Quarterly Market

REPORT

REVIEW AND OUTLOOK

4th QUARTER 2023 REVIEW AND OUTLOOK

The Everything Rally Saves an Underwhelming Year

Overview

Markets wrapped up 2023 with an epic rally that started in late October across both equity and fixed income markets and gathered momentum in November as investors concluded that the major central banks had completed their rate hiking cycles and would be able to start moving official rates back down from restrictive territory in 2024. The U.S. and other developed economies have experienced substantial declines in inflation versus peak levels. Core inflation, which excludes volatile food and energy components, remains elevated and is declining more slowly than headline CPI. The Federal Reserve boosted hopes of rate cuts in December by including three cuts in 2024 in its *Summary of Economic Projections* (SEP). Other central banks were reluctant to embrace the dovish rhetoric. The ECB and BoE extended their hawkish "higher for longer" stance and Norway's central bank surprised markets with a 25 basis point hike. As central banks around the world navigate different policies, the macroeconomic indicators that influence currency pricing have begun to diverge. As a result, the U.S. dollar depreciated this year, losing 2% against a broad swathe of currencies, its first loss since 2020. The labor market is still historically tight, placing upward pressure on wages. Rising real wages should drive further consumer spending growth. A wage-price inflationary spiral could cause higher inflation to become entrenched and more difficult to stifle, as occurred in the 1970s. The Fed will be wary of repeating the mistakes of that era, when the Fed cut rates prematurely only to see inflation come roaring back. As such, the Fed will be keenly focused on balancing rate-cutting decisions while keeping policy mildly restrictive.

Although the recent drop in bond yields could possibly be explained by an imminent 'soft-landing,' an alternative explanation might be that rates markets are pricing in recession; especially when considering the magnitude of anticipated cuts.

It’s not uncommon for equity and bond markets to send contradictory signals: the equity “risk-on” rally of recent weeks has tended to drown out the potential concern being expressed by lower bond yields. Although the headline jobs report showed nonfarm payrolls up 216,000 in December (beating consensus of 175,000), digging a little deeper may present some cause for concern: October payrolls were revised down by 45,000 and the November figure was lowered by 26,000. These downward revisions have now occurred in ten out of the past eleven months. Furthermore, the types of jobs being added are heavily skewed toward government/education/health care jobs – which are generally considered lower quality jobs. The U.S. unemployment rate currently stands at 3.7%; it has been below 4% for 23 straight months, the longest streak since the 1960s.

Constructive Observations

- Disinflation momentum is still on track globally; central banks in developed countries have essentially ended their rate hiking campaigns.
- Labor markets are stabilizing; unemployment is low and participation rates are rising.
- Economic growth/resiliency remains intact despite recessionary fears.
- Households are benefiting from real wage gains as inflation slows, which should support consumption.

Cautious Observations

- China’s deleveraging crisis could negatively impact the global economy.
- Geopolitical tensions around the globe unlikely to diminish.
- Higher costs of capital and declining profit margins may threaten viability of weaker companies with higher indebtedness.
- Political dysfunction continues in Washington as the presidential election looms while long-term fiscal policy, debt, and outlays present challenges.

MACRO OVERVIEW

Economic performance in 2023 defied nearly every mainstream prediction. Despite numerous recession warnings, GDP is estimated to have grown by 2.4% for the year and unemployment remains near record lows. The Federal Reserve continued hiking rates to fight inflation, with headline CPI subsequently falling to 3%. Monetary policy is highly dependent on inflation, and several indicators suggest inflation will continue falling in 2024. As inflation pressures ease, the Fed will have more flexibility to cut interest rates. Markets now expect more than 125 bps of rate cuts in 2024 and a “soft landing” seems to be a plausible outcome. Economic growth is expected to slow as the effects of record economic stimulus dissipate. A recent New York Fed study showed that delinquency rates on most credit product types have been rising from the historic lows of mid-2021. Auto loan and credit card delinquencies have surpassed their pre-pandemic levels and continue to rise.

In addition to the Fed’s efforts, fiscal policy may impact the future trajectory of interest rates. The federal budget deficit was $1.69 trillion in 2023, or 6.3% of GDP, up from $1.37 trillion (5.4% of GDP) in 2022. Both years are well above the 50-year average of 3.7%. The Congressional Budget Office projects that by the early 2030s all Federal government revenues will be consumed by entitlement payments and interest on the Federal debt. The government is funding many new manufacturing construction projects with the CHIPS Act and Inflation Reduction Act. Although Fed policy will continue to influence short-term interest rates, fiscal policy could start having a greater impact further out on the yield curve.

U.S. consumer spending consistently surprised to the upside in 2023, a reflection of tight labor markets, a wealth effect from rising equity and home prices, and excess savings which are still being drawn down. Both the Conference Board’s and University of Michigan’s consumer sentiment surveys saw dramatic upticks in December, reversing several months of declines. The jump in confidence occurred across age groups and household income levels. 30-year mortgage rates have declined from their high of nearly 8% in early November to approximately 7% currently. With mortgage rates down over the past month, home builders are reporting an uptick in traffic as some prospective buyers who previously felt priced out of the market are taking a second look.

