2023 Market Review & 2024 Outlook

2023 Economic & Market Review/Comments

After a grim 2022 (stocks and bonds returned between - 15% and - 20%), inflation pushing 8% for a time, a European war, and much higher interest rates, the stage was set for an even more challenging 2023. Almost all economists, asset managers, major banks, and even the FED thought chances of a recession were elevated (if not probable) coming into 2023. Traphagen was no exception in sharing this view. As we reviewed earnings expectations, the likely impact of much higher rates, an inverted yield curve, quantitative tightening, and high inflation we were cautious. We recognized however, there are no 'sure things' in the markets, so we constructed our client portfolios in a way that would provide significant and meaningful protection if we did get the much-anticipated recession, while at the same time enabling our clients to participate in a bull market. The below excerpt was taken word for word from our 2022 review newsletter written one year ago.

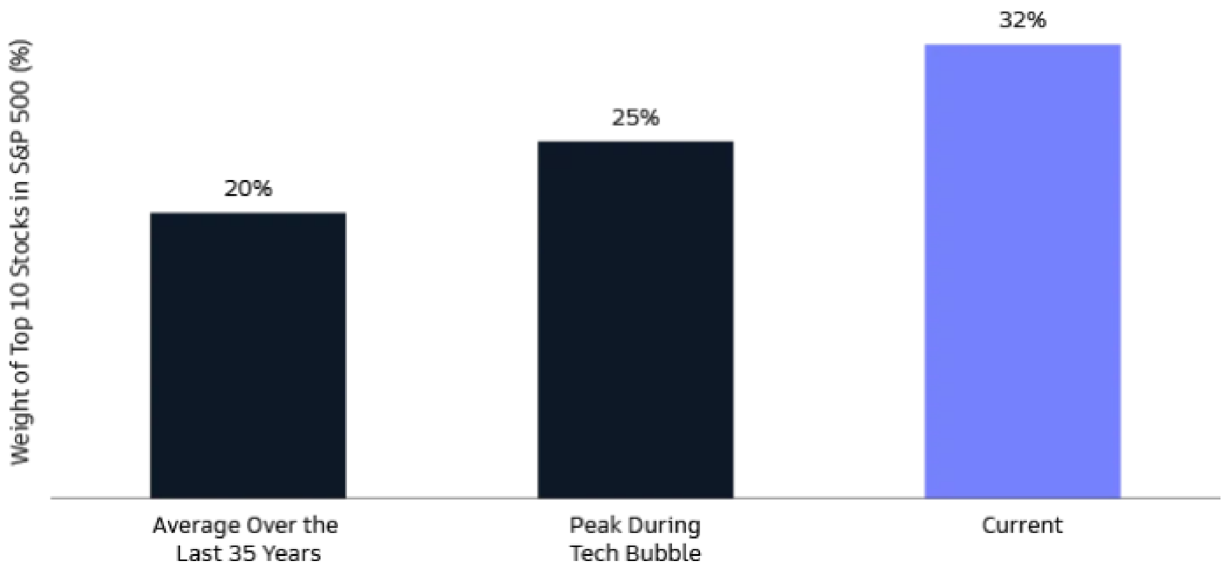
"With this backdrop, we are cautious, but think bonds will have a good year and stocks will have a materially better 2023 than 2022…If we see much lower inflation, muted (but still positive) earnings/economic growth, and get a 'soft landing' all pieces of our portfolio should perform well, and we would expect total returns in the upper single digits or more for most clients."

Fortunately, we avoided a recession (at least to date) and the above referenced scenario played out with all but the most conservative Traphagen clients returning between 8% and 20% for the year.

Despite the continuing rise in rates, a regional banking crisis, and nearly flat corporate earnings, investors were excited about much lower inflation and continued government fiscal support in 2023. In response to this, stocks were bid up significantly from around 16X earnings in late 2022 to the current level of around 21X. This increase in stock valuation translated to a return of + 22% for the global stock market (ACWI) with US stocks far outperforming foreign stocks yet again.

