2023 Fourth Quarter Commentary

MARKET RECAP

After a tenuous start to the fourth quarter, markets roared to life with the Fed's announcement of at least three planned rate cuts in 2024. The strong finish left most traditional asset classes with strong returns for 2023. The 2023 performance surprised most market professionals, even the bulls, as many entered 2023 predicting recession. Save for the mini banking crisis in March, the economy remained remarkably robust throughout the year, boasting low unemployment, steady growth and an improving inflation outlook. Neither consumer nor federal spending shows any material signs of moderating. Going into next year, some uncertainties remain, but these are largely overshadowed by positive developments.

The stock market overall had a phenomenal year. Buoyed by Artificial Intelligence (AI) exuberance and the stunning outperformance of the "Magnificent Seven[1]," the S&P 500 delivered a 11.64% return on the quarter and 26% on the year. Bonds[2] began the quarter in the red then quickly reversed course, delivering 6.69% for the quarter and 5.59% for the year. The 10-year U.S. Treasury began the quarter above 5% but fell quickly following the Fed meeting and ended the year at 3.88%.

Alternative assets had somewhat mixed performance. Commodity markets delivered -4.63% for the quarter. Meanwhile, alternative strategies, such as trend following (proxied by the Morningstar U.S. Systematic Trend Group) and multi-alternative funds (proxied by the Morningstar U.S. Multistrategy Peer Group) delivered -5.2% and 1.82% for the quarter, respectively.

FIGURE 1: ASSET CLASS RETURNS

Asset Class Returns	4Q 2023	FY 2023
SPDR® S&P 500 ETF Trust	11.64	26.14
iShares Core US Aggregate Bond ETF	6.69	5.59
Bloomberg Commodity TR USD	-4.63	-7.91
US Fund Systematic Trend	-5.2	-3.83
US Fund Multistrategy	1.82	6.22
Bloomberg US Treasury 3-10 Yr TR USD	5.05	4.27
MSCI EM NR USD	7.86	9.83
Russell 1000 Growth TR USD	14.16	42.68
Russell 1000 Value TR USD	9.5	11.46
Bloomberg US Agg Bond TR USD	6.82	5.53
NASDAQ Composite TR USD	13.79	44.64
Russell 2000 TR USD	14.03	16.93
iShares 20+ Year Treasury Bond ETF	12.9	2.96
ICE BofA US High Yield TR USD	7.06	13.46

Source: Morningstar[3]

ECONOMIC UPDATE

As we closed out the year, economic growth remains robust, with GDP (Gross Domestic Product) increasing at a rate of 4.9% during the third quarter, up from 2.1% in the second quarter.[4] Consumer spending rebounded, contributing 3.6% more to GDP this quarter compared to last quarter. Fiscal spending shows no sign of moderating, with federal spending as a percentage of GDP up 7.7% from the second quarter.[5] Since the Covid years, this figure just seems to keep rising and rising. The federal deficit for fiscal year 2023 now stands at a staggering $1.70 trillion, up $44 billion from the same period last year.[6]

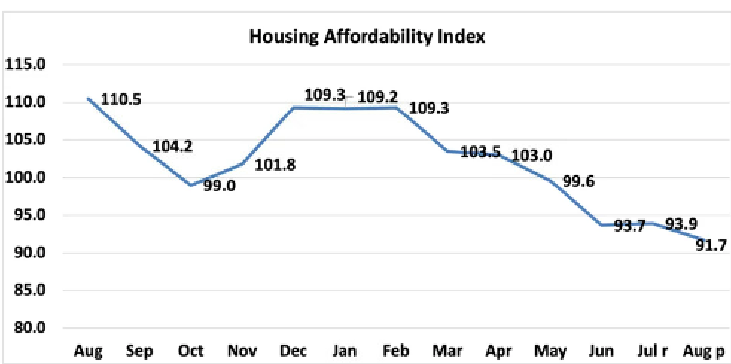
[1] Defined as Amazon (AMZN), Apple (AAPL), Alphabet (GOOGL), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA), and Tesla (TSLA).
[2] Return here defined by the Barclays Aggregate Bond Index
[3] Any securities are for illustrative purposes as proxies for indices and are not recommendations to buy or sell any specific security.
[4] Bureau of Economic Analysis
[5] Bureau of Economic Analysis
[6] Fiscal Data

