Patten & Patten

December 2023
QUARTERLY INVESTOR LETTER

Happy New Year! **<u>Please save the date:</u>** Thursday, February 22, 2024 for Patten & Patten's 15th Annual Investment Symposium at the Westin Downtown Chattanooga.

Looking Back

Several narratives competed for investor attention throughout 2023. Investors fixated on whether and when the Federal Reserve would terminate rate hikes. Some commentators feared rates were already restrictive. Recession became consensus with the expectation the Fed would cut rates to support the economy. Depleted excess savings from pandemic support programs would damage consumption. Consensus held that the fight to defeat inflation would require higher unemployment. Finally, higher interest rates would eventually devastate prospects for growth. Somewhat offsetting domestic deceleration, China's economy was expected to grow as it finally ended its futile and ill-conceived "zero COVID" policy.

We disagreed with consensus last year, with the exception of the outlook for China. We believed supply factors contributed more to inflation than demand. Logistics networks gradually normalized following COVID and geo-political disruptions, restoring equilibrium to important commodities markets in the process. In addition, tighter monetary policy mitigated general inflation pressures. Higher interest rates reduced demand for capital, but most companies and consumers locked in funding costs when rates were near historic lows. For these reasons, we rejected the recession scenario. Our outlook included moderating inflation without a commensurate increase in unemployment.

Artificial Intellegence

Chat-GPT was last year's major surprise. Investors shifted focus to artificial intelligence, and market performance concentrated among seven stocks with the greatest exposure. The lack of market breadth was a worrisome development. During much of the Third Quarter, a murky outlook led to volatility, and conflicting economic data heightened uncertainty. Persistent services-sector inflation pushed 10-year Treasury yields to near 5.0%, their highest level since 2007.

A Second Shift

Fed Chair Powell delivered the second surprise. During commentary, Powell shifted dramatically with regard to the direction of future monetary policy. The market interpreted the comments as a "pivot" from restrictive to accommodative policy. In response, both stock and bond markets rallied. 10-year Treasury yields fell from 5.0% to 3.9%. Stock market breadth improved substantially.

Earnings growth expectations have improved, and the global economic outlook is less gloomy. However, the rapid decline in rates suggests both stock and bond markets likely over-reacted to the so-called pivot. Stock market valuations quickly adjusted to prospects of a lower rate environment. The bond market now expects the Fed to cut rates multiple times in 2024. These developments represent risk to stock and bond market performance in 2024 to the extent inflation remains stubbornly above the Fed's 2.0% target. Meanwhile, short-term Treasuries and money market yields remain anchored close to the policy benchmark. Thus, savers continue to benefit at the expense of borrowers, with cash as an attractive, albeit temporary, alternative to markets.

We look forward to discussing these issues with you in the New Year. Please contact the office if you would like to schedule a virtual or in person meeting.