Review & Outlook

Fourth Quarter 2023

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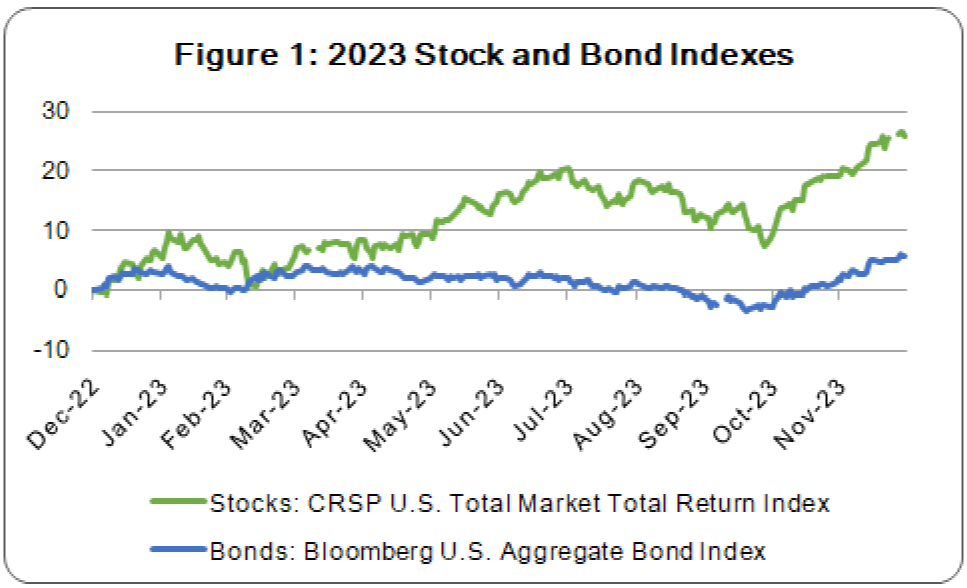
Review and Outlook

The U.S. economy was surprisingly resilient in 2023. The broader economy grew at an annualized rate of almost 6% in the third quarter, and the stock market followed with a strong rally in the fourth. So, the recession that most everyone was expecting at the end of 2023 never happened.

Figure 1 shows the 2023 performance of the CRSP Index for U.S. stocks and the Bloomberg Aggregate Index for U.S. bonds.[2] It shows the striking rally in the fourth quarter following the downward trends for both stocks and bonds from August to the end of October.

But it is only now that the stock market is back to where it was at the end of 2021, having recovered all the losses from the steady interest rate increases in 2022 and early 2023. The bond market, however, is still 8% below where it was at the end of 2021.

Figure 2 shows the performance of the broad stock and bond indexes for the most recent quarter with a proxy for money market funds included.[2] Clearly, the money market funds have lagged over the past three months.



However, when looking at the same indices since the end of 2021, we see a very different picture. Figure 3 shows that the bond market is still 8% below where it was two years ago, and stocks are just now returning to their previous levels.[2] Over that period of time, very short-term treasuries, or money market funds, outperformed both the broad stock market and the aggregate bond market.

Index Performance Data
Total Return as of 12/31/2023

Indices[1]	Q4 2023	Trailing 12 Months
CRSP U.S. Total Market Index Total Return	12.14%	25.98%
MSCI ACWI Ex-U.S. Total Return	4.85%	13.59%
Bloomberg U.S. Aggregate Bond Index	6.82%	5.53%

Predictions a year ago called for rising interest rates to slow the economy, with the strong consumer spending coming to an end in the second half of the year. Many expected a recession as excess savings dwindled, student loan payments resumed, and business were forced to refinance at significantly higher rates.

However, hindsight reveals a different picture. Higher interest rates failed to hurt the pocket books of homeowners who locked in lower mortgage rates in 2021 and early 2022. And by not listing their homes for sale, reducing supply, home prices have remained fairly strong. Savings lasted longer than most predicted, especially for households in higher income brackets, so consumer spending remained strong through the holidays. Even the labor market held up much better than expected. All this combined to bolster “soft landing” expectations that the market only bought into at the end of October, when both the stock and bond markets raced forward. Still, questions remain.