The gains in the stock market were robust, but extremely concentrated in just a handful of mega cap technology companies. If we isolate just US large cap stocks using the SP500, the difference in performance of the entire index was + 26%, while the other 493 companies in aggregate only returned around + 7%. This has led to the most concentrated US stock market in recent history.

Below you will see the historical average and where we are in now in SP500 concentration with the top 10 largest stocks.



Traphagen and all investors must take this into account when constructing the stock portion of a portfolio. Although ultra-cheap index funds are still a foundation of our exposure, there needs to be other strategies used to reduce concentration risk and hopefully increase potential returns in companies that were left behind last year and have much cheaper valuations.

Other risk assets generally performed well, with Bitcoin by far the best performer. GBTC (our Bitcoin investment holding) returned over 300% in 2023 alone. This was partially due to a recovery from a very poor 2022, increased regulation and clarity within the space, and especially the approval of several Bitcoin ETFs in early 2024 that will allow many more to invest.

Public real estate and small cap stocks were actually negative on the year through the end of October, but then experienced a rapid recovery in November and December and ended 2023 up between 12% and 19%.

Bonds had an incredibly volatile year with the 10-year Treasury hitting a multi-decade high of 5% in October before falling back below 4% in rapid fashion by the end of December. All in all, the 10-year Treasury rate was on a roller coaster to nowhere starting and ending the year at the same level of 3.87%. With this, returns within the bond market roughly equaled their yields, with 3% to 8% returns common.

Select 2024 Asset Class Returns	
Digital Assets (Bitcoin)	+ 317.6%
US Large Cap Stocks (IVV)	+ 26.1%
Insurance Securities (XILSX/SHRIX)	+ 20.0%
Foreign Developed Stocks (IEFA)	+ 17.9%
Private Infrastructure (STRUX)	+ 15.1%
Middle Market Lending (CCLFX)	+ 12.7%
Public Real Estate (IYR)	+ 11.9%
Emerging Market Stocks (IEMG)	+ 11.5%
Diversified Private Credit (NICHX/CELFX)	+ 10.8%
Pipeline Companies (TPYP)	+ 10.5%
Investment Grade Bonds (LQD)	+ 9.4%
Asset Backed Lending (AMCJX)	+ 8.1%
Municipal Bonds (MUB)	+ 5.6%
Diversified Real Assets (VCRRX)	+ 4.8%
Intermediate Treasury Bonds (IEF)	+ 3.9%
Private Equity (PIIVX/XPMIX)	0.0%
Consumer Lending (LENDX)	- 2.1%
Private Real Estate (TIPWX)	- 11.5%

