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Economic & Market Update

2023 Review & January 2024 Outlook

Review of 2023

- Think back to January 2023. Equity and bond markets had just wrapped up one of their worst collective years on record. The yield curve had been solidly inverted for over six months. Consumer Price Index (CPI) inflation was still running north of 6%. The Federal Reserve (Fed) had hiked rates seven times in the previous year, including four 75 basis point "jumbo" hikes, and was promising to keep pushing. Consumer spending was holding up but probably because consumers were still working down the massive cash piles they had built up during pandemic lockdowns. Economic growth was stabilizing after real growth domestic product (GDP) fell in the first two quarters, while the unemployment rate was holding firm at 3.4%. But the outlook for 2023 was uncertain at best. Many analysts believed the battle against resurgent inflation through aggressive rate hikes would cause enough collateral damage to tip global economies into recession. Closely watched leading economic indicators such as business and consumer survey data seemed to support this belief.
- While this was the prevalent case for the "hard-landing" scenario, not all market participants adhered to this thesis. We believed the U.S. economy had more inherent momentum that was underappreciated by most. A positive byproduct of the inflationary spike was a substantial step-up in wages, particularly for those in lower-income tiers. Labor markets in general were strong and had plenty of breathing room before they would be considered even close to recessionary. Even if certain parts of the economy such as housing and manufacturing were turning down, the American consumer had ample wealth and spending power to maintain overall positive economic growth. Services spending makes up almost half of the U.S. economy. It was difficult to accept calls for imminent downturns with such strength in this key component. On the business side, the domestic reshoring initiative requires significant capital expenditures that most manufacturing corporations were able to anticipate even before the bulk of the government incentives began to kick in.
- Given the belief that U.S. economic strength was being underestimated and that consecutive down years in U.S. equity markets are a rare historical occurrence, it appeared sensible to position portfolios for some element of recovery in stock prices.

SO, WHAT HAPPENED IN 2023?

- Inflation did fall from 6.4% in January to 3.1% in November but not because a recession had destroyed demand. In fact, real GDP held strong at trend-like growth of 2.2% in the first quarter and 2.1% in the second quarter before jumping ahead to 4.9% in the third quarter. The Atlanta Fed GDPNow estimate for the fourth quarter of 2023 was at a respectable 2.0% as we approached year-end. The unemployment rate rose from 3.4% in January to a high of 3.9% in October. But higher unemployment was driven by a 0.4% increase in the labor force participation rate rather than actual job losses. Wage growth remained solid throughout the year with the rate of growth declining as the year progressed. As the decline in the overall inflation rate was faster than the slowdown in wage growth, the resulting improvement in real wages helped consumers to better absorb high price levels and to keep spending at elevated levels throughout the year. It was clearly not only dwindling COVID-19 relief payments that were propping up this strong U.S. economy.

- The year's impressive economic resilience took place despite several high-profile bank failures, which rattled the country's regional banking system and stoked fears of a consequential pullback in bank lending. The historic decline in bond prices during 2022 had left banks with large paper losses on their portfolios of credit-risk-free U.S. Treasurys. While investors in Treasury bonds are virtually guaranteed full repayment of principal at maturity, the spike in rates would have forced banks to liquidate these securities at a loss had they needed to sell them to meet draws on deposits. As online rumors began to swirl around the capital depletion implications under this scenario, an electronic version of a bank run ensued and led to the ultimate demise of several large banks, the most prominent victims being Silicon Valley Bank, Signature Bank and First Republic Bank. This latest episode of a run on the banking system was unique in American history as runs usually occur when credit losses build on the loan side of the portfolio that eat away at the structurally thin capital base. Going into 2023, the banks' loan books were solid, but the losses came from their more interest-rate sensitive Treasury and mortgage-backed securities holdings. Also, the pervasiveness of social media and electronic banking supercharged the timeline for panicked withdrawals. For Silicon Valley Bank, that meant withdrawals to the tune of $42 billion in one day. For context, during the ultimate failure of Washington Mutual in 2008, depositors took nine days to withdraw $16.7 billion.

- Regulators reacted to this situation by quickly devising and implementing a new set of tools, the most prominent being the Bank Term Funding Program (BTFP). The BTFP allowed banks to lend their securities to the Fed at par, which would effectively allow the banks to avoid taking losses on their beaten-down bonds to meet redemptions. The Federal Deposit Insurance Corporation (FDIC) also announced that all deposits, not just those within the limits of FDIC insurance, would be made whole in any failures that had already occurred. These measures were successful in stopping the wave of withdrawals, although fears were growing that the incident would have a chilling effect on bank lending for the foreseeable future. While bank lending did slow somewhat over the remainder of the year, it did not collapse, and the growing nonbank lending industry led by the fast-growing private debt sector effectively supplied ample credit to the U.S. economy.

