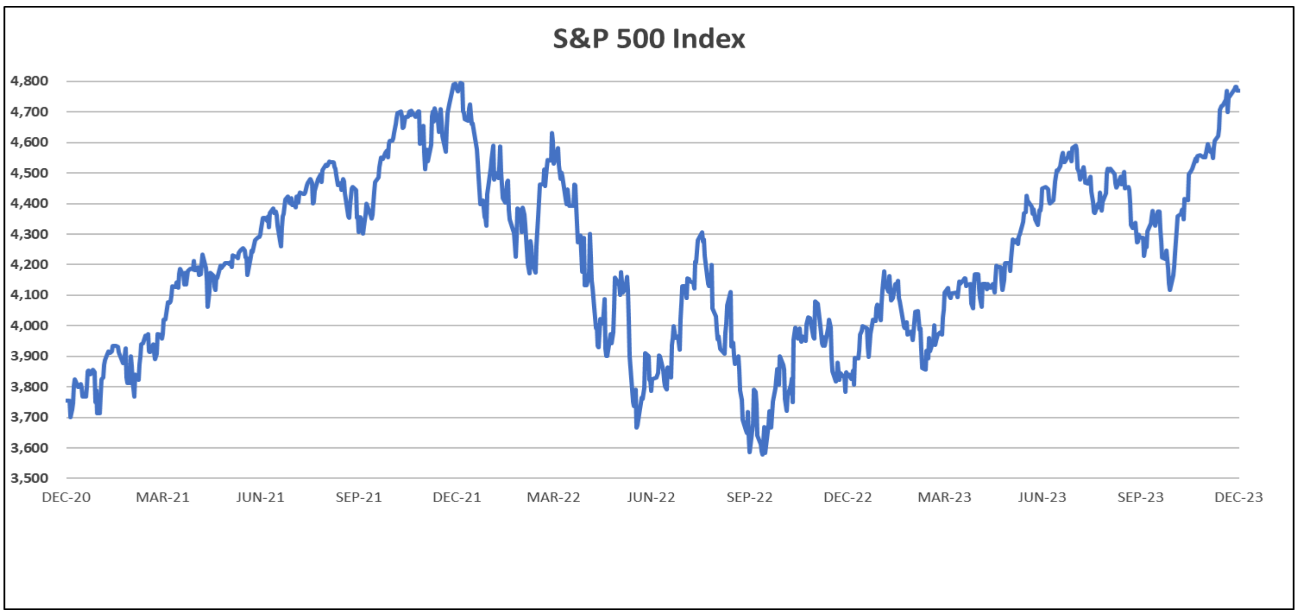
KEATING INVESTMENT COUNSELORS, INC.

REGISTERED INVESTMENT ADVISOR FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

Investment Strategy
January 2024

2023 was an unusual year for investors. At first glance, the S&P 500 essentially regained everything that was lost in 2022, up 24.2% overall. As a result, we finished the year only slightly below the all-time highs from nearly two years ago. However, the gains in 2023 have been very narrowly focused as 72% of the stocks in the S&P 500 Index have underperformed this year, the highest percentage since 1980. <u>Our portfolios have significantly diverged from the overall market over the past two years</u>. In 2022, we were able to sidestep the large declines in both stock and bond prices. During 2023, our portfolios largely missed the rally that was primarily concentrated in overpriced technology stocks. We believe this low correlation with the S&P 500 is enviable as the index remains very richly priced based on the past century. More importantly, we believe we are properly positioned when looking at the two most likely scenarios ahead of us.



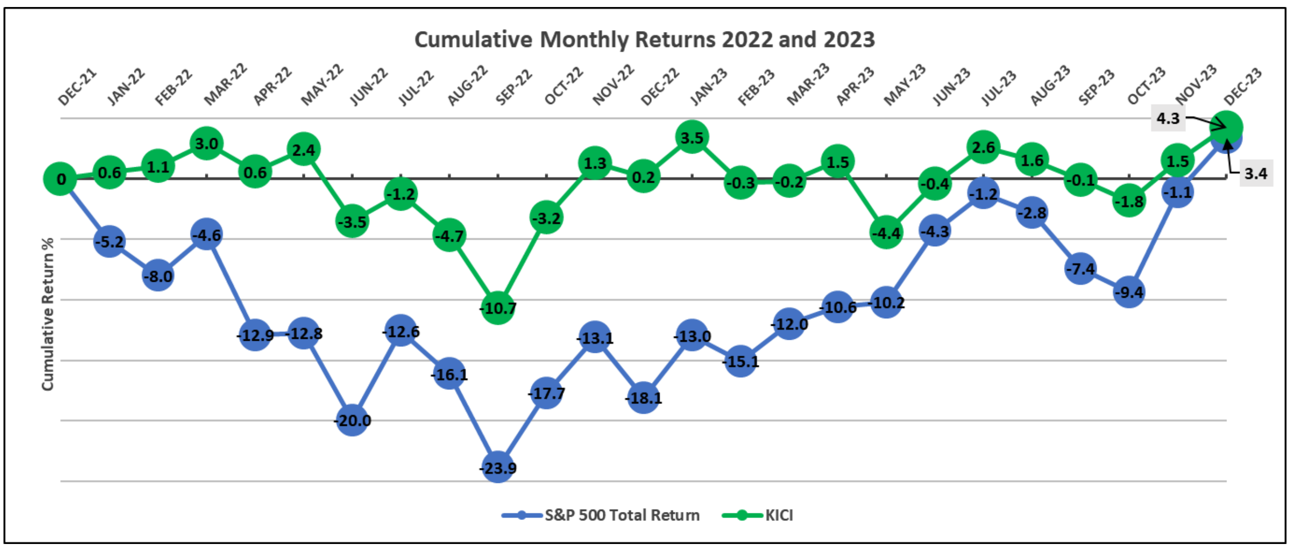
The chart above shows the S&P 500 Index over the past three years. As you can see, the market is back at its all-time high after a furious surge to end the year. The rally started last year in October after declining consistently throughout 2022. As is typical in a bear market, the rally was narrowly driven by the biggest winners from the generational bull market we enjoyed from 2009-2022. In fact, at certain points over this past summer the entire gain in the S&P 500 index for 2023 was driven by the 7 mega-sized tech companies[1]! Interestingly, the market was essentially trading sideways between mid-2022 through March 2023. As you may recall, March is when several regional banks collapsed and were seized by the FDIC. As part of the rescue process, the Fed provided liquidity (and confidence) into the system, spurring a rally through the summer. This period was particularly dominated by the