According to data from the Treasury Department, net interest costs on this debt reached $659 billion in 2023 – nearly double the 2020 figure, making it the fourth largest government program.[7] Looking ahead to fourth quarter, the Atlanta Fed projects GDP growth to land around 2.3%, having revised its estimate in mid-December higher.[8]

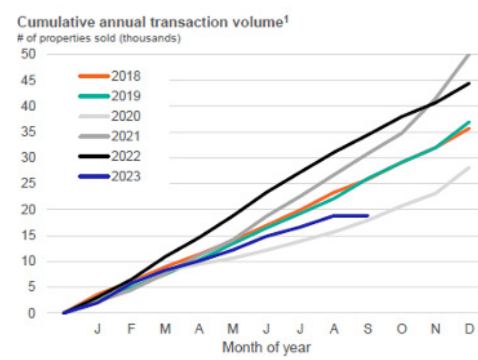
Headline inflation for the year ending November 2023 amounted to 3.1%. However, we feel that core PCE (personal consumption expenditures) is a more relevant inflation metric, as it drives the Fed's policymaking. Core PCE services was up 2.7% in November and overall PCE was up only 2.6%. Also, on a 6-month annualized basis, the core PCE was up 1.9%, marking the first time in three years the measure was below Fed target.[9] The inflation news is very good for now.

Job growth appeared to moderate slightly in November, with a gain in non-farm payroll employment of 199,000. This is below the average monthly gain of 240,000 we have seen in the past 12 months, but overall, in line with recent months. However, this figure does take into account striking workers in the automobile and entertainment industry returning to their jobs. Job growth was concentrated in healthcare, government and leisure. Wage growth remains strong, with hourly earnings up 4% year over year.[10]

The housing market still remains a more challenged sector of the economy. With the highest rates in decades, many buyers are simply being priced out of this market. Mortgage applications in October were the lowest since May 1995, which is no huge shock given the 30-year rate is up nearly 10% from last year and the 15-year rate is up 12.5%.[11] Yet as demonstrated by the S&P Case Shiller 20-City Home Price Index, property values continue to increase, which reflects a simple supply and demand dynamic: homeowners who refinanced at near zero-rates in 2020 and 2021 are in no rush to move, creating a dearth of properties listed on the market and low transaction volume. However, if sluggish transaction activity persists, we will eventually see a cap on price increases, across both commercial and residential real estate.



A Housing Affordability Index value of 100 means that a family with the median income has exactly enough to qualify for a mortgage on a median-priced home. An index of 120 signifies that a family earning the median income has 20% more than the level of income needed to pay the mortgage on a median-priced home. Source: National Association of Realtors, Oct. 19, 2023.



[1]MSCI Real Capital Analytics, as of September 30, 2023.
Source: FS Investments, Nov. 2023

[7] https://www.crfb.org/blogs/2023-interest-costs-reach-659-billion
[8] https://www.atlantafed.org/cqer/research/gdpnow
[9] Bureau of Economic Analysis
[10] BLS
[11] Bureau of Economic Analysis

FIXED INCOME AND CREDIT

This quarter was unusually eventful for the broad bond benchmark[12] – after months of lackluster performance, November saw the index deliver its strongest monthly performance since the early 1980s. Treasuries had a turbulent quarter as well. The 10-year treasury started off the period with yields around 5%, then traded down over 1% by the close of the quarter.

This year, higher rates revived fixed income markets after 2022's abysmal performance. Bonds delivered substantial income at levels not seen since at least 2007. Riskier debt, typically called high yield, did particularly well, outpacing both the S&P earnings yield and dividend yield. The risk-return profile of high yield debt also improved, with interest coverage ratios reaching record levels and higher credit quality overall in the high yield basket (majority BB-rated).

