December 2023
# Market Commentary

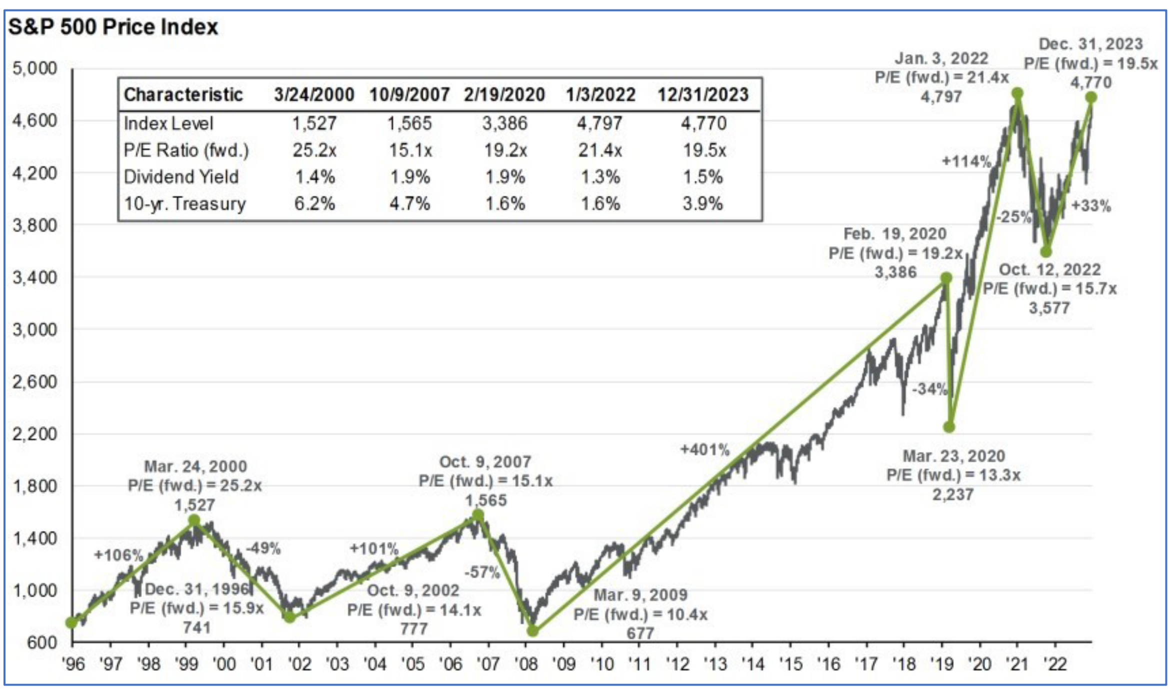
## Quo VADIS – Where are we going?
By Theresa Gusman
January 18, 2024

### Overview

The S&P 500 advanced 11.7% in the fourth quarter, cementing a 24.3% rise in 2023. Through most of last year, the S&P 500's narrow leadership camouflaged the paltry returns of the broader index and punished investors underweight the Artificial Intelligence (AI)-fueled stocks known as the Magnificent Seven. The rally broadened in the fourth quarter, with the equal- and market cap-weighted S&P 500 indices delivering almost identical performance.

With the recent surge, the US equity market is fairly valued given current earnings projections. Most market observers have an overly sanguine economic outlook, in our opinion, geopolitical risks are rising worldwide, and major elections looming in the US, Russia, the EU, India, South Africa, and elsewhere. Against this backdrop, we believe markets could be choppy but return to trend increases in the mid-to-high single digits with better breadth as 2024 progresses.

