Economic & Markets Commentary

Market Returns
Periods ended December 31, 2023

	4Q '23	1 Year	3 Year
MSCI All Country World Index	11.1%	22.8%	6.2%
S&P 500 Index	11.7%	26.3%	10.0%
Dow Jones Industrial Average	13.1%	16.2%	9.4%
Russell 2000 Index	14.0%	16.9%	2.2%
MSCI EAFE Index	10.5%	18.9%	4.5%
MSCI Emerging Markets Index	7.9%	10.3%	-4.7%
Barclays Global Aggregate Bond Index	8.1%	5.7%	-5.5%
S&P Global Dev. ex- Bond Index	5.4%	5.2%	-4.1%
Barclays Aggregate Bond Index	6.8%	5.5%	-3.3%

Source: FactSet, all returns in U.S. dollars.

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"Monetary changes have their effect only after a considerable lag and over a long period"

Milton Friedman

“If you have to forecast, forecast often.”

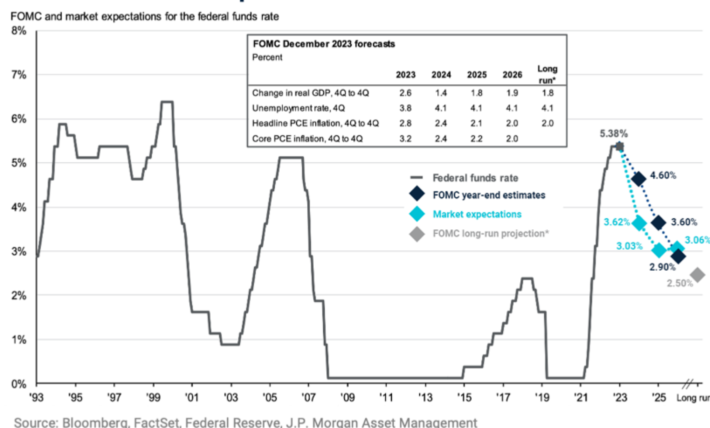
Edgar Fieldler

The quote above about forecasting is an appropriate reprise from our last letter. We were all reminded last year of the difficulty of making accurate forecasts about the short-term direction of the stock market. Given the widespread assumption that a U.S. economic recession was inevitable, not a single prognosticator we know of predicted a one-year gain even close to the 26.3% return generated by the S&P 500 in 2023. From an investment perspective the year just ended stands as a testament to the resilience of the markets amidst a maelstrom of macro-economic pressures. Stock markets around the world enjoyed strong returns despite the backdrop that included the most aggressive Federal Reserve rate hikes since the 1980s and geopolitical tensions including wars in Ukraine and the Middle East and heightened concerns about China and Taiwan. The normally reliable indicators were flashing red; the U.S. Treasury yield curve was inverted, inflation was over 5% and unemployment was low at 3.5%. History was telling us that aggressive monetary tightening by the Fed would force a trade-off between lower inflation and higher unemployment, so there was a high probability of a hard landing for the U.S. economy. That assumption was reflected in asset prices a year ago after declines of 20% or more for stock indices over the course of 2022.

Defying all odds, the U.S. economy remained in growth mode in 2023, with unemployment sticking near historical lows and real GDP expanding at a healthy 2.8%. That performance, which former Fed chair Ben Bernanke described as "immaculate disinflation" has shifted the narrative to the point that a soft landing is now the consensus expectation. November was the pivot point to this new consensus as economic resilience and disinflation continued. Global stocks rose 9.2% for the month and the yield on the benchmark 10-year Treasury bond fell 60 basis points, producing its best monthly return in over a decade. The underlying foundation for the shift in sentiment was the growing hope and expectation the Fed will begin cutting rates early this year, and the jubilation over the prospect of cheaper borrowing costs led to the huge rally in risk assets in November and December. As we’ll discuss later the late-year surge leaves stocks vulnerable from a fundamental valuation perspective.