Opportunities in credit are currently the strongest they've been in over two decades. March's "mini" banking crisis created a void in lending by smaller regional banks, especially in commercial real estate. Dislocation in this market remains high, creating abundant opportunities for private lenders to lend to high-quality borrowers. Even insurance companies were forced to offload loans with underlying credit intact, allowing third party lenders to purchase these at favorable terms. Many of our credit managers delivered equity-like or near equity-like returns, along with current income in the high single to low double digits.

Outlook for Fixed Income and Credit:

We expect a more favorable environment for fixed income investing as we head into 2024. Credit remains a key area of focus for our allocators. Regional banks have nearly disappeared from many lending markets post the SVB collapse. This has enabled private and alternative lenders to fill this gap and take advantage of the higher rate environment. The mortgage market may be another area that displays high dislocation – we will continue to monitor and allocate capital to managers in this space opportunistically.

After a year of relatively muted credit defaults, as evidenced by spread levels, one potential item of concern for us in the credit space is the large amount of debt maturities coming due in 2024/2025. Looking ahead to this period, we can expect to see a growing amount of commercial real estate and small business debt that needs to be refinanced at rates as much as 4-5% higher than the original rate. Bank's tighter lending standards post-SVB collapse may not allow these borrowers to refinance. This could force them into the private lending market where terms and rates might be too strict, or even cause them to default. Another potential risk is that paying an elevated interest expense will force firms to reduce their capital spending and labor costs, resulting in a drag on wage growth and monthly payrolls.[13] These second-order effects, however, are likely not to be felt meaningfully until late 2024 or 2025.

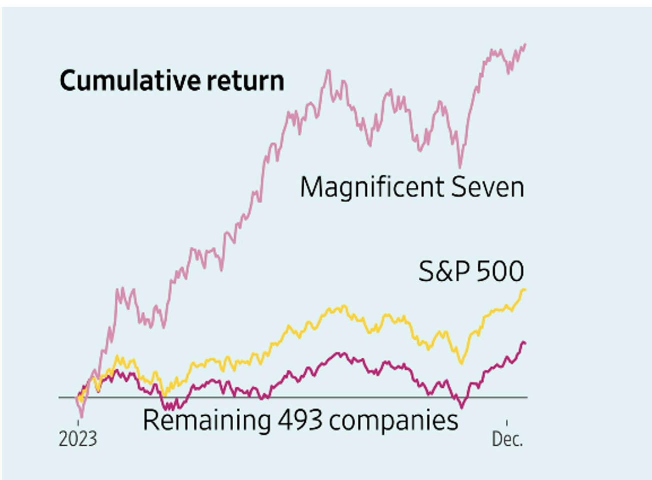
Finally, heading into the new year, we feel comfortable adding on more duration to our fixed income portfolios. We believe the "belly" of the Treasury curve (3-7 years) currently offers the most attractive risk-return profile. Considering the reinvestment risk that comes with short-term Treasuries, one of the best times to put money to work in this asset class is before rate cuts. Wait too long, and you may miss the window of bond price appreciation that accompanies a decline in rates.

[12] We use the iShares Core US Aggregate Bond (AGG) as the broad bond benchmark. This ETF seeks to track the returns of the total US investment-grade bond market. This ETF is solely being used as a proxy for market indices due to availability of current data. This is not intended to reflect securities bought and sold by AlphaCore.
[13] Goldman Sachs