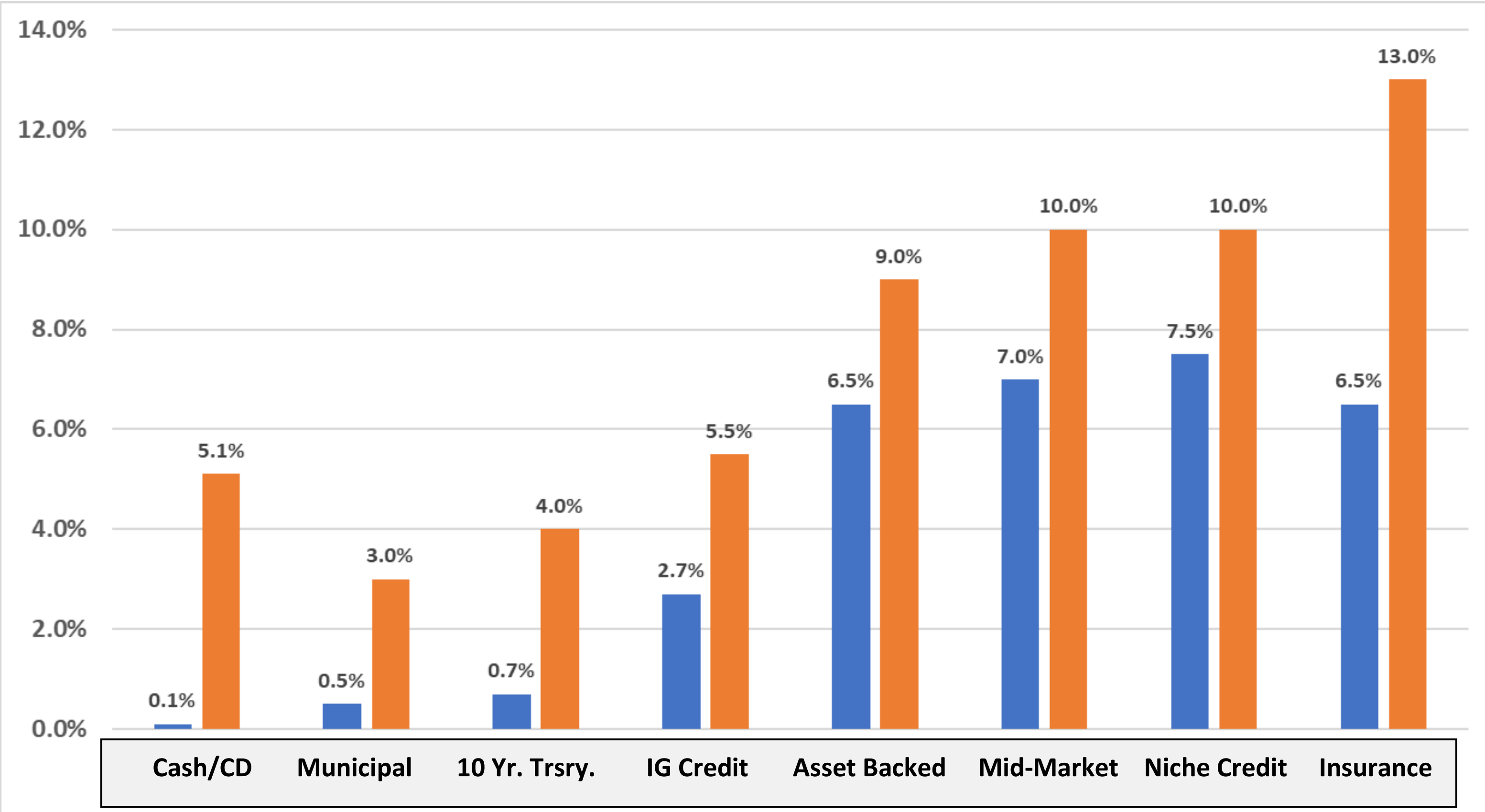
Yellow shaded rows indicate Traphagen private/alternative investments; blue indicates traditional investment classes.

Much like 2022, the alternative/private suite we employ for a large portion of most portfolios has produced virtually no volatility or correlation with bonds or stocks. As importantly, in aggregate as held by our investors, these investments produced solid mid/upper single digit returns for our clients. By a large margin, insurance securities was the best performing alternative asset with a + 20% return as insurance premiums reached near record (inflation adjusted) highs in 2023. These premiums remain high as we enter 2024. Some private real estate, some private equity, and consumer credit were the only negative returning assets.

As we enter 2024, as rates are again higher than in prior years the total return opportunity in bonds and cash flow orientated private/alternative investments remains robust. We remain excited about our allocations regardless if we enter a slowdown/recession.

Given the returns/yields available on many alternatives and some bonds, we can earn stock like returns of between 8% and 11% per year net of all fees. This, in addition to much lower risk, volatility, and significant protection in the case of a recession, makes these investments very attractive.

