Davenport Asset Management Quarterly Update | Q4 2023

December 31, 2023

Market Returns	Q4 2023	2023
U.S. Large Caps	11.7	26.3
U.S. Mid Caps	12.8	17.2
U.S. Small Caps	14.0	16.9
International Developed Markets	10.4	18.2
Emerging Markets	7.9	9.8
Intermediate Term Bonds	4.6	5.2

Source: Morningstar Direct. Please see index for definitions.

Equity markets generated surprisingly robust returns in 2023. The S&P 500® Index gained 26.3% for the year and the Russell 2000® Index returned 16.9%. Much of the gains were fueled by a feverish late-year rally. For the fourth quarter alone, the S&P and Russell returned 11.7% and 14.0%, respectively. As you may recall, we came into 2023 with rampant negativity and widespread calls for a recession. While there were hurdles to surmount along the way, markets largely defied the odds and generated very impressive results.

The year brought plenty of wild turns and major developments. While it now seems like a distant memory, we started the year with a banking crisis that exacerbated recession fears and further weighed on stocks following 2022 declines. Soon, however, this disaster was standing in the shadows of the artificial intelligence (AI) craze. AI took the investment world by storm as investors anticipated a wave of innovation and profits. Large technology companies mopped up investor capital and the so-called "Magnificent Seven" were born (Apple, Microsoft, NVIDIA, Amazon, Meta, Tesla and Alphabet). These stocks powered most of the S&P's gains for a while as many other areas of the market continued to struggle. Later in the year, we saw war break out in the Middle East, adding more tension to an already fragile geopolitical climate.

All the while, the Federal Reserve was busy raising interest rates in an effort to combat inflation. Following a series of rate hikes in 2022, the Fed raised rates four more times in 2023. This brought their benchmark rate to the highest level in 22 years. While the last hike occurred in July, the Fed's "hawkish" tone continued to concern investors through the third quarter of the year. More recently, however, inflation data has cooled alongside weaker economic readings and policymakers have adopted a softer tone. It now appears the rate hike cycle has ended and, in a somewhat surprising about face, the Fed is even signaling the possibility of interest rate cuts in 2024.

In our last letter, we noted signs of "peak Fed" could breathe new life into stocks. Indeed, this has come to fruition in a major way. Stocks have rallied very sharply to close the year and have very quickly discounted the dream scenario of declining interest rates and a "soft landing" for the economy (i.e. we successfully tame inflation without tipping into a recession). We've witnessed somewhat of an "everything rally" that has encompassed almost all corners of the market. Gains have spread to include areas other than the large cap tech behemoths that led markets for most of 2023. Perhaps the most striking example is the small cap-oriented Russell 2000, which gained 22% in the final two months of the year.

This vigorous rally has changed market dynamics. In a short period, it seems investors have shifted from having too much worry to having no worries. To wit, the CNN Fear & Greed Index has moved from "extreme fear" at the end of October to "extreme greed" as of year-end. The S&P 500 now trades for 19.7x projected earnings, which is above the 10-year average (17.8x) and seems to leave little room for further valuation expansion. There's no doubt that more accommodative (or less restrictive) Fed policy should support markets, and lower interest rates would boost everything from housing activity to mergers/acquisitions. But, investors may be disappointed short term if inflation remains sticky, rate cuts don't come to fruition as soon as hoped, and/or the economy weakens more than expected.

Despite a dose of near-term caution, we still think there is value to be found in the market. The equal-weighted S&P 500, which adjusts for the heavy weightings of the biggest and more expensive companies, trades for a more reasonable 16.3x earnings. This is clearly up from a few months ago, but still below the 10-year mean of 16.5x. This tells us the average stock is still fairly priced and that some segments of the market have further room for improvement. We also recognize domestic equity markets have essentially gone nowhere for two years (the Russell 2000 is actually still down over two years) despite the recently rally. This period of digestion could augur well for returns going forward, even if the scalding hot pace of recent months cools off.

Amidst a backdrop of confounding crosscurrents, heightened volatility and financial media myopia, we think it is important as ever to remember we are investing for the long term. We all frequently hear from investors, strategists and media personalities that are negative one day and positive the next. These distractions are only likely to intensify as we enter a presidential election year. Though we constantly adapt our view to new information and data, we think it's important to step back and focus on the backbone of our investment philosophy – buying stakes in good businesses at reasonable prices. We remain confident this approach will yield solid results for our clients over time. Thank you for your trust and we wish you all the best in 2024!

