



## Year-End Market Surges While All Eyes on the Fed in 2024 January 2024

Dear Client:

The final quarter of 2023 saw a massive surge in market optimism based on inflation coming under control, Fed interest rate cuts foreseen for 2024, and huge gains on Wall Street.

After a weak fall, with a low point in late October, stocks abruptly rallied on hints that the Federal Reserve was at or near the end of its current rate-hiking cycle. Softer-than-predicted U.S. inflation data further drove an extensive rally in equity markets, lifting both U.S. and international stocks and growth and value stocks.

The resilient economy continues to confound. Many had expected the U.S. to dive into a recession by year-end after the steep hike in interest rates implemented by the Federal Open Market Committee (FOMC). The Bureau of Economic Analysis released the third estimate of the third-quarter 2023 real GDP, a seasonally adjusted annualized rise of 4.9%, a decline from the 5.2% prior estimate but a marked increase over the previous quarter. Employment was mixed in 4Q23, as employers added fewer than expected jobs in November (199,000), though the unemployment rate was slightly lower, at 3.7%.

In the fourth quarter, the Standard & Poor's 500 Index spiked 11.7% and finished the year with a gain of 26.3%; the Nasdaq soared 13.8% during the quarter. Yet behind the headlines, a massive divergence reignited. The "Magnificent Seven" stocks (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, and Tesla) accounted for two-thirds of the S&P 500 Index returns, each gaining 50% to 240% in price, far beyond the other 493 index companies. The top 10 stocks delivered 90% of S&P 500 returns – a troubling concentration.

In an everything-rises, fourth quarter developed international market equities rose 10.4%. While growth and value stocks were solid, large- and mid-growth took the lead this quarter after lagging in 3Q23. The gap in performance between the two styles for 2023 was the second largest on record, topped only by the 2020 Covid market, with large-growth stocks besting large-value by 31% in 2023 (35% gap for 2020). Similarly, energy stocks flip-flopped from last quarter's standout to the fourth quarter's worst-performing sector.

While the U.S. consumer continues to spend, the Institute for Supply Management (ISM) Services Index December reading of 50.6% reflects a marked slowing from earlier in the year, indicating that household finances are becoming tighter as consumers' excess pandemic-era savings are depleted.

Eyes remain on the Fed and its ability to achieve a "soft landing," aka no recession or an extremely mild one. Core and headline inflation continue decelerating, with core inflation down to 3.2% and headline





inflation down to 2.6% in November 2023. The inflation measures remain above the Fed's targets, yet FOMC predicts it will cut rates three times in 2024.

The market is even more confident of lower rates, which fueled higher stock prices at year's end and into 2024. It is currently pricing six rate cuts in 2024, with the first in March. One of the two expectations will be deeply wrong this year.

## Domestic Equity Market



In the fourth quarter, the broad stock market, as measured by the Russell 3000, was firmly up (12%) – once again, a whiplash reversal from the negative return of the prior quarter. Growth-style and value-style stocks had solid returns in every cap size in U.S. markets. In large caps, the Russell 1000 growth was up 14.16%, and the Russell 1000 Value was up 9.5% each. Russell Mid Cap Growth led Russell Mid Cap value from 14.5% to 12.1% for the period. Small Cap Growth was up 12.75%, and the Russell 2000 Value index had the most robust performance, with a positive 15.26%.

The first several weeks of the quarter saw the S&P 500 slide before surging higher for the remainder of Q4. Looking at the 11 S&P sectors, returns were positive for the quarter, except energy. Real Estate (+18.8%), Information Technology (+17.2%), and Financials (+14%) were the strongest for the three months. Industrials (+13%), Consumer Discretionary (+11.3%), Communications Services (+11%), Materials (+9.7%), and Utilities (+8.5%) were the next-strongest. Health Care (+6.4%), Consumer Staples (+5.5%), and Energy (-6.4%) were the poorest relative performers in the high-rising quarter.

Time and time again, investors chose optimism over caution throughout 2023, with enthusiasm for artificial intelligence and the Fed pivot to rate cuts becoming consensus. The fourth quarter ended with a pop, and the "Magnificent Seven" returned 107% for 2023. Importantly, we saw robust performance out of the small-cap and mid-cap categories, producing segments of growth and value that outperformed the large-caps.

Many investors have sought broadening market returns for the past several quarters. When healthy, an S&P 500 market will not rely on its top 10 stocks to deliver 90% of the market gains for the year. Market performance in 2023 was also not a result of more robust earnings but expanding valuations: The multiple price/earnings changes explained virtually all of the S&P 500's growth last year. More simply, investors valued each dollar of earnings approximately 25% more at the close of 2023 than at the start of the year. A more balanced, vigorous, and healthier environment should raise the fortunes of all companies, not just a few. We will see if this optimism becomes a fact in 2024.