***Below:** Current (Orange) vs. 4/2020 (Blue) net of fee yields on different bond/alternative assets classes*



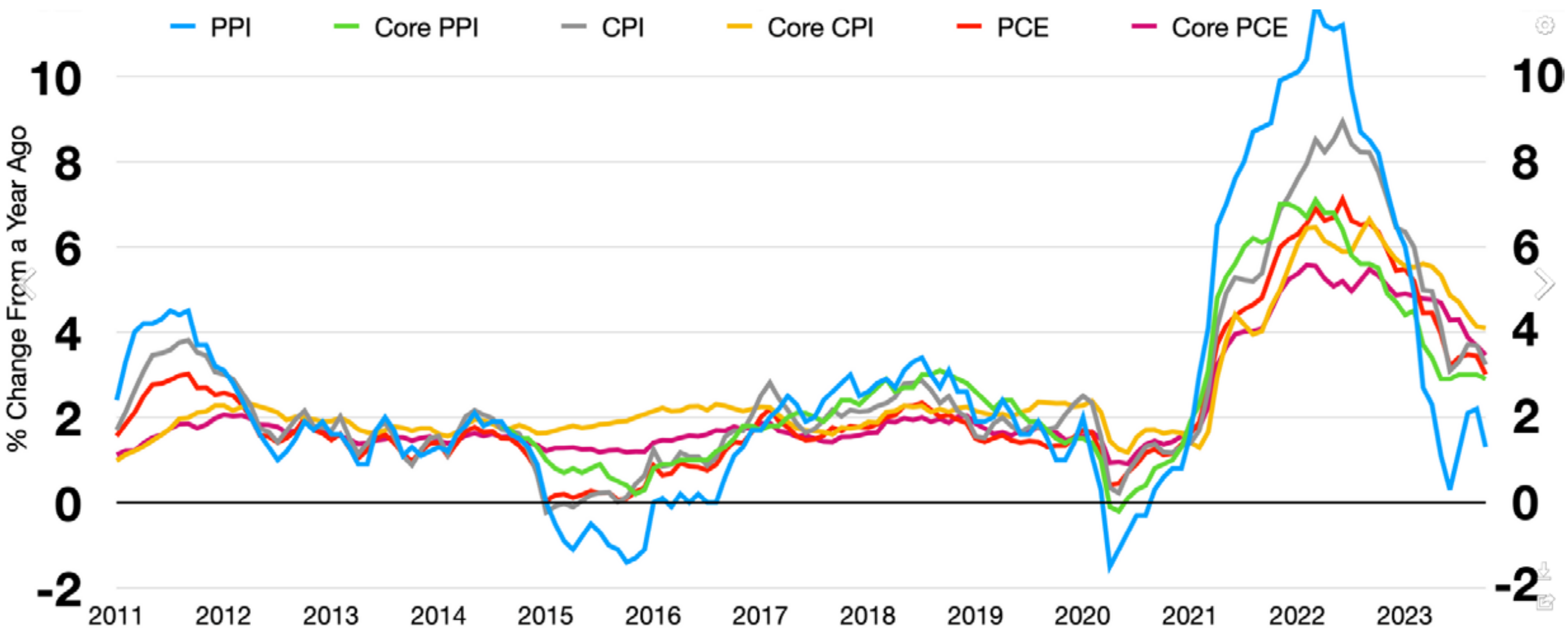
Much like in 2023, with the above net returns/yields available within the high-quality bond and alternative/private asset classes, we remain constructive on both, and for all but the most aggressive portfolios, will allocate a material amount here.

Along with this suite of lower risk and higher yielding securities, we have an allocation to well diversified high quality, highly profitable, and growing US stocks, private infrastructure, utilities, pipelines, and diversified private equity. We feel this combination is protective in the case of a slowdown/recession, yet able to deliver another significant positive return year if we remain in a bull market.

Until recently, we felt there was a roughly equal chance of a higher inflation/rate environment vs. a lower rate/inflation backdrop and thusly allocated with hedges on both sides. Over the past couple months more evidence is building that inflation and rates are heading lower, and therefore as we go through 2024, we are leaning portfolios in that direction by purchasing companies able to grow free cash flow over time regardless of the shorter-term environment.

Major Issues that impacted the markets & client portfolios in 2023:

Significant reduction in inflation: In mid-2022 inflation peaked at around 8%, the highest in more than 40 years. This caused massive disruptions in the housing, bond, and stock markets along with impacting affordability for many consumers. The FED at the beginning of 2022 announced their 'war on inflation' and willingness to do whatever was needed to defeat it. Since that point in mid-2022, inflation has come down precipitously from that red hot 8% (CPI) figure to the current level of around 3% or so. The FED has more room to go to attain their 2% target, but current evidence points in that direction. This is why Traphagen believes 2-4 short term rate cuts are likely in 2024.



