



POST OAK PRIVATE WEALTH ADVISORS

ADVISORY, CONSULTING & INVESTMENT MANAGEMENT

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2023 Year-End Market Review

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If there was any time to say “What a difference a year makes”, this is it. The story for 2023 couldn’t be more different than the 2022 version. Last January, we had just emerged from the worst year for stocks since 2008 in the peak of the Global Financial Crisis. Inflation had spiked earlier in 2022 and the Fed was well into its campaign of swift rate hikes to counter the surge in prices. There was no refuge in bonds, where yields were rising and values declining.

Fast forward to the end of 2023 and we find investors largely in fine spirits. A 28% annual gain for the S&P 500 and a 43% rise in the Nasdaq Composite Index would have that effect on most people. Stocks climbed steadily earlier in the year, except for those “Magnificent Seven” which mostly saw one-way traffic going up. A summer wobble gave investors some time to catch their breath before a new rally kicked off to close the year.

The point of looking back is not to bask in the success, however, but to help us prepare for the year to come. Today, you can find plenty of reasons for optimism in the stock market, the economy and the outlook for the future Federal Reserve decisions on interest rates. But we should be cautious, or at least not get ahead of ourselves. For one, the Fed has more work to do, even if the cycle of rate hikes appears to be over.

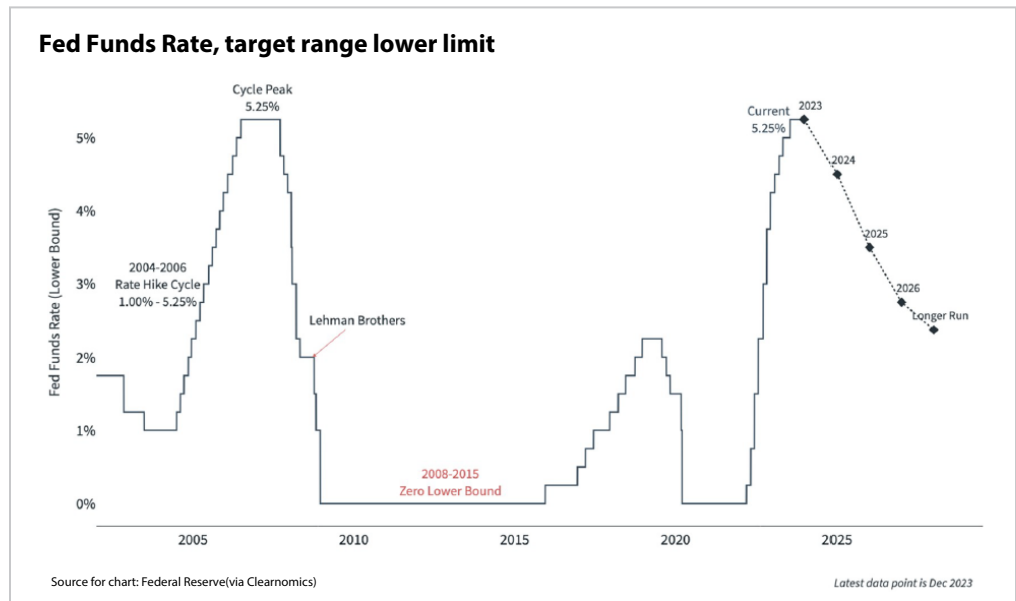
The Fed holds steady—for now

This past year was notable for the shift in Federal Reserve policy away from rate tightening to holding steady, at least for the time being. The door is open for rate cuts, potentially to come in the first half of 2024, with Fed Chair Jerome Powell underscoring the risks of maintaining a restrictive monetary policy for too long in his comments after the December FOMC meeting. Fed officials say they intend to keep rates high for the near term to prevent inflation from surging again. However, many market indicators suggest the Fed could be near the end of its rate hike cycle and is heading in the right direction for managing a “soft landing” for the U.S. economy. But it all depends on the path of inflation and the strength of the economy going forward.