The current official guidance from the Fed calls for three 25 basis point reductions in the Fed funds target rate in 2024, but the markets are expecting much more. Barron’s columnist Randall Forsyth recently recalled economist Paul Samuelson’s famous quip about the stock market predicting nine of the last five recessions. Now, he says, investors are making a similar mistake by pricing in six of the next three Federal Reserve interest rate cuts. The Fed’s recent guidance would bring the target for the Fed funds rate down 75 basis points from its current 5.25% to 5.5% range to a range of 4.5% to 4.75%. As the chart below reveals, the futures market is pricing in a decline twice that size, to a range of 3.5% to 4.0% for December 2024, so the market’s expectation is for far more aggressive easing than the Fed is predicting. We won’t have to wait long to see how the story unfolds because the market also expects the first rate cut to come at the FOMC’s March meeting.

Federal Fund Rate Expectations



	2023	2024	2025	2026	Long run*
Change in real GDP, 4Q to 4Q	2.6	1.4	1.8	1.9	1.8
Unemployment rate, 4Q	3.8	4.1	4.1	4.1	4.1
Headline PCE inflation, 4Q to 4Q	2.8	2.4	2.1	2.0	2.0
Core PCE inflation, 4Q to 4Q	3.2	2.4	2.2	2.0	

Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management

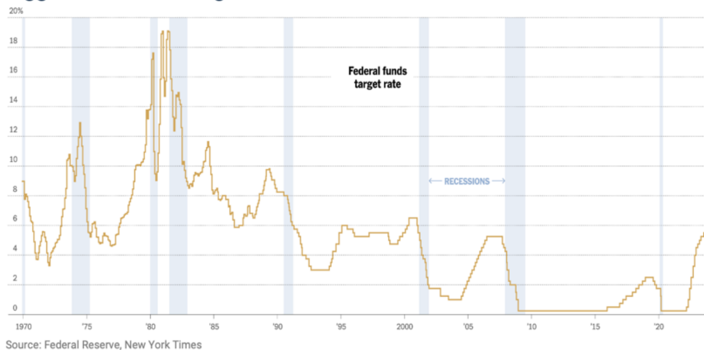
The Fed will be reluctant to cut rates as much as the futures market expects if inflation remains sticky, and while inflation moderated significantly in 2023 the progress was lumpy. As Forsyth points out in Barron’s the impact of Fed policy, which affects the demand side of the economy, has played a smaller role in dampening inflation than improvements in the supply chain and lower energy prices. Core PCE (Personal Consumption Expenditures) inflation, the Fed's preferred metric, will be the most closely watched indicator. Core PCE came in at a 3.2% annual rate in November, down sharply from its peak above 7% in mid-2022 but still above the Fed’s 2% target. With the market expecting even more accommodation than the Fed is projecting, any modification to the Fed’s outlook that hints at a more measured policy (fewer or later rate cuts than expected) would be both an immediate hit to investor sentiment and a strong challenge to the so-far resilient economy.

On the other hand and complicating matters is the risk the Fed will ease too much too soon. Multiple rate cuts by the FOMC send a strong message and are usually

used to boost the economy during a recession, not to soften the slowdown of a growing economy. Certainly, six rate cuts in a year could loosen conditions too much, reigniting inflation and driving intermediate and longer-term interest rates higher.

Even with the Fed's expected support this year the economy faces a number of challenges. The top item on the list of challenges should probably be the simple fact that the impact of the Fed's aggressive rate hike cycle may not have had time to work fully through the economy. According to Deutsche Bank recessions typically begin two years after the first increase in a rate hike cycle, and that lag can be seen clearly in the chart below. The first of the Fed's 11 increases in the current cycle was in March 2022, leaving lots of uncertainty around their impact in 2024.

