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January 31, 2024

2023 Year End Review
A.I. to New Highs

The stock market put on a powerful show in the 4th quarter of 2023 and into the new year by advancing 12 of 13 weeks into the month of January. It has been an extraordinary and extraordinarily narrow advance with only a handful of stocks (sometimes called "The Magnificent 7") powering most of the move. It is even more striking to realize that, even after this spirited rally, the S&P 500 rose to a level by year end that was essentially even with the level achieved at the end of 2021, fully two years ago. Since then, we survived a nasty bear market in 2022 taking major stock indexes down 18% to over 30%, while long-term bonds lost 30% of their face value as interest rates rose. It was the worst drubbing that the classic "balanced" portfolios of stock and bonds had suffered in decades.

2023 brought fears of an expected recession caused by rapidly increasing interest rates as the Federal Reserve (Fed) ratcheted the Feds Fund rate from nearly 0% in 2022 to a high of over 5% into the summer of 2023. With short term interest rates so high and with the S&P 500 dividend yield falling to below 1.5%, high-yielding treasury bills and money market funds offered an opportunity to earn a reasonable return with minimal risk. Through the end of this past September, the Dow Jones Industrials was still down for the year. Then came the fourth quarter and several developments ignited a rally that has persisted to date.

First, the Fed (led by Jay Powell) paused in the series of interest rate increases and mentioned the possibility that they were finished hiking rates entirely. At the same time, the rate of inflation began to fall from the height of +9% in the previous year to levels still above, but closer to, the Fed's target of 2%. The much anticipated "Fed Pivot" (from hiking to pausing, and then lowering rates) became a possibility in the foreseeable future. Then came the AI "gold rush."

Artificial intelligence (AI) has been in development and inching toward wider use for many years. However, the rapid adoption of ChatGPT and the pronouncements by chip maker Nvdia regarding the ballooning demand for AI hardware ignited a frenzy that bears at least some resemblance to a gold rush, as well as to the internet "dot-com" bubble of 2000. However, there are some significant differences from the dot-com bubble. That bubble was mostly hype and little profitability. This rally is some hype and a lot of surprising increases in profits as demand soars.

AI requires more sophisticated hardware, and a small number of computer chip makers are providing the picks and shovels for this particular gold rush. Nvidia, for example, had made a name for itself in high-end applications, bitcoin mining, real-time gaming, and high-end calculation applications. Their business hit a slump as Bitcoin mining sagged, and their sales declined. Their stock fell 66% to the bear market lows of 2022. However, they saw a wave of demand coming from large technology companies who needed their chips to compete with each other in their AI-related services. This surge of demand is potentially massive and has powered much of the recent advance in technology stocks and, therefore, in the indexes. We may be in the first phase of another wave of technological change. We fully expect the usual drama and volatility such a change often brings. Demand may begin to shift from hardware suppliers to software and service providers as this new technology takes hold. We intend to take positions in individual stocks of potential beneficiaries as well as exchange-traded funds that spread the risk among more than a few participants. As always, we will work to invest in this important developing long-term trend while attempting to manage the short-term risks appropriately.

A subject of growing concern for the broader economy and the banking system is the increasing default rates for commercial real estate (CRE) loans. In particular, office buildings have been hit by a combination of lower occupancy rates, inflating operating costs, and dramatic increases in interest expense as their maturing debt must be refinanced at much higher current rates. You may have read headlines in the financial news regarding property owners defaulting and "turning over the keys to the lender" because the properties are now worth less than debt owned on them. Regional banks are the primary lenders in that market, and some may very well fail if the defaults continue to increase. It was less than a year ago that we saw the failure of several large regional banks that shook the financial system, but that was due to a different set of problems related to falling Treasury bond prices. We think it wise at this point to avoid investments tied to these types of properties, including many regional banks that have considerable exposure.

In other news, Bitcoin passed a milestone recently with the introduction of the first exchange-traded funds tied to the value of the cryptocurrency. There are several now trading daily on regulated exchanges that are sponsored by Fidelity, Blackrock, and other high-profile financial institutions. Some believe that increased access by the average investor will increase demand and drive the price of Bitcoins higher. In addition, this spring will bring another "halving" in bitcoin, which means that it will take twice as much "mining" to produce each bitcoin. This is a built-in limit to the supply of bitcoins which some believe makes this cryptocurrency superior to "fiat currency" like the dollar, which can be created in abundance at the whim of central bankers. We do not recommend cryptocurrency investments, but you can now take such a position within a normal brokerage account by buying any of the ETFs if you so desire.

In addition to technological trends, there are some anomalies in the current market that we hope to take advantage of. The most glaring of which is the fact that small company stocks represented by the Wilshire 2000 are still down 20% from their highs made 2 years ago while the major indexes are hitting new highs. Energy stocks are low, and many provide good dividends that will look even better when interest rates begin to decline again. Solar energy stocks have been pummeled since they are so sensitive to interest rates in their pay-back calculations on the cost of installation. They may begin to recover as rates ease.

The recession expected in 2023 didn't show up even with a string of economic indicators pointing to its inevitability. So far, the economy remains resilient, and investors are betting on business activity continuing to grow as higher interest rates are absorbed and inflation continues to abate. The so-called "soft landing" would be a transition for the economy to these higher interest rates without having a recession. At that point, the Fed may be able to lower interest rates without reigniting inflation, or so the thinking goes.

Our highest priority is preserving your assets, and we were effective in doing so through the bear market of 2022. Our conservative posture into 2023 was based on reasonable expectations of recessionary headwinds and historically high valuations. As the economy has remained resilient, we have shifted asset mixes and taken a somewhat more aggressive stance while being mindful of the possibility that a normal market "correction" could come at any time, and likely will sometime during this year.

As always, we want to shape your investments to fit your goals, desires, and appetite for risk. Please feel free to call and discuss increasing or decreasing your risk profile to suit your desires. Enclosed you will find reports and statements that you can review at your leisure.

We consider it a privilege to work with you on your investments and look forward to continuing to do so in the year ahead.

Best regards,

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