The inflation picture has improved greatly from a year ago, but we haven’t yet reached the Fed’s 2% target for the annual inflation rate. For November, the headline Consumer Price Index (CPI) rate came in at 3.1% year-over-year, a small improvement over the previous month, while the core rate for November remained flat at 4.0% year-over-year. This incremental progress in taming inflation is one reason why the Fed is likely to stay committed to “higher for longer” interest rates for the next few months—and why investors shouldn’t get ahead on themselves in expecting rate cuts to come sooner than later.

Much of the improvement in inflation we saw in 2023 happened in the first half of the year, as supply-side constraints untangled and the CPI growth rate fell markedly. Perhaps Fed officials were right about the “transitory” nature of inflation during the worst of the cycle for price

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increases, but there's no way inflation would have been tamed without Fed rate tightening. As Powell commented during the December FOMC news conference:

"This inflation was not the classic demand overload, pot-boiling-over kind of inflation that we think about. It was a combination of very strong demand, without question, and unusual supply-side restrictions, both on the goods side but also on the labor side, because we had a [labor force] participation shock."

Despite the reports showing gradual improvements in CPI over the past year, people generally aren't seeing it in their daily lives. It's important to remember that slowing inflation means the rate of change has slowed; prices may not fall, but they won't go up as much either. Some prices have come down from where they were earlier this year, but this may be the establishment of a "new normal" for many consumer goods and services. Any talk of improving inflation is cold comfort to those who have tightened their household budgets because of inflation. This could explain the dissonance between the recent positive economic reports and the public's sour mood about the current state of the economy.

A brighter mood in the markets

Not only have we seen the Federal Reserve adjust their position on monetary policy in the last few weeks, investors have had to rethink their hawkish views on interest rates too. The huge change in the Fed's expectations for inflation for the coming year helps explain the market's reaction over the past two months. Emerging from the late summer/early fall downturn, the S&P 500 finished the year in strong fashion with a nearly 15% gain in November and December. Perhaps more significantly, good performance reached across the spectrum of equity categories; small- and mid-caps enjoyed strong months, value and dividend stocks shone, but growth and quality stocks weren't slouches either.

Still, a majority of institutional investors remain in the bearish camp when it comes to stocks and are sitting on a significant amount of cash, looking for attractive opportunities for investment.

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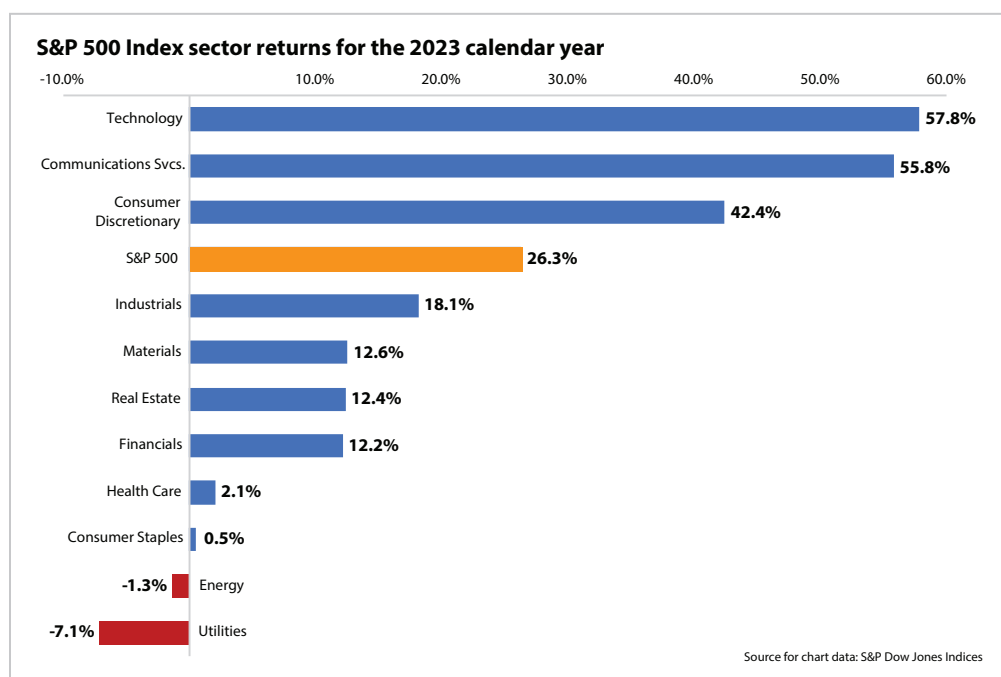
Some of this money is flowing into stocks, which could be a sign of panic buying by large investors trying to dodge FOMO (fear of missing out). The “Magnificent Seven” stocks outshone the market as a whole for the year, thanks to their strong returns in the first six months, but their lofty valuations have more recently prompted some investors to seek opportunities elsewhere. We could see some of the more neglected sectors to come back into favor, as financial, energy and health care stocks may participate more in the market’s gains.

