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OUTLOOK 2024

Bulls, Bears, and Blurred Horizons

Presented by the Investment Policy Committee of
Clearwater Capital Partners

First Quarter 2024

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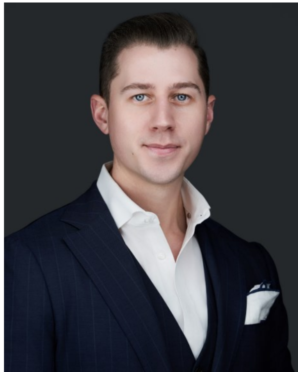

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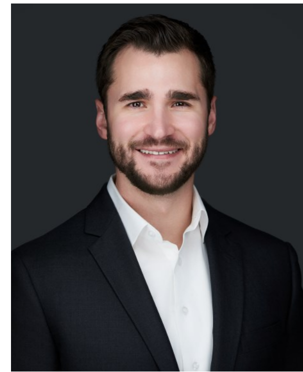

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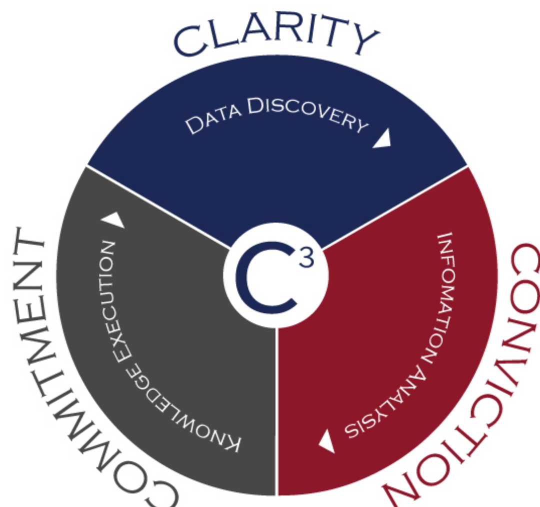
About Clearwater Capital

Successful wealth management is the product of clear thinking, hard work, and consistent follow-through. The professionals of Clearwater Capital Partners have developed a rigorous framework for decision-making that we call Clearwater C3. This disciplined process guides successful individuals and families through the prioritization of long-term objectives, the evaluation of high impact tactics, and the implementation of comprehensive strategies.



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BULLS, BEARS, AND BLURRED HORIZONS

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Introduction

We are pleased to share with you the Clearwater Capital Partners ***Outlook 2024*** report entitled:

"Bulls, Bears, and Blurred Horizons"

Each year, your team at Clearwater Capital Partners comes together to establish a foundational set of economic assumptions and insights for the upcoming year. Our overriding goal is to present rational economic perspectives that inform and steer our investment strategies throughout the year.

This process kicks off with a thorough examination of research from leading financial firms and esteemed academic institutions across the nation. Delving into a variety of perspectives, our team engages in thoughtful deliberations and debates the spectrum of opinions. It's essential to note that our efforts go well beyond a mere recapitulation of Wall Street commentary; we strive to integrate our macro view with real world insights from our clients and their businesses.

The content within these pages encapsulates our independent conclusions and perspectives as we endeavor to objectively identify primary trends and issues impacting the economy. The report places emphasis on the directional merits of our forecasts and observations, drawing on historical perspectives for added context.

Our aim is to construct an intelligent framework for decision-making. We embrace the rigorous work that leads us to our insights and opinions, fostering a deeper understanding of the key forces influencing the financial system.

Producing a report of this nature necessitates grappling with conflicting evidence and navigating a myriad of plausible interpretations. Some variables are inherently unpredictable, while others may unexpectedly become explosive as the year progresses. Our economy and the capital markets are shaped by the simultaneous impact of numerous variables and the uncertainties are in constant flux.

In writing this report, we confront the challenge of providing comprehensive details on a broad spectrum of topics versus offering a succinct summary narrative. Recognizing that not all readers have the time or inclination for a deep dive into economic theory or market strategy, we present a condensed version of our message highlighted in yellow. For those seeking more depth, the entire text awaits.

Crucially, we emphasize that this report is not designed to time market movements or establish active trading schemes. Also, none of the content herein should be construed as investment advice. Authentic counsel can only be achieved through a close working relationship with individual clients.

Lastly, the methodologies employed to establish and maintain our base case for the upcoming year have proven effective over time. Still, conditions can be expected to change quickly and in surprising ways. Accordingly, we will remain vigilant, providing timely updates through monthly letters, virtual presentations, and various speaking engagements throughout the year, offering multiple opportunities for our readers to stay informed.

Thank you for your continued confidence in our ability to deliver meaningful value to you and your family. We work hard to earn your trust every day, in everything we do.

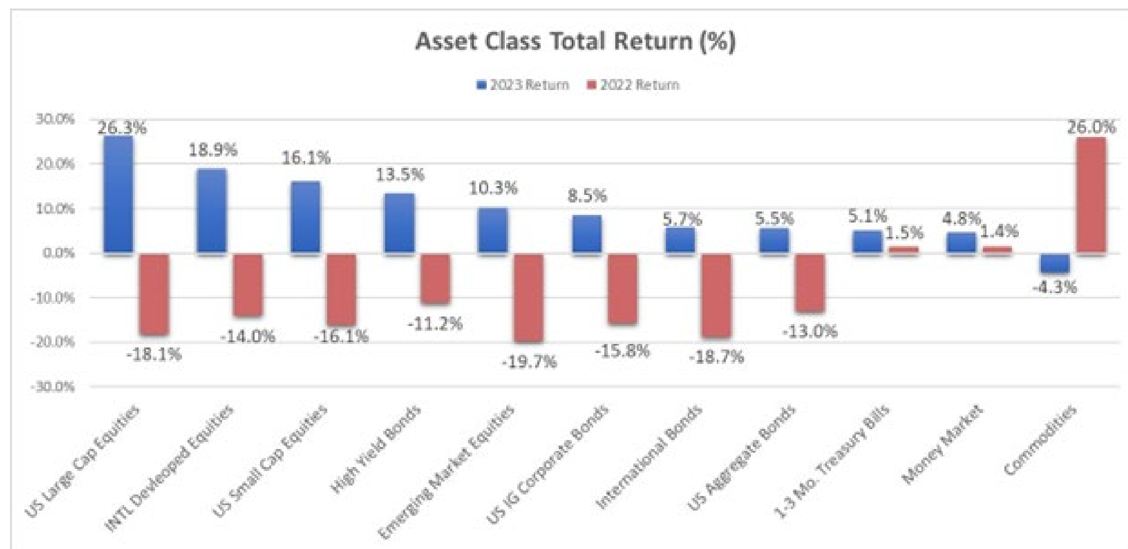
John E. Chapman, January 2024

Looking Back at an Extraordinary Year

After a tumultuous 2022 in which the Federal Reserve implemented the most rapid series of interest rate hikes since the 1980s, few anticipated that 2023 would be a productive year for investors. According to a MarketWatch survey at the beginning of the year, the average year-end 2023 forecast for the S&P 500 was only 4,031 at the beginning of the year.

Not only did the economy escape a much-anticipated recession in 2023 but stocks, as measured by the S&P 500, ended the year at 4,769 representing a 24% gain (about 26% including dividends). Remarkably, the S&P 500 is back to 52-week highs and has erased the entire bear market experienced in 2022.

Other major asset classes also produced favorable returns for the year as can be seen in the following graphic:



Source: Y-Charts

Market performance by the end of the year starkly contrasted with the prevailing pessimism that characterized the beginning of 2023. A year ago, Wall Street commentators were predicting a recession. Instead, inflation continued its descent, consumers maintained their spending habits, and the unemployment rate dropped levels not seen since the late 1960s.

Clearwater's Investment Policy Committee (IPC) had an overweight bias to equities relative to benchmarks coming into 2023. Given the ongoing deterioration in leading economic indicators and the aggressive Federal monetary policy, we gradually paired back the equity overweight in favor of short-term high quality fixed income exposure yielding upwards of 4% to 6%.

By March the tighter financial conditions engineered by the Fed produced the largest bank failure since the global financial crisis with the collapse of Silicon Valley Bank. Soon after, Signature Bank and First Republic bank both failed and concerns over the financial system reverberated throughout Wall Street.

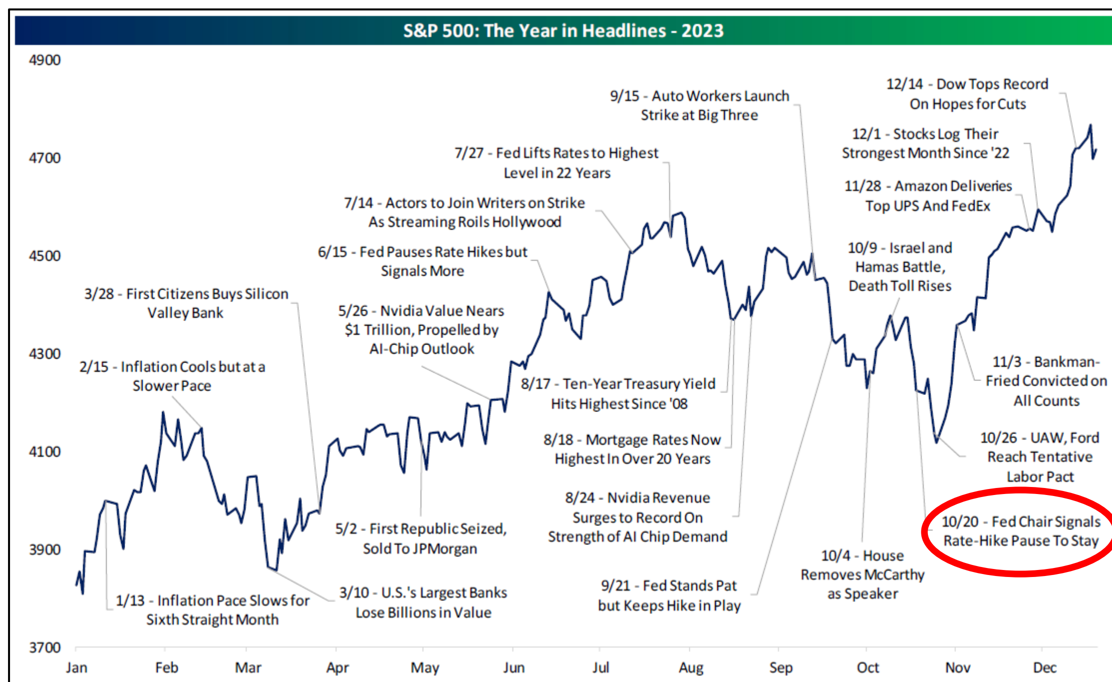
The Fed reacted quickly to the evolving crisis with unprecedented government intervention. New policies were hurriedly put in place to guarantee depositor funds at the failed banks along with novel credit facilities which effectively provided emergency bank liquidity to calm fears.

