# CALLAN

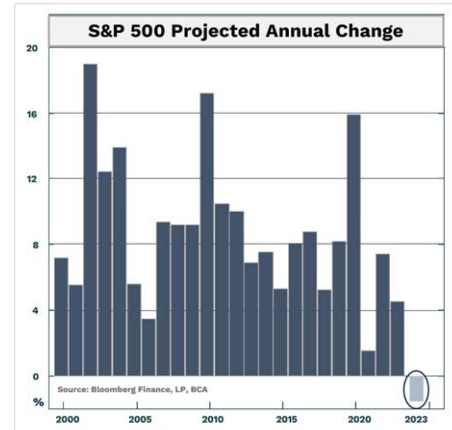
FAMILY OFFICE

## 2023 Review & Outlook

## The Rashomon Effect

There were four witnesses to the crime and four different depictions of what happened. This was the plot line of Rashomon, the 1950 film by Akira Kurosawa, and would give rise to the psychological effect carrying its name. Different motives and circumstances influence how one observes an event and can give rise to contradictory conclusions about what happened. This year the investing landscape was defined by several seemingly peculiar outcomes, and how you navigated it was predicated upon your perspective along the way. Finance cannot escape the Rashomon Effect. And we would argue it should not.

## Looking Back at 2023




Going back to 2000, Wall Street strategists collectively predicted a gain for each of the ensuing calendar years, including three 15%+ return forecasts[i]. The year 2023 marked the first time that the consensus projected a down year for the S&P 500 and, with the index up nearly 20%, that seems unlikely. Importantly, these forecasts are an amalgamation of many views, but they often rhyme. The social proof theory suggests we look to what others do to dictate our own actions. As such, perspectives on the market can easily converge. At Callan Family Office we are aware of this, and this is one of the reasons we actively seek out these independent, non-consensus views of the markets.

Our approach is to blend our own insight with research from other firms that see the world differently. Factoring in these outside perspectives allows us to build a diversified mosaic to guide our investment decision-making. This helps challenge our own thinking and brings more balance to our analysis. We intentionally introduce the Rashomon Effect into our process to help avoid simply anchoring to the consensus narrative. This year, we were fully aware of what could go wrong but did not discount what could go right and maintained balanced positioning (full asset class weightings) as a result. With equities up considerably this year, this consideration of outlier views served our clients well.

The calendar year started off with a focus on a bevy of important matters, from interest rates to earnings. All remain important. But they mattered in different ways than anticipated and reinforced the virtues of a multi-dimensional view.

## What Was Missed?

Restrictive monetary policy had been a centerpiece to the bearish case entering the year. Yet, the 'long and variable lags' that Milton Friedman warned of have proven much 'longer' than anticipated. In large measure this is due to a resilient consumer, and one that took advantage of the previous monetary policy regime. Notably, mortgage rates hit all-time lows during the pandemic to 2.65% at the nadir[ii]. This would fuel a frenzy with about 14 million mortgage borrowers refinancing their homes between 2020 and 2021. This locked in generationally low rates for years with the effective yield on all outstanding mortgages still at 3.8%, or half what a new rate could easily be today[iii]. Corporations also restructured their balance sheets. As it currently stands, 46% of the S&P 500's (ex-financials) outstanding debt will mature after 2030[iv].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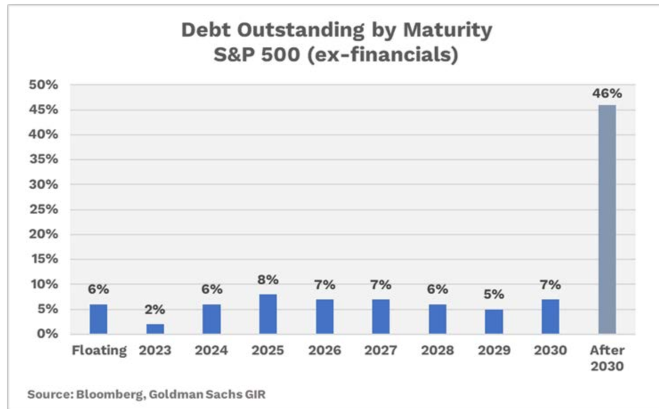
This refinancing frenzy made the economy overall less sensitive to higher rates and delayed the adverse lag effects fretted over. As Jerome Powell put it, "…the unwinding of the pandemic effects, that's what makes this cycle unique, I think, and, you know, we're still learning."[v] As was seen and learned throughout the year, higher interest rates created surprising and uneven effects. There were recessionary pockets brought on by rising rates, as we saw with a slew of high-profile bank failures earlier in the year. But the bigger picture did not square with the bearish rhetoric. Notably, third quarter GDP, the broadest measure of economic activity, was a robust +5.2%. Higher rates have yet to derail spending as the consumer, which accounts for two-thirds of GDP, remains a key economic piston.




