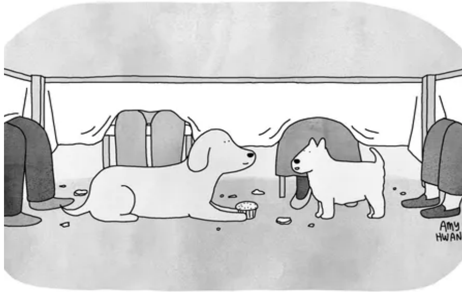
MONTAG

Viewpoints

FOURTH QUARTER 2023



"WE HAVE A LOT TO BE THANKFUL FOR TOO."

Amy Hwang/CartoonStock—Used by permission

WELCOME

2024 is now upon us and we anticipate the new year with hope, excitement and new beginnings. While it is always nice to look back, it may be even better to think forward and be thankful for what is yet to come. When evaluating the investment landscape, the analyst forecasts and the market performance develops from future expectations of what lies ahead. You can look back for historical perspective, but the future is what we strive to plan for. Working closely with our clients and, the financial planning which shapes your lives, is what drives the staff at MONTAG. Thank you for trusting us and allowing us to be of service to you and your families. Happy New Year!

MARKET OBSERVATIONS — *Chris Guinther, Senior Investment Strategist*

Let's begin by noting the 2023 final quarter's market numbers, as of the quarter's close of December 31st:

	Q4 2023	YTD 2023
S&P 500	11.69%	26.29%
DJIA	13.09%	16.18%
NASDAQ	13.84%	44.70%

The equity markets finished the year off on a positive note and we think for good reason. After roughly 2 years of falling corporate earnings due to the FED raising interest rates to kill inflation, it seems likely that they are nearing the end of the rate hiking campaign. As inflation is falling, our view is that it will continue to lower as the lag effects of the interest rate hikes play out. In November, interest rates on the 10-year Treasury Bonds dropped over 1% (from 5% to 4%) to account for the likely end of the FED's tightening, and belief that inflation will fall back to the target of 2% sometime within 2024. That significant 1% drop in interest rates on longer term bonds was nearly unprecedented and that move coincided with new highs on the S&P 500, the Nasdaq and the Dow. Generally, investors are turning bullish and we tend to agree, as the notable turn down in inflation has changed the outlook and mood.

As the equity markets zig and zag every year, investors are often trying to anticipate 'major inflection points', although many times the 'major inflection point' doesn't occur. For now, we think there is a better and improving case to be made for earnings to rise broadly in 2024 and into 2025.

While overall GDP growth may only be 2%, a similar growth rate that we experienced in the decade before Covid, investors have had concern for a steep fall off in earnings. This outlook has been waning as the FED appears to have taken their foot off the brakes since inflation is cooling. At the moment, we're viewing all this as 'mission accomplished' by the Fed, as they managed to slow demand in the economy just enough to allow supplies to rise and meet demand without causing panic or a recession. From here, it appears we will be able to resume slow growth in the U.S. While there is "some" upside for stocks driven by their earnings growth, the market is still pretty rich, trading at over 18x

Continued on page 2

Inside This Issue

Welcome 1

Market Observations 1-2

Factors Influencing Long-term Stock Returns 2-3

Did You Know? 3/4

Your Bond Statement 4

A Parting Thought 4

MONTAG *Viewpoints* is published quarterly by MONTAG Wealth

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January 10, 2024

earnings, hindering the upside from valuations.

The continuing U.S. Government deficit spending and now excessive U.S. debt, while extremely helpful in averting a recession, has managed to kick the can down the road for now. Interestingly, as the levers are pulled, on the one hand, the Federal reserve was slowing the economy by raising interest rates to slow inflation and on the other hand the U.S. Government spent $6 trillion dollars to stimulate the economy. This combination, although not good in the long term, did help to soften the landing for now.

We will continue to monitor the indicators and the economy to make sure client portfolios are in line with our expectations and within your investment profile. M

The equity markets finished off the year on a positive note….