Lagged Effect of Changes in Fed Funds Rate



Source: Federal Reserve, New York Times

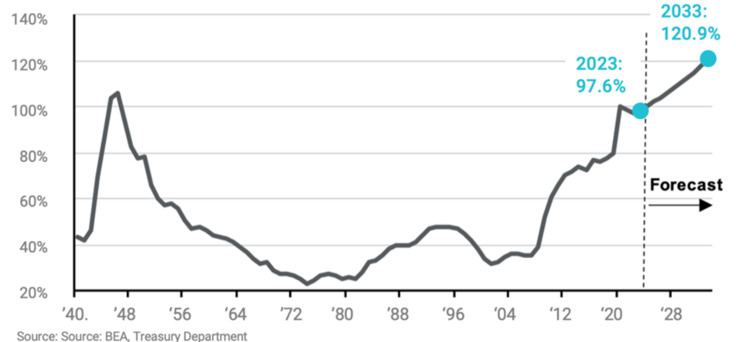
Politics in the U.S and abroad will also likely emerge as major factors in economic uncertainty this year especially as the path to the November Presidential election unfolds. The political picture in the U.S. will also have consequences for the direction of the wars in the Middle East and Ukraine which could, in turn, exacerbate global supply chain challenges.

As we've discussed consumer spending was an important source of economic strength and resilience last year, but consumer exhaustion is setting in. Higher interest rates will reduce households' appetite for more borrowing, COVID related excess savings are being spent down, and home equity is a less viable source of liquidity. Precise data on these variables is hard to find; most agree households had accumulated $2 trillion in excess savings by the end of 2021, but estimates of remaining balances vary. Still, recent information from the New York Fed reveals higher debt burdens at the household level and rising credit card and car loan delinquencies. Consumer spending as measured by U.S. retail sales has already flattened, and weaker job growth, higher energy bills, and the resumption of student loan payments won't help.

A less discussed but potentially important factor this year and next is the continued runoff of low interest-rate debt which will need to be refinanced at today's much higher yields. The dynamic will play out not only for households but also at the government and corporate levels. U.S. Treasury debt issuance will have to expand as the deficit grows and the Fed shrinks its balance sheet. At the federal level our gross national debt just surpassed $34 trillion, an almost incomprehensibly large figure that is expected to grow by another $1 trillion in the first quarter. At this point the economic impact of the national debt is difficult to assess, but the math is fairly simple. The average interest rate on U.S. government debt was 3% in October, up from just over 1.5% in early 2022. With new debt being issued at rates between 3.5% and 5% the debt burden will continue to grow, at some point crowding out other spending and investments. Without some combination of more tax revenue and less spending in Washington rising deficits and higher interest rates will threaten the fiscal sustainability of the U.S. With our leaders scrambling to lock in another short term deal to avoid a government shutdown, we foresee this issue moving to the forefront for the economy and investors in 2024.

Federal Net Debt (Accumulated Deficits)

% of GDP, 1940 – 2033, Adj. CBO Baseline Forecast*, end of fiscal year



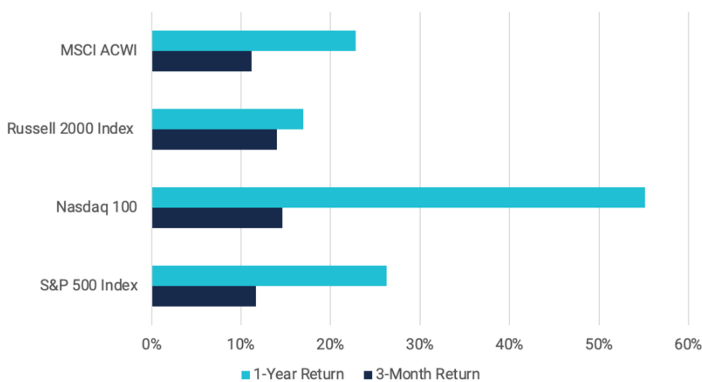
Source: Source: BEA, Treasury Department