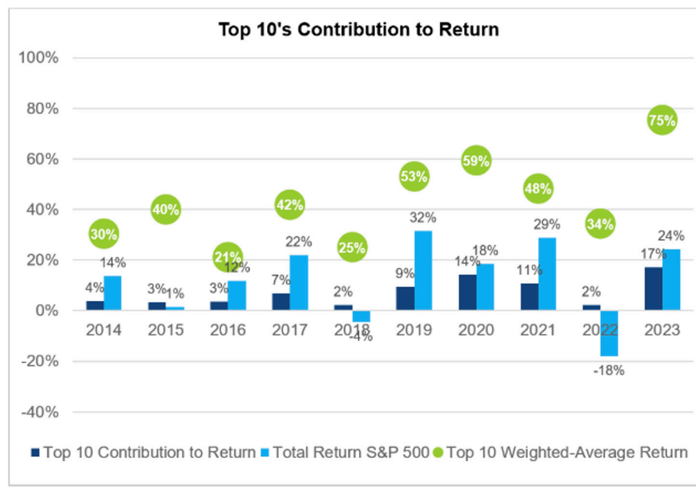
EQUITY MARKETS

This year, the equity market rode the wave of AI optimism to seemingly new heights, wiping investor's memories clean of the pain of last year, save for a few brief pullbacks. An overall exemplary year for stocks culminated in the S&P on track to deliver nearly 26% and the Dow achieving its first record close in nearly two years following the Fed's mid-December announcement.

But upon closer examination, things aren't quite what they seem. Throughout the year, we've repeatedly emphasized the narrowness of the equity market rally, propelled by the outsize success of mega-cap tech stocks. The top 10 stocks contributed a remarkable 75% of the total return of the S&P 500. The aforementioned "Magnificent Seven," which now comprise 30% of the S&P 500's market value, led the charge including stellar returns from Microsoft and Apple.[14] Few other stocks could keep pace, whether in terms of earnings, valuations or share price growth. Small caps in particular, which are more cyclically sensitive, lagged this year.



Source: The Wall St. Journal, Dec. 17, 2023.



Source: FactSet Prices

It remains to be seen whether artificial intelligence will continue to buoy the equity market next year or if it will need to find a new catalyst. Thanks in no small part to mega cap tech, equity market multiples have once again become incredibly rich. Current multiples are pricing in earnings growth of 12-13%, a staggeringly high figure considering GDP growth is only around 2%. High PE multiples can no longer be explained away by near-zero interest rates, rather they are being influenced by the continued domination of the higher-PE "Magnificent 7."

Outlook for Equities:

We anticipate a bipolar outcome in equity markets next year. One possibility is that the elusive "soft landing" we've been hearing of during 2023 comes fully into focus. This would mean economic indicators hold steady, inflation remains on a downtrend, and the Fed makes good on its promise to begin cutting rates. Entering 2024, market forecasters are predicting 12% earnings growth. If this scenario occurs, we would expect to see a broadening of equity returns away from mega-caps. The equal-weighted S&P and the Russell 2000 index, both of which lagged this year, should begin to catch up (in fact, we have already seen this begin to occur in the fourth quarter). The S&P 500 should have another strong showing overall; historically, equities tend to do well the year following a particularly good year.[15] It is worth noting that this is the outcome the market appears to be pricing in.

[14] https://www.wsj.com/finance/stocks/its-the-magnificent-sevens-market-the-other-stocks-are-just-living-in-it-5d212f95. Illustrative purposes only. Not a recommendation to buy or sell any specific security.
[15] 1999 is a notable exception; in 1999, the S&P returned 20% then entered a 3-year downturn.