MARKETS OVERVIEW

Equities

The various Russell size and style indices indicate large-cap and mid-cap growth stocks outperformed the corresponding value segments in the fourth quarter. Large-growth stocks returned 14% in the fourth quarter, meaningfully ahead of the large value 9.5% return. Midcap growth returned 14.5% , ahead of the midcap value 12% return. Among small-caps, value stocks (15%) outperformed growth stocks (13%) in the fourth quarter. Ten of eleven S&P sectors were positive this quarter. Leading sectors this quarter included Real Estate (19%), Technology (17%), Financials (14%), and Industrials (13%). Energy (-7%) was the sole negative sector this quarter. Although most stocks increased in value this quarter, the other laggards included Consumer Staples (6%), Health Care (6%) and Utilities (9%)

The S&P 500 rose 12% in the fourth quarter, finishing the year up 26%. The equal-weighted S&P 500 rose 14% for the year, illustrating the concentration that has driven the index's recent performance. Technology and Communication Services both increased over 55% in 2023. Defensive sectors lagged considerably: Consumer Staples were flat for the year, Utilities declined 7%, and Health Care stocks rose a modest 2% in 2023. Small caps had a strong December with the Russell 2000 posting a one-month gain of 12.2% which accounted for the majority of the year's 17% performance.

In 2023, S&P 500 earnings were flat; they were up 33% for the 'Magnificent 7' stocks and down 5% across the rest of the S&P 500. Equity valuations are at the high end of the historic range (~19x forward P/E) for the market cap-weighted S&P 500 and closer to median (~16x forward P/E) for the equal-weighted S&P 500. The internals of the U.S. corporate sector are a bit weaker than headline earnings suggest; revenues and operating earnings per share have been flat in real terms since early 2022 and free cash flow of the S&P 500 excluding the 'Magnificent 7' has also been flat since that time. Last year saw the second highest percentage of S&P 500 stocks underperforming the index since 1980 (72% underperformed vs. 52% average).

Non-U.S. equity markets capped off a positive year, thanks in part to the strong final two months. Developed markets led emerging markets in December, supported by returns in Europe, while China continued to lag. Developed international stocks rose 10% in the fourth quarter, finishing the year up 18%. Year-to-date, Europe (21%) outperformed Asia/Far East (16%). France, Germany, and Japan all increased over 20% for the year with the U.K. rising 14% in 2023. Many emerging market economies have exhibited resiliency, rising almost 8% in the quarter, and just over 10% for the year. Stocks increased dramatically this quarter in Brazil (18%), India (12%), Korea (15%), Mexico (19%) and Taiwan (18%), with China falling 4%. For the full year, Chinese stocks declined 11%, whereas most other emerging countries rose 20%+. China has been a noteworthy exception among emerging economies. Plagued by a worsening property crisis, local government debt concerns and continued geopolitical tensions, China's economic reopening did not yield the optimistic outcome many had expected.

Fixed Income

The fourth quarter was characterized by central banks shifting to a wait-and-see mode, to assess the transmission of the aggressive series of rate hikes since early 2022, as well as the tightening of financial conditions and bank lending standards. Progress is being made on the inflation-fighting front, but a cautious emphasis on data-dependency has dominated central bankers' rhetoric to avoid being caught off-guard prematurely by a few good months of inflation data (or inflation "head fakes", as Fed Chair Powell referenced).

Long-term bonds outpaced most stock indices this quarter as the everything rally was sparked by plunging bond yields. Long-Term Treasury bonds (20+ year maturities) gained 13% this quarter but finished the year up a more modest 2.7%. Quarterly returns for U.S. Treasuries generally increased with maturities, along the yield curve. Total returns for the year ranged between 3.0% – 4.5% for most Treasury bond positions. The Bloomberg U.S. Aggregate Bond index rose almost 7% this quarter, finishing the year up 5.5%. Both the U.S. and Global Aggregate bond indices (with histories from 1990) posted their largest two-month gains since inception at the end of December: 8.53% and 9.41%, respectively. Interestingly, the 10-year Treasury yield ended the year at 3.88%, which is almost exactly where it began the year. Additionally, the entire U.S. Treasury yield curve (apart from shorter maturities under 3 years) is very similarly shaped and positioned as it was a year ago.

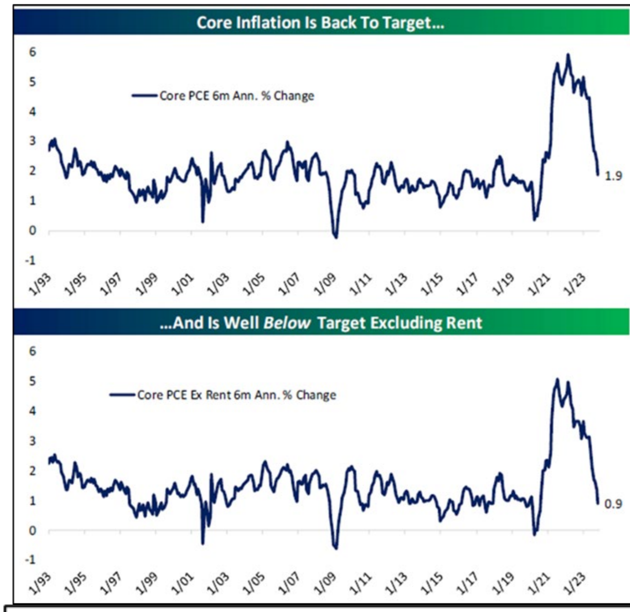
U.S. large cap companies have been minimally impacted by rising rates. The main reason is S&P 500 debt is now 76% fixed compared to less than 50% in 2007. The corporate sector termed out debt maturities before the rise in rates, partially immunizing itself from interest rate increases. Thus, interest coverage ratios still look good despite high levels of debt to cash flow and debt to assets. Investment grade bonds have also benefited from an improving upgrade cycle. For high yield, maturities are at an all-time low which increases exposure to higher rates, and spreads are not far from the tightest levels since 2009.