### Figure 1. S&P 500 at Inflection Points – Bull and Bear Markets, 1996 to Date

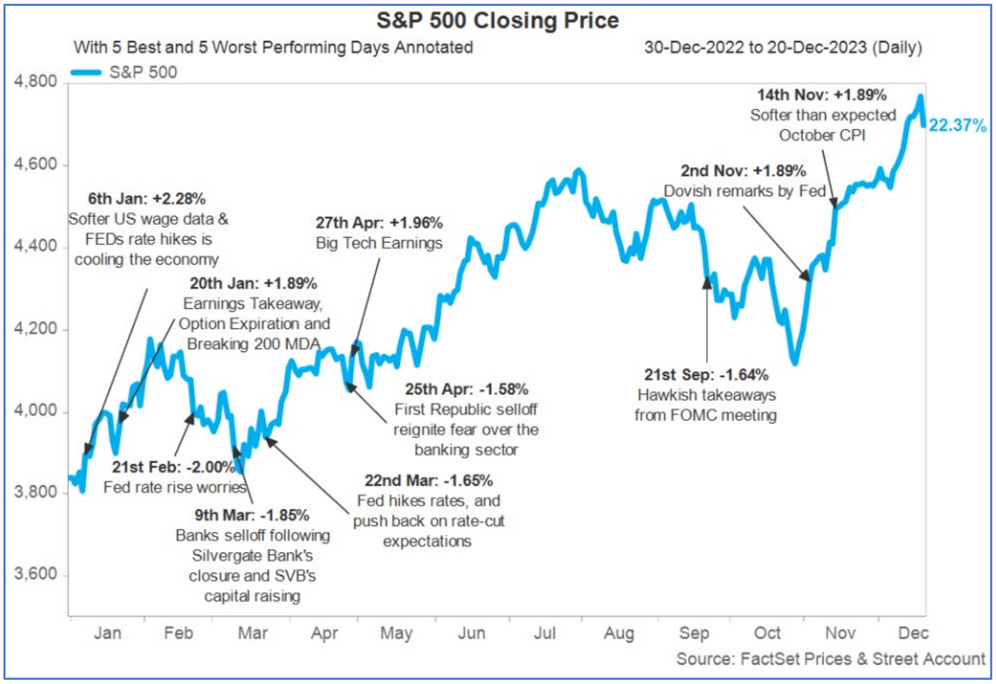



Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of December 31, 2023

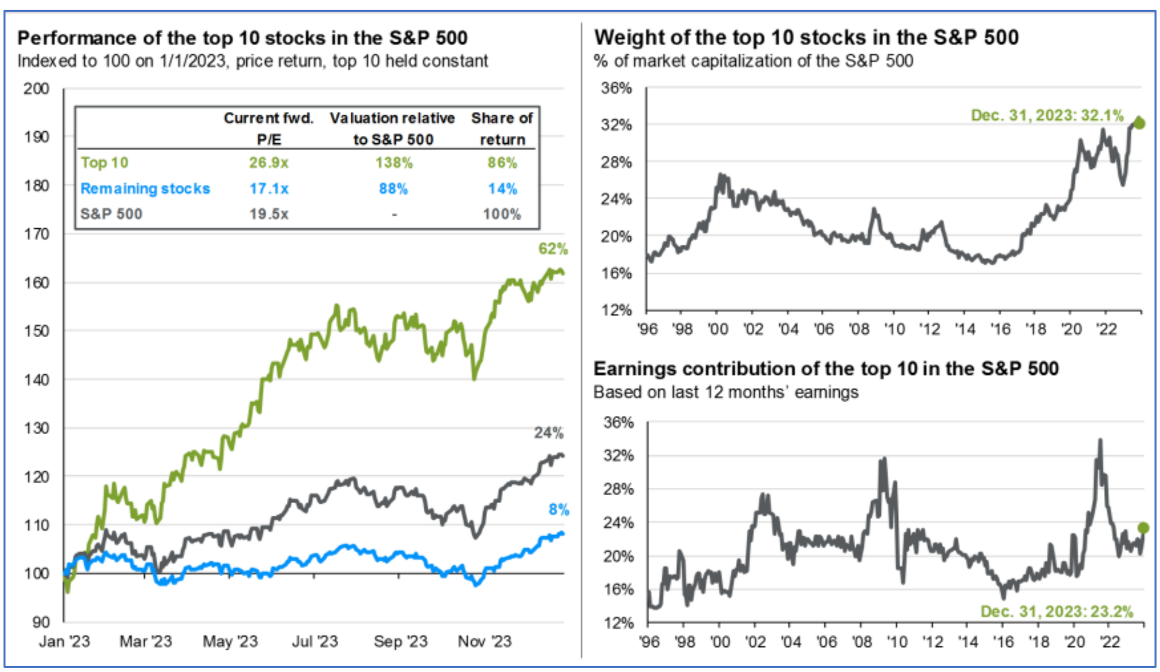
### Revenge of the Nerds – A look back at 2023

