CMH Wealth Management, LLC

Issue 17

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Annual Returns Last 25 Years
US Stocks vs. US Bonds

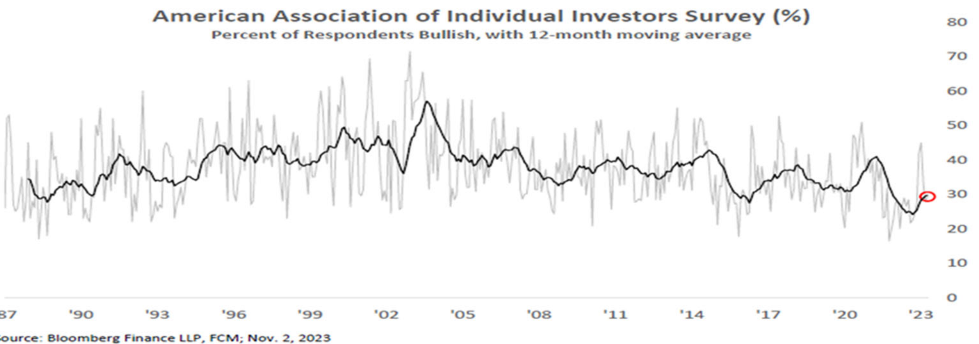
Year Ending	S&P 500	BB Agg Bond Index
2023	26.3%	5.5%
2022	-18.1%	-13.0%
2021	28.7%	-1.5%
2020	18.4%	7.5%
2019	31.5%	8.7%
2018	-4.4%	0.0%
2017	21.8%	3.5%
2016	12.0%	2.6%
2015	1.4%	0.6%
2014	13.7%	6.0%
2013	32.4%	-2.0%
2012	16.0%	4.2%
2011	2.1%	7.8%
2010	15.1%	6.5%
2009	26.5%	5.9%
2008	-37.0%	5.2%
2007	5.5%	7.0%
2006	15.8%	4.3%
2005	4.9%	2.4%
2004	10.9%	4.3%
2003	28.7%	4.1%
2002	-22.1%	10.3%
2001	-11.9%	8.4%
2000	-9.1%	11.6%
1999	21.0%	-0.8%
Average Annualized	**7.6%**	**3.8%**

Table Source: Tamarac, S&P Dow Jones Indices, Bloomberg Barclays US Aggregate Bond Index

Capitalizing on Opportunities

As we entered 2023, we asked ourselves; "What could go right?" After a tough year for stocks, bonds, and growth assets in 2022, it was important to start looking for opportunities. The S&P 500 ended 2023 up 26.3%, while the Bloomberg US Aggregate Bond Index ended the year up 5.5%. This was a dramatic positive turn of events.

At the end of calendar year 2022, bear market sentiment became extreme. Responders to the American Association of Individual Investors survey reported the lowest bullish reading in history, going back to 1987 (light gray line below). Shortly after the start of 2023, the twelve-month moving average of bullish sentiment (dark black line below) hit the lowest reading on record at 25%. This proved to be fertile contrarian ground and helped lead to a strong counter-trend rally.



