Madison Funds Quarterly Newsletter

Winter 2023

Economic Review

The fourth quarter of 2023 saw the continuation of the major concerns that shaped the investment climate for the year. The Federal Reserve's high-rate battle against inflation appeared to gain traction while there was no shortage of speculation over whether the end result would be a mild recession, a more severe recession, or a "soft landing" that might avoid recession altogether. Geopolitical pressures included the outbreak of war in the Mideast and a growing impression of stalemate in the war in Ukraine. The market seemed to shrug off the disturbing news and other global negatives including evidence of a slowing Chinese economy.

The quarter opened with another dreary month of stock returns, making three straight months of market losses. But just as it seemed that the unexpected index gains of the previous months were in danger of erosion, November produced the best stock and bond returns of the year. The S&P 500® Index returned 9.1% for that month alone, pushing the year-to-date return up to 20.8%, while a sharp decrease in bond yields propelled a 4.1% gain in the Bloomberg Aggregate Bond Index. The result was a nice boost in portfolio values as we entered the thick of the holiday spending season. Stock market returns for the first half of December added to the upward trend. A 20%-plus year would be an excellent result, putting returns into the top third historically.

Both the stock and bond markets paid close attention While such a sharp shift in investment fortunes might suggest some tectonic economic movement, the causes were much more subtle. For much of the year the Federal Reserve Board has been carefully cultivating a skepticism regarding the anti-inflation efficacy of its precipitous rate increases, including the possibility of an additional quarter-point rise in the fourth quarter. Promoting a shift in this thinking were some promising inflation data prints along with some bad-news-is-good-news signs of economic slowdowns. This, combined with a softening of Fed rhetoric, was enough to reset investor expectations, including a recognition that a late-year rate increase was unlikely. Signs of a slowing economy, which suggested that Fed action was producing results, included a downward trend in new jobs and a small uptick in unemployment claims (which still stayed stubbornly in the under-4% range). Key manufacturing data added to the sense that Fed action was producing results.

One of the most notable aspects of the fourth quarter stock rally was its breadth. For much of 2023, index returns have been driven by the outsized returns of seven highly valued large technology firms, which began to be referred to as "the magnificent seven." There was particular froth around firms at the forefront of artificial intelligence, widely believed to be a primary force for innovation in the years to come. The fourth quarter rally saw strong returns from the equal-weighted S&P 500 as well as from smaller and international stocks.

All of which raises the question: Can the prospect of lower Fed rates in 2024 offset the downward trend of the economy when it comes to stock returns? The current 12-14% 2024 earnings growth expectations for the S&P 500 strike us as highly optimistic. Corporate profits have been basically flat over the past year -- can they really take off in 2024 given the signs of a weakening consumer? We continue to be wary of the lag effects of the Fed's rate increases, a growing factor as low-rate financing expires and businesses have to refinance at rates that may be double or more. While strong consumer spending has been a foundation of economic strength over the past two years, the level of consumer loan defaults, the expansion of credit card debt, and the increased availability and popularity of borrowing to buy suggest potential problems ahead.

In short, we are not proponents of letting the welcome results of the fourth quarter stock market rally expand into excessive exuberance. The persistence of low unemployment and wage growth suggests that inflation may be sticky heading into 2024, making next year's widely anticipated Federal Reserve Bond rate cuts potentially less aggressive than widely believed. In fact, conditions may result in an extended period of rates well above pre-pandemic levels. The lack of economic clarity in 2024 can be seen in not only the possible over optimism in analyst expectations for corporate earnings but the lack of consensus seen in the expanded range of their predictions.

Meanwhile, high yields continue to provide the prospect of real returns from fixed income allocations, tempering the natural tendency to chase stock market returns with increased stock allocations. The broadening of stock returns we saw this quarter is encouraging for the diversified investment portfolios we build and recommend. While we would welcome Federal Reserve rate cuts in 2024, we feel the prospects of quality companies are not dependent on them. The sharp shifts in the stock market we saw this quarter should confirm the value of sticking with an appropriate asset allocation, even with the acceptance that we may not see another 9% monthly gain for some time.

News You Can Use

Yearend Tax Reporting

With income tax filing on the horizon, Madison Funds may send you tax forms in late January to help you complete your income tax returns. When you receive them, keep them for your records. The forms you receive are specific to the type of account you hold and your circumstances.

Form 1099-DIV: Reports dividends and capital gains paid to taxable accounts. **Madison Funds observes an IRS rule that allows us not to send Form 1099-DIV if your taxable ordinary dividends for any fund totals $10 or less,** however, you must still include such dividends on your income tax return. Please review the enclosed year-end investor statement to see if this applies to you.

Form 1099-B: Reports the proceeds from fund shares you sold or exchanged in taxable accounts.

Form 1099-R: Reports redemptions from qualified retirement accounts such as IRAs.

Form 1099-Q: Reports redemptions from Coverdell Education Savings Accounts (ESAs).

Form 5498 and 5498-ESA: The Fair Market Value statement mailed in May (5498) and April (5498-ESA) will report contributions made to qualified individual retirement accounts (e.g., IRAs) and ESAs through April 15, 2024, for the 2023 tax year. As of December 31, 2023, we report the Fair Market Value of these accounts on your year-end investor statement.

TurboTax® and H&R Block® Tax Software: Download your tax information for your account directly into your tax return using TurboTax or H&R Block software. You can import your fund-related tax information for three tax forms: 1099-DIV, 1099-B, and 1099-R. Follow the instructions provided with your tax software.

Tax Inserts: A tax insert may accompany your tax form. The inserts include general information on capital gains and losses from the sale of fund shares, fund specific percentages of income derived from U.S. government obligation, and AMT tax liability for tax-free funds. We recommend you consult with your tax advisor for complete information when doing tax planning and preparing your tax returns.

Feel free to contact Shareholder Services at 1-800-877-6089 if we can be of further assistance. But please remember we cannot offer tax advice; that is best left to tax professionals who can better answer questions and advise you about your specific circumstances.

Contact Us

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Consider the investment objectives, risks, and charges and expenses of Madison Funds carefully before investing. Each fund's prospectus contains this and other information about the fund. Call 800.877.6089 or visit madisonfunds.com to obtain a prospectus and read it carefully before investing.