***Above:** Chart of US inflation (measured by six metrics) from 2011 - 2024*

Ending of short-term rate hikes and anticipation of rate reductions in 2024: The FED at their most recent meeting strongly hinted, at a minimum, of a 'partial pivot' away from the possibility of any further hikes and towards eventual rate cuts. Traphagen does see rate cuts as likely in 2024, and as long we can avoid a recession or 'hard landing' we see 2-4 cuts as the most likely outcome. This would put cash/CDs rates near 4% at the end of the year. If we enter a more pronounced slowdown/recession, short term rates could go much lower.

Expansion of Stock Multiples (especially Mega-Cap Tech): From the stock market lows in October 2022 where the price to earnings multiple on the SP500 was 16X (about average), the sharp increase in stock prices on the index this year increased this valuation to near 21X (above average). However, it is very important to 'dig in' here and divide the SP500 into two components. The S&P 7 (largest tech stocks trading at near 35X earnings) and the S&P 493 (all the rest) still trading near the lower valuations of 16X. Although fairly expensive on the surface, if you employ certain unique strategies, there are still many stocks to be bought at reasonable prices.

The 'Birth' of Widespread Artificial Intelligence: 2023 could be known in the future as the year that marked the beginning of widespread artificial intelligence utilization. ChatGPT started the trend, but other applications are quickly being developed in graphic arts, creative writing, finance, manufacturing, medicine, and many other areas. This is one space we have been and continue to weave into portfolios in a diversified manner.

Below: Main areas we think 'value' will accrue through the emergence of AI

Utilities/Grid	Demand for reliable electricity is increasing rapidly for use in AI, EVs, and other high-end computing
Data Centers/Infra.	Demand for compute power/infrastructure for AI is insatiable and data centers are the cornerstone
Semiconductors	Diversified high power semiconductor chips/components are needed to power AI applications
Big Data Owners/ Software	Companies like Google, Meta, Amazon, etc. own the data that is needed to power all AI platforms
Niche-Use AI	These companies are mostly private and are used to power manufacturing, medicine, etc.

Traphagen 2023 Portfolio Comments:

At the beginning of 2023 we wanted to construct portfolios that were well hedged and protected against a recession (which we did feel was probable), but at the same time be able to participate nicely in a bull market. Even though we had this 'recession insurance' built into most portfolios, it was not needed, and high single digit to around 20% returns were obtained by all but the most conservative investors.

We are pleased with the majority of new securities or existing securities we added allocation to in the portfolios within 2023; a summary of these are found below.

Below: *List of new and 'significant add' investments made within 2023*

Security & Description	Interest/ Div. Yield	2023 Client Return/Time
AMCJX: Asset Backed Private Credit	**9.5%**	**+ 1.8% (2M)**
SCHD: Quality and High Dividend Yield US Stocks	**3.5%**	**+ 3.0% (12M)**
GBTC: Bitcoin Exposure	**0.0%**	**+ 330% (12M)**
QQQE: Equal Weight Nasdaq (Diversified Tech/Growth)	**0.2%**	**+ 11.2% (6M)**
XPMIX: Stepstone Diversified Private Equity Fund	**2.0%**	**+ 4.9% (6M)**
TLTW: Long Treasury Bonds + Call Option Selling	**~ 15.5%**	**- 4.0% (9M)**
STRUX: Private Infrastructure (Data centers,	**3.5%**	**+ 15.2% (4M)**
SHRIX/CBYYX: Insurance Securities (Cat Bonds)	**13.5%**	**+ 20.0% (12M)**

We made two large additions to existing positions in 2023 including 'GBTC' (Bitcoin) for our more risk tolerant investors and SHRIX/insurance securities for all our investors. We added close to 100% of our existing GBTC position in late 2022/early 2023 upon our rebalance and that has paid off in spades with a more than 300% return from that point through the end of the year. And already in 2024, GBTC is up another 20% as several Bitcoin ETFs gained SEC approval.