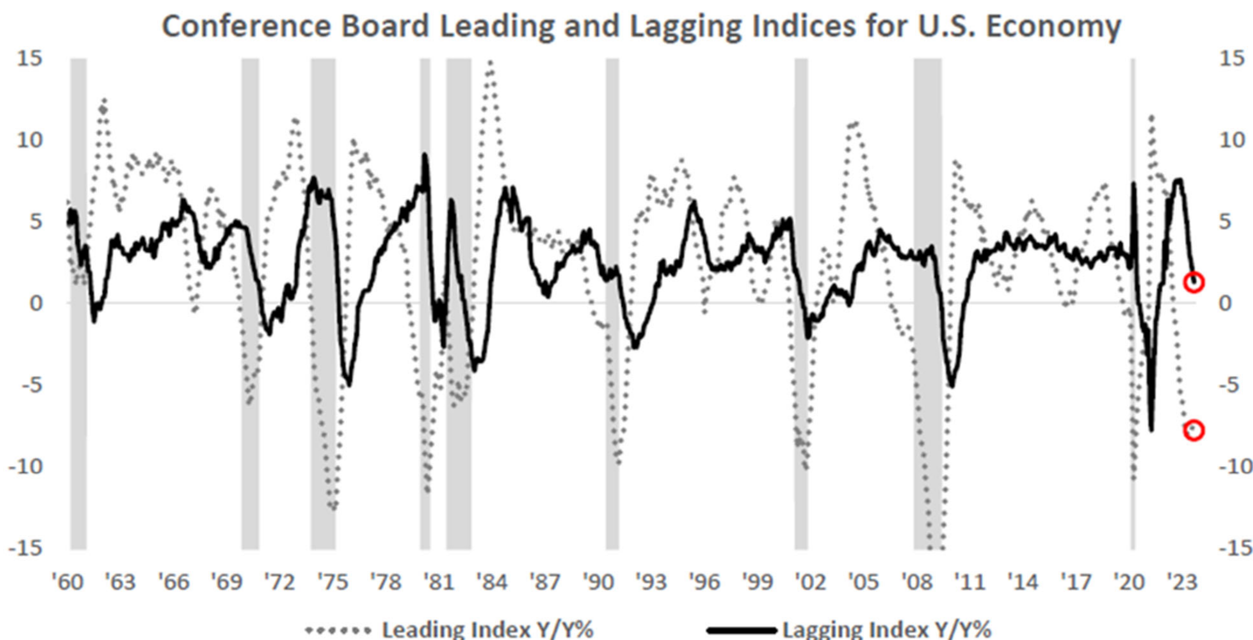
The sharp rise in interest rates in 2022, despite being expected to continue into 2023, offered opportunities investors had not seen for a number of years. While higher interest rates can negatively impact the value of stocks, the impact is more pronounced for long-maturity bonds and for growth stocks, which typically realize cash flows over an extended period of time. Eventually interest rates rise enough to slow economic growth, which in turn can have a positive impact on companies that are growing at an above average rate. This is one of the many factors that "went right" in 2023.

Cheaper valuations, declining growth expectations, and projected peaking of interest rates helped contribute to a strong year for growth-orientated equities in 2023. The Nasdaq (growth equity index) ended 2023 up 44.6%, well above the S&P 500 (core equity index). While it may be easier to ask oneself; "What could go wrong?" when challenges appear everywhere, we encourage investors focus on "What could go right?".

Economic Easing: Federal Reserve Balancing Act

In last year's newsletter, we discussed the divergence between leading and lagging indicators. As a brief reference, think about driving a car. Would you drive looking through the front windshield (leading) or looking through the rear-view mirror (lagging)? While we look to understand lagging indicators, leading indicators are what help us navigate the road ahead.

The Leading Economic Index (LEI) hit 18 months of sequential decline (October 2023). This has not happened in its history (since 1960) without the US economy being in recession. In 2023, both leading and lagging indicators were trending down. Recent weakening in both categories of indicators typically suggests the economy remains in the late stage of the economic growth cycle.



The good news in this case is that the reduction in economic activity was designed and driven by the Federal Reserve in their push to fight inflation. It is not just the result of organic economic weakness. Even if a recession were the next stage in this cycle, we remind investors that recessions are healthy for the economy. They remove excesses in the economy and free up both capital and resources. Despite higher interest rates, the U.S. economy has proven resilient. This is due to our reliance on both a very strong consumer and strong corporations, with less reliance on traditional manufacturing industries.

As we look to 2024, we see a high probability that interest rates have already peaked. This will prove to be a difficult phase - a balancing act - in the Federal Reserve's monetary policy cycle. While central banks have likely finished raising interest rates, they do not want to celebrate prematurely. Doing so may create an easing in financial markets and set off the animal spirits of investors, encouraging elevated risk-taking. We expect the Federal Reserve to cautiously seek opportunities for lower short-term rates in order to normalize the short-end of the yield curve.