Corporations, which don't have the luxury of printing money to fund their debts, will need to face the challenges of higher interest rates more directly. According to data from both Goldman Sachs and Morgan Stanley $1.8 trillion of corporate debt will mature in the U.S. in the next two years. As interest costs rise companies will feel the pressure on earnings, and the profitability and balance sheet metrics that drive the availability and cost of new borrowings will be impacted. Ironically, net corporate debt payments reached 40-year lows last year because corporate CFO's were able to invest their cash balances in much higher yielding securities while the low fixed rate on their debt was unchanged. As that cheap debt matures and is either retired or refinanced at higher rates, companies' capacity to invest in capital projects and growth initiatives will be diminished.

EQUITY MARKET OVERVIEW

Stocks finished the year on a high note in December, with the S&P rising more than 4% on the heels of the 9% gain in November. That strong finish turned what many feared would be a lackluster year for equities into one of the best in a decade. The broadest global equity benchmark, the MSCI All Country World Index ended the quarter up 11.1% and finished the year with a 22.8% gain. The S&P 500 rose 11.7% in the quarter and 26.3% for the year. Despite strong nominal returns developed international equities as represented by the MSCI EAFE index trailed U.S. equities again in 2023 with a 10.5% return in the fourth quarter and a 18.9% return for the full year.

2023 – Equity Index Returns



Source: FactSet. As of December 31, 2023.

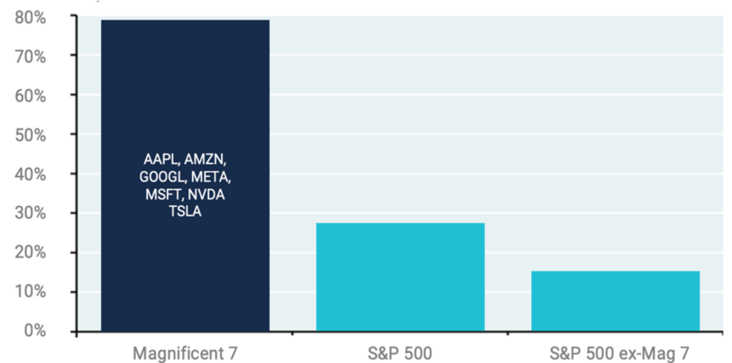
For most of the year market leadership remained extremely narrow, with large cap growth stocks, and particularly technology companies associated with AI, generating most of the return. Through the end of October the average stock in the S&P 500 was down 3% but the index itself was up 11%, and all of that gain was attributable to the tech giants now known as the Magnificent Seven: Apple (AAPL), Alphabet (GOOGL), Microsoft (MSFT), Amazon.com (AMZN), Meta Platforms (META), Tesla (TSLA) and Nvidia (NVDA).

The market broadened in November and December as the rising tide of optimism about inflation and interest rates lifted all boats, resulting in an "everything rally" that stretched to all corners of the market including long-ignored small cap stocks. The Russell 2000 index was barely positive for 2023 at the end of October but ended the quarter with a 14% three-month gain and a 16.9% gain for the year, just enough to erase all of its losses in 2022. Small cap value stocks, which tend to be highly leveraged companies and thus most sensitive to changes in interest rates, were the best performing segment in the fourth quarter with a gain of 15.3%. Even so, as the graph above reveals, the vast majority of the gains in 2023 were attributable to those seven "magnificent" stocks.

Looking forward into 2024 we see a mirror image of the picture at the end of 2022, when investors had endured a historically poor year in the market and were extrapolating more of the same. The Fed was aggressively raising rates and, as we discussed, economists and traders expected a recession. Expectations for stocks were muted, and valuations reflected the modest outlook. Today, based upon expectations for lower inflation and interest rates and the markets' strong close in November and December, investor sentiment has improved dramatically, a contrary indicator that suggests the possibility that markets are overbought, at least in the short term. The forward P/E ratio for the S&P 500 ended the year at 19.5 times expected earnings for 2024, well above the 17.5 multiple a year ago and the 16.5 average multiple over the past 30 years. The Magnificent Seven seem expensive, ending the year trading at an average forward P/E ratio of 33.6 times earnings despite their 40% aggregate earnings increase in 2023.

