Market Commentary
Fourth Quarter 2023

2023: A Two-Year Round Trip	Page 2
Our Outlook	Page 4
Asset Class Outlook	Page 5

2023: A Two-Year Round Trip

The past year was widely expected to be a challenging one for both the markets and the broader economy. For much of 2023, the question was not if, but when, the economy would lose steam in the face of the Federal Reserve's aggressive inflation-combating interest rate hikes and there was a broad consensus that we would see a recession materialize at some point during the year. Instead, the labor market proved resilient in the face of tightening monetary policy and consumers kept spending, largely shrugging off the impact of higher interest rates and still-elevated inflation. This drove GDP growth to a blistering pace of 4.9% in the third quarter. At the same time, a raft of promising economic data pointed to a sustained downturn in inflation and messaging from the Fed hinted at a more accommodating stance on the horizon. This gave many investors hope that the Fed was on the path to achieve the difficult task of providing the economy with a soft landing, meaning that inflation would return to normal levels without triggering a recession. This led to a strong rally in the markets throughout the end of the year. The Dow Jones Industrial Average reached a new all-time high in late 2023, and the S&P 500 index climbed 24%, coming within spitting distance of an all-time high. After coming off one of the worst years on record in 2022, the U.S. bond market, as measured by the Bloomberg U.S. Aggregate Bond Index, returned 5.5%.

	2022	***2023***	***24-Month Return***
S&P 500 (including dividends)	-18.11%	+26.44%	+0.10%
U.S. Agg. Bond Index	-13%	+5.5%	-8.20%

As impressive as this performance may seem, focusing only on the past 12 months' performance obscures what has been happening in the markets. Looking back over the past 24 months, it is apparent that the stock market has essentially taken a two-year round trip and is largely in the same place it was in early 2022. The steep bear market decline of 2022 saw the S&P 500 lose 18.11% (with dividends), and the cruel reality of mathematical losses means that even the robust gain of 26.44% (with dividends) in 2023 was not enough to completely recoup the losses, leaving the index just shy of its previous all-time high. Focusing on limited and arbitrary timeframes such as one calendar year can skew performance and obscure the larger trends at play. This dynamic is readily apparent when looking at the "Magnificent 7," the handful of primarily tech stocks from household names like Microsoft and Tesla that have driven the stock market's gains this year. These stocks saw blistering returns this year, gaining 80, 90, or in some cases even more than 100 percent, but, again, focusing just on 2023's performance overlooks the broader trend, and taking a longer time horizon shows that much of the year's performance was making up for lost ground the previous year. As impressive as the Magnificent 7's performance was in 2023, when looking back over the past 24 months, the group of stocks is up just 9%.

The whipsaw path the markets have taken over the past 2 years highlights another important aspect of the modern investing landscape. Modern markets are highly efficient. Opportunities for arbitrage are extremely limited and the adage of "buy low, sell high" can be incredibly difficult to put into practice in a world where pricing data quickly reflects a raft of factors like economic projections, investor sentiment, geopolitical outlook, etc. History has shown time and again that attempts to time the stock market are a losing game. Rather than focus on where an asset was one year ago and where it might be a year from now, investors should look at their portfolios as long-term investments, and plan to maintain an asset allocation for at least 3 to 5 years.

As we head into 2024, the big question facing investors is whether 2023's gains were a sustained rally that will continue to support the markets in the coming year, or if it was merely a "dead cat bounce" from the turmoil of the year before. Much of this will be determined by the Fed's actions regarding interest rates and the path the economy will take. Wall Street prognosticators are already pontificating on recessionary risks and year-end stock levels, but it begs the question: why should these predictions hold any more water than the erroneous predictions they made at the start of the last year? It would be unfair to reduce economic projections to little more than educated guesses, but these projections are always made based on current assumptions. One of the key assumptions undergirding any economic forecast is that there will be no disruptions. In a highly globalized world, the markets and broader economy are driven by geopolitical events. In early 2022, no economic forecast could have foreseen Russia's invasion of Ukraine and the ensuing turmoil it would cause. At the start of 2024, no one can predict if that war will see an escalation, or if conflicts in the Middle East will escalate, upending global trade and commodities markets. Even a few months ago, few would have predicted that global trade routes would be disrupted by modern day pirates.

