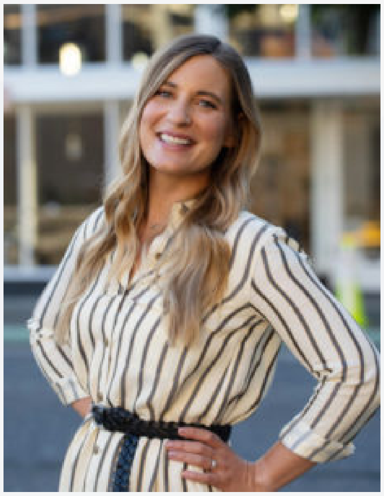


Capstone Wealth Advisors is pleased to release our Mid-Year Outlook on the Markets written entirely by our advisory team. Our outlook is based on our views and philosophies as we see them impacting financial markets, and your money. Current trends, economic indicators and in-depth analysis is at the core of what we do. We monitor and analyze economic trends to help our clients have a clear understanding of the direction the economy is headed and how that impacts your portfolio strategies.

We have six offices throughout the Pacific Northwest, utilizing a team approach to provide continuity for your asset planning needs. Our investment committee meets weekly to discuss current economic events, market trends, asset allocations and more. By using a disciplined and methodical approach to investing, we remove the noise and emotion from your investment portfolio and allow you to focus on the things you love and enjoy most.

Under the weight of elevated inflation and high interest rates, the world's major economies are diverging. Surprising resilience in the United States, Japan and India is helping to boost the global economic outlook for 2024, while ongoing signs of weakness in Europe and China are tempering expectations for the new year.

At the beginning of 2023, more than 85% of economists expected a U.S. recession before year's end[1]. They had good reason: The yield curve, usually a strong indicator of recession, inverted in July 2022, when rates for two-year Treasury bonds surpassed those for 10-year bonds. Meanwhile, Google searches for the term "recession" hit the highest mark in history.

However, as we enter 2024, that recession has yet to materialize, and many of those same economists now expect a "soft landing" – meaning a very mild recession or even the possibility that we avoid one altogether. With the U.S. economy expanding at a rate of 3.3% in Q4 of 2023[2], unemployment remaining under 4%[3] and the Consumer Price Index down to 3.4%[4], preliminary results indicate the Federal Reserve may have succeeded in "threading the needle" by reducing inflation through rapid interest rate hikes while avoiding a recession. However, it is premature to assume the economy will be unscathed, one simply needs to look at the Federal Reserve's website where the recession probability indicator forecasts a 70.85% probability of recession by May 2024.[5], the second highest probability on record going all the way back to 1959.

If the recession expectations over the past year come with any lesson, it is that the economy and markets can be incredibly resilient and seemingly irrational at times.

If the Fed succeeds in orchestrating a soft landing for the US economy, it would be useful to look at the ISM Manufacturing PMI, or Purchasing Managers Index, a measure of industrial activity that has dropped in concert with every recession over the last three decades. A number below 50 means a contraction of manufacturing activity, while a number above 50 represents an expansion. The current PMI (as of December 2023) was 47.4%, with a low of 46.0% occurring in June 2023. The last time it hit lows in the 45% – 50% range without triggering a recession was in June of 1995[6].

Elections:

2024 will be a pivotal election year, not only in the United States but in several other countries as well, including India, Russia, South Africa, the U.K. and Taiwan. Globally, it could be one of the most impactful election years in history.

The U.S. presidential election will take center stage. Investors may be feeling anxious about how markets will react to a potentially volatile campaign season and the possibility of a close vote, not unlike the 2020 election.

Although markets can be tumultuous in election years, according to Forbes, the average return during any presidential election year is 11.3%, regardless of who won. However, for long-term investors the political party that wins the White House can be more impactful in the long run. Historically, the market averages 15.2% for Republicans and 8.1% for Democrats[7] in election years.