Magnificent 7 Stocks Led S&P 500 in 2023

Percent, YTD Return

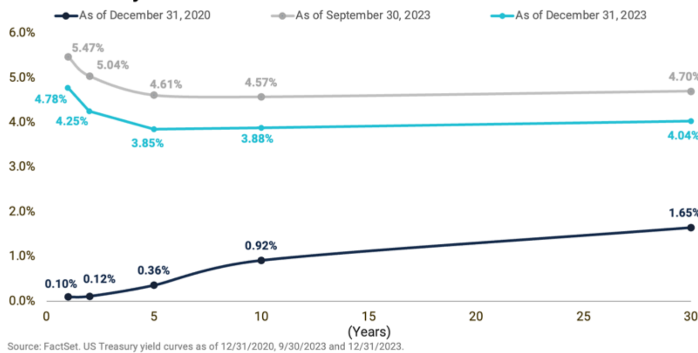


Source: Bloomberg, JP Morgan Asset Management, December 27, 2023

Despite those valuations we see a path to reasonable returns for equities in 2024. Wall Street estimates call for S&P 500 revenue to grow 5.5% this year and earnings are projected to grow by 11.5%. If we avoid a deep recession and those estimates prove accurate, and if valuations are supported by lower interest rates, equity returns in the mid single digit range look achievable for the S&P 500. Other segments of the market, particularly small and mid cap and international stocks, are less expensive and could generate higher returns if investor appetite for sectors other than large cap growth continues to grow. The bottom line is that we expect the wide divergence in performance across equity sectors to create opportunities for diversified investors with the discipline to remain committed to asset classes that are out of favor, avoid making big portfolio changes based upon short term news, and to rebalance portfolios to take advantage of volatility.

BOND MARKET OVERVIEW

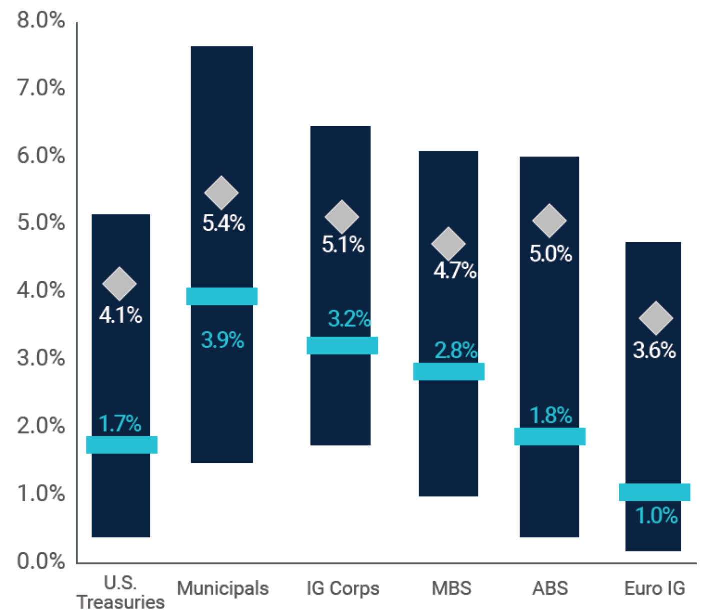
Fixed income investors almost literally rode a roller coaster in 2023. The benchmark 10-year Treasury yield began and ended the year at the exact same level, 3.88%, but just because we got on and off at the same spot doesn't mean the ride wasn't exciting. The yield rose to over 4% in March, fell to the yearly low of 3.3% in early April, and raced to over 5% for the first time since 2007 in late October before plummeting back to its start/end point by December 31. The rally in interest rates in November and December bailed out investors in longer maturity bonds, which were under water for the first three quarters. For example, the iShares 20+ year Treasury Bond ETF was down 9% at the end of September but rallied 12.9% in the last quarter to finish the year up 2.8%.



