Market Commentary

December 31, 2023

DAVIDSON INVESTMENT ADVISORS

U.S. Equities Market

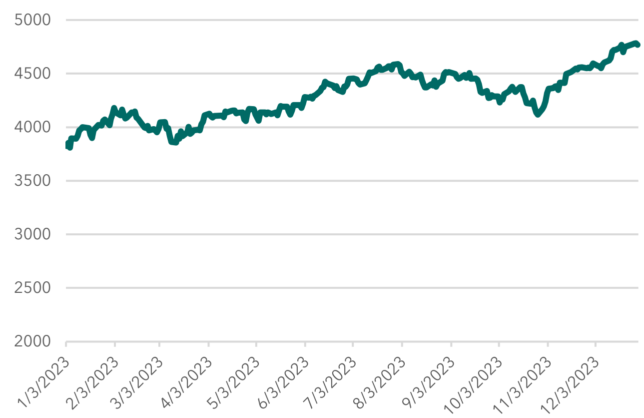
Mr. Pillow

The U.S. equity markets closed the year with strong positive performance, as the S&P 500® Index increased 11.7% in the fourth quarter, up 26.3% for the year. Interest rate-sensitive equities in the Real Estate and Financial Services sectors were among the top performers in the quarter as expectations of Federal Reserve (Fed) rate cuts were heightened following the Federal Open Market Committee (FOMC) meeting in December. Information Technology stocks also outperformed. The lone sector in the red was Energy, as the slowing global economy, particularly in China, weighed on demand. Despite the rally in banks, growth continued to outperform value with the Russell 1000® Growth Index beating its Value counterpart by over 4% and by a staggering 31% for the year, mainly due to the outperformance of large-cap technology stocks.

At the beginning of 2023, few anticipated such strong equity performance in the face of the fastest rate hikes in history and expectations of recession. Ever fewer felt bullish in March when several banks, Silicon Valley Bank and First Republic Bank among them, went bankrupt due to deposit runs and funding issues. However, the strong U.S. labor market allowed the American consumer to continue to spend and supply chains began to heal which led inflation lower, particularly in goods. Higher mortgage rates have slowed housing appreciation but have yet to cause distress, save for those trying to buy a home for the first time as housing affordability plummeted to historic lows. Energy markets fell throughout the year as ample supplies in the U.S. offset turmoil in Ukraine and Russia. In early 2023, Fed Chair Jerome Powell (aka Mr. Pillow) was warning the market that he was willing to force unemployment up and the economy into recession in order to combat the highest inflation in decades. By the end of the year, he was signaling rate hikes were over and cuts were coming in the new year. The much-doubted soft landing the Fed was attempting began to emerge as many investors' most likely scenario, with Mr. Powell its chief engineer.

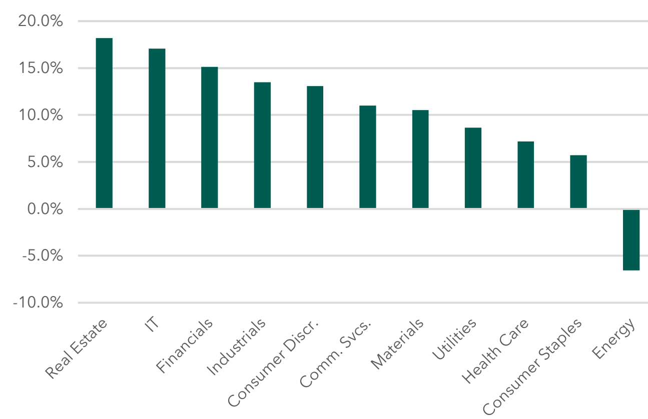
Despite a higher likelihood of a soft landing - or no landing at all - this path is not without potential issues. Inflation, though declining, is still above the Fed's 2% target, especially in the service economy where labor supply remains scarce. Short-term rates are above 5%, and the yield curve is inverted, a traditional warning sign of recession. Government deficits are at historic highs despite a resilient economy, and there are wars in the Middle East and Ukraine with global tensions the highest since perhaps the Cold War. The economy is most definitely slowing, even more so outside the United States, yet equity valuations remain elevated and are assuming rate cuts by the middle of the year. If such interest rate relief does not materialize, Mr. Powell's intended soft landing may become less comfortable.