This resilient consumer buying also accrues to the benefit of American businesses, and their upside also was underestimated. Consider that the 3Q S&P 500 consensus earnings forecast before reporting season started was a contraction of 0.3%. Actual results would come in at +3.9% and mark the first time since Q3 2022 there was positive year-over-year growth[vi]. Financial market results have outperformed this year, but like the economic conditions that fuel them, the outcomes have been unequal.

This new cost of capital regime has played out in different ways this year and will continue to do so. On one end, the largest companies hold a relative advantage. Scale matters when it comes to access and cost of financing, which, along with their Artificial Intelligence (AI) ties, contributed to the returns of the Magnificent Seven (Meta Platforms, Apple, Amazon, Alphabet, Microsoft, Nvidia, and Tesla). In fact, these companies have debt issuance outstanding with yields less than 'risk-free' Treasuries of comparable maturities. The Magnificent Seven had a collective return of +88% year-to-date through September 30th (equal weighted) and the perception of this lopsided performance had significance[vii]. Was the rest of the public stock opportunity set flawed or poised to play catch up? In our last quarterly letter, we advised the latter and taking advantage of the generational valuation gap between Large and Small Cap stocks. The embedded view that smaller companies were facing an economic climate that rivaled the 2008-09 credit crisis just did not add up. Others came around to this view as well when the Russell 2000 Small Cap Index finished +9.1% in November alone. Depending on your perspective, it was a rally that easily could have been missed.

## Looking Forward

As we look forward into 2024, interest rates will continue to have our focus. For starters, it will shape the relative valuation case of stocks versus bonds for which we currently have a balanced view. Namely, investment grade bonds, including Treasuries, have some of the more attractive real (inflation-adjusted) yields in well over a decade. One common investing goal is to grow spending power, and this can currently be achieved with these more conservative assets. But this objective could become more complex if interest rates move lower as expected.

Currently, markets are pricing in a 100% chance that by this time next year the Federal Reserve reduces their short-term borrowing rates[viii]. Decelerating inflation is a popular explanation. Notably, the PCE Price Index, the Fed's key inflation reading, is projected to gradually decline from +3.5% in October 2023 to +2.0% in 2026. With inflation subdued, monetary policy could afford to be less restrictive. As Federal Reserve Governor Christopher Waller said in November, "If inflation goes down, you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would lower the policy rate." The Fed's Summary of Economic Projections (SEP) released on December 13th now implies two rate cuts in 2024 (4.6% Federal Funds Rate) whereas the September release had them holding rates the same next year. This is the constructive view. The more cynical perspective is the economy will run into the recession that most forecasters thought was an assured fate in 2023. The Fed will be forced to cut rates more significantly in such an instance. Small cap stocks, and the broadening out of the recent market rally, suggest the economy has more tailwinds than headwinds. Yet, irrespective of your view of the cause, the effect is interest rates have likely plateaued.

Of increasing focus are higher duration or interest rate sensitive assets, but in ways you might not intuitively expect. Real estate, which is renowned for its interest rate sensitivity, has been remolded by this monetary policy shift and other pandemic-related factors, such as the bank lending retreat and hybrid work phenomenon. This combination of maturing debt, structural work force shift, and curtailed financing affecting the asset class is already playing out. Consider the following sales in 2023:

- One Liberty Plaza in New York City sold at a valuation of $1 billion compared with $1.5 billion in 2017 and,
- Union Bank Plaza tower in downtown Los Angeles sold at a $104 million loss in March 2023 and,
- Institute Place Lofts in Chicago sold for $17 million compared with $43.5 million in 2017.