Facts to Consider

- **The S&P/Case-Shiller Home Price Index,** widely recognized as the gauge for home price movements, reported that national home prices have gradually been increasing since 2012, however, it peaked in June 2022 and began to decline. In June 2023 it reached its previous record high and has been slowly increasing since. The index currently sits at 312.95 as of October 2023.[8]

- **The Consumer Confidence Index®** rose in January to 114.8 (1985=100), up from a revised 108.0 in December. The reading was the highest since December 2021, and marked the third straight monthly increase. The Present Situation Index—based on consumers' assessment of current business and labor market conditions—surged to 161.3 (1985=100) from 147.2 last month. The Expectations Index—based on consumers' short-term outlook for income, business, and labor market conditions—improved to 83.8 (1985=100) in January, up from a revised reading of 81.9 in December. "January's increase in consumer confidence likely reflected slower inflation, anticipation of lower interest rates ahead, and generally favorable employment conditions as companies continue to hoard labor," said Dana Peterson, Chief Economist at The Conference Board.[9]

- **The Purchasing Managers Index (PMI)®** registered 47.4% in December, up 0.7 percentage point from the 46.7% recorded in November. The overall economy continued in contraction for a third month after one month of weak expansion preceded by nine months of contraction and a 30-month period of expansion before that. The New Orders Index remained in contraction territory at 47.1%, 1.2 percentage points lower than the figure of 48.3% recorded in November.[10]

- **The National Federation of Independent Business** reported the percentage of small business owners reporting labor quality as their top problem remains elevated at 20%, according to NFIB's monthly jobs report. Labor costs were reported as the single most important problem for business owners, increasing one point to 9%, four points below the highest reading of 13% reached in December 2021. "The tight labor market has been a consistent concern for small business owners throughout 2023," said NFIB Chief Economist Bill Dunkelberg. "The level of job openings suggests a solid labor market will continue on Main Street for 2024, as owners raise compensation to attract qualified workers and consumers spend."[11]

- **The Bureau of Economic Analysis (BEA)** reported personal income increased $60.0 billion (0.3% at a monthly rate) in December. Disposable personal income (DPI), personal income less personal current taxes, increased $51.8 billion (0.3%) and personal consumption expenditures (PCE) increased $133.9 billion (0.7%). The PCE price index increased 0.2%. Excluding food and energy, the PCE price index increased 0.2%. Real DPI increased 0.1% in December and real PCE increased 0.5%; goods increased 1.1% and services increased 0.3%.[12]

- **The Official Unemployment Rate** in the US, known as "U-3", stands at a seasonally adjusted 3.7% in December. A more comprehensive measure of unemployment known as "U-6", increased 0.1% to 7.1% in December marking in increase in the broader measure of unemployment from the December 2022 rate of 6.5%.[13]

- **Real Gross Domestic Product (GDP)** increased at an annual rate of 3.3% in the fourth quarter of 2023. In the third quarter, Real GDP – which is adjusted for inflation – increased 4.9%. The increase in real GDP reflected increases in consumer spending, exports, state and local government spending, nonresidential fixed investment, federal government spending, private inventory investment, and residential fixed investment. Imports, which are a subtraction in the calculation of GDP, increased as well.[14]

- **CBOE Volatility Index (VIX)** continues to remain at levels below its historical average, closing out January 2024 with a reading of 14.35. The Volatility index, commonly referred to as the "fear gauge" for US stocks has seen periods of significant volatility over the past several years reaching 66.04 in March of 2020. However, over the past year, it has been steadily declining since the index's most recent peak in March 2022 at 36.45.[15]

US Equity Markets:

The U.S. stock market is currently top-heavy, with the S&P 500 Index more heavily concentrated than it was at the peak of the dot-com era.

As of December 31, 2023, the five largest companies in the S&P 500 accounted for 23% of the entire index. That compares with a 19% weighting for the five largest companies in the index as of March 2000.