S&P 500 Index



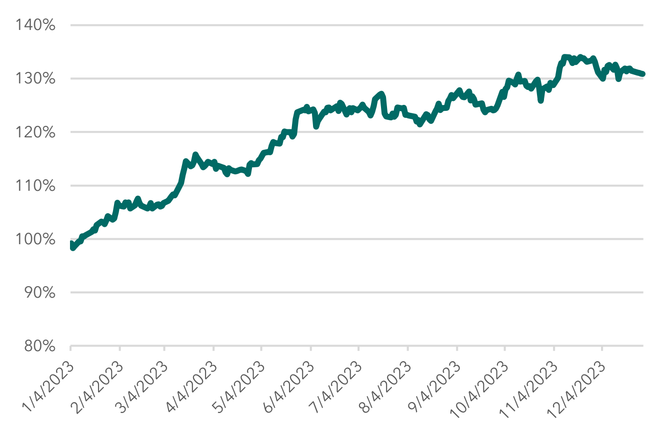
Source: Bloomberg

Q4 2023 Russell 3000 Returns by Sector



Source: Bloomberg

Russell 1000 Growth / Russell 1000 Value



Source: Bloomberg

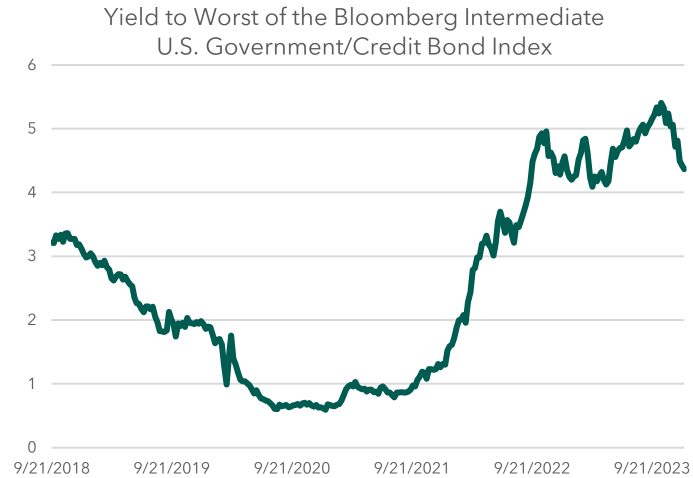
U.S. Taxable Fixed Income Market

Doves Spread Their Wings

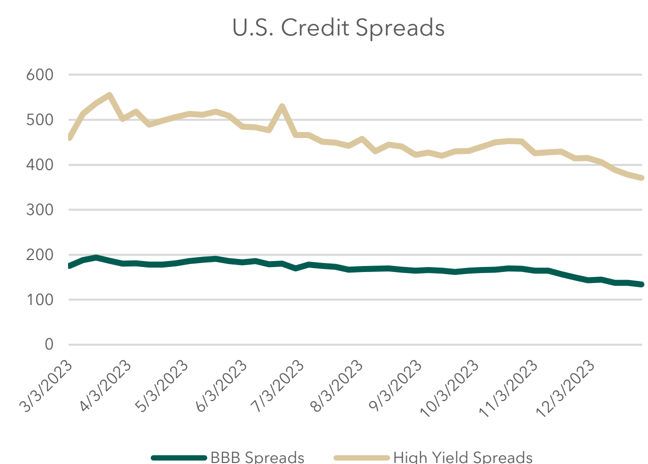
The final quarter of the year started with yields rising, as solid economic data came in and investors began to seriously contemplate whether the United States could afford to pay its debt at rates near 5%. However, it ended with rates falling dramatically as the Fed doves finally left the nest and spread their wings. This led to the Bloomberg Intermediate U.S. Government/Credit Bond Index returning 4.6% in the fourth quarter and 5.2% for 2023.

After starting the quarter at 4.57% and rising to 5% by mid-October, the yield on the 10-year U.S. Treasury note ended the quarter at 3.88%. Much of this move was driven by market expectations for Fed cuts in 2024, which members of the Federal Open Market Committee (FOMC) refused to push back against, and in some instances, even endorsed. Seeing the hurdle of higher long-term rates lowered helped propel risk assets across the board, including both high-yield and investment-grade corporate bonds. Spreads on BBB-rated corporate bonds fell from 165 basis points (bps) to 134 bps in the quarter while spreads for high yield bonds fell from 431 bps to 371 bps. The expectations for future Fed cuts clearly had an impact.