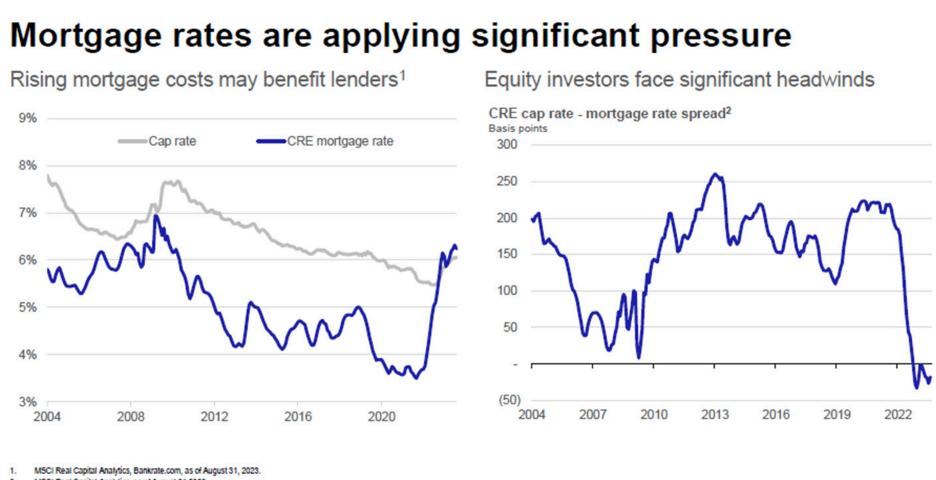
On the flipside, we may see the negative impacts of the fastest rate hike in history finally materialize. Corporate bottom lines could take a hit from the two-pronged impact of high interest costs and high inflation. If this occurs, we may be in for a healthy pullback as earnings are pressured and valuations reset lower.

Regardless of the equity market's trajectory next year, we maintain conviction in our value and quality-biased positioning. Our goal is to create portfolios that can do well across economic cycles. After a year like 2023, it can be tempting to go all in on growth, regardless of whether these stocks are overvalued. Although our Core and Active Equity allocations lagged the cap-weighted indices, the focus on strong free-cash-flow generating companies still delivered strong double-digit returns. We believe that looking beyond the growth names du jour and instead focusing on companies with solid fundamentals and durable profits will pay off in the long run – most academic literature also supports this notion. We also maintain our conviction in active stock selection strategies. We continue to have confidence in certain equity managers we believe have demonstrated a keen aptitude for identifying high quality, reasonably priced names that may be able to withstand a drawdown in the broader market.

ALTERNATIVE INVESTMENTS

This year, alternatives' performance was mixed. Most strategies did not outperform equities, but many outperformed bonds. Recall, the primary purpose of an alternatives allocation is to provide diversification and uncorrelated return, potentially buffering losses during a downturn to help investors preserve their capital. In a year like 2023, alternatives shouldn't be expected to play alongside equities 1:1, but it is crucial not to lose sight of the importance of including them in a portfolio.

That being said, certain strategies had an excellent year, including structured credit. This strategy has demonstrated it can deliver equity-like returns and high current income investing across the commercial real estate and mortgage-backed credit markets. Private corporate credit also did very well, as the reset in base rates finally accreted to investor returns. Given higher cash rates raise the hurdle rate for all strategies, the impressive performance of our credit managers emphasizes the strength of this asset class. Allocations to value-aware long/short equity strategies also delivered another strong year of returns with lower volatility than public equity markets. Some of our largest exposures in the alternatives space are multistrategy hedge funds. These managers have maintained consistently positive performance throughout this market cycle, and we remain confident in their ability to capitalize on new opportunities in 2024.



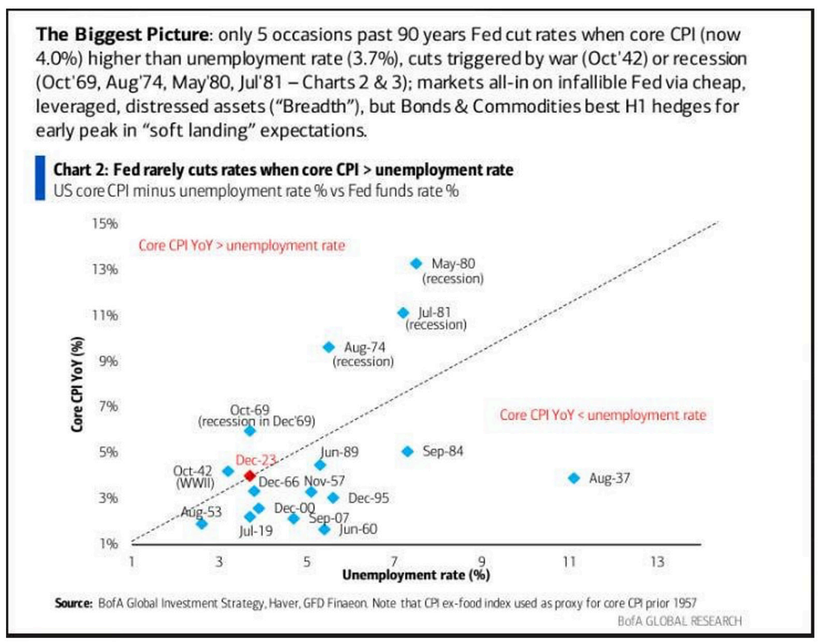
We strongly prefer investing in commercial real estate debt over equity.
Source: FS Investments, Nov. 2023.