As these challenges persist for office real estate, a potential opportunity has been a frequent topic of investor conversation: converting office buildings into residential properties. A **recent report from Callan LLC** delves into office-to-residential conversions.

These transactions are a matter of perspective – good for the buyer, not for the seller. Buying assets from motivated sellers has long been a point of emphasis for our investment platform and why we have a keen focus on these transactions. We are actively pursuing strategies to take advantage of what looks to be a multi-year dislocation. Equity-type investments will be one angle, and the other is opportunistic credit funds for which we have already approved investment solutions.

There remains a wall of commercial real estate debt maturities, upwards of $1.5 trillion, coming due over the next three years. Other leveraged corporations and entities face similar financing challenges ahead. But the magnitude of debt within real estate will equate to a vast opportunity set as they are forced to refinance in a higher rate environment, with banks unable or unwilling to participate near historic trends. In addition, creative structures and confidence to close are often required, allowing select private credit funds to command attractive returns and covenants. As such, a willingness to manage stressed and distressed outcomes including bankruptcies is an especially desirable attribute and unique skill set.

For more of our insights of this opportunity set, please see our recent webinar on **Private Credit: The Good, the Bad, and the Ugly.**

## Election Season

Politics will be a dominant narrative next year, and not just in the U.S. Forty countries, representing 41% of the world's population, 42% of its GDP, and nearly 80% of its stock market capitalization, will have national elections[ix] Speculation and conjecture will be rampant, but our focus remains on how this will materially affect the financial markets and economy. Currently, earnings are expected to

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continue their upward trajectory and persevere through the political brinkmanship. There is a +11.3% forecasted growth rate for the S&P 500 in 2024[x].

Further, election years do tend to be positive, as the median S&P 500 gain is +10.7% since World War II, and these results are often backloaded. The other trend is that the stock market bottoms during May of election years[xi]. Incentives matter as current economic conditions could tip the scales in close races, and the incumbent party will benefit if recession is avoided.

There is a rather big problem, though. Any stimulus efforts will draw scrutiny given the enormity of the national debt, which now stands at $33 trillion. This number is poised to go higher, as amongst other expenditures, the federal budget now includes funding two wars abroad. And while not directly a part of the Fed's dual mandate, more tax revenues devoted to paying bond interest are funds not allocated to job-creating initiatives, such as education or infrastructure investments. Said differently, there might be 33 trillion reasons why interest rates have plateaued. One thing is certain in 2024: the Fed will continue to have the attention of the financial markets in various ways. And as Warren Buffett put it, "The most important item over time in valuation is obviously interest rates."

## In Closing

There remains plenty to think about heading into the new year, and there will be plenty of perspectives on these matters, too. What will not change in 2024 is our approach -- one that is disciplined when it comes to valuation and does not make changes solely based on the opinions of others. We also have an experienced team that contributes to our investment process and their collective insights add rigor to our core views. This diversity of perspectives, both internal and external, is a welcome embrace of the Rashomon Effect that often enhances our decision making and client outcomes. Please reach out to find out how these discussed themes and ideas are being incorporated into your individualized portfolios by your investment professionals.

We value your relationship and wish you a wonderful holiday season.

For more information visit us at:
**www.callanfo.com**

i. Bloomberg Finance, LP, BCA
ii. Investopedia, Why So Few Houses For Sale? Pandemic-Refinancers Have 24 Billion Reasons to Stay Put
iii. @carlquintinilla, November 12th, 2023
iv. Bloomberg, Goldman Sachs GIR
v. Transcript of Chair Powell's Press Conference November 1, 2023
vi. FactSet, S&P 500 earnings season update: November 3, 2023
vii. Morningstar, Alphabet Class C return used
viii. CME FedWatch Tool, December 6th, 2023
ix. Strategas, Bloomberg
x. Yardeni Research, December 4th, 2023
xi. Ned Davis Research, NDR 2024 U.S. Outlook


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