Magnificent Equities

It would not be an official 2024 newsletter if we did not discuss "The Magnificent Seven": Apple, Amazon, Alphabet, Nvidia, Tesla, Meta, and Microsoft. These stocks now comprise 29% of the S&P 500 market capitalization. To put this in perspective, this is three times the entire Russell 2000 small cap index. Through the first 11 months of 2023, these seven stocks returned 71%, while the remaining 493 stocks in the S&P 500 returned 6%. While alarm bells might ring, many forget a big part of their strong returns is the reversal of poor performance in 2022. The magnificent seven was down 39% in 2022, while the remaining 493 stocks were down only 11%. Remember the narrative in 2022 for why they performed so poorly? It was because of rising interest rates. Guess what happened in 2023: interest rates still rose!

Despite interest rate changes having a significant impact on performance in the short term, fundamentals win in the long run. These seven stocks have faster expected sales growth (11% vs 3%), higher margins (22% vs 10%), higher earnings growth (59% vs -13%), greater re-investment ratio (61% vs 18%), and stronger balance sheets than the other 493 stocks. In addition, they trade at a relative valuation in line with recent averages, after accounting for expected growth (.90 relative price/earnings-to-growth ratio, or PEG ratio).

The table below summarizes the fundamental contributors to what went right for the "Mag 7." While the fundamentals still screen positive for these stocks, we recognize the risk/reward is less favorable than at the start of 2023.

Magnificent 7 fundamentals vs other 493

	Size		Total Return		Fundamentals (bottom-up consensus)						Valuation				Balance Sheet
	Market cap (trillions)	Weight in S&P 500	2022	2023	2023-2025 revenue CAGR	2023 net margin	2023-2025 net margin growth	YoY EPS growth	YTD revision to 2024 EPS	3-year Growth re-inv Ratio	Current forward 12m P/E	P/E at start of 2023	Forward 12m EV/Sales	Relative PEG Ratio	Net Debt / EBITDA
Magnificent 7	**$11.7**	**29%**	**-39%**	**71%**	**11%**	**22%**	**147 bps**	**59%**	**13%**	**61%**	**29 x**	**22 x**	**6 x**	**0.9**	**-.1 x**
Other 493	$28.3	71%	-10%	6%	3%	10%	99 bps	-13%	-4%	18%	16 x	16 x	3 x	1.0	2.2 x

CAGR = Compound annual growth rate
EPS = Earnings per share
Re-inv = reinvestment ratio
Source: FactSet, Goldman Sachs Global Investment Research "2024 US Equity Outlook" dated 11/15/2023

P/E = Price to earnings
EV = Enterprise Value
PEG = Price to earnings growth ratio
EBITDA = Earnings before interest taxes and depreciation

Artificial Intelligence (AI) could be the next catalyst for growth, and all seven of these stock are already participating in AI. AI's impact is not only in technology focused companies, but other companies that are able to capitalize on AI's productivity and profit potential. For example:

- Drug companies should find efficiencies as they run massive simulations to find potential cures for diseases not yet treated.
- Lenders can use AI tools for credit scoring and lending decisions to create a more efficient risk-versus-profit profile. The use of AI, can help lenders move beyond the simple focus on credit scores and potentially provide more liquidity to borrowers.
- Large language models and machine learning have the ability to summarize large documents or live meetings to facilitate dissemination.
- The Cosmetics Industry can use AI to analyze skin tones and customize a match to cosmetic products. This added 'personalized touch' may help improve sales as customers have an increased confidence in the added analytics.

2024 Portfolio Positioning

Equites:

We continue to favor domestic large capitalization equities over international. International equities come with an elevated exposure to geopolitical, currency, regulatory, and environmental risks, to name a few. Some would argue these risk have all been elevated the past three years with China tensions, supply chain disruptions, Ukraine/Russia relations, Middle East conflicts, and now Red Sea transit challenges. Large U.S. based companies have the resources, both legal and capital, to reasonably navigate these waters.

Small and mid-cap stocks have significantly underperformed large cap stocks in the last few years. Weak market breadth (magnificent seven outperformance vs small caps), tighter monetary policy, and the fear of declining growth drive our neutral positioning. Monetary policy is fluidly shifting from a tightening phase to the discovery of a more neutral stance. This could provide a reflexive relief rally in small/mid-cap stocks. We would welcome the privates (small cap) to follow the generals (large cap) to help broaden the market's growth potential.