As for market gains, just seven companies — Apple, Meta, Microsoft, NVIDIA, Amazon, Alphabet and Tesla — accounted for a staggering 130% of the index's total return in the first 10 months of 2023. In other words, without the so-called "Magnificent Seven," the S&P 500 would have posted a decline during that period.

Such levels of concentration represent potential risks for investors, particularly those in passive index investments, which seek to replicate a benchmark's return pattern. While tech innovators may very well continue to lead in 2024, investors should consider diversifying their stock holdings.

While investors watched the powerful AI-dominated market rally, valuations for dividend-paying stocks quietly drifted toward multi-decade lows compared to the broader market. With economic growth expected to moderate in 2024, and the potential for recession still lingering, dividends may take a more prominent role in driving total returns for investors.

International Equity Markets:

When comparing major international stock indexes against the US stock market, it shows international equity markets are significantly less concentrated and may provide a broader range of opportunities. As of October 31, 2023, the ten largest companies in the S&P 500 accounted for a 31.2% weighting of the index. In contrast, the ten largest companies in the MSCI EAFE Index, a conglomerate of the major non-U.S. markets, accounted for 15.2% of the total index.

Emerging Equity Markets:

In emerging markets, China's economic troubles have dominated headlines, but opportunities are growing in countries such as India, Indonesia, and Mexico, where infrastructure growth is accelerating, government balance sheets are stronger and supply chain shifts are all boosting those regional economies.

Bonds:

Economic weakening is generally positive for bonds, both from the standpoint of absolute returns and diversification from equities.

"It's been easier for inflation to fall from peak levels last year to near 3% now than it will be to see it come back down to the Fed's 2% target," Chit Purani (Fixed Income Portfolio Manager at American Funds) says. "Given growth has been more resilient than most expected, interest rates are likely to remain 'higher for longer,' and that's been reflected in the market this year."

The higher-for-longer view anticipates that rates, while not necessarily rising much further, may stay at elevated levels for an extended period.

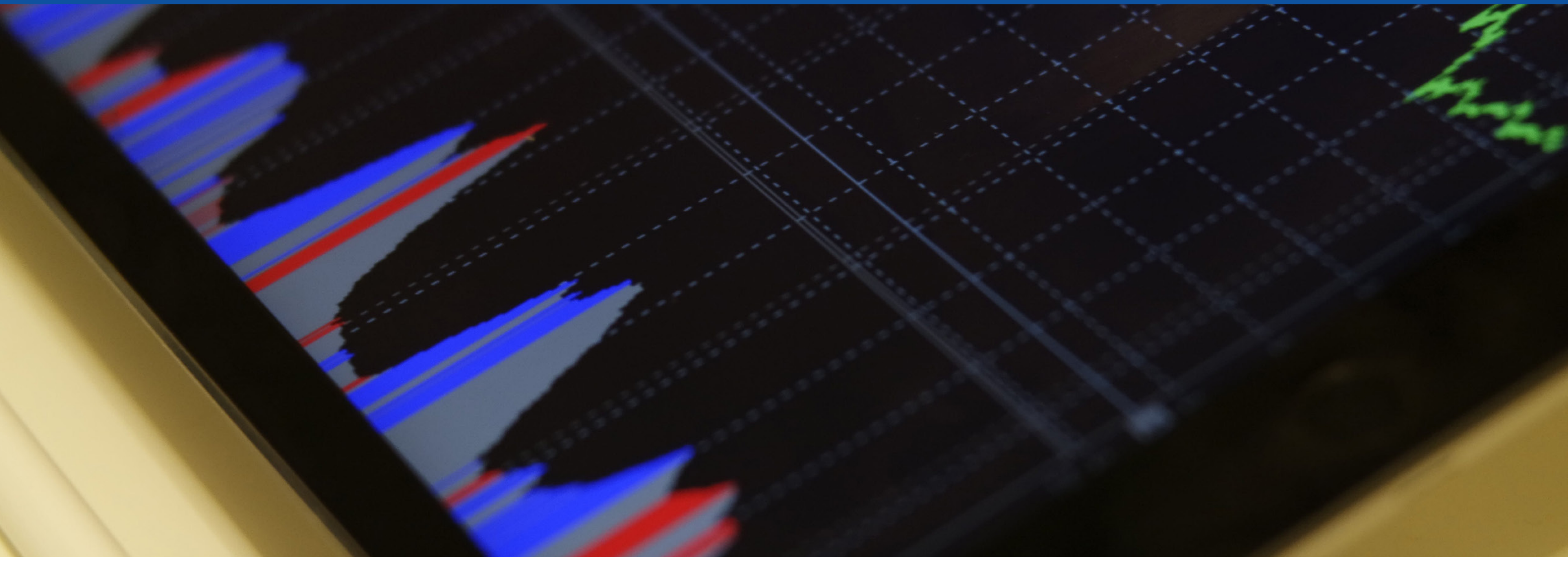
After the end of previous Fed hiking cycles, bonds have typically posted strong returns in the subsequent 12 months from a total return standpoint," Purani explains. "That's historically been a good time to buy into fixed income." Higher starting yields may support an attractive return profile, but bonds have the potential to diversify against equity volatility with even stronger returns if economic growth materially deteriorates.