We also added insurance security exposure in December 2022 and early 2023 between XILSX, SHRIX, SRDBX, and CBYYX. Most clients held around 10% or more of their entire portfolios in these securities through 2023 as insurance premiums hit all time highs (on an inflation adjusted basis). We felt this area was priced to deliver exceptional risk adjusted returns and we were not disappointed. With virtually no volatility or correlation to any other asset, the funds we held for the entire year returned 20%. We are still excited here as insurance premiums remain near record highs and higher base interest rates also produce a tailwind. Of course, we can get an extreme hurricane or earthquake that would produce negative returns, but we are starting off (like we did in 2023) from a great position.

Although it is very early with only a few months exposure; XPMIX (private equity), AMCJX (asset backed private lending), and STRUX (private infrastructure) have performed very well for our investors. XPMIX in the first 6 months has produced just under 5% in returns with very low volatility for our clients. This is essentially a ‘private equity index fund’ with over 2000 private companies held within the fund. This fund returned 13.3% for 2023 and 24.7% per year since its inception in 2020.

We like AMCJX as a diversifying fund within our private credit sector. This is an investment with credits backed by specific assets (as opposed to cash flows), which historically have experienced much higher recovery rates in the case of defaults. In the case of defaults, cash-flow based lending recovers on average around 65-70 cents on the dollar, where asset backed lending recovers closer to 90-95 cents on the dollar. This is both a nice diversifier for us, and a way to reduce risk. This fund returned + 8.5% in 2023.

STRUX is a new private infrastructure fund that concentrates in the ‘digital transition’ theme with a large allocation to data centers, cell towers, hypers scalers, along with some traditional assets (electricity generation, pipelines, etc.). We are gradually allocating funds here, but so far, the performance has been excellent. Over just 4 months, it has returned 15.2%.

SCHD (Schwab dividend ETF) has underperformed materially over the past year, and although we like the underlying premise and it historically has performed well, we feel there are better options for total returns in the US stock market. We will be exiting this position in favor of ‘VFLO’ within the next month. VFLO is a concentrated ETF combining high free cash flows, attractive valuation, and growth.

TLTW (Long Treasury/Call Option Selling), although down 4% or so for most of our clients since we purchased in the spring of 2023, remains a core bond holding. We did use this security for tax loss harvesting purposes in December, so there were some large sales, but within the next month the security will be bought back in these instances. TLTW is unique in the fact, it is default risk free (being 100% US Treasuries), and with the addition of monthly option selling has been yielding around 15% per year. The yield will be variable, but over time we would expect an average yield (assuming current base rates remain stable) in the low to mid-teens. We feel this is a very attractive way to earn a good yield and protect capital in the case of a recession.

QQQE has performed well since purchase and feel it is a nice way to avoid ‘concentration risk’ within the technology/growth area, as it equal weights the top 100 stocks in the NASDAQ index.

In addition to these changes, we have trimmed some existing private credit funds to take profits and reallocate those funds to private infrastructure debt and equity along with some US stocks and Treasuries. We are also trimming our healthcare overweight materially in the light of some regulatory changes and the possible large negative impact of the GLP-1 (weight loss) drugs on many other companies/industries in the space.

With the help of the changes just mentioned in 2023, others made in 2022, along with the extensive use of private/alternative investments a 'balanced' Traphagen client has outperformed both the global stock market (ACWI) and the bond aggregate (AGG) with a modest positive return, while experiencing much less risk/volatility over the past two years. This is not an easy feat, as almost all investors in stocks, bonds, or any combination therein have lost money over the past two years with stocks just shy of breakeven and bonds down close to 9%.

Below: Chart of bond index (blue), global stock index (red), and Traphagen balanced client (Black) from 1/1/2022 – 1/11/2024.

Private Investment Update *(for $1M+ Traphagen/Accredited clients only)*

Private Equity (GPB Fund II): In December of 2023 GPB II fund was granted their request to be placed in receivership. This would allow the large cash distribution/dividend to be sent to investors within 45 days. There is currently more than $350M within the fund in cash waiting to be distributed to investors (along with operating healthcare/IT companies). Shortly after this receivership was granted, a temporary 'stay order' was put in place stopping this designation. We will need to wait until the stay order is lifted for the cash distributions to be disbursed to investors. The fund returned – 3.5% in 2023 after a very good 2022.