By August, the 10-Year Treasury yield hit its highest level since 2008 and mortgage rates were the highest they had been in 20 years. In October, a new and brutal war broke out in the Middle East and investors were forced to contemplate the possibilities that the conflict could spread throughout the region.

The markets appeared content, however, to set geopolitical risks aside and focus almost exclusively on Fed policy. Following the banking scare in the Spring, the Fed has consistently signaled a "wait-and-see" posture relative to any further tightening and now it would appear the tightening cycle has ended. While many market participants are expecting as many as six rate cuts in 2024, that remains to be seen.

From our perspective, it would seem unlikely that the Fed would so dramatically reverse policy in 2024 unless we were to experience a serious deterioration in economic activity.

The graphic below shows movement in the S&P 500 in 2023 and against various headlines. Even as equities struggled with challenging news flow throughout the year, it is easy to see the breathtaking rally that ensued in the fourth quarter when Fed Chair Jerome Powell signaled a shift in monetary policy.

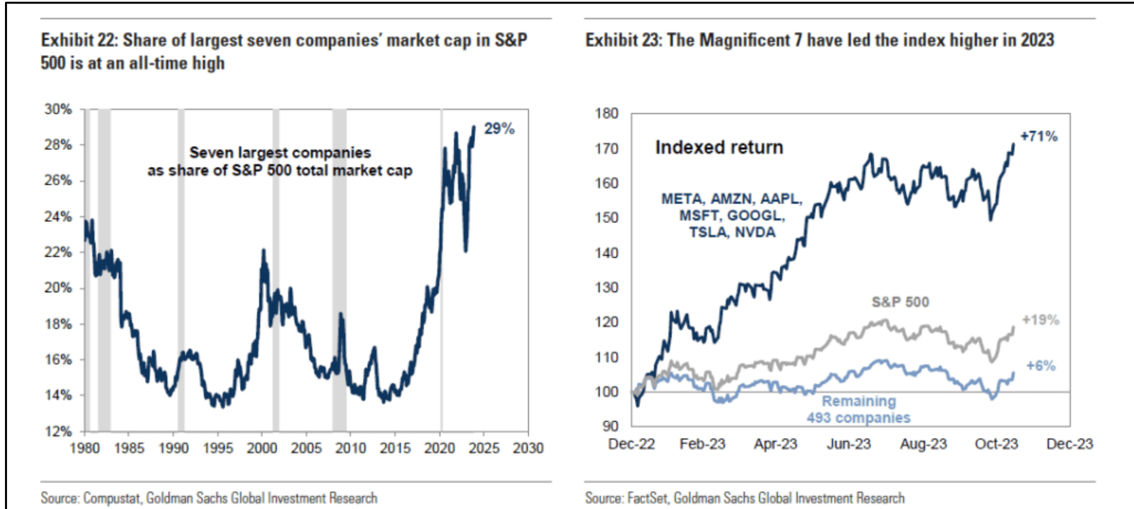


Source: BESPOKE

This said, it is investor sentiment that drives market movement over the short-term. A dramatic shift in investor sentiment began in early November when the Treasury Department announced funding requirements had eased somewhat. Additionally, the Fed offered financial markets a "dovish" perspective interpreted broadly as the Fed was finished with its rate hiking campaign. The perceived Fed pivot fueled a remarkable year-end rally for stocks with the S&P 500 surging nearly 13% in the final two months of the year alone.

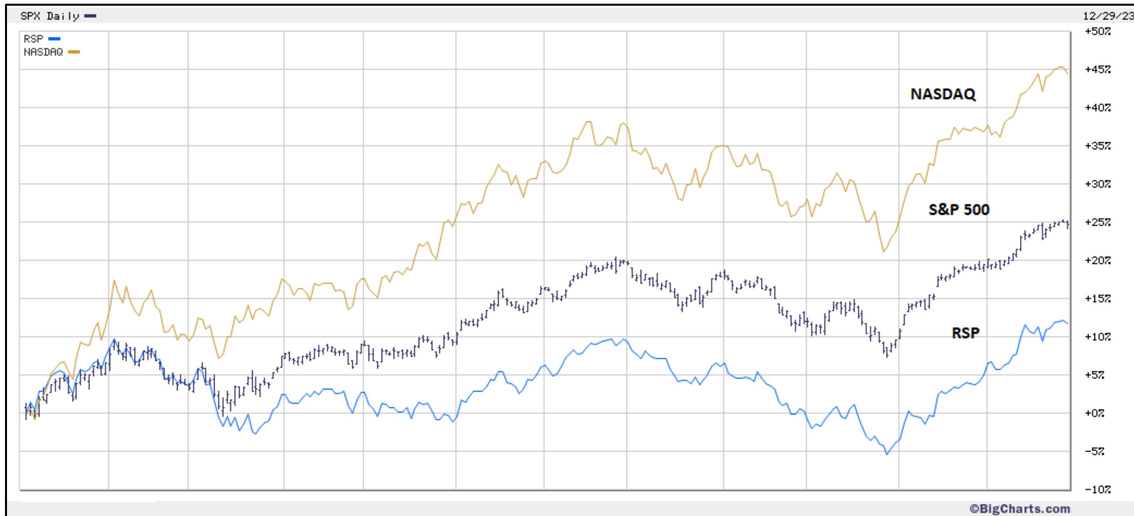
Most of the gain in the index last year came from essentially seven stocks having the largest concentration in the index in terms of market capitalization. These seven companies account for nearly 30% of the total market capitalization of the S&P 500. The surge in those stocks has skewed the performance of the broad market index, with the performance of the bottom 493 stocks markedly different.

The Magnificent Seven stocks are Amazon.com (AMZN), Apple (AAPL), Google parent Alphabet (GOOGL), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA) and Tesla (TSLA).



Unsurprisingly, the NASDAQ index had a monster year in 2023 with the index rising more than 44%. Together, Apple, Amazon, Alphabet, NVIDIA, Meta, Microsoft, and Tesla were up around 70% last year. And if you were to take them out of the S&P 500, the index would have been up around 6%. Said another way, the Magnificent Seven accounted for about 60% of the S&P 500's total 2023 return.

As we have previously observed, the headline return numbers are probably not what most investors saw in their balanced and diversified portfolio strategies.

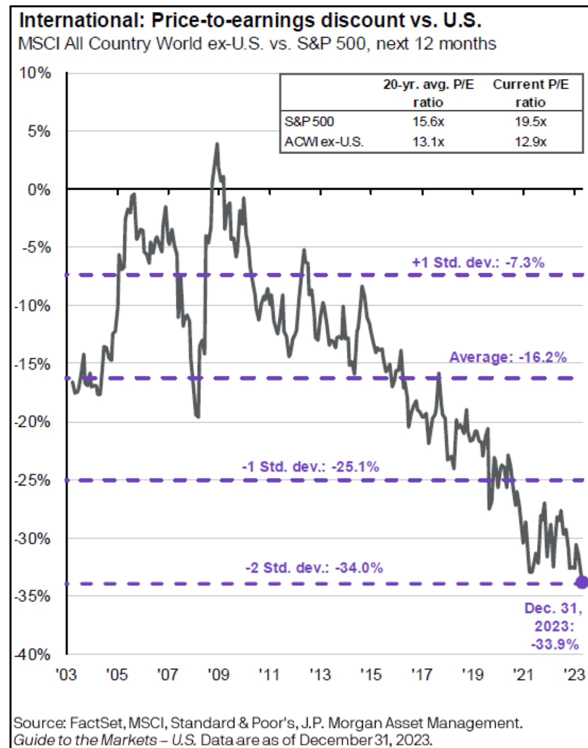


The chart above shows the full year price movement of the NASDAQ, the S&P 500 Index (capitalization weighted), and Invesco's S&P 500 Equal Weight ETF (symbol RSP). As measured by market breadth, 2023 represented the narrowest market since at least 1995 (Source: First Trust).

The Magnificent Seven traded at an average price-to-earnings (P/E) ratio above 37 times in late 2023 -- almost double the S&P 500's P/E ratio (slightly over 20 times) and well above the tech-heavy Nasdaq 100 (around 28 times).

After a few years of underperformance, thematic strategies such as FinTech, Cybersecurity, Robotics & AI, and Cloud Computing would also go on to have a very strong 2023 with returns north of 30%.

U.S. stocks outperformed international stocks in 2023 even as the dollar index weakened slightly. The All-Country World Index ex USA returned 16.2% trailing the S&P 500 by about 10%. Developed international markets outpaced emerging markets as emerging markets lagged with the poor performance in Chinese equities given its economic woes. However, several areas globally showed strong performance with areas like Japan, Germany, Spain, India, Brazil, and others generating returns above 20%.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. *Guide to the Markets – U.S.* Data are as of December 31, 2023.

The outperformance of U.S. equities, largely caused by increased valuations given optimistic earnings expectations, has resulted in a new low in the relative valuations of international stocks compared to the S&P 500 as shown in the graph to the right.

Overall, clients' equity strategies performed well in 2023. Even as areas of the portfolio underperformed such as U.S. small cap, and emerging markets, the vast outperformance of thematic strategies made up for those areas.

One inherent aspect of human nature is the tendency to perceive our portfolio performance as sufficient until we encounter external comparisons. For example, achieving a 12% return when a 8% target was set should be a cause for satisfaction. However, with the contemplation of better external benchmarks, such as learning that the S&P 500 Index surged by 24%, often results in unwarranted disappointment. The question arises: does this discrepancy truly matter?

In the context of a year like 2023, where the performance of seven companies significantly influenced the S&P 500 index, individuals may be tempted to alter their investment strategies due to a perceived sense of missing out. This said, history suggests that such impulses are often misguided.

