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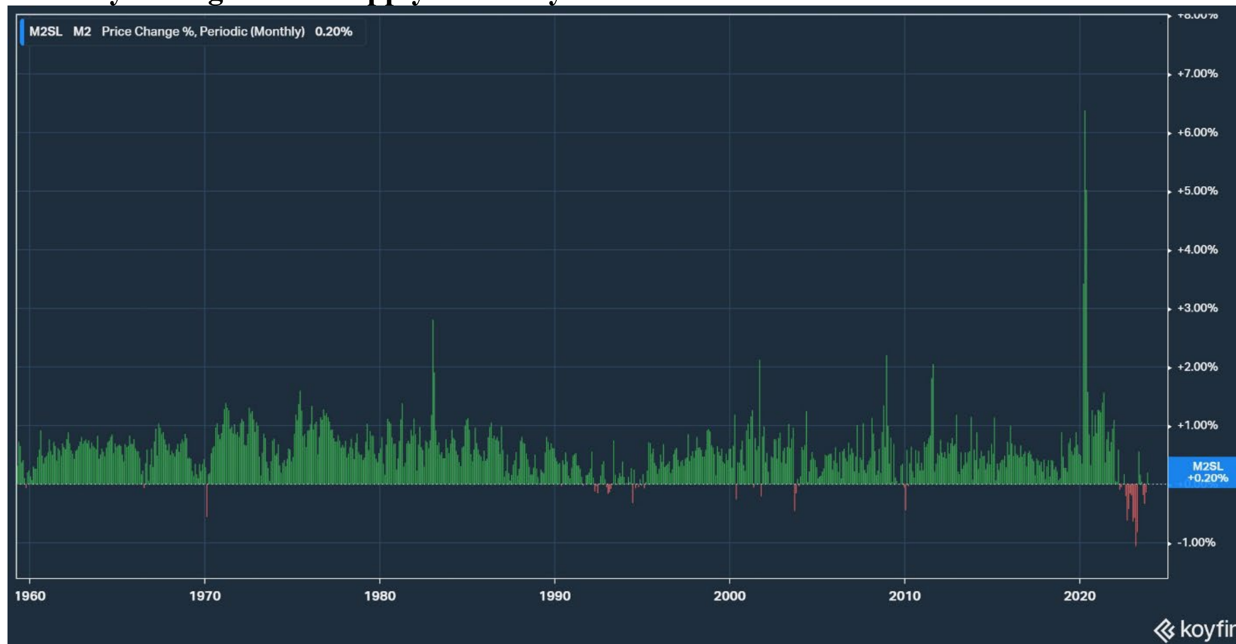
Venado Investment Advisors
2023 Year End Review and 2024 Outlook

The Year in Review: 2023

The US economy and stock markets defied conventional relationships in 2023, and the best explanation is that the consequences of COVID economics continue to pervade. These forces are likely to diminish in the coming year but provided more than a few head scratching outcomes last year.

The Federal Reserve's effort to tame inflation created the tightest monetary conditions in recent history. The chart below shows the monthly change in the supply of money entering the economy where the areas in green represent an increase in money supply and the areas in red show a decline. The past 12 months have seen the sharpest declines in the supply of money since 1960. The closest parallels are from 1970, which ultimately led the US to abandon the gold standard, and 2009, the peak of the Great Financial Crisis.

Monthly Change in the Supply of Money: 1960 - 2023



Source: Koyfin

Heading into 2023, many observers were concerned the economy was likely to enter into a recession. It's easy to dismiss skeptics, but if you had told me we would have experienced this level of monetary decline I would have said that a recession was near certain, and we would likely have had a banking crisis. Well, we avoided a recession and the closest we came to a banking crisis was the failures of Silicon Valley Bank and First Republic.

That the failures were quickly contained is not surprising given the state of regulatory oversight post-2008. However, that the economy avoided a recession is somewhat more surprising. The best explanation is the economy was still operating in a post-COVID-driven environment. The following chart supports this. It shows the velocity of money, otherwise known as the frequency of spending in the economy. High velocity reflects a high volume of spending while negative velocity shows people saving. During the shutdowns, spending experienced the sharpest decline recorded since 1960 and by a wide margin. Since then, consumers have compensated for the quarantine by going on vacations, eating out and generally making up for lost time. The difference between spending rates and money available was a net positive and therefore we saw positive economic growth.

Monthly Change in the Velocity of Money: 1960-2023

Source: Koyfin

One issue carrying over from 2023 is the inflation rate. Subsequent data indicates the spike in inflation was driven by supply issues that were transitory. However, there are structural changes that might be underappreciated. Yes, supply chain issues have been largely resolved but there are still issues with trade policy and China, labor/immigration issues, and a paradigm shift in unionization. All these factors are likely to keep inflation rates at levels higher than we experienced the prior two decades. That said, this risk is more an issue to financial markets than the broader economy, unlike the situation a year ago.

