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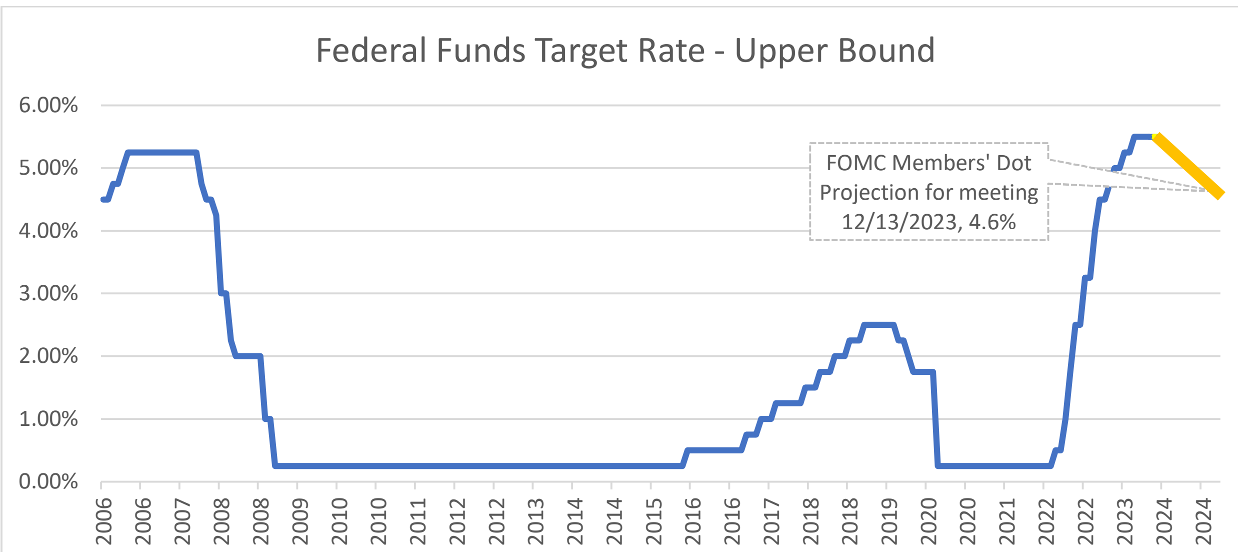
Q4 2023 Commentary and Investment Outlook

Since 2021, the Federal Reserve has embarked on the most aggressive interest rate hike cycle in decades, and with inflation pulling back from forty-year highs, we expect policy rates to remain higher for longer for the first half of 2024, then decline a bit for the remainder of the year, but still, remain restrictive.

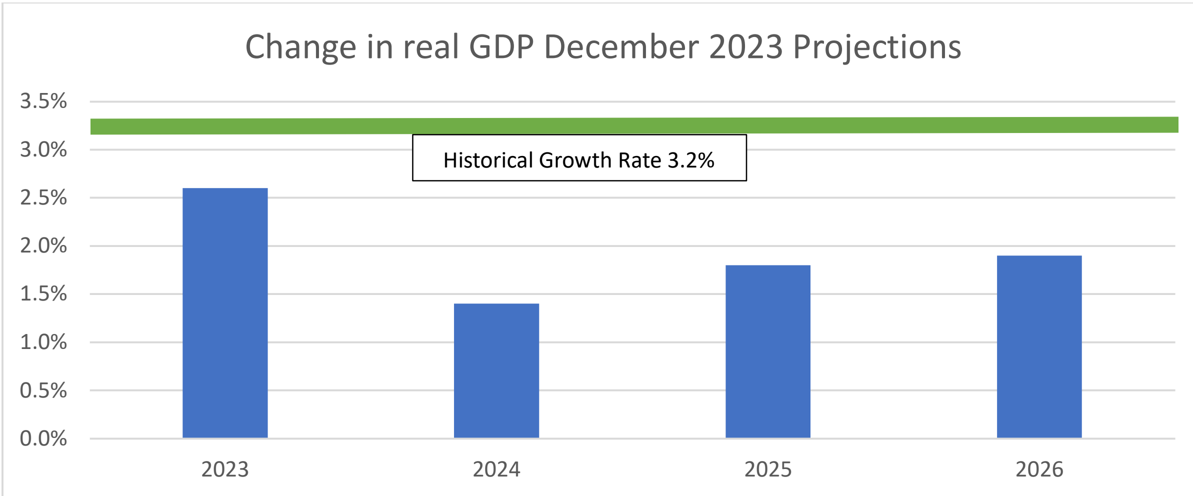
FOMC members at the last meeting of 2023 agreed that it would be appropriate to maintain a restrictive stance "for some time," while affirming they were probably at the peak rate for the tightening cycle.

The FOMC has indicated, through released minutes and their quarterly implied Fed Funds Target rate dot plot, that the majority of participants think rates will decline by 75 basis points (three cuts), by the end of 2024.[1] The graph below illustrates that projection in yellow. However, futures markets are anticipating greater declines in rates, 150 basis points (six cuts) by end of 2024, at the time of this writing.