Bloomberg Market Returns	Q4 2023	2023
U.S. Govt/Credit	6.63	5.72
U.S. Govt/Credit Interm	4.56	5.24
High Yield Corporate	7.16	13.45
Municipal 1-10Y Blend 1-12Yr	5.46	4.61
U.S. Govt/Credit 1-5 Yr	3.44	4.89
U.S. Govt/Credit 1-3 Yr	2.69	4.61

Source: Morningstar Direct. Please see index for definitions.

Fixed income markets had a very strong finish to 2023. Both the Treasury and corporate bond markets witnessed their constituent security prices march higher into year-end. Falling interest rates were the dominant lever behind the fourth quarter's impressive total returns. Investors and central bankers largely concluded runaway inflation was under control, leading to lower interest rates and higher bond prices. The path in 2023 was neither smooth nor linear but marked by elevated bouts of volatility. Prudent portfolio management incorporated a high quality holdings bias, structural portfolio flexibility, and embedded liquidity to navigate a unique year and position for the opportunities and risks in 2024.

As the calendar turns to 2024, many themes from 2023 remain intact. Geopolitical risk isn't going away. Global tensions are evident with the Middle East conflict and the ongoing Russia-Ukraine war. The impact on U.S. financial markets might seem subdued to date but future stability is not guaranteed. Risks include additional countries involvement in existing stages and/or on new fronts such as a Chinese invasion of Taiwan. Aside from the horrific humanitarian aspect, the global economy and commodity market remain vulnerable to unknowns associated with a geopolitical escalation in what looks to be a dynamic presidential election year.

To better understand economic nuances on the horizon, a closer look at the health of the individual consumer is warranted. The labor market remains stable but consumer spending has become more dependent on borrowed money than individual savings. The compounded impact of inflation and higher interest rates only exacerbates consumer sentiment and concerns. On Main Street, elevated daily living costs outweigh the recent financial markets rally. We are not ready to count the consumer out but cannot ignore stretched personal balance sheets and strained incomes which will play an outsized role in the type of economic outcome in the year ahead.

Fiscal and monetary policy collectively play a more prominent role than in past cycles. Rapidly expanding fiscal spending and deficits have led to outstanding U.S. Treasury debt breaching $34 trillion, with recent borrowing occurring at multi-decade high interest rates. Rating agencies downgraded the U.S. outlook to negative due in part to its 1.2 debt to GDP ratio. Late 2023 market euphoria was largely due to expectations for a dovish tilt from the Fed. We continue to believe the Fed will be cautious with the timing and magnitude of its accommodative pivot.

Looking to markets, we believe valuations have come far and fast. Credit spreads price in a fairly rosy outlook that might understate some of our highlighted risks. Valuations at the lower end of the investment grade ratings spectrum appear most vulnerable and why we favor borrowers with strong fundamentals to service debt and access debt markets when needed. We also believe our increased portfolio liquidity affords the flexibility to opportunistically and selectively allocate capital in what is likely to be another volatile year.

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The ICE BofA **US High Grade Corporate Master Index** tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. The ICE BofA **US High Yield Master II Index** is an unmanaged index comprised of over 1,200 high yield bonds representative of high yield bond markets as a whole. All information provided by ICE is owned by or licensed to ICE. ICE retains exclusive ownership of the ICE Indices, including the ICE BofAML Indexes, and the analytics used to create this analysis ICE may in its absolute discretion and without prior notice revise or terminate the ICE information, Indices and analytics at any time. The **Bloomberg Municipal 1-10 Year Blend 1-12 Year Index** measures the performance of short and intermediate components of the Municipal Bond Index — an unmanaged, market value-weighted index which covers the U.S. investment grade, tax-exempt bond market. A **Treasury Index** is an index based on recent auctions of U.S. Treasury bills and is commonly used as a benchmark when determining interest rates, such as mortgage rates. A **High Grade Corporate Bond** is believed to have a lower risk of default and receive higher ratings by the credit rating agencies. A **Leveraged Loan** is a type of loan that is extended to companies or individuals that already have considerable amounts of debt or poor credit history. A **Municipal Bond**, commonly known as a muni, is a bond issued by state or local governments, or entities they create such as authorities and special districts. A **Convertible Security** is a security—usually a bond or a preferred stock—that can be converted into a different security—typically shares of the company's common stock. A **Preferred Stock** is a class of stock that is granted certain rights that differ from common stock. A **Mortgage Master** is an investment similar to a bond that consists of a bundle of home loans bought from the banks that issued them.

A security's credit rating is the grade a rating agency assigns to indicate the risk of default and, in some cases, takes into consideration the potential loss to investors in the event of default. Further information and a more extensive discussion on credit ratings can be found at www.sec.gov/ocr. Users are cautioned that rating agencies may assign different meanings to similar terms.

An index is not available for direct investment; therefore its performance does not reflect the expenses, fees and taxes generally paid with the active management of an actual portfolio.

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