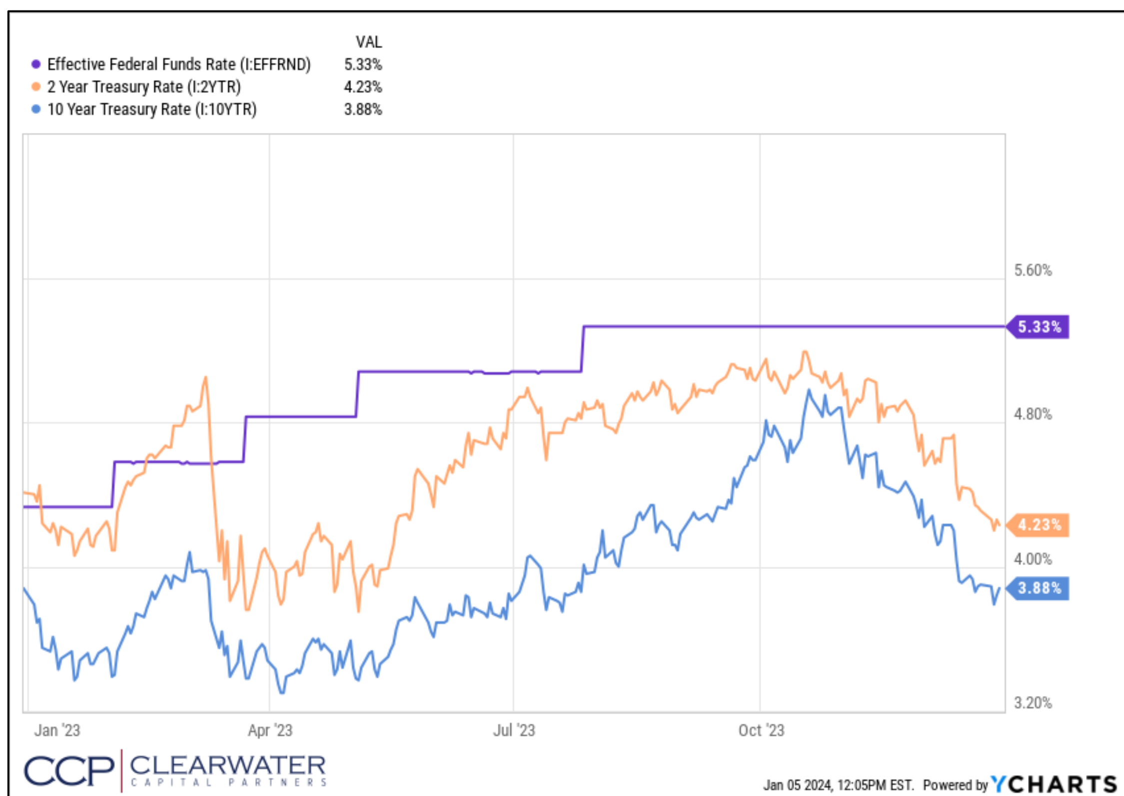
The focus for bond markets coming into 2023 continued to be the Fed's response function to changes in inflation and employment data.

The labor market continued to be strong throughout 2023 with some modest signs of loosening after a robust 2022. U.S. nonfarm payrolls grew at an average rate of 225,850, but the unemployment rate would go from 3.5% to start the year and finish at 3.7%.

Inflation, as measured by the Consumer Price Index (CPI) started the year at 6.4% in the December 2022 report but would quickly come down to, and hover around, 3.3%. Energy prices would be deflationary for most of 2023, however, the shelter component, which makes up a significant portion of the CPI, continued to be strong keeping the inflation index elevated.

A strong job market and an inflation rate above the Fed's 2% target resulted in ongoing rate hikes in 2023. The Fed would go on to hike rates 4 times bringing the Fed Funds Rate to a range of 5.25%-5.50% in July before pausing for the balance of the year.

Bond yields would be volatile throughout the year despite finishing near levels where they started the year. The 10-year US Treasury rate started the year at 3.88% and would trade in a range before breaking out higher in August.



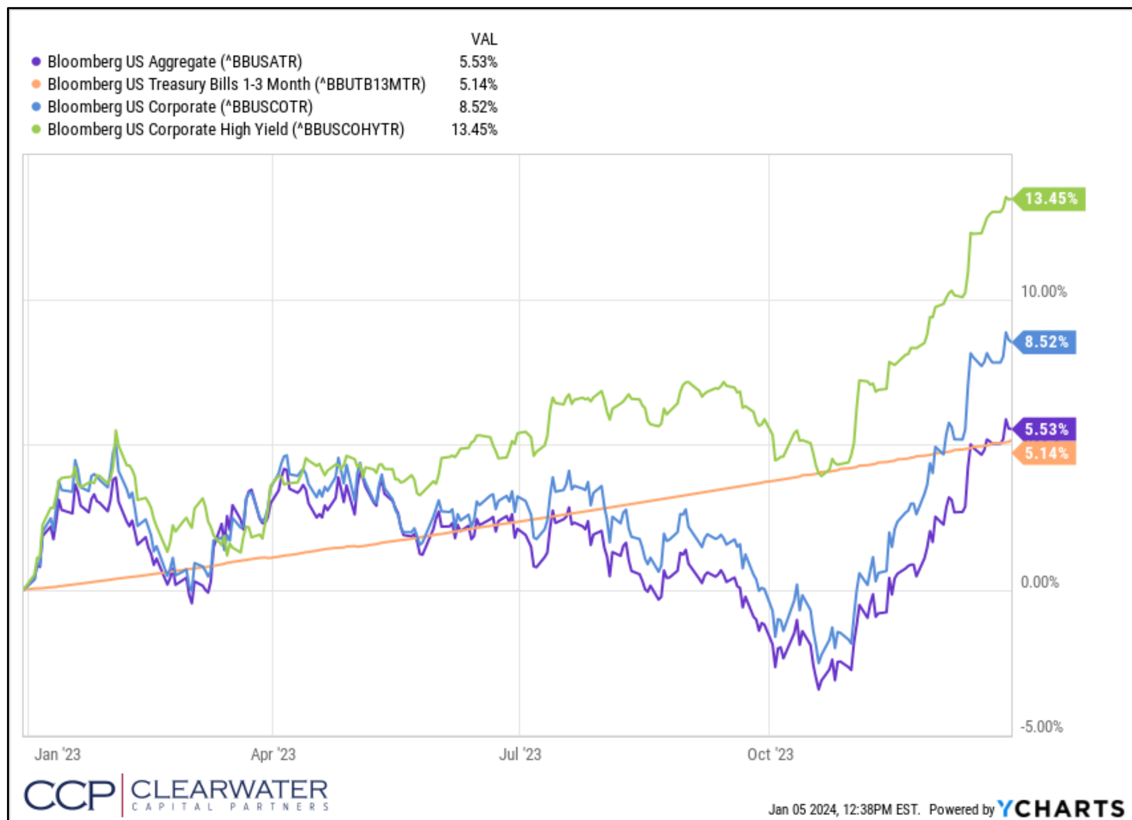
In August, the U.S. Treasury department announced that they were going to issue a larger than expected amount of treasuries in its quarterly refunding statement. With the U.S. government running large deficits and higher interest rates, the need to issue debt in the form of U.S. treasury bonds continued to grow.

This wave of supply unnerved the bond markets leading to a selloff that would see the 10-year treasury rate reach 5% in October.

Bonds would then have a year-end rally in the final two months of the year as the 10-year Treasury rate would go from 5% to finish the year at 3.88%. The move lower in rates was caused by some loosening in the job market, better inflation reports, and the Fed signaling it may pivot to rate cuts in 2024.

After a painful 2022, bonds staged a comeback to generate strong returns in 2023 as the U.S. aggregate bond index returned 5.5% which outperformed the 1-3month T-Bill index.

However, it was credit markets that reigned in 2023. With long-term benchmark rates ending at similar levels to where the year began, the higher starting yield for U.S. corporate bonds aided in the outperformance. Along with higher starting yields, corporate bonds benefited from credit spreads tightening throughout the year as fears of a recession and an accompanying default cycle faded. Accordingly, U.S. investment grade corporate bonds returned 9.4% and the more risky, high yield corporate bonds returned 11.5%.



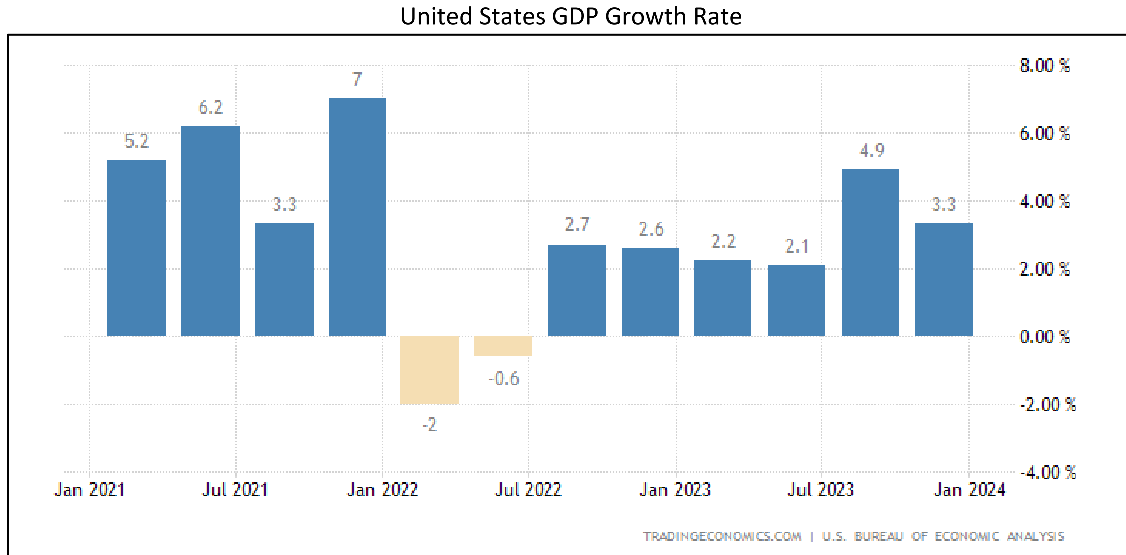
Clearwater's fixed income strategies performed better than U.S. aggregate bond market in 2023. The driving force for the outperformance was our tactical management of duration. Duration is a measure of a bond, or bond portfolio's, price sensitivity to interest rates. The higher the duration the more sensitive the portfolio is to changes in interest rates.

Entering the year, Clearwater's Investment Policy Committee maintained the fixed income strategy's duration significantly lower than the benchmark given the view of rising interest rates. As rates rose throughout the year, this presented opportunities to methodically increase duration by selling short-term bond exposures in favor of longer-term bonds. This approach was rewarded as those longer-term bonds went on to have a significant year-end rally as rates fell.