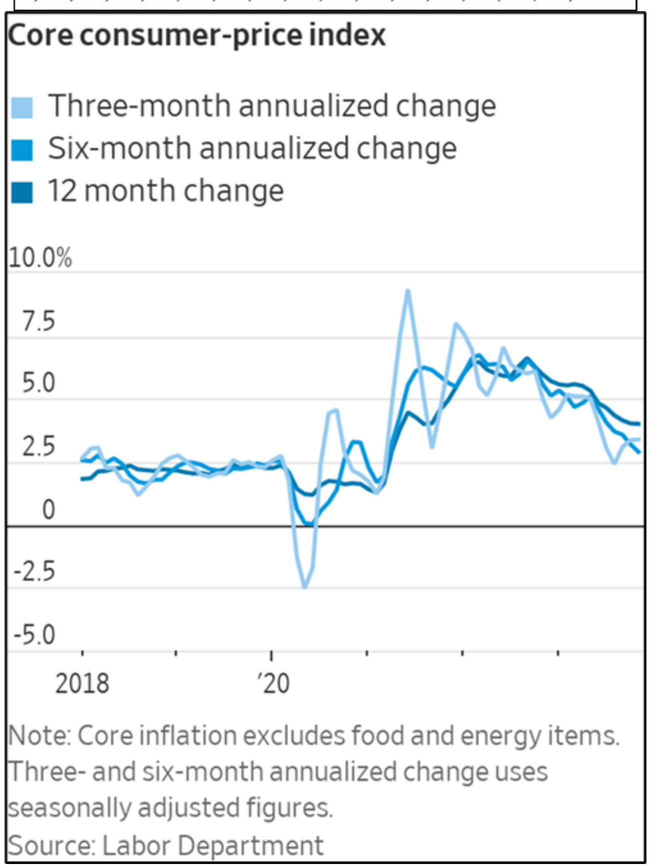
U.S. investment-grade corporate bonds returned a little over 8% in the fourth quarter, also their return for the year as they were effectively flat for the year at the end of September. High yield bonds returned 7% this quarter and 13% for the year. Leveraged loans returned 3% this quarter, and 13% for the year, similar to high yield bonds.

Real Assets

Commodity markets are the most diverse asset class and ended the year in classic fashion with various sub-sectors volatile in different directions. The Bloomberg Commodity Index corrected 3% this quarter, falling 8% on the year. Industrial metal prices rose marginally this quarter on the back of expectations of continued strong global growth, but energy markets prices (especially natural gas) continued to drop (despite the tensions in the Middle East) as markets feared oversupply and a global slowdown. WTI crude oil declined 18% this quarter and natural gas fell 25%. Agricultural prices also declined this quarter: corn, cotton, and sugar were lower while wheat and coffee bucked the trend and rallied. Livestock prices (hogs & cattle) fell 9% in the fourth quarter. Unlike broader commodities and many risk-off benchmarks, gold gained 11% in the fourth quarter and finished up 13% for the year, reaching a record high of $2,108/ troy ounce on December 27th in response to the easing of global financial conditions.