Chris Guinther is Senior Investment Strategist & Portfolio Manager

Which Factors Influence Long-term Stock Market Returns? *— Ned Montag, CEO*

As 2024 opens, we are reminded that the work we do is all about remembering the basics and maintaining our composure in the face of uncertainty. The world seems to fuel itself on uncertainty in increasing volume, but thankfully the laws of humanity and even of some sciences (like investing) still track very familiar patterns.

Adaptation, curiosity, intuition and many other human qualities make progress possible. And most of all we trust in our work, and in one another. Trust is about selecting who you travel with on this journey we call life. It matters a lot. And we are reminded that reviewing the basics is always an exercise in testing who and what you still trust.

In the past, we have commented on the futility of making (or at least putting heavy reliance into) short-term forecasts of the direction of the stock market, the economy or interest rates. These systems are far too complex to be modeled and predicted in the short run with any consistency (although building forecasts is useful for sharpening our thinking around potential investment opportunities).

Is It Possible to Forecast Stock Market Returns?

While short-run forecasting of the stock market is extremely chancy, forecasting long-run returns, such as 10-year returns, is really fairly simple and reasonably useful. So for those who want to plan ahead, let's give it a try. Let's test the basics and see what we come to as a result.

In the long run, freed from the moods and investment fads of the moment, the stock market will return exactly the sum of its earnings growth rate, its dividends paid and any change in the price/earnings ratio of stocks from start to finish. That's it. If we can reasonably project these three elements, we have a forecast. We believe in this.

How Does Inflation Affect Such Forecasts?

The earnings growth rate of U.S. stocks as a group tends to track the average annual growth of the economy, including inflation. Fortunately for us, the average annual growth of the economy will be comprised of growth in the labor force, quite steady over time at 0.5%; growth in the productivity of labor, also quite steady at a normal 1.5%; and the average rate of inflation.

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Continued on page 3

DID YOU KNOW?

Throughout the winter months, many of us look to indoor entertainment to pass the time. One of the most popular ways to beat the winter blues is to play board games with family and friends—whether online or in person.

What is the top selling board game of all time?

A. Scrabble
B. Chess
C. Monopoly
D. Battleship

(Answer on Page 4)

In the long run...the stock market will return exactly the sum of its earnings growth rate, its dividends paid and any change in the price/ earnings ratio from start to finish. That's it.

Ned Montag is CEO

MONTAG

FACTORS INFLUENCING LONG-TERM STOCK RETURNS *continued from page 2*

Although the rate of inflation has varied wildly of late due to the displacements of the COVID shutdowns and then the burst of consumption post-shutdown, the average rate of inflation over the past 60 years has been 3.8%. We think that due to changes in the economy, that 3.8% number will be a little too high, but we also think a structurally tight labor market will prevent a return of inflation at the Federal Reserve target of 2.0%. We will assume an average rate of 3.5%. Based on these inputs, the average earnings growth for U.S. stocks over the next 10 years should be around 0.5 + 1.5 + 3.5 = 5.5%. (Annual earnings growth over the past two decades has exceeded GDP growth due to shifts in our economy from manufacturing to services, but we believe that earnings enhancing shift is largely over.)

Calculating dividends paid is easy. The current yield on the S&P 500 Index is 1.6%, and we assume that dividends will grow at about the same pace as earnings, say 6% per annum. If that is close to the mark, we see dividends paid over the next 10 years averaging about a 2.0% return.

The Impact of the Earnings Multiplier on Stock Market Returns

Finally, the big swing factor from one decade to the next has always been changes in the earnings multiplier over the course of the 10-year period. Today, the S&P 500 Index calculation, dominated by very large, very, very profitable companies (think Apple, Google, Facebook, NVIDIA, Microsoft, a few others) trades between 19 and 20 times current earnings. A more normal valuation would be 17.5-18.0 times earnings, so the S&P 500 appears to be about 10% overpriced. If we assume that by Year 10, the valuation will be normal, then we need to deduct 10%, or about 1% per annum, from our return calculation, leaving us with a final return projection of 5.5% + 2.0% -1.0% = 6.5%.