## International Markets

As measured by the MSCI EAFE Index, international developed markets were up 10.4% for the quarter; the MSCI Emerging Markets Index rose 7.9%. Eastern Europe was the most vital regional performer (29%), and China was the worst (-4.2%) in 4Q23. There were fears that stimulus measures by the Chinese government may not be sufficient to spur growth in the world's second-largest economy. The ongoing real estate crisis and uncertainty over China's regulatory regime also weakened sentiment towards Chinese stocks.

The Organization for Economic Cooperation and Development (OECD) global growth national product (GDP) rose 2.9% in 2023 compared with an anticipated 2.7% for 2024.



Asia is projected to account for the bulk of global growth in 2024, which will continue to be below the pre-pandemic global growth rate. In Europe, economic growth contracted in the third quarter, which marked the first decline since the pandemic year of 2020. With a 2023 GDP of 7%, India is on pace to pass China in population next year and surpass Japan as third in the world economy list by 2030. The OECD also forecasts China is projected to grow at 5.2% in 2023 and then slow to 4.7% in 2024 due to weak manufacturing activity, mounting distress in its real estate market, and high household savings rates, leading to less consumer spending.

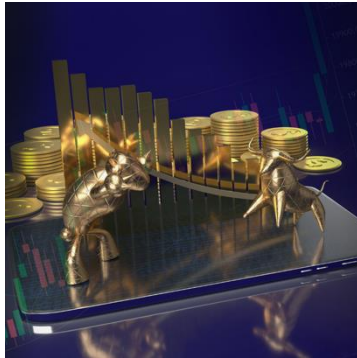
China is distinct from other large economies in that it has its own cyclical and structural stresses. High debt and the ailing property sector provide significant challenges, and consumer spending has been slow to recover after the post-pandemic reopening. Beijing has opted for a broad but piecemeal approach to stimulus, characterized by modest cuts to interest rates, extended tax breaks for companies, and lowered consumer mortgage costs.

Global inflation has steadily receded from its mid-2022 peak, with headline inflation falling in almost all economies and core inflation dropping (yet remaining higher than desirable). Given the effects of prior rate hikes and subsiding cost pressures, inflation is anticipated to continue easing gradually.

Another bright spot in the inflation story has been the decline in oil prices. Yet, the ongoing Ukraine-Russia war and the growing Israel-Hamas conflict can disrupt commodity prices, inflation, and global trade drastically.

A last key factor impacting global growth and shaping policy now and in years to come is the inevitable rise in government debt, currently running at *113% of GDP* for the OECD. The IMF figures show that the U.S. and U.K. now have government debt-to-GDP ratios of more than 100%. This is unsustainable.

## Bond Markets



The FOMC's recent dovish outlook, with the committee expected to reverse course. Lower rates in 2024 create a favorable environment for bonds: The bond market rallied strongly in 4Q23 as tempering inflation concerns pushed rates down and prices higher.

The Fed's preferred measure of core inflation registered 3.2% in November, well beneath the 4.9% rate with which it began 2023. Investors reversed the record outflows of -\$345 billion in 2022 that had made them net sellers for more than a year; they returned to the bond market in 2023 as fixed income flows were a positive \$159 billion.

Despite the favorable inflation backdrop and the Fed pause after July, the overarching theme for 2023 was rate volatility. The Treasury yield curve maintained an inverted slope throughout the year, as the curve for 2-year maturities versus 10-year maturities remained inverted. After a start to the year at -55 bps, March had the deepest inversion since 1980, at -107 bps, with the spread ending the year at -37 bps.

Yields on the short-term maturities of up to one year declined as much as 60 basis points while yields in the curve's intermediate- and long-term segments dropped 45 to 75 basis points. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury note was lower, ending at 3.88%, compared with 4.57% on September 30. The yield on the 10-year Treasury trended consistently higher for the first month of the quarter, peaking on the last day of October.

Within this context, the yield on the 3-month Treasury Bill settled at 5.34% at the end of the quarter, lower by 11 basis points from the previous quarter. The yield on the 5-year Treasury Note ended the quarter at 3.85%, compared with 4.61% on September 30, and, as mentioned above, the yield on the 10-year Treasury Note settled at 3.88% in Q4 23, compared with 4.57% at the end of Q323.