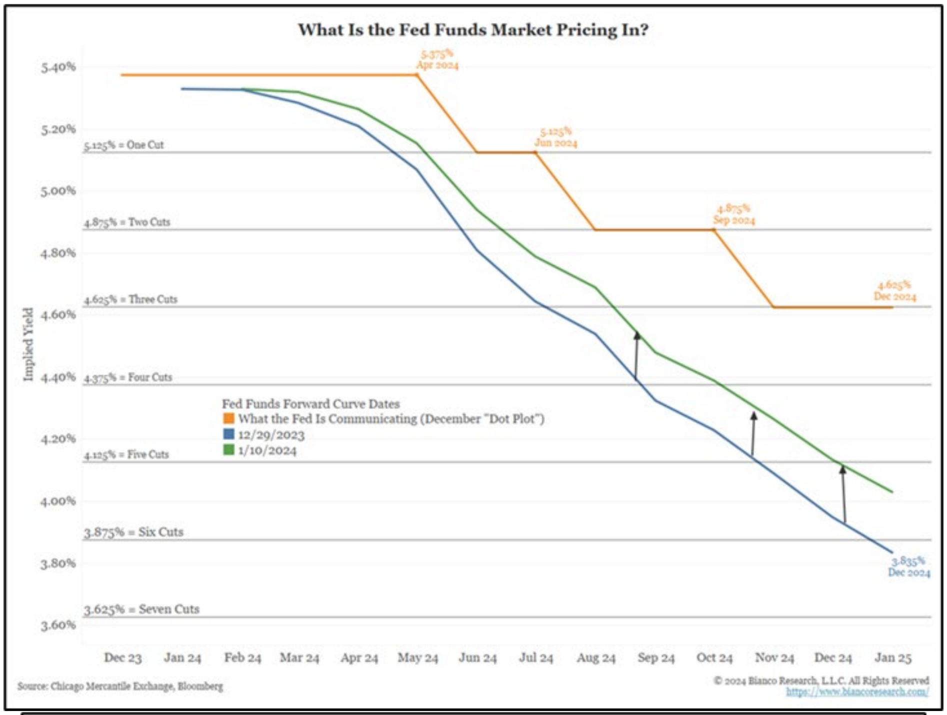
DISINFLATIONARY TRENDS SPARKED STOCK AND BOND RALLY IN Q4

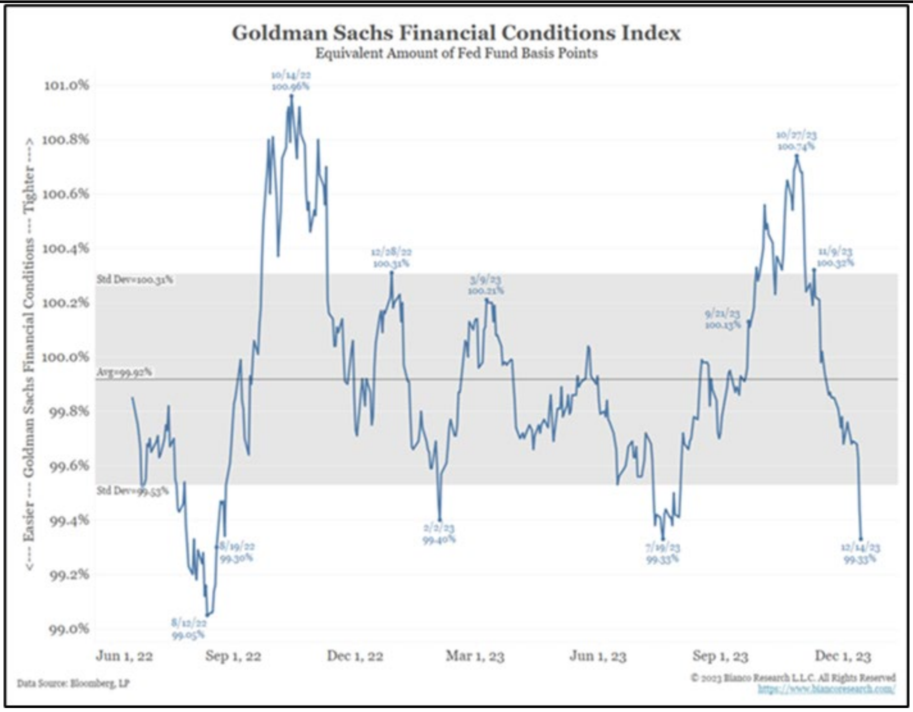




SOURCE: BESPOKE. WSJ

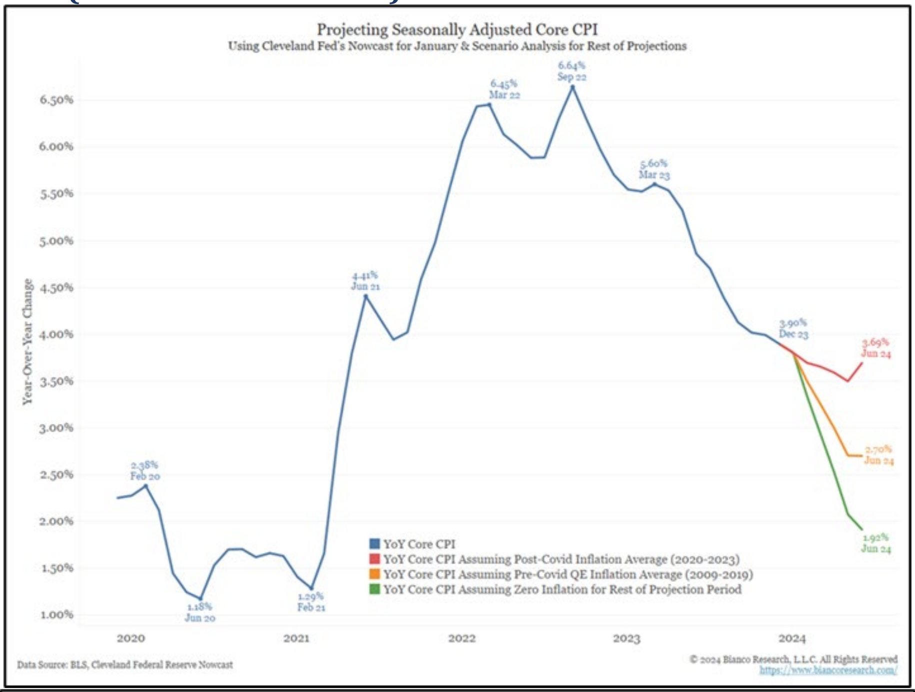
DISINFLATIONARY TRENDS FINALLY RECOGNIZED BY THE MARKET AND FED