We entered 2023 expecting significant short-term mean reversion in growth style stocks. Growth stocks engineered a substantial outperformance relative to value stocks, despite higher interest rates. While the short-term outperformance may take a pause, we expect the long-term secular themes to still favor growth at a reasonable price.

We remain focused on companies growing at an above average rate, while still trading at reasonable valuations. These include some of the magnificent seven, in addition to other high quality and opportunistic companies. Even though our holdings still appear attractive, we booked profits during 2023. As opportunities arise, we will continue taking profits in the coming year.

Fixed Income:

We materially increased the average duration of the investment grade corporate bond portfolio over the past few years. It is now in the 5.5 to 6.5 year range. This locked in higher yields for longer and provides benefits if rates soften. High Yield is still underweight as its spread (difference in yield between low and high quality bonds) is low by historical standards.

Here's a summary of our current portfolio positioning:

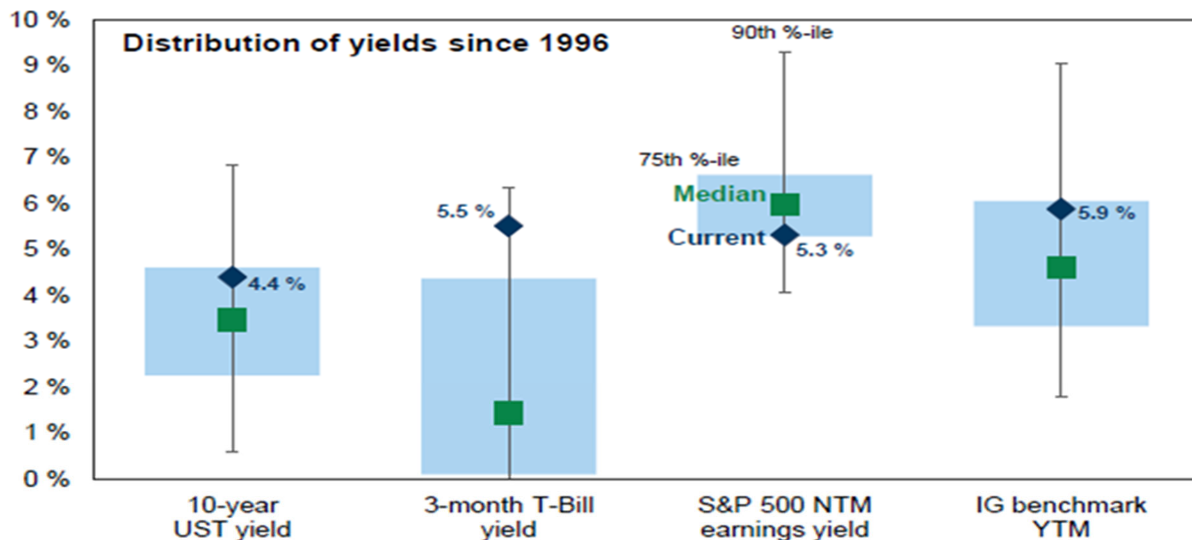
Asset Class	Summary of Current Tactical Views
Fixed Income	
Investment Grade	Underweight and favoring high quality corporate bonds. Extended duration.
High Yield	Underweight this lower quality & higher risk asset class, though underweight has been reduced.
Equity	
Large Capitalization	Overweight domestic quality companies and favoring Growth style.
Small & Mid Capitalization	Neutral on SMID. Overweight higher growth sectors.
International	Underweight developed and emerging international markets.

Fixed Income—Bonds are Back!

In 2023, interest rates reached levels last seen right before the great recession in 2007. Until the fourth quarter, bond returns were headed for an extremely rare event: a three-year sequential negative return. As it turns out, yields peaked in October and declined rather rapidly, proving to be quite an opportunity for long-term active bond investors.