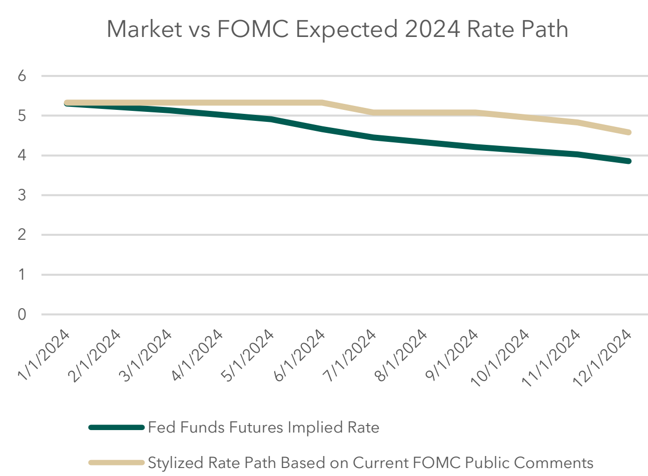
Given the marked impact that expectations for Fed cuts have had on the financial markets in such a short amount of time, it does raise the question whether things have gone too far too fast. For instance, it is worth noting that the market is currently expecting the Fed to cut rates six times, while the median FOMC member only forecasts three 25 bps cuts in 2024, with many members saying they don't anticipate cutting before the third quarter at all. So, the market is expecting twice the cuts, while also expecting them to begin in March. If risk assets have responded to the market expectation for cuts, then it is likely they've priced in an optimistic outcome. While recent economic data points do provide some reasons for optimism, indicators of the potential for a recession remain; with the Conference Board U.S. Leading Index Ten Economic Indicators at levels commensurate with a recession, a slowly rising unemployment rate, and models designed to estimate the probability of a recession still indicating one is more probable than not. Given the recent tightening of spreads and macroeconomic pressures, we continue to emphasize our deep credit research and focus on security selection.



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg, Federal Reserve Board

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U.S. Municipal Fixed Income Market

Large Sentiment Shifts, Less Yield Change

The yield on the 10-year U.S. Treasury finished 2023 little changed compared to a year ago. However, one would be mistaken to think that rates were stable over the last 12 months. Municipal bond yields, also volatile over the period, posted one of their largest turnarounds in history, with a strong year-end rally that more than reversed several quarters of quickly rising rates.

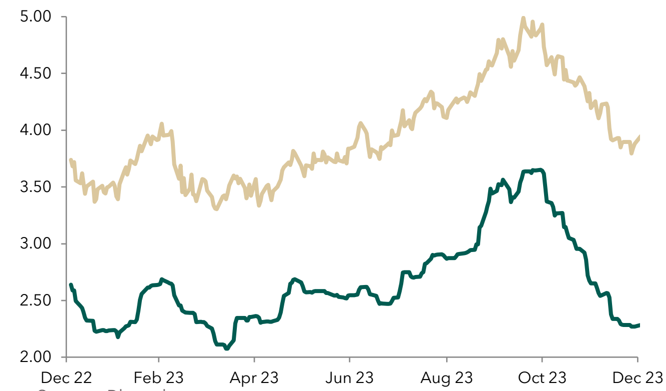
The Bloomberg AAA 10-Year Municipal Index began '23 at a yield of 2.64% before rising above 3.5% in October, then rallying nearly 140 bps over the last two months of the year. Municipal to Treasury ratios around 10 years also declined from nearly 70% to below 60%, as strong demand and limited supply dominated the market late in the year.

Higher yield income and late year price gains helped contribute to strong municipal total returns, approximately 4.6% for the Bloomberg Muni 1-10 Year Blend Index for the year. Overall gains in municipals were further bolstered by strong investor demand, seen by the rotation of separately managed accounts (SMA's) into the asset class. Households added nearly $5 billion to their holdings through the third quarter, for a total of approximately $1.6 trillion. Limited supply also helped support the market, as municipal issuance declined due to rate volatility and higher financing costs for state and local issuers. In total, 2023 saw approximately $365 billion of tax-exempt issuance, nearly 12% below the five-year average of $414 billion.

At the beginning of 2023, many market participants believed the economy was going to slow and the Fed would begin cutting interest rates soon, hence an inverted yield curve in both Treasuries and municipals. Similar to last year, much of the market is again convinced that the Fed Funds rate will fall significantly in 2024. Market participants may be jumping the gun again, but we are starting from a Fed Funds rate 100 basis points higher than the beginning of 2023, and a slowdown, in part due to higher interest rates, is more visible in some sectors of the economy. We do believe short-term interest rates will generally decline in 2024, but perhaps not to the magnitude that the market is anticipating.