Overall, 2023 rewarded investors who maintained their long-term core strategies.

The U.S. economy grew 3.1% in 2023, defying projections of a recession as a resilient labor market supported strong consumer spending. The year was capped by a fourth quarter in which the economy grew at a 3.3% seasonally and inflation-adjusted annualized pace, as household outlays and government spending rose. The quarterly reading was a slowdown from the summer's torrid 4.9% pace, but still a healthy rate.

United States GDP Growth Rate



A consistent pace of consumer spending helped drive the expansion, as did government spending. Consumer purchasing power however, is running into headwinds due to the depletion of COVID-stimulus related savings as well as slow wage growth when adjusted for inflation. Also, the surge in government purchases in the past year will likely fade in 2024 as the federal deficit is on an unsustainable course.

Economic & Market Conditions for 2024

If predicting which football team might win on any given Sunday is difficult, forecasting where stocks will trade in a global economy should be considered impossible; and it is. The best we can do is offer our view of current conditions and lay out various scenarios that appear to us as more likely than not. Then, as conditions shift throughout the year, we will provide updates on our strategies.

Calendar year 2023 ended with profoundly bullish sentiment – perhaps too bullish. The yield curve is still inverted, leading economic indicators are weak, corporate earnings have flatlined, and economic data has been trending lower. Interest rates remain high and while inflation has shown some promising movement lower, the Consumer Price Index (CPI) remains above the Fed's target rate of 2%.

Equity valuations are stretched, but credit markets have not seized up and there are pockets in the U.S. economy that are proving quite resilient. While it might not seem conceivable in such a politically charged environment, it is worth noting that election years have historically been positive for investors.

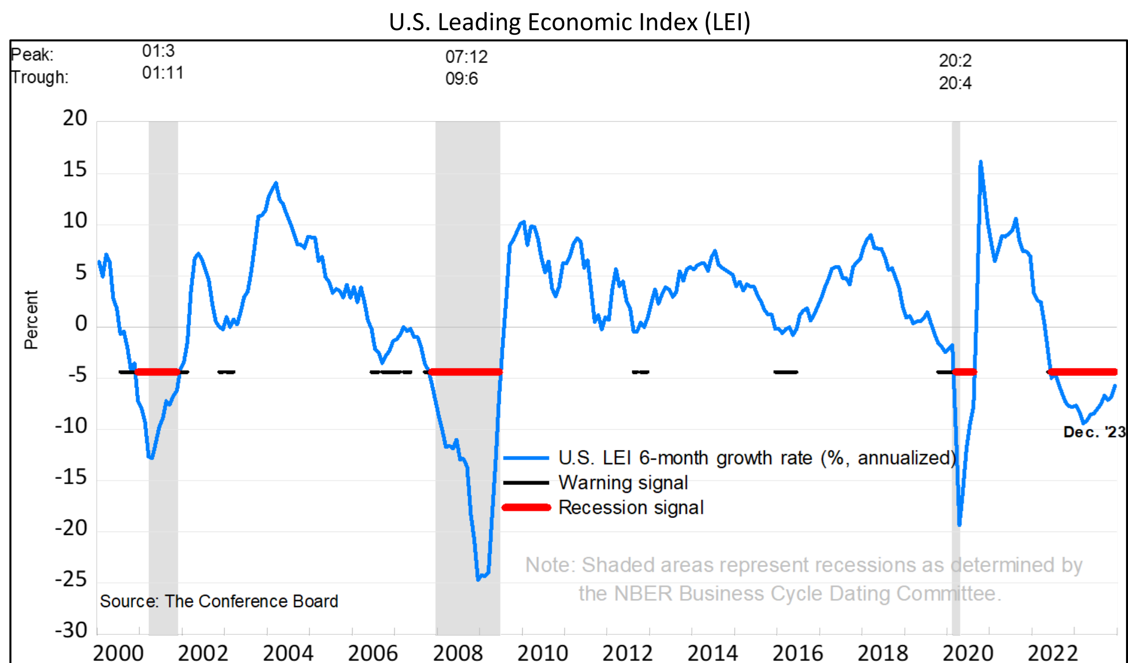
Relative to the possibility of the U.S. falling into recession in 2024, there are valid arguments to be made on both sides of this issue. We have been expecting a short and shallow recession for much of the past 12 months and now the question is: were we wrong, or just early?

Looking at a variety of measurements of investor sentiment we can readily observe that 2023 ended with elevated bullish levels. Historically, bullish sentiment has had a contrarian bias when it comes to average future returns. Ironically, consumer sentiment by contrast has been on the weak side reflecting ongoing concerns over inflation, higher interest rates, and multiple geopolitical hot spots.

Other hard datapoints suggest an economy that might be struggling. Housing starts peaked in April 2022 with the 12-month average declining in 16 of the last 18 months. The ISM Manufacturing PMI has been below 50 for 12 straight months. Historically, every other double-digit streak of readings below 50 either preceded or coincided with a recession. When streaks lasted 12 months or more, there has only been one such streak (namely 1954) when the economy wasn't already in a recession (Source: BESPOKE).

The Conference Board's Leading Economic Index (LEI) has a well-established reputation for providing an early indication of significant turning points in the business cycle and where the economy is heading in the near term.

U.S. Leading Economic Index (LEI)

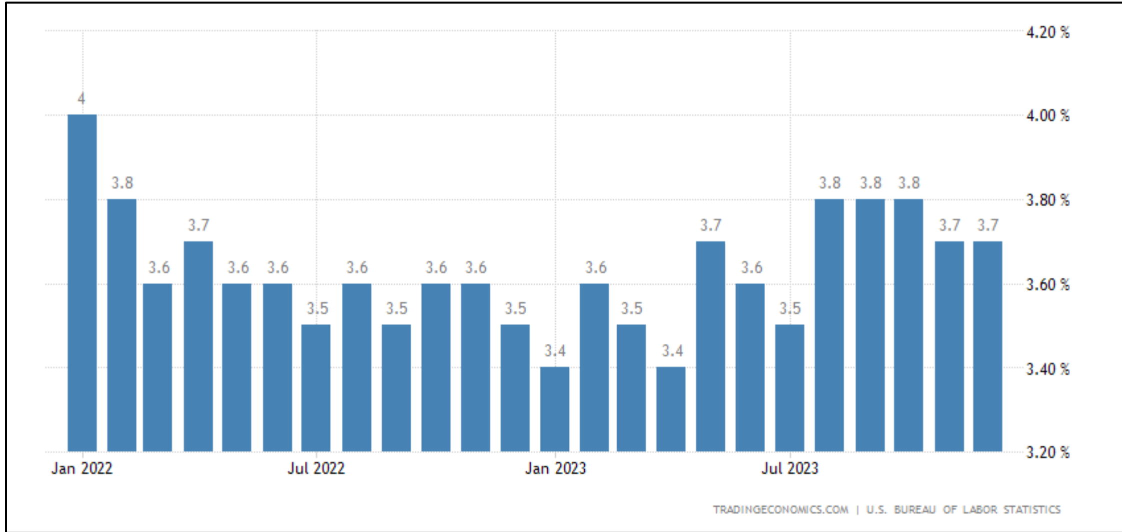


The LEI has declined for 21 straight months through December 2023, continuing to signal underlying weakness in the U.S. economy and an elevated risk of recession ahead.

The U.S. employment situation remains positive but has clearly shown signs of slowing down from the torrid pace of growth in 2021 and early 2022. If conditions can stabilize around these levels, the market backdrop surrounding the labor market should be positive, however if economic activity slows dramatically in the coming year, employment data could deteriorate quickly.

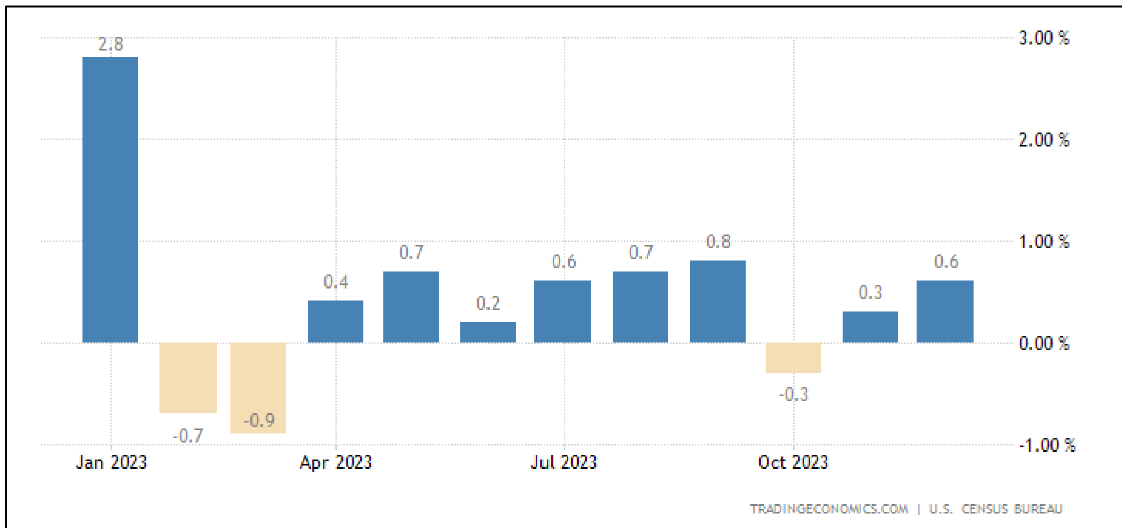
The year ended on a positive note for labor markets. December's jobs report showed employers added 216,000 jobs for the month while the unemployment rate held at 3.7%. Average hourly earnings rose 0.4% on the month and were up 4.1% from a year ago, both higher than the respective estimates for 0.3% and 3.9%. The report showed that inflationary pressures, despite receding elsewhere, are still prevalent in the labor market.

U.S. Unemployment Rate



It is interesting to observe that from January to November 2023, downward revisions to previously reported numbers have occurred 10 out of the 11 months—a trend witnessed only a few times in history, notably in 2008 and 2009. Nonfarm payroll revisions totaled 427,000 fewer jobs in 2023 than originally reported. Another element of potential weakness over the past year has been the shift to part-time job growth over full-time job growth.