As measured by the Bloomberg U.S. Aggregate bond index, the bond market was up 6.82% for the quarter, bringing YTD returns to 5.53%. Excess returns were positive for the quarter and year across fixed-income subsectors. EM debt returns (+9.71) were solid in the fourth quarter, as were Investment Grade Corporate returns (+8.5%), Taxable municipals (+9%), Municipals (+7.9%), Agency RMBS (+7.5%) and HY Corp (7.2%). Hopes for Fed easing and a soft landing fueled this strong 4Q23 rally in lower-quality market segments in which HY corporations and EM debt delivered excess returns of 3.31% and 5.31%, respectively.

Higher mortgage rates pressured housing, as existing home sales in November hovered at their lowest levels in a decade. Mortgage rates were slightly down from their recent highs, yet home affordability is problematic for many buyers compared to last year. Further, the disincentive to sell continued for those homeowners who had previously locked in mortgages of around 3% or less, keeping the inventory of available homes extremely low. The inventory of existing homes remained at a level of 3.5 months' supply, up slightly from levels of the prior quarter and year.





Our colleague Brian Westbury at First Trust recently shared these thoughts:

"The yield curve has been inverted for more than a year and is likely to remain so well into 2024, and the M2 measure of the money supply is down 3.3% from a year ago, while commercial and industrial loans have also declined. Government subsidies have temporarily and artificially supported commercial construction in the past few years and should soon start faltering. Payrolls have grown quickly in the past year even with a meager unemployment rate, suggesting that businesses have over-hired."

While we often disagree with Westbury, his comments illustrate a draining of liquidity as the Fed continues to end its quantitative easing experiment and replace it with quantitative tightening (QT). Government subsidy is a standard pre-election year tactic regardless of which party is in power. Payroll growth decelerated from a January 2023 peak of +472K to a monthly average of less than +200K in the second half of 2023; monthly payroll figures have been recently revised downward, too.

The Fed maintained the target range on its funds rate of 5.25% to 5.5%, and its Summary of Economic Projections (SEP) signaled that the Fed expects rates to be 0.75% lower by the end of 2024. Yet the stock market futures say the Fed will cut rates six times or by 1.5% in this election.

Only one can be right – but what if they're both wrong?

### **A Look Ahead**

The markets' move higher surprised me and many investors last year. The resiliency of economic growth and job market gains have surprised many economists, too, and though risks remain to the downside, conditions are such that analysts say that the economy may also make a surprise move to the upside and be more robust than expected for 2024. Now, most stock market investors think that a soft landing has been achieved, and they should be optimistic about a future rising S&P 500.



But this past year's stock market, while climbing "the wall of worry" past recession, inflation, and consumers exhausting their Covid savings, reveals an interesting fact: The January 3, 2022, high in the market was met and surpassed on January 19 this year (as I was writing this commentary). Did we take a 24-month round trip?

The economy isn't out of the woods yet, not just because of volatile geopolitics around Ukraine, Gaza, and Taiwan or because of inflation, consumer habits, interest rates, or government debt (all reasons for concern and query). The consensus among economists is that the economy will continue to grow in 2024, with a soft landing and no recession. I think that's too close to perfection for two entities – the Fed and economists – who are almost always wrong.

Volatile markets benefit targeted diversified investment portfolios. My portfolio recommendations for your asset allocation have a few changes from last quarter.



Maintain a risk-balanced focus and multi-asset class approach, evaluate opportunities, and be ready (with cash) to invest when more significant short-term declines occur – and as declines occur, as distress situations are on the horizon.

Consider:

- Rebalance U.S. equity allocations to portfolio targets; continue to favor Value over Growth, International vs. U.S. and Private vs. Public markets at the portfolio level;
- When assets aren't cheap, cash inside your portfolio remains a great idea, with Treasury Bills and money markets able to earn a risk-free 5% until risk assets get cheaper;
- Focus on high-quality, fixed-income holdings with short duration (1- to 3-year), paired with proven opportunistic private credit strategies for yield; avoid high-yield bonds;
- Keep private equity cash distributions on hand for future opportunities;
- Continue to increase allocations to Value across Mid, Large, and Small Cap; as well as emerging and international stocks within your portfolio target ranges;
- Selectively use cash on hand for well-priced private market alternatives, including private credit including some real estate, venture capital, growth equity, and co-investments, as well as opportunistic strategies and secondary private investments (don't pay premium prices); and
- Increase allocations to cashflow-generating real estate and real asset investments, both equity and debt, in private and public space (logistics, warehouses, data centers, infrastructure, commodities/natural resources, multi-family, and farmland).

Maintain a disciplined focus on your investment strategies, especially during volatile periods. Many investors' interests in the "E" for the environment (as well as in "S" for social and "G" for governance) of ESG continue to grow. Please know that this has been and always will be a deeply embedded part of our firm's philosophy that we can happily talk about at length.

It is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

With appreciation,

*Walid L. Petiri*

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, JPMorgan Asset Management, First Trust.