In 2023, the S&P 500 advanced 24%, recovering from a 19% decline in 2022 and falling just short of an all-time high (see Figure 1, above). Although the Fed and the economy drove market sentiment (see Figure 2, page 2), the real story was the emergence of Artificial Intelligence and the dominance of the associated companies. Driven by Amazon, Apple, Google, Meta, Microsoft, Nvidia, and Tesla, the Top 10 stocks in the S&P 500 surged 62% in 2023, comprising 86% of the overall index return (see Figure 3, page 2). By comparison, the other 490 stocks in the S&P 500 posted a more pedestrian 8% return, comprising 14% of the index return. At year end, the Top 10 comprised nearly a third (32.1%) of the market capitalization of the S&P 500 – the highest in recent history -- but only 23.2% of last-twelve-months earnings.

### Figure 2. The Days that Moved the Market in 2023




### Figure 3. S&P 500 Index: Concentration



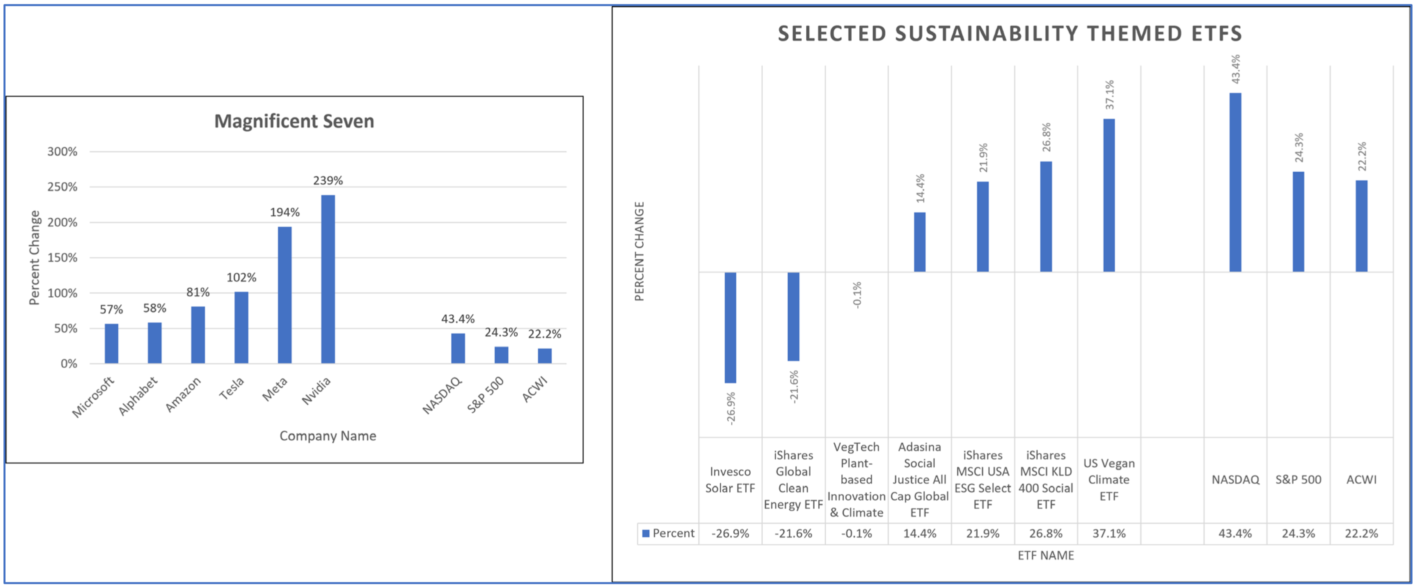

Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of March 31, 2022

The narrow tenor of the market wreaked havoc on active managers in 2023. Research by LSEG Lipper found most actively managed funds and active ETFs underperformed their benchmarks in 2023. Of the 13,938 actively managed funds globally, including conventional and ESG strategies, just 4,741 – a paltry 34% of active strategies – outperformed their respective indices. In fact, among all active equity strategies, the average fund underperformed its benchmark by -2.4% (240 basis points), only two-thirds of which "can be attributed to fees and expenses". Finally, LSEG Lipper observes, ESG-related funds performed worse than conventional strategies in 2023, with approximately 37% of conventional funds outperforming their benchmarks, compared with only 28.6% of ESG-related funds.