Private Equity (I-Capital KKR Private Equity Fund): This well diversified private equity fund was a solid performer with a 2023 return of + 12.7% through November.

Private Real Estate Equity (Blackstone BREIT): After an excellent six year run where the fund returned + 92%, this largely residential/industrial/data center/student housing real estate trust took a breather and was breakeven in 2023 through November.

Stepstone Venture Capital & Growth (SPRING): Stepstone's diversified venture capital fund had a great full first year. The fund which invests in start up private companies returned + 17.4% through November.

JP Morgan Private Real Estate Fund (JPREIT): In a tough year for most real estate, the newer JP Morgan fund performed very well. Through November of this year it has returned + 6.7%, and after a recent residential purchase is poised to add to those gains in December.

2024 Portfolio & Economic Commentary

It might sound like a broken record, but the most important factor that will impact markets in 2024 is the interplay between inflation, interest rates, and FED policy. Since inflation and rate volatility have dropped recently and stock valuations have expanded, earnings growth will be an important variable as well. In 2023, despite nearly flat earnings, the SP500 was able to return + 26%. This was due to multiple or valuation 'expansion'. We think that this phenomenon is largely behind us and stock returns from this point forward will be dictated by earnings growth and their dividend yield.

On the economic side, we still see a tight/healthy labor market with some softening, but unemployment remains very low at 3.7%. Long-term rates seem to have stabilized between 3.5% and 4.5% and inflation is coming down, but still above the FED target of 2%.

Many are troubled by both the upcoming US Presidential election and geopolitical issues/wars around the world. Historically, presidential election years are very positive for the stock markets as by the end of the period there is 100% clarity in the election result. This is especially so if the outcome is a split government.

In terms of geopolitical hotspots in the Mideast, Ukraine/Russia, and China we are constantly monitoring these areas of concern, but very rarely do these types of events have a long term impact on the US stock market. In terms of China, since we hold essentially no exposure to foreign markets we are greatly insulated.

With the above backdrop in mind, below you will find major tenants of our portfolios going forward.

Major 2024 Portfolio Themes
Gain diversified exposure to AI within all portfolios
Significant allocation to private infrastructure debt & equity
High free cash flow/equal weight growth/quality US stocks
Retain overweight to insurance and private credit
Material allocation to high quality bonds (4.0% - 15% yields)
Remain well protected against recession or higher inflation

Much like in 2023, with alternative/private investments yielding near or over 10% and high-quality bonds having 4%+ yields, this enables us to play offense and defense at the same time for conservative and mid-range portfolios. When these assets are paired with quality, high free cash flowing, and well diversified growth/technology stocks with a tilt to the AI theme, we forsee a positive outcome in 2024. If we can avoid a recession most portfolios should again be able to deliver upper single digits to mid teen returns this year as they did in 2023.

If we enter a recession, portfolio returns could certainly be negative, but again like last year, we retain significant protections in the form of high-quality bonds, alternative/private investments, and infrastructure.

Major Issues we will be monitoring throughout 2024:

2024 Economic/Market/Portfolio Issues to Monitor
Geopolitical Issues (especially China relations)
2024 US Presidential & Congressional Elections
Hurricane Season/Natural Disaster Severity
US Corporate Earnings Trends
The Pace at which Inflation and Rates come down

Traphagen feels we have adjusted quickly to this higher rate and much different investment environment we first entered in 2022. The renewed viability of traditional bonds, the strong movement towards private credit vs. traditional bank credit, increased use of alternative/private investments in general, allocation to private infrastructure credit and equity, and entry into a diversified basket of assets that should benefit from the secular AI trend should all be important building blocks of portfolios as we move through this new environment.

We are happy Traphagen has been at the forefront of these long-term trends and are pleased we have passed the benefits on to our clients over the past few years and are confident that will continue.

We wish all our clients and their families a very happy new year and offer our continued appreciation for your trust through the recent volatile and transitional period.

Best Regards,

Your Traphagen Investment Team