Is this reasonable? The Leuthold Group, an investment advisory and research firm, undertook a calculation of all rolling 10-year returns on stocks from 1926 through 2011, and it found that when the starting valuation was as elevated as today's, the subsequent 10-year return averaged 6.8%. If the next 10 years resembles market history, our 6.5% projection, while undoubtedly uncertain, appears to be reasonable.

Now For Some Good News...

Although the very largest company stocks sell for high price-earnings ratio and thereby stretch the valuation of the S&P 500, the great majority of U.S. stocks are selling at much lower valuations. For example, smaller company U.S. stocks are currently valued, as a group, at about 15 times current earnings. It would be consistent with market history to expect them to produce returns more in line with their historical average of 10% per annum. While the very expensive large company stocks have exciting technologies that dominate the news cycle (think Tesla with EV's, Microsoft with artificial intelligence, Apple with new devices, etc.), there will still be growth ahead for smaller companies that meet our basic needs on a daily basis. Now might be a good time to diversify holdings to include some of those smaller company stocks or exchange traded funds, something we at MONTAG have been discussing for months. Changes in this vein are on deck and occurring. Your portfolio manager likely has already discussed this topic with you, or will if you ask.

At MONTAG, we are about adapting and maintaining our curiosity and using our intuition. And we appreciate the chance to work for you as we do. M

Sources: Yardeni.com, bls.gov, schroders.com, worlddata.info, Leuthold study (1926– 2011)

Understanding Your Bond Statement

(When a loss is not a loss...)

Portfolio managers use bonds to earn income for clients while offering a level of stability in asset value. Stocks, otherwise known as equities, are invested in businesses to grow with the economy and, as a result, the path of their returns can be volatile. The blending of bonds and equities can allow for growth of assets, stability of value, provides for any cash needs over the next few years and can even produce income, if needed.

So why does it look like I am losing money in the bond portion of my portfolio when I am looking at my account statement? The bond market, like the stock market, trades minute by minute throughout the day with prices adjusting to changes in the interest rate environment. As interest rates go up, bond prices go down and as interest rates go down, bond prices go up.

When looking at your account statement, it will show the daily change in bond prices just like the equity portion of the statement, but unless you sell the bond, these adjustments won't change the final return you earn on a bond. Unlike stocks, when we buy a bond and hold to maturity, an investor knows what they are going to earn. If a bond yields 5% at purchase, whether you paid a premium or discount, it will ultimately mature at its face, or "par value". So as the price fluctuates before maturity, an investor knows that they will actually receive 5% in income each year along with getting back the stated par value at maturity.

Ideally, the bond portion of a portfolio should be tailored to each client's investment objectives. At MONTAG, we purchase most bonds in the secondary market, meaning, instead of buying at the auction when the bonds are issued, we can choose for each client the dollar amount, quality, maturity and price. Buying in the secondary market provides MONTAG with the flexibility to construct a portfolio that will meet a clients need for income and allows us to time bond maturities to coincide with cash needs. This tailored approach allows us to set the goal of achieving the highest yield to maturity while ensuring cash is available when needed.

Building a portfolio this way allows us to hold most bonds to maturity. Though you may see prices fluctuate on a statement, by holding to maturity you are most likely to not only get the original investment returned to you, but also to lock in the income that was fixed on the day the bond was purchased. M

DID YOU KNOW? *(from page 3)*

ANSWER: "B: Chess"

Originated in India, the history of chess dates back over 1500 years. Over three million games of chess are sold annually in the US alone.

Looking for something new to play? Below are the top selling board games of all time:

1. Chess
2. Checkers
3. Monopoly
4. Scrabble
5. Clue
6. Battleship
7. Trivial Pursuit
8. Backgammon
9. Candyland
10. Rummikub

M Source: Fun.com

A PARTING THOUGHT

"The beginning is the most important part of the work."

- Plato

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