[1] Apple, Google, Meta (Facebook), Tesla, NVIDIA, Microsoft, Amazon

major tech companies. The market then rolled over from late July through October and behaved in the same manner as most of 2022: big tech underperformed while energy stocks moved higher.

Starting in late October the market bounced violently and finished the year up 9 weeks in a row, something that hadn't occurred since 1985. During this period, the bond market also rallied sharply as the yield on a 10-year treasury plummeted from 4.99% to 3.87%. These incredible moves were triggered after the Federal Reserve indicated that interest rate hikes were over and, surprisingly, that cuts may be appropriate next year. This sharp year-end rally was not led by the major tech companies. Instead, this bear market surge was driven by the most heavily shorted stocks in the market. Regional banks were up 37%[2], profitless tech companies gained 54%[3], and REITs surged 26%[4]. It appears these past two months were a "short squeeze" as traders that were betting the market would decline had to rapidly reverse their trades.

While the S&P 500 Index has gone on a roller coaster ride over the past two years, our portfolios have been much less volatile. As you can see in the chart below, our portfolios have largely been going sideways over this period[5].



We believe this lack of sensitivity to the market is desirable in the current environment. As we have written previously, the S&P 500 Index is priced to deliver very poor returns over the next 5-10 years. In contrast, the stocks we own are reasonably valued with many delivering

[2] iShares U.S Regional Banks ETF (IAT)
[3] We use the Ark Innovation ETF (ARKK) as a proxy for this type of company
[4] Vanguard Real Estate Index Fund ETF (VNQ)
[5] The KICI portfolio is all the portfolios under our management that follow our main strategy. This performance is unaudited and is for illustration purposes only. Every portfolio is different and performance will vary.

dividends well above 5%. We also purposely own stocks that are not in the major U.S. index, including international energy companies, Canadian gold miners, and European telecommunication firms. While these stocks missed the U.S tech party in 2023, hopefully they won't be as impacted if the market comes under renewed pressure as this bear market endures.

While we believe the bear market continues, many market participants are arguing that inflation has been conquered. They believe this will allow the Fed to return to their asset-pumping policies in early 2024 to support the economy as we head into a contentious election. If the Fed does engage in expansionary policies, we think inflationary forces will return. Despite headline inflation coming down largely due to lower energy prices, increased labor costs continue to filter through the economy as employees try to recoup lost purchasing power from the previous three years. Investors should also be aware that the two most important transit points in the world (Panama Canal[6] and Suez Canal[7]) are gummed up for the foreseeable future. For these reasons and many others, we believe the necessary ingredients for another surge of inflation lie just below the surface. Therefore, if the Fed tries to over-stimulate, our investments in oil, gold[8], and other hard assets should perform well.

We believe it is more likely the economy will continue to deteriorate. The Fed Chairman, Jerome Powell, comes from the world of private equity which specializes in buying assets and loading them with debt to increase returns. As a result, Powell has a good understanding of when companies have fallen into financial distress that will require a "restructuring" of some nature. Looking across the economy today, we see rapidly rising bankruptcies, companies taking on extremely expensive debt to survive, and a complete train wreck in commercial real estate across most major U.S. cities. Therefore, Powell might be hinting at interest rate cuts because he believes the credit cycle has been triggered and will fully reveal itself in 2024. By reducing borrowing costs, he can help healthier companies access capital to avoid unnecessary damage to the economy. We suspect this is the reality on the ground and it is why we remain conservatively positioned with a very large allocation of U.S. Treasury bonds. Overall, we believe the combination of cheap resource stocks along with a healthy dose of Treasuries should position us well regardless of how the economy and market unfold in the year ahead.

Sincerely,

Keating Investment Counselors, Inc

[6] Panama is in a huge drought, reducing water levels in the canal.
[7] Suez canal is accessed through the Red Sea where Iranian-proxies in Yemen are attacking merchant ships.
[8] Trading right at an all-time high. Already at all-time highs in every other major currency.

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