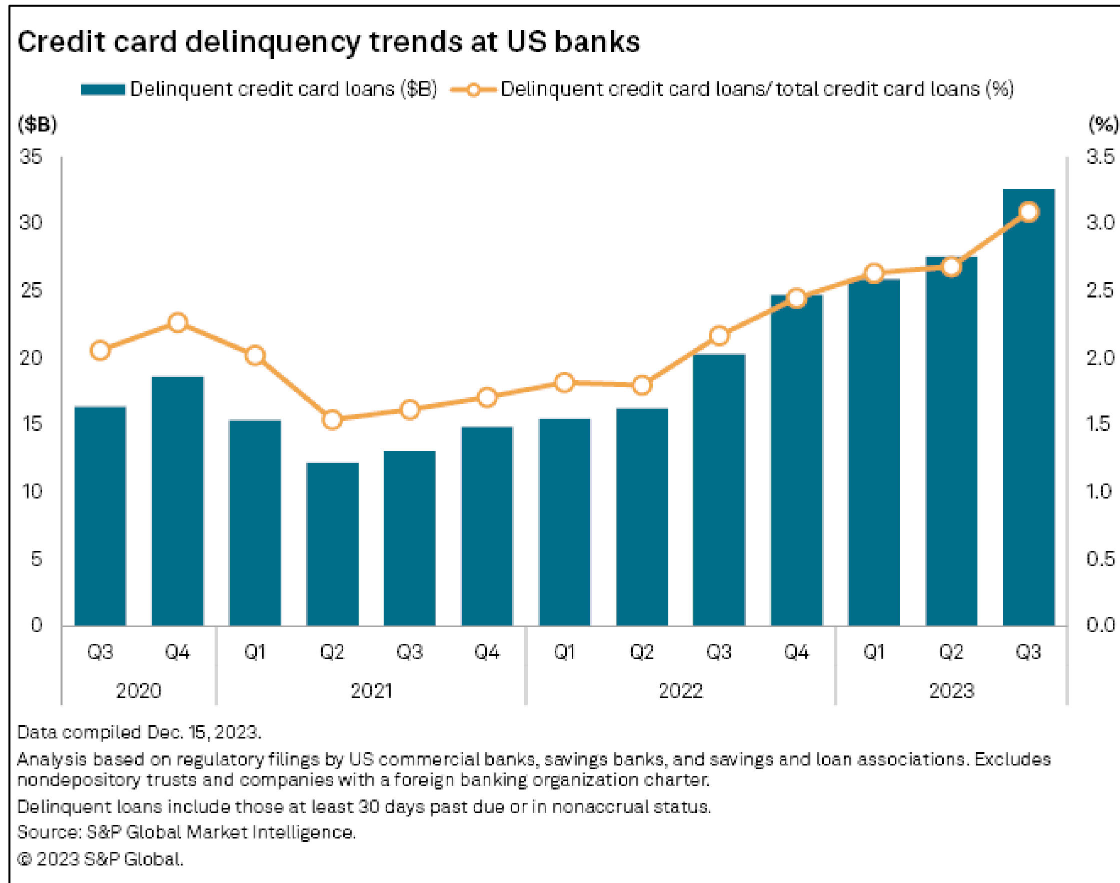
Nominal U.S. Retail Sales



Retail sales are at record highs unadjusted for inflation, but in "real" (inflation-adjusted) terms, they have been sluggish. Real retail sales peaked in April 2022 and have since declined by 1.9% from that peak. As Brian Wesbury has frequently observed, it has been forty years since the U.S. had an inflation problem, so it is important to remember that it can distort data. We expect further deterioration in real retail sales into 2024 as tighter credit conditions along with higher borrowing costs take their toll.

Looking on the brighter side, the ISM Services report (representing about two-thirds of the U.S. economy) was above 50 every month in 2023 indicating economic growth.

All stages of credit card delinquency (30, 60 and 90 days past due) moved higher last year, surpassing pre-pandemic levels for the first time, according to a report released by the Federal Reserve Bank of Philadelphia. Outstanding credit card balances surpassed the $1 trillion mark for the first time.



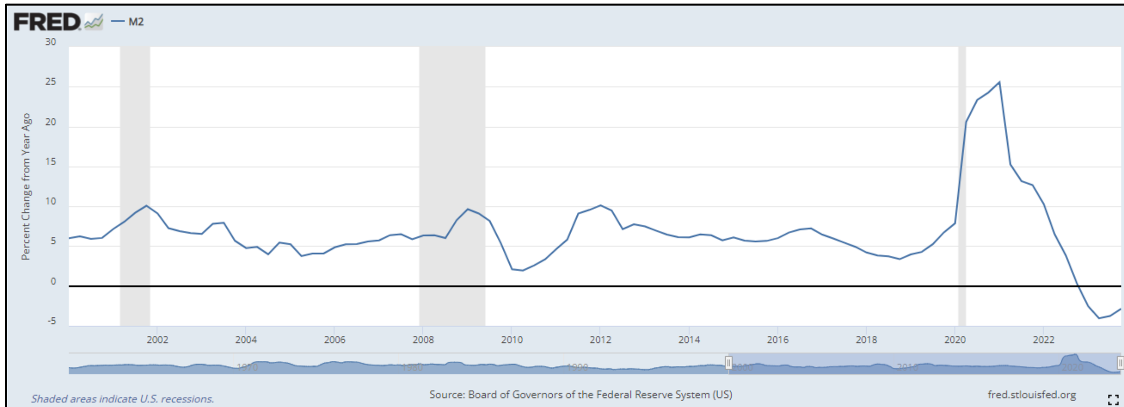
Borrowers are also falling behind on car loan payments with delinquency rates at their highest levels in 27 years. Transportation costs make up about 17% of Americans' personal annual expenditures, second only to housing costs, according to the Bureau of Labor Statistics.

In 2020, during the height of the coronavirus government lockdowns, the U.S. government spent enormous amounts of money to keep the economy, financial system, and stock market from collapsing. Trillions of dollars in additional government spending occurred, all of which was financed with debt and money printing.

The never-before-seen levels of money creation were fueled by policies set by the Federal Reserve, which encouraged Congress to spend more money and kept interest rates extremely low, despite warnings from economists about the threat of future inflation.

This all changed when the annual M2 money supply growth rate turned negative for most of the past year and the amount of money available in our economy decreased rapidly. In the past 110 years, the only other time Americans have seen the money supply drop this sharply was in the early 1930s during the height of the Great Depression.

U.S. M2 Money Supply



This time around, the growth of currency is back to the trend it followed from about 1995 through 2019. Demand for dollars, by this measure, has apparently returned to normal. This said, it will be important that the supply of money does not continue to decline.

With the New Year now underway, investors have widely embraced the expectation that the Fed will soon be retreating from their tight monetary policy and deliver a series of interest rate cuts over the coming months. The significant risk to any outlook for 2024 is what happens with Federal Reserve policy, interest rates, and inflation. Some important indicators suggest a recession is still possible, while other markers indicate the opposite.

The process of normalizing our interpretations of traditional economic readings remains especially complicated given the lingering distortions of the COVID economy. While fiscal conditions remain supportive of economic growth, monetary conditions are tight; even as the Fed signals that it is done hiking rates. The challenges surrounding what is referred to as ***quantitative tightening*** (the Fed's balance sheet runoff program) further obscure forecasts simply because it has never happened before, and we do not have a historical context from which to draw important conclusions.

With such crosscurrents we must abide by our portfolio management disciplines and remain highly flexible. It is likely there will be more than a few surprises for investors in 2024. As the market dynamics change, for better or worse, we must be willing to adapt and change accordingly.

The New Market Regime Revisited

In our 2023 report, we observed that the prevailing environment had shifted in three critical ways.

- **The End of Loose Money Policies**: An unprecedented surge in government stimulus payments in response to the pandemic produced a staggering expansion of the government's balance sheet and the historic rise in M2 money supply. This sparked a spike in inflation that was higher, and possibly stickier, than at any point in the last 40 years. The era of free money is over.

- **The Shift Towards Deglobalization**: The pandemic also triggered a disruption to supply chains which has led business leaders to rethink how and where they source vital input components for their businesses. This is typically done to improve supply chain resilience, reduce the dependence on foreign suppliers, increase control over the quality of products, and address political and geopolitical risks. While globalization has not collapsed, it is in decline.

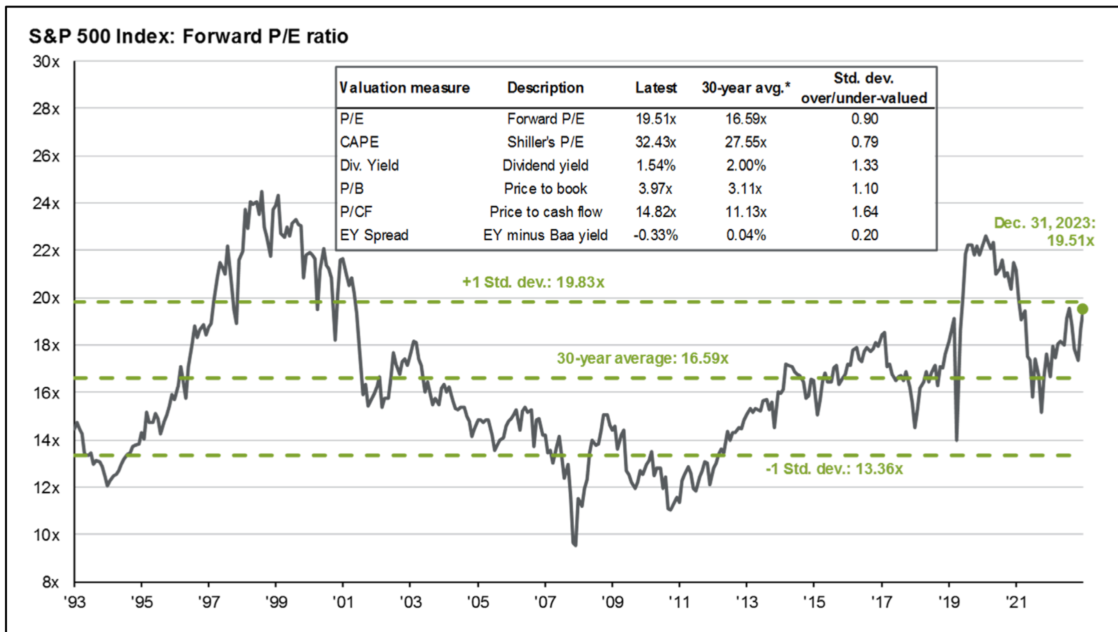
- **The Rise in Geopolitical Instability**: International relationships have grown significantly more strained over the past year. Russia's invasion of Ukraine marked the first large scale war on the European continent in decades. The U.S. - China relationship has deteriorated due to the pandemic, significant trade tensions, and uncertainty over the future of Taiwan. Tensions between Israel and Iran are rising as Iran moves closer to developing nuclear weapons and Israel's Benjamin Netanyahu returns to power as prime minister.