The exhibit below (as of November 2023) outlines how attractive bonds are relative to both equities and also to historic bond yields. The blue diamond is the current yield for each asset class, while the green square is the historical median back to 1996. Example: The 3-month Treasury-Bill yield is 5.5% while the median since 1996 is about 1.5%, making the Treasury-Bill a very attractive current investment. This is also a higher yield than the current S&P 500 earnings yield. These attractive interest rates have reignited asset allocation discussions.

Exhibit 20: Yield-bearing assets offer attractive risk-adjusted yields relative to equities



Source: Haver. FactSet. Goldman Sachs Global Investment Research

We have taken advantage of the rising interest rate environment in four ways:

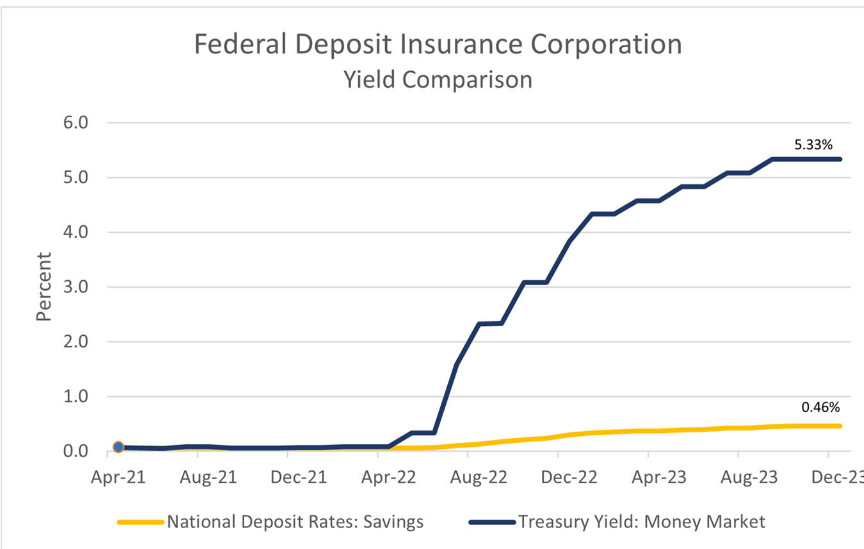
- Tax Loss Harvesting: Selling a bond at a loss and reinvesting the proceeds to lock in a tax asset
- Increasing Duration/Maturity: Locking in a higher yield for longer
- Increasing Spread: Reducing government bond holdings and buying higher yielding investment grade corporate bonds. In addition, we have increased our weight in high yield fixed income
- Reducing Equity Risk: Decreasing our overweight in equity and allocating the proceeds to fixed income

While bonds did not provide their typical capital protection in the most recent equity downturn, they now have what we call "coupon/yield protection". Interest rates are materially higher than at any point since 2007. These higher rates offer positive projected returns, even if the Federal Reserve were to hike on a few more occasions (hiking more is not our expectation). This coupon protection, or higher nominal yield, in addition to a strong equity market for 2023 has allowed us an opportunity to invest more capital in fixed income assets relative to equities. While we are at our lowest equity overweight since 2018, it is more a function of the interest rate opportunity rather than a fear of a drastic economic event.

Bank Savings Account vs. Money Market Fund

For over a decade, holding cash in a savings account felt quite discouraging. Most bank savings accounts were paying less than 1%, and in many cases close to 0%. But an alternative was hard to find. That changed with rising rates over the past few years.

There are a number of reasons to hold cash on hand: short-term liquidity needs, emergency savings, or an upcoming planned expense. It is not uncommon today to see bank savings rates still well below money market rates. That has led significant money to move to high-yield savings accounts and money market accounts.



Source: Federal Deposit Insurance Corporation, fred.stlouisfed.org

We are often asked the difference between keeping cash in a bank savings account versus a money market. For comparison purposes, we will focus on standard bank accounts versus the type of money market we use for client cash.

A bank savings account is highly liquid, and there is an ease in transferring money from a savings account to a checking account, or vice versa. Often the transfer can occur instantaneously. Money can often be withdrawn using an ATM card. Balances are insured up to $250,000 per depositor by the Federal Deposit Insurance Corporation (FDIC) at banks or by the National Credit Union Administration (NCUA) at credit unions.