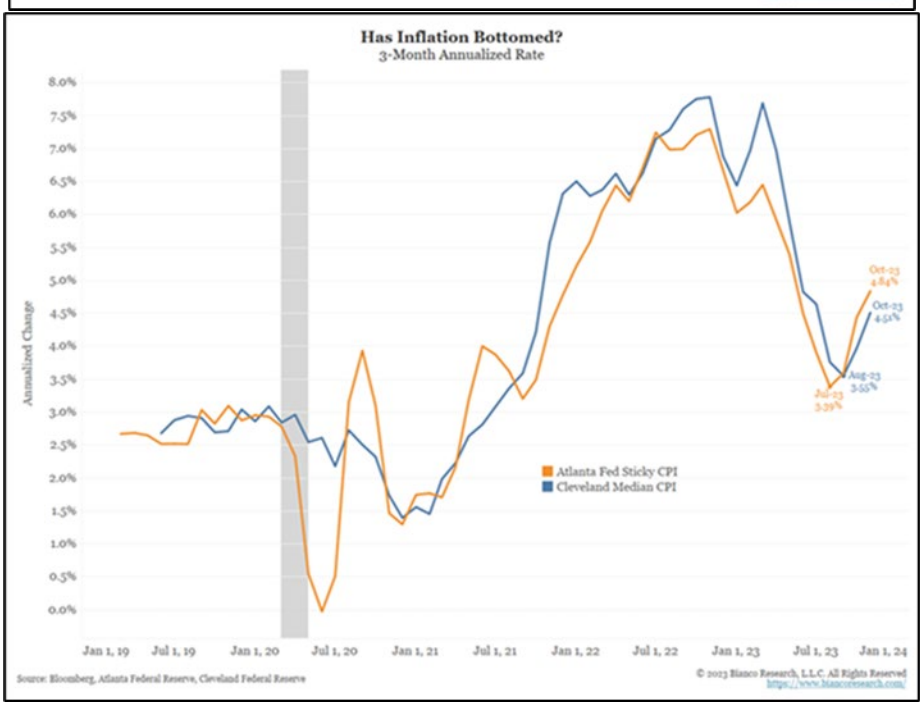




SOURCE: BIANCO RESEARCH

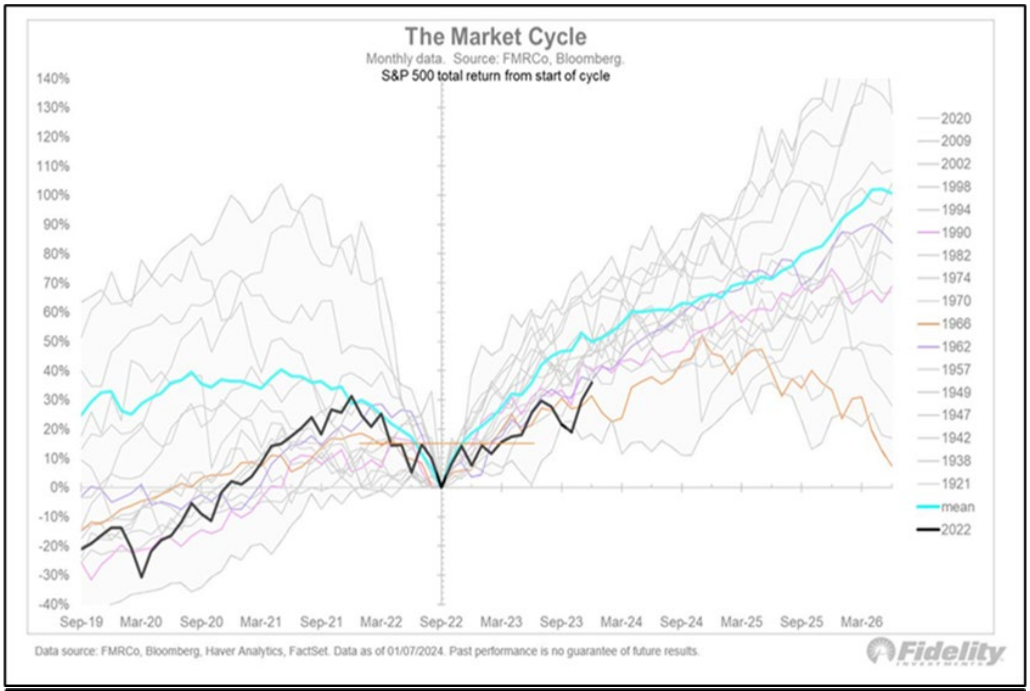
THE LAST MILE (2% CORE INFLATION) COULD BE CHALLENGING

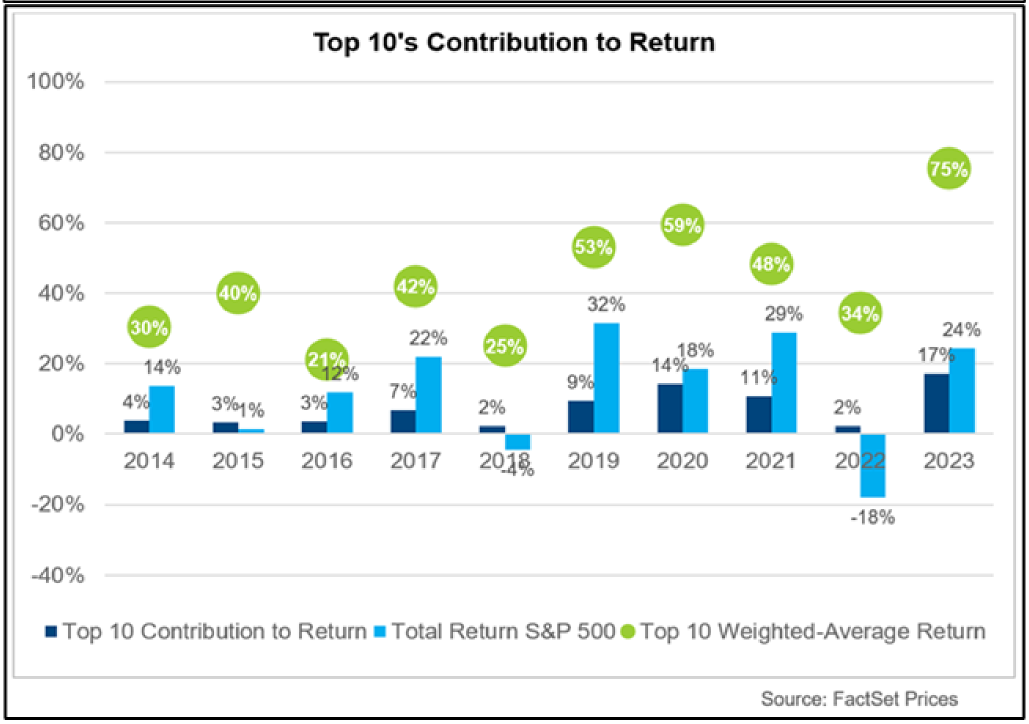




SOURCE: BIANCO RESEARCH

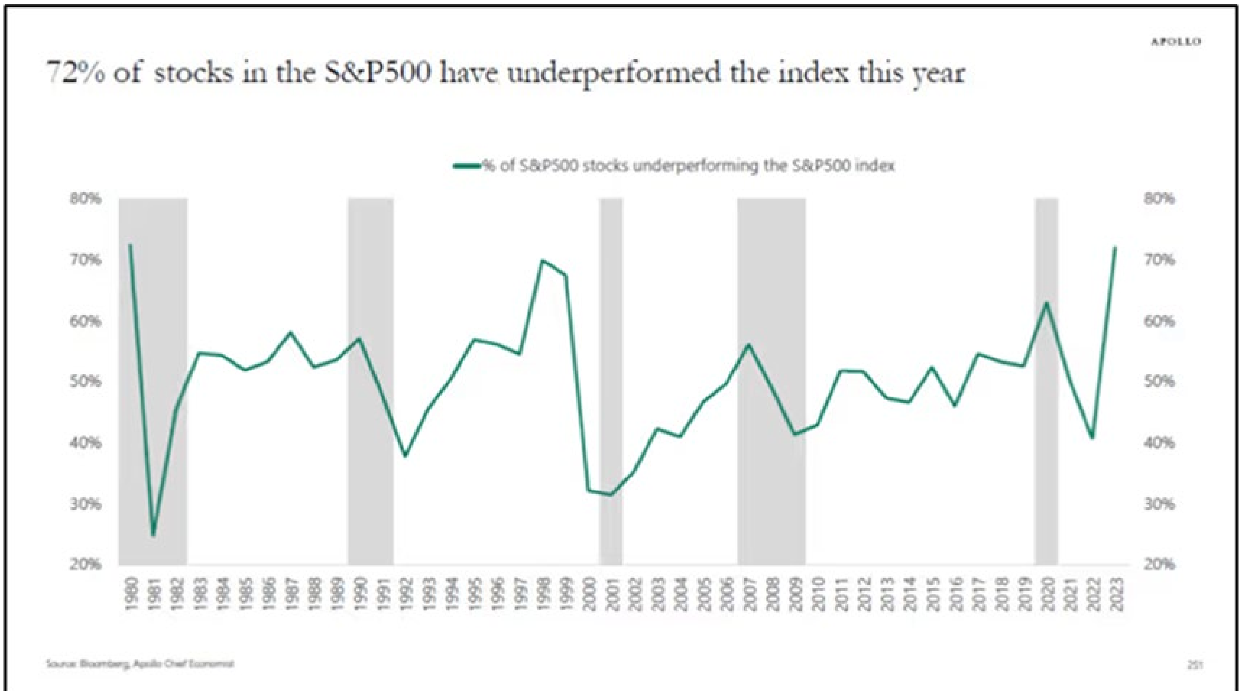
TEPID RALLY WITH WEAK BREADTH CONTINUES





