FAYEZ SAROFIM & CO.

January 2024

Economic Comment and Market Outlook

2023 marked Fayez Sarofim & Co.'s 65th year in operation, a milestone we could not have achieved without your support. Throughout the firm's history, we have been fortunate to partner with clients who trust our firm and its long-term approach to investing. As one excellent example of that kind of relationship, we recently celebrated the 50th anniversary of managing funds for one of our longstanding clients and reflected upon some similarities between the investment environment when that relationship began and that of today. Five decades ago, there was heightened political turmoil as the Watergate scandal was emerging, and the Cold War was ongoing. Social unrest and political divisions permeated the domestic political landscape. War in the Middle East and the 1973 oil embargo created geopolitical turmoil and commodity price pressures. In short, the investment environment then was one of significant angst and uncertainty, like we are experiencing in many areas today. While many investors may have been tempted to avoid the volatility and exit the market, a $10,000 investment in the S&P 500 at that time would have grown to $2,000,000 today, an increase of 200 times. If you had invested that principal with Fayez Sarofim & Co., you would have done even better. Today, we are experiencing geopolitical turmoil as conflicts in Ukraine and the Middle East continue. A new Cold War between the US and China is a possibility while energy prices remain volatile. The US will have a Presidential election in 2024 that promises to be contentious, with court cases involving a leading candidate already on the docket. This historical reflection highlights the importance of long-term focus, patience, and conviction in delivering investment returns for our clients. We remain grateful to our founder Fayez Sarofim for imbuing these values as a core part of our firm's heritage.

Relying on long-term focus, patience, and conviction also positioned the firm and our clients to benefit from healthy returns in 2023. Twelve months ago, financial market participants were contemplating the consequences of extremely rapid increases in interest rates designed to combat inflation. A "soft landing" scenario of falling inflation accompanied by some growth in the economy seemed unlikely. Fast forward to today, and that soft landing scenario has been materializing. Inflation has cooled, and the US economy has remained surprisingly resilient. Taking its cues from that shifting environment, the S&P 500 reversed its course from 2022's decline and proceeded to generate a 26.3% total return for 2023, before then returning to a record closing high just days ago in the first month of 2024. As we noted in our letter at this time last year, we believe there is a high degree of futility in trying to "time the market," and so our focus always remains on owning superior businesses that offer long-term growth prospects. We believe that formula for building wealth for our clients will prove rewarding, and improving earnings and declining interest rates augur well for future returns.

Lower inflation allowed the Federal Reserve and other central banks to slow their pace of interest rate increases and then to pause in raising rates, with the CPI declining from an annual rate of 6.5% at the end of 2022 to 3.4% in December 2023. With some important components, especially rents, expected to damp down future readings, market expectations have shifted to anticipate rate cuts in 2024. Longer-term interest rates also reflected a new calculus on future conditions; whereas the yield on the 10-year Treasury bond had been rising from levels around 3.5% in the spring to almost 5% in late October, it fell sharply to 3.9% at the end of the year.

Investors eagerly responded to the slowing inflationary environment and the prospect of changing monetary policy, re-engaging with the more "growthy" parts of the stock market during 2023. This development was a reversal of the trends in 2022, and, in many ways, 2023 was a mirror image of the previous year. Where the growth indices declined dramatically in 2022, they outperformed the market meaningfully in 2023, with the Russell 1000 Growth Index rising 42.7%. Within the S&P 500, the market sectors that held up best in 2022 had the weakest performance in 2023, and vice versa. For example, consumer staples, energy, and health care, which led the market in 2022 due to their defensive characteristics in a downturn, were barely changed last year. Combining the two years together, the S&P 500 had increased a total of 3.4% with dividends included. Abetted by the release of ChatGPT and a fascination with artificial intelligence, the "Magnificent 7" stocks (Apple, Microsoft, Amazon, Alphabet, Nvidia, Meta, and Tesla) provided the majority of market returns in 2023. These seven companies, the largest components of the S&P 500, accounted for 26% of the index's market cap at the end of 2023 but provided 62% of the index's return for the year, rising 76% as a group. In addition to bringing forth exciting innovations, most of these companies also refocused on improving efficiency and profitability, leading to rising earnings expectations. As a group, this set of companies is trading at 28 times forward earnings estimates, nearly identical to the level at which they were valued two years ago. Given their leading positions, strong financial characteristics, and growth opportunities, most of these companies warrant a premium valuation. Valuations for companies outside of the Magnificent 7 remain much lower, with the other 493 companies in the S&P 500 trading at approximately 17 times forward earnings estimates, close to the 30-year average for the S&P 500 and where this set of companies traded two years ago.

Given the prospect for a resumption in earnings growth, we are optimistic about the engine for long-term appreciation revving up in 2024. In a period of rising interest rates, tighter credit, and increasing costs, the S&P 500 was able to protect its high level of profitability over the past two years. In each of the past two years, the components of the index generated record profits of almost $1.9 trillion, or approximately $220 per share. We believe the S&P should resume profit growth in 2024, with overall earnings rising over 6% to approximately $2.0 trillion. We expect our portfolio companies' earnings to outgrow the index as they deploy their competitive advantages in attractive industries and enhance shareholder returns with growing dividends and stock buybacks. Of course, there will be obstacles along the way, with a Presidential election, an unsettled geopolitical environment, and other risks that will surface. However, we rely on our investment portfolio to play both offense and defense as it delivers for us over the long-term.

Thank you for trusting Fayez Sarofim & Co. to be your investment adviser, and please contact us if there is anything else with which we can assist you.

Sincerely yours,

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