After our 30 years of experience, we are acutely aware that the modern financial markets are driven in the short term by emotion and geopolitical events that cannot be predicted or controlled. We believe that in times like this, the best thing to do is to focus on the things that we do have control over. Cost is something that we have absolute control over. Unnecessary costs directly erode returns, and Hanover practices disciplined cost control. This not only applies to the expense ratios of investments, but the prices that stocks are purchased at, relative to their earnings. Buying stocks with high valuations increases risk, and finding growth opportunities at reasonable values is one of the best ways to get ahead. Taxes are also something we are keenly aware of. Every dollar sent to Uncle Sam is a dollar that is gone forever, and temporary declines in the market are preferable to a tax hit, as those losses can be regained. Perhaps the most important factor for investors to focus on is their personal risk tolerance. Specifically, we quantify risk in terms of volatility to ensure that clients understand and are able to tolerate fluctuations in the market. Since 1980, the average intra-year swing for the S&P 500 is 14%. This means that even an "average" year can expect to see big swings in the market. Again, this highlights the importance of maintaining a long time horizon, as looking over a 3 to 5 year period significantly smooths out the volatility that can be seen when focusing on monthly, quarterly, or even annual performance. More than that, however, investors should truly understand what their risk tolerance means in practical terms, how much volatility they are comfortable with, what their own investing goals are, and whether they require the higher returns that a riskier portfolio would necessitate. Riskier investments can generate higher returns, but if an investor can meet their goals with a more conservative allocation, why risk what you already have for what you don't need?

Our Outlook

Despite the many surprises to the upside that we saw in 2023, we head into 2024 with a great deal of uncertainty about the path the economy will take. There is a growing consensus among economic forecasters and prognosticators that the Federal Reserve is on track to achieve a soft landing. However, the modern global economy contains too many moving pieces to find a methodology that can have repeated success when it comes to making economic predictions. There is a raft of evidence that points to a sustained downturn in inflation, and though the economy is losing momentum, growth remains positive. The American consumer has proven to be far more resilient than many analysts expected, weathering the one-two punch of higher interest rates and still-elevated inflation. The labor market has largely shrugged off the impact of higher interest rates and remains extremely strong. However, cracks are beginning to appear beneath the surface. While job creation numbers have been robust, there is a clear loss of momentum when comparing 2022's monthly average gain of nearly 400,000 to 2023's average monthly gain of 225,000, and an increasing portion of the new jobs are coming from government positions. While the topline unemployment rate has moved up only slightly and remains near historic lows, a broader measure of unemployment that includes discouraged workers who have given up the search for employment and those who work multiple part-time jobs has seen a notable increase in recent months. The workforce participation rate, which tracks the portion of the working-age population that is employed or actively seeking employment, has reversed its post-pandemic trend and fallen in recent months. Most worryingly, the U.S. bond market is still in the midst of an inverted yield curve, meaning that the yield on short-term Treasuries is higher than that of long-term Treasuries. This means that the bond market is forecasting an economic slowdown, and as this indicator has accurately predicted all 8 of the past 8 recessions, it is an indicator that we give a great deal of credence.

All of this is to say simply that the jury is still out on whether we see a recession this year or not. Historically, the Fed raising rates as quickly and aggressively as they have done over the past 18 months almost always results in a recession. A soft landing has been achieved just once during the Fed's previous 11 interest rate tightening cycles. There is an adage about the Fed that says they will raise rates until they break something. The Fed has signaled that they are done raising rates and will look toward cutting in the coming year, and thus far nothing has broken, leaving many to conclude prematurely that the Fed has achieved its goal of a soft landing. There are two problems with this. This first is that interest rate increases are said to have a "lagging and varied" impact on the economy. On average, there is a lag of about 14 months between the final rate hike of a cycle and the onset of a recession. The current business cycle has been so distorted by the pandemic that it is possible that the lag will be longer than normal, and we may still see the impact of higher rates hit the economy hard. The other issue with declaring victory too soon is that the Fed could pivot yet again. The markets expect the Fed to begin cutting as soon as March, but "stickier" inflation could cause the Fed to keep rates elevated longer than expected. The markets have already priced in rate cuts on the horizon, so the Fed keeping them higher for longer, or even worse, raising them further would mean bad news for both stocks and bonds. On the flip side, a rapid downturn in the economy could prompt the Fed to cut more aggressively than expected, and a severe economic downturn, or "hard landing," would impact earnings and hit stock prices.

As we head into the coming year, it is important that investors keep in mind what it actually means to invest in the stock market. Short-term trading, speculating, and attempting to time the market reduce the market to little more than a casino, and that is a sure way to bust. Investing in the long term means investing in human ingenuity and industriousness. True wealth creation comes from new services, disruptive products, and increased productivity, not short-term gains made on speculative trades. Regardless of what the year ahead holds in store, the best move any investor can make is to be fully invested in their risk-based, long-term, target portfolio, and focus on the things that can be managed, such as taxes, costs, and risk. Focusing on things that you can control can lessen the emotional impact of the market's short-term fluctuations, putting you in a better position to weather a potential downturn and fully capture the upswings.