Several factors contribute to the underperformance of ESG-related or sustainable funds in 2023:

- Unless they were greenwashed, selected solar, clean energy, vegan and climate innovation, and social justice themed ETFs grossly lagged the broad market indices in 2023. Figure 4, page 4 shows 2023 returns for the magnificent seven (for comparative purposes) and selected sustainability themed ETFs.
- Among ESG-oriented ETFs, only those with the Magnificent Seven among their largest holdings showed positive returns. For example, the Top 5 holdings in the MSCI KLD 400 Social Index (+26.8% in 2023) – long the benchmark for social and sustainable investors – are MSFT, NVDA, GOOG, GOOGL, and TSLA, and these stocks comprise 27.5% of holdings. Even more interestingly, the Top 10 holdings of VEGN (+37.1% in 2023), the US Vegan Climate ETF – which touts its humane, animal friendly, good for the environment, and good for people approach – are NVDA, TSLA, AVGO, UNH, V, MA, CRM, CSCO, GOOG and GOOGL, and these stocks comprise 36% of the portfolio.
- By comparison, specialty solar, clean energy, plant-based innovation, and social justice ETFs – TAN (-26.9%), ICLN (-21.6%), EATV (-0.1%), and JSTC (+14.4%), respectively, lagged the broader indices. This underperformance comes amid mounting losses for electric vehicle, wind, and solar companies.
- Below we cite a few of the third quarter earnings headlines related to the clean energy transition:
    - Ford posted an EV operating loss of $1.3 billion in the 3Q, up from $1.1 billion in the 2Q and more than double its Q3 2022 loss. This means Ford lost approximately $36,000 on every EV it sold in the quarter.
    - Mercedes-Benz said a "brutal" EV market with heavy price cuts and supply chain issues meant it would likely hit the lower end of its 12-14% adjusted return on sales forecast for the cars division, as third-quarter earnings fell.
    - BP wrote off $540 million in the 3Q on its offshore NY wind power projects after officials rejected a request for better terms to reflect what BP referred to as "inflationary pressures and permitting delays". The projects have since been shelved.
    - Several pure solar and wind companies posted sizeable losses amid slackening demand, rising costs, and increased NIMBY issues.
    - More recently, Hertz Global Holdings, a major player in the vehicle rental industry, announced a significant change in its electric vehicle strategy. The company is selling about 20,000 EVs, including a substantial number of Teslas, from its U.S. fleet because, “consumers do not want those vehicles”, according to a spokesperson.

## Figure 4. 2023 Returns – Magnificent Seven and Selected Sustainability Themed ETFs




Source: First Affirmative Data are as December 31, 2023

### Quo VADIS – Where are we going?

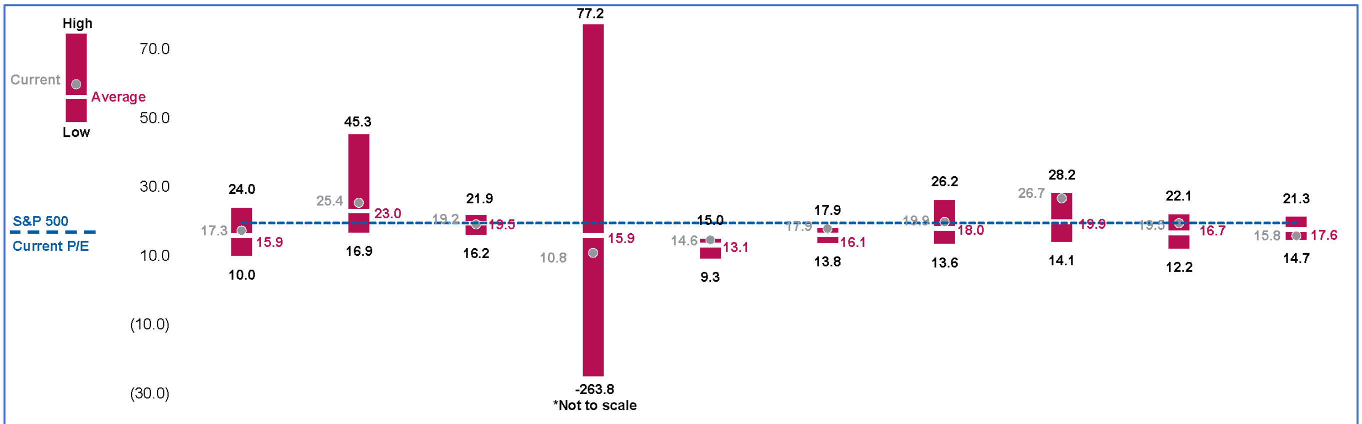
Most market observers entered 2023 humbled with dividends, the previous year. As a result, a cautious market outlook prevailed underpinned by expectations of persistent high inflation, additional interest rate increases, very low unemployment, and a recession on the horizon. As we enter 2024, inflation has moderated, the Fed has signaled interest rate increases have come to an end, unemployment remains low, and most see slow, steady economic growth with little to no chance of recession. Some pundits are even looking for interest rate cuts to begin as soon as the current quarter.