Other strategies proved less equipped to deliver returns in the current market environment. Trend following and managed futures had a difficult year, as choppy markets prevented strong trends from taking hold. Our discretionary global macro strategy suffered a similar fate, failing to rally following the banking crisis in March. Private real estate, especially the equity part of the capital structure, had muted performance as well. Pressure on cap rates continues to create headwinds for real estate equity, and certain sectors, particularly office, remain sluggish. Currently, we have a strong preference for real estate debt over equity, with debt funds outperforming real estate equity in 2023. As previously articulated, it is paying extremely well to lend at this time. Finally, our event-driven equity strategy underperformed. IPO activity over the past couple of years is a fraction of what it used to be, meaning opportunities for this strategy are few and far between. However, recent court victories along with a healthy backlog of private companies desiring to go public may be signs this market will come back to life in 2024.

CONCLUSION

We are looking ahead to 2024 with cautious optimism. This year, markets certainly fared better than anyone could have expected, especially after 2022's mildly scarring events. Now, it seems nearly every asset class is pricing in the "best case scenario" – the economy remains in robust health, inflation remains moderate, and the Fed upholds its promise to cut rates. Although the current data generally supports a favorable outcome, we are acutely aware of the many uncertainties that remain.

Among the most pressing are the escalating geopolitical tensions both at home and abroad. We are now grappling with two major regional conflicts – Ukraine and Gaza – with a potential third bubbling up in Taiwan. All three involve global economic powers: Russia, China, Iran. These wars weave an increasingly complex diplomatic web in which the United States will inevitably become ensnared to some degree. The eventual scale and scope of these wars will undoubtably have far-reaching consequences for markets. To complicate matters further, 2024 is also an election year in the United States – which is shaping up to be surely one of the most bizarre contests in American memory. Levels of social division and discord remain at all-time highs. Furthermore, we can expect to see the deglobalizing trends continue, particularly with US-China decoupling. International trade activity with China is currently at a historic low, shifting to India, Southeast Asia and Mexico.



Source: BofA Global Research, Dec. 2023. In the past, the times the Fed has cut rates when CPI was higher than unemployment have more frequently led to rate hikes. This is not to say this will occur if the Fed cuts rates in 2024, but it merits caution.

Moreover, with the Fed announcing in mid-December it plans to cut rates by 0.75% next year, a conundrum may emerge. If the economy continues its positive trajectory, and both personal and federal spending remain strong, the Fed likely will not cut rates for fear inflation will balloon once again. The failure of the Fed to make good on its announcement may beget negative consequences for markets. On the other hand, if the Fed indeed follows through with three rate cuts, it could be as a result of deteriorating economic conditions. We see these rate cuts as a potential catch-22.

These are just a few of the dynamics occupying our Investment Committee debates as we ponder our approach to rebalancing portfolios and allocating capital next year. Of course, we still believe the best offense is always a good defense, so we will continue to abide by our three-pronged approach to portfolio construction. The 60/40 portfolio rebounded strongly in 2023 after a challenging 2022. We must be careful to not let recency bias cloud our memories and judgement. With the rapid pace of change in our world, we believe it is essential to have true diversification with many sources of uncorrelated return. We strive to design our portfolios with the resilience to withstand whatever the market throws at us. And if the past few years have taught us anything, it is that we never know what is around the corner.

