Alley Company Quarterly Letter
Crystal Ball

January 12, 2024

Many economists predicted that a recession was imminent as the Federal Reserve began hiking interest rates in early 2022, in its attempt to ward off inflation. The stock market obliged these predictions as the S&P 500 Index fell during that year.

But, the stock market rebuked these recession concerns during 2023. As we described in our third quarter "Anatomy of the Stock Market" letter, the "Magnificent 7" stocks propelled the market-capitalization-weighted S&P 500 Index forward. Additionally, the equal-weighted S&P 500 Index, which is more representative of the average stock, modestly narrowed the gap as strong fourth quarter performance led the early stages of a potential broadening of the market.

Concurrently, positive fundamental economic data pushed economists to update their forecasts, postponing their predicted start of a supposed impending recession with each passing quarter. Real gross domestic product (GDP) grew at an annual rate of 4.9% during 2023's third quarter, and nonfarm labor productivity's 4.7% annualized increase was its most rapid advance in three years.[1] The December 2023 U.S. unemployment rate of 3.7% remained well *below* the 5.7% long-term average dating back to 1950, while labor force participation among the important 25-54 age cohort rose to more than 83% from roughly 80% in early 2020.[2]

All the while, inflation marched downward to 3.4% as of December 2023 from a June 2022 peak of more than 9%, nearly fulfilling the flip side of the Federal Reserve's dual mandate of maintaining maximum employment and keeping prices stable. This foreshadows the potential end of this interest-rate hiking cycle.

Despite these positive developments, there are foreboding circumstances for pessimistic investors to hang their hat on, as media outlets never cease to let us forget. To name a few, there is the risk that elevated interest rates take time to inflict more damage on the economy, inflation could reverse its recent downward trend, and geopolitical tensions are omnipresent and bear watching.

However, it's important to remember that historical efforts to time the impact of such events on financial markets have been futile. No market strategist or economist possesses a crystal ball.

Warren Buffett wisely frames the appropriate and timeless approach to these matters in Berkshire Hathaway's 1995 letter to shareholders:

> *We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen. Thirty years ago, no one could have*

foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks, the resignation of a president, the dissolution of the Soviet Union, a one-day drop in the Dow of 508 points, or treasury bill yields fluctuating between 2.8% and 17.4%.

But, surprise – none of these blockbuster events made the slightest dent in Ben Graham's investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let a fear of unknowns cause us to defer or alter the deployment of capital.

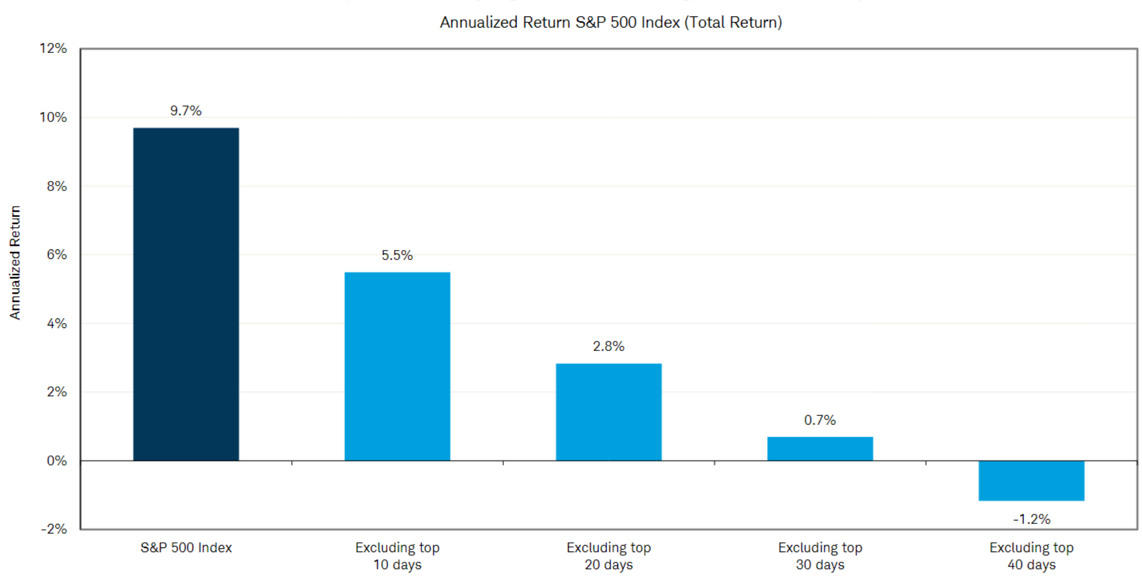
Today, many investors are happy to sit on the sidelines. This is evidenced by money market fund assets, which sat near all-time highs at the end of 2023, clocking in at $5.9 trillion[3].

This hesitation is understandable. After all, short-term interest rates pay better than they have in several years. Couple that with media-driven uncertainty and it's natural to think that this is a prudent decision.

But, that stance could be costly. The financial markets don't wait for the all-clear signal, and investors that do can miss much of the reward. The chart[4] below outlines the annualized return investors would have attained if they missed the best days in the market. Said another way, $1 million invested for the entire period would have resulted in a $6.37 million pre-tax ending value, while just missing the ten best performing days in the market would have cut that value by more than half, resulting in a $2.92 million pre-tax ending value.[5]

Time in the market is more important than timing the market

Missing the 10 strongest days of the market from 2004-2023 resulted in a significantly weaker annualized total return, compared to staying invested throughout the entire period.



Source: Bloomberg as of 12/31/2023. Returns assume reinvestment of dividends and interest. Indexes are unmanaged, do not incur management fees, costs, and expenses, and cannot be invested in directly. Schwab does not recommend the use of technical analysis as a sole means of investment research. Investing involves risk, including loss of principal. For illustrative purposes only. **Past performance is no guarantee of future results.**

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We do not claim to have a crystal ball either. Pessimistic economists and strategists could be proven right in the near term.

However, perpetual U.S. innovation and progress transcends short-term market prognostication. For example, the seedlings of internet proliferation that began in the 1990s trounced the concerns of that decade and continue to bestow market rewards today.

It's our belief that it's best to avoid the potentially expensive exercise of engaging in market timing. Instead, we believe the correct approach to investing through continuous political and economic challenges is for an investor to remain true to their strategic stock and bond asset allocation. And, within that allocation, hold stakes in high-quality, blue-chip companies that have shown consistent resilience in navigating such challenges.

1. Bureau of Economic Analysis (BEA), U.S. Bureau of Labor Statistics. Seasonally adjusted annual rate.
2. U.S. Bureau of Labor Statistics, retrieved from FRED, Federal Reserve Bank of St. Louis, J.P. Morgan Asset Management.
3. Investment Company Institute (ICI).
4. Charles Schwab Quarterly Chartbook.
5. Alley Company calculation.