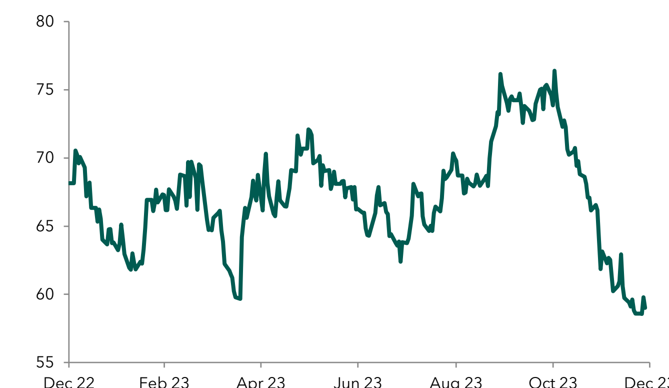
Portfolio structure and positioning remain paramount in this rapidly evolving environment. The recent rally may be overdone, but we do feel comfortable in our assessment that the Federal Reserve has finished tightening. So, to position our portfolios for the coming year we will continue to buy judiciously and try to find value in an overbought market. While hoping for the fabled soft-landing to be achieved by the Federal Reserve, we also appreciate the history of previous tightening cycles and prepare for those less favorable outcomes.

10-Year AAA Muni Yield & 10-Year U.S. Treasury Yield



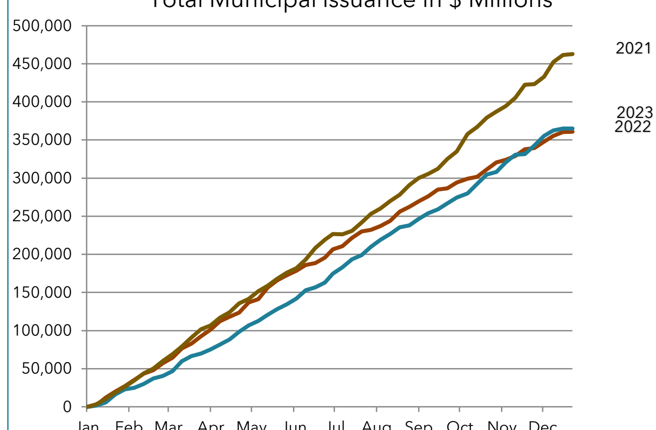
Source: Bloomberg

10-Year AAA Muni Yield as % of 10-Year U.S. Treasury Yield



Source: Bloomberg

Total Municipal Issuance in $ Millions



Source: Bloomberg

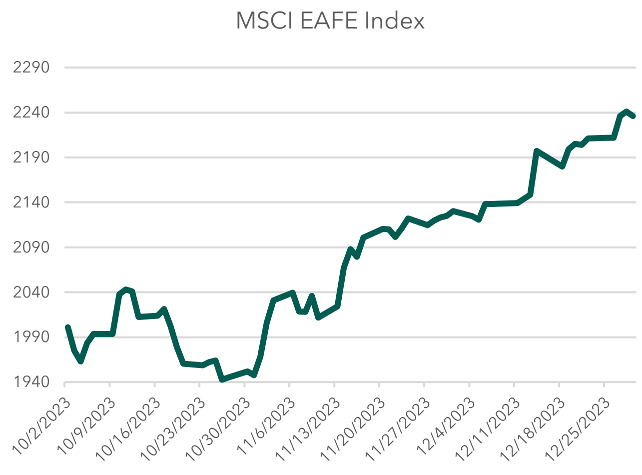
International Equities Market

Change of Focus

Both the MSCI EAFE and Emerging Markets Indices finished higher for the quarter and for the year. The MSCI EAFE Index recorded a 10.4% total return for the fourth quarter and a 18.2% return for the year. The MSCI Emerging Markets Index recorded a 7.9% and 9.8% total return for the fourth quarter and for the year, respectively. Despite the positive returns, international equity performance lagged domestic equity performance during both time periods given the strength of the U.S economy. The U.S. dollar fell during the quarter and the year, contributing to international performance.

Interest rates again played a role in this quarter's performance, particularly, interest rate expectations. For much of this year, the market focused on the continued tightening of monetary policies by Central Banks across the world's major economies. However, during this quarter the focus changed. The consensus view is that policy makers are done tightening, causing investors to focus on when central banks will begin to reverse course and ease. This reversal is pertinent, given the role interest rates play in financing costs and in valuation. Consequently, higher rate expectations should no longer be a headwind to asset valuations like they have been for the past two years.