The unusual nature of the markets can be seen by the performance of major asset classes. Technology stocks, represented by the Nasdaq index, dominated the year while small cap stocks, represented by the Russell 2000 lagged. This is unusual because typically both perform well in similar environments as both are considered somewhat riskier. After a disastrous 2022, the bond market returned to normalcy with the Bloomberg Aggregate Bond Index returning 5.6%.

Market Returns in 2023	
Index	**2023 Total Return**
S&P 500	24.23%
Russell 2000	15.09%
Nasdaq	43.42%
MSCI EAFE (Developed International Stocks)	16.2%
MSCI Emerging Markets	10.3%
Bloomberg Aggregate Bond Index	5.6%

Footnotes:
1. *The S&P 500 is an index comprised of roughly the 500 largest publicly traded companies in the United States as determined by market value.*
2. *The Russell 2000 is an index comprised of roughly 2,000 companies determined by Frank Russell Co. to represent small cap stocks.*
3. *The Nasdaq is an index of 100 of the largest companies listed on the Nasdaq exchange.*
4. *The MSCI EAFE index measures the performance of roughly 800 of the largest companies in developed markets outside of the United States.*
5. *The MSCI Emerging Markets Index measures the performance of roughly 1,4000 companies in countries considered to be emerging markets.*
6. *The Bloomberg Aggregate Bond Index is a diversified index of bonds including Treasuries, corporate bonds, mortgage bonds, municipal bonds, and agency bonds that are considered investment grade.*

The Outlook for 2024

Now that the inflation rate has returned to more stable levels, we expect the Federal Reserve to loosen monetary policy to something neutral, if not accommodating. Given the healthy rate of employment and favorable monetary policy, the US should continue to grow in 2024. As Covid related effects ease a new headline will start to dominate - the election. Straight to the point, the role of the election is massively overblown in terms of its impact on the economy. After Trump was elected in 2016, the market rallied and the same was true when Biden was elected. This does not mean that elections do not affect the economy or the market. But it does mean that it is not automatic that either Trump or Biden will be better for either.

It is difficult to parse out fact from opinion when studying politics. However, there are two truths which I believe hold true. First, circumstance plays a bigger role than party and how the individual reacts to the specific moment is more important than their ideology. For example, it could be argued that Hoover should have been more aggressive about saving banks and lowering rates in 1930 and by failing to do so he allowed the Great Depression to hit harder than it might have otherwise. Meanwhile, George Bush and the Fed acted aggressively in 2008. While the efforts might have been controversial, they undoubtedly softened the blow of the crisis. Two individuals with similar political ideologies drove vastly different outcomes.

Second, and more importantly, it is imperative that investors operate with a neutral political bias. Too often investors focus on what they believe should happen based on ideology and not on what is actually happening. Although biases and the challenge of overcoming them are inherent to investing, political biases are the worst because they are so easily identifiable and therefore correctable.

Suffice to say, while the election will at some level affect the economy, and subsequently the markets, it is not a significant component of our outlook. Rather, we are focused on the direction of the economy, and the relative return potential of various asset classes.

At this point, the thinking is this:

- The economy will remain strong even if growth softens during the year.
- The Fed will adopt an accommodating monetary policy, supporting the markets.
- The stock market has already assumed this, which exposes it to a potential correction.

- Structurally the economy and financial system are strong enough to limit the magnitude and duration of any correction. In the absence of any severe exogenous shocks, we are unlikely to experience a severe decline.

Our portfolios are positioned to reflect this. Our stock and bond exposure reflects strategic allocations and does not incorporate any short-term tactical shifts. Within bonds, we hold Treasuries with shorter maturities and corporate bonds with higher quality ratings, driven by their respective risk and return profiles.

Internationally, China remains a concern as politics continues to restrain economic growth. This will likely limit the upside to most commodities. Relative country returns will be heavily influenced by their exports to China. Outside of this, there are pockets of potential outperformance.

Below is a summation of our current thinking.

Asset Class	Current Thoughts
Large Cap US Equities	Magnificent 7 is likely to underperform. Broader markets should start to improve.
Small Cap US Equities	Looser monetary policy should be a tailwind
International	Attractive relative to the US
Emerging Markets	China exposure is a headwind. Other areas offer better return opportunities to the extent they are not dependent upon selling to China.
Treasury Bonds	Shorter maturities have better risk/reward
Corporate Bonds	Higher quality offers better risk/reward
Real Estate	Industrial better than office. Residential has long-term tailwinds.
Commodities	Chinese economic weakness will likely hold them down. One potential bright spot could be a decline in the dollar as Europe and Japan improve.

While we are optimistic about the overall environment, we do believe the markets will continue to be volatile, not unlike the last few years. Given this, it is important to make sure your investment strategy is aligned with both your long-term goals and short-term liquidity needs. Please feel free to reach out if you wish to review your current strategy.

To our clients, thank you for entrusting us. To friends and future clients, thank you for taking time to learn about us. We hope we can have a long relationship with all of you.

Sincerely,

Gregory Toppe, CFA
Chief Investment Officer
Venado Investment Advisors