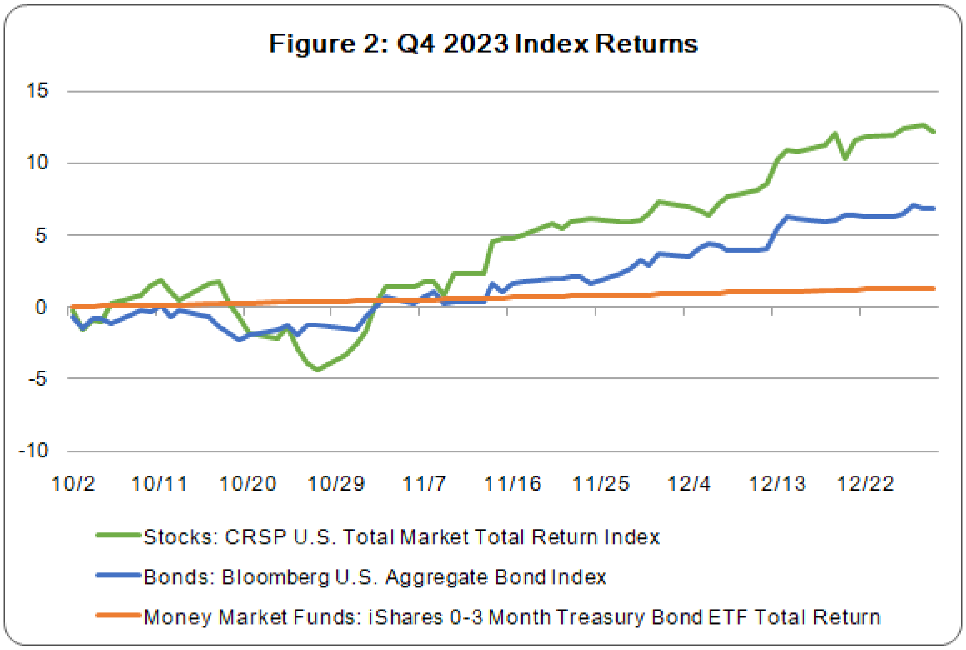


Figure 2: Q4 2023 Index Returns

The mantra from the Fed is that interest rate hikes do work, but not immediately, meaning it takes a while for the medicine to kick in. However, as we wait see if the treatment has side effects; like growing unemployment, slowing consumer spending, and a consequent downturn in the broader economy; the principal malady, high inflation, has dropped its fever at a remarkable rate, seemingly closing in on the Fed's long-term target of 2%.

Despite all the optimism, it isn't clear to us that the rally in late 2023 can continue with much vigor, given that stock valuations are relatively high, the rise in interest rates may still bite into earnings and investment for companies facing a higher cost of capital, and global growth forecasts are muted at best.

At the end of October, the stock market was not particularly remarkable, as money market funds had a similar year-to-date return as U.S. stocks (4% vs. 7.4%). The yield on 10-Year Treasuries was around 5%, and many people expected those yields to increase, given what money market funds were paying and the amount of debt the U.S. government now has to manage. Two months later, we find that inflation is fading away without any harm to the labor market. And while it is true that the economy has had a remarkable run, much of what was concerning to us in late October remains, just obscured by the excitement about a potential soft landing.

