Oakwood
FINANCIAL ADVISORS

The Financial Year That Was & What Lies Ahead – January 2024

What An Encouraging Difference A Year Makes

Coming into 2023, the economy and global markets were in a precarious position. After a year of negative returns in 2022, inflation was close to record high levels in most developed markets. Interest rates had been increased to fight this dangerous enemy. There was a constant debate about the US economy (and hence the global economy) moving into recession territory. Yet none of this came to pass. Both media commentary and investor sentiment were universally negative. Even as recently as November past, I felt it prudent to issue a client note Cultivating Stability due to the volume of queries from concerned clients to counteract the negative news flows.

A Year Of Positive Returns

It is great to be able to look back and see global financial markets confounded the downbeat expectations in 2023 (further outlining the Folly of Forecasting). Stocks (equities) and bonds rallied after a poor first quarter. Recession fears were replaced by growing confidence that US policymakers would achieve an economic soft landing. The knock on effect was felt across global markets producing strong returns. Many major share indices recorded double-digit gains during the year, helped by a strong rally in November and December, as falling inflation made analysts more hopeful of an interest rate cut in 2024.

2023 Returns	
Index, Currency, Bond	**Gain/Loss**
MSCI World Index (€)	19.6%
Dow Jones Industrial Average ($)	13.7%
S&P 500 Index ($)	26.3%
Emerging Markets Index (€)	6.1%
Eurozone Equities (€)	18.8%
Irish Property	-11.3%
Gold Price (€)	10.1%
Commodities Index (€)	-11.1%
Eurozone Government Bonds	8.5%
Eurozone Corporate Bonds	8.2%
Eurozone Inflation Linked Bonds	5.9%
Irish Inflation (projected)*	4.06%

Uncertainty A Factor In High Expectations

If we look solely at the S&P 500 in the US (the 500 largest companies in the US), it is close to new high ground on a total return basis (when we include dividends). However it has to be noted that a handful of technology stocks called the Magnificent Seven (Apple, Microsoft, Amazon, Tesla, Meta and Nvidia) in the main drove these gains on Wall Street in 2023.

Realism Must Be Factored In

The strong rally in US equity markets has also been based on a rosier view about inflation and interest rates. But whether or not that comes to pass, consensus forward earnings growth expectations are very demanding. For the US market the consensus figure of 12% appears a real stretch given that margins are already above their ten-year average.

We Predicted A Bond Bounce Back

In our client update issued early November 2023 (Cultivating Stability) we used a gardening analogy to describe how interest rate hikes were being used to tame inflation. We also commented on the potential for a strong Bond Bounce back over the coming months in to 2024. With yields on medium and long-dated Eurozone government bonds near zero in late 2021, government bond prices had nowhere to go but down once interest rates started to rise. Quite simply, when interest rates rise, government bond prices must fall to provide a yield that competes with the higher European central bank rates (i.e. the higher level of interest rates).

This came to pass with a rally in bonds in December as can be seen in the previous table with bonds all posting significant growth figures.

Hard Times Ahead For Commercial Property Sector

2023 proved to be a challenging period for the Commercial Property sector, continuing the downward trend that began in late 2022. This decline is exemplified by the Irish Life Exempt Property Fund, a near real-time indicator for the sector, which saw a decrease of 11.3% in its value. It's important to note that some Commercial Property Fund valuations are not fully aligned with underlying market fundamentals. This suggests that we might anticipate additional decreases in commercial property values into 2024.