Taken together these three elements represent a noteworthy and ongoing transformation of the environment for businesses, consumers, and investors. This regime change will require everyone to adjust strategic thinking for years to come.

Clearwater Capital's Base Case for 2024

The U.S. economy is a vast, complex ecosystem of interrelated forces. Accordingly, it takes businesses and consumers time to recognize, feel, and act on changes in financial conditions. Monetary policy unquestionably works with a lag. The full impact of rapid tightening takes anywhere from six months to two years to work its way through different sectors of the economy.

The U.S. equity markets are now trading at nearly 20 times forward earnings, and it is reasonable to observe that valuations are a bit extended. The S&P 500 finished 2023 with a price-earnings multiple (P/E) just shy of one standard deviation above the 30-year average.



Valuation measure	Description	Latest	30-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	19.51x	16.59x	0.90
CAPE	Shiller's P/E	32.43x	27.55x	0.79
Div. Yield	Dividend yield	1.54%	2.00%	1.33
P/B	Price to book	3.97x	3.11x	1.10
P/CF	Price to cash flow	14.82x	11.13x	1.64
EY Spread	EY minus Baa yield	-0.33%	0.04%	0.20

Source: JP Morgan Asset Management

Valuations are a relatively poor indicator of near-term market performance, however over a 5-year period, valuation levels provide a more meaningful signal. In other words, there is a discernable relationship between valuations and future returns, but only over longer investment horizons. For example, historically the higher valuations are at any particular point in time, the lower the forward average returns will be for the subsequent 5-year period.

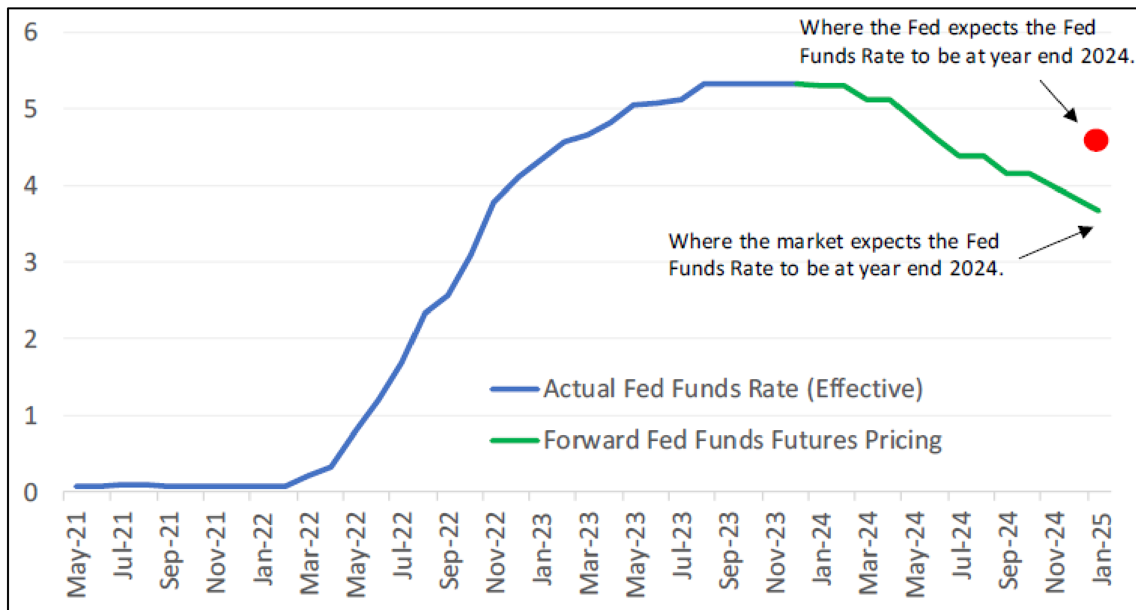
S&P 500 earnings are expected to increase 11% overall in 2024 after rising a modest 3% last year, according to current estimates. Given the recent rally in equity markets, earnings growth will be critical to support lofty valuations in stocks.

Our base case for earnings is that current estimates will be adjusted lower in 2024 as economic activity decelerates and the effects of higher-for-longer interest rates cut into consumer spending and business investment. Even with a short and shallow recession, we believe GDP growth in 2024 will come in positive for the full year, but at no more than 1% to 2% when all is said and done.

Heading into 2024, Fed officials were looking for three 25 basis point cuts on a median basis by year end but appear committed to the current pace of ***quantitative tightening***. Currently running at about $95 billion per month, quantitative tightening is projected to remove approximately $1 trillion from the U.S. economy in 2024.

The Fed is on record saying that *"it would not be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent."* The Consumer Price Index rose 3.4% in 2023, versus a 6.5% rise in 2022. However, Core CPI is still up a problematic 3.9% from a year ago compared to 5.7% in 2022. The key risk regarding higher-than-expected inflation in 2024 is higher oil prices due to a potential escalation of the war in the Middle East.

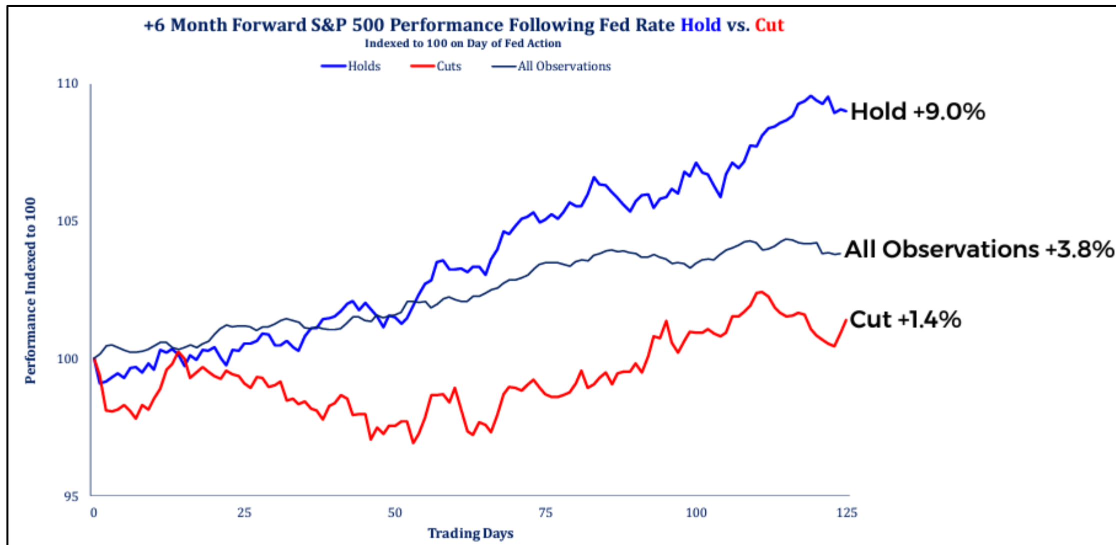
The graph below is a snapshot of how market participants see the Fed Funds Rate moving throughout 2024. As the new year gets underway, the market appears to expect six to seven 25 basis point rate cuts which stands in sharp contrast to the Fed's expectation for only three such cuts.



Source: BESPOKE

Our base case for Fed policy in 2024 is that they will be reluctant to cut as early, or as much, as the market expects. We see only two or three cuts; provided economic activity holds up. Additionally, we do not expect a rate cut in either the March or May Fed meetings. Accordingly, should rate cuts happen, we feel they would not likely begin until the second half of the year.

It is reasonable to be concerned about the disconnect in expectations following the strong rally in equities over the past two months. It is also worth noting that, historically, the stock market has not performed particularly well in periods immediately following rate cuts (see chart below). This is largely because rate cuts typically coincide with a weakening economy. Should the Fed meet market expectations for six or more rate cuts in 2024, it would seem likely that a faster shift in monetary policy would be the result of an economy that was beginning to falter.



Source: Strategas

Our base case for U.S. equity markets is for only moderate single digit returns over the full year (approximately 6% to 8%). This translates into S&P 500 levels reaching about 5,100. We further believe that the first half of the year will likely be more challenging for investors with an uptick in volatility. Market participants now appear to be as convinced a soft landing is coming as they were of a recession in 2023. Such high levels of consensus thinking should be monitored carefully.

The yield curve has been inverted for 278 trading days through December 20, 2023. Looking back at 60 years of historical data, there has never been a longer streak. It has now been over a year since the yield curve first inverted and it is worth noting that it normally takes well over a year for a recession to occur from when the yield curve first inverts.

Of all the times the yield curve inverted since 1962, the average number of calendar days separating the first day that the yield curve first inverted from the start of the recession was 589. Through December 20, 2023 the yield curve has been inverted for 419 days (278 trading days), so there are still 170 days left before we would even get to the average amount of time that passes before a recession starts. That would take us out to the first week of June (Source: BESPOKE).

Other important indicators such as the Leading Economic Index (LEI) and housing are still flashing recession. As mentioned above, the LEI has declined for 21 straight months. The housing sector has declined by more than 30% over the past 18 months amid higher mortgage rates. Housing affordability metrics are currently near a 40-year low.

Through October, the cost to cover a monthly payment on the median existing home at prevailing mortgage rates hit its highest levels relative to wages since 1990.

Fiscal spending and government hiring in the labor market both provided a boost to the U.S. economy in 2023 and will likely soften in 2024. While the odds of a recession have come down in recent months, the possibility cannot be completely dismissed.

The key takeaway for our base case expectations in 2024 is that markets have priced in a nearly perfect fact pattern for the coming year. Expectations are for inflation to gently drift down to 2%, the Fed to cut rates multiple times, and revenue growth of 5% or more with 11% earnings growth. The geopolitical assessment would seem to be one in which the current conflicts are contained with no flashpoints developing.

Our base case for the probability of a recession in 2024 is now only about 30%. However, we can't help but feel like we are not out of the woods yet and a downturn could still materialize. It is not difficult to imagine scenarios in which inflation remains stickier, the Fed stays higher-for-longer, and the economy weakens considerably more than expected given the lagged effects of tighter financial conditions. While we certainly hope the current geopolitical tensions do not intensify, it is difficult to be confident they won't. In other words, it would not take much for the highly anticipated soft landing to fall apart.