Given the above, investor focus should shift to profit and growth expectations. With that in mind, market expectations vary across the world. Using domestic markets as a baseline, analysts expect earnings to grow 10% next year after flat growth in 2023. For the EAFE Index, profit growth expectations are modest, up just over 1%, but that compares to 11% for 2023. On the other hand, emerging market growth expectations are the most robust at 18%, but that is against a relatively easy year-over-year comparison with the 2023 earnings decline of 9%. For context, expectations for a rebound come after two consecutive years with negative growth. These earnings expectations appear in-line with consensus economic growth forecasts for each market. It will be interesting to see if there are any lagging monetary policy effects on these economies and what impact they may have on profit growth expectations in the new year.



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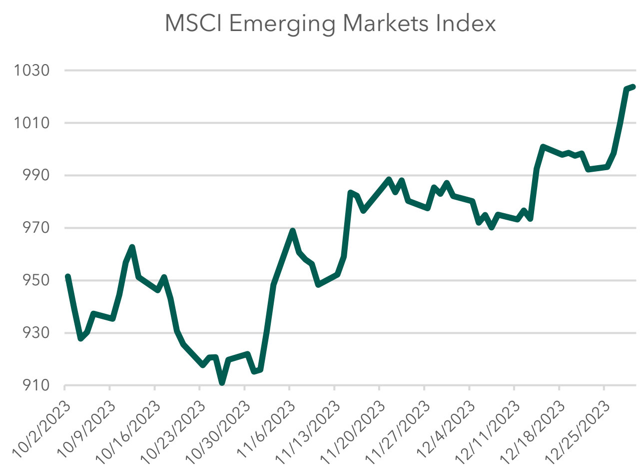

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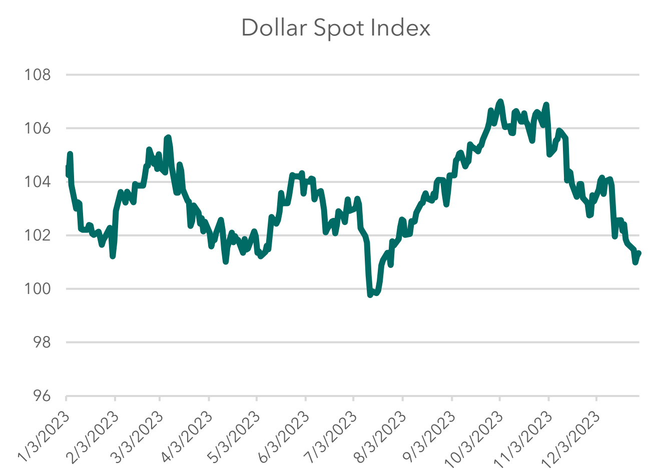

Source: Bloomberg

Disclosures

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The information on indices is presented for illustrative purposes only and is not intended to imply the potential performance of any fund or investment. Index performance assumes the reinvestment of all distributions, but does not assume any transaction costs, taxes, management fees, or other expenses. Indices are not available for direct investment.

The S&P 500® Index is a gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected.

The Russell 1000® Growth Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

The Bloomberg Intermediate Government/Credit Index measures the performance of U.S. Dollar-denominated U.S. Treasury bonds, government-related bonds (i.e., U.S. and non-U.S. agencies, sovereign, supranational and local authority debt) and investment-grade U.S. corporate bonds that have a remaining maturity of greater than or equal to one year and less than 10 years.

The Conference Board U.S. Leading Index includes economic variables that tend to move before changes in the overall economy and thus give a sense of the future state of an economy.

The Bloomberg AAA 10-year municipal index is populated with high quality U.S. municipal bonds with an average rating of AAA from Moody's and S&P.

The Bloomberg Municipal 1-10 Year Blend Index measures the performance of short and intermediate components of the Bloomberg Municipal Bond Index, an unmanaged, market value-weighted index which covers the U.S. investment grade, tax-exempt bond market.

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The MSCI Emerging Markets Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is broadly recognized as the pre-eminent benchmark for U.S. investors to measure international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia and the Far East, excluding the U.S. and Canada. Numerous exchange-traded funds are based on the MSCI EAFE Index, and the Chicago Mercantile Exchange, NYSE Liffe U.S. and the Bclear platform of Liffe are licensed to list futures contracts on this index as well.

The Bloomberg Dollar Spot Index tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar. It has a dynamically updated composition and represents a diverse set of currencies that are important from trade and liquidity perspectives.