We wonder how much of this pollyannaish view reflects the "feel good" associated with last year's sharp market rebound.

- Figure 5, real interest rates remain well below normal, suggesting equilibrium rates around current levels – if inflation falls to the Fed's 2% target.
- On the economic front, we put chances of a recession at "slim but not out of the question".
    - COVID-related relief has worked its way through the economy.
    - Government spending will be flat, at best, in 2024. Among other things, this suggests the fastest growing employer in the US may pause. To put this in perspective, per the December 2023 employment report, government employment increased by 52,000 (nearly one-quarter of the overall nonfarm payroll increase of 216,000) last month, and government added an average of 56,000 jobs per month in 2023, more than double the average monthly gain of 23,000 in 2022.
    - The consumer is stretched. Consumer balance sheets held up well during the pandemic thanks to massive fiscal support. After declining to a 40-year low during the pandemic, aggressive Fed tightening has contributed to higher household borrowing costs and an increase in the household debt service ratio to pre-pandemic levels. As a result, auto and credit card loans 30 or more days delinquent have increased to 7.4% and 8.0%, respectively, after remaining flat for most of the prior decade. Finally, personal savings as a percentage of disposable income fell to 4.6% YTD in 2023, well below the 8.6% average of the past 60 years.
- The US equity market as measured by the S&P 500 is fairly-valued given current earnings projections. From a sector perspective, information technology is most overvalued relative to its 10-year average

and energy is most undervalued (see Figure 5 and 6, page 5). Across regions and styles, the Russell 1000 Growth index is most overvalued, and the MSCI World ex-USA Small Cap index is most undervalued. None of this is surprising given the dominant performance of seven large cap US stocks in 2023. Possibly heralding broader market participation ahead, the rally broadened in the fourth quarter, with the equal- and market cap-weighted S&P 500 indices delivering almost identical performance (11.3% v 11.7%, respectively).

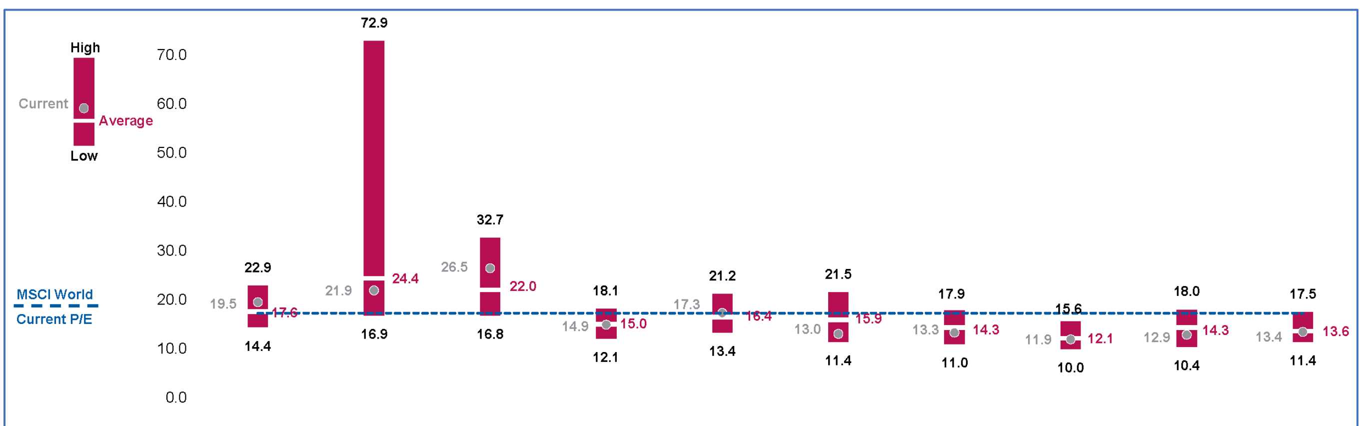
## Figure 5. Valuation Analysis – S&P 500 Sectors: Current NTM P/E v 10-year High, Low, Average