Lastly, we would be remiss if we failed to observe that exogenous risks exist and something unexpected in our economy could go terribly wrong. When contemplating the range of startling scenarios, we must cope with the possibility that "something breaks" triggering a cascading effect of negative after-effects.

One such area of concern continues to involve the commercial real estate market where foreclosure notices, particularly those involving mezzanine loans, have been rising. Mezzanine loans are notoriously difficult to track because they are not recorded in property records. What is more, the layering of mezzanine loans has increased with the total debt outstanding often adding up to more than the value of the building. Simply put, no one really knows how much of this debt is out there.

The stress on commercial real estate has been well documented. Interest rates and maintenance costs have risen while the ways people work, shop, and live have shifted dramatically. Evolving work-from-home dynamics show that some types of remote work arer up over 50% from a year ago with nearly two-thirds of companies offering worker flexibility policies.

U.S. office vacancy rates are now about as high as they were in the 2008 financial crisis and building values are under pressure. This is all troubling news for the biggest lenders and owners of commercial buildings which primarily include regional banks, pension funds and money managers. It certainly does not help that about 40% of commercial mortgage debt will be coming up for renewal in the next few years.

U. S. commercial real estate values have fallen by some 20% between early 2022 and late 2023, and they'll probably drop another 5% to 15% next year, according to global real estate firm CBRE.

A new report by the National Bureau of Economic Research (NBER) asserts that difficulties in the commercial real estate sector could lead to serious problems for up to 385 American banks, most of them smaller regional institutions.

Our base case is that the problems in the commercial real estate market are troubling, but alone are not enough to derail the economy. This said, there is an interconnectivity these issues have with other important elements of our system. Should the economy weaken unexpectedly, troubling developments from an already impaired commercial real estate market could "break something" in unexpected ways. Once the system becomes unstable (like in March 2023) things can happen quite quickly.

The Changing World Order

Famed billionaire hedge fund manager Ray Dalio is a well-respected thought leader on global trends and the evolution of the geopolitical landscape. In 2021, Dalio wrote a book entitled **The Changing World Order** in which he offered a fascinating look at history's most turbulent economic and political periods to help identify important developments that may be coming our way.

In a recent online post, Ray Dalio presented his thoughts on the unique risk profile for 2024. His observations are paraphrased below:

> *2024 is poised to be a crucial year on multiple fronts. It will serve as a litmus test for the resilience of the existing democratic order in the U.S. and the containment of global international conflicts. The trajectory of the long-term debt cycle is steering towards heightened indebtedness, particularly in government debts, with potential serious repercussions if not addressed soon.*
>
> *Current market trends project a scenario where inflation aligns with central banks' targets, real growth remains moderate, and central banks swiftly lower interest rates, portraying a Goldilocks economy. However, inflation may not decrease as anticipated, growth might not be as robust, and interest rates may not decline as much as expected. Factors contributing to this include a slowing growth rate, depletion of the cash/savings accumulated from 2020 and 2021 stimulations, and rising interest costs on existing debts as they mature.*
>
> *Key countries, notably the U.S., grapple with internal conflicts surrounding wealth, values, and power. The primary risks in 2024 stem from potential large-scale internal and/or external conflicts, marked by intense political division and a lack of contemplative debate over the many challenges we face.*
>
> *The foundation of democracies rests on thoughtful disagreements and adherence to systems that resolve differences through established rules. However, challenges arise from political maneuvers aimed at weakening opponents, rigid party-line voting, media distortion, polarization leading to defensive movements, and a contentious mindset likely to influence the 2024 U.S. elections.*
>
> *The outcomes of the elections will significantly impact markets, economies, domestic and world orders, geopolitical and economic issues, climate, and technology matters, as the elected sides hold divergent views. The handling of economic regulation, taxes, immigration, trade agreements, tariffs, and social issues will vary based on the election results. The interconnected nature of these challenges adds complexity and risk, underscoring the need for careful consideration.*

The coming year will indeed be a pivotal time around the globe with 40% of countries, 41% of the global population, about 60% of global GDP, and nearly 80% of global capitalization having national elections.

In the U.S., election years have historically been the second strongest of the four-year cycle for the S&P 500. Since 1928, the S&P has posted yearly gains in 74% of election years for a median gain of 9.54%. On average, the index generally trades sideways over the first one-third of the year before rallying during the summer, taking a pause in September and October, and then rallying again in the final two months of the year.

Bob Doll from Crossmark observes the following:

- Voters have kicked out of office the party in power in 9 of the last 10 elections,
- The stock market has not declined in a year in which an incumbent president was running for election since 1952 (regardless if elected or not),
- No incumbent president has run for re-election and LOST if there was no recession in the two years leading up to the election,
- No incumbent president has run for re-election and WON if there had been a recession in the two years leading up to the election,
- In the three months leading up to election day, the incumbent party has been RE-ELECTED 92% of the time IF the stock market is up, and
- In the three months leading up to election day, the incumbent party has been DEFEATED 73% of the time IF the stock market is down.

One significant difference in the upcoming election cycle is the risk that malicious actors implement wide ranging disinformation campaigns on social media platforms via artificial intelligence systems. In addition to potentially impacting election outcomes, such activity would also serve to erode trust in political systems all around the globe.

For many years we have embraced the notion that investors are best served by keeping their politics and investment strategies separate. While we continue to see the wisdom in this, we do recognize that 2024 will be a momentous political year with the potential for unexpected disruptions.

Conclusion

The U.S. economy has remained stronger for longer than most expected. While the economy's flight path has been relatively smooth over the past year doesn't mean there won't be turbulence ahead. A bullish case for the year ahead is in many ways just as plausible as the bearish case. Hence the title of this year's report: **Bulls, Bears and Blurred Horizons**.

In just the past few months the conventional wisdom has shifted to an "all clear" perspective regarding any risk of recession and we are concerned that this soft-landing optimism has spiked even as some economic indicators remain weak.

JP Morgan Chase CEO Jamie Dimon recently commented that he remains doubtful of the economic scenario that financial markets are now largely expecting for the U.S. economy. ***"I'm a little skeptical in this kind of Goldilocks kind of scenario. I still think the chance of it not being a soft landing are higher than other people currently believe. I put the geopolitical stuff as something you can't look at this year and say that it will not have an effect."***

Consumers are running out of the extra spending power they enjoyed from COVID stimulus programs, businesses are challenged with rising labor costs, and interest rates remain elevated as the Fed continues to drive inflation down to 2%. In the past 80 years, the Fed has *never* managed to bring inflation down substantially without sparking a recession.

The economy is slowing, however there is no sign of an imminent recession. A soft landing is likely to come with a period of subdued global economic growth. This said, a soft landing is far from guaranteed. Our view is that the economy will slow in 2024. Whether or not this downturn is sufficient to trigger an official recession remains to be seen.

The U.S. economy has proven more resilient than anyone anticipated early in 2023. Leading indicators point to slowing economic growth but not a collapse. The soft-landing camp is winning the debate for now, but the environment remains fragile. The good news is that even if a recession develops in 2024, it is likely to be a mild one.

We believe investors should remain constructive in 2024 while being especially attentive to the unique risk patterns present in our economy and around the globe. The potential headwinds we may encounter in the coming year suggest a range of possible outcomes that are wider than we would normally expect.

Thank You

As we often say, we do not get to choose the circumstances, the challenges, or the opportunities we will face. The best we can ask of ourselves is that we lean into them as we always have and do everything possible to shape a bright future for ourselves and those we care about.

That's what we do. Proper wealth management demands a sound framework for decision-making. It is about planning over long horizons of time and not becoming distracted by the inevitable twists and turns along the way. Our thesis will shift as new information becomes available, but our commitment to understanding the big picture will not.

The economy and the markets are cyclical. Good times follow bad times, and bad times follow good times. While creating and growing wealth is an exciting challenge, we recognize that the road forward will not be easy, comfortable, or quick. The journey will be asymmetrical, volatile, and incredibly frustrating at times. Volatility and market drawdowns are often painful for even the most seasoned investor. Please know we will work tirelessly to maintain relevant perspectives that will help us navigate the difficult times.

Thank you for taking the time to review our perspectives and forecasts. We look forward to a prosperous 2024 and are deeply grateful for the many relationships of trust and commitment we share with our clients.

Clearwater Capital Partners
January 2024

Why Clearwater Capital Partners

Clearwater Capital Partners (CCP) is an independent Registered Investment Advisor registered with the Securities and Exchange Commission (SEC). The firm was founded in 2006, by John Chapman, as a locally owned, privately held professional services firm.

The firm provides comprehensive wealth management services to successful individuals and families through its Private Client and Family Office Practices. The firm's Institutional Advisory Group offers a suite of professional services to businesses, non-profit organizations, foundations, and ERISA governed retirement plans.

Our services are designed to help simplify the increasing demands and complexities related to making sound financial decisions.

As an independent advisory firm, we embrace the fiduciary responsibilities we have for our clients and are at liberty to deliver solutions we believe best reflect their unique needs.

We believe that our firm's only allegiance is to our client.

We do not represent the interests of any financial institution, brokerage firm or portfolio manager. We believe that the only valid wealth management strategy is one that accurately and objectively reflects the needs, preferences, and goals of the individual client.

Wealth management is a process; one that takes place over long spans of time, and one that is best served through dedicated expertise, meticulous evaluations, and disciplined judgment. Our process adheres to these precepts and seeks to create an intelligent framework for consistent and rational decision making.

Our process, named Clearwater C^3, is a consistent system for prioritizing goals and setting forth a course of deliberate action with deep commitment. Our methods are focused each client's most critical objectives and are designed to achieve congruity between values and actions.

Wealth management firms vary widely in their philosophies and in the services they offer. Clearwater Capital is dedicated to a well-organized process that places the client at the center of our business model. We are uniquely qualified in the disciplines of wealth management, and our clients have entrusted us with the care of their most cherished ambitions. In return, we endeavor to meet this privilege with diligence and accountability.

We place a premium on commitment, objectivity, and transparency. We embrace the fiduciary duty we have for our clients, putting their objectives before all else. Our independence allows us the freedom to develop world-class solutions - without interference or a proprietary product bias.

We exist to inspire and empower our clients to live with confidence, joy, and a spirit of abundance.

What can we do for your family in 2024?