- After falling briefly during the banking turmoil, interest rates continued their ascent on the back of strong economic growth and an ongoing monetary tightening campaign at the Fed. The 10-year U.S. Treasury yield rose to a high of just under 5% by October. By that time, continued progress on inflation led to greater conviction that the Fed's rate hiking cycle was at an end. This spurred a reversal in bond markets that sent 10-year yields below 4% by year-end. After a year of substantial volatility, the 10-year U.S. Treasury yield ended 2023 almost exactly where it started. With price changes ultimately washing out, appealing yields for intermediate duration Treasurys (as represented by the Bloomberg US Treasury 5–7 Year Index) drove a total return of 4.5%. As imminent recession fears abated, credit spreads tightened, driving solid performance in investment-grade credit and even better performance in the below-investment-grade credit space. On the tax-exempt side, the Bloomberg Municipal

1–10 Year Blend 1–12 Year Index also posted a gain of 4.6%, delivering impressive performance even before accounting for the tax benefits.

- Equity markets experienced a strong year, at least in terms of the headline indexes. The tech-heavy Nasdaq bounced back strongly, gaining 44.6% to reach an all-time high after falling by 32.5% in 2022. The Dow Jones Industrial Average also reached an all-time high in December on the way to gaining 16.2% through year-end. The S&P 500 Index rose 26.3% to end the year at 4,770, a stone's throw from its own all-time high. Under the surface, the picture was much more mixed. Most of the stock market gains were due to incredibly strong appreciation in the stock prices of the "Magnificent Seven" (Microsoft, Amazon, Meta, Apple, Alphabet, NVIDIA and Tesla). These seven stocks alone gained about $5 trillion in market cap and accounted for well over half of the entire index's gain. The experience for the average stock was not quite as good, with the S&P 500 Equal Weight Index gaining 13.9% for the year. It was not a bad year by any means, but 72% of S&P 500 stocks trailed the index and it took a late-year rally for the rest of the market to begin to participate. In fact, the equal-weight index was down for the year as late as early November. Small caps were a similar story, with the Russell 2000 Index down 4.5% through October 31, yet ending the year up a respectable 16.9%.

- Earnings for large cap equities fell on a year-over-year basis in the first two quarters but rebounded by year-end to remain roughly flat for 2023 when compared to 2022. Expectations for solid double-digit growth in 2024 likely played a part in the fourth quarter rally, as investors began to put 2023 earnings in the rearview mirror. Small cap earnings did not fare as well, with the S&P 600 Index posting 12.5% earnings per share (EPS) declines in 2023 versus 2022 (using the current fourth quarter estimate).

- Economic activity has been considerably slower overseas, both in developed and emerging countries. The eurozone is struggling to move beyond an energy crisis that sent inflation north of 10% and led to aggressive central bank tightening into already slowing economies. Due to its more cyclical corporate landscape and higher proportion of floating rate or short-maturity debt, rate hikes for the European Union have had more of an impact than in the United States, holding real GDP growth at effectively zero for four straight quarters. Despite this weak growth, the MSCI EAFE Index put together a solid performance as inflation rates declined, with the index gaining 18.2% for the year in U.S. dollar terms. Over the course of the year, the euro-U.S. dollar currency pair lacked direction, bouncing between 1.05 and 1.10, though trending higher to end the year.

- The Bank of Japan (BOJ) cheered the return of inflation to a Japanese economy that had been trapped in a deflationary doom loop for several decades. The central bank continued its relatively divergent monetary policy by keeping rates low and generally maintaining its yield curve control strategy. Like the Fed, the BOJ maintains a 2% inflation target. However, while the Fed has been looking to drive inflation back down to this target, the BOJ is more interested in maintaining inflation at current levels as it has been difficult to fight the deflationary forces that have plagued Japan for decades. This easy monetary policy stance caused the Japanese yen to notably weaken through most of 2023 before strengthening against the U.S. dollar in the last few months of the year. Despite volatile and uneven economic growth, equity investors cheered the long-awaited return to inflation and the impact of the weaker Japanese yen by pushing the MSCI Japan Index up by 20.3% in U.S. dollar terms.