Source: Bloomberg 12/31/2023 Federal Reserve

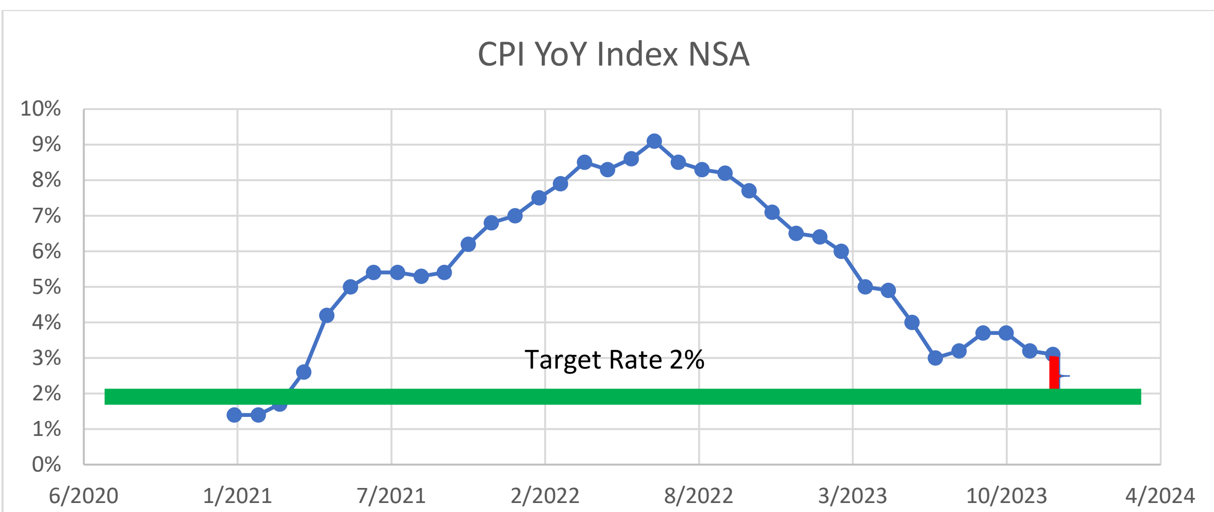
The resilience of the U.S. economy in 2023 was remarkable considering the Federal Reserve was very aggressive in restricting monetary policy to slow down the economy. The economy was driven by strong labor markets (>200,000 average monthly job creations for 2023), strong consumer spending, and large fiscal stimulus (Inflation Reduction Act and Infrastructure Law). In 2024, it is likely the economy will slow as the effects of COVID stimulus (fiscal policy) wane. The Federal Reserve in their December Summary of Economic Projections is expecting GDP to grow 1.4% in 2024 and below 2% for the next few years. We do expect the economy to grow in 2024, but below the historical average of 3.2% as indicated by the green line in the chart below.[2] It is these growth projections that are contributing to lower interest rate expectations in the next few years. These forecasts change over time, and in fact, are updated quarterly by the Federal Reserve.



Source: Federal Reserve Summary of Economic Projections 12/13/2023

The Federal Reserve relies on a number of data points to gauge inflation. An analysis of the Consumer Price Index measured year-over-year (CPI YoY) is typically the leading inflation measurement to gauge price changes. CPI YoY which peaked in June at 9.1% driven by pandemic related supply imbalances and an expansionary fiscal policy, will continue to decline.[3] However, target inflation at 2% might take longer to reach. The final push to 2% inflation might be more difficult to achieve, and because of this, we expect monetary policy to pivot and reduce the Federal Funds Target rate in the second half of 2024.

The graph below highlights (red line) what the Federal Reserve is looking to achieve, 2% inflation. CPI YoY was at 3.1% as of 11/30/2023. The much debated "soft landing" for the economy is an outcome where inflation approaches the 2% target and demand does not adversely weaken, which is a possibility. However, there is also a possibility that the economy will slow due to lower GDP growth, higher unemployment, and lower wage growth.



Source: Bureau of Labor Statistics 12/31/2023

Slower GDP growth combined with a longer period to achieve target inflation will most likely give the Federal Reserve a good reason to lower rates in the second half of 2024. During one of our recent research meetings, an analyst made a great point, that after a decade of low interest rates, we are not returning to zero interest rates anytime soon, and it is likely that rates will normalize at these higher levels. Rates will likely decline slightly in 2024, but we expect by the end of 2024 the target Federal Funds rate will be above 4.5%, and the yield curve to become less inverted/steeper.

SWS Capital Management's (SWSCM) philosophy is based on a value-oriented, active management style which emphasizes liquidity and risk management. This philosophy is woven into all our strategies. Security selection, sector allocation, and yield curve positioning are based upon our interest rate forecast as well as our fundamental economic outlook.

SWSCM focuses on short-to-intermediate maturity portfolios invested in higher rated investment grade securities. The rise in interest rates which occurred over the last two years and the "higher for longer" outlook is favorable for our strategies. Our portfolios are generating higher levels of yield and returns than before the Fed started the recent hiking cycle.

SWSCM will continue to favor US Treasury Bills as the government will continue to issue more supply to address budgetary funding needs. We will continue to increase exposure in commercial paper and corporate bonds for all strategies, where applicable. Moreover, we will continue to increase duration and maturity horizons in all strategies as we think we are at an inflection point in the current interest rate cycle.

As always, we appreciate your business and look forward to working with you in 2024.

Happy New Year.

US Indices	Q4 Return	2023 Return
ICE BofA U.S. 3-Month Treasury Bill Index	0.46%	5.02%
ICE BofA U.S. 1-Year Treasury Bill Index	1.86%	4.92%
Bloomberg U.S. Aggregate Index	3.83%	5.53%
Bloomberg U.S. Corporate Investment Grade Index	4.34%	8.52%
Bloomberg U.S. Treasury Index	3.36%	4.05%
S&P 500 Index	11.24%	24.23%

Source: Bloomberg as of 12/31/2023

[1] FOMC Meeting Minutes release 1/3/2024
[2] GDP US Chained Dollars QoQ SAAR – Average 1947-2023 – Bureau of Economic Analysis
[3] US CPI Urban Consumers YoY NSA – Bureau of Labor Statistics