A Resurgence Of Gold

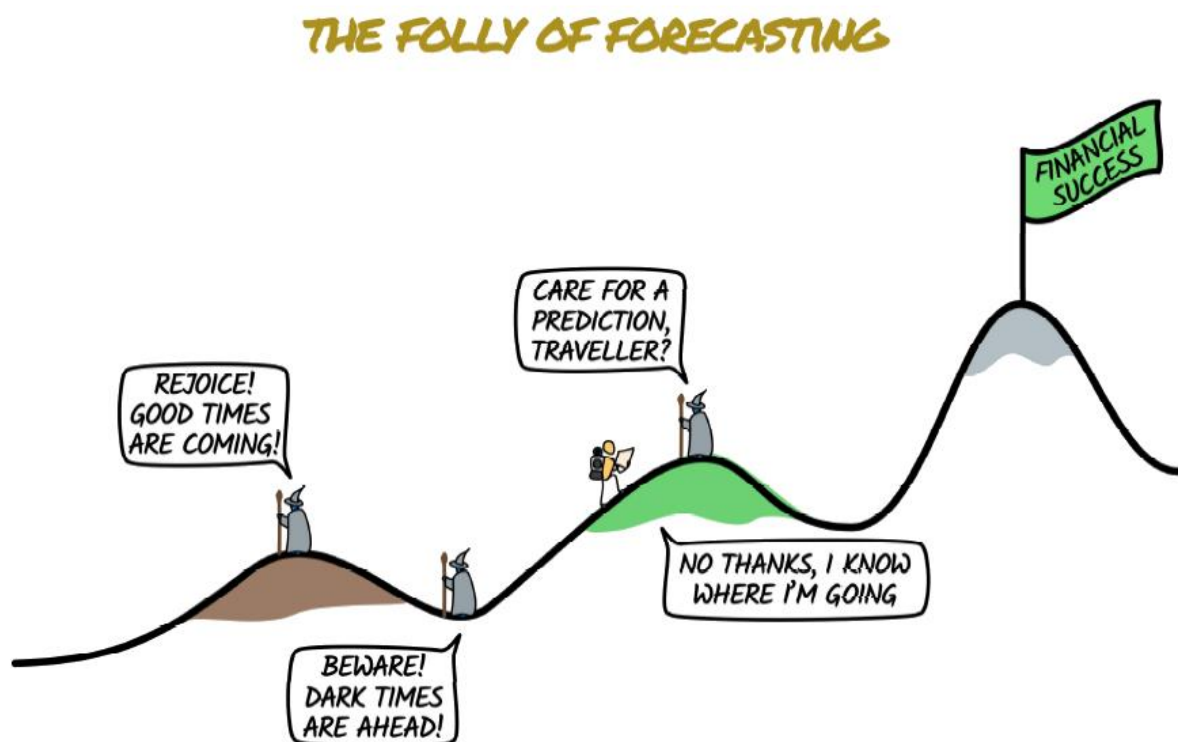
2023 marked a significant upturn for gold, breaking its previous two-year spell of modest performance. The precious metal achieved a noteworthy gain of over 10%, surpassing its 2020 peak of $2,056 per ounce. This surge in gold's value seems to be driven more by strategic acquisitions by national central banks, particularly in countries like Russia, China, India, and Turkey, than by individual investor demand. These nations are increasingly opting to bolster their monetary reserves with gold rather than relying solely on US dollars, a shift likely contributing to the current high prices of gold.

Russia Circumventing Sanctions

The dynamics behind this trend are intriguing, especially against the backdrop of global political developments. Take Russia's situation for instance. Since the onset of the conflict with Ukraine, the West has imposed stringent economic sanctions on Russia, including the seizure of its foreign-held assets. In response, Russia has shown a preference for converting its reserves into gold. As a universally recognised and liquid asset, gold offers a secure alternative that remains beyond the reach of international banking restrictions and potential asset confiscation. This strategic move by Russia exemplifies the broader trend we are witnessing in gold's increasing appeal as a safe and reliable reserve asset under current global (unstable) conditions.

Lessons To Be Learned from 2023

Why equities performed so strongly in 2023 is irrelevant to the lessons to be drawn from this experience. There are almost as many theories and explanations of ***why*** as there are market commentators, of whom I am happily not one. (I would point out, however, that the number of said commentators who successfully forecast both the market action of 2022 ***and*** that of 2023 is, to my knowledge, **plus or minus zero.**)



Lead Us Not Into Temptation
As we enter 2024, many media outlets will publish stock market forecasts from various market analysts. These forecasts will make bold predictions about where stocks, bonds, and the economy are headed in 2024. However, before you put any confidence in these forecasts, let's explore why one finds them so tempting in the first place.

Our Brains Crave Predictability – Even Illusionary
Before explaining why we believe that market predictions are futile, it's essential to understand why human beings are so attracted to these forecasts in the first place. Psychologists tell us that we have an innate preference for certainty over uncertainty. When facing an unpredictable future, we crave clarity, assurances, and some sense of control, even if it is an illusion.

Making predictions, even inaccurate ones, helps satisfy our brain's desire for order and our inability to accept events as random. Having some concept of what the future may hold makes us feel safer and less anxious. Of course, the realities of the complex world mean many things cannot be predicted accurately.

Pundits Are Fallible
Nonetheless, pundits who boldly predict detailed market outcomes will always have an audience because of how our brains are wired. Admitting that the future is ultimately unpredictable is unsatisfying. This is why the temptation to listen to market forecasts remains, despite their terrible track record.

What happened, happened!
What should matter most, to long-term, goal-focused investors is not ***why*** this happened but ***that*** it happened. Specifically, that there could be a pervasive and very significant bear markets (loss of over 20%) during most of one year, and that those declines could be entirely erased in the following year. Although not nearly as quick, or as perfectly symmetrical as the 2022-23 experience, in the largest sense, ***that's how it works.***

Rational Definition of Money is PURCHASING POWER
The only rational long-term definition of "money" is "**purchasing power**." The number of units of the currency one holds, and the returns thereon, are at any given moment, irrelevant.

- The goal of long-term investing can therefore only be the increase of purchasing power.
- In the long run, the owners of successful businesses (the stockholders) must make far greater returns than do the lenders to those businesses (the bondholders). This is simple logic: if rational owners could not earn a significant return above their borrowing costs, they would not borrow.