| | Communication Services | Consumer Discretionary | Consumer Staples | Energy | Financials | Health Care | Industrials | Information Technology | Materials | Utilities |
|---|---|---|---|---|---|---|---|---|---|---|
| High Date | 8/20 | 6/20 | 12/21 | 4/16 | 10/21 | 12/23 | 8/20 | 12/21 | 7/20 | 3/22 |
| Low Date | 5/18 | 2/16 | 1/14 | 7/20 | 3/20 | 3/20 | 12/18 | 1/14 | 9/15 | 12/13 |

Source: Eaton Vance Monthly Market Monitor, January 2024

## Figure 6. Valuation Analysis – Regions/Styles: Current NTM P/E v 10-year High, Low, Average




| | S&P 500 | Russell 2000 | Russell 1000 Growth | Russell 1000 Value | MSCI World | MSCI World ex USA Small Cap | MSCI EAFE | MSCI EM | MSCI Europe | MSCI AC Asia Pac |
|---|---|---|---|---|---|---|---|---|---|---|
| High Date | 8/20 | 6/20 | 8/20 | 3/21 | 8/20 | 8/20 | 8/20 | 1/21 | 6/20 | 1/21 |
| Low Date | 12/18 | 9/22 | 2/16 | 9/22 | 12/18 | 9/22 | 9/22 | 1/14 | 9/22 | 12/18 |

Source: Eaton Vance Monthly Market Monitor, January 2024

With an overly sanguine economic outlook among many market observers, geopolitical risks rising worldwide, and major elections looming in the US, Russia, the EU, India, South Africa, and elsewhere, we believe markets could be choppy but return to trend increases in the mid-to-high single digits with better breadth as 2024 progresses.

## Investing in the World as you want it to be

The market reflects the world as it is today. Sustainable, responsible, and impact (SRI) investors invest in the world as they want it to be and look to achieve long term financial and impact goals aligned with their values. Some have called into question the rationale for investing in ESG-related mutual funds and ETFs considering the poor performance of active strategies in 2023.

We believe investors must take responsibility for the impact their money has in the world. Since 1988, we have served individuals and institutions seeking to achieve financial returns and align their portfolios with their values. Our Values-Aligned Direct Index Solution (VADIS) represents the future of hyper-customized portfolio management and enables clients to invest in the world as they want it to be. By combining trusted personal financial advice, leading sustainable and responsible investment expertise, and scalable technology, VADIS enables advisors to provide personalized portfolios aligned to each client's financial goals and values.

The shift into sustainable, responsible, and impact (SRI) investments continues – albeit at a slower pace. As noted earlier, nearly two-thirds of ESG-related mutual funds and ETFs underperformed their benchmarks in 2023. The MSCI KLI 400 index was among the exceptions (see Figure 7, below), reflecting its sizable positions in MSFT, NVDA, GOOG, GOOGL, and TSLA, which these stocks comprise 27.5% of its holdings.

As always, everything we do at First Affirmative is driven by our dedication to enabling advisors to deliver financial results to clients and belief in the power of capital to bring about lasting environmental and social change. Our innovative Values-Aligned Direct Index Solution (VADIS) and Sustainable Managed Mutual Fund and Multi-Manager Investment Solutions are built to enable clients to achieve their financial goals over the long term, along with their individual environmental, social, governance, ethical, and values-based objectives. Each portfolio is carefully constructed to be well diversified across assets, sectors, geographies, securities, and management styles –– and designed to weather periods of uncertainty and volatility.

### Figure 7. MSCI KLD 400 vs S&P 500 Indices, December 31, 2023


| | MSCI KLD 400 Social Index* | S&P 500 TR Index |
|---|---|---|
| Annualized Return Since 5/1/90: | 12.09% | 10.49% |

Source: Morningstar. *Data prior to 9/1/2010 is that of the MSCI KLD 400 Social Index GR, while data since 9/1/2010 is that of the MSCI KLD 400 Social Index NR. Indices are unmanaged groups of securities. Index performance does not include the impact of cash, fees, or transaction costs. Investors cannot invest directly in indices but may purchase mutual funds or other investment products designed to track the performance of various indices.

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