Source: FactSet. US Treasury yield curves as of 12/31/2020, 9/30/2023 and 12/31/2023.

Given the inverted yield curve at the beginning of the year and the high volatility throughout the year, short maturity bonds were the place to be in 2023, just as they were in 2022. They enjoyed the higher yields available at the short end of the curve without enduring the volatility on the long end.

Rising rates are painful in the short term because they drive down the price of existing bond holdings, but they increase the return for bonds purchased at the new higher yields. As challenging as the two-year transition to today's higher interest rate environment has been for the bond market, it has set the stage for much better returns for fixed income investors in coming years. Under the new interest rate regime positive real rates will allow the bond segments of portfolios to generate attractive returns, and playing defense will not have to equate to capitulating on portfolio growth. Assuming no default an investor who buys a bond earns the yield to maturity priced into the bond on the day it's purchased, and because interest rates have risen so much bond return expectations have increased substantially. Vanguard now expects U.S. bonds to return a nominal annualized 4.8%–5.8% over the next decade, much more attractive than the 1.5%–2.5% they expected before the Fed rate-hike cycle began. The most important question we're facing now in bond accounts is when and how much to extend the duration of portfolios. In general, we've been well positioned from a duration perspective, so we have an opportunity to lock in higher rates of return by investing cash and the proceeds of maturing bonds in new bonds. As we discussed last quarter cash was an excellent holding as interest rates were rising, and with money market yields still above 5% cash remains an attractive investment today. We will need to be nimble, though, because cash yields will decline when the Fed starts cutting rates, and we want to get any dollars earmarked for bonds invested before they do. The timing decision is complicated by the possibility that the Fed will cut too much too soon, reigniting inflation, and sending longer-term yields higher even as short rates fall. So while we don't want to be holding much cash when the rate cuts begin, we also don't want to be overextended on duration.



Source: Bloomberg, FactSet, J.P. Morgan Credit Research, J.P. Morgan Asset Management

This chart depicts the attractiveness of bonds today by showing the expected returns for all segments of the fixed income market relative to their 10 year ranges and averages. While down a bit from September, yields remain much more attractive than at virtually any time in the last decade. As 2024 unfolds we'll be monitoring the economic data, watching the Fed, and looking for opportunities to take advantage of the new era for interest rates. Our overall positioning remains defensive to protect against, and allow us to take advantage, of rising yields if today's consensus expectation of lower rates proves incorrect.

SUMMARY

The most important issue facing investors in 2024 will be the ability of the economy and markets to transition from policy-supported growth and resilience to a more normal environment in which growth is driven by technological advancement and consumption fueled by innovation and labor. Through that lens we see opportunities and risks over the next several years. Advances in technology continue to accelerate. Last year it was the growth of artificial intelligence that took the spotlight, and AI promises to transform the way much of our economy operates. But innovation is occurring in many fields. We've seen huge gains in the fields of energy, healthcare, applied technology and others which will provide opportunities and careers in fields not even imagined 20 years ago. For those gains to continue to drive the growth of the U.S. and global economies we need a solid foundation of sound money that allows investors in these technologies and industries to earn reasonable risk adjusted returns. In their 2024 economic outlook, Vanguard makes the case that the structural shift to today's higher interest rate environment is the "single best economic and financial development in the last 20 years" because it will impose a new discipline on capital allocation decisions. We agree, but the road to the new regime will be bumpy for the reasons we have discussed.

From a portfolio standpoint, we still believe equities are the best tool to create long-term wealth, but given the higher expected returns for fixed income a more defensive posture may make sense for some investors. Addressing that topic requires us to have a deep understanding of our clients' goals, objectives, and preferences, which can only be gained through communication. To that end, we look forward to a meeting or discussion in the near future!

All the Best,

Partnerning with:

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