SOURCE: FIDELITY, FACTSET

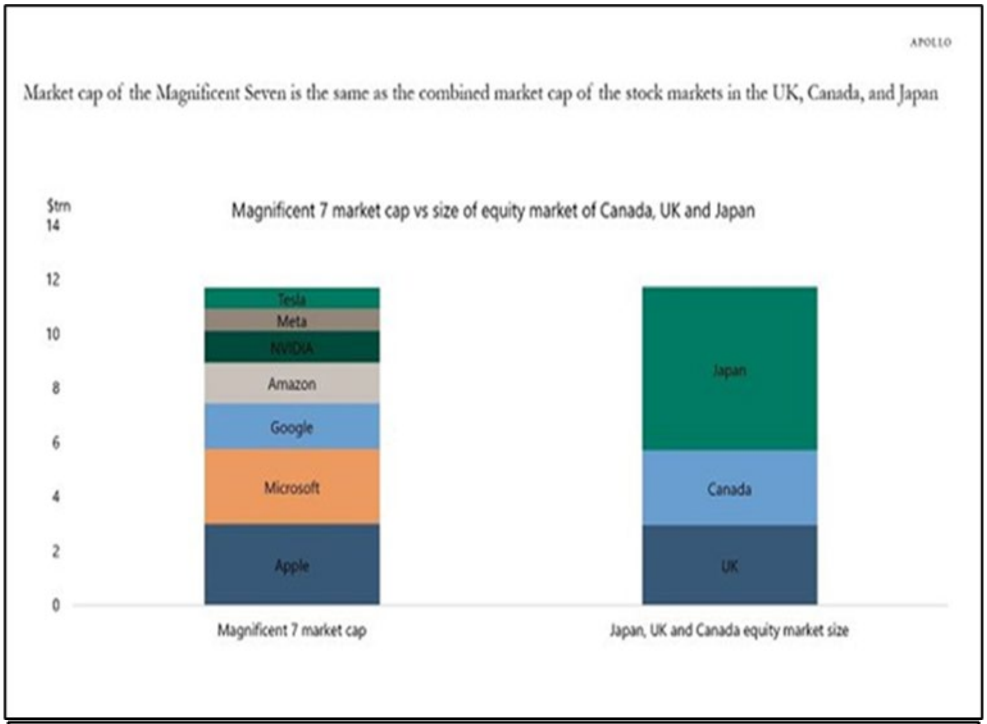
THE YEAR OF THE MAGNIFICENT SEVEN

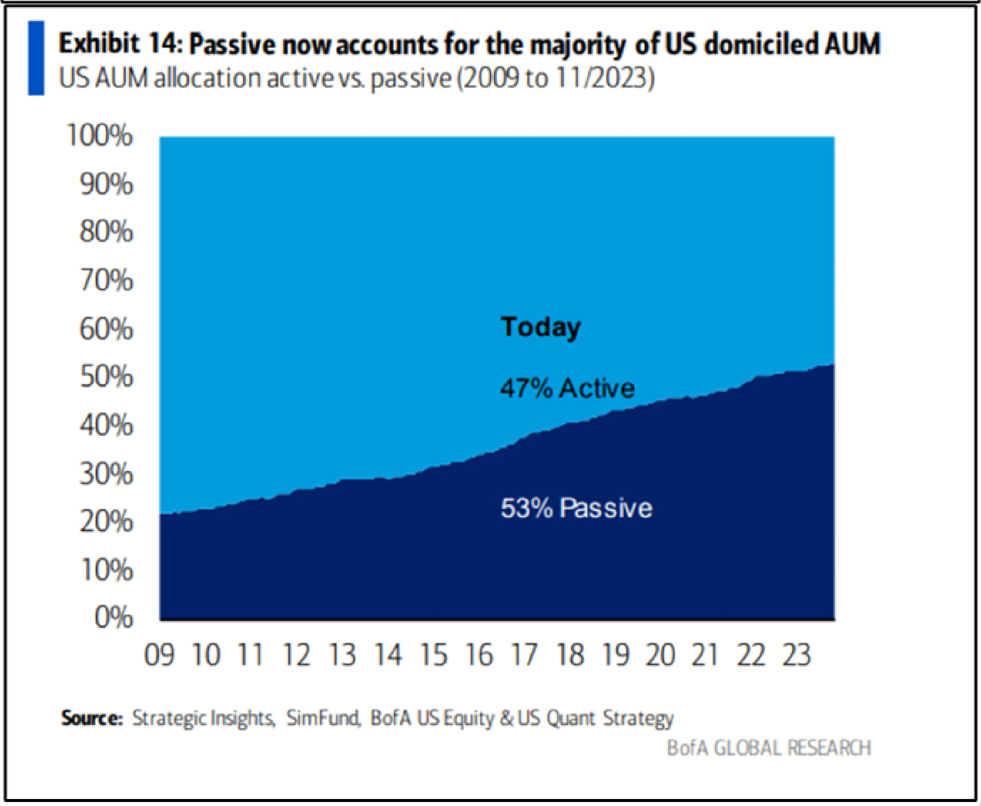


2023 S&P 500 Return Attribution			
Sector	**Weight at start of 2023**	**2023 return**	**Basis points of S&P 500 return**
Info Tech	**26 %**	**58 %**	**1489 bp**
Cons. Discretionary	10	42	415
Comm. Services	7	56	406
Industrials	9	18	157
Financials	12	12	142
Materials	3	13	34
Real Estate	3	12	33
Health Care	16	2	33
Consumer Staples	7	1	4
Energy	5	(1)	(7)
Utilities	3	(7)	(23)
S&P 500	**100 %**	**26 %**	**2629 bp**