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• **BLOOMBERG BARCLAYS CAPITAL U.S. AGGREGATE BOND INDEX:** The index consists of approximately 17,000 bonds. The index represents a wide range of securities, from investment grade and public to fixed income.

• **ICE BOAML HY INDEX:** The index is a commonly used benchmark index for high-yield corporate bonds. It tracks the performance of U.S. dollar denominated below investment grade rated corporate debt publically issued in the U.S. domestic market.

• **RUSSELL 3000 INDEX:** The Russell 3000 Index is a market-capitalization-weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities.

• **RUSSELL 2000 INDEX:** The Russell 2000 Index is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

• **MSCI ACWI (ALL COUNTRY WORLD) INDEX:** The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI Index is comprised of stocks from both developed and emerging markets.

• **MSCI EMERGING MARKETS INDEX:** The MSCI Emerging Markets Index is used to measure the financial performance of companies in fast-growing economies around the world. The index tracks mid-cap and large-cap stocks in 27 countries, dominated by Chinese, Taiwanese and South Korean companies.

• **S&P 500 INDEX:** S&P 500 index is a float-adjusted market-cap weighted index, largely reflecting the large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

• **NASDAQ 100 INDEX:** The Nasdaq 100 Index is a basket of the 100 largest, most actively traded U.S companies listed on the Nasdaq stock exchange. The index includes companies from various industries except for the financial industry, like commercial and investment banks.

• **PURCHASING MANAGERS' INDEX (PMI):** PMI Index is an indicator of economic health for manufacturing and service sectors. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

• **ISM MANUFACTURING INDEX:** The ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity. The index is often referred to as the Purchasing Manager's Index (PMI).

- **THE BLOOMBERG COMMODITY TOTAL RETURN INDEX:** The BCOM TR Index is composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. This combines the returns of the BCOM with the returns on cash collateral invested in 13-week (3 Month) U.S. Treasury Bills.

- **CBOE VOLATILITY INDEX (VIX INDEX):** The VIX Index is a real-time market index used to measure the market's expectation of future volatility. Being a forward-looking index, it is constructed using the implied volatilities on S&P 500 index options (SPX) and represents the market's expectation of 30-day future volatility of the S&P 500 index which is considered the leading indicator of the broad U.S. stock market.

MORNINGSTAR CATEGORIES

MORNINGSTAR MULTI-STRATEGY: This is a Morningstar alternative strategy category. For a multi-asset strategy to qualify in an alternative category, greater than 30% of a strategy's gross exposure must be allocated to alternative substrategies. Alternative substrategies should provide an 'alternative' exposure to the dominant risk factors found in traditional indices, and as standalone strategies, would generally fall into one of the other Morningstar alternative categories: Equity Market Neutral, Event Driven, Macro Trading, Options Trading, Relative Value Arbitrage and Systematic Trend.

MORNINGSTAR SYSTEMATIC TREND: This is a Morningstar alternative strategy category. Systematic trend funds mainly implement trend-following, price-momentum strategies by trading long and short liquid global futures, options, swaps and foreign-exchange contracts. Strategies invest across geographies and assets, including equities, fixed income, commodities, currencies and more.

IMPORTANT INFORMATION

Upcoming Events

Jan. 17, 2024
4:30 P.M. PST

THE CORE CONNECTION: PALM DESERT HAPPY HOUR

If you are interested in joining this event, please contact us to find out how to register.

Learn More Here

Jan. 23, 2024
10 A.M. PST

ALPHACORE WEBINAR FEATURING BLACKSTONE: TOP 10 SURPRISES FOR 2024

As investors begin to embark on a new year and possibly a new frontier, we invite you to join us for our first webinar of 2024.

Learn More Here