- China has been dealing with several issues negatively impacting its economy. The most prominent headwind has been falling housing prices, which is by far the biggest source of wealth within China. The decline in real estate values is dragging down consumer confidence, threatening the solvency of overleveraged developers and grinding new construction to a halt. Stimulus measures have been scant as the government has been hesitant to reverse the progress made on the country's substantial debt loads. Equity markets reflected the economy's weaker-than-anticipated growth and cloudy outlook, with the MSCI China Index losing -11.2% for the year.

Outlook for 2024

U.S. ECONOMY

- As consumers and businesses are apparently less interest-rate sensitive than originally anticipated, the U.S. economy is not currently at risk of falling into recession in early 2024. The ultimate impact of the pronounced tightening of rates and reduction in the Fed's balance sheet is more likely to be a slowdown in economic growth to slightly below trend levels, with a point estimate for 2024 GDP growth of 1.50%.

- Any manufacturing recession the economy may have experienced in 2023 should prove to be short and shallow, as inventories did not grow excessively and well-employed and compensated consumers continued to purchase goods through year-end. The services sector of the economy has been the primary driver of the surprisingly robust growth over the last few quarters and is expected to slow this year as pent-up consumer demand is generally sated. An important secular theme, which should cushion the slowdown and prevent any sharper decline, is the underappreciated financial and physical health of the baby boom generation. This population cohort, born between 1946 and 1964, is still relatively early in its retirement age and has benefited greatly from the myriad medical technology advances achieved in its lifetime. It has also accumulated by far the most assets of any previous generation and shows a proclivity to spend some of that wealth in the early retirement years before passing the remainder to the next generation. There is also an apparent acyclical element to its spending patterns that economists must consider when attempting to discern the impact of countercyclical monetary and fiscal policies.

- The housing sector, which entered recession in 2022 when mortgage rates spiked to over 7%, appears to be bottoming with mortgage rates beginning to decline. As existing home sales remain somewhat stagnant with current homeowners reluctant to give up their historically low mortgage rates, demand among first-time buyers needs to be satisfied by new home construction. The construction of single-family homes at relatively low price points began a notable upturn in 2023 that should continue into 2024. With the strong equity price appreciation of homebuilding companies serving as a leading indicator, housing should be somewhat additive to U.S. economic growth in 2024.

- The overall strength of the labor market has arguably been the most essential element in driving continued economic growth and defying the many calls for a near-term recession due to higher rates. However, the perceived tightness of the labor market and its effect on wages has been most concerning to the Fed in its fight against entrenched inflation. A distinct trend seen entering the new year has been a decline in job openings coupled with an increase in the labor force participation rate. This has allowed employment and wage growth to slow without a notable pickup in unemployment. Adding the sharp advance to worker productivity to this mix has led to an actual decline in unit labor costs, which are much more correlated to the CPI than wages.

INFLATION AND THE FED

- The inflation rate, as measured by the headline CPI, should break below 3% early in the first quarter in its seemingly inevitable journey toward the Fed's 2% target. While the concept of transitory inflation because of COVID-19 and the policy responses to the pandemic became very controversial as inflation proved to be more stubborn, it appears to merely have taken just a little more time than initially anticipated to normalize the goods and labor supply impediments that caused prices to rise at rates not seen since the 1980s. Higher interest rates initiated by the monetary authorities have effectively slowed demand without causing a rapid decline. Another fortuitous element in helping bring down the inflation rate has been the rather sharp decline in energy prices, as the OPEC+ cartel has had difficulty keeping its members from adhering to production cut quotas and U.S. production has notably increased to take advantage of the previously high prices.

» This expected move toward target inflation rates should allow the Fed to begin cutting the federal funds rate as early as the end of the first quarter. Given the level of the nominal federal funds rate entering the year and the current and expected inflation rate, the Fed should soon acknowledge the "real" federal funds rate has become quite restrictive. Continued economic growth will cause the Fed to be more cautious in its approach to rate cutting during the year and will likely lead to only three reductions of 25 basis points. There is a risk that maintaining too high of a real federal funds rate could put further pressure on the economy if the Fed is slow to adjust to a weaker growth environment.

BOND MARKETS

» As the Fed ultimately wins the battle against inflation and lowers the federal funds rate in a nonrecessionary environment, the inverted yield curve should gradually move back to a more normal upward slope. This would entail short maturity rates moving down while intermediate to longer maturity rates increase from current levels. Another source of upward pressure for intermediate maturities can be the growing fiscal budget deficit, which will lead to an increased supply of Treasury securities at a time when the Fed is no longer an incremental source of demand. Despite some of these lingering concerns about rate increases in the belly of the yield curve, the magnitude should be limited in this lower inflation environment, and the overall normalization of rates is likely beneficial to both investors and the overall economy.