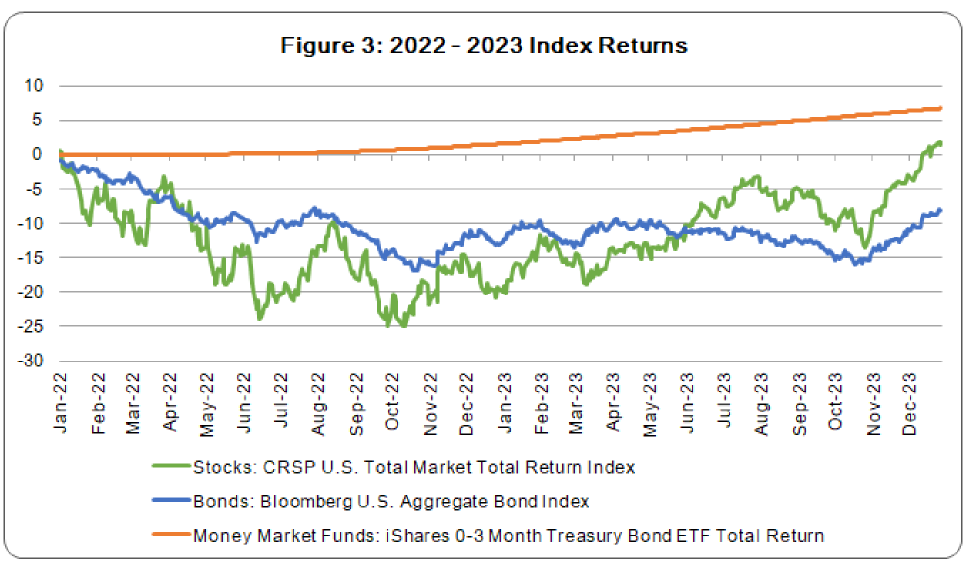


Figure 3: 2022 - 2023 Index Returns

The stock market rally through November and December has moved valuations back to where they were when the yield on 10-Year U.S. Treasuries was half of what it is today. All other things being equal, higher interest rates should result in lower equity valuations, providing more evidence that the rally may be difficult to sustain. And U.S. debt will continue to pose challenges going forward.

Inflation has fallen to 3%, still above the Fed's target of 2%, and bringing it down another percent could be tricky. For example, oil prices could rise with tensions in the Middle East; and wage increases, including higher minimum wages in many locations, could mean higher prices on different products. So, while inflation has become more manageable, the dragon has not been slayed.

It seems to us that the extreme optimism captured by the stock market in the fourth quarter of 2023 was just that – extreme. The increase in stock prices was based on expectations of significantly lower interest rates and continued growth. But those two things can't go together right now. It would take a recession or significant weakness in the economy for the Federal Reserve to ignore the risks of continued inflation and lower interest rates to where they were in late 2021 or very early 2022. If we have continued growth, the Federal Reserve has to manage continued inflation risks while continuing to borrow to help manage the debt.

There are also growing signs that GDP growth is increasingly being fueled not just by government spending, but also by consumer debt, and at a rate that is likely unsustainable. Usually, we think of how much is produced in the U.S. (gross domestic product – GDP) and how much is earned (gross domestic income – GDI) as being two sides of the same thing; the numbers should be similar in a balanced economy.

However, while GDP increased nicely in 2023, GDI did not. Since late 2022, gross domestic income has grown at a noticeably slower rate than gross domestic product. One explanation for this is that consumption is not being fueled by increased earnings, but rather by increased borrowing. That difference could be an indicator that the economy has been slowing, instead of growing as much as the traditional GDP number suggests, or that GDP is likely to slow in the coming months because weaker income growth means reduced spending on the horizon.

In Focus

One reason the stock market moved up in 2023 was speculation about the benefits of artificial intelligence (AI). Much of the gain for indexes like the S&P500 or the CRSP was due to a handful of stocks, most with links to AI. Nvidia, a computer chip designer, was the most notable of the big movers, although companies such as Adobe and Microsoft also saw healthy gains.

One noteworthy milestone was when Microsoft dropped ChatGPT into the public space. And Alphabet (Google) has since introduced Google Bard. Both Generative AI models are types of artificial intelligence that can create new content, like text, images, music, and code. They work by learning the patterns and relationships within a dataset of existing content, and then use that knowledge to generate new things that are similar. Generative AI can create realistic images and videos, write different kinds of creative content, generate synthetic data, and personalize user experiences, like recommending products or content that is likely to be of interest to the user.

It is also being said that Generative AI has the potential to revolutionize many different industries. For example, it could be used to develop new drugs and materials, create new art and music, personalize education and learning, and make the world a more creative and innovative place. However, there are also many risks associated with generative AI, such as the possibility of it being used to create deepfakes or other forms of misinformation. Understandably, there is also concern that this technology could put a lot of people out of work. There is a large debate happening now among the developers of generative AI tools about whether there should be a prime directive to make sure they provide tools that humans can use to enhance their work, rather wholly replace people at work.

From the investment side of things, there is clearly a lot of hype right now, and it feels a bit like the late 90s during the "dot com" mania, which ultimately became the "dot com bust". Nevertheless, there are a number of amazing companies that came out of that era too. Currently we think that many of the large companies such as Microsoft and Alphabet will have strong exposure to any market benefits, and this is a reasonable place to tolerate valuations that reflect fairly lofty growth expectations. This technology will require a lot of evolving computing power, so chip companies such as Nvidia will have much success, and many competitors. Given that it is still early days for AI, a sound investment strategy is diversification, while being mindful to try and avoid "bubble"-like valuations. A poster child of this philosophy is Cisco Systems, which traded at over $70 a share in March of 2000, but has never returned to that level almost 25 years later, trading at around $50 today.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
2. Chart data provided by YCharts!