In the past four cycles, returns on the Bloomberg U.S. Aggregate Bond Index have averaged 10.1% in the 12-month period following the Fed's last hike. Current index yields have also closed the gap with three-month U.S. Treasury bills, which may cause investors to rethink holding cash-like investments in favor of bonds with greater interest rate exposure.

What does this mean to you and your portfolio?

In the equity markets, the U.S. market's concentration in a few large tech companies and the quieter, yet promising, performance of dividend-paying stocks provides a clear message: diversification is crucial. International markets, which are less concentrated and ripe with growth potential, particularly in a select group of emerging economies, offer promising avenues for diversification but do carry a higher degree of risk.

The bond market is becoming increasingly attractive and the expectation of "higher for longer" interest rates makes a compelling case for bonds as a diversification tool and a source of potential favorable risk adjusted returns for more conservative clients, especially in the wake of the Fed's rate hikes.



Conclusion:

As we navigate the complexities of 2024, the economic, political and financial landscape presents a unique blend of challenges and opportunities. This year is pivotal, not just because of the global economic divergence and the significant election year dynamics, but also due to the evolving nature of the U.S. and international equity markets, and the renewed focus on bonds.

Our analysis indicates that while the threat of a recession looms, the resilience of the global economy, particularly in the United States, Japan, and India, offers a counterbalance. The potential for a “soft landing” in the U.S. economy suggests that we may skirt a severe downturn, though vigilance is key given the fluctuating economic indicators.

The election year dynamics of 2024, with critical elections in the U.S. and other major economies, add an additional layer of complexity. However, history teaches us that market fundamentals often have a more lasting impact than the short-term volatility induced by political events. Thus, while keeping an eye on the political landscape, our focus remains steadfast on economic fundamentals.

2024 is a year for strategic navigation and thoughtful investment. At Capstone Wealth Advisors, we are poised to guide our clients through these intricate times. Our approach is anchored in deep market analysis, global economic understanding, and a commitment to your long-term financial success. Together, we will harness the opportunities that this year presents, always with an eye towards safeguarding and growing your investments in this dynamic environment.

To our valued clients, your investment portfolios already reflect our investment philosophy. As market conditions change, we will continue to proactively implement portfolio adjustments as part of our investment process. For those of you who are not currently a client and would like to learn how we can help assist you in your retirement planning and investment management during these challenging times, we invite you to schedule a complimentary consultation with our team. We can discuss our current eco nomic outlook in greater detail and specifically how it might affect your existing portfolio. If you would like to schedule, please call our office directly at (877) 739-6007 or email us at info@capstonewealthadvisors.com.

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