A money market account typically offers a much higher yield than that of a standard bank savings account. At the end of 2023, a number of money market funds offered yields over 5%. It is important to note that these yields are not locked in. They are based on the current interest rate environment, and can increase or decrease over time. Typically transfers between a checking account and money market account will take up to a few days.

The goal of any money market fund is to provide some current income, while maintaining liquidity and stability. This includes maintaining a stable Net Asset Value (NAV) of $1.00, ensuring that the value of principal will never change. But not all money markets are the same. Some money markets can purchase non-government issued securities, and their NAV can float, which means it is not always stable at $1.00. These funds must charge a liquidity fee if total daily net redemptions exceed 5% of the fund's net assets. The Boards also have discretion to charge the fee in instances of smaller net redemptions.

For years, CMH Wealth Management has been using only Government or U.S. Treasury money market funds. Government and Treasury money market funds are exempt from the floating NAV requirement and the requirement to charge liquidity fees in specific instances. They can opt to charge a liquidity fee to redeeming investors for a period of time if they deem it to be in the best interest of the fund. Because of these beneficial characteristics, the funds we use have a constant NAV of $1.00. Having been through challenging financial times, we have prioritized money market funds that provide the most security for our investments.

If you are holding a substantial amount of funds in a bank savings account, it is prudent to periodically check the interest rate that those funds are earning. While we do recommend keeping cash on hand, it is also important to take advantage of current yield opportunities. Please feel free to reach out to your advisor team if you have questions regarding your savings vehicles.

Economic Normalization

What does Economic Normalization mean, especially in an election year? Putting together highlights previously mentioned, here is our summary as we focus on mini-market cycles of the past few years:

2020—2021 Excess Monetary & Fiscal Policy:
This period was characterized by enhanced government spending. The government stimulated the US Economy with upwards of $4 trillion to $5 trillion of liquidity. In addition to regular Medicare, Social Security, debt interest, veterans support, this included unique pandemic support for business, unemployment insurance, and health care programs under the CARES Act & American Rescue Plan.

2022-2023 Monetary Tightening:
This was a speedy transition from the Quantitative Easing (QE) period above to a focus on fighting inflation. The Federal Reserve hiked rates 11 times to a current short-term rate of 5.25% (or 525 basis points). In addition, the Fed continued to reduce it's balance sheet (quantitative tightening, or QT). In 2023, the Fed's balance sheet was reduced by $1 trillion to about $7.7 trillion. This QT continues at a monthly rate of about $100 billion into 2024.

2024-2025 Economic Normalization:
The material gyrations originally related to the pandemic and then the resultant inflation are now behind us, with a few residual continuing programs. This is good news as the economy regains the ability to stand on it's own two feet, thus normalizing.

We expect a few Fed short-term rate cuts as the 5.25% rate seems about 200 basis points too high as compared to longer term normal markets. The balance sheet tightening will probably continue as long as they can get down toward a more normal $4-$5 trillion balance sheet. This also replenishes a QE tool for future use.

Since markets like predictability and normalcy, this is all a positive for the economy and, as a result, equity and bond markets.

We ended the year with an exciting move back into Portsmouth. We look forward to hosting you in our new office in 2024.

Wishing you all the best in the New Year!

The CMH Wealth Team

100 Market Street, Ste. 201

Portsmouth, NH 03801

Sources include: Rosenberg Research, Various 2023 Issues. Goldman Sachs, *2024 US Equity Outlook: "All You Had To Do Was Stay"*, November 15, 2023. Fidelity Investments, *Fidelity Capital Markets 2024 Outlook*, November 15, 2022. T. Rowe Price, *2024 Global Market Outlook: Techtonic Shifts Create New Opportunities*, December 2023. Ropes & Gray, *SEC Adopts Money Market Fund Reforms and Changes to Reporting Requirements for Large Liquidity Fund Advisers*, July 27, 2023. Data source providers include St. Louis Federal Reserve, FactSet, S&P Dow Jones, Tamarac, and providers to.

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