Broader participation would be welcome and a positive sign for stocks going forward. It’s hard to predict what sectors will outperform in any given period, which is why a diversified investment approach works over the long run. A continuation of this two-month stock rally would likely put more pressure on institutional investors to get off the sidelines and commit more cash to the market. Should that occur, it would help bolster the bullish climate for stock investors even more. One fear, however, may be that the market’s latest gains have “front-loaded” the current rally, so the first half of 2024 may end up being sluggish in comparison to the past two months. Yet, we remain very constructive on stock performance for the year to come and cautiously optimistic for the investment climate overall.

It’s not all about tech stocks—for once

If there was one word to describe the stock market in 2023, it would be technology; tech was the top performing sector for 2023, although communications and consumer discretionary stocks outperformed the broad market as well. If there were two words to describe 2023, I’d say artificial intelligence—any company with an AI angle seemed to draw interest from stock investors. This included the “Magnificent Seven” but there were other firms joined the ride as well.

The closing months of 2023 saw a change in market leadership with old-school industrial and financial sectors taking the lead. Tech stocks finished the year in fine shape, even if the sector settled to the middle of the pack in December. It’s not like the strong gains for these stocks weren’t justified;



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the earnings recession expected for much of this year never really showed up, and by the 3rd Quarter earnings season S&P 500 firms had reported the strongest earnings growth in a year. Moreover, the “Magnificent Seven” in general exceeded the results analysts were looking for, helping to counter any investor worry about these growth stocks due to the rise in long-term interest rates. These firms are on the bleeding edge of AI innovation and much more is expected from the technology as development continues. But we’re not likely to see meteoric-like gains from these stocks in the year ahead. Investors can expect the good run to continue, but it won’t be like 2023.

Among the disappointments in sector performance for the past year was energy, which ended the year in the red (and outpaced to the bottom only by utilities for the worst performing sector for the year.) Energy markets can be affected by geopolitical conflict, especially when it breaks out in an oil-rich region like the Middle East. Oil prices were actually on the way up through the summer months and even peaked in the days before the Hamas attack on Israeli civilians in October, but eventually settled lower than where they started the year. The bigger disruptor, in my view, is on shipping and consequently supply chains, as transporting any goods in and around the Middle East and Gulf region became more treacherous.

Despite the weakness for the energy sector in 2023, we are constructive on energy stocks going forward. As the U.S. economy evolves beyond the expected “soft landing” and back to growth mode, demand for energy products should increase and help sustain oil prices. The potential for the ongoing conflict to spread beyond Israel or flare up in other regions is a risk that requires vigilance.

2024: Things are looking up

With the caveat that it’s impossible to know exactly what the future will bring, I do believe we are headed in the right direction from an investment standpoint and remain cautiously optimistic for the opportunities ahead. The first half of the coming year may be positive but sluggish, especially in the wake of the market rally over the last two months. Overall, I expect 2024 to be a good year for investors. There will be risks to manage, but there’s no reward without assuming some risk. Success comes from being smart about managing risk, with strategies in place to help minimize the impact of any significant downturns.

On behalf of the entire Post Oak team, I wish you all a very happy, healthy and prosperous new year. Thank you for your continued trust and confidence in our portfolio management services. We look forward to helping you navigate the markets in 2024 and helping you make progress on your personal financial goals again this year.

Past performance does not guarantee future results. There is no guarantee that any investment strategy or account will be profitable or will not incur loss. Investors should consider the investment objectives, risks, charges and expenses that make up this investment strategy carefully before investing. Investing involves risk, including the possible loss of principal. Share price, principal value, and return on investments will vary, and you may have a gain or a loss when you sell your investment.

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