SOURCE: APOLLO, GOLDMAN SACHS

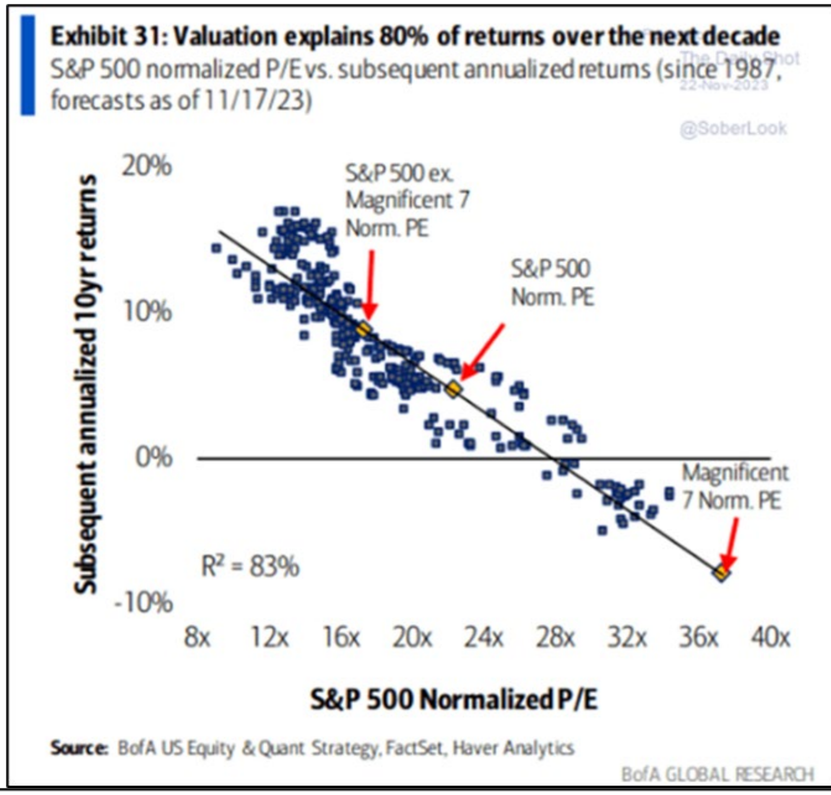
PASSIVE FLOWS CONTRIBUTED TO MAGNIFICENT 7 RALLY

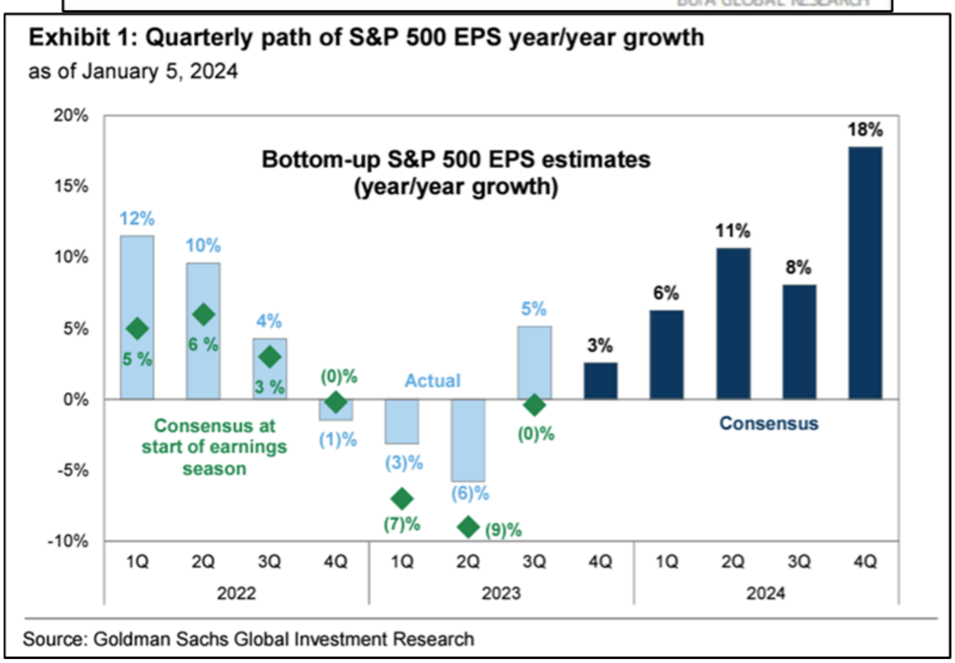




SOURCE: APOLLO, BANK OF AMERICA

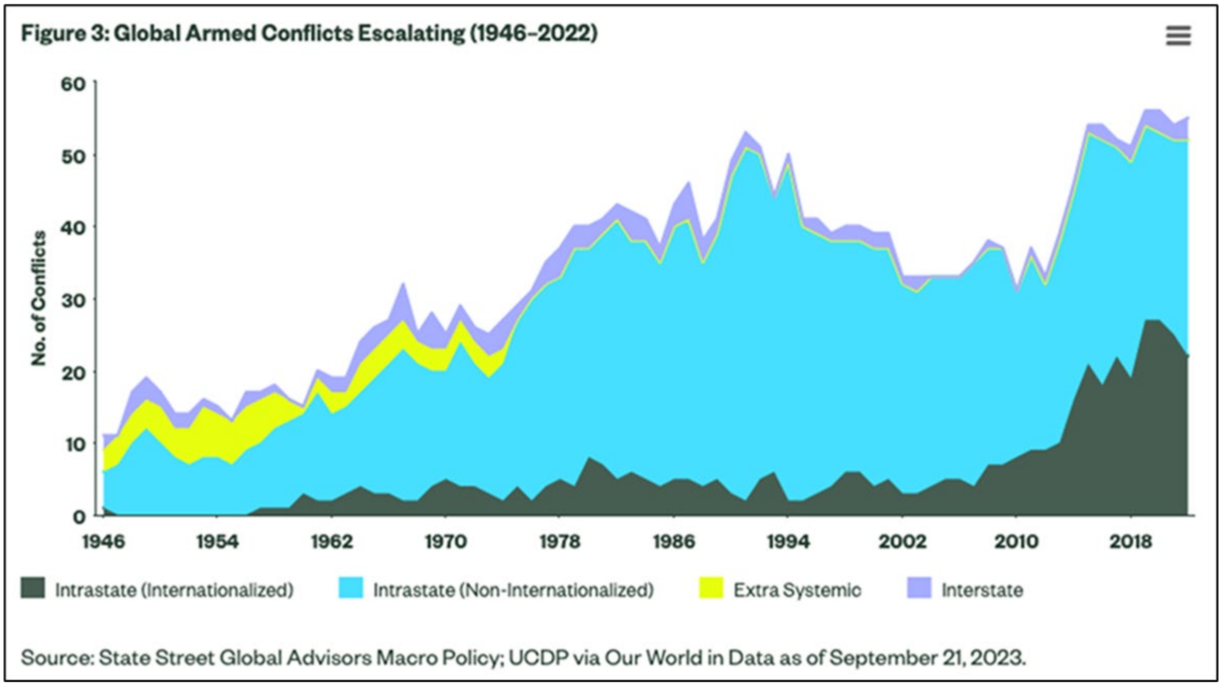
US (EX-MAG7) FAIRLY VALUED. EARNINGS APPEAR OPTIMISTIC





SOURCE: BANK OF AMERICA, GOLDMAN SACHS

GEOPOLITICAL TENSIONS PRESENT UPSIDE RISK TO VOLATILITY



SOURCE: STATE STREET GLOBAL ADVISORS

IMPORTANT DISCLOSURES