Asset Class Outlook

U.S. Stocks

The major theme for the U.S. stock market in 2023, and likely for much of 2024, has been the dominance of the so-called "Magnificent 7." These stocks, primarily tech-focused growth stocks like Nvidia, Apple, and Microsoft, drove the S&P 500 this year, accounting for the bulk of the index's 24% gain. When these seven stocks are removed, the index's returns fall to single digits. However, focusing on how much this handful of stocks pushed the index higher in 2023 overlooks how much they contributed to the bear market plunge in 2022. Since the S&P 500 reached its previous all-time high in early 2022, the Magnificent 7 are up just 6%, while the other 493 stocks in the index are down 6%. Despite the wild swings the markets have made in the past two years, the markets have largely been treading water.

In periods like this, when uncertainty is so elevated, it is important to maintain a diversified position. Fear of missing out, or "FOMO," causes investors to herd into hot stocks like the Magnificent 7, but these stocks are not immune to the business cycle and the impact of the Fed's decisions. Everybody wants to chase these stocks when they are on the way up, but no one wants to be left holding the bag when they turn down. Historically, when one segment of the stock market widely outperforms the rest of the market, the rest of the market catches up, and we expect that the gains captured by the Magnificent 7 will broaden out to the rest of the market over the next 18-24 months, particularly as the hype around technological advancements involving artificial intelligence (AI) focuses less on the companies that create the technology and more on the companies that can adopt it to increase productivity. The valuations, meaning the amount paid per each dollar of earnings, that investors are paying for stocks are also cause for concern. The S&P 500 is trading at roughly 20 times earnings, slightly higher than its long-term historical average. The Magnificent 7 on the other hand, are trading at elevated valuations, sometimes higher than 100 times earnings. Purchasing such expensively valued stocks introduces a great deal of risk and increases the likelihood of disappointment should earnings take a downturn amid higher-than-expected interest rates or weaker-than-expected economic performance. On the flip side, many small company stocks and stocks that focus on value instead of growth are trading at just 11 or 12 times earnings and appear to have already priced in a potential recession, making them a relatively attractive buy. Until there is more clarity on the trajectory that interest rates and the economy will take, the best thing to do is focus on your long-term investing goals, ensure that you are comfortable with your level of risk, and maintain a diversified and well-balanced approach.

U.S. Fixed Income

Many economists have argued that 2022 was the worst year for the U.S. bond market in more than 250 years, but the U.S. bond market stabilized somewhat in 2023. Surging yields pushed bond prices lower, but the flip side is that, in addition to the diversification benefits they offer, bonds are now a good place to earn interest. Investment grade corporate bonds are offering healthy interest and high yield "junk" bonds are finally offering yields high enough to sufficiently compensate for their increased level of risk. Short-term Treasury yields were pushed higher as the Fed raised interest rates, topping the yield on 10-year Treasuries and inverting the yield curve. However, as we enter a period of falling interest rates, short-term yields are likely to retreat. In this environment, maturity and duration should be extended to "lock in" the higher yields. At the same time, potential fluctuations in interest rates mean increased risk. Hanover is managing this by "laddering" our bond holdings, allowing a staggered portion to reach maturity each year so that the proceeds can be reinvested at higher rates if they continue to climb, or in higher-yielding investments if rates fall.

Alternative and International Assets

One alternative investment that we see as attractive in 2024 is commercial real estate. It has taken a beating in recent years amid the shift to working from home since the pandemic. Vanguard's real estate index fund, which represents a well-diversified portfolio of real estate holdings, is down roughly 20% (excluding distributions) over the past two years and is essentially flat over the past 5 years. Investors have thrown out the baby with the bathwater when it comes to commercial real estate, which makes for an attractive buying opportunity. It is important to remember that real estate is not just one asset class and commercial real estate encompasses much more than just office space. As the world becomes less globalized, North America is likely to see a manufacturing renaissance, which will mean a greater need for industrial plants, warehousing, refrigerated storage, and data centers. Real estate investment trusts (REITs) allow investors to easily gain exposure to a variety of sectors within the real estate market. These assets are traded like stocks, ensuring ready liquidity. REITs must distribute 90% of their net operating income to investors, so they pay healthy dividends, and they offer a variety of taxation benefits as well.

Outside of the U.S., we see emerging markets, with the exclusion of China, as attractive. As the global economy becomes less synchronized in its growth cycles, emerging markets can offer valuable diversification at relatively low valuations. We remain extremely wary of China. The nation's sagging real estate sector and meager domestic consumption have continued to weigh on the economy, and just as the rest of the world is seeing inflation finally retreat, China is facing the specter of a potential deflationary cycle which will weigh down the nation's economic prospects in the short term. In the long term, we remain very concerned about the nation's debt levels and the demographic struggles it will face in the coming years. Many developed international economies are expected to lag behind the U.S., but they still offer the benefit of diversification, and if we see the U.S. dollar lose some of its strength, there is a benefit to holding foreign currency.

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