	TOTAL RETURNS								
Major Equity Indices	**YTD**	**1 Wk**	**1 Mo**	**3 Mo**	**6 Mo**	**12 Mo**	**3 Yr^**	**5 Yr^**	**10 Yr****
S&P 500®	26.26%	0.34%	4.53%	11.68%	8.02%	26.26%	9.98%	15.67%	12.02%
S&P MidCap 400®	16.39%	-0.14%	8.72%	11.66%	6.97%	16.39%	8.06%	12.59%	9.25%
S&P SmallCap 600®	15.94%	-0.02%	12.79%	15.07%	9.39%	15.94%	7.21%	10.96%	8.60%
S&P Composite 1500®	25.43%	0.30%	4.97%	11.77%	8.01%	25.43%	9.81%	15.36%	11.74%
Russell 1000®	26.50%	0.31%	4.93%	11.95%	8.43%	26.50%	8.95%	15.50%	11.79%
Russell 2000®	16.88%	-0.26%	12.23%	14.02%	8.16%	16.88%	2.19%	9.94%	7.13%
Russell 3000®	25.93%	0.28%	5.29%	12.06%	8.41%	25.93%	8.52%	15.14%	11.47%
Dow Jones Industrial Average®	16.18%	0.81%	4.93%	13.09%	10.72%	16.18%	9.38%	12.47%	11.07%
Nasdaq Composite®	44.70%	0.17%	5.62%	13.84%	9.35%	44.70%	6.07%	18.81%	14.87%
MSCI ACWI ex USA	16.21%	1.75%	5.05%	9.82%	5.78%	16.21%	2.04%	7.60%	4.32%
MSCI Europe	17.02%	0.64%	4.94%	10.75%	4.85%	17.02%	3.44%	6.62%	1.68%
MSCI EAFE	18.85%	1.17%	5.33%	10.47%	6.00%	18.85%	4.53%	8.69%	4.78%
MSCI Emerging Markets	10.27%	3.25%	3.95%	7.93%	4.92%	10.27%	-4.71%	4.07%	3.05%
MSCI ACWI	22.81%	0.85%	4.83%	11.14%	7.48%	22.81%	6.26%	12.29%	8.51%
Alerian MLP	26.27%	0.11%	-2.17%	4.93%	15.25%	26.27%	32.10%	11.82%	1.81%
Major Bond Indices	**YTD**	**1 Wk**	**1 Mo**	**3 Mo**	**6 Mo**	**12 Mo**	**3 Yr^**	**5 Yr^**	**10 Yr****
ICE BofA US High Yield Constrained	13.45%	0.35%	3.67%	7.07%	7.62%	13.46%	2.00%	5.19%	4.51%
Morningstar® LSTA® US Leveraged Loan	13.26%	0.29%	1.60%	2.84%	6.37%	13.29%	5.74%	5.78%	4.41%
ICE BofA Fixed Rate Preferred Securities	10.20%	-0.10%	2.76%	6.62%	5.35%	10.20%	-1.28%	3.91%	4.99%
ICE BofA US Mortgage Backed Securities	4.96%	0.34%	4.21%	7.36%	2.98%	4.97%	-2.96%	0.26%	1.38%
ICE BofA US Investment Grade Institutional Capital Securities	8.38%	0.41%	4.03%	7.91%	4.99%	8.39%	-3.17%	2.63%	2.98%
ICE BofA US-3 Month Treasury	5.01%	0.10%	0.47%	1.37%	2.70%	5.01%	2.15%	1.88%	1.25%
ICE BofA Current 2-Year US Treasury	3.47%	0.13%	1.09%	2.43%	2.97%	3.49%	-0.47%	1.01%	0.85%
ICE BofA Current 5-Year US Treasury	3.71%	0.20%	2.28%	4.40%	3.07%	3.72%	-3.12%	0.64%	1.03%
ICE BofA Current 10-Year US Treasury	2.81%	0.19%	4.02%	6.58%	1.08%	2.82%	-6.06%	-0.03%	1.29%
ICE BofA Current 30-Year US Treasury	1.20%	0.28%	8.19%	12.26%	-2.07%	1.21%	-13.71%	-2.38%	1.75%
ICE BofA Global Corporate	9.46%	0.40%	4.13%	8.66%	5.79%	9.47%	-3.99%	1.70%	1.73%
ICE BofA 7-12 Year US Municipal Securities	5.46%	0.18%	2.41%	7.10%	3.42%	5.46%	-0.24%	2.42%	3.03%
Bloomberg Municipal High Yield	9.21%	0.04%	3.00%	9.21%	4.57%	9.21%	0.75%	3.49%	5.00%
Bloomberg US Aggregate Bond	5.53%	0.48%	3.83%	6.82%	3.37%	5.53%	-3.31%	1.10%	1.81%
Bloomberg Global-Aggregate	5.72%	0.48%	4.16%	8.10%	4.22%	5.72%	-5.51%	-0.32%	0.38%
Commodities Indices	**YTD**	**1 Wk**	**1 Mo**	**3 Mo**	**6 Mo**	**12 Mo**	**3 Yr^**	**5 Yr^**	**10 Yr****
Bloomberg Commodity	-7.91%	-0.61%	-2.69%	-4.63%	-0.14%	-7.91%	10.76%	7.23%	-1.11%
S&P GSCI®	-4.27%	-1.39%	-3.31%	-10.73%	3.53%	-4.27%	19.18%	8.72%	-3.60%
S&P GSCI Gold	12.82%	0.23%	1.14%	11.38%	7.06%	12.82%	2.34%	8.88%	4.70%
S&P 500 Economic Sectors	**YTD**	**1 Wk**	**1 Mo**	**3 Mo**	**6 Mo**	**12 Mo**	**3 Yr^**	**5 Yr^**	**10 Yr****
S&P 500 Information Technology	57.84%	0.27%	3.83%	17.17%	10.55%	57.84%	15.10%	26.94%	20.78%
S&P 500 Communication Services	55.80%	-0.40%	4.81%	10.95%	14.36%	55.80%	4.42%	13.31%	7.81%
S&P 500 Consumer Discretionary	42.30%	-0.43%	6.10%	12.42%	7.02%	42.30%	3.70%	13.72%	11.68%
S&P 500 Industrials	18.08%	0.74%	6.96%	13.00%	7.16%	18.08%	10.55%	14.18%	9.98%
S&P 500 Materials	12.55%	-0.07%	4.56%	9.69%	4.46%	12.55%	7.91%	13.58%	8.60%
S&P 500 Real Estate	12.27%	0.84%	8.70%	18.83%	8.25%	12.27%	6.58%	8.85%	7.90%
S&P 500 Financials	12.10%	0.74%	5.36%	13.98%	12.70%	12.10%	10.58%	11.90%	10.00%
S&P 500 Health Care	2.06%	0.97%	4.30%	6.41%	3.59%	2.06%	8.07%	11.59%	11.35%
S&P 500 Consumer Staples	0.52%	1.11%	2.67%	5.54%	-0.76%	0.52%	5.82%	10.86%	8.54%
S&P 500 Energy	-1.42%	-1.37%	-0.08%	-6.99%	4.38%	-1.42%	36.04%	13.30%	3.44%
S&P 500 Utilities	-7.08%	1.21%	1.91%	8.56%	-1.48%	-7.08%	3.56%	7.12%	8.92%
S&P Style Indices	**YTD**	**1 Wk**	**1 Mo**	**3 Mo**	**6 Mo**	**12 Mo**	**3 Yr^**	**5 Yr^**	**10 Yr****
S&P 500 Growth	30.02%	0.09%	3.71%	10.09%	7.24%	30.02%	6.60%	16.22%	13.35%
S&P 500 Value	22.19%	0.63%	5.51%	13.62%	8.97%	22.19%	13.07%	14.08%	9.99%
S&P MidCap 400 Growth	17.44%	-0.22%	7.40%	9.93%	6.37%	17.44%	4.18%	11.88%	9.03%
S&P MidCap 400 Value	15.35%	-0.06%	10.19%	13.62%	7.68%	15.35%	11.90%	12.86%	9.14%
S&P SmallCap 600 Growth	16.93%	-0.18%	12.09%	14.20%	9.33%	16.93%	4.17%	10.35%	8.89%
S&P SmallCap 600 Value	14.84%	0.13%	13.40%	15.83%	9.34%	14.84%	10.14%	11.25%	8.12%
S&P 500 Equal Weighted	13.84%	0.51%	6.84%	11.85%	6.37%	13.84%	9.30%	13.74%	10.38%
S&P 500® Dividend Aristocrats®	8.44%	0.59%	5.22%	8.33%	2.44%	8.44%	8.62%	12.25%	10.67%
MSCI USA Quality	36.30%	0.46%	4.87%	12.03%	10.46%	36.30%	10.39%	18.13%	13.81%
MSCI USA Minimum Volatility	9.79%	0.71%	2.71%	7.79%	5.59%	9.79%	6.46%	10.30%	10.41%
MSCI USA Momentum	9.50%	0.41%	4.81%	12.76%	9.56%	9.50%	0.70%	11.13%	11.72%
MSCI USA High Dividend Yield	6.83%	0.50%	5.37%	8.31%	6.05%	6.83%	7.83%	9.32%	9.39%

Source: Bloomberg

Notes:

Notes:

IMPORTANT DISCLOSURES

The opinions presented are those of Clearwater Capital Partners and John Chapman, Chief Executive Officer, and Chief Investment Strategist, as of January 2024 and may change, without notice, as subsequent economic and market conditions vary.

This material is presented as opinion and commentary. It is not intended to be relied upon as a forecast, research, or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. It is strictly intended for educational purposes only.

The information and opinions contained in this material are derived from proprietary and nonproprietary sources deemed by Clearwater Capital Partners to be reliable, are not necessarily all inclusive and are not guaranteed as to accuracy. Past performance does not guarantee future results. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader. No investment or investment strategy is risk free.

International investing involves additional risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments.

Index performance is referenced for illustrative purposes only. You cannot invest directly in an index. The Dow Jones Industrial Average is owned by S&P Global, the S&P 500 is a registered trademark of The McGraw-Hill Companies, and The Russell 3,000 Index is maintained by FTSE Russell. Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The two main risks related to fixed-income investment are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

Nothing contained herein is offered as tax advice. Please consult qualified professionals with any tax planning needs or tax questions you may have.

Investment Advice offered through Clearwater Capital Partners, a registered Investment Advisor. Please consult with a qualified investment professional before investing.

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