» Sustained economic growth with no recession should prevent any meaningful spread widening in the municipal bond, investment-grade corporate bond and mortgage-backed securities sectors. The high yield (or noninvestment grade) space poses more of a quandary as yield spreads to government bonds have continued to narrow to levels that question if investors are receiving enough extra income to protect them from credit losses. With the economy expected to maintain positive growth, any pickup in defaults is more likely to come from the risk of having to refinance debt over the coming years at much higher rates as opposed to a reduction in revenues needed to support the debt.

EQUITY MARKETS

» To sustain the bull market in U.S. equities seen since the October 2022 lows, more companies need to participate in the advance. Leadership of the run-up in prices into the end of 2023 began to move away from the top seven large cap companies that had dominated so much of the gains for most of the year. A sustainable change in leadership to include companies in the more cyclical sectors of the market would rectify one of the prominent criticisms of this bull market. A greater breadth of participation should also extend to the small- and mid-capitalization equity asset classes where valuations appear much more attractive.

» As 2023 equity market gains were driven primarily by multiple expansions in a generally flat earnings environment, a recovery in earnings that began with the third quarter earnings reporting season should continue into 2024. While slower economic growth may make the current consensus estimate of 12% earnings growth for the S&P 500 a bit of a stretch, high single-digit EPS growth is achievable. With inflation coming down and the Fed able to loosen monetary policy during the year, the market may also see some slight multiple expansion as well.

» A more exciting story may be found in the small- and mid-cap space where valuations are notably lower, and the anticipated earnings rebound can have a much greater effect in allowing the shares of these smaller companies to catch up to the strong performance already seen in the large-cap space. Additionally, a lower short-term interest rate environment should be beneficial to the financials sector, which comprises the largest sector weighting in the asset class.

- Looking overseas, European equities are entering the year trading at the lowest valuation levels relative to the United States in this century. A certain level of discount is warranted by the relative market structure, which favors the fast-growing U.S. companies in the information technology, communication services and consumer discretionary sectors. But this level of undervaluation appears somewhat excessive. As valuation is never really a catalyst in propelling a market higher, investors are looking to a declining U.S. dollar as a possible propellant for relative outperformance. With the Fed, the Bank of England and the European Central Bank apparently poised to ease monetary policy at basically the same level, it is difficult to make a case for much U.S. dollar depreciation. Global investors will likely be happy if stocks in Europe keep up with the expected appreciation forecast for the United States.

- After very disappointing performance because of trade frictions with the United States and a collapse in the property market, Chinese equities appear to need more aggressive government support from both fiscal and monetary authorities. A commitment to more open business practices and better government support of the country's national business champions would also help improve the confidence of both domestic and international investors.

- The Japanese equity market will likely not have a depreciating currency at its back in 2024, but it should continue to have a relatively easy monetary policy out of the Bank of Japan as a catalyst for further appreciation. With domestic demand still somewhat stagnant, market participants will look to large exporters as the primary drivers of equity returns in 2024.

LONGER-TERM THEMES TO CONSIDER

- A trend that will continue to dominate the rest of this decade is the movement to reshore or nearshore production to gain greater control of supply chains and to avoid the potential weaponization of trade by placing too much dependence on the continued benevolence of potential adversaries. While some fear this growing deglobalization trend will produce greater secular inflation as labor costs are higher in and around the United States, businesses appear to understand that ample capital investment in productivity-enhancing technology hardware and software is necessary to control the costs inherent in this transition.

- While the increased use of advanced robotics in manufacturing processes was the original manifestation of this reshoring trend, the rapid development of artificial intelligence applications may be accelerating the movement and enhancing productivity in both the manufacturing and services sectors of the U.S. economy. The United States is clearly ahead in adopting these technologies, but other developed economies should be able to catch up to U.S. investment, assuming these businesses have the will and regulatory permission to invest at the same rate.

- The inevitable transition to clean or cleaner energy sources will also be driven by technological advances that should provide clear economic benefits to moving away from fossil fuel production and utilization. However, the beginning of the Russia-Ukraine war provided a reminder that nations must effectively secure their near-term energy security before embarking on hasty energy transition strategies. It appears the secular demand for certain commodities needed for electric vehicle battery production should create investment opportunities, but there remains a cyclical element to both the vehicles and the underlying commodities that needs to be considered when investing in liquid alternative energy assets. It may be better to gear investments in the space toward the private markets venue to resist the tendency to sell investments during a short downturn in a still-strong secular theme.

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