- This logic is amply supported by the historical record. Over nearly the last half century we can see the compounding effect of equities and their dividends in the attached link – **The Case for Equities**. The S&P 500-Stock Index (and its predecessor until 1957, the S&P 90) when compounded, **net of inflation**, stands at 7%. The most comparable corporate bond index, compounded at an inflation-adjusted, is 3%.
- The true test of an investment's long-term safety is **its long-term total return in excess of inflation**. That excess return to the stockholders has historically been more than twice the directly comparable return to the bondholders. By the standard that matters most, therefore, stocks have been significantly safer than bonds.
- But the return of stocks has been considerably more volatile around its long-term uptrend line than that of bonds. This simply means higher highs as well as lower lows — "volatility" in both directions.
- **The average annual peak-to-trough drawdown over this near-century has been around 15%.** Average declines of nearly twice that have taken place irregularly, about every five years on average. 2023 is a prime example. As shown in the previous the chart **Annual Equity Market Returns & Declines** at one point the S&P 500 was down 10% in 2023 yet finished the year up over 20%.
- Stated another way, the prices of mainstream equities have gone down often, and sometimes significantly. But not for long. After which returns have always caught up to their long-term trend.
- The cash dividend of the S&P 500 has grown since 1926 at a five percent compound rate versus the average inflation rate of three percent. Since 1980, the rate of dividend growth has accelerated to very nearly six percent, while CPI inflation has continued at about three percent. Dividends that grow significantly faster than inflation will be a critical need in three-decade, two-person retirements.
- The economy cannot be consistently forecast, nor the equity market consistently timed. The only way to be sure of capturing equities' premium long-term return is therefore to remain invested all the time.
- All successful long-term investing is goal-focused and plan-driven. Investing must at all times be driven by the plan, and never by current events. Investment policy that is based on a view of the economy and/or the markets must fail in the long run.
- Unaided, human nature is incapable of detaching its investment policy from current events/trends for any length of time. It will serially make the same fatal mistakes—panicking out of a temporarily declining market, piling into a temporarily hot fad—unless an advisor who is totally focused on planning and behaviour management intervenes.

Current Commentary influenced by unpredictability

Long-term disruptions and distortions from the COVID pandemic continue to reverberate through the global economy, financial markets, and society. These ongoing effects are unfolding in unpredictable ways, making them challenging to distil into a coherent investment policy.

- The central financial event, in response to COVID, was an explosion in the money supply by Central Banks across the globe. It predictably ignited a firestorm of inflation.
- Inflation continues to be the critical variable for financial markets, most particularly, bonds. At a time when labour markets in many of the developed world are still tight, **it is far from certain that services inflation will be as well behaved as central banks will require it to be,** for the data to justify cutting rates any time soon.
- To stamp out that inflation, Central Banks then implemented the sharpest, fastest interest rate spike in history. Both debt and equity markets cratered in response.
- Despite this, economic activity just about everywhere, has remained relatively robust; employment activity has, at least so far, been largely unaffected.
- Inflation has come down significantly, but not yet close to most Central Banks' target of 2%. Yet prices for most goods and nearly all services remain elevated, straining many families' budgets.
- Capital markets have recovered significantly, as speculation now centres on the reduction of interest rates in 2024, and whether a recession will start up.

These outcomes are unknowable and don't lend themselves to forming a rational long-term investment policy. No different to 2023, significant uncertainties still abound and trends in global national debt continue to appear unsustainable. In the US, a bitterly partisan presidential election looms. The markets will face significant challenges in 2024, as indeed they do every year.

Summary – An Evidence-Based Strategy

While we acknowledge the natural curiosity about market forecasts, we continue to focus on what has proven most effective. That remains, a solid, evidence-based investment strategy tied to the steady progress of human innovation and resilience. A portfolio of global equities and bonds allows for a balanced approach to risk and return. Equities offer growth potential, bonds can provide income and act as a buffer during market dips.

Don't Follow The Pundits

As we navigate 2024 together, our commitment remains steadfast—to adapt and refine your financial plan to meet evolving needs, goals, and aspirations, **ensuring it remains robust no matter what the headline of the day might claim.** We only recommend adjustments when circumstances or priorities shift, not when a pundit makes another faulty guess about next year's market.

Equities For Reliability of Growth

Our core advice to clients remains consistent with our stance at the outset of both 2022 and 2023, despite these years yielding markedly different outcomes. Over the long term, equities continue to present the most potential for growth and the preservation of your funds' purchasing power. With the rise in interest rates during 2023, bonds now offer a valuable diversification element. They can provide more stable returns and are an appealing choice for investors seeking to mitigate short-term portfolio volatility.

I hope you have found this update useful and as always we remain on hand to help with any queries.

Ronan McGrath
Managing Director
Oakwood Financial Advisors

7th Jan 2024

> *The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioural discipline that are likely to get you where you want to go.*
>
> **Benjamin Graham**

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